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[¶5208] **In the Matter of The Citizens Bank of Clovis, Clovis, New Mexico, Docket No. FDIC-91-406b (12-7-93).**

Board accepts ALJ's recommendation and issues cease and desist order against bank found to have engaged in unsafe or unsound banking practices and violations including inadequate loan policies, extending loan due dates without collecting interest or requiring additional collateral, maintaining a high volume of adversely classified loans and inadequate reserves, and operating with poor management supervision over bank affairs. *(The decision was affirmed by the United States Court of Appeals for the District of Columbia Circuit, 50 F.3d 1096.)*

[.1] Cease and Desist Orders—Unsafe or Unsound Practices

Bank need not have violated any specific law or regulation to be subject to a cease and desist order; existence of unsafe or unsound practices can be proved by the number of adversely classified loans, weak underwriting practices and insufficient comprehensive banking policies.

[.2] Practice and Procedure—Evidence—Discovery

FDIC's failure to produce policy documents in response to bank's discovery request resulted in no prejudice to bank since documents are contained in the record as bank exhibits.

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[.3] Examination of Banks—FDIC Review

FDIC's failure to give bank an informal review of the examination in question does not deprive FDIC of jurisdiction to conduct a cease and desist proceeding; procedures specifically provide that informal review does not affect any enforcement action in progress.

In the Matter of

**THE CITIZENS BANK OF CLOVIS
CLOVIS, NEW MEXICO
(Insured State Nonmember Bank)
DECISION AND ORDER ON CEASE
AND DESIST PROCEEDING
FDIC-91-406b**

INTRODUCTION

This is a proceeding initiated by the Federal Deposit Insurance Corporation ("FDIC") on December 19, 1991, seeking an Order to Cease-and-Desist against The Citizens Bank of Clovis, Clovis, New Mexico ("Respondent" or "Bank"). The alleged unsafe or unsound practices and violations of law, rule or regulation include inadequate loan policies, extending loan due dates without requiring additional collateral or payment of interest, maintaining an excessive volume of adversely classified loans, failing to maintain adequate reserves and poor management with insufficient supervision by the Bank's board of directors.

Administrative Law Judge Walter J. Alprin ("ALJ") held a hearing in this matter on March 16, 1993 through March 19, 1993, in Albuquerque, New Mexico. In his Recommended Decision¹ issued July 27, 1993, the ALJ concluded that Respondent had engaged in unsafe or unsound banking practices, and recommended issuance of an Order to Cease-and-Desist. Respondent filed exceptions to the ALJ's Recommended Decision.

DISCUSSION

After a thorough review of the record in this proceeding, the Board of Directors ("Board") of the FDIC agrees with the ALJ's findings and conclusions, and adopts and incorporates herein by reference the ALJ's Recommended Decision with two minor modifications². The Board further finds that Respondent's Exceptions lack merit—most merely reargue matters raised before and adequately addressed by the ALJ, or present assertions with no factual basis in the record.³ The following exceptions merit Board

comment.

First, Respondent asserts, but fails to demonstrate, that the ALJ's Recommended Decision fails to comply with the Administrative Procedure Act ("APA"), 5 U.S.C. § 557(c), which states:

"The record shall show the ruling on each finding, conclusion, or exception presented. All decisions, including initial, recommended, and tentative decisions, are a part of the record and shall include a statement of—

(A) findings and conclusions, and the

¹ Citations to the record of this proceeding shall be as follows:

Recommended Decision "R.D. at ____."

Hearing transcripts "Tr. vol. ____ at ____."

Bank's Exceptions "Except. at ____."

Respondent's Exhibits "Resp. Ex. ____."

Respondent's January 1, 1992 Discovery Request

"Resp. Dis. ____."

² The Board makes the following two modifications: First, on page 19 of the ALJ's Recommended Decision, the sentence that begins on the second line, "Agency wants outside directors..." shall be modified by deleting the phrase "whose interests are not limited to banking." This phrase is replaced by "who have no connection to The Citizens Bank of Clovis other than their directorships."

Second, on page 40 of the ALJ's Recommended Decision, under the hearing "VI. *Commentary*", the second sentence that begins "The term 'unsafe or unsound'" shall be modified by deleting the following phrase "is purposefully ambiguous." This phrase is replaced by "is an intentionally broad term."

³ The Bank excepts to the form and substance of virtually every statement and finding contained in the ALJ's Recommended Decision that does not present a positive view of the Bank's condition. The Bank disagrees with many of the findings concerning adverse classifications of its loans and assets, as well as the ALJ's conclusion that unsafe or unsound banking practices are present.

⁴ Any other exceptions not specifically mentioned here are rejected and deemed unnecessary to address because they reargue matters adequately covered by the ALJ or have no factual basis in the record.

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reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record; and

(B) the appropriate rule, order, sanction, relief, or denial thereof."

Respondent does not support this exception with any specific material issue of fact, etc., that was allegedly not addressed by the ALJ. The board has reviewed the entire record of this proceeding, including the ALJ's Recommended Decision, in light of this exception and finds no evidence of a failure to fully comply with the above provision. Accordingly, the Board rejects this exception as unsupported by the record.

[.1] Second, regarding the Bank's loan policies and procedures, Respondent excepts to the ALJ's alleged failure to point to a single instance where a loss was caused by anything contained in, or left out of the Bank's loan manual. The Bank also states that its manual "deals with every requirement of the Manual of Examination Policy" ("MEP"). Except. at 7. In focussing on the presence or absence of loss and compliance with the MEP, Respondent misses the point. The ALJ observed that much of the Bank's case "was spent proving that its banking practices did not violate any specific law, rule, or regulation."⁵ However, 12 U.S.C. § 1818(b) also authorizes entry of a cease-and-desist order for commission of unsafe or unsound banking practices. R.D. at 40. The term "unsafe or unsound" is not limited to a few precisely prescribed practices. It is purposefully broad to allow discretion on a case-by-case basis to determine what practices pose an unnecessary risk to an institution and are contrary to prudent banking practices.⁶ The ALJ concluded that FDIC proved the existence of unsafe or unsound practices "by the number of adversely classified loans, the weak underwriting practices, and insufficient comprehensive banking policies." R.D. at 40. The board finds no weakness in the ALJ's analysis, and accordingly rejects this exception.

[.2] Third, the Bank excepts that the "FDIC did not even produce" the Inter-agency Policies dated

March 1, 1991, Resp. Ex. 3, the Uniform Agreement on the Classification of Assets and Appraisal of Securities of April 26, 1991, Resp. Ex. 3A, and a news release entitled: Regulators Issue Joint Supervisory Policy Statement of November 7, 1991, Resp. Ex. 6, Except. at 9. However, the Board's examination of the Bank's discovery request of January 7, 1992, the only one which contains any reference to these documents, only solicits copies of any documents that advise examiners concerning these policy statements. The underlying policy statements, however, are not requested.⁷ Indeed, the Bank's references to these documents in the discovery request suggest that it already had copies of these news releases and published policy statements. In fact, the Bank had copies of these policy statements since they are in the record as Bank exhibits 3, 3A, and 6. Therefore, there can be no prejudice to the Bank by any failure to produce these documents. Accordingly, the Board rejects this exception as not supported by the record.

[.3] Fourth, Respondent states "This court has no jurisdiction because of the willful failure of the FDIC to give the Bank a review of the July 5, 1991 Report of Examination by persons not in the review process." Except. at 12 and 34.⁸ Respondent's jurisdictional argument is clearly erroneous.

⁵ The ALJ's footnote No. 10 states as follows: "Respondent often argued that its banking practices did not violate the Manual of Examination Policies ("MEP") used by the FDIC as a guide in conducting its examinations. Bank examiner Jeffers testified that MEP is not a bible for all banks in determining safe banking practices but only a guide used in conducting bank examinations. Since many instances of unsafe or unsound banking practices may not be addressed in the MEP, Respondent's reliance on this guide is misplaced." R.D. at 40 n. 10.

⁶ *Hoffman v. FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990). Further, it is settled law that bank regulators' discretionary authority to define unsafe or unsound practices is to be "liberally construed." *Independent Bankers Association v. Heimann*, 613 F.2d 1164, 1169 (D.C. Cir. 1979).

⁷ Each item that references one of these policy statements begins with the following language: "Produce all of the FDIC's documents and those of any other bank regulatory agency whose documents are possessed by the FDIC stating what examiners are expected to change in carrying out each of the policies enunciated in the March 1, 1991, Joint Agency News Release titled 'Regulators Issue Joint Supervisory Policies' and the 'General Statement' attached thereto..." Resp. Dis. at 15, item 22.

Respondent's items that reference the other two policy statements and news releases are preceded with identical language. Resp. Dis. at 13, items 23 and 25.

⁸ Respondent cites to his exhibits 3, 3A, 6, and 7; Respondent's exceptions also state that "the reviewing person, Calvin B. Riddick, Assistant Regional Director in the FDIC's Regional Office in Dallas, Texas, admits that he did not read all of the Report of Examination and the Bank's policies, and therefore" the informal review was flawed. From the Board's review, the Assistant Regional Director merely testified that he did not review "line for line every page" of the July 5, 1991, Report of Examination. 4 Tr. vol. 4 at 105. Further, the Assistant [\(Continued\)](#)

[{{2-28-94 p.A-2351}}](#)The FDIC's procedures for informal review specifically provides: "The use of this informal review process will not affect, delay, or impede any formal or informal supervisory or enforcement action in progress."⁹ Thus, any alleged failure to grant informal review of the Bank's Report of Examination would have no affect, jurisdictional or otherwise, upon this enforcement action. Accordingly, the Board rejects this exception.

The Bank also states: "The court lacks jurisdiction because of the FDIC's erroneous holding that the Bank was not entitled to a private trial..." Except. at 12. The board rejects this exception as without merit. The Board's March 2, 1992 Decision states that the request for a private hearing was denied because the Bank failed to prove sufficient grounds under the statute, 12 U.S.C. § 1818(u)(2).

Finally, respondent asserts that the ALJ erred in failing to admit, as an admission against interest, the Bank's Exhibit 67, a March 10, 1993, interagency policy statement on credit availability. The ALJ sustained objections to this exhibit because it was offered as a policy statement effective almost two years after the examination was conducted and over a year after this proceeding was initiated. The Board finds that it is not appropriate to apply a later adopted policy statement to the disputed issues in this proceeding.¹⁰ Accordingly, the Board also rejects this exception.

CONCLUSION

The Board concludes that the record fully supports issuance of the Order to Cease-and-Desist recommended by the ALJ.

ORDER

The Board of Directors of the FDIC, having considered the entire record in this proceeding, hereby ORDERS that The Citizens Bank of Clovis, Clovis, New Mexico ("Bank"), and institution-affiliated parties of the Bank cease-and-desist from the following unsafe or unsound banking practices and violations of laws, rules and regulations:

- (a) Operating the Bank without adequate written loan policies and procedures;
- (b) Renewing or extending the due dates of loans without collecting interest due or obtaining adequate additional collateral to secure credit advanced for the purpose of paying interest;
- (c) Operating the Bank with an excessive level of adversely classified assets;
- (d) Failing to provide an adequate allowance for loan and lease losses;
- (e) Operating the Bank in violation of applicable Federal and state laws and regulations as more fully set forth on page 6-b of the Report of Examination of the Bank as of July 5, 1991;
- (f) Engaging in hazardous lending and lax collection practices;
- (g) Operating the Bank with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits; and
- (h) Operating the Bank without adequate supervision and direction by the board of directors over the management of the Bank.

IT IS FURTHER ORDERED, that the Bank and institution-affiliated parties of the Bank take affirmative action as follows:

1. Within 60 days after the effective date of this ORDER, the Bank shall revise, adopt, and implement written lending and collection policies and procedures to provide effective guidance and control over the Bank's lending function. Such policies and their implementation shall be in a form and manner acceptable to the Regional Director, as determined at subsequent examinations, and shall include, at a minimum, the following:

- (a) A provision that deviations from the written lending policies and procedures require approval of the board of directors of the Bank;
- (b) A provision that establishes the lending limit of each loan officer;
- (c) A requirement that extensions of credit shall not be refinanced, reworked, or renewed unless current financial information and documentation have been obtained;

⁸ Continued: Regional Director would not normally review the Bank's policies because they are not customarily attached to Reports of Examination.

⁹ "Procedures for Requesting Review of Supervisory Decisions," Resp. Ex. 7.

¹⁰ Moreover, Respondent did not argue that application of the policy statement to the loans at issue would be more favorable to it, nor could it because the policy statement does not change the standards for adversely classifying loans.

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- (d) A requirement that all loans shall have written repayment understandings;
 - (e) A bank policy to address loans which are renewed or have their due dates extended without the full collection of interest thereon; such policy shall prohibit, except under specified circumstances, (i) the acceptance of separate notes in lieu of payment of interest, and (ii) the capitalization of interest to the balance of the note, which merely increases the original indebtedness;
 - (f) Limitations on the amount advanced in relation to the value of the collateral securing the credit and the documentation required by the Bank for each type of secured credit;
 - (g) A provision specifically outlining the collection procedures to be taken by the Bank when borrowers fail to make timely payments;
 - (h) Guidelines for determining what rate of interest will be charged on all secured and unsecured loans; and
 - (i) A provision outlining the documentation required on all secured loans.
2. (a) Upon the effective date of the ORDER, the Bank shall, to the extent that it has not previously done so, eliminate from its books, by charge-off or collection, all assets or portions of assets

classified Loss and one-half of the assets classified Doubtful by the FDIC as a result of its examination of the Bank as of July 5, 1991. Reduction of these assets through proceeds of loans made by the Bank shall not be considered "collection" for the purpose of this paragraph.

(b) Within 60 days after the effective date of this ORDER, the Bank shall submit a written plan to the Regional Director to reduce the remaining assets classified Doubtful and Substandard as of July 5, 1991. At a minimum, the plan shall include the following:

(i) A schedule providing quarterly goals to reduce the remaining adversely classified assets as of July 5, 1991, to levels which do not exceed a specified percentage of total equity capital and reserves, as reported each quarter by the Bank in its Consolidated Reports of Condition and Income and shall include no less than six consecutive quarterly target dates;

(ii) An explanation showing the complete rationale used by the Bank in constructing the reduction schedule; and

(iii) A provision requiring, at a minimum, quarterly reviews by the Bank's board of directors whereby the extent of the Bank's compliance with the plan is expressly addressed, with the results of each review to be recorded in the corporate minutes of the board of directors.

(c) Upon written notice from the Regional Director that the submitted plan is not acceptable, the Bank shall, within 30 days after receipt of such notice, submit amendments to the plan to the Regional Director, including any modifications or amendments requested by the Regional Director. Upon written notice that the plan is accepted, it shall be adopted by the board of directors of the Bank. The Bank shall then immediately initiate measures detailed in the plan to the extent such measures have not been initiated.

(d) For purposes of the plan, the reduction of the level of adversely classified assets as of July 5, 1991, to a specified percentage of total equity capital and reserves may be accomplished by:

(i) Charge-off;

(ii) Collection;

(iii) Sufficient improvement in the quality of adversely classified assets so as to warrant removing any adverse classification, as determined by the FDIC; or

(iv) Increase of total equity capital and reserves.

(e) While this ORDER is in effect, the Bank shall eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss as determined at any examination conducted by the FDIC or the State at such time as the report of examination is received by the Bank.

3. (a) Within 10 days from the effective date of this ORDER, the Bank shall increase its allowance for loan and lease losses ("allowance") to an adequate level.

(b) Thereafter, the Bank shall maintain its allowance in accordance with the prevailing requirements of the Instructions for the Consolidated Reports of Condition and Income ("Instructions"). Toward this end, within 60 days of this ORDER, the Bank's board of directors shall establish

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a comprehensive policy for determining the adequacy of the Bank's allowance. The policy shall provide for a review of the allowance at least once each calendar quarter. The review should focus on the results of the Bank's internal loan review, loan loss experience, trends of delinquent and non-accrual loans, an estimate of potential loss exposure on significant credits, concentrations of credit, and present and prospective economic conditions. The adequacy of the allowance in relation to the loss potential in the loan portfolio shall be reviewed by the Bank's board of directors, and adjustments to the allowance shall be made accordingly. Details of these reviews shall be incorporated into the minutes of the board of directors, including the methodology used to determine the adjustments.

4. Within 60 days after the effective date of this ORDER, the board of directors shall establish a loan review committee to periodically review the Bank's loan portfolio and identify and categorize problem credits. The committee shall file a report with the board of directors. This report shall include the following information:

(a) The overall quality of the loan portfolio;

(b) The identification, by type and amount, of each problem or delinquent loan;

(c) The identification of all loans not in conformance with the Bank's lending policy; and

(d) The identification of all loans to officers, directors, principal shareholders, or their related interests.

At least 50 percent of the members of the loan review committee shall be directors not employed in any capacity by the Bank other than as a director.

5. After the effective date of this ORDER, the Bank, consistent with sound banking practices, shall eliminate and/or correct all violations of laws and/or regulations existing in the Bank as of July 5, 1991, as more fully set forth on page 6-b of the July 5, 1991 Report of Examination. In addition, the Bank shall ensure its future compliance with all applicable laws and regulations.

6. While this ORDER is in effect, the Bank shall neither declare nor pay, directly or indirectly, any cash dividend to shareholders without the prior written consent of the Regional Director.

7. (a) While this ORDER is in effect, the Bank shall not extend, directly or indirectly, any additional credit to or for the benefit of any borrower who has an extension of credit with the Bank that has been classified Loss, either in whole or in part, and is uncollected, or to any borrower who is already obligated in any manner to the Bank on any extension of credit, including any portion thereof, that has been charged off the books of the Bank and remains uncollected. The requirements of this paragraph shall not prohibit the Bank from renewing credit already extended to a borrower after full collection, in cash, of interest due from the borrower.

(b) While this ORDER is in effect, the Bank shall not extend, directly or indirectly, any additional credit to or for the benefit of any borrower whose extension of credit is classified Doubtful and/or Substandard, either in whole or in part, and is uncollected, unless the Bank's board of directors has signed a detailed written statement giving reasons why failure to extend such credit would be detrimental to the best interests of the Bank. The statement shall be placed in the appropriate loan file and included in the minutes of the applicable board of directors' meeting.

8. The Bank shall have and retain qualified management. Each member of management shall possess qualifications and experience commensurate with his or her duties and responsibilities at the Bank. The qualifications of management personnel shall be evaluated on their ability to: (i) comply with the requirements of the ORDER, (ii) operate the Bank in a safe or sound manner, (iii) comply with applicable laws and regulations, and (iv) restore all aspects of the Bank to a safe or sound condition, including asset quality, capital adequacy, earnings, management effectiveness, and liquidity. During the life of the ORDER, the Bank shall notify the Regional Director in writing of any changes in management. The notification must include the name(s) and background(s) of any replacement personnel and must be provided prior to the individual(s) assuming the new position(s).

9. (a) Within 60 days after the date of this ORDER, the Bank shall prepare a plan for submission to the shareholders at their

[{{2-28-94 p.A-2354}}](#) next meeting to reorganize the board of directors so that at least 50 percent of the members of the board shall be independent, outside directors as defined herein, during the life of this ORDER.

(b) For the purpose of this ORDER, an "outside director" shall be an individual:

(i) Who shall not be employed by the Bank or its affiliates other than as a director of the Bank or an affiliate;

(ii) Who shall not own or control more than 5 percent of the voting stock of the Bank or its holding company;

(iii) Who shall not be indebted to the Bank or any of its affiliates in an amount greater than 5 percent of the Bank's Part 325 Tier 1 capital or \$500,000, whichever is less;

(iv) Who shall not be related to any director, principal shareholder of the Bank, or to any director or principal shareholder of any affiliate of the Bank; and

(v) Who shall be a resident of, or engage in business in, the Bank's trade area.

10. Within 60 days after the effective date of this ORDER, the board of directors shall establish a committee of the board of directors charged with the responsibility of ensuring that the Bank complies with the provisions of this ORDER. At least 50 percent of the members of such committee shall be outside directors as defined herein. The committee shall report monthly to the full board of directors, and a copy of the report of any discussion relating to the report or the ORDER shall be noted in the records of the board of directors. The establishment of this committee shall not diminish the responsibility or liability of the entire board of directors to ensure compliance with the provisions of this ORDER.

11. After the effective date of this ORDER, the Bank shall send to its shareholders, or otherwise furnish, a description of this ORDER (a) in conjunction with the Bank's next shareholder communication, and also

(b) in conjunction with its notice or proxy statement preceding the Bank's next shareholder meeting. The description shall fully describe the ORDER in all material respects. The description and any accompanying communication, statement, or notice shall be sent to the FDIC, Registration and Disclosure Unit, 550 17th Street, N.W., Washington, D.C. 20429, for review at least 20 days prior to dissemination to shareholders. Any changes requested to be made by the FDIC shall be made prior to dissemination of the description, communication, notice, or statement.

12. Within 30 days after the end of the first calendar quarter following the effective date of this ORDER, and within 30 days after the end of each successive calendar quarter, the Bank shall furnish written progress reports to the Regional Director detailing the form and manner of any actions taken to secure compliance with this ORDER and the results thereof. Such reports may be discontinued when the corrections required by this ORDER have been accomplished and the Regional Director has released the Bank in writing from making additional reports.

13. The effective date of this ORDER shall be 30 days after the date of its issuance. The ORDER shall be binding upon the Bank and all institution-affiliated parties of the Bank.

The provisions of this ORDER shall remain effective and enforceable except to the extent that, and until such time as, any provisions of this ORDER shall have been modified, terminated, suspended, or set aside by the FDIC.

By direction of the Board of Directors.

Dated at Washington, D.C., this 7th day of December, 1993.

/s/ Robert E. Feldman

Deputy Executive Secretary

RECOMMENDED DECISION

In the Matter of

THE CITIZENS BANK OF CLOVIS

CLOVIS, NEW MEXICO

(Insured State Nonmember Bank)

Docket No. FDIC-91-406b

Walter J. Alprin, Administrative Law Judge:

[{{2-28-94 p.A-2355}}](#)

I. PROCEDURAL HISTORY

On December 19, 1991, the Federal Deposit Insurance Corporation ("FDIC") initiated a Cease and Desist action against Respondent Citizens Bank of Clovis ("CBC" or "bank") pursuant to its authority under Section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b). FDIC alleges that CBC engaged in the following unsafe or unsound practices: operating with inadequate loan policies, extending loan due dates without additional collateral or cash, having excessive adversely classified loans and an inadequate allowance for loan or lease losses (ALLL), engaging in hazardous lending and lax collection practices, and having poor management and inadequate supervision by the Board of Directors. The Notice of Charges ("Notice") also alleges that CBC violated part 323 of the FDIC Rules and Regulations, 12 C.F.R. § 323.1 *et sec*, concerning real estate appraisals.

Agency initiated this action as a result of an examination of CBC on July 5, 1991, conducted by both FDIC examiners and examiners from Financial Institutions Division of New Mexico. A hearing commenced before the undersigned in Albuquerque, New Mexico, on March 16, 1993 and concluded on March 19, 1993.

II. STATEMENT OF THE CASE

The relief sought by FDIC is the discontinuance of practices which are not prudent and constitute unsafe and unsound banking practices. These practices have led to excessive adversely classified loans, some of which have been and others of which may have to be charged off as a loss. Enforcement counsel attributes these practices to poor management. CBC is not seriously under-capitalized, there is no threat of imminent insolvency, and neither of those circumstances is alleged by the FDIC. This proceeding primarily seeks to ensure the future safety of the institution, and hence of the Insurance Fund.

CBC questions the accuracy of the FDIC Examiner's adverse loan classifications. CBC maintains that it is a healthy institution and disputes that its practices have already caused or may cause loss to the Bank. CBC's position is that it is sufficient if its banking practices, alleged to be unsafe or unsound, do not

violate specific written laws, regulations or any specific requirements formally established by the FDIC.

III. FINDINGS OF FACT

A. General

1. CBC is, and was at all relevant times a corporation existing and doing business under the laws of the State of New Mexico, having its principal place of business in Clovis, New Mexico, as a State nonmember bank insured by the Federal Deposit Insurance Corporation. It is, and has been at all relevant times subject to the rules and regulations and policies of the FDIC, and the laws of the State of New Mexico.

(Stipulations 1 through 4.)¹

2. CBC was inspected by a team of FDIC examiners as of the close of business on May 4, 1990 ("May 1990 Examination"), and a written Report of Examination was prepared. (Stipulation No. 5.) CBC was thereafter inspected by a team of FDIC examiners, of which Steven L. Jeffers ("Examiner") was Examiner-in-Charge, as of the close of business on July 5, 1991 ("July 1991 Examination"), and a written Report of the Examination was prepared. (Stipulation No. 6.)

3. In the ordinary course of their duties during the examinations, the FDIC examiners gathered information from CBC's records, including note and credit files and CBC's daily ledger, and from the CBC's management, for use in analysis of the bank's loans and other assets. (Stipulation No. 7.)

4. The July 1991 examination was conducted in accordance with the instructions, guidelines, standards and policies issued by the FDIC. (FDIC Ex. 15.)

5. The assignment of an adverse classification to an asset by an FDIC examiner is an expression of the degree of risk to CBC that a certain loan or other obligation owed to CBC will not be fully paid in accordance to its terms. (Vol. I, p. 17.)

6. "Other real estate," or "other real estate owned" (OREO) consists of all real estate, other than bank premises, actually

¹ Stipulations admitted as ALJ Exhibit 2 are referred to as Stipulation No. _____. Exhibits are identified by the designation of the offeror, and number. Transcript pages are identified as "TR" followed by the volume number in Roman Numerals, comma, page number in Arabic numerals, as in "TR I, 21." [\[2-28-94 p.A-2356\]](#) owned by a bank and its consolidated subsidiaries. (Stipulation No. 10.)

7. "Overdue loans" are loans which are a minimum of 30 days past their maturity, or on which interest or principal is due and unpaid for a minimum of 30 days. (Stipulation No. 16(a).)

B. Condition of CBC

8. The May 1990 Examination revealed adversely classified assets as follows:

Substandard	\$13,228,000
Doubtful	\$-0-
Loss	\$982,000
Total	\$14,210,000

(FDIC Ex. 1, p. 2.)

9. The July 1991 Examination² revealed adversely classified assets as follows:³

Substandard	\$31,114,000
Doubtful	\$403,000
Loss	\$1,025,000
Total	\$32,542,000

(Stipulation No. 21; FDIC Ex. 2, p. 2.) Before adverse classifications, total loans and leases at CBC equaled \$100,464,000. (Stipulation No. 22; FDIC Ex. 2, p. 2.) In addition, total adversely classified loans and leases of \$22,825,000 equaled 22.72 percent of total loans and leases (stipulation No. 23; FDIC Ex. 2, p. 2), and overdue loans and leases equaled 11.12 percent of gross loans and leases. (FDIC Ex. 2, p. 2.)

10. At a bank without significant collection problems, the FDIC would expect the ratio of overdue loans and leases to gross loans and leases to be substantially less than 5 percent. (TR Vol. III, p. 29.)

11. As of July 5, 1991, CBC's total equity capital and reserves equaled \$19,728,000. (Stipulation No. 31; FDIC Ex. 2, p.3.) The bank had more than the minimum capital requirement, as its ratio of adversely classified assets to total equity capital and reserves equaled 164.95 percent (Stipulation No. 32; FDIC Ex. 2, p. 3-a) and its ratio of adversely classified assets to total assets was 20.31 percent. (Stipulation No. 33; FDIC Ex. 2, p. 2.)

12. As of May 4, 1990, \$1,831,000 or 14.34 percent of loans classified Substandard at the previous examination in July 1988 were classified Loss or had been charged off. (Stipulation No. 34; FDIC Ex. 1, p. 2-b.) Compared to this, \$1,866,000 or 15.25 percent of loans classified Substandard at the May 1990 Examination were classified Loss or had been charged off. (Stipulation No. 35; FDIC Ex. 2, p. 2-b.)

13. As of July 5, 1991, the balance of the allowance for loan losses was \$2,200,000. After adjusting the allowance for loan losses to subtract loans classified Loss and one-half of loans classified Doubtful as of July 5, 1991, the balance in the allowance for loan losses was \$991,000. There was not sufficient provision in the allowance for loan losses for the remaining classified loans totaling \$21,616,000 and unclassified loans totaling \$77,639,000. (Stipulations No. 36((a), (b) and (c)).

14. In the year ending December 31, 1990, CBC's net income was \$826,000. (Stipulation No. 37; FDIC Ex. 2, p. 4). CBC's year-to-date earnings as of June 30, 1991, equaled a negative \$131,000 prior to incorporating the results of the July 1991 Examination and a negative \$2,596,000 after incorporating the results of the July 1991 Examination (Stipulation No. 38; FDIC Ex. 2, p. 4), indicating significant deterioration in income from May 1990 to July 1991. (TR Vol. I, p. 21; TR Vol. III, p. 27; FDIC Ex. 2, p. 2.)

15. The CBC's Uniform Composite Rating was 4 at the July 1991 Examination. (Stipulation No. 39.)

C. Written Policies on Loans and Investments

16. The CBC's written loan policies and procedures do not address the lending authority of each loan officer or members of the loan or executive committee (TR Vol. III, pp. 34–35); do not have adequate pro-

² The Bank did not stipulate to the accuracy of asset classifications resulting in the ratios and numbers contained in Stipulations No. 23–42, but did stipulate that these ratios and numbers are the findings contained in the July 1991 Report with adjustments having been made to take into account the adjustment regarding the Big Country Ford, Inc. loans.

³ Results of the July 1991 Examination were adjusted to reflect the deletion of the Big Country Ford, Inc. Substandard classification in the amount of \$605,000.

{{2-28-94 p.A-2357}}visions for obtaining and reviewing real estate appraisals as well as reappraisals (FDIC Ex. 3); do not address appropriate and adequate collection procedures (TR Vol. III, pp. 40–41); do not address documentation required by CBC for each type of secured loan (TR Vol. III, p. 42); do not address a loan review and loan grading system (TR Vol. III, pp. 45–46); do not address written repayment understandings (TR Vol. III, pp. 36–38); do not address maintenance of an adequate allowance for loan losses (TR Vol. III, pp. 56–58); and, do not address procedures concerning deviations from the written lending policies and procedure (TR Vol. III, pp. 33–34.)

D. Capitalized Interest

17. During both the July 1991 Examination and the May 1990 Examination, CBC could not identify which specific loans had capitalized interest. (FDIC Ex. 2. Officers Questionnaire, Question No. 6, FDIC Ex. 1. Officers Questionnaire, Question No. 6.)

18. On or about August 30, 1989, CBC capitalized interest as follows:

(a) Capitalized interest upon renewal of a loan of \$136,000 to The Rochelle Corporation which originated on or about June 30, 1988. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 44.) As of July 5, 1991, total debt of The Rochelle Corporation at CBC for various notes equaled \$1,389,000. (Stipulation No. 47.)

(b) Capitalized \$10,000 in interest at renewal of a loan to The Rochelle Corporation which originated on or about June 30, 1989 in the amount of \$76,000. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 45.)

(c) Capitalized interest at the renewals of a loan to The Rochelle Corporation which originated on or about November 30, 1987, in the amount of \$531,000. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 43.) At the time that CBC granted a loan to pay itself interest, the August 30, 1990, financial statement of The Rochelle Corporation indicated total assets of \$1,653,000, total liabilities of \$1,373,000, and a net worth of only \$280,000. (Stipulation No. 46.)

(d) Granted a loan to Dean Eldridge in the amount of \$256,000 to pay interest on loans at CBC to The Eldridge Companies and The Rochelle Corporation. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 41; TR Vol. I, pp. 31–32.) At the time that CBC granted a loan to pay itself interest, Dean Eldridge's August 1990 financial statement indicated

total liabilities of \$264,000 and a negative net worth of \$243,000 with contingent liabilities in excess of \$1,000,000. (Stipulation No. 42.)

19. On or about February 27, 1991, CBC capitalized \$800 in interest at renewal on a loan to Charles Hardisty. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 48.) On or about June 28, 1991, CBC granted a loan in the amount of \$4,900 to Charles Hardisty to pay interest on another of his loans at CBC. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 49.) At the times that CBC granted loans to pay itself interest, Charles Hardisty's December 31, 1990, financial statement indicated total liabilities of \$450,000 and a net worth of only \$170,000. (Stipulation No. 50.)

20. On or about April 12, 1991, CBC capitalized approximately \$1,000 in interest when renewing and consolidating three loans to Wilbur Johnson. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 54.) On or about June 26, 1991, CBC capitalized \$3,000 in interest at renewal on a \$32,000 loan to Wilbur Johnson. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 51.) On or about June 26, 1991, CBC capitalized \$20,000 in interest at renewal on a \$226,000 loan to Wilbur Johnson. This loan was classified Substandard at the July 1991 Examination. (Stipulation No. 53.) No financial information concerning Wilbur Johnson was in CBC's files as of July 5, 1991, to aid CBC in determining if advancing funds to pay itself interest was appropriate. (TR Vol. II, p. 110.)

21. In 1990 and 1991, CBC granted three new loans to O.H. Pattison for the purpose of paying interest on a loan at CBC. During the July 1991 Examination these notes were reversed against current year income. (Stipulation No. 55.) At the time that CBC granted loans to pay itself interest, O.H. Pattison's October 1, 1990, financial statement indicated total assets of \$1,172,000, total liabilities of \$931,000 and a net worth of only

{{2-28-94 p.A-2358}}\$241,000. (TR Vol. I, p. 24.) O.H. Pattison's debt in the amount of \$590,000 at CBC had been classified Substandard at the May 1990 Examination. (Stipulation No. 56; TR Vol. I, p. 36.)

22. On or about March 24, 1989, CBC capitalized \$7,900 in interest at renewal of a loan to Westside Sheet Metal, Inc. Westside Sheet Metal, Inc.'s debt at CBC was classified Substandard at the May 1990 Examination. (Stipulation No. 60.) This loan was classified Substandard at the July 1991 Examination, based in part on a finding that Westside had a negative net worth of \$660,000. (Stipulations No. 57, 58.)

23. John D. Wood's debt at CBC was classified Substandard at the May 1990 Examination. (Stipulation No. 64.) On or about December 27, 1990, CBC capitalized interest at renewal on a loan to John D. Wood. (Stipulation No. 61.)

E. Appraisals

24. On or about September 28, 1991, CBC renewed a loan to Wilbur Johnson in the amount of \$226,000 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 66, 67.)

25. On or about September 28, 1990, CBC renewed a loan to Hager Sign Company in the amount of \$185,500 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 68, 69.)

26. On or about February 27, 1991, CBC renewed a loan to Charles Hardisty in the amount of \$96,600 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 70, 71.)

27. On or about March 29, 1991, CBC renewed another loan to Charles Hardisty in the amount of \$165,600 which was also secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 72, 73.)

28. On or about June 28, 1991, CBC again renewed a loan to Charles Hardisty in the amount of \$50,900 which was also secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 74, 75.)

29. On or about January 14, 1991, CBC renewed a loan to Valley Equipment and Fertilizer Co. in the amount of \$127,000 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 76, 77.)

30. On or about June 28, 1991, CBC renewed a loan to O.H. Pattison in the amount of \$548,000 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 78, 79.)

31. At various dates after September 1990, CBC renewed loans to Westside Sheet Metal, Inc. in amounts of \$50,000 or greater which were secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loans. (Stipulations No. 80, 81.)

32. At various dates after September 1990, CBC renewed loans to The Rochelle Corporation in

amounts of \$50,000 or greater which were secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loans. (Stipulations No. 82, 83.)

33. At various dates after September 1990, CBC renewed loans to Calvin Stout in amounts of \$50,000 or greater which were secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loans. (Stipulations No. 84, 85.)

F. Management

34. CBC is owned by CBC, Inc., a one-bank holding company. Chairman of the Board Lynell G. Skarda owns 3,333 shares, or 66.66 percent, of CBC, Inc., and Director Langdon L. Skarda owns 1,647 shares, or 32.92 percent of CBC, Inc. (Stipulation No. 86.) The board of Directors of CBC consists of Lynell G. Skarda, Langdon L. Skarda and Bank President Kent Carruthers. (Stipulation No. 87, TR Vol. III, p. 33.) CBC has no independent, outside directors. TR Vol. III, p. 64.)

35. CBC is controlled by Lynell and Langdon Skarda, and all major decisions including lending decisions at CBC are made by them. (FDIC Ex. 2 p. A-1 (Examiner's Comments And Conclusions)).

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IV. DISCUSSION

There are, on the whole, no disputed issues of fact presented in this matter. The dispute in which CBC and the FDIC engage related to the judgement of the Examiner, and of his Regional supervisors in supporting that judgment, in adversely classifying loans and criticizing the manner in which CBC is operated by the two sole controlling brothers. There is not even the issue of whether a supervisory action, such as a Memorandum of Understanding, rather than entry of a Cease and Desist Order, might be more appropriate.

12 U.S.C. § 1818(b)(1) provides in pertinent part that the FDIC may issue a cease & desist order if an institution is engaged in unsafe or unsound banking practices, or has violated a law, rule, or Regulation. Pursuant to 12 U.S.C. § 1818(b)(6) the FDIC may require affirmative action to correct conditions resulting from such practices or violations. Enforcement counsel in this instance seeks relief under § 1818(b)(6)(F) which authorizes FDIC to "take such other action" as it "determines to be appropriate."

The threshold issue in this proceeding is whether Citizens Bank of Clovis has engaged in unsafe or unsound banking practices, or violated any law, rule, or regulation. The second issue is whether the conduct alleged justifies the affirmative action sought by enforcement counsel in its proposed order. Each of the charges in the Notice will be carefully reviewed in turn to determine if the action constitutes an unsafe or unsound practice or a violation.

The phrase "unsafe or unsound practice" is not defined in section 8(b) of the Act, 12 U.S.C. § 1818(b). The statute also does not specify practices which are deemed to be unsafe or unsound. Although not explained or clarified in the statute, the phrase has been commonly understood to mean the following:

...[T]he term "unsafe or unsound practices" has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund.

Financial Institutions Supervisory Act of 1966: Hearings on S. 3158 Before the House Committee on Banking and currency, 89th Congress., 2nd Sess., at 49–50 (1966).

There are primarily six areas of sound banking practice with which the FDIC wants CBC to comply. The Notice charges CBC with having (a) poor management, resulting in (b) an excessive amount of adversely classified loans and with (c) an inadequate Allowance for Loan and Lease losses, (d) continual involvement in the risky practice of capitalizing interest and (e) with violating 12 C.F.R. Part 323 regarding compliance with appraisal requirements. FDIC also alleges that CBC's (f) written loan and investment policies need to be more comprehensive.

A. Management

There are three members of the board of directors of CBC that also run the day-to-day management: President Kent Carruthers, Secretary of the Board Langdon Skarda and Chairman of the Board Lynell Skarda. The bank is wholly-owned by CBC, Inc. a one-bank holding company. Lynell Skarda owns 66.7 percent of the holding company stock, Langdon Skarda owns 32.9, and Kent Carruthers owns the remaining fractional interest. Lynell Skarda became a director of CBC in 1960 and Langdon became a

director in 1966. Kent Carruthers joined the bank as President on January 31, 1986 after having been employed by the Office of the Comptroller of the Currency from 1972 to 1977. Carruthers became a National Bank Examiner in 1975, and from 1977 to 1986 was employed as an officer at various banks.

CBC services a farm community and has been managed by the same two brothers for some thirty years. The management has much of their lives invested in this bank and controlling shareholder/chairman of the board/ employee Lynell Skarda represented CBC at hearing. Lynell and Langdon Skarda and Kent Carruthers all wear many hats with respect to their participation in the affairs of CBC.

From the evidence presented at hearing, management has conducted business with the best interest of the bank in mind and, symbiotically, the continuing viability of CBC is also in the best interest of management whose livelihoods depend on the bank. There have been absolutely no allegations of personal impropriety, self-dealing or wrong-doing of any kind by management. CBC has remained adequately capitalized through difficult economic times where many other institutions have not survived.

Management's policies and practices have served the bank adequately up to this point. However, FDIC has presented a solid case for necessary reforms to ensure the continued safety of CBC, and the continued safety of the Insurance Fund. The FDIC charges CBC with operating policies detrimental to CBC and thus constituting unsafe and unsound banking practices, including operating with poor management. Management received a 4 rating during the July 5, 1991 bank examination.⁴ (TR Vol. III, p. 48; Vol IV, p. 132.)

FDIC alleges that management is not vigilant in monitoring its watch list, an internal document listing problem loans. During the hearing, the Examiner pointed out two significant loans, W.L. Lockmiller and Calvin Stout, that he felt should have been on the watch list and were not. Management strongly disagreed with the classifications of the above-mentioned loans.⁵ With few exceptions, the Examiner found the loans adversely classified also to be on the bank's internal watch list.

In its proposed order, enforcement counsel does not seek to replace present management. Agency wants outside directors to be appointed to the board in addition to the existing directors, in order that the Board contain individuals whose interests are not limited to banking. The request is not unreasonable and would add needed diversity to the Board of Directors.

B. Adversely Classified Loans

The purpose of an adverse classification is to reveal the bank's weak assets and more accurately reflect the true condition of the institution. There are three categories of adversely classified loans: substandard, doubtful, or loss. Substandard assets have welldefined weaknesses that jeopardize the liquidation of the debt, but do not require the institution to make adjustments to its capital account. Loans classified doubtful are inadequately protected by the current sound worth and paying capacity of the obligor or collateral pledged, signifying that fifty percent of such assets are deducted from primary and total capital in analyzing the capital of the bank. Assets classified loss are charged off or deducted from stockholders equity in computing primary and total capital.

CBC's adversely classified assets increased by 133 percent from the 1990 bank examination to the 1991 examination. Adversely classified loans equal about 165 percent of the total equity capital and reserves as of the date of the July 5, 1991 examination. Calvin Riddick (Riddick), FDIC Assistant Regional Director for the FDIC Dallas Regional office, testified that generally the goal of sound banking practice is to prevent the total equity capital and reserves from exceeding 100 percent in order to protect the solvency of the bank. Riddick attributes the high level of adversely classified assets in CBC to a combination of economic conditions and unsafe or unsound banking practices.

CBC contends that the loans were misclassified by the FDIC Examiner at the July 1991 bank examination and that the condition of the bank was thus misrepresented. CBC stipulates that the ratios and numbers contained in the July 1991 Report are the findings of the examiner but CBC does not stipulate to the accuracy of the asset classifications which give rise to the results. In fact, CBC argues that CBC used the Manual of Examination Policies (MEP) as guidance and could not have known that certain loans would be classified substandard, so that any examination finding unnoted classifications could not have been conducted in accordance to FDIC policies and procedures.

At the hearing, CBC asked the Examiner why some of the loans classified substandard would not have been more appropriately classified special mention. Special mention loans are weak or deficient loans, but do not presently expose the bank to a sufficient degree of risk to merit an adverse classification and no adjustment to the capital account

⁴ The 4 assessment is a component of the CAMEL rating which is a composite of an institution's capital,

asset, management, earnings, and liquidity. 1 is the highest rating and 5 is the lowest.

⁵ CBC argues that Mr. Lockmiller is worth \$3 million and is a sound credit risk and his loan should not be on the watch list and should not have been classified substandard. Agency's position is that funds were extended for start up costs on a failed business and went five years without a significant reduction. Further at the time of classification, there were no equipment inspections or livestock invoices to support Mr. Lockmiller's net worth. Vol. II, p. 24.

{{2-28-94 p.A-2361}} is necessary. The Examiner testified that in order for loans to be considered special mention a bank must have a well-conceived plan to work through the classifications. For instance, each credit's weaknesses would need to be acknowledged, and in working with the borrower a plan would have to be implemented to determine how much time to allow the borrower to perform. The testimony presented and evidence admitted at hearing was that CBC had no such plan of action and the loan files contained no such information.

CBC argues that many of the loans classified substandard are adequately collateralized. It maintains that loans secured with collateral equal to or valued slightly higher than the debt should not be classified substandard because the collateral is adequate to extinguish the debt and the bank will therefore not be exposed to risk of loss. If contemporary appraisals had been available and it had been known that the collateral's value truly was sufficient to extinguish the debt, an adverse classification would not have been made. As the Examiner testified, however, the underlying collateral is only one factor to consider in examining risk of nonpayment:

Well, first we look at the paying capacity of the borrower. We check performance. If the loan is past due, we would look at other sources of repayment through analysis of the financial statements and discussions with management. If the financial statements showed a highly leveraged position and no liquidity whatsoever, or minimal liquidity, then we look to the underlying collateral values.

(TR Vol. I, p. 39.) The Examiner testified that in his expert opinion collateral valued at 10 percent more than the amount owed the bank in an instance where the borrower is comparatively insolvent or has no cash flow, would generally justify a substandard classification (TR Vol. I, p. 57), and collateral not recently appraised is even more justification for an adverse classification. The Examiner further explained that experience shows that a financial statement not indicating any other source of repayment other than the real estate, signifies a well-defined weakness that can jeopardize the liquidation of the debt. CBC argues that the Manual of Examination Policies defines substandard to include loans adequately protected by either the current sound worth and paying capacity of the obligor or of the underlying collateral. As to CBC's loans, however, time and time again there were either no current appraisals of the property in the loan file, or even a complete lack of documentation, so that the current true value of the collateral in many instances was not known.

The FDIC Examiner's loan classifications are entitled to deference, and will not be overturned unless shown to be arbitrary and capricious or outside a zone of reasonableness. *Sunshine State Bank v. Federal Deposit Ins. Corp.*, 783 F.2d 1580 (11th Cir. 1986). CBC did not effectively show why the adverse classifications were arbitrary or capricious, or unreasonable, or why the adversely classified loans actually were sound extensions of credit, and presented no testimony to contradict the findings, loan by loan, as testified to by the Examiner. The only contradictory evidence submitted was the opinion of CBC's President, Kent Carruthers who, despite his extensive experience, is not afforded the deference in making classifications of loans which is granted current FDIC Examiners. *In the Matter of The Stephens Security Bank*, FDIC-89-324b, 1 P-H-Enf. Dec. ¶5168 at A-1787 (1991). Rather than contradicting the Examiners' testimony, as shown in the Reports of Examination, cross-examination did no more than result in repetition of the testimony given on direct examination and support for the Reports of Examination. Stale and nonexistent appraisals could not support a claim of arbitrary or capricious classification. The Examiner's adverse classifications are a reasonable extrapolation from the circumstances found during the bank examination as shown by the undisputed facts of record. As demonstrated below, the bank examiner effectively discredited CBC's contention that the loans were improperly classified, and there is no basis upon which the undersigned could recommend revisiting the Examiner's classifications.

SPECIFIC LOANS

Many loans, such as the Dale Reichert loan and the West Side Sheet Metal loan, were adversely classified based in part on inadequate collateral security and in part on a past due status. (TR Vol. I, p. 37–38.) The following are only some of the loans discussed at hearing:

1. A & M Building Systems, Inc. and
A & M Farm and Ranch Supply

Two problems loans are A & M Building Systems, Inc. found to be substandard in the amount of \$1,626,000, and A & M Farm and Ranch Supply, Inc. classified substandard in the amount of \$972,000. (TR Vol. I, p. 29.) The Examiner testified that both businesses are in financial distress as evidenced by cash flow problems and operating losses.

As of July 31, 1990 to the time of the May 5, 1991, examination, its operating statement indicated that the A & M Farm & Ranch Supply lost \$17,000. A & M Building Systems is secured by collateral valued just slightly over the loan. The debt is worth \$1,626,000 and the collateral was last reported at \$1,633,000. Vol. 1, p. 29. The Examiner testified that without any formal inspections of the collateral to determine an up to date appraisal, there is a substantial risk of loss to the bank in the event CBC closes the business. Vol. 1 p. 30. A & M building also had an overdraft in the amount of \$153,000 evidencing its cash flow problem and is reported to have an insolvent position of \$600,000.

2. Eldridge Companies and Rochelle
Corporation

Both the Eldridge Companies and the Rochelle Corporation have properties, parcels of real estate and mineral rights as collateral. (TR Vol. I, p. 31.) The loan files were not well documented and did not contain current appraisals on the property, and some of the collateral had not been appraised for more than four years. The Examiner testified that the Rochelle Corporation was not able to pay \$256,000 in accrued interest and a loan in that amount was granted to Deal Eldridge to cover the accrued interest. (TR Vol. I, p. 31.) The basic reason for the adverse classifications of the debt incurred by these businesses is the combined effect of their highly leveraged and illiquid financial statements, inappropriate capitalization of interest, and questionable values for the real estate securing the loans.

3. Garrentt Relationship

The Garrett Relationship consists of loans made to D'Aun Garrett, Malcolm Garrett, Garrett Corporation, Garrett Farms and the Irene Garrett estate. The loans made to these entities were classified substandard and loss. The loans individually contained problems and risks but were assessed together as a whole. The aggregate collateral, approximately 25,000 acres of property, with inadequate or no appraisals, was valued at \$4,838,000 while the debt from the Garrett Relationship totaled \$5,173,000 resulting in a loss classification of \$338,000. (TR Vol. II, p. 99.) The bank had no more than a second lien on some of the property used as collateral, and other property was encumbered by unpaid taxes. The balance of the whole debt was \$5.1 million, of which \$4 million was 611 days past due. (TR Vol. II, p. 100.) Over \$4 million worth of assets of the Garrett relationship were, through no fault of CBC, not available because of litigation unrelated to the present administrative proceeding.⁶ Ultimately, of the \$5,173,000 currently on the books, \$4,838,000 was substandard and \$335,000 was assigned as loss. (TR Vol. I, p. 35.)

4. O.H. Pattison

The O.H. Pattison loan was adversely classified because of inadequate collateral, poor performance and inappropriate capitalization of interest. (TR Vol. I, p. 37.) The loan was secured with a half interest in a feed mill, half interest in an ethanol plant and five and a half acres of un-appraised land. The estimated value of the total, tangible collateral was \$385,000 and the debt equaled \$673,000 resulting in a \$163,000 classified as loss, \$385,000 classified as substandard. The bank loaned Mr. Pattison \$548,000 in 1987 for farm operating expenses and there has been no reduction on that loan. (TR Vol. I, p. 36.) Three additional notes for a total of \$125,000 were made to cover the accrued interest on that large note. (TR Vol. I, p. 36.) The loan file was devoid of any equipment inspections whatsoever.

5. Curry Country Grain Elevator

ELEVATOR

The Garretts originally owned and ran the Curry County Grain Elevator. In 1986, au-

⁶ In 1986, CBC determined that Malcolm Garrett, a manager of the elevator, had diverted monies that

were due on accounts receivable that were pledged to the bank. The bank never received those proceeds from the collections of those receivables in the amount of between 4 and 5 million. (TR Vol. IV, p. 145.) The bank was required to initiate a lawsuit to collect the funds. (TR Vol. II, p. 55.) [\[\[2-28-94 p.A-2363\]\]](#)itors for Curry County Grain determined that the inventory was overstated by almost \$2 million. At that time the Commodity Credit Corporation, the entity regulating such elevators, had to decide whether to close down the elevator. The elevator had in excess of 6 million bushels of grain. CBC's position was that it wanted to keep the elevator afloat for the benefit of the community as well as for the bank's security in obtaining loan repayment. (TR Vol. IV, p. 147.) In 1987, the elevator was acquired by the bank. Curry County Grain Elevator was classified \$8.4 million substandard during the 1991 bank examination.

One criticism with this property is that the organization currently leasing the elevator, the Peavey Company, dictates the terms of the lease at each renewal, and obtains terms beneficial to the lessee and detrimental to CBC. For instance, the Peavey Co. demanded and obtained a change in lease payments so that it would retain the first \$10,000 in profits, and that the bank's lease compensation, a pro-rata share profits, would be computed without considering the first \$10,000. (TR Vol. I, p. 41.) The lease agreement is renewed on a six months basis and the lessee has the right to terminate the lease at expiration. (FDIC Ex. 2. at 2-a-24.) Most of the negotiating power is in the hands of the leasing organization and the bank's income from the property is decreasing, leading the Examiner to conclude that the loan would not liquidate under the circumstances. (TR Vol. I, p. 40.) The property is classified substandard due to the declining amount of income generated, the likelihood of further reductions, the tenuous nature of the lease agreement, and the absence of timely liquidation. (FDIC Ex. 2 at 2-a-24.)

C. ALLOWANCE FOR LOAN AND LEASE LOSSES

Allowance for loan and lease losses (ALLL) provides a cushion for estimated losses in the loan portfolio. It is otherwise known as a loan valuation reserve and is a permanent segregation to the capital accounts. (TR Vol. I, p. 19.) It is an unsafe or unsound banking practice to allow the ALLL to become deficient; it must always have a credit balance to defend against loan and lease losses. If the allowance for loan and lease losses is underfunded, capital accounts would be considered overstated, and vice versa, and the true condition of the bank's capital would not be accurately reflected. (TR Vol. I, p. 109.)

The Examiner determined that the ALLL was deficient based on the number of adversely classified loans. The total percent of adversely classified loans had risen from 13 percent at the 1990 examination to 23 percent at the 1991 bank examination. (TR Vol. I, p. 20.) Further, approximately 10.38 percent of gross loans were non-accrual and 11.12 percent of loans and leases were past due, so that the Examiner considered the past due ratio excessive. He further testified that it is basically a judgment call as to when banks should put money into the ALLL to keep it current (TR Vol. I, p. 111), but that, at a minimum, the ALLL should be scrutinized on a quarterly basis to determine whether or not additions need be made prior to the bank's filing the quarterly reports. (TR Vol. IV, p. 129.) The Examiner pointed out that even if a bank is adequately capitalized and has sufficient capital surplus, undistributed profits, and the reserves necessary for protection of anticipated losses, by not properly segregating reserves the call report requirements would not be met and the report would inaccurately reflect the true state of the bank. As noted at the hearing, CBC's ability to correct the inadequate ALLL provisions is fairly easy. CBC need only make a bookkeeping entry that is a reflection on the earnings performance of the bank. The Examiner notes that CBC's total risk based capital is above policy guidelines leading the undersigned to conclude that at the time of examination the bank was in no imminent danger of great loss.

D. CAPITALIZATION OF INTEREST

Capitalizing interest is not an unsafe or unsound banking practice in all circumstances. It is not imprudent if the total amount at risk is properly collateralized, or if there are other factors insuring service and repayment. If it is done inappropriately, however, it exposes the bank to unnecessary risk. Where a borrower is unable to pay the currently accrued interest there is a significant question or doubt as to whether it will be able to pay the principal. In most instances if a borrower were ready, willing and able to service a debt and there were no cash flow problems then there would be no need for the bank to capitalize the interest.

[\[\[2-28-94 p.A-2364\]\]](#)

SPECIFIC INSTANCES

The Examiner testified to the growing trend of CBC's practice of capitalizing interest. A fair number of specific instances of the practice were presented at hearing but only several examples are provided

below and are indicative of the other instances and the general liquidity and cash flow problems of the borrowers.

1. John D. Wood

The John D. Wood loan is secured by collateral consisting of farm-related equipment. A \$34,000 note exists with a \$34,000 balance. The debt originated September 8, 1986 at \$9,000 for operations and land payments. (TR Vol. II, p. 125.) During the course of five years a \$9,000 note increased to \$34,000 as follows: there was a \$7,000 advance during September 1987; during April 1988, there was a \$1,000 reduction; during June 1989, there was a \$17,000 advance; during January 1990, there was a \$1,500 reduction; on August 14, 1990, there was a \$5,000 advance; on March 22, 1991, there was a \$1,500 reduction, to the current balance of \$34,000. (TR Vol. II, p. 125.) There has been no collateral inspection performed for the equipment securing the loan. The continued capitalized of interest has been made on a debt secured with equipment valued solely on a property statement of December 6, 1990. Making loans collateralized by farm-related equipment, or any assets, the current value of which is unknown to the bank, is an unsafe and unsound banking practice.

2. O.H. Pattison

This loan, which originate in 1987, was in excess of \$500,000 with no reduction at the time of the 1991 bank examination. The bank had loaned Pattison \$125,000 in 1990 and 1991 to pay the accrued interest. (TR Vol. I, p. 25, and 59–60.)

3. W.L. Lockmiller

W.L. Lockmiller has a \$371,000 debt consisting of nine notes, many of the which were renewed and had similar inherent risks. For example, Note Number 73725 originated at \$32,000 on July 3, 1989. On September 5, 1989, the note was renewed with \$40,000 of new funds advanced and on March 1, 1990, the note was renewed again with \$25,000 advanced. From the time of origination, the note has never had any principal reduction. The loan file failed to contain the purpose of the debt and the use of the proceeds. (TR Vol. II, p. 20.)

4. Dean Eldridge

Dean Eldridge has a negative net worth and his business interests, Eldridge Companies and the Rochelle Corporation, were highly leveraged and illiquid. (TR Vol. 2, p. 33.) The accrued interest could not be paid and the bank loaned Eldridge \$256,000 to cover the interest. (TR Vol. I, p. 23.)

E. 12 C.F.R. PART 323

CBC is charged in the Notice with violating 12 C.F.R. Part 323, the only violation of a law, rule, or regulation which FDIC charges.⁷ Section 323 of the Federal Deposit Insurance Corporation's Rules and Regulations requires a detailed appraisal to be performed on real estate loans in excess of a certain dollar amount, made or renewed after September 1990. The purpose of the regulation is to ensure the safety of federal financial and public policy interests in federally related real estate transactions⁸ by mandating uniform, comprehensive appraisals in writing conducted by competent and supervised appraisers. A review of that Part of the Regulations will be useful.

The part is entitled "Appraisals." It was published in the Federal Regulations, 55 FR 33888, on August 20, 1990, and except for Subsections .3(b) and (c), became effective September 19, 1990 as 12 C.F.R. § 323, with seven subsections, the first of which dealt with "Authority, purpose, and scope." Subsection .1(b)(1), dealing with purpose and scope, provides that:

...Title XI (of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, FIRREA) provides protection for federal financial and public policy interests in real estate related transactions by acquiring real estate appraisals used in connection with federally related transactions be performed in writing, in accordance with uniform standards, by appraisers whose competency has been demon-

⁷ Since the same facts underlying this charge have already been cited as evidence of unsafe and unsound practices, this charge is not of great importance herein. It should be ruled on, however, for precedential purposes.

⁸ Pursuant to 12 U.S.C. § 3350(4) "federally related transaction" is defined as any real estate transaction which a federal financial institutions regulatory agency or the Resolution Trust Corporation engages in, contracts for, or regulates and requires the services of an appraiser.

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strated and whose professional conduct will be subject to effective supervision...(Parenthetical material added.)

Subsection .1(b)(2) provides that:

This part: (i) Identifies which real estate-related financial transactions require the services of an appraiser; (ii) Prescribes which categories of federally related transactions shall be appraised by a State certified appraiser, and which by a State licensed appraiser; and (iii) Prescribes minimum standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of the FDIC.

Subsection .4, entitled "Appraisal standards," provides in detail fourteen standards applicable to the minimum requirements of appraisals required by the Part. Subsections .5, .6 and .7 deal, respectively with the independence, and the competency of appraisers, and enforcement of requirements of the Part.

It is Subsection .3 which is said by CBC to confuse this proceeding as it pertains to allegation of violations of a Regulation. That Subsection is entitled "Appraisal not required; transactions requiring a State certified or licensed appraiser." Subsection .3(a), which went into effect on the original effective date, provides in part:

While supervisory guidelines, general banking practice or other prudent standards require an appropriate valuation of real property collateral, an appraisal performed in accordance with this part is not required for...

several specified circumstances, which are not of concern herein. Subsection .3(b) and (c), which did not become effective until January 1, 1993, detailed the transactions for which an appraisal must be provided by a "State certified appraiser" as opposed to the transactions which an appraisal could be provided by either a "State certified appraiser" or a "State licensed appraiser."⁹ These provisions were thus not in effect during the period of the 1990 and 1991 examinations.

CBC takes the position that since Subsection .3(b) and .3(c) were not in effect, none of the other provisions of Part 323 were in effect. This is not so. The requirements of the minimum standards for appraisal of real property related to federal transactions were in effect, and those minimum standards at 12 C.F.R. § 323.4(a) were not met by CBC during the period of September 19, 1990 to the date of the last bank examination in May of 1992. To rule otherwise would be contrary to the clearly defined purpose of the Regulation, at 12 C.F.R. § 323.1(b)(1), to implement Title IX of FIRREA for the protection of federal financial and public policy interests in defined federally related real estate transactions through a system of written appraisals with specific requirements not at that time relating to state authorization of appraisers.

F. LOAN AND INVESTMENT POLICIES

One of agency's greatest concerns for the future safety of CBC is its lack of adequate written loan policies. While CBC is currently no more than a three-man operation, with an extended Board of Directors it will be necessary for management to have written policies describing the manner in which operations are to be conducted, so that no employee exceeds his or her authority, or fails to perform his or her obligations.

1. *Collection Procedures on Past Due Loans*

CBC's collection procedures are insufficient to constitute safe or sound banking practices in that they are no more than that the loan officer should review the facts and meet with the bank's attorney and with the customer and determine if the borrower appreciates the problem. If the borrower does not realize that a problem exists, the bank should immediately require that the loan be paid in full. With bad loans, CBC's manual states that the bank can either try to rehabilitate the loan or try to collect the debt. The generalities are excellent, but the particulars are missing. As the Examiner put it,

In other words, at what point in time when that loan becomes past due do you begin sending

written notices or get on the phone and start calling? At what point do you strengthen those efforts and start sending Certified Mail? At what point do you go even further and send a demand notice?

⁹ It might be noted that nowhere in Part 323 is there a limitation that under appropriate circumstances the state authorizing the appraiser must be the state in which the real property is located, or the state in which the lending institution is located, or any other specific state or territory.

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At what point do you actually decide that the borrower is not going to cooperate and go repossess the vehicle or foreclose on the property? (TR Vol 1. p. 36.)

CBC explained that significant problem loans are presented to the board for proper resolution. This, however, merely shifts responsibility from loan officers to the Directors on an *ad hoc* basis, without providing specific guidance.

2. Written Repayment Plan

The purpose of a collection plan is that both lender and borrower have the same expectations with respect to repayment, or renewals, of loans. The risk involved in failing to prepare a written repayment plan is that lender may underestimate that credit worthiness of the borrower and not realize until CBC has already suffered loss, while the borrower may underestimate the intention of the lender to obtain timely payments of principal and interest.

The Examiner testified that safe or sound practice require that there be a plan for orderly reduction of debt, specifically referring to the W.L. Lockmiller loan to show CBC's failure in implementing a payment plan, and its adverse effects. The use of the proceeds and the purpose of the debt for the most part were not documented, a note was renewed several times with a total of about \$65,000 in additional cash advanced without a reduction in the principal and without an established payment plan. The Examiner also referred to the O.H. Pattison loan, with no payment plan, that was four years old and had been renewed several times with no reduction in principal.

3. Collateral Guidance

CBC lending policies were unsafe and unsound in failing to define when an appraisal should be documented. The bank has a number of agricultural loans and the underwriting for those were found to be lacking. Examples of such loans are O.H. Pattison, W.L. Lockmiller, and John Wood referred to previously. The Examiner commented on the need for specificity and detail in documentation, with this testimony that drive-by inspections of collateral such as livestock did not replace the need for written, comprehensive appraisals.

If the collateral is cattle, you should do a periodic inspection. You know, check the brand of the cattle to make sure that it is indeed your cattle. Various things need to be documented such as, obviously, how many head you have, where the cattle are located, is it in a feed yard, is it on grassland or on wheat, the estimated pound per date growth. This all needs to be totaled up and multiplied by a market price per pound and an estimate given or compared against the current outstanding balance to determine your equity position.

Similar procedures need to be done for crop production loans such as wheat. All this is done to adequately assess the risk in the loan portfolio and make appropriate provisions to the loan valuation reserve if necessary. (TR Vol. I, p. 44.)

CBC's present collateral guidance is insufficient. CBC's policy on collateral states that the ratio of loan amount to appraised value of collateral depends on the type of loan and that 50%—70% is considered to be a safe and prudent level in most instances. The provision fails to specify whether the margin should be different for different types of collateral such as cattle, grain, equipment or real estate, or to give details as to various types of collateral.

4. Grading System

A watch list is a document identifying all loans adversely classified by the bank itself. CBC's internal loan review document indicates names, balances, and dates. Safe or sound banking practice requires an additional system of grading the risk factor, i.e. doubtful, substandard, or loss. If management is not aware of the degree of risk involved, its reserves may be underestimated.

5. Deviations from Loan Policy

Safe or sound banking policy requires a written policy that all loans deviating from standard written lending practices be approved by the board of directors, with a notation to that effect in board meeting minutes.

6. Lending Limit Authority

Safe or sound banking practice requires a written specified lending limit authority for its loan officers. Dollar amount, type of loan—whether it be secured or unsecured, are factors to be included in the provision. CBC's present practice of having all loans approved by the board of directors rather than establishing lending limits again does no more than shift responsibility, and gives [{{2-28-94 p.A-2367}}](#)no real guidance to the loan officers accountable for arranging the loan.

7. Supporting Documentation

Failing to provide supporting documentation is an unsafe and unsound practice. The record is replete with instances of insufficient or no supporting documentation. Specific instances have already been discussed above. CBC needs to implement more detailed bank provisions regarding underlying documentation of secured loans and unsecured loans. For instance, guidelines should be established regarding the necessity for a current financial statement indicating a borrower's income and expenses, the value of the collateral as evidenced by a recent comprehensive appraisal, and the borrower's equity in the collateral.

V. CONCLUSIONS OF LAW

1. The FDIC has jurisdiction over CBC and this action pursuant to the Act, 12 U.S.C. §§ 1811–18311, and the FDIC Rules and Regulations, 12 C.F.R. Chapter III.

2. At all times pertinent to this proceeding, CBC was an insured State nonmember bank within the meaning of sections 3(e)(2) and 8(b) of the Act, 12 U.S.C. §§ 1813(e)(2) and 1813(b), and section 308.01(i) of the FDIC Rules of Practice and Procedure, 12 C.F.R. § 308.01(i).

3. The FDIC has authority to issue an Order to Cease and Desist ("Order") against CBC pursuant to section 8(b) of the Act, 12 U.S.C. § 1818(b).

4. CBC has engaged in the following unsafe or unsound banking practices within the meaning of section 8(b) of the Act, 12 U.S.C. § 1818(b):

(a) Failing to have written loan policies and procedures which adequately articulate and describe prudent lending practices.

(b) Extending the due dates of loans or renewing loans without collection in cash of interest due or obtaining adequate additional collateral to secure credit advanced for the purpose of paying interest.

(c) Failing to recognize and identify problem credits.

(d) Operating with an excessive volume of poor quality loans and loan related assets.

(e) Failing to provide an adequate reserve for loan losses which has the effect of misrepresenting and misstating the earnings of CBC.

(f) Violating Part 323 of FDIC Rules and Regulations, 12 C.F.R. Part 323, by renewing or extending loans without either (1) a current or updated appraisal or (2) a current or updated appraisal which did not comply with the requirements of Part 323.

(g) Operating with management, including the board of directors, whose practices and policies are detrimental to CBC and jeopardize the safety of its deposits.

9. In this action to issue an Order to Cease and Desist, the FDIC has satisfied all statutory requirements of section 8(b) of the Act, 12 U.S.C. § 1818(b).

VI. COMMENTARY

FDIC charges management with allowing unsafe or unsound banking practices to exist. The term "unsafe or unsound" is purposefully ambiguous to allow agency greater discretion in determining on a case-by case basis what practices may pose an unnecessary risk to an institution and are contrary to commonly considered prudent banking practices. Much of CBC's case was spent providing that its banking practices did not violate any specific law, rule, or regulation.¹⁰ However, the language of 1818(b) provides for entry of a cease and desist order for either a violation of statute, rule or regulation, or for

unsafe or unsound practices.

The FDIC has effectively proven that unsafe or unsound practices did exist in part by the number of adversely classified loans, the weak underwriting practices, and insufficient comprehensive banking policies. Some of the inadequate banking practices may have been a result of those "constantly changing factual circumstances" expostulated to the Congress in 1966. What once was common and considered a safe banking practice may change over the thirty years of current management, and now constitute operations

¹⁰ Respondent often argued that its banking practices did not violate the Manual of Examination Policies ("MEP") used by the FDIC as guide in conducting its examinations. Bank examiner Jeffers testified that MEP is not a bible for all banks in determining safe banking practices but only a guide used in conducting bank examinations. Since many instances of unsafe or unsound banking practices may not be addressed in the MEP, Respondent's reliance on this guide is misplaced.

{{2-28-94 p.A-2368}}"which, if continued, would be abnormal risk or loss or damage" to the institution, its stockholders and depositors, and to the Insurance Fund.

While the agency does not have an absolutely free hand in shaping the relief to be granted, it does have "broad discretion in exercising its expertise in fashioning an appropriate remedy to stop the practice and/or violation, to prevent future such abuses and to correct the effect of the practice or violation." (Citations omitted.) *In the Matter of * * **, FDIC-84-23b and FDIC-84-67k, 1 P-H Enf. Dec. ¶5061 at A-720 (1986). The relief sought by the FDIC in this matter is relatively modest. Agency wants no more than to have CBC cease and desist from unsafe or unsound practices which will inure to its disadvantage and threaten the Insurance fund. FDIC is not demanding any capital infusion or seeking a penalty, but rather wants no more than a reform of CBC's banking practices and the ability to supervise these changes. Enforcement counsel has met its burden of proof by a preponderance of the evidence, and has effectively proven that the proposed changes are warranted.

VII. RECOMMENDED ORDER

Pursuant to the provisions of section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. ¶1818(b), an Order in the form recommended and attached hereto and made a part hereof should issue against CBC. It is recommended that CBC be required to cease and desist from engaging in the unsafe or unsound practices, and violation of statute, as found herein, and to correct adverse conditions resulting therefrom.

PROPOSED ORDER TO CEASE AND DESIST

In the Matter of
The Citizens Bank of Clovis
Clovis, New Mexico
(Insured State Nonmember Bank)
Docket No. FDIC-91-406b

IT IS ORDERED, that The Citizens Bank of Clovis, Clovis, New Mexico ("Bank"), and institution-affiliated parties of the Bank cease and desist from the following unsafe or unsound banking practices and violations of laws and/or regulations:

- (a) Operating the Bank without adequate written loan policies and procedures;
- (b) Renewing or extending the due dates of loans without collection in case of interest due or obtaining adequate additional collateral to secure credit advanced for the purpose of paying interest;
- (c) Operating the Bank with an excessive level of adversely classified assets;
- (d) Failing to provide an adequate allowance for loan and lease losses;
- (e) Operating the Bank in violation of applicable Federal and state laws and regulations as more fully set forth on pages 6-b of the Report of Examination of the Bank as of July 5, 1991.
- (f) Engaging in hazardous lending and lax collection practices;
- (g) Operating the Bank with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits;
- (h) Operating the Bank without adequate supervision and direction by the board of directors over the management of the Bank;

IT IS FURTHER ORDERED, that the Bank and institution-affiliated parties of the Bank take affirmative action as follows:

1. Within 60 days after the effective date of this ORDER, the Bank shall revise, adopt, and implement written lending and collection policies and procedures to provide effective guidance and control over the Bank's lending function. Such policies and their implementation shall be in a form and manner acceptable

to the Regional Director, as determined at subsequent examinations, and shall include, at a minimum, the following:

- (a) A provision that deviations from the written lending policies and procedures require approval of the board of directors of the Bank;
- (b) A provision that establishes the lending limit of each loan officer;
- (c) A requirement that extensions of credit shall not be refinanced, reworked or renewed unless current financial information and documentation have been obtained;
- (d) A requirement that all loans shall have written repayment understandings;
- (e) Guidelines under which loans are renewed or have their due dates extended (i) Without full collection of interest thereon, (ii) by acceptance of separate notes in payment of interest, or (iii) by capitalization of interest in the balance of the noted;

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- (f) Limitations on the amount advanced in relation to the value of the collateral securing the credit and the documentation required by the Bank for each type of secure credit;
- (g) A provision specifically outlining the collection procedures to be taken by the Bank when borrowers fail to make timely payments;
- (h) Guidelines for determining what rate of interest will be charged on all secured and unsecured loans; and
- (i) A provision outlining the documentation required on all secured loans.

2. (a) Upon the effective date of the Order, the Bank shall, to the extent that it has not previously done so, eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss and one-half of the assets classified Doubtful by the FDIC as a result of its examination of the Bank as of July 5, 1991. Reduction of these assets through proceeds of loans made by the Bank shall not be considered "collection" for the purpose of this paragraph.

(b) Within 60 days after the effective date of this ORDER, the Bank shall submit a written plan to the Regional Director to reduce the remaining assets classified Doubtful and Substandard as of July 5, 1991. At a minimum, the plan shall include the following:

- (i) A schedule providing quarterly goals to reduce the remaining adversely classified assets as of July 5, 1991 to levels representing not more than a specified percentage of total equity capital and reserves as reported each quarter by the Bank in its Consolidated Reports of Condition and Income and shall include no less than six consecutive quarterly target dates;
- (ii) An explanation showing the complete rationale used by the Bank in constructing the reduction schedule; and,
- (iii) A provision requiring, at a minimum, quarterly reviews by the Bank's board of directors whereby the extent of the Bank's compliance with the plan is expressly addressed, with the results of each review to be recorded in the corporate minutes of the board of directors.

(c) Upon written notice from the Regional Director that the Submitted plan is not acceptable, the bank shall, within 30 days after receipt of such notice, submit amendments to the plan to the Regional Director, including any modifications or amendments requested by the Regional Director. Upon written notice that the plan is accepted, it shall be adopted by the board of directors of the Bank. The Bank shall then immediately initiate measures detailed in the plan to the extent such measures have not been initiated.

(d) For purposes of the plan, the reduction of the level of adversely classified assets as of July 5, 1991, to a specified percentage of total equity capital and reserves may be accomplished by:

- (i) Charge-off;
- (ii) Collection;
- (iii) Sufficient improvement in the quality of adversely classified assets so as to warrant removing any adverse classification, as determined by the FDIC; or
- (iv) Increase of total equity capital and reserves.

(e) While this ORDER is in effect, the Bank shall eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss as determined at any examination conducted by the FDIC or the State at such time as the report of examination is received by the Bank.

3. (a) Within 10 days from the effective date of this ORDER, the Bank shall increase its allowance for loan and lease losses ("allowance") to an adequate level.

(b) Thereafter, the Bank shall maintain its allowance in accordance with the prevailing

requirements of the Instructions for the Consolidated Reports of Condition and Income ("Instructions"). Toward this end, within 60 days of this ORDER, the Bank's board of directors shall establish a comprehensive policy for determining the adequacy of the Bank's allowance. The policy shall provide for a review of the allowance at least once each calendar quarter. The review should focus on the results of the Bank's internal loan review, loan loss experience, trends of delinquent

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and non-accrual loans, an estimate of potential loss exposure on significant credits, concentrations of credit, and present and prospective economic conditions. The adequacy of the allowance in relation to the loss potential in the loan portfolio will be reviewed by the Board of Directors, and adjustments to the allowance will be made accordingly. Details of these reviews will be incorporated into the minutes of the Board of Directors, including the methodology used to determine the adjustments.

4. Within 60 days after the effective date of this ORDER, the board of directors shall establish a loan review committee to periodically review the Bank's loan portfolio and identify and categorize problem credits. The committee shall file a report with the board of directors. This report shall include the following information:

- (a) The overall quality of the loan portfolio;
- (b) The identification, by type and amount, of each problem or delinquent loan;
- (c) The identification of all loans not in conformance with the Bank's lending policy; and
- (d) The identification of all loans to officers, directors, principal shareholders or their related interest.

At least 50 percent of the members of the loan review committee shall be directors not employed in any capacity by the Bank other than as a director.

5. After the effective date of this ORDER, the Bank, consistent with sound banking practices, shall eliminate and/or correct all violations of laws and/or regulations existing in the Bank as of July 5, 1991, as more fully set forth on page 6-b of the July 5, 1991 Report of Examination. In addition, the Bank shall ensure its future compliance with all applicable laws and regulations.

6. While this ORDER is in effect, the Bank shall neither declare nor pay, directly or indirectly, any cash dividend to shareholders without the prior written consent of the Regional Director.

7. (a) While this ORDER is in effect, the Bank shall not extend, directly or indirectly, any additional credit to or for the benefit of any borrower who has an extension of credit with the Bank that has been classified Loss, either in whole or in part, and is uncollected, or to any borrower who is already obligated in any manner to the Bank on any extension of credit, including any portion thereof, that has been charged off the books of the Bank and remains uncollected. The requirements of this paragraph shall not prohibit the Bank from renewing credit already extended to a borrower after full collection, in cash, of interest due from the borrower.

(b) While this ORDER is in effect, the Bank shall not extend, directly or indirectly, any additional credit to or for the benefit of any borrower whose extension of credit is classified Doubtful and/or Substandard, either in whole or in part, and is uncollected, unless the Bank's board of directors has signed a detailed written statement giving reasons why failure to extend such credit would be detrimental to the best interests of the Bank. The statement shall be placed in the appropriate loan file and included in the minutes of the applicable board of directors' meeting.

8. The Bank shall have and retain qualified management. Each member of management shall possess qualifications and experience commensurate with his or her duties and responsibilities at the Bank. The qualifications of management personnel shall be evaluated on their ability to: (i) comply with the requirements of the ORDER, (ii) operate the Bank in a safe or sound manner, (iii) comply with applicable laws and regulations, and (iv) restore all aspects of the Bank to a safe or sound condition, including asset quality, capital adequacy, earnings, management effectiveness, and liquidity. During the life of the ORDER, the Bank shall notify the Regional Director in writing of any changes in management. The notification must include the name(s) and background(s) of any replacement personnel and must be provided prior to the individual(s) assuming the new position(s).

9. (a) Within 60 days after the date of this ORDER, the Bank shall prepare a plan for submission to the shareholders at their next meeting to reorganize the board of directors either by increasing the

number of directors or by appointing new directors so that for so long as their ORDER is outstanding at least 50 percent of the members of the board shall be independent, outside directors as defined herein.

(b) For the purpose of this ORDER, an "outside director" shall be an individual:

(i) Who shall not be employed by the

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Bank or its affiliates other than as a director of the Bank or an affiliate;

(ii) Who shall not own or control more than 5 percent of the voting stock of the Bank or its holding company;

(iii) Who shall not be indebted to the Bank or any of its affiliates in an amount greater than 5 percent of the Bank's Tier 1 capital or \$500,000 whichever is less;

(iv) Who shall not be related to any director, principal shareholder of the Bank or to any director or principal shareholder of any affiliate of the Bank; and

(v) Who shall be a resident of, or engage in business in, the Bank's trade area.

10. Within 60 days after the effective date of this ORDER, the board of directors shall establish a committee of the board of directors charged with the responsibility of ensuring that the Bank complies with the provisions of this ORDER. At least 50 percent of the members of such committee shall be outside directors as defined herein. The committee shall report monthly to the full board of directors; and, a copy of the report of any discussion relating to the report or the ORDER shall be noted in the records of the board of directors. The establishment of this committee shall not diminish the responsibility or liability of the entire board of directors to ensure compliance with the provisions of this ORDER.

11. After the effective date of this ORDER, the Bank shall send to its shareholders or otherwise furnish a description of this ORDER, (a) in conjunction with the Bank's next shareholder communication, and also (b) in conjunction with its notice or proxy statement preceding the Bank's next shareholder meeting. The description shall fully describe the ORDER in all material respects. The description and any accompanying communication, statement, or notice shall be sent to the FDIC, Registration and Disclosure Unit, 550 17th Street, N.W., Washington, D.C. 20429, for review at least 20 days prior to dissemination to shareholders. Any changes requested to be made by the FDIC shall be made prior to dissemination of the description, communication, notice, or statement.

12. Within 30 days after the end of the first calendar quarter following the effective date of this ORDER, and within 30 days after the end of each successive calendar quarter, the Bank shall furnish written progress reports to the Regional Director detailing the form and manner of any actions taken to secure compliance with this ORDER and the results thereof. Such reports may be discontinued when the corrections required by this ORDER have been accomplished and the Regional Director have released the Bank in writing from making additional reports.

13. The effective date of this ORDER shall be 30 days after the date of its issuance. This ORDER shall be binding upon the Bank and all institution-affiliated parties of the Bank.

The provisions of this ORDER shall remain effective and enforceable except to the extent that, and until such time as, any provisions of this ORDER shall have been modified, terminated, suspended, or set aside by the FDIC.

By Order of the Board of Directors.

Dated at Washington, D.C., this ____ day of ____, 1993.

/s/ Hoyle L. Robinson

Executive Secretary