Office of Inspector General

Office of Program Audits and Evaluations
Report No. AUD-18-002

Material Loss Review of First NBC Bank, New Orleans, Louisiana

November 2017

Office of Inspector General

Executive Summary

Material Loss Review of First NBC Bank, New Orleans, Louisiana

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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance (FDI) Act requires the Inspector General (IG) of the appropriate federal banking agency to complete a review and prepare a report when the Deposit Insurance Fund (DIF) incurs a material loss with respect to an insured depository institution for which the FDIC is appointed Receiver. For losses that occur after January 1, 2014, the FDI Act defines a material loss as any estimated loss to the DIF in excess of $50 million. The Louisiana Office of Financial Institutions (OFI) closed First NBC Bank, New Orleans, Louisiana (First NBC), and appointed the FDIC as Receiver on April 28, 2017. First NBC's total assets at closing were $4.0 billion, and the estimated loss to the DIF was $996.9 million.

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

Background

First NBC was a state-chartered nonmember bank headquartered in New Orleans, Louisiana, that opened on May 19, 2006. The bank was wholly owned by First NBC Bank Holding Company, New Orleans, Louisiana, which was generally considered a source of strength for the bank. First NBC grew rapidly and eventually operated 35 branches in southern Louisiana and 5 branches in the Florida panhandle. The bank also had several subsidiaries that were used primarily to facilitate investments in various federal and state tax credit investment programs. The bank became increasingly dependent on the loans and direct investments in projects eligible for investment tax credits to help meet requirements under the Community Reinvestment Act, generate earnings, and reduce income tax liability when the bank was profitable.

The holding company's 2015 external audit identified significant accounting errors related to the tax credit investments, which delayed the holding company's filing of financial reports and resulted in the restatement of the bank's December 31, 2015 financial statements, including a reduction in retained earnings of approximately $54 million. First NBC took steps to stabilize the bank following public disclosure of the accounting errors, including addressing a significant run-off of deposits caused by concern with the bank's newly identified financial troubles. However, First NBC was unable to maintain sufficient capital to cover the subsequent investment and loan losses that the bank experienced.

Audit Results

Causes of Failure and Material Loss

First NBC exhibited many of the characteristics of bank failures we have identified in prior material loss reviews and other reviews of the FDIC's supervision program. These characteristics included a dominant official with broad lending authority and limited Board of Directors (Board) oversight, rapid growth funded by high-cost deposits, and large lending relationships and concentrations without adequate risk management controls to mitigate the risks. The bank also developed significant concentrations in trade receivables and complex tax credit investments. The losses the bank realized on its large loan relationships, trade receivables, and tax credit investments severely diminished earnings and depleted capital to a point at which the bank could not recover.

The FDIC's Supervision of First NBC

Between 2006 and 2017, the FDIC and OFI conducted nine full-scope joint safety and soundness examinations and six visitations of First NBC consistent with requirements. However, the FDIC's use of enforcement actions and examination ratings to address First NBC issues was counter to the agency's forward-looking supervisory approach. That is, although examiners identified repeated risk management weaknesses, they relied too heavily on the bank's financial condition and ability to raise capital in taking supervisory action and assigning management and asset quality ratings. From 2009 to 2015, First NBC adopted four Board Resolutions (BRs) to address examination findings and matters requiring board attention (MRBA). In hindsight, the FDIC's continued reliance on BRs and MRBA was largely ineffective in correcting the issues raised. In our view, a stronger enforcement action was warranted as early as 2010 based on the bank's risk profile. The FDIC should have set a strong supervisory tone by pursuing a more formal action, which would have been consistent with lessons learned from the financial crisis. Instead, RMS did not take more formal action at First NBC until late 2016 once the bank's financial condition had deteriorated significantly.

Taking a more formal action is predicated, in part, on the examination ratings. Examiners rated First NBC as satisfactory overall from inception through 2015. Examiners reported repeated concerns with bank management and asset quality, but assigned improved ratings to both areas in 2011 and 2014, years that First NBC received significant capital injections. With respect to the management rating, a more critical assessment of the Chief Executive Officer's (CEO) influence on the bank's activities was warranted in light of the bank's rapid growth, reliance of volatile funding, and concentrations in risky loans and complex investments. The 2016 final examination of First NBC was the first to clearly link the Board's reliance on the CEO with significant weaknesses in corporate governance and oversight.

With respect to asset quality, we could not identify any significant improvements in the bank's adversely classified assets trends during the 2011 and 2014 examinations that would warrant an increase in the asset quality rating. The ratings did not reflect the impact of the loan administration issues on asset quality. The asset quality ratings for those two years also did not reflect the complex nature of First NBC's assets, which required robust management practices. Based on the supervisory actions taken with respect to First NBC, the FDIC properly implemented applicable PCA provisions of Section 38 of the FDI Act.

While the First NBC Board and management are ultimately responsible for the poor risk management practices that led to the bank's failure, we are concerned that RMS did not fully apply forward-looking supervision at First NBC – especially considering the characteristics associated with the bank's failure were similar to prior failures and the significance of the loss to the DIF.

Recommendations and Corporation Comments

The report contains two recommendations aimed at ensuring the lessons learned from this failure are appropriately embedded in FDIC's supervision program. On October 31, 2017, the Director, Division of Risk Management Supervision (RMS), provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. In the response, RMS stated that it agreed with the OIG's conclusions regarding the causes of First NBC's failure and concurred with the two recommendations.

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

Office of Program Audits and Evaluations
Office of Inspector General

DATE: November 3, 2017

MEMORANDUM TO: Doreen R. Eberley, Director
Division of Risk Management Supervision

/Signed/
FROM: E. Marshall Gentry
Assistant Inspector General for Program Audits and Evaluations

SUBJECT: *Material Loss Review of First NBC Bank, New Orleans, Louisiana* (Report No. AUD-2018-002)

Section 38(k) of the Federal Deposit Insurance (FDI) Act requires the Inspector General (IG) of the appropriate federal banking agency to complete a review and prepare a report when the Deposit Insurance Fund (DIF)[1] incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver. For losses that occur after January 1, 2014, the FDI Act defines a material loss as any estimated loss to the DIF in excess $50 million. The Louisiana Office of Financial Institutions (OFI) closed First NBC Bank, New Orleans, Louisiana, (First NBC) and appointed the FDIC as receiver on April 28, 2017. First NBC's total assets at closing were $4.0 billion, and the estimated loss to the DIF was $996.9 million.

Accordingly, consistent with our review responsibilities under Section 38, the objectives of this audit were to (1) determine the causes of First NBC's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of First NBC, including implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. The scope of our review included 2008 through April 2017, when First NBC failed. Reviewing this period allowed us to evaluate significant events, issues, and risks that contributed to the bank's failure and how they were addressed by the FDIC. Appendix 1 contains additional details on our objectives, scope, and methodology.

This report presents our analysis of First NBC's failure and the FDIC's efforts to ensure the bank's Board of Directors (Board) and management operated the institution in a safe and sound manner. The report contains two recommendations aimed at ensuring the lessons learned from this failure are appropriately embedded in FDIC's supervision program. In addition, we will periodically analyze major causes, trends, and common characteristics of institution failures that are identified in our material loss reviews (MLR). When appropriate, we will communicate the results of our analyses to FDIC management and may make related recommendations.

[1] Certain terms are underlined when first used in this report and defined in Appendix 2, *Glossary of Terms*.

Background

First NBC was a state-chartered nonmember bank headquartered in New Orleans, Louisiana that opened on May 19, 2006. Initial chartering efforts were interrupted by Hurricane Katrina in August 2005, but investors remained committed to establishing a traditional commercial bank to help with post-Katrina rebuilding efforts in New Orleans. As such the bank was positioned to participate in the post-Katrina recovery efforts that helped fuel much of the bank's growth. The bank was wholly owned by First NBC Bank Holding Company, New Orleans, Louisiana. For most of the bank's existence, the holding company helped to support the bank's financial operations.

The bank grew rapidly during its de novo period through deposit growth and merger activity and eventually operated 35 branches in southern Louisiana and 5 branches located in the Florida panhandle. First NBC also had several subsidiaries that were used primarily to facilitate investments in various federal and state tax credit investment programs. The bank became increasingly reliant on the tax credit investments to boost the bank's earnings.

Beginning with calendar year 2009, the bank was subject to the requirements of Part 362 of the FDIC's Rules and Regulations to have an annual financial statement audit by an independent public accountant and a management report containing, among other items, a statement of management's responsibilities for establishing and maintaining an adequate internal control structure and procedures for financial reporting. In May 2013, the holding company completed its initial public stock offering and was listed on the NASDAQ stock exchange. As a publicly traded company, the holding company was also required to submit certain financial disclosure documents (including a Form 10-K) and was required to have an external audit of its financial statements.

The holding company's 2015 annual external audit identified accounting errors related to the tax credit investments. The external auditor could not provide assurance about the accuracy of the holding company's financial information because of the significance of the errors and thus delayed the holding company's filing of financial reports with NASDAQ. The errors related to the tax credits also resulted in the restatement of the bank's December 31, 2015 financial statements, including a reduction in retained earnings of approximately $54 million. First NBC took steps to stabilize the bank following public disclosure of the accounting errors, including addressing a significant withdrawal of deposits that was caused by concern with the bank's newly identified financial troubles. However, First NBC was unable to maintain sufficient capital to cover the investment and other losses the bank experienced. Table 1 presents selected financial data for the 8 years ending December 31, 2016.

Table 1: Selected Financial Data for First NBC, 2009 to 2016

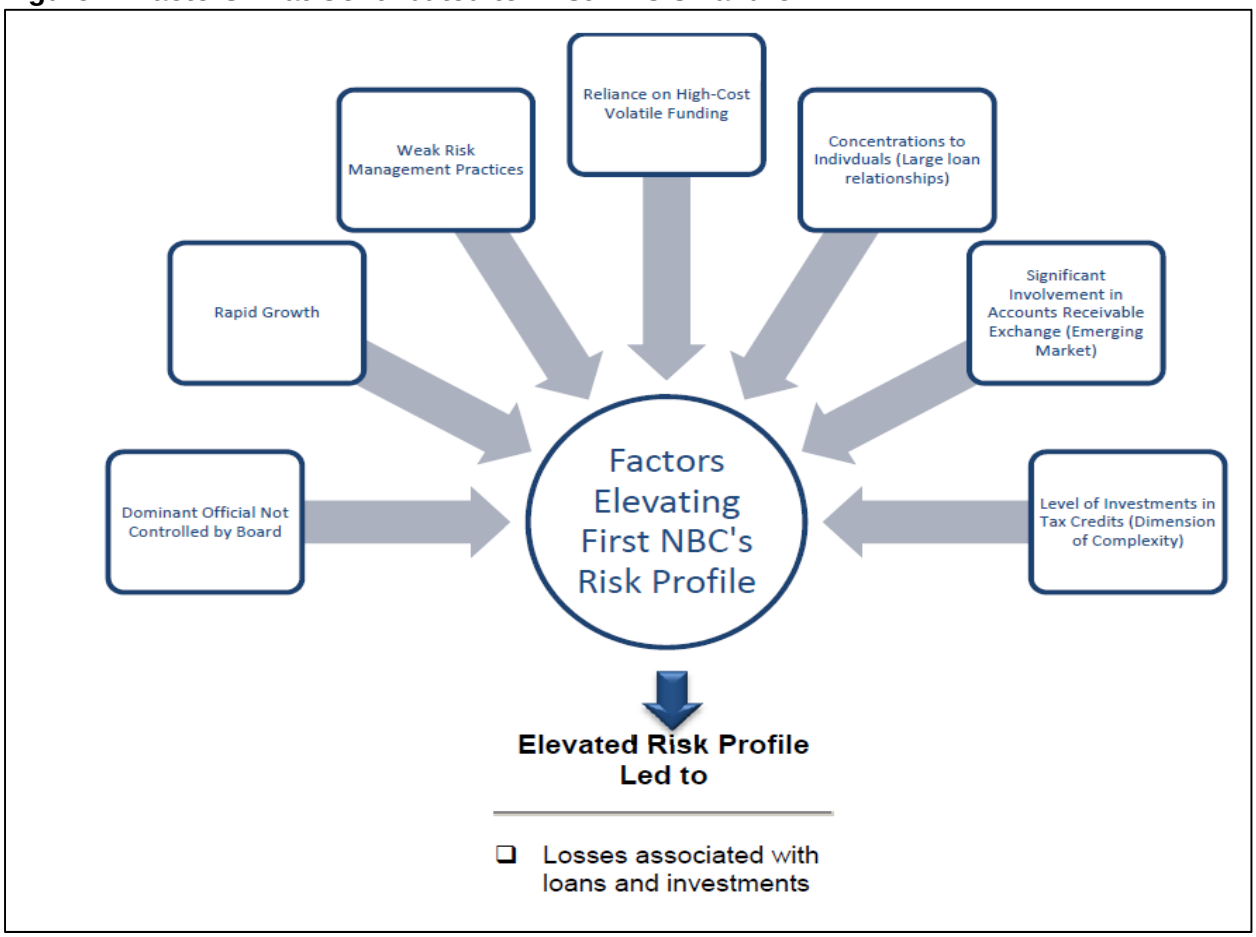
Financial Data ($000s)	12/31/16	12/31/15	12/31/14	12/31/13	12/31/12	12/31/11	12/31/10	12/31/09
Total Assets	4,191,732	4,699,556	3,719,547	3,269,812	2,660,935	2,229,274	1,460,844	994,323
Total Loans	3,945,914	3,486,795	2,947,069	2,544,557	1,914,473	1,613,898	1,115,967	790,992
Total Investments	316,413	666,684	355,127	376,125	495,940	361,372	244,628	141,717
Total Deposits	3,542,798	3,847,295	3,140,317	2,750,969	2,267,788	1,903,616	1,295,018	898,918
Total Equity Capital	-141,691	436,361	381,844	338,306	251,143	216,731	131,731	83,004
FHLB Borrowings*	86,903	8,000	0	0	0	0	0	0
Brokered Deposits	162,940	220,578	220,695	179,283	149,060	97,945	101,437	116,588
Net Income	-568,326	-21,826	45,428	34,459	24,996	17,750	10,443	5,268

Source: Uniform Bank Performance Reports (UBPR) for First NBC.
*Federal Home Loan Bank (FHLB) borrowings with maturity dates of less than 1 year.

Causes of Failure and Material Loss

The following sections detail First NBC's risky banking strategies and practices which led to significant losses and the depletion of the bank's capital. Figure 1 summarizes contributing factors.

Figure 1: Factors That Contributed to First NBC's Failure



Source: OIG analysis of First NBC Reports of Examination and other supervisory documents.

Notably, First NBC exhibited many of the characteristics of bank failures we have identified in prior MLRs and other reviews of the FDIC's supervision program.[2]

Dominant Official with Broad Lending Authority and Limited Board Oversight

Dominant officials and weak Board oversight have been common contributing factors identified in previous MLRs and proved to be a factor at First NBC. Bank officers are responsible for running day-to-day operations in a safe and sound manner and in compliance with applicable laws, rules, and regulations. This responsibility includes implementing appropriate policies and business objectives. The Board is responsible for the formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. First NBC's officers had extensive banking experience and were familiar with the New Orleans banking environment. Examiners noted that the Board members exhibited a diverse set of backgrounds and experiences to help guide the bank. However, an institution may be exposed to potential abuse and/or poor risk selection when the Board relies excessively on a dominant

[2] Prior MLRs reports and the FDIC's actions taken to address trends were captured in the following report: *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010, dated December 2010). The objectives of this assignment are discussed in Appendix 1.

individual or group for its strategy, policy, membership selection, and other decision-making processes.

Throughout its history, examiners characterized First NBC's Chief Executive Officer (CEO) as a dominant official who made most, if not all, of the operational and executive decisions. FDIC guidance related to a dominant official notes that the presence of such an official should not be construed as a supervisory concern in and of itself. Rather, the presence of a dominant official coupled with other risk factors is a concern. These risk factors included a lack of adequate Board oversight, and engaging in questionable or risky business strategies irrespective of the financial performance of the bank. According to a statement in the 2016 examination report, the First NBC CEO dominated the bank's strategy, risk appetite, credit culture, and daily operations through December 2016, when the Board replaced him. According to examination reports, the CEO:

- Was the driver behind the bank's aggressive growth and funding strategy, which is described in more detail in the next section of the report.
- Fulfilled roles not usually compatible with that of a CEO. For example, he acted as the Chief Financial Officer (CFO) overseeing the bank's accounting and financial activities for the first 4 years of the bank's existence, served on the Audit Committee early in the bank's history, and directly oversaw the audit function and its reporting.
- Operated the bank outside policy guidelines at times and engaged in certain lending practices that were not prudent.
- Continued to make loan extensions and other risky credit and investment decisions during his tenure even when those activities were subject to examiner criticisms.
- Was involved in questionable lending decisions. For example, the CEO obtained a $2 million personal loan from one of the bank's borrowers, who had recently received a $9 million unsecured loan from the bank.

Further, examination reports stated that the Board showed little willingness to exercise greater control over the CEO's broad lending authority. Examiners first raised the issue of curtailing the CEO's lending authority in the bank's de novo visitation in 2006. Notably, in 2009, the CEO's lending authority had reached an excessive $13 million. In 2011, the Board reduced his lending authority to $5 million. The Board later increased his loan authority to $7.5 million in 2013 despite prior supervisory concerns about the level of the CEO's lending limit.

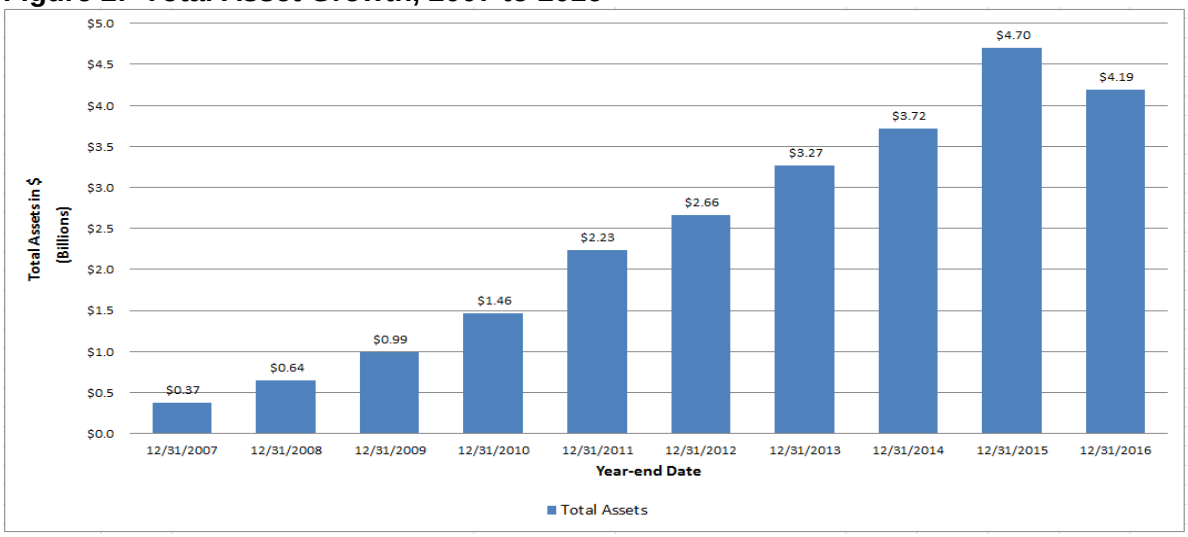
However, the Board did take some action to address supervisory concerns related to the CEO's dominance during the bank's existence. For example, the Board updated the bank's lending policies to address lending authorities; clarified the Board's responsibilities with respect to loan review; hired a CFO so that the CEO could focus his time and attention on Board-approved policies and procedures; and adopted plans to control growth. Unfortunately, the Board did not adequately control the CEO's activities and influence until the bank's asset quality, earnings, and capital had diminished to a point at which the bank was unable to recover. The 2016 examination report attributed the significant weaknesses in corporate governance and oversight to the Board's reliance on the CEO.

Growth and Funding Strategy Elevated the Bank's Risk Profile

First NBC exhibited two other characteristics common to institutions that failed during the financial crisis — pursuit of rapid and aggressive growth and over reliance on volatile funding, including brokered deposits. First NBC conducted these activities without appropriate mitigating risk management and contingency funding strategies. First NBC's initial growth of over $200 million in its first year of operation was in accordance with the bank's business plan.[3] However, by 2008, examiners noted that First NBC's business plan needed to be revised to account for potential merger and acquisition activity not addressed in the original business plan. The FDIC and OFI approved a revised business plan in December 2008. While the bank's total assets were within an acceptable range, the 2009 examination report noted that by June 30, 2009, the bank's asset and liability mix were materially different than what was in the revised plan. In response to regulatory concerns, the bank submitted an updated *Strategic Plan* to the FDIC on March 25, 2010 that was subsequently approved by the Board in July 2010.

In 2010, examiners again noted that the bank's strategic planning process, including the Board's participation, should be reviewed. The bank updated its *Capital and Strategic Plan* in April 2011, but examiners commented that growth seemed to be more aggressive than the bank projected in 2010. From the examiner's perspective, the level of growth was straining the bank's infrastructure (i.e., staffing and the sophistication of risk management processes relative to the bank's portfolio). As shown in Figure 2, First NBC total assets grew from $374 million in 2007 to $4.7 billion at the end of 2015. More specifically, the annual growth rate between 2010 and 2012 was 40 percent. Further, between 2013 and 2016, the bank's 22-percent average asset growth was double the peer group average.

Figure 2: Total Asset Growth, 2007 to 2016



Source: UBPR for First NBC.
*During 2016, First NBC sold assets to Whitney Bank in an effort to reduce its portfolio and to provide additional liquidity.

[3] One of the conditions under the FDIC's Order Granting Deposit Insurance to First NBC required that the bank operate within the parameters of the business plan submitted to the FDIC. Furthermore, during the first 3 years of its operations, First NBC had to notify the FDIC of any major deviation or material change from the plan 60 days before consummation of the change. The FDIC and OFI approved all proposed changes.

To fuel the bank's early growth, First NBC relied heavily on volatile funding beyond the level permitted in the bank's *Asset/Liability Management Policy*.[4] In general, reliance on volatile funding reduces a bank's ability to meet any unforeseen liquidity needs that may arise should these more volatile funding sources leave. In contrast, core deposits are generally stable, lower cost funding sources. Liquidity is essential in all banks to meet customer withdrawals, compensate for balance sheet fluctuations, and provide funds for growth. Liquidity also reflects a financial institution's ability to fund assets and meet financial obligations. In response to examiners' concerns, First NBC management indicated that it monitored the bank's liquidity position on a daily basis and informed the Board of the liquidity position monthly.

In 2008, First NBC's volatile funding sources comprised almost 50 percent of the bank's total liquidity and although volatile funding decreased over the next several years, the bank's use of volatile funding consistently exceeded that of its peer banks. The bank's funding strategy generally included offering the highest interest rates on deposit accounts across the New Orleans metropolitan area. That strategy depended on the bank's ability to satisfy customers' desire for higher interest rates and increased its cost of funds. For example, in 2015, the bank's cost of funds was over 100 basis points higher than the bank's national peer group. The extremely high cost of funding presented risks to earnings, capital, and liquidity. The CEO believed that the rates paid to customers developed loyalty and would establish goodwill among depositors during a period of historically low interest rates.

Offering high interest rates also attracted large deposits – in the form of certificates of deposits larger than insured deposit limits.[5] By March 31, 2016, the bank reported approximately $1.2 billion in uninsured deposits, which represented approximately 30 percent of total deposit liabilities. Uninsured deposits are considered volatile because rising interest rates or negative publicity about the institution can cause these uninsured deposits to flee quickly, which happened at First NBC. Specifically, in October 2016, the media reported that the Federal Reserve Bank of Atlanta and OFI deemed the holding company to be in "troubled condition." This caused many First NBC depositors, primarily large non-core depositors, to withdraw their deposits. Those withdrawals diminished available funding and the bank experienced a significant liquidity crisis. The liquidity crisis was stabilized when Whitney Bank purchased from First NBC $1.3 billion in loans, and assumed approximately $400 million in transaction deposits and $605 million in Federal Home Loan Bank (FHLB) borrowings. However, OFI officials told us that between October 2016 and when the bank closed, dealing with the bank's liquidity position consumed a great deal of management's attention and focus, thereby limiting the bank's ability to properly market assets for sale. According to OFI officials, this forced the bank to sell valuable assets on less than favorable terms in a limited timeframe.

[4] As competitive pressures increase and shareholders seek greater returns, institutions look for ways to fund loan growth. One way is to use non-core or volatile funds.

[5] Since October 3, 2008, the standard insurance amount is $250,000 per depositor, per insured bank, for each account ownership category. Prior to that time the standard insurance amount was $100,000.

Weak Risk Management Practices Exacerbated Credit Risks

Despite significant growth in assets and in the breadth of its activities, the organizational structure and controls at First NBC did not materially change. In the context of newly chartered institutions, the FDIC's Examination Manual states that "changes lead to increased risk and financial problems if accompanying controls and risk management practices are inadequate." Critical elements of effective management and Board supervision include ensuring that appropriate policies, organizational controls, and risk parameters are in place. First NBC's Board and management failed to establish an adequate risk management program commensurate with the risk in the bank's loan portfolio. Risk management deficiencies related to loan extensions and loan reviews were the most prevalent.

First NBC also had several large loan concentrations to single borrowers, which at one point led to four individual borrowers having loan relationships that each exceeded 25 percent of Tier 1 Capital (i.e., one of the FDIC's concentration threshold guidelines). The Examination Manual states that "[c]oncentrations generally are not inherently bad, but do add a dimension of risk which the management of the institution should consider when formulating plans and policies."

Loan Extensions. First NBC's liberal lending practices presented elevated risk to the bank. Specifically, from 2008 through 2016, examiners criticized the bank's liberal lending practices to financially distressed borrowers, such as numerous renewals with little or no repayment of principal, new loans or renewals with additional advances, and questionable collateral protection. The bank extended additional funds to borrowers with apparent cash flow shortfalls through working capital lines of credit. For two borrowers, these lines of credit evolved into short-term, interest-only working capital loans made in 2008 and 2009 and then became long-term fixed borrowings with little or no requirement for repayment of principal within the contractual terms.

Management extended new loans that were used to make payments on existing loans and to cover current taxes and insurance. First NBC also extended loans and allowed proceeds to be used to pay off other delinquent bank loans, again without any requirement for principal payments from the borrowers. Further, many of these loans lacked current appraisals, included limited owner's equity, and had renewals or extensions without principal reduction. The CEO also approved credit line extensions and overdrafts to adversely classified borrowers. First NBC's loan policy did not include maximum maturity dates, capital limits, or other common controls for these relationships.

These extensions masked potential delinquencies and jeopardized the overall safety and soundness of the bank. For instance, a borrower needing multiple loan renewals is likely having cash flow problems. Further, if the bank does not ensure that loan advances are supported by sufficient collateral, the bank's credit risk increases (i.e., the borrower may not repay a loan and the lender may lose the principal of the loan or the interest associated with it). When principal or interest payments are not being paid as scheduled, loans should be reflected as nonperforming. These large loans had on-going renewals or extensions without principal reductions. First NBC suffered significant losses related to large loan relationships that were extended multiple times. The development of large lending relationships and/or individual concentrations without implementing adequate risk management controls to mitigate the risks was another characteristic

commonly found in prior financial institutions that failed. Table 2 illustrates the extent to which three loan relationships grew as a result of multiple loan extensions described by examiners.

Table 2: Selected First NBC Loan Extensions

Borrower	Loan Balance	Increase in Loan Balance Including Loan Extensions	2017 Loan Balance	Percent Increase
A	$5,737,000	$16,954,000	$22,691,000*	296
B	$5,801,176	$12,714,824	$18,516,000	219
C	$7,000,000	$103,545,000	$110,545,000	1,479

Source: OIG analysis of First NBC Reports of Examination and visitations.
* Balance based on 2016 Examination Report.

One of these credits related to oil and gas lending. This was an area for which First NBC did not develop guidance before engaging in this type of lending. The FDIC notes in FIL-49-2016, *Prudent Risk Management of Oil and Gas Exposures*, that lending for oil and gas exploration and production activities requires conservative underwriting, appropriate structuring, experienced and knowledgeable lending staff, and sound loan administration practices. Given the size of the loan, the Board should have established a policy to ensure that the risk limits were defined and the bank's risk exposure could be monitored by the Board. Examiners noted that the loan was not properly underwritten originally in 2011 and the advances were used to finance operating expenses. According to the 2015 examination, the purpose of the credit was to finance oil and gas production at various wells scattered across southern Louisiana. First NBC did not follow any of the common risk management practices for lending in this industry to reduce the impact of pricing and operation risks associated with energy production. By extending additional advances for this loan First NBC exacerbated its risk exposure.

Loan Review. Loan reviews provide the basis for funding the Allowance for Loan and Lease Losses (ALLL) and identifying problem assets in need of workout plans. First NBC loan reviews were overseen by the CEO. Larger institutions typically establish separate loan review departments staffed by independent credit analysts and loan review personnel that report their findings directly to the Board or a Board committee.

Examiners reported weaknesses in First NBC's loan review function in four of six examination reports issued between 2010 and 2016 (see the adjacent text box for specific concerns). First NBC began establishing an internal loan review function in 2011; however, in 2012, examiners reported that the staffing level of two internal reviewers was inadequate. The bank also did not maintain an effective external loan review program as it grew larger and more complex. For example, in 2012 examiners noted instances of the external loan review function not

Nature of Loan Review Deficiencies Noted by Examiners

- Untimely reviews,
- Understaffed,
- Insufficient documentation,
- Failure to identify impairments, and
- Ineffective for the size and complexity of the bank.

Source: First NBC Reports of Examination, 2010 to 2016.

identifying problem credits in a timely manner and by 2016, examiners described the external loan review program as ineffective for the size and complexity of the bank. In addition, the external loan review function failed to cover technically difficult areas of the bank's lending portfolio, such as loans made under the bank's tax credit program.

Examiners also noted that staffing shortages led to accounting, reporting, and credit review deficiencies. In 2010, examiners pointed out that the bank's failure to evaluate the adequacy of the credit analysis staff relative to the growth, size, and complexity of the loan portfolio exacerbated the risk posed to the bank in the credit administration area. According to examiners, the total volume of adversely classified items increased in 2012 to 30 percent of total capital during a time when the loan review function was understaffed. Examiners also attributed apparent violations and contraventions of Statements of Policy to inadequate staffing. Further, due to the ongoing weaknesses in First NBC's loan review program and improper classification of problem loans, First NBC overstated the true condition of the loan portfolio and underfunded the ALLL.

Poor Quality Assets. First NBC's practice of liberally extending additional credit to poorly performing or weak borrowers significantly increased the bank's risk profile, as evidenced by the increase in the volume of adversely classified items relative to capital and the size of individual adversely classified items relative to capital. As shown in Table 3 below, a small number of the bank's large loan relationships comprised a large percentage of the total Adversely Classified Items (ACI) coverage ratio. The ACI coverage ratio is a measure of asset risk and ability of capital to protect against that risk. A higher ratio indicates exposure to poor-quality assets and less ability for the bank's capital to absorb any losses associated with those assets.

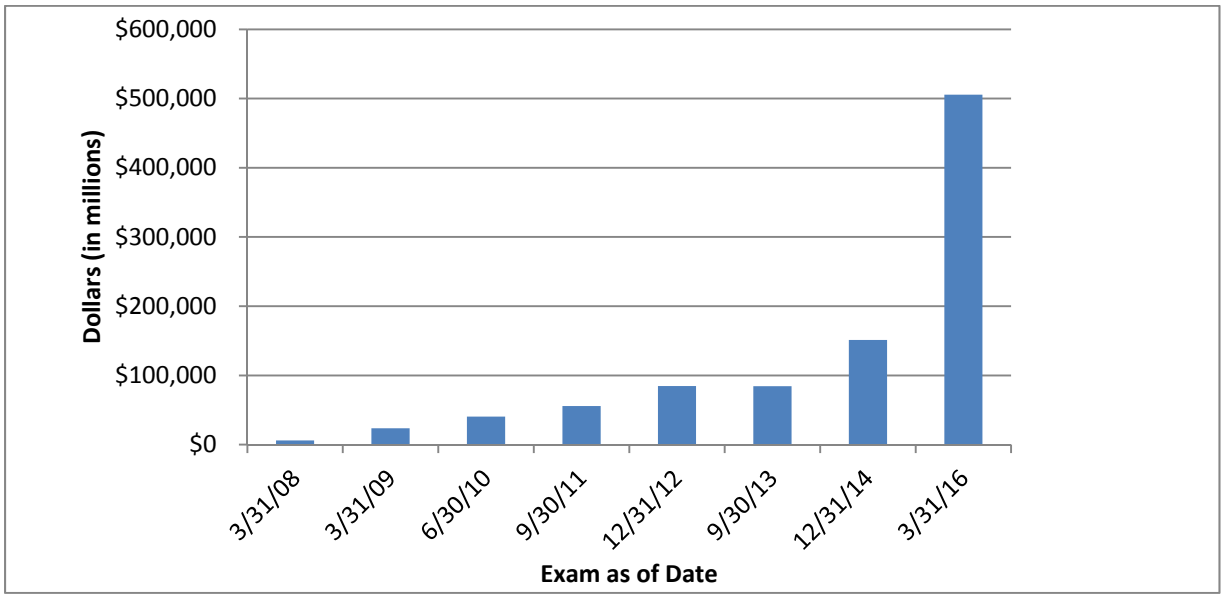
Table 3: Large Loans' Percentage of ACI in Selected Examinations, 2011 to 2016

Examination Date	Number of Loans	Percentage of ACI
October 11, 2011	2	48
December 3, 2012	3	49
February 23, 2015	1	38
May 2, 2016	2	51

Source: First NBC Reports of Examination.

Examiners highlighted in the 2015 examination report that, as an indication of the risks being taken as part of the overall growth of the bank, the volume of ACI increased 274 percent between 2010 and 2015, which was 47 percent faster than the 227 percent growth in assets during the same timeframe. This indicated the high degree of risks taken by the bank as part of its growth strategy. At the 2016 examination, the volume of adversely classified items had more than tripled to $506 million, with at least $90 million in new loan extensions made since the prior examination. Figure 3 indicates the continual increase in the amount of adversely classified items at First NBC.

Figure 3: First NBC's Adversely Classified Items, 2008 to 2016



Source: First NBC Reports of Examination, 2008 to 2016.

Losses Associated with Investment in Trade Receivables

Under the CEO's direction, First NBC also became involved in the purchase of short-term trade receivables in 2013, which were acquired through a third-party intermediary. Specifically, First NBC invested in short-term receivables traded over The Receivables Exchange (TRE). This activity involved purchasing accounts receivable from sellers willing to take a discount on the overall amount owed to them in exchange for immediate returns. Sellers guaranteed repayment of the receivables within a certain period of time, usually less than 120 days. First NBC entered the market for purchasing trade receivables when it was relatively new and became one of the largest national investors. These investments presented credit, liquidity and concentration risk. First NBC's loan policy granted unlimited authority to the CEO up to an average exposure level of $250 million without prior approval or ratification by the Board, which reflected considerable Board deference and less than satisfactory oversight. By 2015, the bank's $250 million investment in trade receivables represented more than 50 percent of total capital. Additionally, First NBC had a substantial concentration in one company, which further elevated its credit risk.

Management perceived these assets as having low risk and earned an average of 1-percent return on funds. Examiners noted that the bank performed a satisfactory level of financial due diligence on any potential purchase and monitored the financial performance of sellers quarterly. However, in addition to concentration risk associated with the level of investment, examiners identified two other risks created by these investments:

- Liquidity Risk. Liquidity risk is the potential that a bank will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding. In a liquidity stress event, it is unknown if the bank can reduce its position on its trade receivables on very short notice without the value of the receivable declining.

- Credit Risk. Credit risk refers to the risk that a borrower may not repay a loan and that the lender may lose the principal of the loan or the interest associated with it. Repayment of the trade receivables is dependent on the financial condition/cash flow from the selling entities.

Examiners determined that the bank had been reporting the receivables as asset-backed debt securities instead of loans as required by Call Report instructions and related accounting standards. The misclassification resulted in a material Call Report error. Further, the bank was not allocating amounts to the ALLL for this category of loans. Banks must maintain an ALLL adequate to absorb estimated credit losses associated with the loan portfolio. By 2016, examiners noted that the bank had an unrecognized impairment in its accounts receivable investments. The charge off of the accounts receivable investments, when coupled with errors related to its tax credit investments discussed below, contributed to the financial decline of the bank.

Accounting Errors Related to Tax Credit Investments Significantly Impacted First NBC's Earnings and Capital

First NBC had a significant investment in projects that generated tax credits totaling $108.6 million as of December 31, 2015. The structure of these investments and related tax credits varied depending on the type of transaction. Further, the bank's significant tax credit investments created another concentration risk. Examiners noted that investing significant sums of money in such instruments carried credit and economic risks and added a dimension of complexity, thus heightening the bank's risk profile.

The bank generally invested in three key types of tax credit transactions:

- New Market Tax Credits. Funded by the U.S. Treasury Department's Community Development Financial Institutions Fund, these credits attract private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic growth, and create jobs.

- Historic Tax Credits. Tax credits that are generated by the re-development of historic properties, which are then sold to inject additional equity into the project upon completion.

How Do Tax Credits Work?

When the bank invests in a project that qualifies for a federal income tax credit, the bank is able to reduce its federal income tax owed by a certain amount based on the percentage granted by the tax credit. For example, the bank invested $100,000 in a historic property valued at $1 million and the tax credit percentage was 20 percent. The bank would be able to directly reduce the amount of federal income taxes owed for that year by $20,000 or 20 percent of the $100,000 current value of its investment.

What if the Bank cannot use all of the available tax credit because the tax credit amount exceeds total income tax owed?

If the tax credit was worth $20,000 but the bank's tax liability for the year was only $15,000, then the bank could record a $5,000 Deferred Tax Asset (DTA) to be used in future years.

- Low-Income Tax Credits. Tax credits that are issued upon completion of housing units and apartments with a percentage of housing designated for low income renters.

As long as these projects were structured properly, they were government approved and would yield tax credits that flowed through to First NBC's earnings.[6] Excess credits that were not used in the current year were recorded as a DTA on the bank's financial statements and could be used in future years when the bank had a tax obligation and income. These "tax carryforwards" are realized only if the institution generates sufficient future taxable income during the carryforward period. Examiners reported that the practice of generating tax credits through loans and direct investments appeared to be an effective strategy as long as the bank remained profitable.

The CEO viewed the investment tax credits to be attractive because they helped to meet requirements under the Community Reinvestment Act (CRA), generated significant earnings, and reduced First NBC's income tax liability. However, two issues existed with this premise: (1) impairments could occur on some of the tax credits because of issues with the related investment project and (2) the bank had to generate enough pre-tax earnings to use the DTA associated with the tax credits. As the bank's investments in complicated federal and state tax credit entities continued to grow, the bank became increasingly reliant on these tax credits to boost earnings performance. As explained in its 2014 annual report, the bank's investment in tax credits was a key part of a strategy to provide shareholders with exceptional returns. Examiners reported that by 2014, recognized tax benefits from tax credit investments accounted for 47 percent of net income.

During the external audit of the bank holding company's 2015 financial statements, the auditors determined that the bank had been incorrectly accounting for tax credit investments. The impairments primarily related to the investments in historic tax credits and resulted in an adjustment of $54 million to retained earnings going back to 2009 with the majority of the impairments recognized in 2014 and 2015. Later in March 2017, the bank recognized a $45 million write-down against retained earnings on its tax credit investments. In addition, just prior to the bank's failure, external auditors determined that the majority of the DTA totaling $400 million would need to be charged off or recognized as significantly impaired, increasing the bank's net losses.[7]

The combination of the losses the bank realized related to its large loan relationships, accounts receivable, and investment tax credits severely diminished the bank's earnings and depleted capital to a point at which the bank could not recover.

The FDIC's Supervision of First NBC

The following sections detail First NBC's supervisory history, and the FDIC's supervisory response to key risks and implementation of PCA.

[6] These investments are subject to tax regulations that must be followed for a 7-year compliance period. If regulations are not followed, the investor risks the recapture of the tax credits. These investments were complicated and heightened the bank's risk profile.

[7] A large portion of the bank's DTA was already excluded from regulatory capital.

Supervisory History

Section 337.12 of the FDIC Rules and Regulations implements section 10(d) of the FDI Act and governs the frequency of examinations for insured state nonmember banks and state savings associations. Between 2006 and 2017, the FDIC and OFI conducted nine full-scope joint safety and soundness examinations of First NBC consistent with these requirements. The FDIC and OFI also conducted six visitations during this period due to its de novo status and for other supervisory follow-up. Table 4 summarizes First NBC Bank's supervisory history, including resulting supervisory ratings and supervisory actions.

Table 4: Supervisory History of First NBC, 2006 to 2017

Examination Start Date	Examination or Visitation	Supervisory Ratings (UFIRS)	Enforcement / Supervisory Action
11/27/2006	Initial visitation 6 months after bank opening	None	None.
06/04/2007	Examination	112322/2	None.
06/30/2008	Examination	212222/2	None.
04/20/2009	Visitation	212222/2	None.
07/13/2009	Examination	232232/2	Board Resolution (BR) dated January 27, 2010 to address deficiencies noted during 2009 examination. Matters Requiring Board's Attention (MRBA).
08/09/2010	Examination	233222/2	BR dated March 2, 2011. The 2010 BR was released on March 2, 2011, and replaced by a new BR of that same date . MRBA.
05/24/2011	Visitation	233222/2	2011 BR remained in effect.
10/11/2011	Examination	222222/2	2011 BR released. February 7, 2012. MRBA.
02/06/2012	Visitation	222222/2	None.
12/03/2012	Examination	233222/2	BR of June 26, 2013. The BR addressed MRBA and other weaknesses. MRBA.
09/30/2013	Visitation	233222/2	2013 BR remained in effect.
01/13/2014	Examination	222122/2	2013 BR released. MRBA.
02/23/2015	Examination	232222/2	BR dated August 26, 2015. MRBA.
05/02/2016	Examination	444443/4	Consent Order of November 10, 2016. MRBA.
11/04/2016	Interim Rating	445453/5	Interim downgrade. The composite, liquidity, and management ratings were downgraded to "5" through an interim downgrade letter.
02/13/2017	Visitation	445453/5	2016 Consent Order remained in effect.
03/03/2017	Interim Rating	545453/5	Interim downgrade. The capital rating was downgraded to "5" through an interim downgrade letter.

Examination Start Date	Examination or Visitation	Supervisory Ratings (UFIRS)	Enforcement / Supervisory Action
04/13/2017	Interim Rating	555555/5	Interim downgrade. The asset quality, earnings, and sensitivity to market risk ratings were downgraded to "5" through an interim downgrade letter.

Source: First NBC reports of examination.

Assessment of Enforcement Actions

As depicted in Table 4, examiners used informal action BRs and MRBA[8] to address examination findings (types of enforcement actions are explained in the text box on this page). MRBA are used to communicate concerns that require the attention of the Board or senior management. MRBAs are a subset of supervisory recommendations and signal a significant level of concern.[9] Supervisory recommendations are not formal or informal enforcement actions, but they are communications of the FDIC's expectations of banks. As required, examiners evaluated actions taken by the Board through follow-up visitations and in subsequent examinations to address both the BRs and MRBA. The BRs also included provisions for providing written progress reports to the FDIC. For the most part, examiners determined that the Board had completed action or acknowledged the Board's effort to comply with the provisions.

The use of the BR and MRBA in 2009 appears consistent with FDIC guidance. Specifically, according to the FIAP Manual, when unacceptable practices are detected early, examiners should bring these matters to the attention of management and engage in discussions regarding the problematic areas and potential corrective actions.

Types of Enforcement Actions

The FDIC generally initiates formal or informal corrective action against institutions with a composite safety and soundness or compliance rating of "3," "4," or "5," unless specific circumstances warrant otherwise.

Informal actions (i.e., BRs or memorandum of understanding (MOU)) are voluntary commitments made by the Board of a financial institution. Informal actions are neither publicly available nor legally enforceable. Informal actions are subject to appropriate follow-up during an interim contact, on-site visitation, or the next examination. A financial institution's failure to implement the corrective measures detailed in an informal agreement may lead to formal corrective actions.

Formal actions (i.e., Consent Orders; removal, prohibition, and suspension actions; and civil monetary penalties) are notices or orders issued by the FDIC against insured financial institutions and/or individual respondents and are legally enforceable. Final orders related to formal actions are available to the public after issuance.

Source: FDIC's *Formal and Informal Actions Procedures Manual* (FIAP).

[8] Since 2010, the FDIC has employed an MRBA tracking system to detail examination recommendations, document management responses from bank management, and facilitate follow-up by regional office and field office staff. The FDIC also periodically analyzes supervisory trends and has summarized those trends in its *Supervisory Insights* publication. That publication is used to promote sound principles and practices for bank supervision.

[9] Supervisory recommendations are FDIC communications with a bank that are intended to inform the bank of the FDIC's views about changes needed in practices, operations, or financial condition.

The ability for examiners and management to engage in discussions is a vital and longstanding part of the examination process and often results in the type of early intervention that is necessary to correct problems before they become serious. Further, if management shows the ability and willingness to correct deficiencies within a reasonable timeframe, then documenting the problems, recommendations for correction, and management's commitment for corrective action in the report of examination will likely be a sufficient supervisory response, subject to appropriate follow-up.

In hindsight, the FDIC's supervisory strategy of relying on BRs and MRBA in subsequent years was largely ineffective in correcting the earlier issues raised. When viewed retrospectively, the actions taken by the Board did not effectively resolve issues because a number of issues reappeared at later examinations. The following MRBA's raised in 2009 and 2010 were never effectively addressed, were subject to repeat criticisms, and ultimately contributed to the bank's failure:

- Need for the Board to become more active in the supervision of the bank,
- CEO's excessive lending authority,
- Reliance on volatile funding sources,
- Level of adversely classified items,
- Staffing shortfall in key areas, and
- Risks associated with tax credit investment limits and guidance.

When actions do not achieve the desired result or if the initially identified problems are more serious, FDIC guidance states that the issuance of an informal or even formal corrective action may be warranted. This may be the case even when an institution is rated a composite "1" or "2" for safety and soundness examinations so that the specific actions or inactions by the institution can be addressed and corrected. Examination recommendations are not always effective in prompting management to take corrective action, and greater supervisory concern and earlier action is needed to address banks with high-risk profiles or weak risk management practices. Moreover, the supervisory strategy pursued for First NBC was not reflective of the FDIC's conclusions based on trends from prior MLRs.

Forward-Looking Supervision

Developed in response to the MLR trends and issues, the FDIC's forward-looking supervision initiative was designed to build upon the strengths of the supervision program, emphasized balanced and timely response to weak risk management practices and identified risk, and emphasized a forward-looking approach to analysis and ratings based upon lessons learned from financial institution failures during the financial crisis.

The goal of the program is to identify and assess the potential impact of an institution's new and/or growing risks and ensure early mitigation if necessary.

The FDIC should have entered into an MOU with First NBC as early as 2010 based on the bank's risk profile. More formal action was not taken until late in 2016 once the bank's financial condition had deteriorated significantly. Setting a strong supervisory tone by pursuing a more formal action earlier would have been consistent with lessons learned from the financial crisis and the FDIC's forward-looking supervisory approach developed in response to those trends. For example, strong enforcement action is needed early for young institutions that are aggressive growers, rely on volatile funding, and have weak risk

management practices.[10] Also, taking a more aggressive supervisory posture could have helped ensure the Board understood and responded to the risks of relying on the CEO to the degree that it did and the responsibility it bore for not controlling his activities. As noted in supervisory guidance, not dealing with a dominant official early makes supervisory action more difficult later. Considering First NBC exhibited many characteristics common to banks that failed and, as previously discussed in the *Causes of Failure and Material Loss* section of the report, the need for a more aggressive supervisory response should have been clear.

In addition, examiners should have included a provision to address the CEO's dominance in 2010. Although the March 2011 BR included a provision related to management, the provision focused on the retention of qualified management. Indeed, the Board engaged a firm to evaluate the qualifications and experience of the management team. That firm concluded that management was qualified. The FDIC's guidance on dominant officials states that enforcement action provisions should be tailored to, and specifically address, the risks identified by specifying what actions the institution should take to mitigate the risks. For example, a provision could have required a study to identify specific actions that the Board should take to mitigate the risks associated with the dominant CEO. In retrospect, it is clear that requiring First NBC to undertake such a study would have been appropriate and timely.

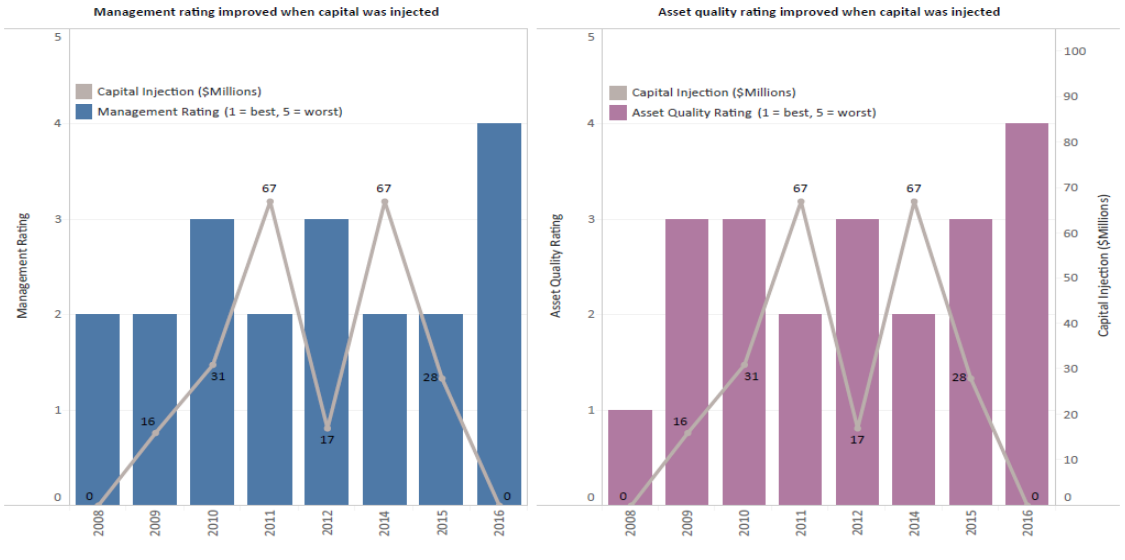
Supervisory Response Not Reflective of Forward-Looking Supervision Principles

The ratings at First NBC reflected the bank's financial condition at the time of the examination, rather than a forward-looking perspective of the bank's increasing risk profile and ability to mitigate risks. Analysis of prior failures has indicated that although the management component rating is stand-alone, in some instances examiners found it difficult to rate management low (i.e., "4" or "5") if capital and earnings were strong, even if examiners had noted concerns with management practices. As a result, in some cases, composite ratings remained relatively high (i.e., "1" or" 2") until capital and earnings began to decline.[11]

As shown in figure 4, asset quality and management ratings improved in 2011 and 2014, years that First NBC received significant capital injections, despite the fact that various risk factors were consistently identified. Moreover, First NBC's composite rating was a "2" (i.e., fundamentally sound) until the institution experienced financial decline in 2016 and then it was downgraded to a "4" (i.e., exhibiting unsafe and unsound practices).

[10] Institutions that are less than 8 years old are considered "young" institutions.
[11] United States Government Accountability Office (GAO) report entitled *Lessons Learned and a Framework for Monitoring Emerging Risks and Regulatory Response* (Report No. GAO-15-365).

Figure 4: Analysis of Asset Quality and Management-Related Issues, 2008 to 2016



Examiners noted repeated management and asset quality concerns

Concerns	2008	2009	2010	2011	2012	2014	2015	2016
Asset quality		✓	✓	✓	✓	✓	✓	✓
CEO excessive lending authorities		✓	✓		✓	✓	✓	✓
Credit concentrations	✓	✓	✓	✓	✓	✓	✓	✓
Inactive Board of Directors	✓	✓	✓	✓	✓		✓	✓
Loan underwriting / credit administration	✓	✓	✓	✓	✓	✓	✓	✓
Presence of a dominant official	✓	✓	✓	✓	✓	✓	✓	✓
Rapid growth	✓	✓	✓	✓	✓	✓	✓	✓
Reliance on volatile funding sources	✓	✓	✓	✓			✓	✓

Source: OIG analysis of First NBC Reports of Examination.

The FDIC should have considered the totality of First NBC's risk profile in assigning the composite and component ratings – particularly the management and asset quality ratings. Our detailed assessment of the management, asset quality, and capital ratings follows.

<u>Management Ratings Did Not Consistently Reflect Risk and Repetitiveness of Issues</u>

According to the Examination Manual, "the management component rating indicates the capability of the Board and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation is in compliance with applicable laws and regulations." Table 5 summarizes First NBC's management component ratings relative to capital ratings and capital injections.

Table 5: First NBC's Management Rating, 2008 to 2016

Examination	2008-2009	2010	2011	2012	2014	2015	2016
Management Rating	2	3	2	3	2	2	4*
Capital Injection($000)	16,050	31,348	67,043	16,600	67,000	27,662	
Capital Rating	2	2	2	2	2	2	4*

Source: First NBC Reports of Examination and Call Reports.
*As a result of 2017 visitation ratings downgraded to "5."

Examiners told us that they were concerned by First NBC's rapid growth and inadequate staffing levels relative to the breadth and complexity of the growing bank's operations. But in 2008 and 2009, examiners were confident that management would ensure adequate staffing was in place to handle the rapid growth. In 2010, the management rating was downgraded to a "3," which indicated improvements were needed and risk management practices were less than satisfactory. The level of management-related issues identified in subsequent examinations could have supported a "3" rating of management – especially considering similarities of issues reported.

According to the Division of Risk Management Supervision's (RMS) own analysis of the bank's supervisory history, increased capital levels supported the component rating increase in 2011. The FDIC should have been proactive in 2011 and established clear supervisory expectations to a young growing institution. Keeping the management rating a "3" would have emphasized the underlying importance of establishing strong credit and risk management practices to keep pace with the bank's growth and increasing volume of adversely classified items before the financial condition of the institution was in jeopardy. This is a fundamental principle of forward-looking supervision. Further, a "3" rating would have better reflected the risks associated with the presence of a dominant official, given examiners had encouraged the Board to take a more active role in overseeing the bank beginning in 2009.

The 2014 examination stated that the management component "2" rating reflected improvements and placed emphasis on the financial condition of the bank, including a $67 million capital injection from the holding company. Although examiners concluded that risk management practices were adequate, the examination report notes management's use of loan extensions and overdrafts and other loan administration issues previously noted as concerns.

Examiner's Assessment of the Dominant CEO. One of the factors that should be assessed when assigning the management component rating is "the extent that the [Board] and management is affected by, or susceptible to, dominant influence or concentration of authority." Dominant officials or policymakers have been identified as a key risk factor in not only fraud and abuse schemes in financial institutions but also near failures and failures for many years. Specifically, institutions with dominant officials present at least two supervisory concerns:

- The bank may become vulnerable to dishonest or incompetent management should the dominant official become incapacitated; and

- Normal supervisory efforts to solve problem situations resulting from mismanagement are more difficult because the problems are often attributed to the dominant official.

In this case, examiners did identify and assess the CEO as a dominant official in every examination. However, a more critical assessment of his influence on the bank's activities was warranted considering criticisms related to the lack of Board oversight and the risky business strategies that the bank pursued. Prior to the 2009 examination, his dominance was not a concern. Specifically, examiners viewed the bank's CEO to be capable, experienced, and gave him credit for assembling an experienced team. In 2009, examiners began emphasizing that the Board needed to take a more active role. The report noted that the CEO oversaw the daily operations and was a dominant policymaker in the organization. The CEO had adopted an

aggressive growth strategy funded by volatile liabilities, grew the institution materially beyond the approved business plan, had an excessive lending authority, and had been allowed to operate the bank outside policy guidance for liquidity and non-core funding for an extended period. These observations did not appear to impact the management component rating.

Likewise, in a 2013 visitation, the examiners' conclusion that the Board showed little willingness to exercise greater oversight and control over the CEO did not appear to factor into the management rating in 2014. The 2014 examination did not draw a similar conclusion, but this examination noted that the Board had not established any formal underwriting or administrative guidelines for the trade receivables other than establishing a $250 million limit. While the examination found the bank's practices to be adequate, the lack of policies surrounding a significant level of activity should have been a concern, especially considering it was not the first time examiners found policies to be lacking.

Moreover, except for 2010 and 2012, the excessive nature of the CEO's lending authority did not factor into the management component rating. The Board took action to define the lending limit in response to the 2010 examination. The Board's decision to increase the CEO's lending authority in 2013 from $5 million to $7.5 million and associated risks did not appear to factor into the management rating despite prior regulatory criticism.

The 2015 examination noted that the CEO continued to dominate policy and exert considerable influence over all key functions with limited Board oversight. As a result, examiners concluded that the bank's overall risk profile was elevated. Again, despite the concern, the management rating remained a "2." The 2016 and last examination of First NBC was the first to clearly link the Board's reliance on the CEO with significant weaknesses in corporate governance and oversight. Further, examiners reported that significant adverse classifications, related to large borrowing relationships originated or indirectly influenced by the CEO, were not internally identified as problem credits.

In response to a recommendation in our prior report *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010, dated December 2010), RMS issued internal guidance on identifying and assessing dominant officials in 2011. The guidance was more recently updated in December 2015 to reinforce, clarify, and re-issue examination guidance. The new guidance is consistent with the earlier guidance and, thus, was available for examiner consideration after 2011.

Examiner's Application of Fraud and Insider Abuse Procedures. RMS guidance on dominant officials also references the *Bank Fraud and Insider Abuse* section in the Examination Manual. That sections states that "[t]he early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the FDIC's deposit insurance funds and uninsured depositors. It is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity." That section of the Examination Manual is designed to help alert examiners to possible fraudulent activity and insider abuse and is viewed as a "tool," a supplement to standard examination procedures "as-needed". It includes a listing of warning signs of the most frequently occurring areas of possible fraud and insider abuse. Table 6 lists some of the warning signs included in this section of the Examination Manual that

were relevant based on our review of examination reports, notwithstanding mitigating factors that might have been considered by examiners.

Table 6: Warning Signs of Possible Fraud or Insider Abuse

• Lack of Board oversight, particularly outside Directors. • CEO controls internal and outside auditors. • Insider borrowing from customers. • Insider appears to receive special favors from institution customers or shows unusual favoritism toward certain institution customers. • Lack of lending policies or failure to enforce existing policies. • Lack of code of conduct or failure to enforce existing code. • Dominant figure allowed to exert influence without restraint.	• Lack of separation of duties. • Lack of accountability. • Entering into transactions where the institution lacks expertise. • Excessive growth through low quality loans. • There is a heavy concentration of loans to a single project or to individuals related to the project. • Unwarranted concentrations. • Volatile sources of funding such as short term deposits from out of area brokers. • High rate - high risk investments. • Underwriting criteria allows high risk loans.	• Lack of documentation or poor documentation. • Lack of adequate credit analysis. • Failure to properly obtain and evaluate credit data, collateral, etc. • Failure to properly analyze and verify financial statement data. • Too much emphasis on character and collateral and not enough emphasis on credit. • Lack of balance in loan portfolio. • Poor loan administration after credit is granted. • Compromising credit policies. • Circumvention of established policies and/or controls.

Source: Excerpts from the Examination Manual Section 9.1, Bank Fraud and Insider Abuse.

Recognizing that consideration of these warning signs is a matter of examiner judgment, the examination reports did not indicate that any expanded procedures related to possible fraud or insider abuse were performed. In June 2016, RMS issued enhanced guidance for conducting internal control and fraud reviews to provide examiners more guidance on how to identify red flags and perform associated examination procedures. The guidance also included a new examiner reference tool. While this enhanced guidance was not available at the time of First NBC's examinations, the memorandum serves as a timely reminder and reiterates tools available to examiners.

In 2016, examiners decreased the management rating to a "4" to reflect significant deterioration in all financial and operational areas. The examination identified for the sixth time that the bank's use of liberal renewal and extension practices to assist distressed borrowers may be masking delinquencies. Examiners made recommendations regarding unresolved credit administration deficiencies, weaknesses in underwriting, unsatisfactory problem loan identification systems, and aggressive growth strategies. Examiners found First NBC's loan reviews to be ineffective in relation to the size and complexity of the bank. A Consent Order was issued requiring among other things that the bank address the examination findings that included numerous risk management issues that were not fully addressed.

Asset Quality Ratings Did Not Reflect Growing Risk Profile

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operations, markets, reputational, strategic, or

compliance risks, should also be considered. Table 7 summarizes First NBC's asset quality component rating.

Table 7: First NBC's Asset Quality Rating, 2007 to 2016

Examination	2007-2008	2009-2010	2011	2012	2014	2015	2016
Asset Quality Rating	1	3	2	3	2	3	4

Source: First NBC Reports of Examination.

In 2009, only three years after the bank opened, examiners identified a dramatic increase in adversely classified items, concentrated in two large loans. Examiners also highlighted underwriting and credit administration weaknesses, including lack of current appraisals, limited owner's equity, and renewals or extensions without principal reduction. Examiners upgraded the asset quality rating to a "2" in 2011 and 2014, in part, because First NBC's ACI coverage ratio declined. The ratio measures the amount of capital at risk should an asset be written off or down due to loan quality issues. We noted that the ACI coverage ratio improved because of increased capital, not because of a significant decrease in the dollar amount of adversely classified items.

In our view, a "2" rating in these 2 years did not reflect a comprehensive perspective of the risks associated with First NBC's assets. For example, the "2" rating did not appear to reflect the complexity associated with the tax credit investments at First NBC. The regional accounting specialist noted that the level of the bank's investment in tax credits added a dimension of risk to what were already complex assets to track and monitor. Also, the 2014 examination report did not mention many of the risk management weaknesses that were included in both the 2012 and 2015 examination reports.

With regard to the trade receivables, examiners first discussed the bank's purchase of trade receivables in the 2013 visitation report. The visitation report indicated that the bank had $177 million in receivables as of June 30, 2013, which represented 52 percent of Tier 1 Capital. As of September 30, 2013, trade receivables had increased to $192 million or 57 percent of Tier 1 Capital representing a concentration to the bank. Further, the 2014 examination pointed out that the bank had incorrectly recorded the trade receivables as securities when they should have been recorded as loans. The bank did not have loan policies governing this new type of investment, including minimum credit quality standards and concentration limits for these investments. While examiner's identified and assessed practices around this new concentration, the lack of policies and limitations on these investments, and incorrect accounting did not appear to impact the asset quality rating in 2014.

The final examination of First NBC in 2016 reported significant asset quality deterioration and the asset quality rating was downgraded to "4." The volume of adversely classified items more than tripled to over $505 million, resulting in an ACI coverage ratio at 124 percent of Tier 1 Capital plus the ALLL. New classifications included the $54 million impairment of the tax credit investments, a $59 million remainder of an accounts receivable loan, $53 million in new extensions to a borrower whose loans were classified at the prior examination, and a $73 million exposure to a previously unclassified borrower, that included $37 million in new extensions since the prior examination. Unresolved credit administration deficiencies, weaknesses in

underwriting, unsatisfactory problem loan identification systems, and aggressive growth strategies also contributed to the overall deterioration in asset quality. As a result of the 2016 examination, the FDIC pursued a Consent Order, which required the Board to develop a plan for reducing problem loans, and addressing loan review and other credit administration weaknesses.

Examiner's Assessment of Capital

The Examination Manual states that "an FDIC-supervised institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks." First NBC's capital levels were "2" rated and considered satisfactory between 2008 and 2015. In 2010, examiners contemplated a "3" rating, but the bank raised capital so the capital rating remained a "2." Although capital was deemed satisfactory in 2015, examiners noted that strong growth coupled with increasing risk factors indicated the potential need for increased capital in the near future unless the Board established firm risk tolerances to limit or reduce the bank's risk profile. First NBC instituted a BR on August 26, 2015 stating that the Tier 1 leverage capital ratio would be maintained at a minimum of 10 percent, and the total risk-based capital ratio shall be maintained at a minimum of 13 percent. Additional information about capital is covered in our assessment of PCA below.

Conclusions on Supervisory Response and Recommendations

RMS implemented its forward-looking supervision program, including related training initiatives, in response to lessons learned from the past financial crisis. The program is intended to help ensure that the supervision program reflects and reinforces lessons learned from the past crisis and continues to be a strategic priority for RMS. That said, we are concerned that RMS did not fully apply a forward-looking supervisory approach at First NBC – especially considering the characteristics associated with the bank's failure were similar to prior failures and the significance of the loss to the DIF. It should be noted that we have an ongoing evaluation related to *Implementing Forward-Looking Supervision*, which will assess whether the intended outcomes of the Forward-Looking Supervision Program have been achieved at the FDIC.

During the financial crisis, the FDIC conducted internal post-material loss assessments of FDIC-supervised institution failures that cause a material loss to the Deposit Insurance Fund. RMS rescinded the Regional Director memorandum containing this requirement in 2011. Although there is no longer a requirement, the Director of RMS informed us that RMS had planned to conduct a post-material loss assessment for First NBC given the unusual aspects of this institution's operations. According to RMS, this assessment will incorporate information from our MLR report, as well as feedback from field examination personnel based on their involvement in the institution's supervision.

We recommend that the Director, RMS:

Recommendation 1. Complete a post material loss assessment of the FDIC's supervision of First NBC to ensure proper implementation of FDIC guidance, including guidance related to (1) dominant officials and (2) application of forward-looking supervision.

Recommendation 2. Update training materials and conduct training to reflect the lessons learned from this failure.

Implementation of PCA

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

Part 324, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 324 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to First NBC, the FDIC properly implemented applicable PCA provisions of Section 38 of the FDI Act. First NBC was considered *Well Capitalized* for PCA purposes from 2006 through February 2015. Table 8 summarizes First NBC's capital ratios relative to the PCA thresholds for *Well Capitalized* institutions during examinations and at other key points in time.

Table 8: First NBC's Capital Ratios and Categories, 2008 to 2017

Examination or Notification Date	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Tier 1 Leverage Capital Ratio	PCA Capital Category
Well Capitalized Thresholds.	**≥10%**	**≥6%(prior to 1/1/15)** **≥8% (post 1/1/15)**	**≥5%**	
06/30/2008	16.12%	15.44%	13.77%	*Well Capitalized*
07/13/2009	10.33%	9.64%	9.02%	*Well Capitalized*
08/09/2010	10.01%	9.21%	7.60%	*Well Capitalized*
10/11/2011	16.00%	14.97%	12.38%	*Well Capitalized*
12/3/2012	12.97%	11.90%	9.90%	*Well Capitalized*
01/13/2014	14.06%	12.92%	10.99%	*Well Capitalized*
02/23/2015	11.92%	10.67%	9.81%	*Well Capitalized*
05/02/2016	9.61%	8.49%	7.43%	*Adequately Capitalized*
02/09/2017 - PCA Notification based on 12/31/2016 Call Report	5.97%	4.65%	4.45%	*Significantly Undercapitalized*
04/26/2017 - PCA Notification effective as of 04/10/2017	-1.72%	-1.99%	-3.13%	*Critically Undercapitalized*

Source: OIG analysis of First NBC's examination reports, enforcement actions, and PCA activities.

In May 2016, examiners downgraded capital to a "4" and concluded that First NBC's capital levels were deficient in relation to the bank's continued high risk profile. Examiners noted that the Tier 1 Leverage Capital ratio was 7.43 percent and the Total Risk Based Capital ratio was 9.61 percent, both well below the requirements outlined in the August 26, 2015 BR. Significant historical tax credit and short-term receivable losses had eroded the capital base. Moreover, capital levels were deemed insufficient given the excessive level of problem assets and rapid growth over the past 3 years. As a result, examiners recommended that management develop a specific action plan to increase capital levels.

By November 2016, First NBC was operating under a Consent Order with a capital maintenance provision, requiring the bank to remain *Well Capitalized* per PCA guidelines until the Order was rescinded. On February 9, 2017, the FDIC sent First NBC a PCA notification letter stating that based on its December 31, 2016, Call Report, the bank fell within the *Significantly Undercapitalized* PCA capital category. This notification letter required the bank to file a capital restoration plan. The FDIC received First NBC's plan on March 22, 2017. Finally, on April 26, 2017, the FDIC sent a notification letter informing First NBC that it was *Critically Undercapitalized*, effective as of April 10, 2017.

OIG Evaluation of Corporation Comments

After we issued our draft report, RMS provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. We also received a letter from the Louisiana Commissioner of Financial Institutions commenting on our draft report and we made revisions to our report where appropriate. On October 31, 2017, the Director, RMS, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. In the response, RMS stated that it agreed with the OIG's conclusions regarding the causes of First NBC's failure and concurred with the two recommendations. A summary of the Corporation's corrective actions is presented in Appendix 5.

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to (1) determine the causes of First NBC's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

Scope and Methodology

The scope of our review covered examinations and visitations performed and supervisory actions taken from 2008 until First NBC failed on April 28, 2017. We selected this time period to ensure coverage of First NBC's de novo period and to include First NBC's acquisition of five other banks in 2008, 2010, and 2015.

To accomplish our objectives, we reviewed:

- The FDIC's *Failing Bank Case* and *Supervisory History* for First NBC and FDIC and OFI examination reports, visitation reports, correspondence, and other relevant documentation.
- Pertinent regulations, policies, procedures, and guidance, including RMS's *Risk Management Manual of Examination Policies* (Examination Manual) and the FDIC's Financial Institution Supervisory and Enforcement Action guidance.
- First NBC Bank Holding Company annual reports, Securities and Exchange Commission 10-k filings, UBPRs, and Call Report data.
- Correspondence and other documentation located in the Regional Automated Document Distribution and Imaging System (RADD) database.

We interviewed RMS officials from the FDIC's Dallas Regional Office, Memphis Area Office, and Baton Rouge Field Office and OFI officials. We obtained their perspectives on the principal causes of First NBC's failure, the FDIC's supervisory approach, and other technical assistance that the FDIC provided to First NBC.

We performed certain procedures to determine whether the FDIC had complied with relevant PCA provisions in section 38 of the FDI Act. We also assessed compliance with aspects of the FDIC Rules and Regulations, including examination frequency requirements defined in Part 337.12.

We obtained data from various FDIC systems, such as the FDIC's Virtual Supervisory Information on the Net (ViSION) and RADD. We determined that information system controls pertaining to these systems were not significant to the audit objectives. Therefore, we did not evaluate the effectiveness of information system controls. We relied primarily upon examination reports, memoranda, and other correspondence, as well as testimonial evidence, to validate system-generated information.

Objectives, Scope, and Methodology

We assessed the risk of fraud and abuse in the context of our audit objectives in the course of evaluating audit evidence. We reviewed available bank and FDIC documentation, inquired with OIG Office of Investigations personnel, and interviewed FDIC and OFI officials about any ongoing investigations or possibility of fraud within the bank.

We conducted our work from May 2017 through August 2017 in accordance with *Generally Accepted Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provided a reasonable basis for our findings and conclusions based on our audit objectives.

We performed our work at the FDIC's offices in Arlington, Virginia, the Dallas Regional Office, and the Baton Rouge Field Office.

Related Coverage of Financial Institution Failures

The OIG issued a number of MLR and related reports that can be found at www.fdicig.gov. We considered the following reports in planning and conducting our MLR of First NBC:

- *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), December 2010. The objectives of the FDIC OIG audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those in response to a May 2009 OIG memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

- *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), September 2011. The OIGs of the FDIC, the Department of the Treasury, and the Board of Governors of the Federal Reserve System issued this evaluation report. This report assessed the role and Federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, Prompt Corrective Action, and section 39, Standards for Safety and Soundness) in the banking crisis.

- *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (Report No. EVAL-13-002), January 2013. This FDIC OIG report addressed a number of topics relevant to institution failures, such as the evaluation and use of appraisals, the implementation of the FDIC's policy statement on CRE loan workouts, risk management enforcement actions, and examiner assessments of capital.

Glossary

Term	Definition
Adversely Classified Items	Assets subject to criticism and/or comment in an examination report. Adversely classified items are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Adversely Classified Items Coverage Ratio	A measure of the level of credit risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and may also indicate less ability to absorb the consequences of bad loans.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Board Resolution (BR)	A BR is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Consolidated Report of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Consent Order	A formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or violation of laws and regulations. A consent order may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

Glossary of Terms

Deferred Tax Asset (DTA)	DTAs are assets that reflect, for reporting purposes, amounts that will be realized as reductions of future taxes or as future receivables from a taxing authority. DTAs may arise because of specific limitations requiring that certain net operating losses or tax credits be carried forward if they cannot be used to recover taxes previously paid. These "tax carryforwards" are realized only if the institution generates sufficient future taxable income during the carryforward period.
De novo	De novo refers to a new bank during its first 3 years of operation. De novo banks are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency.
Deposit Insurance Fund (DIF)	A fund administered by the FDIC, the goal of which is to (1) insure deposits and protect depositors of FDIC-insured institutions and (2) resolve failed FDIC-insured institutions at the least cost (unless a systemic risk determination is made). The DIF is primarily funded by deposit insurance assessments.
External Loan Review Program	An external loan review is performed by a party independent of the financial institution that monitors the quality of the respective institution's loan portfolio as it relates to internal lending policies and the effectiveness of the credit administration function, and is thus a tool to be utilized by Senior Management and the Board. The Board of Directors of each financial institution has the legal responsibility to formulate appropriate lending policies and to supervise ongoing implementation thereof. It is essential that an effective loan review program be in place at all regulated financial institutions.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's Division of Risk Management Supervision (RMS) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
Federal Home Loan Bank (FHLB)	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.

Glossary of Terms

Form 10-K	A form 10-K is a comprehensive overview of the company's business and financial conditions and includes audited financial statements.
Material Loss	Any estimated loss to the DIF in excess of $50 million for losses that occur on or after January 1, 2014 (as defined by section 38(k)(2)(a) and 38(k)(2)(B) of the FDI Act and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act).
Matters Requiring Board Attention (MRBA)	Supervisory recommendations involving an issue or risk of significant importance and that would typically require more effort to address than those correctable in the normal course, need to be brought to the attention of the board and senior management through MRBA comments.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
NASDAQ	A global electronic marketplace for buying and selling securities, as well as the benchmark index for U.S. technology stocks. Nasdaq was created by the National Association of Securities Dealers (NASD) to enable investors to trade securities on a computerized, speedy and transparent system, and commenced operations on February 8, 1971.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 324, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 324.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C., section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*.
The Receivables Exchange	The Receivables Exchange, LLC operates an auction-based online marketplace that connects sellers of trade receivables to a network of institutional buyers. The company provides an electronic exchange for the sale and purchase of accounts receivable.

Glossary of Terms

Tier 1 Capital (Equity Capital)	The sum of Common Equity Tier 1 capital and Additional Tier 1 capital. Common Equity Tier 1 capital is the most loss-absorbing form of capital, which includes qualifying common stock and related surplus net of treasury stock; retained earnings; and qualifying common equity Tier 1 minority interests. Depending on how the institution elects to calculate regulatory capital, Tier 1 capital may also include certain accumulated other comprehensive income elements plus or minus regulatory deductions or adjustments as appropriate. The federal banking agencies expect the majority of common equity Tier 1 capital to be in the form of common voting shares. Additional Tier 1 capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund and Troubled Asset Relief Program instruments that previously qualified for Tier 1 capital, and qualifying Tier 1 minority interests, less certain investments in other unconsolidated financial institutions' instruments that would otherwise qualify as additional Tier 1 capital.
Tier 1 Leverage Capital Ratio	Tier 1 capital (equity capital) divided by average total assets.
Tier 1 Risk-Based Capital Ratio	Tier 1 risk-based capital divided by risk-weighted assets.
Total Risk-Based Capital Ratio	Total risk-based capital divided by risk-weighted assets.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that provides comparisons to peer group performance. It is produced by the FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.
Volatile Funding	Sources of deposits that may be substantially more rate sensitive than the typical core deposits. Volatile funding sources include, but are not limited to, federal funds, public funds, FHLB advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or certificate of deposit listing services. Financial institutions may use volatile funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Acronyms and Abbrevations

ACI	Adversely Classified Items
ALLL	Allowance for Loan and Lease Losses
BR	Board Resolution
CAMELS	**C**apital Adequacy, **A**sset Quality, **M**anagement Practices, **E**arnings Performance, **L**iquidity Position, and **S**ensitivity to Market Risk
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CRA	Community Reinvestment Act
DIF	Deposit Insurance Fund
DTA	Deferred Tax Asset
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
FIAP	Formal and Informal Actions Procedures Manual
GAO	Government Accountability Office
MLR	Material Loss Review
MOU	Memorandum of Understanding
MRBA	Matters Requiring Board Attention
OFI	Louisiana Office of Financial Institutions
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RADD	Regional Automated Document Distribution and Imaging System
RMS	Division of Risk Management Supervision
TRE	The Receivables Exchange
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.C.	United States Code
ViSION	Virtual Supervisory Information on the Net

Corporation Comments

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

October 31, 2017

TO: E. Marshall Gentry
Assistant Inspector General for Program Audits and Evaluations

/Signed/
FROM: Doreen R. Eberley
Director

SUBJECT: Response to the Draft Audit Report Entitled, Material Loss Review of First NBC Bank, New Orleans, Louisiana (Assignment No. 2017-027)

Thank you for the opportunity to review and respond to the Draft Audit Report, Material Loss Review of First NBC Bank, New Orleans, Louisiana, (Draft Report) received October 10, 2017. First NBC Bank became insolvent and failed on April 28, 2017, after recognizing losses on the sale of certain assets, writing down uncollectible assets, and provisioning for future expected loan losses. The Federal Deposit Insurance Corporation (FDIC) was named receiver upon the bank's failure. As detailed more fully below, we agree with the conclusions in the Draft Report that while First NBC Bank's board and management are ultimately responsible for the poor risk management practices that led to the bank's failure, FDIC should have set a strong supervisory tone by pursuing stronger enforcement actions as early as 2010.

When First NBC Bank opened in 2006, its original mission was to assist in the rebuilding of New Orleans, Louisiana, following the devastating effects of Hurricane Katrina in August 2005. The former CEO was clearly a dominant official responsible for all material policy decisions of the bank. First NBC Bank's board adopted strategic objectives but did not require management to enact appropriate risk management processes and limits as the bank began to grow significantly.

First NBC Bank became insolvent because of accounting errors in the carrying value of assets booked primarily in 2014 and 2015 and over-lending to multiple weak borrowers, which escalated after 2015. The accounting errors and over-lending derived from weak board oversight of a dominant policy official, coupled by inadequate risk management practices. The accounting errors led to restatement of First NBC Bank's financial statements, which contributed to a significant run-off of deposits. We agree with the Draft Report's conclusion that First NBC Bank's board did not adequately control the CEO's activities and influence until the bank's condition had diminished to a point where the bank was unable to recover.

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Corporation Comments

In the years, preceding the bank's failure, the Federal Deposit Insurance Corporation and the Louisiana Office of Financial Institutions (OFI) expressed concern about the bank's risk profile and made recommendations for improvement. However, the recommendations were not sufficiently strong to cause First NBC Bank's board and management to take adequate or consistent actions to address the root causes of these concerns or maintain a control environment commensurate with the growth, size, and complexity of its operations. Accordingly, we agree that supervisory efforts by FDIC and OFI to address the weaknesses in board oversight and risk management practices should have been stronger, in line with the FDIC's principles of forward-looking supervision.

The Division of Risk Management Supervision (RMS) concurs with the two recommendations included in the Report. The actions RMS will take to address the recommendations are briefly stated below.

Recommendation 1: *Complete a post material loss assessment of the FDIC's supervision of First NBC to ensure proper implementation of FDIC guidance, including guidance related to (1) dominant officials and (2) application of forward-looking supervision.*

RMS Response: RMS concurs with this recommendation.

Corrective Action: Because of the unusual aspects of this institution's operations, RMS management conducted a review of First NBC Bank's supervisory history and requested two additional assessments. The first is an independent assessment by professional staff outside of the Dallas Region. The second is a post-material loss review assessment being conducted by the Dallas Region. Both assessments are evaluating the supervision of the bank, including the implementation of guidance related to dominant officials and forward-looking supervision.

Completion Date: We expect these efforts to be completed by January 30, 2018.

Recommendation 2: *Update training materials and conduct training to reflect the lessons learned from this failure.*

RMS Response: RMS concurs with this recommendation.

Corrective Action: Once the assessments discussed in the corrective action response to recommendation 1 are complete, RMS will ascertain what additional training is needed and will develop materials for delivery to all examiners. Based in part on the unusual aspects of this institution's operations, certain responsive actions have already been taken:

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Corporation Comments

- RMS incorporated dominant management official and forward-looking supervision case studies into the 2017/2018 training cycle materials. This training has been delivered to all field managers as well as senior examiners and case managers in five regions, and will be delivered to senior examiners and case managers in the remaining region next month. The materials will be delivered to all other examiners in the first half of 2018.
- On June 7, 2017, RMS issued internal examiner guidance to formalize an existing liquidity risk supervisory review and contact process by integrating the program into the RMS quarterly offsite review program.
- On August 30, 2017, RMS issued the Summer 2017 edition of *Supervisory Insights*, which included an article entitled, "Community Bank Liquidity Risk: Trends and Observations from Recent Examinations." The article describes liquidity risk management and contingency funding strategies that community banks can use to help mitigate potential stress, and observes that an unexpected liquidity crisis can impair an institution's viability.
- On November 6, 2017, the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Conference of State Bank Supervisors are jointly hosting a teleconference to discuss trends in community bank liquidity and funds management and related supervisory guidance.

Completion Date: June 30, 2018

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Summary of the Corporation's Corrective Actions

This table presents corrective actions taken or planned by the Corporation in response to the recommendations in the report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	RMS will conduct two assessments to review the supervisory history of First NBC Bank. The first will be an independent assessment by professional staff outside of the Dallas Region. The second will be a post-material loss review assessment being conducted by the Dallas Region. Both assessments are evaluating the supervision of the bank, including the implementation of guidance related to dominant officials and forward-looking supervision.	01/31/2018	$0	Yes	Open
2	Once the assessments discussed in the corrective action response to recommendation 1 are complete, RMS will ascertain what additional training is needed and will develop materials for delivery to all examiners.	06/30/2018	$0	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Recommendations will be closed the OIG confirms that corrective actions have been completed and are responsive.