

Board of Governors of the Federal Reserve System

Review of the Failure of Allied Bank



Office of Inspector General

Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau



Executive Summary, 2018-SR-B-007, March 19, 2018

Review of the Failure of Allied Bank

Findings

Allied Bank failed because of corporate governance weaknesses and asset quality deterioration resulting from deficient credit risk-management practices. Ineffective oversight by Allied Bank's board of directors allowed two management officials, the Special Assets Officer and the President, to exert a dominant influence over the bank's affairs, including its lending decisions, and allegedly engage in insider abuse. Allied Bank's management also failed to establish adequate credit risk-management practices commensurate with the risks in the bank's loan portfolio. Weak credit underwriting and administration practices resulted in violations of certain regulations and bank lending policies, significant loan concentrations, and an excessive volume of classified assets. The bank's asset quality deterioration significantly impaired profitability and eventually depleted capital levels, resulting in the failure.

With respect to supervision, the Federal Reserve Bank of St. Louis (FRB St. Louis) generally took decisive supervisory action to address Allied Bank's weaknesses and deficiencies during the time frame we reviewed, 2009 through 2016, by appropriately downgrading the bank's CAMELS composite rating consistent with its risk profile, increasing the frequency of examinations, and assigning more experienced staff to examinations. FRB St. Louis's supervisory activity included formal enforcement actions and a recommendation to implement enforcement actions against certain Allied Bank officials. We determined that FRB St. Louis could have taken stronger steps by recommending that the Board of Governors of the Federal Reserve System (Board) report suspicious activity to law enforcement when FRB St. Louis first identified signs of insider abuse. Our review resulted in findings related to Suspicious Activity Report filings by the Federal Reserve System and enhanced communication between the Board's Legal Division and the Reserve Banks.

Recommendations

Our report contains recommendations designed to improve supervisory processes and to enhance communication between the Board's Legal Division and Reserve Banks following requests for enforcement action. In its response to our draft report, the Board concurs with our recommendations and outlines actions to address each recommendation. We will follow up to ensure that the recommendations are fully addressed.

Purpose

In accordance with the requirements of section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, we conducted an in-depth review of the failure of Allied Bank because the failure presented unusual circumstances that warranted an in-depth review.

Background

Allied Bank, formerly known as The Bank of Mulberry, Mulberry, Arkansas, began operations in 1902 as a state nonmember bank. In 1997, Allied Bank became a state member bank supervised by FRB St. Louis, jointly with the Arkansas State Bank Department. On September 23, 2016, the Arkansas State Bank Department closed the bank and appointed the Federal Deposit Insurance Corporation as receiver.



Recommendations, 2018-SR-B-007, March 19, 2018

Review of the Failure of Allied Bank

Finding 1: Guidance on the Expectations for Suspicious Activity Reporting by the Federal Reserve System Should Be Clarified

Number	Recommendation	Responsible office
1	Clarify guidance and conduct training on the expectations and process for suspicious activity reporting by the Federal Reserve System, including <ol style="list-style-type: none">the roles and responsibilities of Board and Reserve Bank staff.the circumstances that may warrant Reserve Bank staff recommending that the Board file a SAR.	Division of Supervision and Regulation

Finding 2: Communication After Reserve Bank Requests for Enforcement Action Can Be Improved

Number	Recommendation	Responsible office
2	Clarify expectations for communication following requests for enforcement action from the Reserve Banks. In clarifying expectations, the Legal Division should include <ol style="list-style-type: none">the frequency and type of communication the Legal Division expects from the Reserve Banks.the frequency and type of status updates the Legal Division will provide to the Reserve Banks.	Legal Division



Office of Inspector General

Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

MEMORANDUM

DATE: March 19, 2018

TO: Michael S. Gibson
Director, Division of Supervision and Regulation
Board of Governors of the Federal Reserve System

Mark E. Van Der Weide
General Counsel, Legal Division
Board of Governors of the Federal Reserve System

FROM: Melissa Heist *Melissa Heist*
Associate Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2018-SR-B-007, *Review of the Failure of Allied Bank*

We have completed our report on the subject evaluation. We conducted this evaluation to satisfy our mandate to assess state member bank failures that do not result in a material loss to the Deposit Insurance Fund when our office determines that unusual circumstances surrounding the failure warrant such a review.

Our report contains recommendations designed to improve supervisory processes and to enhance communication between the Board’s Legal Division and the Reserve Banks following requests for enforcement action. We provided you with a draft of our report for review and comment. In your response, you concur with our recommendations and outline actions that will be taken to address our recommendations. We have included your response as appendix C to our report.

We appreciate the cooperation that we received from the Federal Reserve Bank of St. Louis, the Division of Supervision and Regulation, and the Legal Division. Please contact me if you would like to discuss this report or any related issues.

cc: Mary Aiken, Senior Associate Director, Division of Supervision and Regulation
Kevin Bertsch, Associate Director, Division of Supervision and Regulation
Suzanne L. Williams, Deputy Associate Director, Division of Supervision and Regulation
Richard M. Ashton, Deputy General Counsel, Legal Division
Patrick Bryan, Assistant General Counsel, Enforcement, Legal Division

Julie Stackhouse, Executive Vice President, Supervision, Credit, Community Development, and Learning Innovation Division, Federal Reserve Bank of St. Louis

Ricardo A. Aguilera, Chief Financial Officer and Director, Division of Financial Management

Tina White, Senior Manager, Compliance and Internal Control, Division of Financial Management



Contents

Introduction	8
Background	8
Objectives, Scope, and Methodology	9
Causes of the Failure	10
Corporate Governance Weaknesses	10
Dominant Management Officials	10
Weak Oversight by the Board of Directors	11
Alleged Insider Abuse by Allied Bank Management	12
Deficient Credit Risk Management	13
Inadequate Lending Strategy	13
Poor Underwriting and Credit Administration	14
Loan Concentrations	15
Ineffective Problem Loan Identification	17
Deficient ALLL Levels and Methodology	18
Net Losses and Depleted Capital	19
Supervision of Allied Bank	21
FRB St. Louis Downgraded Allied Bank’s Ratings and Implemented Enforcement Actions	22
FRB St. Louis Requested Stronger Supervisory Action	23
Recommendation for Removal, Prohibition, or Civil Money Penalties	23
Referral to the U.S. Department of Labor	24
Continued Deterioration Led to Allied Bank’s Failure	24
Conclusion	24
Finding 1: Guidance on the Expectations for Suspicious Activity Reporting by the Federal Reserve System Should Be Clarified	26
Alleged Insider Abuse by Allied Bank Management Officials Did Not Result in a SAR Filing Prior to the Bank’s Failure	26
Board and Reserve Bank Staff Were Confused About the Expectations for Filing SARs	27
Recommendation	29
Management’s Response	29

OIG Comment	29
Finding 2: Communication After Reserve Bank Requests for Enforcement Action Can Be Improved	30
Limited Communication Between FRB St. Louis and the Legal Division Following the Request for Action	30
Recommendation	32
Management’s Response	32
OIG Comment	32
Appendix A: Glossary of Banking and Regulatory Terms	33
Appendix B: CAMELS Rating System	35
Appendix C: Management’s Response	37
Abbreviations	39



Introduction

Background

Allied Bank, formerly known as The Bank of Mulberry, Mulberry, Arkansas, began operations in 1902 as a state nonmember bank. The Arkansas State Bank Department (ASBD), established in 1913, supervised the bank since its inception. On January 1, 1934, The Bank of Mulberry became an insured depository institution jointly supervised by the Federal Deposit Insurance Corporation (FDIC) and the ASBD. On February 1, 1997, The Bank of Mulberry became a state member bank supervised by the Federal Reserve Bank of St. Louis (FRB St. Louis), under delegated authority from the Board of Governors of the Federal Reserve System (Board). On March 7, 2002, the institution changed its name to Allied Bank, and on April 16, 2002, Allied Bank expanded by merging with the Bank of Mansfield, Mansfield, Arkansas. Prior to the bank's failure, Allied Bank operated five Arkansas branch offices, located in Alma, Little Rock, Mansfield, Mulberry, and Ozark.

In 1986, Allied Bank's eventual Special Assets Officer (SAO) formed ACME Holding Company, Inc. (ACME), to acquire The Bank of Mulberry.¹ The acquisition took place that same year, and the SAO's family maintained control of The Bank of Mulberry and Allied Bank until its failure in September 2016. Allied Bank was a wholly owned subsidiary of ACME, which was primarily owned by members of the same family. The SAO and his son, the President and Chief Executive Officer (hereafter, President), who joined the bank in 1993, controlled the daily operations of Allied Bank.

On September 23, 2016, the ASBD closed the bank and appointed the FDIC as receiver. The FDIC entered into a purchase and assumption agreement with Today's Bank, Huntsville, Arkansas, to assume all deposits of Allied Bank. According to the FDIC, as of June 30, 2016, Allied Bank had approximately \$66.3 million in total assets and \$64.7 million in total deposits. The FDIC estimated that the cost of the bank's failure to the Deposit Insurance Fund (DIF) would be \$6.9 million. Section 987 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), an act that amends section 38(k) of the Federal Deposit Insurance Act, defines a material loss to the DIF as an estimated loss in excess of \$50 million.²

Although the estimated loss to the DIF associated with this failure did not meet the threshold for materiality, for failures beneath the material loss threshold, the Dodd-Frank Act requires our office to assess the circumstances surrounding the failure. Upon identifying unusual circumstances, our office conducts an in-depth review similar to a material loss review.³ As a result of our initial review, we determined that Allied Bank's failure presented unusual circumstances that warranted an in-depth review for several reasons, including questionable business practices and alleged insider abuse.

¹ The SAO previously served as the Chief Executive Officer and the Chief Lending Officer of Allied Bank.

² The \$50 million materiality threshold applied to losses that occurred on or after January 1, 2014.

³ This review fulfills a statutory mandate and does not serve any investigative purposes.

Objectives, Scope, and Methodology

When a loss to the DIF presents unusual circumstances, section 38(k) of the Federal Deposit Insurance Act requires the Inspector General of the appropriate federal banking agency to prepare a report in a manner that is consistent with the requirements of a material loss review. Specifically, the Inspector General of the appropriate federal banking agency is required to undertake the following:

- review the agency’s supervision of the failed institution, including the agency’s implementation of prompt corrective action (PCA)
- ascertain why the institution’s problems resulted in a material loss to the DIF
- make recommendations for preventing any such loss in the future

To accomplish our objectives, we reviewed FRB St. Louis’s supervision of Allied Bank from September 2009 to the bank’s failure in September 2016.⁴ We reviewed the Federal Reserve System’s *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed staff and collected relevant documentation from FRB St. Louis, the ASBD, and the Board’s Division of Supervision and Regulation (S&R) and Legal Division. We reviewed supervisory documentation, including enforcement actions issued against Allied Bank, examination reports, examination workpapers prepared by FRB St. Louis, surveillance and watch list reports, correspondence, and relevant FDIC documents. We also obtained and reviewed guidance on filing Suspicious Activity Reports (SARs) from other federal financial regulatory agencies for informational purposes. In addition, we obtained and reviewed local market data for Allied Bank, including economic, demographic, and real estate data.

We conducted this evaluation from February 2017 through January 2018 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency. Appendixes at the end of the report include a glossary of key banking and regulatory terms and a description of the CAMELS rating system.⁵

⁴ The Board’s Division of Supervision and Regulation leads the execution of supervisory responsibilities by coordinating and participating in supervisory programs and activities. Under delegated authority from the Board, the respective Federal Reserve Banks conduct banking supervision activities, such as onsite examinations and offsite monitoring.

⁵ The CAMELS acronym represents six components: **c**apital adequacy, **a**sset quality, **m**anagement capability, **e**arnings performance, **l**iquidity position, and **s**ensitivity to market risk. For full-scope examinations, examiners assign a rating of 1 through 5 for each component and the overall composite score, with 1 indicating the least regulatory concern and 5 indicating the greatest concern.



Causes of the Failure

Allied Bank failed due to corporate governance weaknesses and asset quality deterioration resulting from deficient credit risk-management practices. Ineffective oversight by the board of directors allowed two management officials to dominate the bank's affairs and allegedly engage in insider abuse. Specifically, Allied Bank's SAO and President, who are father and son, respectively, exerted a dominant influence over lending, policy decisions, and daily operations and maintained control over the board of directors. These corporate governance weaknesses also allowed significant credit risk-management issues to develop and persist. Management failed to establish adequate credit risk-management practices commensurate with the risks in the bank's loan portfolio. Management's poor lending decisions, weak credit underwriting, and deficient credit administration practices resulted in violations of certain regulations and bank lending policies, significant loan concentrations, and an excessive volume of classified assets. Allied Bank incurred significant provision expenses to the allowance for loan and lease losses (ALLL), resulting in net operating losses. Asset quality deterioration significantly impaired profitability and eventually depleted the bank's capital levels, which prompted the ASBD to close Allied Bank and appoint the FDIC as receiver on September 23, 2016.

Corporate Governance Weaknesses

From 2009 to 2016, FRB St. Louis and ASBD examiners identified several corporate governance weaknesses at Allied Bank. These weaknesses included dominant management officials and weak oversight by the board of directors. The presence of these conditions created the opportunity for insider abuse and contributed to the bank's failure.

Dominant Management Officials

Allied Bank's ownership structure allowed for the SAO and the President to maintain control over the bank. As previously noted, Allied Bank was a wholly owned subsidiary of ACME. Family members controlled the majority of ACME's shares, giving them control of Allied Bank. Even after an outsider invested in the holding company, the family was able to maintain control over both ACME and Allied Bank by serving as either trustee or plan administrator of ACME's Employee Stock Ownership Plan (ESOP). The President served as trustee, and the SAO subsequently served as plan administrator appointed by the trustee, which provided these individuals with voting control over the ESOP's shares, granting them full authority to appoint and remove board members. As a result, these individuals were able to dominate all decisions related to ACME and Allied Bank.⁶

In several examinations of Allied Bank from 2010 through 2016, FRB St. Louis and ASBD examiners described the SAO and the President as dominant management officials who controlled the bank's lending, policy decisions, and daily operations. For example, in an October 2010 examination, examiners noted that although the Chief Lending Officer (later known as the SAO) was not on Allied Bank's board of

⁶ The management of ACME discontinued the SAO's voting control over the ESOP shares in January 2014 at the direction of examiners. Additionally, ACME filed for bankruptcy in April 2014. Nevertheless, the family continued to control Allied Bank until its failure in September 2016.

directors, he appeared to dominate major strategy and policy decisions. In 2012, the Chief Lending Officer transitioned to the SAO role; however, examiners noted that this position change appeared to be in title only, because this individual continued to control the lending function. During a May 2013 examination, examiners questioned the SAO's effectiveness in managing the lending function and attributed the bank's financial condition to the SAO's oversight. They also identified potential conflicts of interest related to the SAO's relationships with specific bank customers. According to examiners, these relationships should have precluded him from serving as SAO.

FRB St. Louis examiners noted that they primarily interacted with the SAO and the President during examinations. During a May 2012 examination, FRB St. Louis and ASBD examiners noted that the SAO appeared to omit facts or provide incomplete information to examiners. In addition, one FRB St. Louis interviewee noted that the SAO and the President were evasive and explained that the SAO often did not provide examiners with a straight answer in response to questions.

The SAO and the President also exerted a dominant influence over Allied Bank's board of directors. For example, FRB St. Louis examiners explained that the SAO and the President dominated board meetings by doing most of the talking. Examiners also noted that the SAO and the President did not distribute materials in advance of board meetings and moved quickly through presentations during the meetings, which made it difficult for board members to react to or absorb the information presented.

In the final examination prior to Allied Bank's failure, examiners noted that the bank continued to be dominated by the controlling family, and that the SAO and the President continued to prevail over major strategy and policy decisions. During interviews, several examiners stated that the SAO's and the President's dominant management over the bank and the board of directors contributed to the failure.

Weak Oversight by the Board of Directors

Allied Bank's board of directors failed to provide adequate oversight. During interviews, FRB St. Louis examiners described the board members as weak, passive, and uninvolved. According to an FRB St. Louis examiner, the dominant management officials selected board members for their docility. Examiners indicated that the board members never opposed any motions set forth by the SAO or the President and ratified all their decisions. One examiner noted that even after he explained to the board members that they could be personally liable for certain violations of law, their approach to overseeing the bank's operations did not change. In addition, examiners noted that members of the board lacked experience and independence. Further, Allied Bank's board members were primarily located in Mulberry, Arkansas, roughly a 2-hour drive from Little Rock, Arkansas, where most of the banking activities occurred. Examiners noted that the distance between the board of directors and management officials overseeing the bank contributed to the board's ineffective oversight.

FRB St. Louis and ASBD examiners noted that board oversight was deficient, inadequate, or ineffective in all safety and soundness examination reports from 2010 until the bank's failure in September 2016. Examiners first criticized the board's oversight during an October 2010 examination, primarily because the bank began a new business activity—subprime automobile lending—without establishing adequate credit risk-management practices or policies. FRB St. Louis entered into a memorandum of understanding (MOU) with Allied Bank on March 15, 2011, requiring the bank to revise its lending policy and procedures to limit the bank's exposure to subprime automobile lending, among other provisions.

Allied Bank's board of directors and management also demonstrated an inability to resolve examiner findings contained in FRB St. Louis and ASBD examination reports. Examiners detailed repeat Matters Requiring Attention and Matters Requiring Immediate Attention in examination reports, and the board and management did not appropriately address these matters.⁷ As a result of continued deterioration of the bank and the board of director's and management's inability to address the issues, FRB St. Louis replaced the MOU with a written agreement, effective May 2, 2012. Allied Bank's board of directors and management were unable to fully comply with all provisions of the written agreement prior to the bank's failure.

In addition to FRB St. Louis's written agreement, the ASBD implemented a cease-and-desist order effective November 15, 2011.⁸ As required by the ASBD's cease-and-desist order, Allied Bank engaged the services of a consultant to perform a management study to assess the bank's management and staffing needs.⁹ The consultant's 2013 management study noted corporate governance weaknesses similar to those identified by FRB St. Louis and ASBD examiners, such as an ineffective board of directors and excessive compensation to a bank employee, the SAO's daughter, who did not appear to perform bank-related services. However, the management study attributed the bank's problems to ineffective corporate governance by the board and an ineffective organizational structure, not ineffective management. Despite these findings, the board of directors did not make any significant changes to address weak oversight issues at the bank.

Alleged Insider Abuse by Allied Bank Management

Ineffective oversight by the board of directors created the opportunity for the SAO and the President to control the bank, which allowed these individuals to engage in questionable business practices and alleged insider abuse. During a May 2012 examination, examiners identified several unsafe and unsound banking practices and noted that the problems facing Allied Bank were the direct result of poor operating practices and the family's actions to prioritize its interests above the bank's. Further, during a January 2013 examination, examiners noted that the board of directors often approved management initiatives that benefited members of the controlling family but were detrimental to Allied Bank, ACME, and ACME's ESOP. As early as 2012, examiners identified several instances of alleged insider abuse involving certain members of the family that affected the bank's financial condition, including the following:

- operating a bank branch out of leased spaced in an antique store owned and operated by the SAO's wife, with little to no banking activity occurring at this branch
- incurring questionable transportation expenses, including (1) airplane expenses for personal travel and travel between bank branches located only 135 miles apart without documentation of board approval and (2) expenses for 17 company automobiles, a number of which were provided to members of the controlling family for their personal use

⁷ The CBEM defines *Matters Requiring Attention* as matters that the Federal Reserve expects a banking organization to address over a reasonable period of time and defines *Matters Requiring Immediate Attention* as matters that the Federal Reserve requires a banking organization to address immediately.

⁸ The ASBD revised the cease-and-desist order on December 18, 2012, to include additional provisions.

⁹ FRB St. Louis's 2012 written agreement did not contain a similar management study to the study required by the ASBD's cease-and-desist order.

- providing excessive, and in some cases questionable, compensation to the President, the SAO, and other family members, such as paying family members and their spouses who did not have clearly defined responsibilities at Allied Bank
- providing ACME advisory directors' fees to the SAO's mother when there was no record of her having any involvement with ACME or serving as a director
- allowing members of the controlling family to use bank-issued credit cards for personal expenses
- paying the controlling family's personal cable television, internet, and telephone bills and paying fees to the controlling family's grocery store to house an Allied Bank ATM
- compensating Allied Bank staff for performing activities for family members on matters unrelated to bank business, such as residential construction-related work, during business hours
- holding ACME board meetings in various locations outside Arkansas, including Florida and New York, without a reasonable justification

During the final examination prior to the bank's failure, examiners noted that the controlling family's unsafe and unsound practices and use of the bank for their personal enrichment weakened the bank and the bank holding company. FRB St. Louis attempted to remove the SAO and the President from their management positions by submitting requests for enforcement actions against these individuals to the Board's Legal Division and S&R in March 2013; however, the SAO and the President remained in their positions until Allied Bank failed in September 2016.

Deficient Credit Risk Management

In addition to corporate governance weaknesses, Allied Bank failed primarily because of asset quality deterioration as a result of deficient credit risk-management practices. Management failed to establish an appropriate lending strategy or adequate credit risk-management practices. Weak credit underwriting and administration practices resulted in violations of certain regulations related to appraisals and bank lending policies, significant loan concentrations, and an excessive volume of classified assets. Allied Bank management did not effectively identify problem loans and establish formal workout plans to address the deficiencies associated with these loans. The significant provision expenses to the ALLL required to absorb these losses resulted in net operating losses. The bank's asset quality deterioration significantly impaired profitability and eventually depleted its capital levels.

Inadequate Lending Strategy

The SAO dominated Allied Bank's lending function and failed to establish an appropriate lending strategy or adequate credit risk-management practices. According to the CBEM, senior management is responsible for implementing strategies in a manner that limits risk associated with each strategy. Instead, the SAO exhibited a significant appetite for high-risk loans and made poor lending decisions. FRB St. Louis examiners indicated that Allied Bank management extended loans based on relationships involving the controlling family and did not adequately evaluate the credit risk associated with those loans. FRB St. Louis examiners also described Allied Bank management's risky approach to lending and noted that the SAO had a reputation for taking on loans and borrowers that no other banks would. One FRB St. Louis examiner noted that the SAO made deals, not loans. The SAO's high risk tolerance and

failure to establish an appropriate lending strategy led to loan concentrations and significant classified assets.

Poor Underwriting and Credit Administration

FRB St. Louis and ASBD examiners identified weak loan underwriting and credit administration practices as early as the October 2010 examination and repeatedly criticized underwriting and credit administration in all subsequent examinations until the bank's failure. For example, in a May 2012 examination, examiners noted that credit risk was high and increasing as a result of poor underwriting practices, weak credit administration, and a lack of understanding by management and the board of directors of the inherent risk in the loan portfolio.

FRB St. Louis and ASBD examiners noted that bank personnel and management routinely operated outside of board-approved lending policies. Further, examiners noted that neither the board of directors nor management seemed familiar with the approved loan policy. For example, the loan policy described the bank's "general strategies" and stated that the bank will seek to eliminate high-risk loans; however, the SAO's lending decisions did not align with this approved strategy. The loan policy also details documentation and information that the bank should review prior to extending credit; however, examiners noted various instances in which the bank failed to review appropriate documentation. Examiners identified several instances of loan staff failing to follow the bank's lending policies. For example:

- During five examinations from 2009 through 2016, examiners identified violations of Regulation Y, *Bank Holding Companies and Change in Bank Control*, related to management's failure to obtain adequate real estate appraisals.¹⁰ For example, during a May 2012 examination, examiners identified 27 violations of Regulation Y related to management not obtaining adequate or updated real estate appraisals or evaluations.
- During a May 2013 examination, examiners noted that management renewed, extended, or modified existing loans without properly evaluating the overall financial condition of the borrowers or the guarantors. As a result, examiners downgraded three relationships. Examiners noted that in some instances, the character of the borrower was questionable, but senior management did not evaluate the borrower as part of its underwriting.

Based on interviews with FRB St. Louis examiners, we determined that a key contributing cause for Allied Bank's poor underwriting decisions was the SAO's control over the lending and credit administration function. As previously noted, examiners stated that the SAO frequently extended loans to individuals with whom he had relationships or for self-dealing purposes. Examination reports state that the SAO was responsible for managing and collecting classified assets, even though the SAO was responsible for originating and approving many of these loans. In a May 2013 examination, examiners stated that the SAO's efforts to improve the credit function were ineffective, and his financial relationship with bank customers precluded him from serving in his role. From 2012 to the bank's failure, Allied Bank

¹⁰ Regulation Y generally regulates the acquisition of control of banks and bank holding companies by companies and individuals, with subpart G applying to appraisal standards.

management did not adequately address poor underwriting and weak credit administration, resulting in an excessive volume of classified assets and further contributing to asset quality deterioration.

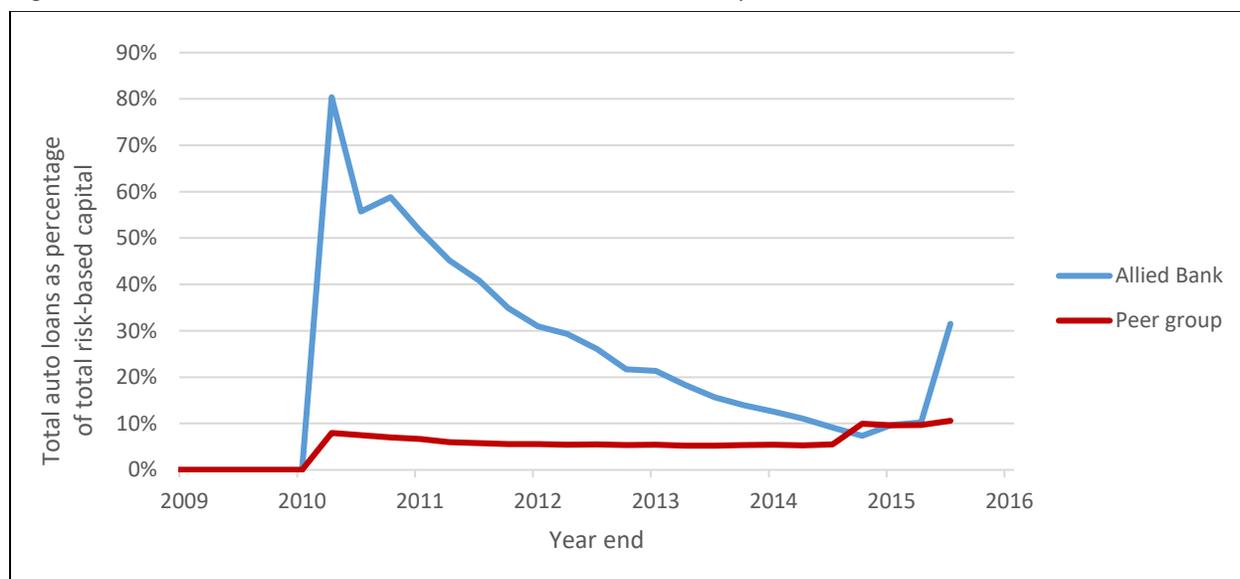
Loan Concentrations

Allied Bank's risky lending decisions, poor underwriting, and deficient credit administration practices led to various loan concentrations, including automobile loans; loans to individual borrowers; and construction, land, and land development (CLD) loans.

Automobile Loans

During an October 2010 examination, examiners noted that Allied Bank's board and senior management entered into a new business activity with local automobile dealers to purchase subprime automobile loans. Examiners further noted that bank management entered into this inherently high-risk lending activity without establishing appropriate risk management practices, including formal policies, limits, or appropriate internal controls. As depicted in figure 1, Allied Bank's entry into subprime automobile lending resulted in extremely high automobile loan concentrations in 2010 compared to peer averages.

Figure 1. Allied Bank's Automobile Loan Concentrations as Compared With Its Peers, 2010–2016



Source. *Uniform Bank Performance Report* data for Allied Bank, December 2009 through June 2016.

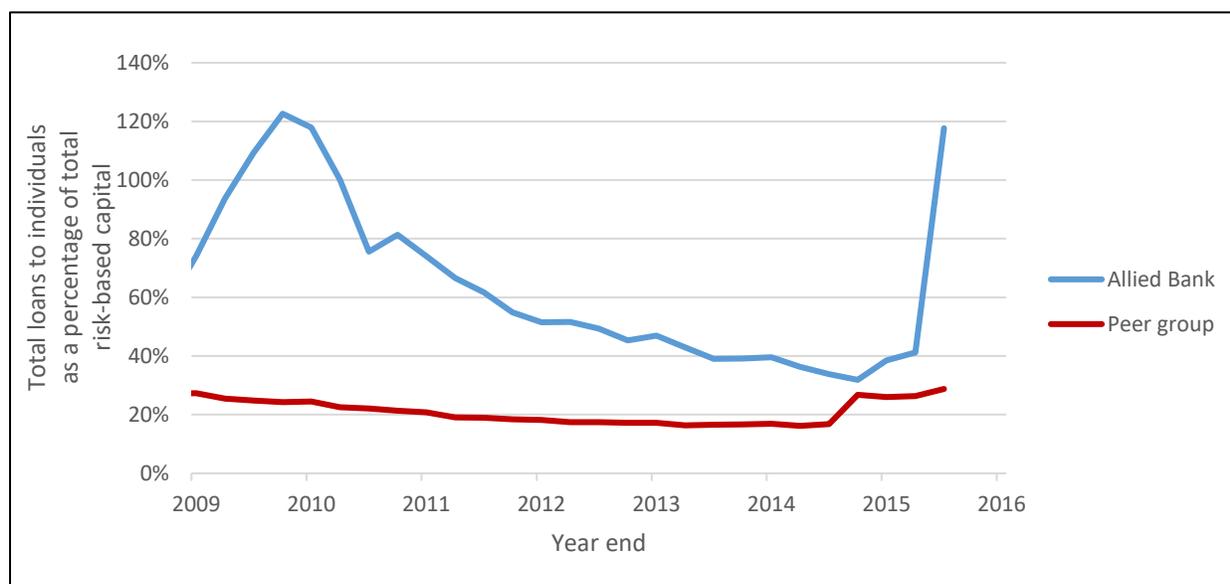
Note. The Federal Financial Institutions Examination Council did not require banks to report auto loan concentrations in *Uniform Bank Performance Report* data until March 2011. Allied Bank's automobile loan concentrations increased in 2016 due to the bank's capital depletion prior to its failure.

FRB St. Louis's MOU with Allied Bank required the bank to revise its lending policy to address concentrations in subprime automobile loans, among other provisions. Although the bank was able to reduce its automobile loan concentrations from 2011 through 2015, certain loan relationships with automobile dealers remained problem assets until the bank's failure in 2016.

Loans to Individual Borrowers

Allied Bank frequently extended loans to individual borrowers based on relationships or business interests involving the controlling family. In a September 2011 examination, loans to an individual and his or her related interests violated Arkansas state legal lending limits. Examiners required senior management and the board of directors to submit a plan to correct this violation, and the following examination report noted fewer loans to this borrower. During a May 2013 examination, examiners noted that the SAO was involved in financial transactions with some problem bank customers and initiated those problem relationships. Examiners also noted loan concentrations related to the oil and gas sector that were associated with a borrower with whom the controlling family had a personal financial relationship. Figure 2 depicts Allied Bank's loan concentrations to individual borrowers, demonstrating higher loans to individuals as a percentage of total capital as compared with the bank's peers from 2009 through 2016.

Figure 2. Allied Bank's Individual Borrower Concentrations as Compared With Its Peers, 2009–2016



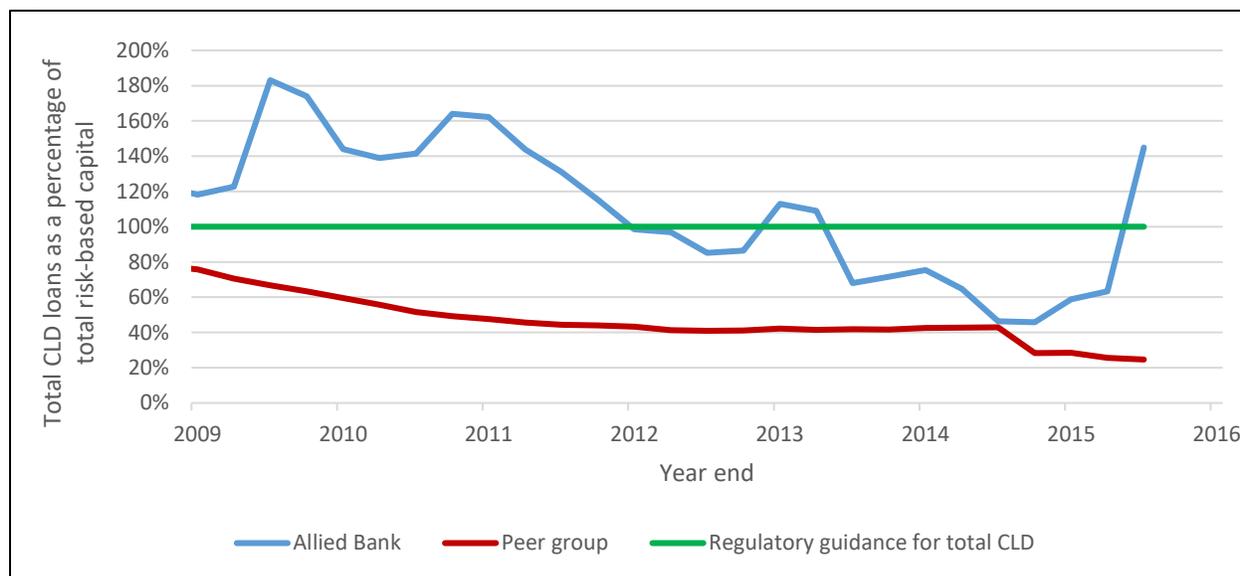
Source. *Uniform Bank Performance Report* data for Allied Bank, December 2009 through June 2016.

Note. Allied Bank's individual borrower concentrations increased in 2016 due to the bank's capital depletion prior to its failure.

CLD Loans

Allied Bank developed significant concentrations in CLD loans from 2009 through 2012 as a result of downturns in the real estate market. CLD loan concentrations generally present heightened risk because developers' capacity to repay loans is contingent on whether they can obtain long-term financing or find a buyer for the completed project. According to the Board's Supervision and Regulation Letter (SR Letter) 07-1, *Concentrations in Commercial Real Estate Lending*, an institution presents a potentially significant commercial real estate concentration risk if total reported CLD loans represent 100 percent or more of its total capital. As shown in figure 3, Allied Bank's CLD concentrations represented over 100 percent of total risk-based capital from 2009 through 2012 and exceeded peer group averages.

Figure 3. Allied Bank’s Total CLD Loan Concentrations, 2009–2016



Source. *Uniform Bank Performance Report* data for Allied Bank, December 2009 through June 2016.

Note. Allied Bank’s total CLD loan concentrations increased in 2016 due to the bank’s capital depletion prior to its failure.

The May 2012 written agreement between Allied Bank and FRB St. Louis included a provision requiring the bank to submit a plan to strengthen the bank’s management of asset concentrations, including steps to reduce or mitigate the concentration risk in light of market conditions. Allied Bank partially complied with this provision from 2012 to its failure. Examiners noted that the bank reduced the overall CLD and commercial real estate exposure but had not adequately established commercial real estate concentration limits in its loan policy.

Ineffective Problem Loan Identification

Allied Bank management did not implement adequate credit risk-management practices to effectively identify problem loans and establish formal workout plans for those loans. The bank’s ineffective problem loan identification resulted in a large number of charged-off loans and loans transferred to the Other Real Estate Owned account. Examiners downgraded loan relationships during several examinations, leading to sustained increases in the bank’s classified assets. For example, during a May 2012 examination, examiners downgraded 30 loans totaling \$8.5 million, and during a May 2013 examination, examiners downgraded 12 loans totaling \$9.4 million. Additionally, Allied Bank management hired an independent consulting firm to review Allied Bank’s largest loan relationships. The firm noted similar findings to examination criticisms, such as recommended downgrades to several loan relationships; however, Allied Bank management did not take actions to address these recommendations. As illustrated in table 1, Allied Bank’s classified assets increased significantly from 2009 through 2013. By March 2013, classified assets represented over 234 percent of the bank’s tier 1 capital and ALLL.

Table 1. Allied Bank’s Classified Assets as Reported in Examination Reports, June 2009–February 2016

Classified assets	Jun 2009	Sep 2010	Jun 2011	Apr 2012	Mar 2013	Dec 2013	Dec 2014	Feb 2016
In thousands of dollars	2,002	13,441	25,475	33,296	39,568	21,498	25,919	20,972
As percentage of tier 1 capital plus ALLL	15.89	80.20	138.41	192.91	234.60	180.51	236.12	282.11

Source. FRB St. Louis and ASBD examination reports, 2009 to 2016.

Note. This table includes only those reports in which examiners specifically noted classified asset amounts.

FRB St. Louis supervision staff noted that Allied Bank’s management was often unwilling to accept loan downgrades that examiners presented during examinations. FRB St. Louis examiners noted that Allied Bank management never recognized a loss unless examiners directed them to do so. For example, one FRB St. Louis examiner noted that it was an unwritten policy at Allied Bank to avoid downgrading loan relationships and to instead let examiners identify necessary downgrades. Further, interviewees noted that in some instances, after examiners persuaded Allied Bank management to downgrade certain loan relationships, the bank subsequently upgraded those loan relationships after examiners concluded the examinations. We confirmed that Allied Bank’s classified assets fluctuated over time as a result of examiner downgrades and the bank’s subsequent upgrades to loan relationships.

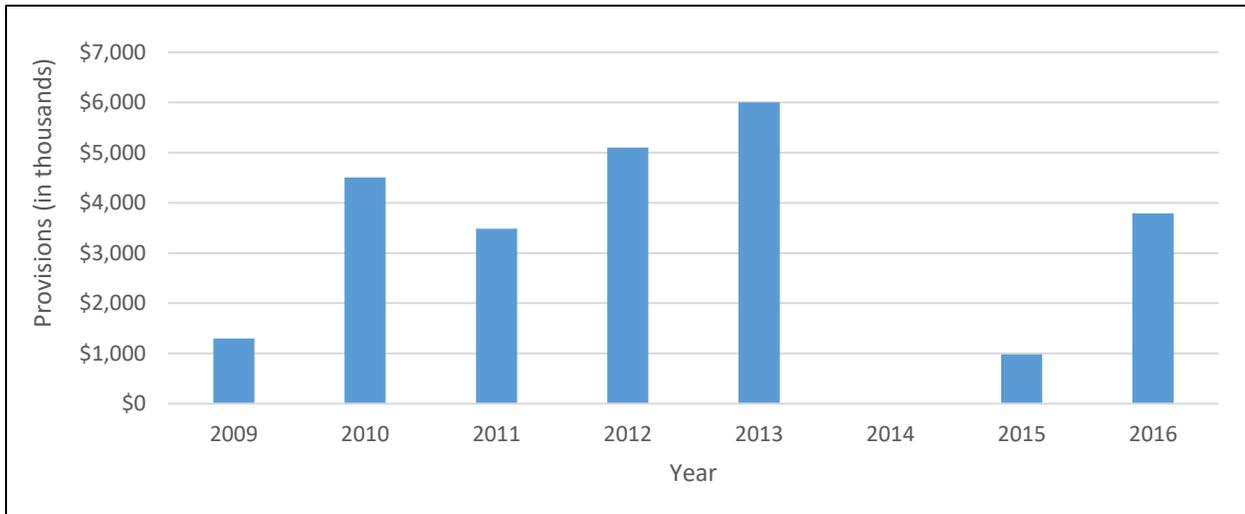
Deficient ALLL Levels and Methodology

From 2010 to 2016, examiners repeatedly criticized Allied Bank’s ALLL levels, ALLL methodology, and provision expenses. The May 2012 written agreement required Allied Bank to maintain sound processes for determining, documenting, and recording an adequate ALLL in accordance with regulatory guidance and to submit a written program for maintaining adequate ALLL levels.¹¹ Allied Bank was unable to fully comply with this requirement from 2012 until the bank’s failure.

Allied Bank management failed to adequately allocate reserves against potential losses. Allied Bank had to make significant provision expenses to return the ALLL to satisfactory levels as a result of weak credit administration, continued downgrades to loan relationships by examiners, and increased classified assets. Figure 4 summarizes Allied Bank’s provisions to the ALLL from 2009 through 2016.

¹¹ According to SR Letter 06-17, *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)*, “Each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses.”

Figure 4. Allied Bank Provisions to the ALLL, 2009–2016



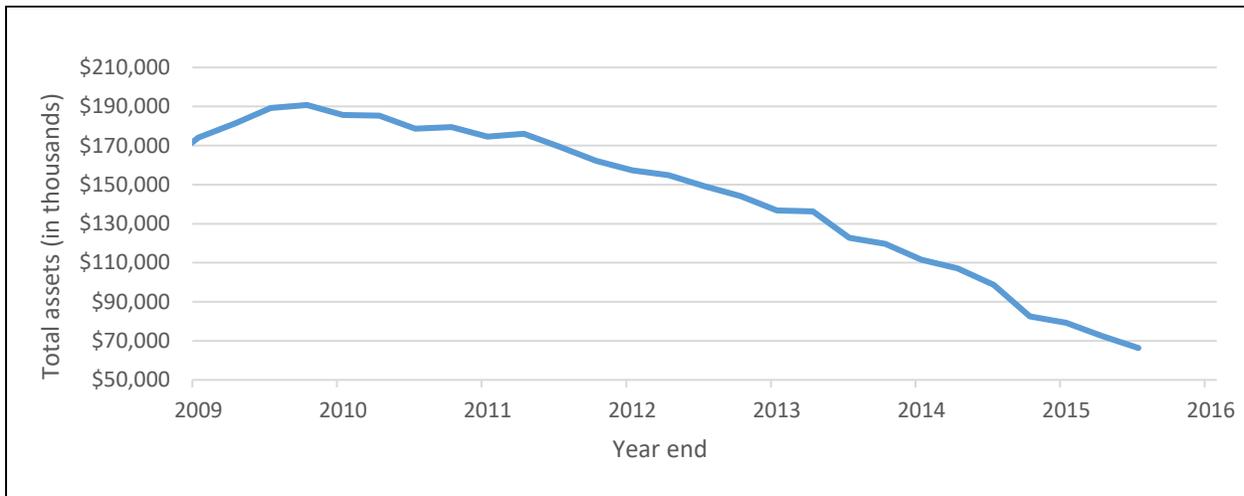
Source. *Uniform Bank Performance Report* data for Allied Bank, December 2009 through June 2016.

Note. FRB St. Louis examiners noted that they did not require Allied Bank to make provisions to the ALLL in 2014 because of significant provision expenses to the ALLL in 2013 and the timing of the examinations of Allied Bank during 2014.

Net Losses and Depleted Capital

Allied Bank’s asset quality deterioration resulted in net losses and depleted capital. FRB St. Louis examiners explained that Allied Bank sought to maintain its capital by actively reducing the bank’s assets. As shown in figure 5, Allied Bank decreased its total assets significantly, from over \$190 million in September 2010 to \$66 million prior to the bank’s failure in 2016. An FRB St. Louis official noted that under this strategy, the bank lost its good loan relationships; some borrowers moved their loans to other banks, leaving the bank with weaker loan relationships. Further, Allied Bank’s holding company, ACME, did not serve as a source of strength for the bank by providing financial support. ACME received a capital injection from an outside investor in 2012 and used those funds to cover holding company debt. Allied Bank received no funds from the holding company capital injection. ACME filed for bankruptcy in 2014.

Figure 5. Allied Bank's Total Assets, 2009–2016



Source: *Uniform Bank Performance Report* data for Allied Bank, December 2009 through June 2016.

Allied Bank maintained its *well-capitalized* PCA designation from 2009 until 2016. During a May 2016 examination, the final examination prior to the bank's failure, examiners downgraded several large loan relationships, causing Allied Bank's capital levels to drop from *well-capitalized* to *critically undercapitalized*. As a result of Allied Bank's capital erosion and declining PCA status, the Board issued a PCA directive, effective August 15, 2016. The PCA directive afforded Allied Bank 30 days to (1) increase the bank's equity through the sale of shares or contributions to surplus in an amount sufficient to make the bank adequately capitalized, (2) enter into and close a contract to be acquired by a depository institution holding company, or (3) take other necessary measures to adequately capitalize the bank. Allied Bank did not comply with the PCA directive, and as a result, the ASBD appointed the FDIC as receiver on September 23, 2016.

Supervision of Allied Bank

From September 2009 through September 2016, FRB St. Louis complied with examination frequency guidelines in CBEM section 1000.1 by conducting seven full-scope examinations, four target examinations, and regular offsite monitoring. From the end of 2010 to the bank's failure, FRB St. Louis conducted all examinations jointly with the ASBD at 6-month intervals. FRB St. Louis's supervisory activity during 2009 through 2016 related to the safety and soundness of Allied Bank resulted in FRB St. Louis implementing an MOU, a written agreement, and a PCA directive. As shown in table 2, Allied Bank's CAMELS composite rating declined from a 2 in 2009 to a 3 in 2010, a 4 in 2011, and a 5 in 2012, where it remained until it failed in 2016.

Table 2. Supervisory Overview of Allied Bank, 2009–2016

Examination				CAMELS composite rating	CAMELS component and risk management ratings							Supervisory actions
Start date	Report issue date	Scope	Agency conducting examination		Capital	Asset quality	Management	Earnings	Liquidity	Sensitivity	Risk management	
10/13/2009	12/03/2009	Full	ASBD	2	2	2	2	2	2	2	2	
10/18/2010	02/04/2011	Full	FRB St. Louis, ASBD	3	3	3	3	4	3	2	3	MOU 03/15/2011
06/06/2011	07/06/2011	Target	FRB St. Louis, ASBD	3	3	3	3	4	3	2	3	
09/26/2011	12/06/2011	Full	FRB St. Louis, ASBD	4	4	4	4	5	4	4	n.r.	
05/21/2012	09/06/2012	Full	FRB St. Louis, ASBD	5	5	5	5	5	5	5	5	Written agreement 05/02/2012
01/14/2013	03/21/2013	Target	FRB St. Louis, ASBD, FDIC	5	5	5	5	5	5	5	5	
05/20/2013	09/27/2013	Full	FRB St. Louis, ASBD	5	5	5	5	5	5	5	n.r.	
03/24/2014	06/23/2014	Full	FRB St. Louis, ASBD	5	5	5	5	5	5	5	5	
09/15/2014	12/04/2014	Target	FRB St. Louis, ASBD, FDIC	5	5	5	5	5	5	5	5	
04/06/2015	08/06/2015	Full	FRB St. Louis, ASBD	5	5	5	5	5	4	5	n.r.	
11/30/2015	01/07/2016	Target	FRB St. Louis, ASBD	n.r.	n.r.	n.r.	n.r.	n.r.	n.r.	n.r.	n.r.	
05/02/2016	08/09/2016	Full	FRB St. Louis, ASBD, FDIC	5	5	5	5	5	5	5	5	PCA directive 08/15/2016

Source. FRB St. Louis and ASBD examination reports, 2009 to 2016.

Note. This table does not include ASBD enforcement actions against Allied Bank.

n.r. not reported.

FRB St. Louis Downgraded Allied Bank's Ratings and Implemented Enforcement Actions

During an October 2009 examination conducted by the ASBD, examiners determined that Allied Bank's condition was satisfactory and assigned the bank a CAMELS composite 2 rating. Prior to the next examination in October 2010, Allied Bank developed significant subprime automobile loan concentrations without establishing appropriate risk management practices and limits. FRB St. Louis examiners noted that at the time, they were concerned that the bank's entry into subprime automobile lending coupled with a \$1.7 million loss due to an alleged loan fraud could have caused the bank to fail. As a result, FRB St. Louis officials assigned more experienced examiners to work on the October 2010 examination, and examiners focused on areas that posed heightened risk to the bank, including asset quality and subprime automobile lending. During this examination, FRB St. Louis and the ASBD downgraded Allied Bank's CAMELS composite rating from a 2 to a 3 and FRB St. Louis took decisive supervisory action by entering into an MOU with Allied Bank, effective March 15, 2011. The MOU contained eight provisions, which directed Allied Bank to revise its lending policy and procedures to limit the bank's exposure to subprime automobile lending, submit a plan to correct its credit underwriting and administration deficiencies, and enhance its ALLL methodology, among other actions.

In subsequent examinations, Allied Bank's condition deteriorated, and FRB St. Louis downgraded the bank's CAMELS composite rating and implemented a stronger enforcement action. During a September 2011 full-scope examination, FRB St. Louis and ASBD examiners determined that the bank exhibited unsafe and unsound banking practices and downgraded the CAMELS composite rating from a 3 to a 4. Examiners assessed Allied Bank's compliance with the MOU and found that the bank had not fully complied with the enforcement action. As a result of the September 2011 examination findings, the ASBD issued a cease-and-desist order, effective November 15, 2011, and FRB St. Louis replaced the MOU with a written agreement, effective May 2, 2012.

The written agreement contained 17 provisions directing the bank to strengthen its credit risk-management practices; enhance its management of asset concentrations; and maintain a sound process for determining, documenting, and recording an adequate ALLL, among other actions. As previously noted, FRB St. Louis's written agreement did not require a management study. FRB St. Louis officials explained their general reservations about compelling third parties to perform management studies as part of an enforcement action by noting that management studies are often ineffective because bank management hires and pays the consultant to perform the study, which may result in findings that favor the management officials who are the subject of the review. As required by the ASBD, consultants performed a management study in 2013. The consultants issued the study to Allied Bank's board of directors; however, management continued to exert control over the board of directors, and the board did not make changes to address weak oversight issues identified in the management study. FRB St. Louis monitored Allied Bank's compliance with the provisions of its written agreement during each examination from 2012 until the bank's failure. The bank was unable to comply with all of the provisions of the written agreement prior to its failure.

During a May 2012 examination, examiners downgraded Allied Bank's CAMELS composite rating from a 4 to a 5. Examiners found that oversight by the board of directors and management was critically deficient and that significant risks were not being adequately identified, monitored, or controlled. Examiners identified numerous violations of laws, including a violation of Regulation W, *Transactions between*

Member Banks and Their Affiliates, due to a diversion of bank assets in the form of energy stock from Allied Bank to ACME, without any compensation to the bank for loss of income. Further, Allied Bank advanced funds to ACME reportedly for tax payments. Examiners noted that these funds were excessive compared to the potential tax liability and were used to service other debt obligations of ACME. FRB St. Louis and the ASBD instructed ACME to reverse the transaction, and ACME subsequently returned the funds.

FRB St. Louis Requested Stronger Supervisory Action

FRB St. Louis examiners identified numerous unsafe and unsound banking practices and alleged insider abuse during a May 2012 examination. FRB St. Louis determined that management needed to be strengthened or replaced and took two decisive supervisory actions in an attempt to remove Allied Bank management officials.

Recommendation for Removal, Prohibition, or Civil Money Penalties

On March 8, 2013, FRB St. Louis submitted a recommendation to the Board's Legal Division and S&R seeking enforcement actions against members of the controlling family. The recommendation for removal, prohibition, or civil money penalties detailed various unsafe and unsound practices that FRB St. Louis supervision staff identified during a May 2012 examination, examples of deficient credit administration practices, and examples of actions that the controlling family took for its personal benefit rather than to fulfill its fiduciary responsibilities.

The Board's Legal Division discussed the recommendation with FRB St. Louis and subsequently submitted a request for information to Allied Bank. After receiving the bank's initial response, the Legal Division requested additional information from FRB St. Louis. The Board's Legal Division considered removal, prohibition, or civil money penalties against members of Allied Bank management but did not implement actions against those management officials before the bank failed in September 2016. Legal Division officials explained that they did not implement removal and prohibition orders before the failure for the following reasons:

- The Legal Division's Enforcement group had limited resources available at the time and had to balance competing priorities.
- The Legal Division determined that further evidence needed to be gathered relating to the alleged misconduct.

Since the time FRB St. Louis submitted the recommendation, the Legal Division’s Enforcement group increased its staff from 8 to more than 20 attorneys, and the Legal Division has increased its focus on actions against institution-affiliated parties.¹²

Referral to the U.S. Department of Labor

FRB St. Louis prepared a referral for Board staff to submit to the U.S. Department of Labor on May 16, 2013, in a separate attempt to remove the members of the controlling family from their management positions at Allied Bank and ACME and on ACME’s ESOP. This referral noted possible violations of The Employee Retirement Income Security Act of 1974, section 404(a)(1), and questioned whether the President, as trustee of the ESOP, operated consistent with his fiduciary duty to act solely in the best interests of the plan participants and beneficiaries. Specifically, the referral noted that illiquid employer securities must be valued by an independent appraisal and outlined the criteria for performing the valuation. The referral stated that ACME management did not satisfy the required criteria and noted, among other concerns, that the President and ACME management provided pro forma income statements to an independent appraiser that they knew, or should have known, were unreasonable.¹³

Continued Deterioration Led to Allied Bank’s Failure

Allied Bank continued to deteriorate and remained a CAMELS composite 5–rated institution from 2012 until its failure in 2016. FRB St. Louis officials noted that they dedicated significant resources to supervising Allied Bank in all examinations. As a result of Allied Bank’s capital erosion following the May 2016 examination, the bank’s PCA status declined to *critically undercapitalized* and the Board issued a PCA directive, effective August 15, 2016. Allied Bank did not comply with the PCA directive, and as a result, the ASBD appointed the FDIC as receiver on September 23, 2016.

In March 2017, after the bank failed, FRB St. Louis recommended that the Board file the appropriate notification forms addressing the alleged insider abuse identified in 2012. Such forms had not been previously submitted by Allied Bank or FRB St. Louis to address those insider abuse allegations.

Conclusion

From 2009 through 2016, FRB St. Louis generally took decisive supervisory action to address Allied Bank’s weaknesses and deficiencies. FRB St. Louis and ASBD examiners appropriately downgraded Allied Bank’s CAMELS composite rating from a 2 to a 5 consistent with the bank’s risk profile. In addition, FRB St. Louis assigned more experienced staff to participate in Allied Bank examinations beginning in 2010 when they

¹² The CBEM defines an *institution-affiliated party* as an individual associated with an institution and states that the definition “includes any officer, director, employee, controlling shareholder, or agent of a financial institution, and any other person who has filed or is required to file a change-in-control notice. It also includes any shareholder, consultant, joint-venture partner, or any other person who participates in the conduct of the affairs of the financial institution as well as any independent contractors, including attorneys, appraisers, and accountants, who knowingly or recklessly participate in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.”

¹³ Actions taken in response to FRB St. Louis’s referral to the U.S. Department of Labor were outside the scope of our review.

identified elevated risks. Further, FRB St. Louis and the ASBD increased the frequency of their examinations to a 6-month examination frequency from the end of 2010 to the bank's failure.

FRB St. Louis implemented three enforcement actions; the Reserve Bank issued an MOU in 2011 as a result of Allied Bank entering into the new high-risk business activity of subprime auto lending, issued a written agreement in 2012, and ultimately implemented a PCA directive in 2016. FRB St. Louis examiners monitored Allied Bank's compliance with enforcement actions, and the bank was unable to fully comply with enforcement actions prior to the failure. Additionally, FRB St. Louis submitted a recommendation to the Board's Legal Division and S&R seeking removal, prohibition, or civil money penalties against key Allied Bank management officials and also prepared a separate referral that Board staff submitted to the U.S. Department of Labor.

Based on our analysis of FRB St. Louis's supervision of Allied Bank, we found that FRB St. Louis generally took appropriate and decisive supervisory action. However, FRB St. Louis supervisory staff could have taken stronger steps by recommending that the Board report the suspicious activity to law enforcement when the Reserve Bank first suspected insider abuse.



Finding 1: Guidance on the Expectations for Suspicious Activity Reporting by the Federal Reserve System Should Be Clarified

We determined that FRB St. Louis suspected insider abuse as early as 2012 but did not recommend that the Board file the appropriate notification forms prior to the bank's failure. Federal law requires that a member bank file a SAR under certain circumstances, including situations involving insider abuse of any amount. The Board's CBEM and Advisory Letter (AD Letter) 13-8, *Suspicious Activity Reporting to FinCEN by the Federal Reserve System*, provide guidance on the process that the Federal Reserve System should follow in recommending that the Board file a SAR on behalf of an institution when that institution failed to file a SAR as required by applicable law. Although the Board issued these guidance documents, we noted confusion among both FRB St. Louis and Board staff as to (1) the circumstances that would warrant a SAR filing to provide necessary information to law enforcement and (2) the roles and responsibilities of Board and Reserve Bank staff related to the SAR filing process. Although we did not conclude that a SAR filing would have prevented the bank's failure, filing a SAR when FRB St. Louis first identified potential insider abuse could have alerted law enforcement of the suspicious activity at Allied Bank prior to the bank's failure.

Alleged Insider Abuse by Allied Bank Management Officials Did Not Result in a SAR Filing Prior to the Bank's Failure

Federal law indicates that a bank must file a SAR when it detects a known or suspected violation of federal law and outlines the circumstances under which a bank is required to file a SAR with the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN); these circumstances include insider abuse of any amount.¹⁴ The Federal Reserve System does not have a similar legal obligation to report suspicious activity as a part of its financial institution supervisory activities. Nevertheless, the Board's CBEM and AD Letter 13-8 provide guidance to examiners about how and when the Federal Reserve System should report suspected criminal violations and suspicious activity, including by filing a SAR.

A subsection of the Board's CBEM section 5020.1, *Reporting of Suspected Criminal Violations by Federal Reserve*, states that if during the course of an examination, an examiner (1) uncovers a situation that is known or suspected to involve a criminal violation of any section of the *United States Code* or state law and (2) finds that no referral, or an inadequate referral, has been made by the bank, the examiner should report the situation immediately to the appropriate Reserve Bank.¹⁵ The CBEM provides further guidance

¹⁴ These requirements for filing SARs are detailed in 12 C.F.R. § 208.62.

¹⁵ CBEM section 5020.1 was updated in October 2012 to reflect amended guidance for filing a SAR. The CBEM is updated on a semiannual basis.

on escalating an issue within the respective Reserve Bank and notes that the appropriate Reserve Bank officer should expeditiously notify and consult with the Bank Secrecy Act/Anti-Money Laundering (BSA/AML) section within S&R. CBEM section 5020.1 states, “If the Reserve Bank, after consulting with the Board’s BSA/AML Section, discovers that in a particular instance a bank failed to report the suspected criminal violation using the SAR or that the bank made an inadequate referral and, upon request, still fails to file a report, a SAR must be submitted to FinCEN.”

AD Letter 13-8 states that in circumstances in which examiners determine that a financial institution has failed to file a SAR as required by applicable law, examiners should expressly communicate this concern to the institution’s management; however, the guidance notes that care should be taken to ensure that no disclosure of the SAR filing is made to the subject of the SAR.¹⁶ This guidance directs examiners to consult with S&R’s BSA/AML section to determine whether it is appropriate for the Federal Reserve System to file a SAR or take other enforcement actions. Finally, the guidance states that if this consultation results in a determination that the situation requires that a SAR be filed to provide necessary information on the suspicious activity to law enforcement, the Board’s BSA/AML section will finalize and electronically file the SAR.

FRB St. Louis examiners identified circumstances involving unsafe and unsound practices at Allied Bank during a May 2012 examination, some of which involved alleged insider abuse. FRB St. Louis cited these circumstances in the examination report and in the recommendation for removal, prohibition, or civil money penalties. FRB St. Louis and S&R staff, including staff from the BSA/AML section, also discussed the need for a SAR filing on behalf of the institution in 2012. However, we determined that the Federal Reserve System did not file a SAR on behalf of the institution during our review period. FRB St. Louis officials explained that the Reserve Bank did not take steps to file a SAR when they first identified unsafe and unsound practices because they hoped the recommendation for removal, prohibition, or civil money penalties would remove the relevant management officials from Allied Bank. Both FRB St. Louis and S&R officials noted that in hindsight, they should have filed a SAR at the same time as the recommendation for removal, prohibition, or civil money penalties against members of Allied Bank management. We determined that in March 2017, the Federal Reserve System filed the appropriate notification forms after Allied Bank’s failure. The notification form filed in 2017 included the same information identified in 2012 and 2013.

Board and Reserve Bank Staff Were Confused About the Expectations for Filing SARs

Despite the guidance in the CBEM and the AD Letter on the topic, we noted confusion among FRB St. Louis supervision staff and Board staff concerning the appropriate circumstances in which to file a SAR on behalf of the institution. One examiner noted that a SAR should be filed when suspicious activity, fraud, or other illegal activity is detected. Another examiner noted that he or she did not think bank examiners were in a position to determine whether an action is criminal and, thus, warrants filing a SAR. Officials from the BSA/AML section explained that the Federal Reserve System is not legally obligated to file SARs; rather, an institution must comply with the requirement. In addition, an official in the BSA/AML section stated that when a bank is unwilling or unable to file a SAR, the Reserve Bank should cite a

¹⁶ AD Letter 13-8 became effective on February 12, 2013.

violation of law against the bank within the examination report. However, as noted previously, the guidance states that care should be taken to ensure that no disclosure of the SAR filing is made to the subject of the SAR, who may have access to the examination report; therefore, it may not be practical to cite a violation in the examination report if the alleged activities involve insiders such as senior management officials.

There also appears to be confusion regarding the roles and responsibilities of Board and Reserve Bank staff regarding filing SARs. As previously noted, the Board's guidance explains that the BSA/AML section is responsible for filing SARs electronically. However, one examiner indicated that SARs can only be initiated by staff in the Board's Legal Division. The guidance also directs the Reserve Banks to contact the BSA/AML section for consultation or questions regarding this process. However, staff from the BSA/AML section indicated that their group is primarily responsible for supervision strategy development related to BSA/AML programs and they do not provide advisory services concerning what to include in a SAR or edit the SAR language. With respect to Allied Bank, an FRB St. Louis official noted that he or she expected the BSA/AML section to play a more consultative role.

Interviewees noted opportunities to clarify the expectations for filing SARs. An S&R official noted that AD Letter 13-8 is vague and should be clarified. In addition, an FRB St. Louis official noted that the guidance contains administrative information, rather than helpful information on what to include in a SAR submission.

For informational purposes, we sought to understand the approaches of other federal financial regulatory agencies to filing SARs. We obtained and reviewed guidance on filing SARs from two other federal financial regulatory agencies.

- The guidance from one federal financial regulatory agency notes that examiners should be concerned with suspicious activities involving insiders and others and directs examiners to immediately notify agency officials of suspicious activities identified during an examination. The guidance notes that agency officials may then instruct examiners to proceed with filing a SAR. This guidance notes that there are other steps examiners can take after a SAR has been filed, such as gathering facts to support corrective actions, including recommendations for removal and prohibition, and disclosing information to law enforcement.
- Guidance from another federal financial regulatory agency indicates that examiners must complete and file a SAR when the required filing institution has either failed to do so or failed to do so properly. This agency's guidance also outlines specific examples of actions that may indicate insider abuse, including unsound lending practices, excessive concentrations of credit, unsound or excessive loans to insiders or their related interests, violations of regulations, and criminal violations.

We determined that guidance from other federal financial regulatory agencies includes additional context on either what examiners can do when they identify suspicious activities or the circumstances that may indicate insider abuse. Although we did not conclude that a SAR filing would have prevented the bank's failure, a SAR filing could have alerted law enforcement of the suspicious activity as early as 2012. Further, the Federal Reserve System may be the last line of defense in the limited circumstances in which an institution is unable or unwilling to file a SAR as required by applicable law, including situations in which bank insiders' involvement in suspicious activities makes it unreasonable to expect that bank employees initiate or submit the required filing or react to an examiner's recommendation to file a SAR.

Recommendation

We recommend that the Director of S&R

1. Clarify guidance and conduct training on the expectations and process for suspicious activity reporting by the Federal Reserve System, including
 - a. the roles and responsibilities of Board and Reserve Bank staff.
 - b. the circumstances that may warrant Reserve Bank staff recommending that the Board file a SAR.

Management's Response

In its response to our draft report, the Board concurs with our recommendation. The agency notes that S&R will issue revised guidance to clarify expectations for suspicious activity reporting and consider training opportunities to communicate expectations.

OIG Comment

The actions described by the Board appear to be responsive to our recommendation. We will follow up to ensure that the recommendation is fully addressed.



Finding 2: Communication After Reserve Bank Requests for Enforcement Action Can Be Improved

FRB St. Louis submitted a recommendation for removal, prohibition, or civil money penalties against members of Allied Bank management to the appropriate parties, including the Board's Legal Division and S&R, in March 2013. The Legal Division made some effort to pursue the recommendation; however, FRB St. Louis supervision staff expressed frustration that despite referring these issues in 2013, members of Allied Bank management remained in their roles until the bank failed in September 2016. AD Letter 07-21, *Processing of Enforcement Matters*, outlines the procedure for Reserve Banks to simultaneously submit recommendations concerning formal enforcement actions to both the Legal Division and S&R and notes that these divisions will coordinate closely with regard to any enforcement actions against institutional insiders. We noted opportunities for enhanced communication between FRB St. Louis and the Legal Division following the Reserve Bank's submission of the recommendation. FRB St. Louis officials noted that they did not receive sufficient status updates regarding the Legal Division's efforts in response to the recommendation, and Legal Division officials noted that it would have been beneficial for FRB St. Louis to follow up more frequently to demonstrate the urgency of the issue. We attribute these challenges to a lack of guidance or expectations on how the Reserve Banks and the Legal Division should communicate after a Reserve Bank submits a request for action. Clearer expectations for communications can increase the likelihood that the divisions coordinate effectively to pursue enforcement actions against institutional insiders.

Limited Communication Between FRB St. Louis and the Legal Division Following the Request for Action

AD Letter 07-21 states that Reserve Banks should submit all recommendations concerning formal enforcement actions simultaneously to both the Legal Division and S&R. The Board issued AD Letter 07-21 as a result of efforts between the Legal Division and S&R to work more closely together on enforcement matters. The AD Letter also notes that this change will allow the Legal Division to begin its review of these matters earlier in the process and that the respective staffs will work together to take appropriate action.

As previously noted, FRB St. Louis submitted a recommendation for removal, prohibition, or civil money penalties against members of Allied Bank management to the Board on March 8, 2013. We found that FRB St. Louis sent the recommendation to the appropriate parties, including the Legal Division and S&R, in accordance with the expectations detailed in AD Letter 07-21. The Legal Division discussed the recommendation with FRB St. Louis and subsequently issued an information request to Allied Bank regarding the conduct described in the recommendation. Upon receiving information from Allied Bank, the Legal Division communicated with FRB St. Louis and requested additional documentation from FRB St. Louis to supplement the information provided by Allied Bank. However, we determined that there was limited communication between FRB St. Louis and the Legal Division following these initial

communications related to the Legal Division's status and actions to address the recommendation. Although the Legal Division described various reasons for not aggressively pursuing the removal and prohibition of Allied Bank management, we found that FRB St. Louis staff were not aware of these reasons during our interviews. FRB St. Louis supervision staff expressed frustration that despite submitting the recommendation in 2013, members of Allied Bank management remained in their roles until the bank failed in September 2016.

In addition, FRB St. Louis officials noted that they did not receive sufficient status updates. For example, FRB St. Louis officials described updates and communication from the Legal Division as "slow" and "sporadic." FRB St. Louis officials explained that they asked the Legal Division for status updates either through emails or phone calls, but the Legal Division did not openly communicate its actions to address FRB St. Louis's recommendation. A Legal Division official noted that the Legal Division tried to keep FRB St. Louis up to date on its efforts. This official acknowledged, however, that there is no formal process for communicating with the Reserve Banks. An FRB St. Louis examiner also noted that there is no process in place for the Legal Division to provide updates in response to Reserve Bank requests for enforcement actions and explained that status updates could be beneficial and could enable examiners to focus on specific areas during subsequent examinations.

S&R officials noted that they inquired about the status of the recommendation on FRB St. Louis's behalf. These officials indicated that the Legal Division did not provide an update and stated that the prohibition order review process takes a long time. In contrast, Legal Division officials told us that they expected FRB St. Louis to follow up more frequently with the Legal Division to demonstrate the urgency of the issue. A senior Legal Division official stated that Reserve Bank follow-ups on the status of requests for action help the Legal Division prioritize its cases. We attribute this disconnect to a lack of clear expectations concerning how the Reserve Banks and the Legal Division should communicate after a Reserve Bank submits a request for an enforcement action.

We found that the Legal Division has recently taken steps to increase coordination with Reserve Banks regarding enforcement matters. Specifically, Legal Division officials noted that they are consulting with Reserve Bank staff regarding potential enforcement approaches earlier in the process, before a Reserve Bank submits a request for action to the Legal Division. Further, the Legal Division and S&R have taken steps to increase communication and transparency between these two divisions. Specifically, S&R officials noted that they requested that the Legal Division provide a list of all open enforcement actions and their current status. These officials also indicated that S&R staff began attending regular meetings with the Legal Division's Enforcement group to increase communication and transparency between the two divisions.

We acknowledge that expectations for communication following a request for action should allow for flexibility depending on the circumstances of the enforcement matter; however, clearer expectations for communication can increase the likelihood that the divisions and Reserve Banks will coordinate effectively to pursue enforcement actions against institutional insiders.

Recommendation

We recommend that the General Counsel

2. Clarify expectations for communication following requests for enforcement action from the Reserve Banks. In clarifying expectations, the Legal Division should include
 - a. the frequency and type of communication the Legal Division expects from the Reserve Banks.
 - b. the frequency and type of status updates the Legal Division will provide to the Reserve Banks.

Management's Response

In its response to our draft report, the Board concurs with our recommendation. The agency notes that the Legal Division will review its current expanded coordination practices to add further clarification to expectations for communications to and from the Reserve Banks on recommendations for enforcement action.

OIG Comment

The actions described by the Board appear to be responsive to our recommendation. We will follow up to ensure that the recommendation is fully addressed.



Appendix A: Glossary of Banking and Regulatory Terms

allowance for loan and lease losses (ALLL)—A valuation reserve established and maintained by charges against the bank’s operating income. As a valuation reserve, it 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. The reserve must be sufficient to absorb probable losses inherent in the institution’s loan and lease portfolio.

classified assets—Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Classified assets are divided into subcategories: *substandard*, *doubtful*, and *loss*. An asset classified as *substandard* is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. An asset classified as *doubtful* has all the weaknesses inherent in one classified as *substandard*, with the added characteristic that the weaknesses make full collection or liquidation highly questionable and improbable. An asset classified as *loss* is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted.

commercial real estate loans—Land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans. Commercial real estate loans also include loans secured by multifamily property and nonfarm, nonresidential property where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

concentration—A significant amount of direct or indirect extensions of credit and contingent obligations that possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry are included in homogeneous risk groupings when assessing asset concentrations.

construction, land, and land development (CLD) loans—A subset of commercial real estate loans, secured by real estate (including nonagricultural vacant land), for (1) onsite construction of industrial, commercial, residential, or farm buildings and (2) land development, including preconstruction preparatory work such as laying sewer and water pipes.

enforcement actions—The Board has a broad range of enforcement powers that includes formal and informal enforcement actions that may be taken, typically after the completion of an onsite bank examination. Formal enforcement actions consist of written agreements, temporary cease-and-desist orders, cease-and-desist orders, prohibition and removal orders, and PCA directives; informal enforcement actions include commitment letters, board resolutions, and MOUs.

liquidity—The ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain the funds it needs, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

prohibition order—An order the Board is authorized to issue to remove any institution-affiliated party as a result of certain violations or misconduct and to prohibit the party from participating in the affairs of any financial institution or its subsidiaries in the future.

prompt corrective action (PCA)—A framework of supervisory actions, set forth in title 12, section 1831o, of the *United States Code*, for insured depository institutions whose capital positions have declined below certain threshold levels. The framework was intended to ensure that when an institution becomes financially troubled, action is taken to resolve the problems of the institution and to incur the least possible long-term loss to the DIF. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

Supervision and Regulation Letter (SR Letter)—SR Letters are issued by S&R. They address significant policy and procedural matters of continuing relevance to the Board’s supervisory effort. SR Letters are distributed to supervised institutions as well as the Reserve Banks.

tier 1 capital—The sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

underwriting—Detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower’s credit history; and the lender’s evaluation of the borrower’s credit needs and ability to pay.

written agreement—A formal supervisory enforcement action that is generally issued when a financial or institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Board or a Reserve Bank that may require the financial institution or the institution-affiliated party (1) to stop engaging in specific practices or violations or (2) to take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. This enforcement action is the least severe of the formal enforcement actions.



Appendix B: CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of the institution’s financial condition and operations:

adequacy of capital

quality of assets

capability of management

quality and level of earnings

adequacy of liquidity

sensitivity to market risk

Evaluations of the components take into consideration the institution’s size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1–5 numerical scale. The highest rating, 1, indicates the strongest performance and risk management practices and the least degree of supervisory concern, while 5 indicates the weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definitions

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution’s managerial, operational, financial, and compliance performance.

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences, such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to their size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For financial institutions to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors’ and management’s capabilities and willingness to

correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institutions' size, complexity, and risk profile. As there are no material supervisory concerns, the supervisory response is informal and limited.

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institutions' size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The board of directors and management are not satisfactorily addressing or resolving weaknesses and problems. Financial institutions in this group generally are not capable of withstanding business fluctuations and may be significantly noncompliant with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required; in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the DIF. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit critically deficient performance; often contain inadequate risk management practices relative to the institutions' size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed for these financial institutions to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the DIF, and failure is highly probable.

Appendix C: Management's Response

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISIONS OF SUPERVISION AND REGULATION & LEGAL

Date: February 28, 2018
To: Melissa Heist, Associate Inspector General
From: Michael S. Gibson, Director, Division of Supervision and Regulation *MG*
Mark E. Van Der Weide, General Counsel, Legal Division *MEV*
Subject: Review of the Failure of Allied Bank

The Division of Supervision and Regulation and the Legal Division have reviewed the draft Review of the Failure of Allied Bank, Mulberry, Arkansas, prepared by the Office of Inspector General (OIG). The report finds that Allied Bank failed due to significant asset quality deterioration caused by corporate governance weaknesses and deficient credit risk management practices. Specifically, ineffective oversight by Allied Bank's board of directors allowed two senior management officers to dominate the bank's affairs and allegedly engage in insider abuse. These two senior officers exerted a controlling influence over the bank's daily operations, in particular the bank's lending and policy decisions. Poor lending decisions coupled with weak credit underwriting and administration practices resulted in significant loan losses that eventually depleted the bank's capital. Allied Bank was supervised by the Federal Reserve Bank of St. Louis (FRB St. Louis) under delegated authority from the Board.

The report states that FRB St. Louis generally took appropriate and decisive supervisory action to address Allied Bank's weaknesses, such as appropriately downgrading Allied Bank's CAMELS composite ratings, placing Allied Bank under various enforcement actions, increasing the examination frequency of Allied Bank, and assigning more experienced staff to participate on Allied Bank's examinations. However, the report also discusses issues with reporting suspicious activity to law enforcement when insider abuse was suspected and issues surrounding FRB St. Louis's recommendation to remove, prohibit or assess civil money penalties against key Allied Bank management officials. As such, the OIG makes the following two recommendations to address these issues.

1. The Division of Supervision and Regulation should clarify guidance and conduct training on the expectations and process for suspicious activity reporting by the Federal Reserve System, including:
 - a. The roles and responsibilities of Board and Reserve Bank staff
 - b. The circumstances that may warrant Reserve Bank staff recommending that the Board file a suspicious activity report (SAR)
2. The Legal Division should clarify expectations for communication following requests for enforcement action from the Reserve Banks, specifically:
 - a. The frequency and type of communication the Legal Division expects from the Reserve Banks
 - b. The frequency and type of status updates the Legal Division will provide to the Reserve Banks

The Division of Supervision and Regulation and the Legal Division acknowledge the conclusions in the report. The Division of Supervision and Regulation agrees with the first recommendation and recognizes the importance of providing clarity regarding the roles and responsibilities of the Reserve Bank and Board staff. In response to the recommendation, the division will issue revised guidance to clarify expectations and consider training opportunities to communicate expectations.

For the second recommendation, the Legal Division appreciates that the report recognizes steps recently taken to increase coordination with the Reserve Banks regarding enforcement matters. The Legal Division agrees with the recommendation and will review its current expanded coordination practices to add further clarification to expectations for communications to and from the Reserve Banks on recommendations for enforcement action received by enforcement staff from the Reserve Banks. As the report recognizes, expectations for such communications will necessarily depend on the particular circumstances involved, including the strength of the merits of the specific case and the Board's overall enforcement priorities.



Abbreviations

ACME	ACME Holding Company, Inc.
AD Letter	Advisory Letter
ALLL	allowance for loan and lease losses
ASBD	Arkansas State Bank Department
Board	Board of Governors of the Federal Reserve System
BSA/AML	Bank Secrecy Act/Anti-Money Laundering
CBEM	<i>Commercial Bank Examination Manual</i>
CLD	construction, land, and land development
DIF	Deposit Insurance Fund
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
ESOP	Employee Stock Ownership Plan
FDIC	Federal Deposit Insurance Corporation
FinCEN	Financial Crimes Enforcement Network
FRB St. Louis	Federal Reserve Bank of St. Louis
MOU	memorandum of understanding
OIG	Office of Inspector General
PCA	prompt corrective action
SAO	Special Assets Officer
SAR	Suspicious Activity Report
SR Letter	Supervision and Regulation Letter
S&R	Division of Supervision and Regulation

Report Contributors

Laura Shakarji, OIG Manager

Stephanie Wake, Project Lead

Matthew Gibbons, Auditor

Stephen O'Connell, Auditor

Michael VanHuysen, Senior OIG Manager for Supervision and Regulation

Melissa Heist, Associate Inspector General for Audits and Evaluations

Contact Information

General

Office of Inspector General
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Mail Stop K-300
Washington, DC 20551

Phone: 202-973-5000

Fax: 202-973-5044

Media and Congressional

OIG.Media@frb.gov



Hotline

Report fraud, waste, and abuse.

Those suspecting possible wrongdoing may contact the OIG Hotline by mail, [web form](#), phone, or fax.

OIG Hotline
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Mail Stop K-300
Washington, DC 20551

Phone: 800-827-3340

Fax: 202-973-5044