

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

In the Matter of)
)
)
Priority Bank) OCC AA-SO-12-53
Ozark, Arkansas)
)

AMENDED NOTICE OF CHARGES FOR AN ORDER TO CEASE AND DESIST

The Comptroller of the Currency of the United States of America (“Comptroller” or “OCC”), charges that Priority Bank, Ozark, Arkansas (“Bank”) is engaging or has engaged, and/or the OCC has reasonable cause to believe that the Bank is about to engage, in unsafe or unsound practices and violations of law, rule, or regulation, and hereby files this Amended Notice of Charges for issuance of a Cease and Desist Order against the Bank pursuant to section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b).

TAKE NOTICE that a hearing will commence in Fort Smith, Arkansas pursuant to 12 U.S.C. § 1818(b) on December 10, 2012, concerning the charges set forth herein to determine whether a Cease and Desist Order should be issued against the Bank. The hearing shall be open to the public unless the Comptroller, in his discretion, determines that an open hearing would be contrary to the public interest.

After examination and investigation into the affairs of the Bank, the Comptroller has determined that the Bank is engaging or has engaged, and/or is about to engage in unsafe or unsound practices and violations of law, rule or regulation. The Comptroller intends to order the Bank to cease and desist from the unsafe or unsound practices and

violations specified herein and, further, to take affirmative action to correct the conditions resulting from such practices.

In support of this Notice of Charges, the Comptroller charges the following:

ARTICLE I

JURISDICTION

At all times relevant to the charges set forth below:

(1) The Bank was a federal savings association, supervised and examined by the OCC pursuant to 12 U.S.C. § 5412(b).¹

(2) The Bank was an “insured depository institution” as defined in 12 U.S.C. § 1813(c)(2) and within in the meaning of 12 U.S.C. § 1818(b).

(3) The OCC is “the appropriate Federal banking agency” within the meaning of 12 U.S.C. § 1813(q)(1) and for the purposes of 12 U.S.C. § 1818(b) to initiate an enforcement proceeding against a federal savings association.

ARTICLE II

BACKGROUND

(4) The Bank is a community bank that currently operates two full service offices, located in Ozark and Fayetteville, Arkansas. The Bank is wholly owned by Priority One Holding Company (“Holding Company”), a bank holding company in

¹ Prior to July 21, 2011 the Bank was regulated by the Office of Thrift Supervision (“OTS”). Pursuant to Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010), all functions of the Office of Thrift Supervision (“OTS”) related to Federal savings associations were transferred to the Office of the Comptroller of the Currency (“OCC”) on July 21, 2011. See Dodd-Frank Act, § 312(b), 12 U.S.C. § 5412.

Fayetteville, Arkansas. As of September 30, 2011, the Bank had approximately \$85 million in total assets.

(5) Priority One Holding Company is wholly owned by the Bank's President and Chairman of the Board.

(6) The Bank's predominant business is owner-occupied 1-4 family mortgage lending. The Bank does not escrow for real estate taxes or property insurance for the majority of its residential borrowers.

(7) The OCC reviews banks' financial information to determine banks' ratings under the Uniform Financial Institutions Rating System ("UFIRS"). UFIRS consists of nine components, eight of which are rated numerically on a scale of "1" to "5," and one of which is rated adjectively. The eight numerically rated components are "capital," "asset quality," "management," "earnings," "liquidity," "sensitivity to market risk," "information technology," and "consumer compliance." These components are commonly referred to as "CAMELSICC" or "CAMELS." Each bank also receives a composite rating based on an evaluation of all nine components. Any component or composite rating of "3" or greater is considered less than satisfactory.

2011 Transitional Examination Findings

(8) The Office of Thrift Supervision ("OTS") conducted a transitional examination of the Bank beginning on June 20, 2011 ("2011 Transitional Examination"). This examination involved limited examination procedures and was tailored to follow up on corrective actions from the OTS's 2009 examination and assess the overall condition of the Bank. As a result of the OTS's findings during this limited examination, the OTS retained the Bank's composite rating of "2."

2011 Full-Scope Examination Findings

(9) The OCC conducted a full-scope examination of the Bank beginning on August 17, 2011 (“2011 Full-Scope Examination”). The OCC reviewed the Bank’s financial information as of June 30, 2011, updated to September 30, 2011 where available.

(10) The OCC notified the Bank of the results of the 2011 Full-Scope Examination in a report of examination delivered to the Bank on April 10, 2012 (“initial 2011 ROE”).

(11) The Bank subsequently appealed certain material supervisory determinations of the 2011 Full-Scope Examination to the OCC’s Ombudsman. Specifically, the Bank appealed the OCC’s determination to classify the Bank’s advances for its borrowers’ taxes and/or insurance as Doubtful and the principal balance of the loans on which advances were made as Substandard. The Bank also appealed its component ratings for capital, asset quality, management, earnings, and liquidity, as well as its composite rating and its “troubled condition” designation.

(12) By decision dated August 16, 2012, the Ombudsman ruled on the Bank’s appeal and issued final CAMELS ratings. The Ombudsman upheld the examiners’ decision to classify the Bank’s advances for taxes or insurance as Doubtful and the principal balances of the underlying loans as Substandard. The Ombudsman upheld the Bank’s composite CAMELS rating, liquidity component rating, and troubled condition designation contained in the initial 2011 ROE. The Ombudsman upgraded the Bank’s capital, asset quality, management, and earnings component ratings contained in the initial 2011 ROE.

(13) The 2011 ROE was revised consistent with the findings in the Ombudsman's August 16, 2012 decision. The Ombudsman delivered the final 2011 ROE to the Bank in September 2012. All examination findings listed below are those contained in the final 2011 ROE as delivered to the Bank by the Ombudsman.

(14) Asset quality as of the 2011 Full-Scope Examination showed deterioration, with classified assets at 209.2 percent of Tier 1 capital plus the Allowance for Loan and Lease Losses ("ALLL") at September 30, 2011, compared to 29.6 percent at the 2009 examination. During the 2011 Full-Scope Examination, the OCC reviewed the Bank's risk ratings and identified assets that should be adversely classified in accordance with interagency policy. The Bank's risk ratings were inaccurate for 28 percent of the loans reviewed by the OCC.

(15) In addition to those loans, the OCC required the Bank to classify as Substandard the \$14.6 million principal balance of the segment of the Bank's residential loan portfolio consisting of borrowers for whom the Bank advanced real estate taxes, property insurance, or both ("T&I") and also required the Bank to classify as Doubtful the \$573 thousand that the Bank had made in T&I advances for those borrowers. The OCC determined asset quality to be less than satisfactory and downgraded the rating to a "3."

(16) In addition to the deterioration in asset quality, the examination uncovered evidence of weak credit risk management. The Bank failed to properly assess borrowers' capacity to pay all of their mortgage obligations, including taxes and insurance, at underwriting and failed to implement adequate repayment policies or procedures to address the collection of T&I advances.

(17) As of the 2011 Full-Scope Examination, management did not establish concentration risk tolerance levels as a percentage of capital, approve a formal Capital Plan, or approve a Dividend Policy. Management and the Board refused to properly report on its December 31, 2011 Thrift Financial Report (“TFR”) the Substandard and Doubtful classification determinations in the Bank’s residential loan portfolio made by the OCC. The OCC determined management to be less than satisfactory and downgraded the rating to a “3.”

(18) During the OCC’s 2011 Examination of the Bank, the Bank made a \$416 thousand adjustment to the ALLL balance, of which \$287 thousand was specifically required by the OCC. The ALLL is a valuation reserve established and maintained by charges against the Bank’s operating income. As a valuation reserve, it is an estimate of an uncollectible amount that is used to reduce the book value of loans and leases to the amount that is expected to be collected.

(19) Liquidity risk at this examination was high and increasing. The Bank continued to heavily rely on Federal Home Loan Bank advances for liquidity funding purposes. Liquidity was less than satisfactory and was downgraded to a “3” rating.

(20) The 2011 ROE notified the Bank that it is designated in “troubled condition” for the purpose of 12 U.S.C. § 1831i, and as a result, the Bank became subject to the provisions of 12 U.S.C. § 1831i and 12 C.F.R. Part 163, Subpart H that relate to providing the OCC with prior notice of changes to directors and senior executive officers and 12 C.F.R. Part 359 regarding golden parachute payments.

(21) The 2011 ROE also identified 14 problem areas that required the Board’s immediate attention, specified as Matters Requiring Attention (“MRA”). An MRA is a

matter that deviates from sound fundamental banking principles, internal controls, or risk management. If not corrected by the Bank, an MRA is likely to result in financial harm or substantive violations of law, as well as expose the Bank's earnings and capital to risk. When the OCC communicates an MRA to a bank, the MRA serves as notification in writing of a deficiency, and requires a bank's board of directors to take immediate corrective action. The 14 MRAs in the 2011 ROE addressed the areas of (1) credit risk, (2) residential loan underwriting, (3) criticized assets, (4) loan portfolio management, (5) problem loan identification and risk rating accuracy, (6) capital plan and strategic plan, (7) ALLL methodology, (8) other real estate owned ("OREO") accounting, (9) concentration risk management, (10) transactions with affiliates, (11) conflict of interest with respect to insider transactions, (12) conflict of interest with respect to purchases of loans originated by an affiliate, (13) inaccurate TFR, and (14) force placement of flood insurance. The MRAs describe necessary actions that the Bank must take in order to remedy or correct the unsafe or unsound practices and to cure the unsafe or unsound condition described in the 2011 ROE.

(22) Based on the above less-than-satisfactory ratings in asset quality, management, and liquidity, the OCC downgraded the Bank's overall composite rating from "2" to "3."

ARTICLE III

UNSAFE OR UNSOUND PRACTICES

(23) The OCC reasserts and realleges the allegations in paragraphs (4) through (22).

Inadequate Credit Risk Management

(24) The Bank failed to maintain prudent underwriting practices associated with its borrowers' capacity to pay all mortgage-related obligations, including real estate taxes and property insurance.

(25) The Bank did not include borrowers' real estate taxes and property insurance obligations in its debt-to-income calculations.

(26) The Bank failed to implement adequate repayment policies or procedures for tax or insurance advances that it made on borrowers' behalf.

(27) The Bank did not follow the provisions in its Lending Policy relating to the collection of advances for taxes or insurance.

(28) Upon advancing a borrower's taxes or insurance, the Bank failed to assess the borrower's ability to pay all mortgage-related obligations, including principal, interest, taxes and insurance, on a going forward basis.

(29) The Bank failed to assess borrowers' ability to repay advances within a reasonable time frame and failed to determine if current collateral values supported additional advances.

(30) The Bank failed to monitor the performance of residential mortgage loans made to customers of a construction company owned by a Bank insider.

(31) The Bank did not review the underwriting of the loans it purchased that were initially originated by Priority One Mortgage Company, an entity outside of the Bank's holding company structure, but wholly owned by the Bank's President.

(32) The Bank engaged in unsafe or unsound practices by failing to properly manage and address credit risk.

Inadequate Management of Criticized Assets

(33) The Bank has a high level of criticized assets, indicated by its ratio of adversely classified assets to Tier 1 capital plus the ALLL of 209.2 percent, as of September 30, 2011.

(34) The excessive level of classified assets is composed mainly of residential loans where the Bank advanced payments for borrowers' taxes or insurance and its failure to implement a system to ensure the repayment of those advances by the borrowers.

(35) On January 27, 2012, the Board passed a resolution refusing to accept the OCC's loan classification determinations on the Bank's T&I loans.

(36) The Bank's December 31, 2011 Thrift Financial Report ("TFR") did not properly report the classification determinations made by the OCC during the 2011 Full-Scope Examination.

(37) The Bank engaged in unsafe or unsound practices by failing to properly manage and report its criticized assets.

Inadequate Loan Portfolio Management

(38) The Bank did not establish an effective process to accurately validate the quality of its loan portfolio and loan risk ratings or to correct credit administration weaknesses.

(39) The Bank did not develop and implement adequate collection policies or procedures on advances for borrowers' taxes or insurance.

(40) The Board of Directors did not establish limitations for loan concentrations in relation to capital.

(41) The Bank failed to obtain current financial information on loans in its commercial loan portfolio, resulting in an excessive level of credit and collateral documentation exceptions.

(42) The weaknesses in the Bank's loan portfolio management resulted in a high level of classified assets, inaccurate TFR reporting, and high aggregate levels of credit, liquidity, operational, and reputation risk.

(43) The Bank engaged in unsafe or unsound practices by failing to properly manage its loan portfolio.

Inadequate Problem Loan Identification and Loan Review

(44) During the 2011 Full-Scope Examination, the OCC reviewed the Bank's risk ratings and identified assets that should be adversely classified in accordance with interagency guidance.

(45) The Bank's risk ratings were inaccurate for 28 percent of the loans reviewed by the OCC.

(46) In addition to the 28 percent of loans, 158 of the Bank's 1-4 family residential loans on which the Bank advanced taxes or insurance were not appropriately risk rated pursuant to the interagency *Uniform Retail Credit Classification and Account Management Policy*.²

(47) The Bank's advances on 104 of its 158 T&I loans covered multiple years of taxes and/or insurance.

(48) The Bank failed to evaluate the collectability or appropriately risk rate the advances themselves.

² Disseminated by OTS CEO Memo 128 and OCC Bulletin 2000-20.

(49) The Bank failed to regularly obtain an adequate external loan review, and consequently, risk ratings were not validated on an ongoing basis.

(50) Training for loan officers was either absent or ineffective.

(51) The Bank was not following its written Classification of Assets Policy at the time of the 2011 Full-Scope Examination.

(52) The Bank engaged in unsafe or unsound practices by failing to properly identify problem loans and regularly obtain an adequate external loan review.

Capital Planning

(53) Management did not prepare a formal capital plan or dividend policy addressing plans for maintaining capital at an adequate level.

(54) The Bank's informal policies and projections did not adequately address the risk to capital from continued asset growth and dividend requirements.

(55) The Bank engaged in unsafe or unsound practices by failing to implement a formal capital plan or dividend policy addressing plans for maintaining satisfactory levels of capital.

Inadequate Allowance for Loan and Lease Losses Methodology

(56) The Bank's ALLL methodology did not fully conform with Accounting Standards Codification ("ASC") 450, "Accounting for Contingencies," and ASC 310, "Accounting by Creditors for Impairment of a Loan" (formerly FAS 5 and FAS 114, respectively) or OTS CEO Memo 250 or OCC Bulletin 2006-47, *Allowance for Loan and Lease Losses*.

(57) The Bank's methodology did not appropriately identify loans to be assessed for impairment or properly identify and support impairment amounts.

(58) The Bank's narratives supporting the qualitative methodology factors were also inadequate.

(59) The Bank engaged in unsafe or unsound practices by failing to maintain an adequate ALLL methodology.

Improper Other Real Estate Owned Accounting

(60) The Bank's Other Real Estate Owned ("OREO") accounting practices did not fully conform to generally accepted accounting principles ("GAAP") or TFR instructions.

(61) The practices did not conform in that:

- (a) repairs were made to properties prior to obtaining title;
- (b) the OREO balance was improperly reduced by amounts received in earnest money;
- (c) regular maintenance and repair costs were improperly capitalized to the OREO balance;
- (d) collateral values were not adequately supported; and
- (e) the OREO balance was improperly reduced by declines in value while in the holding period.

(62) File documentation also needed improvement.

(63) The Bank engaged in unsafe or unsound practices by failing to properly account for its OREO.

Inadequate Concentration Risk Management

(64) The Board did not establish limits for concentrations of credit as a percentage of capital by which to manage its loan portfolio. Risk limits are needed to

provide assurance that current and future activities match the strategic risk appetite of the Board, to provide for a diversified asset mix, and to highlight potential capital exposure within certain pools of loans.

(65) The Bank engaged in unsafe or unsound practices by failing to properly manage and address concentration risk.

Inadequate Controls Over Affiliate and Insider Transactions

(66) The Bank is wholly owned by Priority One Holding Company, which is in turn wholly owned by the Bank's President.

(67) Priority One Mortgage Company ("POMC") is also wholly owned by the Bank's President.

(68) The Bank paid fees to POMC for services provided in mortgage loan origination and underwriting.

(69) There is no written agreement between the Bank and POMC for the services referenced in the preceding paragraph.

(70) POMC paid fees to Bank subsidiary Priority Credit Corporation for sub-servicing on POMC mortgages.

(71) The Bank purchased loans from third parties that were originated by POMC without performing independent underwriting, including determining the borrowers' ability to pay or determining updated collateral values at the time of purchase.

(72) The Bank's purchases from third parties of loans originated by POMC relieved POMC of its recourse obligations on those loans.

(73) A Bank Vice President and Director owns a controlling interest in five home building companies whose customers apply for permanent loans through the Bank to pay off their construction loans.

(74) As of the 2011 Full-Scope Examination, the Bank did not track the volume of loans referenced in the preceding paragraph and did not set limits for its exposure to those loans.

(75) The Bank failed to implement and adhere to a written, comprehensive conflicts of interest policy.

(76) The Bank engaged in unsafe or unsound practices by failing to implement policies, procedures, or internal controls to properly monitor affiliate and insider transactions, including the responsibility to determine that all fees paid to affiliates were reasonable, commensurate with the fair value of the services provided, expended for a legitimate or necessary Bank purpose and with consideration of the impact on the Bank's earnings.

ARTICLE IV

VIOLATION OF 12 U.S.C. § 1464(v), 12 C.F.R. §§ 160.160(a)(1) AND (2),

163.170(c), 163.180(a) AND (b), AND 12 C.F.R. PART 162

(77) The OCC reasserts and realleges the allegations in paragraphs (4) through (76).

(78) The Bank violated 12 C.F.R. § 160.160(a)(1) by failing to adversely classify 158 1-4 family residential loans on which the Bank advanced property taxes or insurance and by failing to adversely classify the T&I advances. The Bank's evaluation

and classification of its assets was not consistent with, or reconcilable to, the asset classification system used by the OTS and OCC.

(79) The Bank violated 12 C.F.R. § 160.160(a)(2), which requires an association to recognize examiner classifications in its reports to the OCC. OCC examiners directed the Bank to adversely classify the 1-4 family residential loans for which T&I advances were made and the T&I advances themselves. The Bank refused to do so and did not correctly report the classifications on its December 31, 2011 TFR.

(80) The Bank violated 12 U.S.C. § 1464(v), 12 C.F.R. Part 162, 12 C.F.R. §§ 163.170(c), and 163.180(a) and (b) by its failure to follow regulatory reporting requirements and failure to properly report classifications of the 1-4 family residential loans for which T&I advances were made and the T&I advances themselves in its December 31, 2011 TFR.

(81) The Bank engaged in violations of law or regulation and unsafe or unsound practices by failing to comply with 12 U.S.C. § 1464(v), 12 C.F.R. §§ 160.160(a)(1) and (2), 163.170(c), 163.180(a) and (b), and 12 C.F.R. Part 162.

ARTICLE V

LEGAL BASES FOR REQUESTED RELIEF

(82) The Comptroller reasserts and realleges the allegations in paragraphs (4) through (81).

(83) As evidenced by the Bank's actions described in Articles II through IV above, the Bank has violated laws or regulations and is engaging or has engaged, and/or is about to engage in unsafe or unsound practices in conducting the affairs of the Bank.

(84) By reason of the Bank's actions, the Comptroller charges that legal grounds exist for the issuance of an Order to Cease and Desist because the Bank violated 12 U.S.C. § 1464(v), 12 C.F.R. §§ 160.160(a)(1) and (2), 163.170(c), 163.180(a) and (b), and 12 C.F.R. Part 162 and is engaging or has engaged, and/or is about to engage in unsafe or unsound banking practices.

OPPORTUNITY FOR HEARING

The Bank is directed to file an answer to this Amended Notice of Charges within ten (10) days from the date of service of this Amended Notice of Charges in accordance with 12 C.F.R. § 109.20(a). The answer shall be filed electronically with the Office of Financial Institution Adjudication at ofia@fdic.gov. A copy of any answer shall also be filed with the OCC Hearing Clerk at HearingClerk@occ.treas.gov and with the attorneys who have filed a Notice of Appearance in this proceeding. **Failure to answer within this time period shall constitute a waiver of the right to appear and contest the allegations contained in this Amended Notice of Charges and shall, upon the Comptroller's motion, cause the Administrative Law Judge or the Comptroller to find the facts in this Amended Notice of Charges to be as alleged and to issue an appropriate order.**

PRAYER FOR RELIEF

The Comptroller prays for relief in the form of the issuance of a Cease and Desist Order that is substantially similar to the Proposed Cease and Desist Order attached hereto as Exhibit A, requiring the Bank to cease and desist from the unsafe or unsound practices

set forth in this Notice of Charges and, further, to take affirmative action to correct the conditions resulting from such practices.

The Comptroller, by his duly authorized designee, issues this Notice of Charges on this 15th day of October, 2012.

/s/
James G. Price
Associate Deputy Comptroller
Southern District Office