

# Office of Inspector General



Office of Material Loss Reviews  
Report No. IDR-10-001

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**In-Depth Review of the Failure of  
EvergreenBank, Seattle, Washington**

August 2010



## Why We Did The Audit

The Washington State Department of Financial Institutions (DFI) closed EvergreenBank (Evergreen), Seattle, Washington on January 22, 2010, and named the FDIC as receiver. On March 1, 2010, the FDIC notified the Office of Inspector General (OIG) that Evergreen's total assets at closing were \$404.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was \$60.7 million. As of June 30, 2010, the estimated loss to the DIF had decreased to \$52.5 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the material loss review (MLR) threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Further, the Financial Reform Act calls for the OIG to perform in-depth reviews of failures when the associated losses are not material but they involve unusual circumstances. At the time the Financial Reform Act was enacted, we had issued a draft of this report to FDIC management. As a result, although the estimated loss for Evergreen no longer meets the threshold requiring an MLR, we decided to complete the audit as an in-depth review and issue this report.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Evergreen's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Evergreen, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

## Background

Evergreen was established as a state nonmember institution in 1971 as Teachers State Bank. During the late 1970s, the institution's business focused primarily on processing share drafts (the equivalent of checks) for credit unions. However, to reflect the institution's growing interest in consumer and commercial markets, and to address a public perception that the institution's products and services were limited to teachers, the institution changed its name in 1980 to EvergreenBank. By 2000, narrowing profit margins and competition in the check processing business prompted Evergreen to withdraw from that activity and pursue consumer and commercial lending. Beginning in 2005, Evergreen began placing considerable emphasis on commercial real estate (CRE) and acquisition, development, and construction (ADC) lending in the Seattle metropolitan area. The institution's ADC lending generally pertained to speculative condominium and townhouse construction and land development projects.

In addition to a main office in Seattle, Evergreen maintained seven branches throughout the Seattle metropolitan area. The institution had no affiliates for purposes of Section 23A of the Federal Reserve Act. Evergreen was wholly-owned by EvergreenBancorp, Inc. (Bancorp), a publicly-traded, one-bank holding company. As of September 2009, the institution's directors owned or controlled just over 4 percent of the holding company's stock. No shareholder owned more than 6 percent of Bancorp's stock, and the shares were widely held.

**Audit Results****Causes of Failure and Loss**

Evergreen failed primarily because its Board and management did not effectively manage the risks associated with the institution's rapid growth and heavy concentrations in CRE and ADC loans. Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in the institution's lending markets deteriorated. Specifically, the institution exhibited weak loan underwriting, credit administration, and related monitoring practices. Evergreen also experienced high staff turnover in the lending function during a critical period for the institution. Further, Evergreen relied heavily upon wholesale funding sources, primarily brokered deposits and Federal Home Loan Bank borrowings, to support its lending activities and to maintain adequate liquidity. These funding sources became restricted when Evergreen's credit risk profile deteriorated in early 2009, placing a severe strain on the institution's liquidity position.

Evergreen's heavy concentration in CRE and ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the Seattle real estate market. Adding to this vulnerability was a general decline in the institution's capital levels between 2004 and 2008 while risk in the loan portfolio was increasing. Evergreen's declining capital reduced the institution's ability to absorb losses due to unforeseen circumstances. During the summer of 2008, the credit quality of Evergreen's loan portfolio began to decline. By year-end 2008, the quality of its loan portfolio had deteriorated significantly with the majority of the deterioration pertaining to ADC loans. Further deterioration occurred in 2009. The associated provisions and losses depleted Evergreen's earnings, eroded its capital, and strained its liquidity. The DFI closed Evergreen on January 22, 2010 because the institution was unable to raise sufficient capital to support its operations.

**The FDIC's Supervision of Evergreen**

The FDIC, in coordination with the DFI, provided ongoing supervisory oversight of Evergreen through regular onsite risk management examinations, an interim offsite review, and offsite monitoring activities. Through these efforts, the FDIC identified risks in Evergreen's operations and brought these risks to the attention of the institution's Board and management through examination reports, correspondence, and supervisory actions. Such risks included the institution's significant concentrations in CRE and ADC loans, weak lending practices, and heavy reliance on wholesale funding sources. In addition, the FDIC identified instances in which Evergreen's Consolidated Reports of Condition and Income (Call Reports) were inaccurate and directed the institution to file amendments to correct the identified errors. During the review, we identified a previously unidentified error in the amount of brokered deposits reported in the institution's December 31, 2007 Call Report, which resulted in an erroneous net non-core funding dependence ratio in the Uniform Bank Performance Report.

At the time of the April 2007 examination, economic conditions in Evergreen's lending markets were generally favorable and the institution's financial condition was satisfactory. In addition, examiners noted that the institution's lending practices were generally sound. Nevertheless, examiners recognized that risk within the institution's loan portfolio was increasing and lowered the component rating for Asset Quality from a "1" (assigned at the prior examination) to a "2". Examiners also made recommendations in certain areas to improve the institution's risk management practices. Examiners concluded that the

overall financial and operational condition of the institution was satisfactory and assigned a composite rating of “2”. Such an approach was consistent with the FDIC’s supervisory practices under such circumstances.

In retrospect, a more proactive supervisory approach during and after the April 2007 examination may have been prudent given the institution’s growing risk profile. Such an approach could have included obtaining a commitment on the part of Evergreen for more affirmative actions, such as stronger concentration and liquidity risk management controls and higher capital levels. Increased monitoring of Evergreen following the April 2007 examination may also have been beneficial. Examiners became sharply critical of Evergreen’s risk management practices during the August 2008 examination and issued a Supervisory Directive in December 2008. However, by that time, the institution’s lending markets were rapidly deteriorating, making remedial efforts difficult. A more proactive approach may have been more effective in influencing Evergreen to curb its CRE and ADC lending and strengthen its risk management controls before its lending markets deteriorated, potentially reducing the institution’s losses.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, recently provided training to its examination workforce wherein the importance of assessing an institution’s risk management practices on a forward-looking basis was emphasized.

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as “prompt corrective actions,” as an institution’s capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Based on the supervisory actions taken with respect to Evergreen, the FDIC properly implemented applicable PCA provisions of section 38.

## **Management Response**

On August 16, 2010, the FDIC’s Division of Supervision and Consumer Protection (DSC) provided a written response to a draft of this report. In its response, DSC reiterated the OIG’s conclusions regarding the causes of Evergreen’s failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. With regard to our assessment of the FDIC’s supervision, DSC stated that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations and volatile funding sources, such as Evergreen. In addition, DSC stated that updated guidance has been issued reminding examiners to take appropriate action when such risks are imprudently managed.

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**DATE:** August 24, 2010

**MEMORANDUM TO:** Sandra L. Thompson, Director  
Division of Supervision and Consumer Protection

**FROM:** */Signed/*  
Stephen M. Beard  
Assistant Inspector General for Material Loss Reviews

**SUBJECT:** *In-Depth Review of the Failure of EvergreenBank, Seattle, Washington (Report No. IDR-10-001)*

The Washington State Department of Financial Institutions (DFI) closed EvergreenBank (Evergreen) on January 22, 2010, and named the FDIC as receiver. On March 1, 2010, the FDIC notified the Office of Inspector General (OIG) that Evergreen's total assets at closing were \$404.4 million and that the estimated loss to the Deposit Insurance Fund (DIF) was \$60.7 million. As of June 30, 2010, the estimated loss to the DIF had decreased to \$52.5 million.

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Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Evergreen's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Evergreen, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Evergreen's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss and in-depth reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.<sup>1</sup>

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<sup>1</sup>A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of the report.

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System (otherwise known as CAMELS ratings). Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on the report.

## **Background**

Evergreen was established as a state nonmember institution in 1971 as Teachers State Bank. During the late 1970s, the institution's business focused primarily on processing share drafts (the equivalent of checks) for credit unions. However, to reflect the institution's growing interest in consumer and commercial markets, and to address a public perception that the institution's products and services were limited to teachers, the institution changed its name in 1980 to EvergreenBank. By 2000, narrowing profit margins and competition in the check processing business prompted Evergreen to withdraw from that business and begin focusing on consumer and commercial lending. During 2005, Evergreen began placing considerable emphasis on commercial real estate (CRE) and acquisition, development, and construction (ADC) lending in the Seattle metropolitan area. The institution's ADC lending generally pertained to single-family home construction, condominium conversions, and commercial construction projects.

In addition to a main office in Seattle, Evergreen maintained seven branches throughout the Seattle metropolitan area. The institution had no affiliates for purposes of section 23A of the Federal Reserve Act, made applicable to insured nonmember institutions by section 18(j) of the FDI Act. Evergreen was wholly-owned by EvergreenBancorp, Inc. (Bancorp), a publicly-traded, one-bank holding company. As of September 2009, the institution's directors owned or controlled just over 4 percent of the holding company's stock. No shareholder owned more than 6 percent of Bancorp's stock, and the shares were widely held. Table 1 summarizes selected financial information for Evergreen for the calendar years ended 2005 through 2009.

**Table 1: Selected Financial Information for Evergreen**

<b>Financial Measure</b>	<b>Dec-09</b>	<b>Dec-08</b>	<b>Dec-07</b>	<b>Dec-06</b>	<b>Dec-05</b>
Total Assets (\$000s)	395,980	460,882	420,022	342,931	248,733
Gross Loans and Leases (\$000s)	370,455	422,671	375,428	292,449	189,188
Deposits (\$000s)	340,378	358,921	309,804	257,098	200,175
Net Non-Core Funding Dependence Ratio	46.86%	57.22%	26.58%*	42.78%	26.11%
Past Due and Noncurrent Loans/Gross Loans	19.59%	5.67%	0.22%	0.17%	0.61%
Loan Growth	(16.00%)	11.02%	28.17%	54.79%	18.61%
Net Income (Loss) (\$000s)	(25,506)	(3,438)	2,114	2,521	1,521

Source: Uniform Bank Performance Reports (UBPR) and Consolidated Reports of Condition and Income (Call Reports) for Evergreen.

\*As discussed more fully on page 9 of the report, we determined that the net non-core funding dependence ratio of 26.58 percent reported on Evergreen's December 31, 2007 UBPR was incorrect. The correct net non-core funding dependence ratio was 49.21 percent.

## Causes of Failure and Loss

Evergreen failed primarily because its Board and management did not effectively manage the risks associated with the institution's rapid growth and heavy concentrations in CRE and ADC loans. Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in the institution's lending markets deteriorated. Specifically, the institution exhibited weak loan underwriting, credit administration, and related monitoring practices. Evergreen also experienced high staff turnover in the lending function during a critical period for the institution. Further, Evergreen relied heavily upon wholesale funding sources, primarily brokered deposits and Federal Home Loan Bank (FHLB) borrowings, to support its lending activities and to maintain adequate liquidity. These funding sources became restricted when Evergreen's credit risk profile deteriorated in early 2009, placing a severe strain on the institution's liquidity position.

Evergreen's heavy concentration in CRE and ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the Seattle real estate market. Adding to this vulnerability was a general decline in the institution's capital levels between 2004 and 2008 while risk in the loan portfolio was increasing. Evergreen's declining capital reduced the institution's ability to absorb losses due to unforeseen circumstances. During the summer of 2008, the credit quality of Evergreen's loan portfolio began to decline. By year-end 2008, the quality of the loan portfolio had deteriorated significantly, with the majority of the deterioration pertaining to ADC loans. Further deterioration occurred in 2009. The associated provisions and losses depleted Evergreen's earnings, eroded its capital, and strained its liquidity. The DFI closed Evergreen on January 22, 2010 because the institution was unable to raise sufficient capital to support its operations.



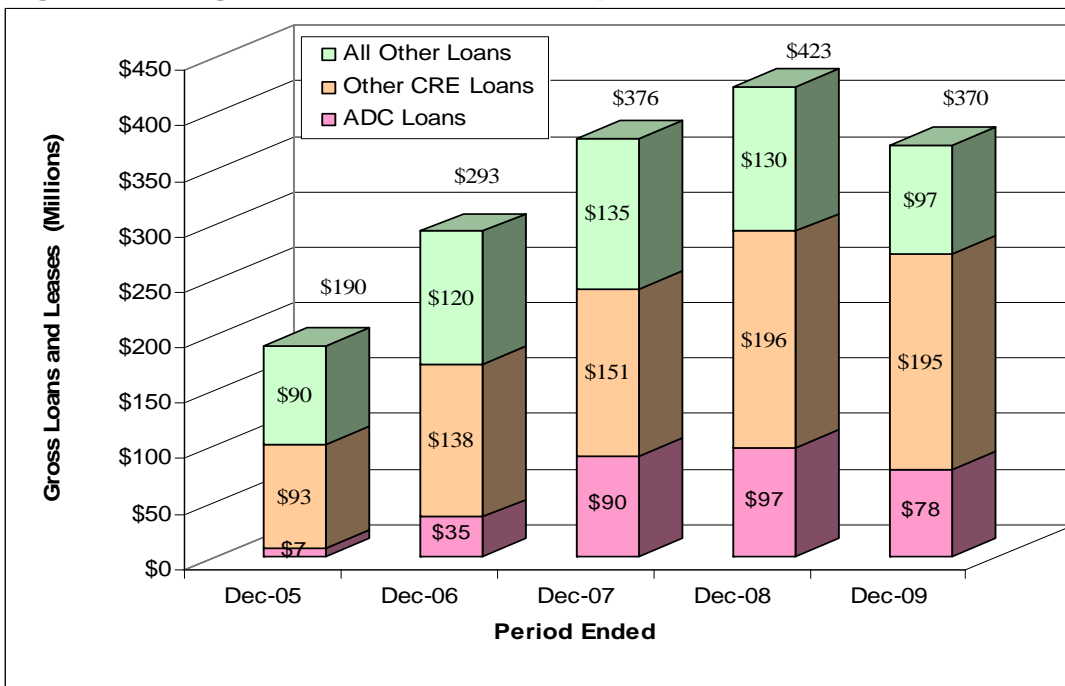
## Rapid Growth and CRE and ADC Loan Concentrations

In 2005, Evergreen embarked on a rapid growth strategy centered in CRE and ADC lending in response to a strong real estate market. However, Evergreen’s Board and management did not effectively manage the risks associated with the institution’s rapid growth and ensuing heavy concentrations in CRE and ADC loans.

### Rapid Growth

Figure 1 illustrates the general composition and growth of Evergreen’s loan portfolio in the years preceding the institution’s failure. The institution’s loan portfolio grew 123 percent during the 3-year period ended December 31, 2008, which was well in excess of the institution’s peer group average. Contributing to this growth was an increase in total CRE loans, including ADC loans, from \$100 million as of December 31, 2005 to \$293 million as of December 31, 2008. During this same period, ADC loans grew from \$7 million (or almost 4 percent of the loan portfolio) to \$97 million (or 23 percent of the loan portfolio). Much of Evergreen’s ADC lending consisted of speculative condominium and townhome construction and land development projects in the Seattle metropolitan area. Further, Evergreen had certain loans and lines of credit with various real estate developers that, although not classified as ADC, were used to provide capital for real estate construction and development projects.

**Figure 1: Evergreen’s Loan Portfolio Composition and Growth**



Source: OIG analysis of Call Reports for Evergreen.

Evergreen continued to grow its CRE and ADC loans during 2007 and 2008 while trends in national home sales and prices were negative. Evergreen’s 2008 Strategic Plan stated that although the national economy had taken “a dramatic turn for the worse” beginning in

mid-2007, the institution's local lending markets remained strong. The plan projected asset growth of approximately 50 percent between 2008 and 2010. While the economy in the Pacific Northwest has historically lagged the general economy in terms of entering and exiting downturns, the institution's decision to continue growing its CRE and ADC loans in such an environment was risky.

### CRE and ADC Loan Concentrations

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). Although the Joint Guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint Guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or
- Total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

As of December 31, 2007, Evergreen's non-owner occupied CRE loans represented 457 percent of the institution's total capital. Further, the institution's ADC loan concentration at year-end 2007 represented 219 percent of total capital. Both of these figures exceeded Evergreen's peer group average and the levels defined in the Joint Guidance as possibly warranting further supervisory analysis. Although Evergreen had implemented certain controls for managing its CRE and ADC loan concentrations, its concentration risk management practices were not adequate. For example, as discussed more fully in the next section of this report, the institution had not established and implemented reasonable limits on its CRE and ADC loan concentrations. In addition, the institution had not stress tested its CRE and ADC loan portfolios to assess the impact that various economic scenarios might have on the institution's asset quality, capital, earnings, and liquidity.

### **Oversight of the Lending Function**

A lack of effective Board and management oversight of the lending function contributed to the asset quality problems that developed when economic conditions in Evergreen's lending markets deteriorated. Specifically, examiners noted weak loan underwriting, credit administration, and related monitoring practices, particularly during the August 2008 and June 2009 examinations. In addition, a high turnover of staff in the

lending function during 2007 and 2008 made effective loan administration difficult. A brief description of these weaknesses follows.

### Loan Underwriting

- **Loan Renewals.** The April 2007 and August 2008 examination reports identified instances in which the institution renewed loans without sufficient or current financial information. In addition, the June 2009 examination report noted that a number of loans listed on Evergreen's internal watch list were renewed during 2008 without obtaining current financial information on the borrowers.
- **Appraisals.** The August 2008 examination report identified several deficiencies related to appraisals. Specifically, Evergreen did not obtain or adequately review current appraisals for some loans, resulting in apparent violations of Part 323, *Appraisals*, of the FDIC Rules and Regulations. In addition, appraisal reviews for large/complex properties were performed by loan officers or loan administration personnel rather than by individuals independent of the lending function. Further, Evergreen's loan policy did not address appraisal requirements for loan participations purchased from other institutions. Moreover, originating institutions did not always order or review appraisals in a timely manner. The June 2009 examination report also identified apparent violations of Part 323.
- **Global Cash Flow Analyses.** The June 2009 examination report noted that the institution failed to perform adequate global cash flow analyses when loans were originated or renewed. Specifically, loan officers did not routinely consider the total debt service requirements of borrowers or the progress of the borrowers' other real estate projects funded by other institutions. Such analyses can provide early indications of problems.

### Credit Administration and Related Monitoring

- **Stress Testing.** The August 2008 and June 2009 examination reports noted that Evergreen had not performed a comprehensive stress test of the loan portfolio. Examiners cited this weakness as a contravention of Appendix A to Part 365—*Interagency Guidelines for Real Estate Lending Policies*, of the FDIC Rules and Regulations, in the June 2009 examination.
- **Recognizing Problem Loans.** The June 2009 examination report noted that Evergreen did not recognize problem loans in a timely manner when the institution's real estate lending markets deteriorated in 2008. Generally, loan downgrades occurred at the time of renewal, during the annual external review, when they became past due, or when borrowers experienced problems. Untimely action in this regard may have resulted in missed opportunities to work with troubled borrowers to shore up loans with additional collateral. Not recognizing problem loans in a timely manner also contributed to an underfunded Allowance

for Loan and Lease Losses (ALLL) and weak ALLL methodology during 2008 and 2009.

- **Reporting Problem Loans.** The June 2009 examination report identified untimely reporting of problem loans to Evergreen's Board. Prior to late 2008, problem loans were reported to the Board on a quarterly basis, with the reports due 30 days after the quarter's end. By the time the Board received these reports, problem loans had often already deteriorated significantly.
- **Reporting Concentrations.** The June 2009 examination report noted that Evergreen ceased preparing detailed concentration monitoring reports when it discontinued CRE and ADC lending in 2009. Examiners cited the lack of reporting as an apparent violation of Appendix A to Part 365.

Evergreen's 2008 annual financial statement audit identified material weaknesses in internal control over financial reporting. Such weaknesses generally pertained to the timely identification and evaluation of problem credits, internal audit and external loan reviews for monitoring problem credits and impaired loans, calculations for loan losses, and reporting to the Board.

#### Staff Turnover

Eight of Evergreen's loan officers, including the Chief Lending Officer (CLO), left the institution during 2007 and 2008. Further, a new CLO and 10 new loan officers were hired during this timeframe. This was a critical period for the institution as many of its CRE and ADC loans were relatively new and unseasoned, and the real estate market was beginning to decline. Examiners noted during the June 2009 examination that there appeared to be little direction provided to the lending staff during this period and that the redistribution of loans from one officer to another resulted in officers not being familiar with their borrowers, making the timely recognition of problems difficult.

#### **Reliance on Wholesale Funding Sources**

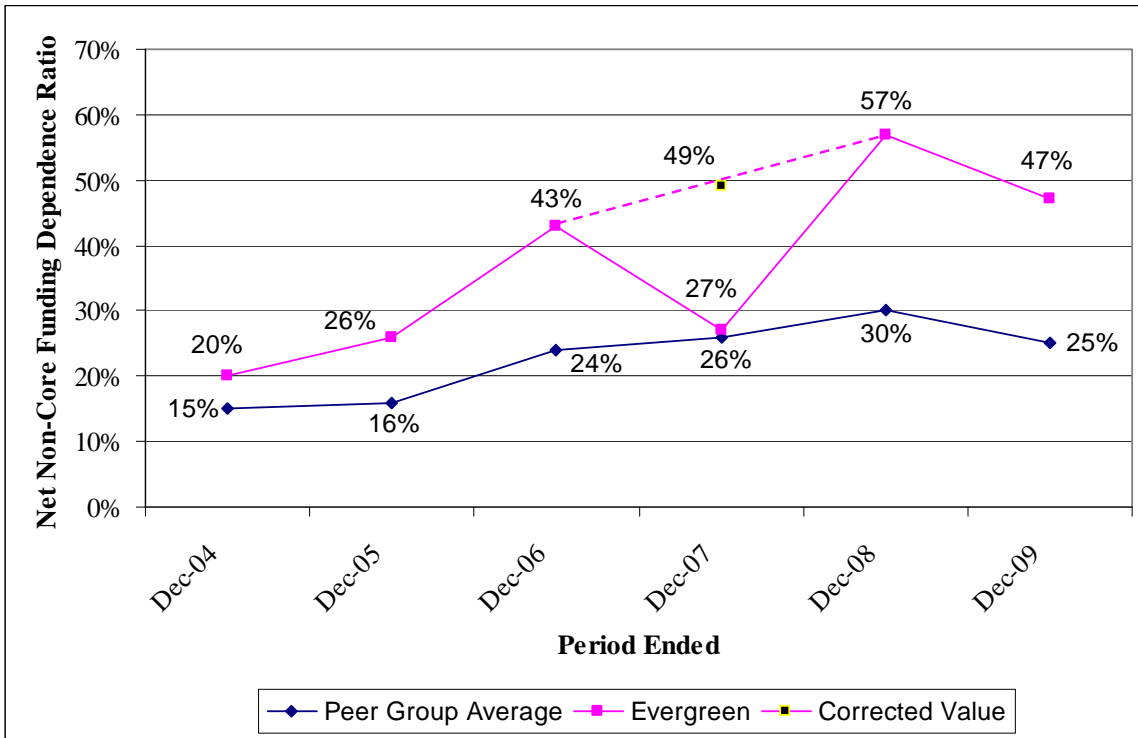
In the years preceding its failure, Evergreen became increasingly reliant on wholesale funding sources, particularly brokered deposits and FHLB borrowings, to fund its rapid loan growth and maintain adequate liquidity. Evergreen began acquiring brokered deposits in 2006, and by year-end 2008, \$130.7 million of the institution's \$358.9 million in total deposits (or 36 percent) consisted of brokered deposits. In addition, Evergreen increased its FHLB borrowings from \$22.7 million at year-end 2005 to \$64.8 million at year-end 2008. While Evergreen's wholesale funding increased, its on-balance sheet liquidity (e.g., marketable securities) decreased as management redeployed these resources to higher-yielding assets, such as ADC loans. Evergreen's management determined that as long as adequate borrowing capacity was available, the reduction in on-balance sheet liquidity was of minor concern. Further, examiners noted in the August 2008 examination that the institution had been operating outside of its policy parameters with respect to borrowings from the FHLB and correspondent banks between December 2007 and July 2008.

In its December 31, 2008 Call Report, Evergreen reported an *Adequately Capitalized* position for PCA purposes. As a result, the institution was prohibited from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. The institution never applied for a brokered deposit waiver because it determined that it was highly unlikely that a waiver would be approved. The institution's inability to accept, renew, or roll over brokered deposits severely strained its liquidity position. In fact, Evergreen's 2008 *Annual Report on Form 10-K* filed with the Securities and Exchange Commission noted that the institution's tenuous liquidity position raised substantial doubt about its ability to continue as a going concern. Further elevating the institution's liquidity risk profile prior to the August 2008 examination was the lack of a contingency liquidity plan that addressed alternative funding sources.

Evergreen made a concerted effort during 2009 to replace its maturing brokered deposits with Internet deposits and core deposits. By September 30, 2009, Evergreen had reduced its brokered deposits to about \$68.2 million, or 16 percent of its \$438.9 million in total deposits, and increased its Internet deposits to \$123.3 million. On November 4, 2009, the FDIC issued a PCA Directive that, among other things, prohibited Evergreen from accepting, renewing, or rolling over deposits from correspondent depository institutions. Since Internet deposits often originate from correspondent institutions, Evergreen's ability to renew its Internet deposits was severely limited, placing additional strain on the institution's liquidity.

Figure 2 illustrates the trend in Evergreen's net non-core funding dependence ratio for the years ended 2004 through 2009. As reflected in the figure, the ratio was substantially higher than Evergreen's peer group average throughout this period.

**Figure 2: Evergreen’s Net Non-Core Funding Dependence Ratio Compared to Peer Group**



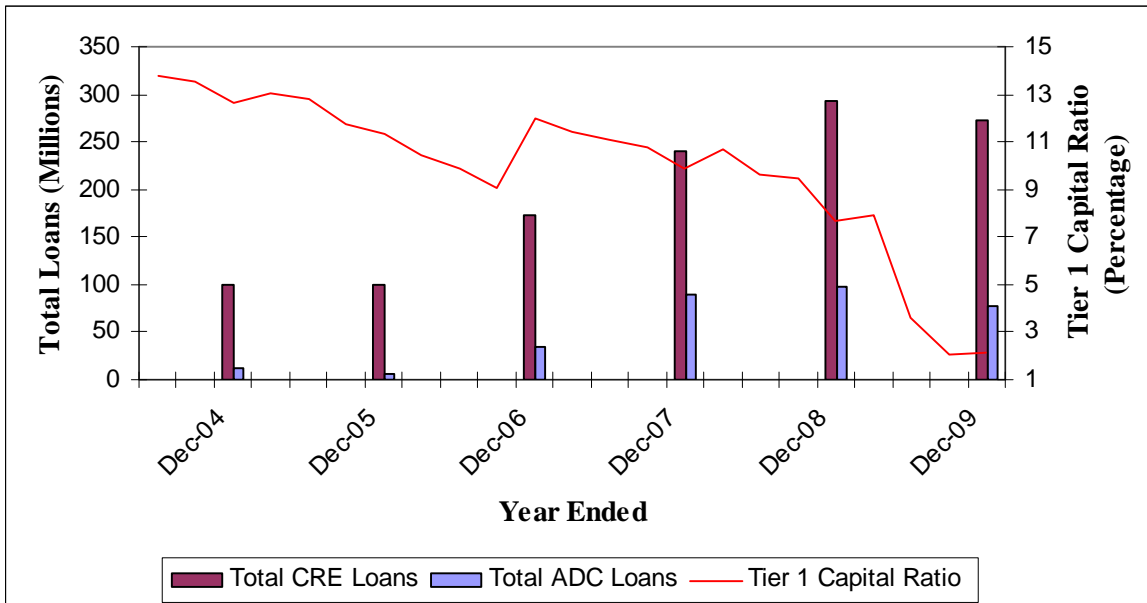
Source: UBPR data for Evergreen.

\* Evergreen’s net non-core funding dependence ratio was incorrectly reported as 26.58 percent on the December 31, 2007 UBPR. The error was caused by Evergreen’s failure to include \$85.5 million in brokered deposits on Line M.2.c, *Total Time Deposits of \$100,000 or More*, of Schedule RC-E, Deposit Liabilities of its December 31, 2007 Call Report. After including the brokered deposits, we determined that the correct figure was 49.21 percent.

### Declining Capital Levels

While risk in Evergreen’s loan portfolio increased between 2004 and 2008, capital levels generally decreased, limiting the institution’s ability to absorb losses due to unforeseen circumstances and contributing to the losses incurred by the DIF when the institution failed. Figure 3 illustrates the trend in Evergreen’s Tier 1 Capital relative to CRE and ADC loans.

**Figure 3: Trend in Evergreen’s Tier 1 Capital Relative to CRE and ADC Loan Growth**



Source: UBPRs and Call Reports for Evergreen.

The FDIC’s *Risk Management Manual of Examination Policies* states that institutions should maintain capital commensurate with the level and nature of risk to which the institutions are exposed. In addition, the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for PCA purposes. Although Evergreen was considered *Well Capitalized* for PCA purposes until year-end 2008, the institution’s capital was not commensurate with its risk profile in the years leading to its failure. In addition, Evergreen did not have a formal capital plan that addressed unexpected adverse events.

At the time of the August 2008 examination, Evergreen’s adversely classified assets were \$32.3 million (or 70 percent of Tier 1 Capital plus the ALLL). By the June 2009 examination, adversely classified assets had increased to \$101.6 million (or 235.5 percent of Tier 1 Capital plus the ALLL). Over \$93 million of this amount consisted of loans, more than half of which pertained to ADC. In its final Call Report for the quarter ended December 31, 2009, Evergreen reported that nearly 20 percent of its total loan portfolio was in non-accrual status. Notably, almost 69 percent of Evergreen’s \$78.1 million in construction and land development loans were in non-accrual status. After recognizing a net loss of \$25.5 million for calendar year 2009, Evergreen fell to a *Critically Undercapitalized* position. Evergreen was closed by the DFI on January 22, 2010 as it was unable to raise sufficient capital to support its operations.

## The FDIC's Supervision of Evergreen

The FDIC, in coordination with the DFI, provided ongoing supervisory oversight of Evergreen through regular onsite risk management examinations, an interim offsite review, and offsite monitoring activities. Through these efforts, the FDIC identified risks in Evergreen's operations and brought these risks to the attention of the institution's Board and management through examination reports, correspondence, and supervisory actions. Such risks included the institution's significant concentrations in CRE and ADC loans, weak lending practices, and heavy reliance on wholesale funding sources. In addition, the FDIC identified instances in which Evergreen's Call Reports were inaccurate and directed the institution to file amendments to correct the identified errors. As noted earlier, we identified a previously unidentified error in the amount of brokered deposits reported in the institution's December 31, 2007 Call Report, which resulted in an erroneous net non-core funding dependence ratio in the UBPR.

At the time of the April 2007 examination, economic conditions in Evergreen's lending markets were generally favorable and the institution's financial condition was satisfactory. In addition, examiners noted that the institution's lending practices were generally sound. Nevertheless, examiners recognized that risk within the institution's loan portfolio was increasing and lowered the component rating for Asset Quality from a "1" (assigned at the prior examination) to a "2". Examiners also made recommendations in certain areas to improve the institution's risk management practices. Examiners concluded that the overall financial and operational condition of the institution was satisfactory and assigned a composite rating of "2". Such an approach was consistent with the FDIC's supervisory practices under such circumstances.

In retrospect, a more proactive supervisory approach during and after the April 2007 examination may have been prudent given the institution's growing risk profile. Such an approach could have included obtaining a commitment on the part of Evergreen for more affirmative actions, such as stronger concentration and liquidity risk management controls and higher capital levels. Increased monitoring of Evergreen following the April 2007 examination may also have been beneficial. Examiners became sharply critical of Evergreen's risk management practices during the August 2008 examination and issued a Supervisory Directive in December 2008. However, by that time, the institution's lending markets were rapidly deteriorating, making remedial efforts difficult. A more proactive approach may have been more effective in influencing Evergreen to curb its CRE and ADC lending and strengthen its risk management controls before its lending markets deteriorated, potentially reducing the institution's losses.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, recently provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.



## Supervisory History

The FDIC and the DFI conducted four onsite risk management examinations of Evergreen between December 2005 and the institution's failure. The FDIC also performed one interim offsite review of the institution that resulted in a ratings downgrade prior to the June 2009 examination. Table 2 summarizes key supervisory information pertaining to the examinations and the referenced review.

**Table 2: Onsite Examinations and Offsite Review of Evergreen**

Date	Examination or Review	Regulators	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken*
06/29/09	Examination	FDIC/DFI	55553/5	C&D Effective October 23, 2009
03/27/09	Offsite Review	FDIC	43442/4	Interim Downgrade
08/25/08	Examination	DFI	33332/3	DFI Supervisory Directive Effective December 22, 2008
04/02/07	Examination	FDIC	22222/2	None
12/27/05	Examination	DFI	21222/2	None

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for Evergreen.

\* Informal corrective actions often take the form of Bank Board Resolutions, Memoranda of Understanding, or Supervisory Directives. Formal corrective actions often take the form of Cease and Desist orders (C&D), and under severe circumstances can include insurance termination proceedings.

The FDIC's offsite monitoring procedures generally consisted of contacting the institution's management from time to time to discuss current and emerging business issues and using automated tools<sup>2</sup> to help identify potential supervisory concerns. The FDIC's offsite monitoring procedures did not identify serious concerns with the institution prior to the August 2008 examination. Based on the results of the August 2008 examination, the FDIC and the DFI downgraded Evergreen's composite rating to a "3" and formally notified the Board in an October 22, 2008 letter that the institution was considered to be in a troubled condition. In addition, the DFI, in coordination with the FDIC, issued a Supervisory Directive requiring, among other things, that Evergreen:

- Reduce the level of its adversely classified and criticized assets.
- Address the credit administration weaknesses identified during the August 2008 examination, including:
  - improving oversight of the lending function,

<sup>2</sup> The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating system and the Growth Monitoring System. Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

- improving the appraisal review process, and
  - taking steps to reduce and control concentration risk.
- Develop and submit a new strategic plan.
  - Reduce the institution's liquidity risk profile by improving its asset/liability management policy, determining whether its reliance on non-core funding sources was reasonable, and developing a plan to achieve a minimum primary liquidity level.
  - Address and/or correct apparent violations of laws and regulations.

As part of its obligations under the Supervisory Directive, Evergreen provided the FDIC and the DFI with quarterly progress reports addressing each of the provisions in the directive.

In late October 2008, the FDIC began monitoring Evergreen's liquidity position on a weekly basis, and before the close of the year, the institution's liquidity was being monitored daily. On March 27, 2009, the FDIC conducted an offsite review of Evergreen that identified significant deterioration in the institution's overall financial condition. Based on the results of the offsite review, the FDIC downgraded the institution's composite rating to a "4" and accelerated the next full-scope examination from October 2009 to June 2009. The June 2009 examination identified continued deterioration in Evergreen's financial condition, and on October 23, 2009, the FDIC, in coordination with the DFI, issued a C&D. Among other things, the C&D required that the institution retain qualified management and ensure active Board participation in the affairs of the institution; have and maintain a Tier 1 leverage capital ratio of 10 percent; significantly increase its ALLL; develop, revise, and implement written lending and collection policies; and provide quarterly progress reports to the FDIC and the DFI.

Evergreen's Board and management were not successful in returning the institution to a safe and sound condition. As a result, the DFI closed the institution on January 22, 2010.

### **Supervisory Response to Key Risks**

At the time of the April 2007 examination, economic conditions in Evergreen's lending markets were generally favorable and the institution's adversely classified assets were a manageable \$3.3 million, or 8.6 percent of Tier 1 Capital and the ALLL. In addition, examiners noted that the institution's larger loans were soundly underwritten and that loan grading was accurate and timely. Nevertheless, examiners recognized that risk within the institution's loan portfolio was increasing and lowered the component rating for Asset Quality from a "1" (assigned at the prior examination) to a "2". Examiners also made recommendations in certain areas to improve the institution's risk management practices. Based on the results of the examination, and management's agreement to address the identified weaknesses, examiners concluded that the overall financial and operational condition of the institution was satisfactory and assigned a composite rating of "2". Such

an approach was consistent with the FDIC's supervisory practices under such circumstances.

Notwithstanding Evergreen's satisfactory financial condition at the time of the April 2007 examination, the institution's risk profile was increasing. Key risk factors included:

- **Rapid Growth.** Growth in the loan portfolio exceeded 56 percent in 2006 and the institution's strategic plan and budget planned for continued growth in the coming years.
- **Increasing ADC Loan Concentration.** ADC loans totaled \$35 million at year-end 2006, up from \$7 million at the prior year-end, and further growth in this high-risk loan category was planned for the near future. The institution had also not performed a stress test of its loan portfolio to assess the impact that various economic scenarios might have on the institution's financial condition.
- **Reliance on Wholesale Funding.** Prior to 2006, Evergreen had no brokered deposits. During 2006, the institution began using brokered deposits to fund its CRE and ADC loan growth. At year-end 2006, Evergreen had \$52.8 million in brokered deposits with plans for further wholesale funding growth. FHLB borrowings also increased from \$22.7 million at year-end 2005 to \$46.8 million at year-end 2006.

Examiners identified Evergreen's rapid loan growth during the April 2007 examination, but determined that the institution's performance goals were reasonable and achievable. While examiners also identified Evergreen's growing concentrations in CRE and ADC loans in the examination report, they stated that the institution's concentration monitoring practices were adequate. Further, examiners expressed some concern regarding the institution's declining liquidity position, but noted that secondary sources of liquidity (e.g., FHLB borrowings, correspondent lines of credit, brokered deposits, and public funds capacity) were adequate and that appropriate liquidity parameters were in place. As previously stated, the economy in the Pacific Northwest has historically lagged the general economy in terms of entering and exiting economic downturns. In hindsight, a more proactive supervisory approach during the April 2007 examination may have been prudent. Such an approach could have included obtaining a commitment from Evergreen for more affirmative actions, such as:

- Stronger concentration risk management controls, such as stress testing of the loan portfolio to assess the impact that various economic scenarios might have on asset quality, earnings, capital, and liquidity.
- Stronger liquidity risk management controls, such as a formal contingency liquidity plan and internal limits on the amount of brokered deposits that the institution could acquire.

- Higher capital levels to reflect the growing risks associated with the institution's loan portfolio and liquidity management practices.

In its May 3, 2007 letter transmitting the April 2007 examination report to Evergreen's Board, the FDIC and the DFI requested a written response to the examination findings.<sup>3</sup> While such a step was prudent, the FDIC could have increased its monitoring of the institution following the 2007 examination. For example, the FDIC could have conducted a visitation to assess the institution's management of key risks, particularly its growing CRE and ADC loan concentrations and increasing reliance on wholesale funding sources. Examiners noted in the April 2007 examination report that some seasoning of the institution's rapidly growing loan portfolio was needed before a positive assessment of quality could be confirmed. A visitation could have provided an opportunity for such an assessment. Had the FDIC conducted a visitation, it may have identified and raised greater concerns about the institution's growing ADC loan concentration and reliance on wholesale funding sources sooner than it did. Based on the results of the visitation, the FDIC may have decided to take stronger supervisory action, if appropriate.

A more proactive supervisory approach during and shortly after the April 2007 examination may have been more effective in influencing Evergreen to curb its CRE and ADC lending, increase its capital, and/or strengthen its risk management controls before its lending markets deteriorated, potentially reducing the institution's losses.

Examiners became more critical of Evergreen's risk management practices during the August 2008 examination. Specifically, examiners downgraded the institution's composite rating to a "3", recommended that Evergreen perform loan portfolio stress testing and develop a contingency liquidity plan, and issued a Supervisory Directive to address the institution's key risks. Examiners also noted that although the institution was considered *Well Capitalized* for PCA purposes, its capital position was not commensurate with its risk profile. At the time of the August 2008 examination, however, the institution's risk profile had increased substantially and the Seattle real estate market was declining, making Evergreen's remedial actions difficult to effectively implement. Evergreen's financial condition continued to deteriorate in 2009, and the institution's management was not successful in returning Evergreen to a safe and sound condition.

### **Prompt Corrective Action**

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

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<sup>3</sup> A copy of the response was not contained in the FDIC's supervisory records for Evergreen. As a result, we were unable to review and assess the response.

procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to Evergreen, the FDIC properly implemented applicable PCA provisions of section 38. Among other things, the FDIC issued timely notices related to the institution's capital category; reviewed and monitored the institution's Call Reports and liquidity reports; and conducted periodic discussions with the institution's management regarding compliance with the restrictions imposed under each PCA capital category. Table 3 illustrates Evergreen's capital levels relative to the PCA thresholds for *Well Capitalized* institutions.

**Table 3: Evergreen's Capital Levels**

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
PCA Threshold	5% or more	6% or more	10% or more	
Dec-05	10.10%	11.36%	12.39%	<i>Well Capitalized</i>
Dec-06	11.15%	12.01%	12.94%	<i>Well Capitalized</i>
Dec-07	8.97%	9.88%	10.99%	<i>Well Capitalized</i>
Dec-08	7.05%	7.69%	8.96%	<i>Adequately Capitalized</i>
Jun-09	2.78%	3.64%	4.93%	<i>Significantly Undercapitalized</i>
Sep-09	1.44%	2.07%	3.39%	<i>Critically Undercapitalized</i>

Source: UBPRs for Evergreen.

Evergreen was considered *Well Capitalized* for PCA purposes until December 31, 2008. On February 23, 2009, Evergreen's management notified the FDIC that the institution intended to amend its Call Report for the quarter ended December 31, 2009 to reflect an increase in the provision for loan loss. In a letter dated March 3, 2009, the FDIC notified Evergreen that based on the increased provision, the institution would fall to *Adequately Capitalized* as of December 31, 2008. The FDIC's notification included a reminder regarding the restrictions imposed on *Adequately Capitalized* institutions, including restrictions on the use of brokered deposits without a waiver from the FDIC. Evergreen filed its amended Call Report on March 13, 2009.

In a letter dated August 6, 2009, the FDIC notified Evergreen that the institution's PCA category had fallen to *Significantly Undercapitalized*. The lower PCA category was based on the institution's June 30, 2009 Call Report and the need for an additional provision to the ALLL identified during the June 2009 examination. The notification directed the institution to (1) submit a capital restoration plan by September 18, 2009 and (2) submit a summary of the specific steps taken by management to comply with the mandatory restrictions of section 38. Evergreen submitted a capital restoration plan on September 18, 2009. However, in a letter dated October 30, 2009, the FDIC advised the institution that the plan was unacceptable. Among other things, the FDIC noted that the plan did not

contain a realistic strategy for recapitalizing the institution and that the timeframes in the plan exceeded the timeframes in the C&D for increasing capital. The FDIC requested that Evergreen submit a new capital restoration plan not later than November 30, 2009. However, the institution never submitted another capital restoration plan.

On September 2, 2009, the DFI provided Evergreen with a written *Thirty Day Notice to Correct Unsafe Condition of Bank*. The notice stated that the institution was operating with an unacceptable level of capital protection and that if the institution did not raise sufficient capital within 30 days, the DFI may, at its option, take immediate possession and control of the institution. On November 4, 2009, the FDIC issued a *Supervisory Prompt Corrective Action Directive* against Evergreen. The PCA directive outlined the mandatory restrictions imposed on the institution based on its capital category and discretionary sanctions under section 38 for failing to submit an acceptable capital restoration plan. On December 2, 2009, the FDIC notified Evergreen that, based on the institution's September 30, 2009 Call Report, which was amended on November 20, 2009, the institution had fallen to *Critically Undercapitalized*. The notice included reminders regarding the requirements imposed on *Critically Undercapitalized* institutions.

Evergreen explored a number of strategic alternatives to raise needed capital during 2008 and 2009. Such options included engaging financial advisors, selling assets, and contacting private equity investors. However, no definitive agreements were ever reached.

## **Corporation Comments**

We issued a draft of this report on July 16, 2010. The Division of Supervision and Consumer Protection (DSC) management subsequently provided us with additional information for our consideration. We made certain changes to the report that we deemed appropriate based on the information that DSC management provided. On August 16, 2010, the Director, DSC, provided a written response to the draft report. The response is presented in its entirety as Appendix 4 of the report.

In its response, DSC reiterated the OIG's conclusions regarding the causes of Evergreen's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. With regard to our assessment of the FDIC's supervision, DSC stated that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations and volatile funding sources, such as Evergreen. In addition, DSC stated that updated guidance has been issued reminding examiners to take appropriate action when such risks are imprudently managed.

## Objectives, Scope, and Methodology

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### Objectives

On July 21, 2010, the President signed into law the Financial Reform Act. The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Further, the Financial Reform Act calls for the OIG to perform in-depth reviews of failures when the associated losses are not material but they involve unusual circumstances. At the time the Financial Reform Act was enacted, we had issued a draft of this report to management. As a result, although the estimated loss for Evergreen no longer meets the threshold requiring an MLR, we decided to complete the audit as an in-depth review and issue this report.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Evergreen's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Evergreen, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from March 2010 to July 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

### Scope and Methodology

The scope of this audit included an analysis of Evergreen's operations from December 2005 until its failure on January 22, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed key documentation, including:
  - Examination reports issued by the FDIC and the DFI between 2005 and 2009.
  - Institution data in Call Reports, UBPRs, and other reports.
  - FDIC and DFI correspondence.
  - Relevant reports prepared by DSC's Washington Office relating to the institution's failure.

## Objectives, Scope, and Methodology

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- Pertinent FDIC regulations, policies, procedures, and guidance.
- Interviewed DSC examination staff in the Washington Office, the San Francisco Regional Office, and the Seattle field office.
- Interviewed DFI examination staff to obtain their perspectives on the failure and to discuss their role in the supervision of the institution.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand Evergreen's management controls pertaining to the causes of failure and loss as discussed in the body of this report.

We obtained data from various FDIC systems, but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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

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

### **Related Coverage of Financial Institution Failures**

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that



## Objectives, Scope, and Methodology

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had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional material loss review reports related to failures of FDIC-supervised institutions and these reports can be found at <http://www.fdicig.gov/index.html>. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent material loss reviews.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

## Glossary of Terms

Term	Definition
<b>Adversely Classified Assets</b>	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
<b>Affiliate</b>	Under section 23A of the Federal Reserve Act (12 U.S.C. section 371c), an affiliate generally includes, among other things, a bank subsidiary, or a company that (1) controls the bank and any other company that is controlled by the company that controls the bank, (2) is sponsored and advised on a contractual basis by the bank, or (3) is controlled by or for the benefit of shareholders who control the bank or in which a majority of directors hold similar positions in the bank.
<b>Allowance for Loan and Lease Losses (ALLL)</b>	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
<b>Annual Report on Form 10-K</b>	An annual report required by the Securities and Exchange Commission that provides a comprehensive summary of a public company's performance. The report includes information such as company history, organizational structure, executive compensation, equity, subsidiaries, and audited financial statements, among other information.
<b>Call Report</b>	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
<b>Cease and Desist Order (C&amp;D)</b>	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
<b>Concentration</b>	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.

## Glossary of Terms

Term	Definition
<b>Contingency Liquidity Plan</b>	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency liquidity plans should be regularly tested and updated to ensure that they are operationally sound. DSC uses the term contingency funding plan and contingency liquidity plan interchangeably.
<b>Criticized Assets</b>	Criticized assets include all assets rated special mention, substandard, doubtful, and loss. The Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the agencies) Uniform Loan Classification Standards, along with the agencies' examination manuals, define these risk rating classifications.
<b>FDIC's Supervision Program</b>	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. DSC (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
<b>Federal Home Loan Bank (FHLB)</b>	FHLBs provide long-and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities.
<b>Financial Holding Company</b>	A financial entity engaged in a broad range of banking-related activities. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The Federal Reserve Board is responsible for supervising the financial condition and activities of financial holding companies.
<b>Global Cash Flow Analysis</b>	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with a particular loan.

## Glossary of Terms

Term	Definition
<b>Material Loss</b>	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Financial Reform Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of \$200 million.
<b>Peer Group</b>	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. Evergreen's peer group included insured commercial institutions with assets between \$300 million and \$1 billion.
<b>Prompt Corrective Action (PCA)</b>	<p>The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, <i>Prompt Corrective Action</i>, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) <i>Well Capitalized</i>, (2) <i>Adequately Capitalized</i>, (3) <i>Undercapitalized</i>, (4) <i>Significantly Undercapitalized</i>, and (5) <i>Critically Undercapitalized</i>.</p> <p>A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.</p>
<b>Section 23A of the Federal Reserve Act</b>	Section 23A: (1) establishes limits on the amount of "covered transactions" between a member bank and its affiliates (any one affiliate and in the aggregate as to all affiliates); (2) requires that all covered transactions between a member bank and its affiliates be on terms and conditions that are consistent with safe and sound banking practices; (3) prohibits the purchase of low-quality assets from an affiliate; and (4) requires that extensions of credit by a member bank to an affiliate, and guarantees on behalf of affiliates, be secured by statutorily defined amounts of collateral.

## Glossary of Terms

Term	Definition
<b>Tier 1 (Core) Capital</b>	<p>Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as:</p> <p><b>The sum of:</b></p> <ul style="list-style-type: none"> <li>• Common stockholder’s equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values);</li> <li>• Non-cumulative perpetual preferred stock; and</li> <li>• Minority interest in consolidated subsidiaries;</li> </ul> <p><b>Minus:</b></p> <ul style="list-style-type: none"> <li>• Certain intangible assets;</li> <li>• Identified losses;</li> <li>• Investments in securities subsidiaries subject to section 337.4; and</li> <li>• Deferred tax assets in excess of the limit set forth in section 325.5(g).</li> </ul>
<b>Uniform Bank Performance Report (UBPR)</b>	<p>The UBPR is an individual analysis of institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.</p>
<b>Uniform Financial Institutions Rating System (UFIRS)</b>	<p>Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank’s performance in six components represented by the CAMELS acronym: <b>C</b>apital adequacy, <b>A</b>sset quality, <b>M</b>anagement practices, <b>E</b>arnings performance, <b>L</b>iquidity position, and <b>S</b>ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.</p>

## Acronyms

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ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity and <u>S</u> ensitivity to Market Risk
CLO	Chief Lending Officer
CRE	Commercial Real Estate
DFI	Washington State Department of Financial Institutions
DIF	Deposit Insurance Fund
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
MLR	Material Loss Review
OIG	Office of Inspector General
PCA	Prompt Corrective Action
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

## Corporation Comments



Federal Deposit Insurance Corporation

550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

August 16, 2010

**TO:** Stephen Beard  
Assistant Inspector General for Material Loss Reviews

**FROM:** /Signed/  
Sandra L. Thompson  
Director

**SUBJECT:** FDIC Response to the Draft Audit Report Entitled, Material Loss Review of EvergreenBank, Seattle, Washington (Assignment No. 2010-024)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of EvergreenBank, Seattle, Washington (Evergreen), which failed on January 22, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on July 16, 2010.

The Report concludes Evergreen failed due to the Board and management's aggressive pursuit of loan growth primarily funded with brokered deposits and Federal Home Loan Bank borrowings. Evergreen's management decision to concentrate the loan portfolio in acquisition, development, and construction (ADC) loans, its aggressive growth in speculative residential condominium and townhouse construction and land development projects, and its reliance on wholesale funding sources were the principal factors leading to Evergreen's deteriorating financial condition and failure. Evergreen's overall weak loan administration in a deteriorating real estate market resulted in increased delinquencies and non-performing assets. Evergreen was unable to raise sufficient capital to absorb the loan losses, support its operations, and maintain liquidity.

As part of DSC's supervisory program from 2005 through January 2010, the FDIC and the Washington State Department of Financial Institutions (DFI) jointly and separately conducted four full-scope examinations. The FDIC also conducted an offsite review and other offsite monitoring activities. At the August 2008 examination, DFI examiners downgraded the institution to a composite 3 rating and noted a heightened risk due to high concentrations in ADC lending. FDIC immediately began offsite monitoring of the steps Evergreen's management took to address recommendations contained in the 2008 report, including steps to address the credit administration and loan review issues. Based on an offsite review, the FDIC further downgraded Evergreen to a composite 4 rating in March 2009. At the FDIC and DFI joint examination in June 2009, examiners found that Evergreen had further deteriorated to a level that raised significant regulatory concern and posed considerable risk. This elevated risk level resulted in a downgrade to a composite 5 rating and implementation of a formal enforcement action. Evergreen management was unable to correct the deficiencies, and Evergreen ultimately failed.

DSC recognizes that strong supervisory attention is necessary for institutions with high commercial real estate and ADC concentrations and volatile funding sources, such as Evergreen, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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