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**Material Loss Review of the Bank of
Clark County, Vancouver, Washington**

AUDIT REPORT

Office of Audits



oig



Federal Deposit Insurance Corporation

Material Loss Review of the Bank of Clark County Vancouver, Washington

Why We Did The Audit

On January 16, 2009, the Washington State Department of Financial Institutions (WDFI) closed the Bank of Clark County (BOCC) and named the FDIC as receiver. On February 4, 2009, the FDIC notified the Office of Inspector General (OIG) that the BOCC's total assets at closing were \$468.1 million and the material loss to the Deposit Insurance Fund (DIF) was \$131.4 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of BOCC.

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

Background

The BOCC was a state-chartered nonmember bank, insured by the FDIC on February 8, 1999 and headquartered in Vancouver, Washington, where the bank had two offices. The BOCC was a wholly-owned subsidiary of Clark County Bancorporation (CCB), a one-bank holding company also located in Vancouver, Washington. CCB's stock was non-publicly traded. The bank provided business banking services within its marketplace.

The BOCC grew continually over the 5 years ended December 31, 2008, more than doubling total assets and total loans and reaching a 30 percent loan growth in 2 of those 5 years. The bank relied significantly on non-core deposits and borrowings to fund loan growth.

The BOCC's loan portfolio was concentrated in commercial real estate (CRE) loans, including acquisition, development, and construction (ADC) loans. These CRE/ADC loans were also highly concentrated geographically in the Portland, Oregon, market. In 2007, examiners noted that this market was affected by a slowdown.

Audit Results

Causes of Failure and Material Loss – The BOCC failed due to bank management's focus on loan growth concentrated in CRE/ADC and funded with higher-cost wholesale deposits and borrowings. Insufficient attention was paid to establishing sound risk identification and mitigation controls. Bank management increased the bank's assets at a rate of at least 17 percent annually and, by September 2008, its CRE loans, as a percentage of capital, exceeded 500 percent. The BOCC concentrated its CRE/ADC lending in rapidly growing markets in the Portland, Oregon, area that subsequently deteriorated. Losses in the bank's loan portfolio were exacerbated by weak credit administration practices, including those related to loan portfolio risk management and problem asset administration and resolution. These practices, coupled with an underfunded allowance for loan and lease losses (ALLL), left the bank unprepared and unable to effectively manage operations in a declining economic environment. As loan losses increased, earnings eroded, liquidity became strained, and BOCC's capital became critically deficient. Ultimately, BOCC was significantly undercapitalized when it was closed by the WDFI.

During 2008, the bank had significant liquidity problems and became increasingly dependent on wholesale funding. Between December 2007 and December 2008, use of brokered deposits doubled to almost \$135 million. According to the November 3, 2008 Report of Examination (ROE), the bank's liquidity levels threatened the bank's ability to continue as a going concern, and BOCC's ability to meet daily obligations was heavily dependent on obtaining Federal Home Loan Bank (FHLB) and the Federal Reserve Bank borrowings, which were unlikely to be sufficient to cover the bank's near-term cash needs.

Assessment of FDIC Supervision and PCA Implementation – The FDIC and WDFI provided supervisory oversight for BOCC, including through risk management examinations and offsite monitoring, and identified to bank management the problems that contributed to BOCC's failure. However, we concluded that the FDIC could have exercised greater supervisory concern regarding the results of the 2007 examination that identified, among other findings, that the bank's board of directors (BOD) did not halt or limit higher-risk ADC lending despite recognizing a slowdown in BOCC's market area.

The November 2008 ROE assigned a composite rating of 5 to BOCC, indicating significant risk to the DIF and a highly probable failure. During the course of this examination, examiners found that bank staff had not been forthright in providing the most current appraisal information on at least 11 lending relationships. Examiners expanded the loan review and demanded access to all appraisal information. Based on the expanded review, examiners determined that an additional provision of \$23.7 million was needed for the ALLL to cover credit losses for a total ALLL of \$28.2 million. Significant charge-offs were also required at the end of 2008. As a result of the November 2008 examination, a Cease and Desist Order (C&D) was presented to the bank on January 15, 2009. The BOD refused to stipulate to the C&D.

Concerning PCA, BOCC was not categorized as Significantly Undercapitalized until just prior to the close of the last examination in November 2008. A PCA Notification Letter was issued to BOCC's BOD on November 28, 2008. The FDIC required BOCC to develop and submit a Capital Restoration Plan (CRP) within 45 days of the receipt of the PCA Notification Letter. In addition, restrictions were placed on BOCC's acceptance, renewal, or rollover of brokered deposits. Also, BOCC was subject to restrictions, including but not limited to, asset growth, acquisitions, new branches, payment of dividends or management fees, and any other capital distributions. On December 23, 2008, the bank submitted its CRP, a Liquidity Plan, and an Adverse Classified Asset Reduction Plan. However, these supervisory actions and BOCC's response did not reverse BOCC's financial deterioration.

The FDIC OIG plans to issue a series of summary reports on material loss reviews and will make appropriate recommendations related to the failure of BOCC and other FDIC-supervised banks at that time.

Management Response

On July 31, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. In its response, DSC stated that it agreed with the OIG's finding that BOCC failed primarily due to management's aggressive pursuit of loan growth concentrated in CRE loans. DSC also stated that BOCC was unprepared and unable to effectively manage its operations given the rapid decline in real estate values within its local market area.

With respect to the FDIC's supervision of BOCC, DSC's response stated that the 2007 ROE demonstrated the level of FDIC supervisory concern by: (1) criticizing the increased volume of CRE/ADC lending and recommending the implementation of more robust risk management procedures and monitoring for CRE and (2) providing specific recommendations for strengthening credit administration and portfolio risk management processes. DSC agreed that stronger supervisory actions, such as enforcement actions and component rating downgrades, could have been taken after the 2007 examination.

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DATE: August 4, 2009

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

FROM: /Signed/
Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of the Bank of Clark County,
Vancouver, Washington* (Report No. AUD-09-018)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss¹ review of the failure of the Bank of Clark County, Vancouver, Washington (BOCC). On January 16, 2009, the Washington Department of Financial Institutions (WDFI) closed the institution and named the FDIC as receiver. On February 4, 2009, the FDIC notified the OIG that the BOCC's total assets at closing were \$468.1 million, and the material loss to the Deposit Insurance Fund (DIF) was \$131.4 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); ascertains why the institution's problems resulted in a material loss to the DIF; and makes recommendations to prevent future losses.

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision² of the institution, including implementation of the PCA provisions of section 38 of the FDI Act. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of terms. Acronyms used in the report are listed in Appendix 4.

¹ As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of \$25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.

² 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 insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (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.

This report presents the FDIC OIG's analysis of the BOCC's failure and the FDIC's efforts to ensure that BOCC's management operated the bank in a safe and sound manner. The FDIC OIG plans to issue a series of summary reports on our observations on the major causes, trends, and common characteristics of financial institution failures resulting in a material loss to the DIF. Recommendations in the summary reports will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

The BOCC was a state-chartered nonmember bank, established and insured by the FDIC on February 8, 1999. The BOCC, headquartered in Vancouver, Washington:

- had two full-service offices in Vancouver, Washington;
- was a wholly-owned subsidiary of Clark County Bancorporation, a one-bank holding company located in Vancouver, Washington, whose stock was non-publicly traded;
- provided business banking services within its marketplace; and
- specialized in commercial real estate (CRE) lending, with concentrations in land acquisition, development, and construction (ADC) loans, funded by wholesale sources.

Details on the BOCC's financial condition, as of September 2008, and for the 4 preceding calendar years follow in Table 1.

Table 1: Financial Condition of BOCC

Uniform Bank Performance Report	Sept-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets (\$000s)	\$464,810	\$403,467	\$328,528	\$279,060	\$233,637
Total Deposits (\$000)	\$376,672	\$325,160	\$265,851	\$246,547	\$200,644
Total Loans (\$000s)	\$433,391	\$387,655	\$297,383	\$250,363	\$186,193
<i>Loan Growth Rate</i>	18.86%	30.60%	18.77%	34.21%	21.68%
Net Income (Loss) (\$000s)	\$1,056	\$4,818	\$5,048	\$3,198	\$2,143
Loan Mix (% of Avg. Gross Loans)					
Total Real Estate Secured Loans	77.71	76.33	77.39	75.04	72.83
Construction and Development	38.87	40.54	37.19	28.96	20.33
Commercial Real Estate	25.53	24.90	29.18	36.45	42.43
Multifamily Residential Real Estate	3.62	4.80	4.41	2.64	4.21
1-4 Family Residential (Excluding Home Equity Lines of Credit)	8.05	4.50	4.14	5.53	5.04
Home Equity Loans	1.62	1.57	2.46	1.46	0.82
Commercial and Industrial Loans	20.54	21.93	20.80	22.83	24.30
Loans to Individuals	1.68	2.20	1.73	1.99	2.70
Funding (%)					
Net Loans/Deposits	113.56	117.75	110.28	100.12	91.67
Core Deposits/Assets	64.87	67.14	62.79	66.18	64.46
Brokered Deposits/Assets	20.01	16.54	11.31	16.19	20.66
Large Time Deposits/Assets	16.61	17.44	24.09	21.73	24.68
Federal Home Loan Bank (FHLB) Borrowings/Assets	8.13	5.23	3.43	2.70	1.07
Net Non-Core Dependency Ratio	50.99%	24.59%	32.03%	29.77%	18.06%
Examination Information	11/3/2008	6/4/2007	6/5/2006	12/6/2004	6/23/2003
Component/Composite Ratings*	555554/5	222222/2	222222/2	222222/2	222232/2
Adverse Classification Ratio	520%	23%	14%	16%	9%

Source: Uniform Bank Performance Reports (UBPR) and Reports of Examination (ROE) for Bank of Clark County.

* 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: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity 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.

CAUSES OF FAILURE AND MATERIAL LOSS

Since its opening in 1999, BOCC management structured an organization that concentrated its assets in CRE and partially funded its loan growth with high-cost wholesale deposits and borrowings. Insufficient attention was paid to establishing sound risk identification and mitigation controls. Bank management increased the bank's assets at a rate of at least 17 percent annually since 2000, and in September 2008, its ADC and CRE loans, as a percentage of capital, totaled 550 percent. The BOCC concentrated its lending in ADC loans in rapidly growing markets in the Portland, Oregon, area that subsequently deteriorated economically. The majority of the ADC loans were for developmental land and properties (land lots) that experienced greater losses and depreciation than home prices. As the Portland economy declined, the volume of the bank's troubled loans increased. Losses in the bank's loan portfolio were exacerbated by weak

credit administration practices related to loan portfolio risk identification and problem asset administration and resolution. These practices, coupled with an underfunded allowance for loan and lease losses (ALLL), left the bank unprepared and unable to effectively manage operations in a declining economic environment. As loan losses increased, earnings and capital eroded, liquidity became strained, and BOCC’s capital became critically deficient. Ultimately, BOCC was “Significantly Undercapitalized”, under PCA provisions, when it was closed by the WDFI, resulting in an estimated material loss of \$131.4 million to the DIF.

Higher-Risk Lending Activities

Aggressive Growth Strategy. From the time the bank was established in February 1999 until September 2008, BOCC’s total assets grew at 17 percent or more annually, as shown in Table 2 below, causing capital ratios to decline as asset growth outpaced capital retention. Management kept the bank well by periodic, but temporary, capital infusions from the holding company’s credit lines. However, after December 2000, the bank’s capital ratios were consistently maintained at a level that was below its peer group average. FDIC examiners identified BOCC’s rapid growth and loan concentrations as potential risk areas of concern as early as its “new bank” visitation in June 1999. In particular, examiners commented on the bank’s rapid growth in eight out of nine examination reports. BOCC’s rate of asset growth was twice that of its peer group in 7 out of 8 years.

Table 2: BOCC’s Growth Rates

Quarter End	Asset Growth Rate (%)	Net Loan and Lease Growth Rate (%)
Dec 2000	53.00	108.47
Dec 2001	49.26	72.70
Dec 2002	39.99	44.88
Dec 2003	26.64	28.99
Dec 2004	35.76	21.68
Dec 2005	24.78	34.21
Dec 2006	17.73	18.77
Dec 2007	22.81	30.60
Sept 2008	21.87	18.86

Source: OIG Review of UBPRs, ROEs, and Summary Analysis of Examination Reports (SAER).

BOCC’s management failed to ensure that, as total bank assets increased, the sophistication of the bank’s risk identification and monitoring systems also expanded to effectively identify, measure, monitor, and control bank operations and risks. Further, according to the FDIC, although the real estate market in the Portland area peaked in June 2007, the bank continued to increase the ADC loan portfolio after the 2007 examination, even though the bank knew the market was softening. One FDIC official we interviewed expressed his opinion that the bank management team could not handle the change in the market and did not have the expertise needed to curtail lending when needed.

Concentrations in Commercial Real Estate. In our opinion, BOCC’s ADC lending was a critical factor that led to the failure of the bank and material loss to the DIF. The BOCC concentrated its lending in ADC loans in rapidly growing markets that subsequently deteriorated. BOCC’s volume of ADC/CRE loans constituted a higher-risk lending structure. For the quarterly periods ended December 2002 through December 2007 and September 2008, BOCC’s combined concentration of ADC and Other CRE³ loans, as a percentage of capital, consistently exceeded 500 percent, as shown in Table 3.

Table 3: BOCC’s ADC and Other CRE Loan Concentrations

Period Ended	ADC Loans (as a % of Total Capital)	Other CRE Loans (as a % of Total Capital)	Total ADC and Other CRE Loan Concentrations (as a % of Total Capital)
Dec 1999	36.00	87.75	123.75
Dec 2000	97.61	159.69	257.30
Dec 2001	118.00	338.79	456.79
Dec 2002	97.11	470.43	567.54
Dec 2003	157.08	386.06	543.14
Dec 2004	182.57	324.87	507.44
Dec 2005	308.40	299.95	608.35
Dec 2006	347.43	207.74	555.17
Dec 2007	344.92	212.51	557.43
Sept 2008	310.87	238.79	549.66

Source: OIG Review of UBPRs, ROEs, and SAERs

Despite indicators of deterioration in the Clark County real estate market as early as the first quarter of 2006 (as noted in the 2007 FDIC examination), management continued to increase ADC balances and commitments through the second quarter of 2008. Other evidence of management’s awareness of market deterioration includes bank board of directors’ (BOD) reports highlighting real estate market trends, as well as updated appraisals on specific credits showing declining values as early as December 2007.

While increasing its ADC concentrations in rapidly expanding markets, BOCC did not always adhere to concentration limits related to ADC loans. According to the FDIC, BOCC’s 2007 General Loan Policy included varying levels of concentration limits, including a total construction limit set at 200 percent of Tier 1 Leverage Capital and a limit of 125 percent of Tier 1 Leverage Capital on speculative construction. However, according to the FDIC, the bank’s actual concentration levels exceeded these limits. In addition, the BOD did not halt or limit the lending activities related to ADC loans despite a significant deterioration in the bank’s primary lending markets.

Examiners stated in the June 2007 ROE that the BOD did not halt or limit higher-risk lending related to ADC loans despite recognizing a market slowdown as early as the first quarter of

³ For the purposes of this report, we used the “Non-Farm Non-Residential” category of loans from the UBPR.

2006.⁴ As of September 2008, ADC loans totaling \$28.9 million were charged off as a loss, and an additional \$53.2 million in loans was classified as non-accrual loans.

The FDIC issued Financial Institution Letter 104-2006 (FIL-104-2006) on December 12, 2006 titled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. The regulatory agencies were concerned that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general commercial real estate market. The guidance acknowledges that a concentration in the CRE loans, coupled with weak loan underwriting and depressed CRE markets, may contribute to significant loan losses.⁵ The guidance reminds banks that their "... risk management practices and capital levels should be commensurate with the level and nature of their CRE concentration risk." In addition, the guidance provides the following supervisory criteria for identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny.

- Total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
- Total commercial real estate loans that represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

BOCC's ADC loans increased from 347 percent to 540 percent of total capital between 2006 and 2008. For this period, the bank was consistently in the 93rd and 99th percentile of its peer group. Based on the above guidance, the concentrations may have warranted additional management attention.

Further, at the November 2008 examination, examiners determined that the ADC loan concentrations significantly exceeded supervisory criteria without adequate bank policies, procedures, and practices for monitoring concentrations, in contravention of Appendix A to Part 365 of the FDIC Rules and Regulations. Appendix A to Part 365 states, in part, that a bank's lending policy should contain a general outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made, serviced, and collected. In particular, the institution's policies on real estate lending should:

- Establish a loan portfolio diversification policy and set limits for real estate loans by type and geographic market (e.g., limits on higher risk loans).
- Identify appropriate terms and conditions by type of real estate loan.

⁴ This comment is based on nationwide information. According to the 2008 ROE, the BOCC's market area decline was evident in 2007.

⁵ Additionally, the FDIC issued FIL-22-2008 on March 17, 2008 entitled, *Managing Commercial Real Estate Concentrations In a Challenging Environment*, which re-emphasized the importance of strong capital, ALLL, and loan risk management practices for state nonmember institutions with significant CRE and construction and development loan concentrations.

- Establish loan origination and approval procedures, both generally and by size and type of loan.

Bank management was required to ensure compliance with Part 365 and FIL-104-2006, which establish heightened risk management priorities for an institution with CRE loan concentrations. At the November 2008 examination, bank management informed examiners that the bank intended to decrease ADC exposure by ceasing lending in its market area; however, examiners noted that divesting of the large non-performing portfolio would be a difficult task. Overall, the 2008 ROE indicated that problems with ADC credits stemmed from a stagnant demand for developed lots and single-family residences, driving down collateral values and stalling borrower cash flow.

Underfunded Allowance for Loan and Lease Losses. BOCC's management did not always employ an ALLL methodology that fully complied with the *Interagency Policy Statement on Allowance for Loan and Lease Losses*. The banking agencies issued the 1993 policy statement to describe the responsibilities of the BODs and management of banks and savings associations and of examiners regarding the ALLL. The need to adjust allocation factors used in the ALLL methodology for changes in market conditions was brought to BOCC management's attention in the June 2007 examination. In addition, the June 2007 ROE notes that management needed to resume its quarterly review of ALLL adequacy, which the bank had recently changed to semiannual, and review the ALLL factors for reasonableness (a repeat of a similar recommendation from the 2004 examination). Examiners also recommended that BOCC management periodically reevaluate the ALLL in light of peer group performance, the competitive environment, the quality of underwriting and credit review processes, and portfolio growth goals. In addition, examiners advised management that changes in reserve coverage should be directionally consistent with those trends and expectations, as well as economic (particularly real estate) developments.

The June 2007 examination identified a \$560,000 shortfall in the ALLL (as shown in Table 4, which follows), due, in large part, to the deterioration of two lending relationships. (It should be noted that, the FDIC determined the ALLL level to be adequate up until the 2007 examination and even after the examination recommended the additional \$560,000 provision expense, the bank maintained a capital category of "Well Capitalized.") Further, at the November 2008 examination, examiners stated that the methodology used to determine a targeted ALLL did not follow regulatory guidance and did not provide for a level appropriate for the condition of the credit portfolio and external market conditions. Management had not adjusted the allocation factors for various segments of the loan portfolio to address the economic downturn. Bank management had increased the ALLL by \$4.5 million in the fourth quarter of 2008; however, during the November 2008 examination, examiners found that bank staff had not been forthright in providing the most current appraised values during the on-site portion of the examination. The lack of current appraisal information affected at least 11 lending relationships in the examiners' original loan review. Examiners returned to the bank and expanded the loan review to include maximum ADC portfolio penetration and demanded access to all appraisal information. As a result of the wider review, more time, and full access to pertinent information, the examiners determined that a \$23.7 million increase was needed for the ALLL to cover the credit losses.

Adverse loan classifications are a key factor in determining the ALLL. BOCC's loan classifications increased, from \$7.8 million in June 2007 to over \$96.7 million in November 2008, as shown in Table 4, which follows. The bank's adverse classifications coverage ratio (Adversely Classified Items to Tier 1 Leverage Capital and ALLL) increased from approximately 23 percent to 520 percent, as previously shown in Table 1, over the same period.

Table 4: BOCC's Loan Classifications and ALLL for 2001- 2008

Examination Date	Asset Quality (Dollars in Thousands)					
	Loan Classifications				Analysis of ALLL	
	Substandard	Doubtful	Loss	Total Classified Assets	ALLL Computed by BOCC	Increase in ALLL Required by Examiners
Jan 2001	\$990	\$73	0	\$1,063	\$646	0
Jan 2002	\$1,024	0	0	\$1,024	\$952	0
June 2003	\$1,005	\$155	0	\$1,160	\$1,800	0
Dec 2004	\$2903	\$115	\$424	\$3,442	\$2,526	0
June 2006	\$2,380	\$1,879	0	\$4,259	\$3,676	0
June 2007	\$4,378	\$2,900	\$571	\$7,849	\$4,413	\$560
Nov 2008	\$70,925	\$992	\$24,819	\$96,736	\$5,654	\$28,201

Source: OIG Review of UBPRs, ROEs, and SAERs.

Inadequate Liquidity Planning and Management

Dependency on Volatile Funding Sources. BOCC's management employed a funding structure that centered on higher-cost wholesale funds. Specifically, BOCC relied on wholesale funding sources, such as FHLB borrowings; brokered deposits; time deposits of \$100,000 or greater; and high-rate core deposits to fund asset growth. BOCC management leveraged the residential construction loan portfolio by utilizing FHLB borrowings to fund growth and pursued ADC loan growth by utilizing brokered deposits. Use of these types of funding sources increased the bank's risk because such sources were higher cost and could be quickly withdrawn or restricted in a deteriorating market or if the bank's financial position declined. According to the FDIC, it appeared that bank management did not fully consider the nature or level of risk created by using these wholesale funding sources, and management failed to implement appropriate risk limits and develop an adequate contingency liquidity plan (CLP).⁶

Examiners identified weaknesses in the bank's funding strategy during the June 2003 examination. According to examiners, management's liquidity strategy focused on using higher-cost liabilities, particularly brokered deposits to provide funding for loans, and the strategy did not furnish sufficient diversification given the lack of adequate liquidity sources or a significant low-cost core deposit base. In addition, during the 2003 examination, examiners commented that the bank's average cost of funds for jumbo certificates of deposit (CD) was approximately

⁶ DSC uses the terms CLP, contingency liquidity plan, and contingency funding plan interchangeably. For purposes of this report, we use CLP.

4 percent, or 100 basis points above its peer group average. According to the examiners, a deposit rate sheet listing local financial institutions revealed that the bank was paying the highest or second-highest deposit rates in the local market, or about 70 basis points above the average rates for certain deposit categories. Further, the bank's Chief Operating Officer informed the examiners that the bank's policy was to offer current and prospective customers a premium of 50 basis points over published deposit rates if they agreed, or had agreed, to open a checking account at the bank (no minimum balance requirement). Examiners concluded that the bank's high-cost funding resulted from the use of brokered deposits, above-average rates paid on local deposits, and a lower volume of core deposits. Examiners also concluded that the higher overall cost of funds indicated potential volatility in the deposit base and contributed to an elevated liquidity risk profile. The examiners also noted that a contributing factor in the decline in the bank's net interest margin was a higher-average cost of funds (3.02 percent compared to the peer group average of 2.26 percent).

A bank's net non-core dependency ratio indicates the degree to which the bank is relying on non-core/wholesale funding: higher ratios indicate greater risk exposure and a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. BOCC's high-cost and non-core funding sources such as FHLB borrowings and brokered deposits were a significant source for funding the bank's loan growth strategy that began in 2001 and ended in 2008. During this period (with the exception of 2007), BOCC was consistently above its peer group average for net non-core funding, as shown in Table 5, which follows.

Table 5: BOCC's Non-Core Funding Sources and Net Non-Core Funding Dependency Ratios

Period Ended	Non-Core Funding Sources (Dollars in Thousands)			Net Non-Core Fund Dependency Ratios (Percent)	
	Time Deposits of \$100m or More	Brokered Deposits	FHLB Borrowings	Bank of Clark County	Peer Group
Dec 2001	\$30,304	\$18,150	0	41.65	10.93
Dec 2002	\$39,719	\$32,427	0	40.68	15.29
Dec 2003	\$43,155	\$41,698	0	36.79	16.92
Dec 2004	\$44,446	\$40,270	\$2,000	18.06	16.47
Dec 2005	\$69,064	\$39,211	\$7,500	29.77	19.20
Dec 2006	\$74,032	\$26,205	\$29,250	32.03	24.46
Dec 2007	\$49,053	\$65,541	\$37,000	24.59	25.68
Dec 2008	\$76,894	\$134,517	\$42,239	59.68	30.43

Source: OIG Review of UBPRs.

The 2008 ROE noted that the bank's rapid loan growth had been almost entirely reliant on wholesale funding, leaving an overall lack of liquidity sources to meet contingency funding requirements.

According to the 2008 ROE, the bank's liquidity levels threatened the bank's ability to continue as a going concern, the bank's ability to meet daily obligations was heavily dependent on

obtaining FHLB and the Federal Reserve Bank borrowings, and it was unlikely that those sources would be sufficient to cover the bank's near-term cash needs. Additionally, according to the November 3, 2008 ROE, the bank's FHLB borrowing lines were restricted (and a hold was placed on the bank's FHLB deposits), its securities portfolio was fully pledged, and other borrowing lines at correspondent banks were cancelled.

Further, during the November 2008 examination, examiners found that since September 30, 2006, the bank's total assets had increased by \$156 million, or 51 percent. Core deposit generation could not keep pace with loan demand; therefore, 79 percent of this growth had been funded by non-core liabilities. As of September 30, 2008, the net non-core funding dependency ratio was at a high of 50.99 percent.

As a result of the November 2008 examination findings, the FDIC notified the BOD of the bank's change in PCA category to "Significantly Undercapitalized," subjecting the bank to brokered deposit and deposit interest rate restrictions. According to the 2008 ROE, as a result of the institution's significant asset quality deterioration, 2008 net losses, and "Significantly Undercapitalized" status, the bank's current funding structure was unsustainable. BOCC management was informed that the BOD would have to take the necessary steps to restore the bank to a sound condition and to immediately raise capital and/or seek merger opportunities. However, on November 17, 2008, bank management ordered \$35 million in additional brokered deposits, despite being orally informed by regulators on November 14, 2008 that bank management should consult with the WDFI and FDIC before obtaining additional brokered deposits. According to the FDIC, on November 28, 2008, after learning of the bank's \$35 million in additional brokered deposits, it again orally instructed the bank to cease further brokered deposit activity. On the same day, the FDIC sent a PCA letter to the bank advising it of its "Undercapitalized" capital category, thus restricting BOCC from obtaining additional brokered deposits.

Inadequate Contingency Liquidity Plan. BOCC's BOD did not ensure that reasonable operating limits and parameters were established or that sufficient mitigating measures were employed to limit the level of liquidity risk. In addition, CLPs were not adequately formulated. Since June 2003, examiners repeatedly recommended that the bank formulate, document, and/or improve a CLP, establish and comply with comprehensive/relevant risk limits, and maintain adequate funds management policies and monitoring practices. However, bank management repeatedly failed to fully implement the examiners' recommendations. In the 2003 ROE, examiners expressed concern that the asset/liability management policy guidelines for liquidity were deficient, and a liquidity contingency funding plan needed to be developed and adopted by the BOD. As a result, examiners recommended a Bank Board Resolution (BBR) to correct the deficiencies. The BBR was considered substantially completed, based on the results of the 2004 risk examination; however, the bank's reliance on large CDs continued to be a significant part of its funding strategy, and liquidity parameters and a monitoring process had not yet been fully developed.

In addition, the 2004 ROE noted that the bank's risk management practices needed to be improved to properly manage the level of risk assumed in the liquidity and funds management area. During the 2007 examination, examiners noted that the bank had been out of compliance

with several of its liquidity parameters since late 2006. The 2007 ROE contained recommendations to further enhance funds management and interest rate risk management practices including: enhancing funds management practices by monitoring and managing liquidity from a cash-flow perspective; revising the liquidity contingency plan to factor in potential deterioration of asset quality and the effects it may have on management's ability to borrow; and analyzing and assessing the volatility of the deposit base.

During the November 2008 examination, examiners determined that funds management policies and procedures were inadequate. Management had implemented daily cash-flow statements and longer-term projections at the requirement of regulators; however, the CLP needed to be enhanced to include realistic contingent funding sources; all sources listed in the existing plan were already in use or had been attempted with limited success. Management also needed to ensure that the contingency funding plan fully satisfied liquidity requirements of FIL-84-2008 *Liquidity Risk Management*, dated August 26, 2008. The FDIC issued this guidance to highlight the importance of liquidity risk management at financial institutions that use wholesale funding, securitizations, brokered deposits, and other high-rate funding strategies to ensure that the institutions' contingency funding plans address relevant stress events.

Weak Credit Administration Practices

Loan Portfolio Risk Identification. BOCC's management allowed significant loan concentrations to exist without adequate risk identification, measuring, monitoring, and controls. According to the 2004 ROE, while growing ADC concentrations in rapidly expanding markets, management did not identify the need for, or establish, a concentration limit related to CRE and ADC loans. Further, according to the 2007 ROE, BOCC's BOD did not establish risk criteria unique to construction and land development lending (i.e., construction delays; cost overruns; slow absorption; number of extensions; unit sales prices that were less than appraised value, thereby jeopardizing collateral margins, etc). The BOD also did not establish risk limits or adequate policies, procedures, and controls to track and report the volume of construction and land development loan extensions. In particular, the BOD should have ensured that as the bank grew, the sophistication of the bank's risk identification and monitoring systems expanded to effectively identify, measure, monitor, and control bank operations and risk.

The 2008 examination categorized the loan portfolio risk identification process as inadequate. Just prior to the start of this examination, BOCC management downgraded its loan portfolio, more than doubling the level of loans required to be placed on the bank's "Watch" list or worse. Nonetheless, as a result of that examination, the number of loans the examiners downgraded was staggering, encompassing 40 loan relationships and over \$55 million in adverse loan classifications.

Examiners found that BOCC had significantly increased its ADC loan portfolio without implementing sufficient programs in a timely manner to identify, measure, monitor, and control risk associated with higher-risk ADC loans. Furthermore, BOCC did not establish appropriate concentration limits or controls to mitigate risk and did not establish prudent loan underwriting

standards, effective loan administration procedures, and appropriate loan risk management practices.

Credit Administration and Problem Asset Resolution. Imprudent credit administration and inadequate problem asset resolution, coupled with a significant downturn in the residential construction market caused considerable deterioration in BOCC's credit portfolio. Historically, BOCC's management had repeatedly neglected to set risk tolerance limits for the portfolio, failed to reduce the concentration in CRE and ADC credits, failed to adequately monitor concentrations, and failed to ensure that credit administration kept pace with the overall growth in the institution.

During the 2004 examination, examiners noted that nearly half of the loan relationships reviewed by the examiners contained loan underwriting and credit administration weaknesses related to loan pricing that was not commensurate with risks, high advance rates on construction or land acquisition and development loans, appraisals and appraisal reviews, cash flow analysis, credit presentations, and excessive reliance on the lead bank's analysis and monitoring for construction loan participation purchases. During the 2007 examination, examiners noted that a number of areas needed attention to ensure that risks were identified and controlled in a timely manner and that a slowdown in local real estate market conditions, coupled with several loans downgraded by the bank, highlighted the need to upgrade risk management practices and policies. In addition, examiners advised bank management that it should enhance the appropriate loan policies and improve underwriting practices with respect to adhering to the applicable appraisal guidance, laws, and regulations.

Specifically, the 2007 ROE states that for credit administration and underwriting, the bank should:

- Refine internal risk rating definitions to include risk criteria unique to construction and land development lending (i.e., construction delays, cost overruns, slow absorption, number of extensions, unit sales prices that are less than appraised value and jeopardize collateral margins, etc.).
- Expand the external review process to include a random sample of existing (as opposed to just new, renewed, or recently modified) loans to validate risk ratings.
- Track and report the volume of construction and land development loan extensions.
- Revise loan presentations to include comments on the loan officer's investigation of environmental risk.
- Ensure loan policy adherence by addressing underwriting requirements for borrower/guarantor net worth, cash flow, and liquidity to inventory/guidance line requirements on credit approval documents.

- Develop a system of written comments for Watch List Credits that defines the problem, establishes a plan of action, defines upgrade and downgrade triggers, and provides a timetable for resolution.
- Consider adjusting loan pricing for the increased risk resulting from collateral margin deterioration or from terming-out land loans.

Further as it related to the loan policy, the ROE states the bank should:

- Establish BOD loan approval authority for the bank’s largest borrowers to improve vigilance over the commercial lending area.
- Incorporate the Part 365 definition of “value” relative to loans used to purchase existing property. Value for these loans is defined as the lesser of actual acquisition cost or the estimated value.
- Add Part 365 aggregate limits for total loans in excess of loan-to-value standard and total loans, excluding 1-4 family residential properties. Part 365 – Appendix A sets these limits at 100 percent and 30 percent, respectively, of total capital.
- Refine non-accrual loan guidelines to require reversal of all previously accrued interest on the date of determination.
- Define the criteria that will be used to determine if a loan is impaired for purposes of the Statement of Financial Accounting Standards (FAS) 114, and revise the bank’s ALLL methodology to incorporate FAS 114 accounting in the assessment of ALLL adequacy.
- Establish standards for the quality of financial information. (i.e, compiled, reviewed, or audited).
- Clarify policy guidelines to ensure that loans using real estate collateral as an “abundance of caution” meet unsecured lending guidelines.
- Develop cash equity requirements for all real estate loans. Current policy allows up to 100 percent of appreciated equity (excluding appreciation since the time of purchase if the property is owned for less than 1 year).
- Formalize problem loan collection procedures.

During the November 2008 examination, examiners found that the bank’s credit administration department, as a whole, lacked structure and leadership. The examiners described the problem asset identification and resolution process as dysfunctional, with a general lack of documentation and a slow process for downgrading credits.

Further, examiners found that the bank used inappropriate practices in dealing with problem clients, to include multiple extensions of nonperforming credits, capitalization of interest, and inadequate control over collateral. The 2008 ROE stated that problem asset reports often took over a month to complete after the assets were downgraded, which was unacceptable in the rapidly changing market. The shortfalls in problem asset administration appeared to stem from very weak and ill-defined processes in this area.

Overall, it was the examiners' opinion that the credit department appeared ill-equipped to handle the problems facing the bank. Further, examiners noted that the problems were exacerbated by the departure of the Chief Credit Officer (CCO), during the examination, causing the credit administration capabilities to be severely impaired. The newly appointed CCO had been with the institution for just a short period of time and lacked specific knowledge of the credit portfolio. Despite the severe level of problem loans, the bank did not have staff specifically dedicated to problem asset resolution, loan officers had stated that they lacked experience with problem loans, and the Chief Executive Officer had indicated a lack of involvement in the credit function.

FDIC SUPERVISION OF THE BANK OF CLARK COUNTY

The following is a description of the FDIC's supervision of BOCC and our assessment of that supervision.

Historical Snapshot of FDIC Supervision

DSC's San Francisco Regional Office (SFRO) and the WDFI alternated safety and soundness examinations of BOCC, conducting one visitation and eight examinations from June 1999 through November 2008. The FDIC cooperates with State banking agencies in many areas, including: conducting alternate, joint, and concurrent safety and soundness examinations of insured depository institutions; developing and issuing informal and formal enforcement actions; and exchanging supervisory information. Such cooperation fulfills a mutual goal of promoting a safe and sound banking system. It is recognized that this close cooperation between the FDIC and state regulators promotes efficiency in the examination process; reduces the regulatory burden on state-chartered, insured depository institutions; and improves the supervisory process.

BOCC's composite ratings remained at 2 from the 1999 through 2007 examinations. As a result of the November 3, 2008 examination, BOCC's composite rating was downgraded to 5, indicating extremely unsafe and unsound practices or conditions, critically deficient performance, and inadequate risk management practices. Table 6, which follows, shows the component and composite ratings received by BOCC from 1999 through 2008.

Table 6: BOCC's Component and Composite Ratings

Examination Date	Examination Type	CAMELS Rating
Nov 2008	Full-scope State	555554/5
June 2007	Full-scope FDIC	222222/2
June 2006	Full-scope State	222222/2
Dec 2004	Full-scope FDIC	222222/2
June 2003	Full-scope FDIC	222232/2
Jan 2002	Full-scope State	212222/2
Jan 2001	Full-scope FDIC	112222/2
Jan 2000	Full-scope Joint	112212/2
June 1999	Initial Visitation	222222/2

Source: OIG Review of UBPR's, ROEs, and SAER.

In addition to providing composite and component CAMELS ratings for each FDIC ROE, the FDIC took other supervisory actions. In particular, the FDIC's ROEs made many specific recommendations to BOCC to improve areas that included, but were not limited to, the bank's identification and monitoring of loan concentrations, establishment of liquidity risk limits and CLPs, internal loan grading system and watch list, and correction of apparent violations of laws and regulations.

To address examiner concerns documented in the June 2003 ROE related to weaknesses in the bank's liquidity and funds management practices, the FDIC requested BOCC to adopt a BBR, which the bank's BOD adopted on July 23, 2003. The BBR contained provisions that addressed reducing reliance on potentially volatile wholesale funding sources, diversification of funding sources, establishment of a formal BOD-approved CLP, and compliance with customer identification program requirements with respect to brokered deposits. During the subsequent examination conducted in December 2004, examiners found the bank to be in substantial compliance with the July 2003 BBR, although all of the provisions had not been fully implemented by the bank. Based on the results of the 2004 FDIC examination, the bank's liquidity rating was upgraded from a 3 to a 2; however, concerns with BOCC's reliance on higher-cost and wholesale (higher-risk) funding was noted in the three subsequent examinations.

The only formal enforcement action, a Cease and Desist Order (C&D), was originally presented to the bank for its consideration on December 16, 2008, before the examination was finalized. It was formally presented to the bank on January 15, 2009, 1 day before the bank's failure. It should be noted that the BOD refused to stipulate to the C&D. According to the FDIC, at that point, the WDFI issued a supervisory directive to the bank covering many of the items contained in the C&D.

OIG Assessment of FDIC Supervision

From the bank's inception in 1999, the FDIC and WDFI provided supervisory oversight of BOCC in many ways, including a visitation, risk management examinations, and offsite monitoring. Examiners identified concerns with BOCC's significant loan growth and ADC loan

concentrations, and recommended, among other things, that management improve its measuring, monitoring, and control of the loan portfolio and reduce reliance on potentially volatile funding sources to fund asset growth. In addition, the ROEs recommended that management improve its loan underwriting and credit administration processes and noted apparent violations and contraventions of the FDIC's Rules and Regulations. Although critical matters that contributed to the failure were brought to the attention of bank management, the FDIC could have exercised greater supervisory concern regarding ADC loan concentrations, the ALLL, volatile funding, liquidity management, and compliance with laws and regulations. Specifically, the 2007 examination findings should have led to elevated supervisory attention and earlier supervisory action to help prevent the bank's failure and/or mitigate the potential level of losses incurred. The impact of the bank's risk profile became increasingly evident after the real estate market deteriorated in 2007 and significant delinquencies and losses occurred, starting in 2008. By that time, however, any actions recommended by the FDIC and taken by BOCC were insufficient to prevent BOCC's failure.

ADC Concentrations. From the June 2003 examination until the final examination in November 2008, examiners noted BOCC's concentrations in commercial and higher-risk ADC lending. Specifically, examiners noted concern that BOCC management had repeatedly neglected to set risk tolerance limits for the loan portfolio, failed to reduce the concentration in CRE and ADC credits, and failed to ensure that credit administration kept pace with the overall growth in the institution. Further, the December 2004 ROE notes that some loan portfolio risk indicators were evident, including continued rapid growth and an increased concentration in residential construction and ADC loans without appropriate risk limitations set by management. However, examiner recommendations were limited to improving concentration monitoring or to adopting combined concentration limits for ADC loans. Examinations, particularly the 2007 examination where the concentrations reached levels in excess of the supervisory guidance as previously discussed, did not result in recommendations related to limiting concentrations or mitigating the bank's risk by requiring BOCC to increase its capital levels. According to the FDIC, the supervisory guidance does not establish limits or maximums on CRE or ADC lending, and examiners typically will not set specific concentration limits.

The 2006 CRE guidance reminds institutions that strong risk management practices and appropriate levels of capital are essential elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans. In addition, according to the guidance, an institution that (1) has experienced rapid growth in CRE lending, (2) has notable exposure to a specific type of CRE, or (3) is approaching or exceeds the supervisory criteria for such lending may be identified for further supervisory analysis of the level and nature of its CRE concentration risk. BOCC's June 2007 ROE noted that ADC loans totaled 294 percent of total capital. Further, when committed but unfunded amounts were included, the exposure level increased to 359 percent of total capital. However, examiners did not make recommendations for specific concentration and risk limits or to address the need for higher capital levels. The November 2008 ROE describes the deterioration in the credit portfolio as considerable, with a staggering \$25.6 million in assets classified as loss. According to the ROE, this was caused by a significant downturn in the residential construction market and BOCC's inadequate underwriting and credit administration. The 2008 ROE states further that the leading cause of the deterioration in loan quality was management's imprudent risk appetite, as demonstrated in

the heavy concentration of ADC credits. The November 2008 ROE states that the BOD ultimately set a policy limit for ADC lending at 400 percent of capital; however, it was the examiners' opinion that the level was excessive.

Allowance for Loan and Lease Losses. From 1999 through the June 2006 examination, examiners routinely reported that BOCC's ALLL methodology was satisfactory. Also, examinations noted that the ALLL and capital levels were commensurate with BOCC's overall risk profile because classifications were low, earnings remained satisfactory, and the bank was "Well Capitalized." However, the June 2007 examination identified a \$560,000 shortfall in the ALLL, due in large part to the deterioration of two large credits. At that time, examiners recommended that the bank:

- Increase the balance of the ALLL by \$560,000 to adequately provide for loans downgraded during the examination.
- Resume the quarterly review of ALLL adequacy, which had been conducted only semiannually. Regulatory guidance requires the BOD to assess the adequacy on a quarterly basis.
- Review the ALLL factors for reasonableness to include loans secured by land and CRE, speculative construction loans, and past dues loans.

At the November 2008 examination, examiners stated that the methodology used to determine a targeted ALLL did not follow regulatory guidance and did not provide for a reserve level appropriate for the condition of the credit portfolio and external market conditions. Even though management had taken a \$4.5 million loss provision in the fourth quarter 2008, during the November 2008 examination, the examiners' analysis of the ALLL determined that an increase of \$23.7 million was needed to cover the credit losses. In addition, the 2008 examination contained findings that the ALLL was underfunded and that the loan grading was inaccurate in several cases. Further, the 2008 ROE contained a repeat recommendation (from the 2007 examination) that the bank needed to adjust risk factors in the ALLL to be directionally consistent with expectations for growth and area market trends.

Volatile Funding. From June 2003 through June 2007, examiners repeatedly identified the bank's reliance on non-core/wholesale funding sources, noting that management had become increasingly reliant on high-cost, wholesale deposits to fund loan growth. Examiners warned that the strategy of funding loan growth largely with brokered deposits did not provide adequate diversification in the funding base and introduced potential liquidity risks if brokered deposits were not readily available due to capital restrictions or adverse market conditions. Examiners also identified the bank's failure to stratify or segment its ADC loan portfolio by risk factors and risk layers and the lack of risk identification, measuring, monitoring, and controls in relation to the bank's liquidity risk profile. However, with the exception of the 2003 examination, the FDIC did not impose restrictions on the bank's use of non-core/wholesale funding sources until the November 2008 examination, when liquidity levels were found to be critically deficient and threatened the bank's ability to continue as a going concern. According to the ROE, recent-year rapid loan growth had been almost entirely reliant on wholesale funding, leaving an overall lack

of liquidity sources to meet current funding requirements. At that point, the bank's ability to meet daily obligations was heavily dependent on obtaining borrowings from the FHLB and the Federal Reserve Bank, and it was unlikely that those sources would be sufficient to cover the bank's near-term cash needs. Available liquidity sources had been constrained due to the cancellation of borrowing lines and declining collateral values.

Liquidity Management and Planning. From January 2003 through November 2008, examiners made recommendations related to the bank's liquidity policies, formulation of risk limits, and formulation and documentation of CLPs. Although examiners continually found that the bank's liquidity risk was higher than average and the bank's funding strategy lacked diversification and was reliant upon brokered deposits, examiners did not express greater supervisory concern about management's repeated failures to: formulate, document, and/or improve a CLP; adequately maintain funds management policies and monitoring procedures; and establish and maintain compliance with wholesale funding liability risk limits and parameters.

Risk Management Practices. The June 2006 ROE noted that the loan portfolio, which was heavily concentrated in ADC real-estate-secured loans, could present potential problems in an economic downturn. However, the examiners' responses to the questions on risk management assessment typically did not address the bank's economic environment or how the bank planned to respond to a potential deterioration in its key market areas. Examiners did not address the impact of the slowdown in the Clark County real estate market until the 2007 examination. According to the risk management assessment in the 2007 ROE, BOCC's asset quality was substantially tied to the general health of the Clark County residential real estate market, which was in the midst of a real estate slowdown that began during the first quarter of 2006. The conclusion was that the institution remained an active construction and land development lender, and it was likely that the value of land purchased for both future development and completed residential lots would decline. In light of the bank's high level of residential construction-related credit exposure, examiners recommended that the BOD:

- Re-evaluate the validity of key assumptions in the bank's Strategic Plan in light of the continued slowing of the Clark County real estate market.
- Review and affirm appropriateness of CRE risk limits in the loan policy to reflect: the level and trend of risk in the loan portfolio, the strength and outlook of the real estate markets, and the BOD's CRE risk tolerance levels.
- Conduct transactional and portfolio-level stress/sensitivity testing to quantify the potential impact of changing economic conditions on asset quality, earnings, and capital.
- Monitor trends in residential-related properties on the bank's books longer than 18 months.

Compliance with Laws and Regulations. Beginning with the bank's January 2002 examination through the 2008 examination, examiners cited BOCC for apparent violations of laws and regulations related to real estate appraisals, loans in excess of supervisory loan-to-value

limits, real estate concentrations, retention of records, standards for safety and soundness, restrictions on transactions with affiliates, and contraventions of interagency policies on interest rate risk, loan to value, and ALLL. Also, the 2008 examination cited repeat violations of appraisal regulations and repeat failure to report loans in excess of supervisory loan-to-value limits to the BOD. Bank management's failure to address these concerns may have contributed to the bank's increase in the volume of adversely classified loans and losses and, ultimately, to the failure of the bank.

2007 Examination. The FDIC could have exercised greater supervisory concern at the end of the 2007 examination and taken additional action to help prevent the bank's failure and/or to mitigate the potential level of losses incurred. During that examination, BOCC's loan portfolio had deteriorated significantly and was highly concentrated in ADC loans; liquidity issues, identified as early as the 2003 examination, were uncorrected or in need of improvement; ALLL was inadequate; and BOCC's risk profile was increasing. Although examiners identified numerous ADC loan underwriting and administration weaknesses, management and asset quality were considered adequate, and no informal or formal corrective action was recommended.

The 2007 ROE stated that internal and external sources indicated that Clark County was in the midst of a real estate slowdown that began in the first quarter of 2006 and acknowledged that the bank remained an active construction and land development lender. According to the FDIC, although the real estate market in the Portland area peaked in June 2007, the bank continued to increase the ADC loan portfolio after the 2007 examination even though the bank knew the market was softening. The weak risk management practices and controls left the bank unprepared and unable to effectively manage operations in a declining economic environment.

Conclusion. Generally, BOCC promised corrective actions for identified deficiencies, and examiners generally followed up on recommendations at subsequent examinations. However, the examiners reported the same concerns in several ROEs related to the bank's measuring, monitoring, and reporting of concentrations; higher-risk ADC lending; reliance on wholesale funding; and apparent violations of laws and regulations.

According to DSC management in the SFRO, the ROEs contained many recommendations for improvement over the years, and the bank gave the appearance of listening and implementing them. While the bank made efforts to follow the recommendations, regional management was not assured the efforts were sincere.

Although bank management is ultimately responsible for determining the success or failure of an institution, the FDIC has authority to take a wide range of supervisory actions. In the case of BOCC, however, supervisory actions in response to the 2007 examination were not timely and effective in addressing the bank's most significant problems. More proactive supervision of credit administration, growth, and concentrations may have helped at an earlier stage.

IMPLEMENTATION OF PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not "Adequately Capitalized."

As of September 2008 BOCC's Tier 1 Risk-Based Capital and Total Risk-Based Capital ratios were 9.77 percent, and 11.02 percent, respectively. BOCC was not deemed "Undercapitalized" until just prior to the close of the last full-scope examination in November 2008 (2 months before BOCC was closed). A PCA Notification Letter was issued to BOCC's BOD on November 28, 2008. In the letter transmitting the 2008 ROE to the BOCC BOD, dated January 14, 2009, BOCC was deemed "Significantly Undercapitalized" with respect to PCA standards. BOCC received a capital component rating of 2 for each of the five examinations conducted from January 2002 through June 2007, but the capital component was downgraded to a 5 rating in the November 2008 examination. The downgrade resulted from the bank's critically deficient level of capital due to severe asset quality problems and losses that rapidly eroded the bank's capital position. Specifically, aggressive asset growth at 28 percent had outpaced earnings retention since the previous examination, compromising capital ratios and weakening the bank.

The FDIC required BOCC to develop and submit a capital restoration plan (CRP) within 45 days of the receipt of the PCA Notification Letter. In addition, restrictions were placed on BOCC's acceptance, renewal, or rollover of brokered deposits. Also, BOCC was subject to restrictions on asset growth, acquisitions, new activities, new branches, payment of dividends or management fees, and on any other capital distributions. On December 23, 2008, the bank submitted its CRP, a Liquidity Plan, and an Adverse Classified Asset Reduction Plan.

On December 2, 2008 the WDFI notified BOCC that it would revoke its charter in 30 days if BOCC's Tier 1 Capital and Total Risk-Based Capital ratios were not increased to 7 percent and 10 percent, respectively.⁷ The 30-day letter also required BOCC to reduce adversely classified assets to less than 125 percent of Tier 1 Capital and the ALLL.

PCA's focus is on capital, and capital can be a lagging indicator of an institution's financial health. In addition, the use of PCA Directives depends on the accuracy of capital ratios in a

⁷ Under Washington law, the state must give a bank at least 30 days to correct identified weaknesses before taking action to close the institution.

financial institution's Consolidated Reports of Condition and Income (Call Reports).⁸ BOCC's capital remained in the "Well Capitalized" range long after its operations had begun to deteriorate because of problems related to management, asset quality, risk management controls, and net losses. In particular, the ALLL was significantly underfunded, which overstated capital and underreported the deterioration of the loan portfolio. (It should be noted that the bank was still considered "Well Capitalized" after adjusting for the underfunded ALLL in 2007.)

Further, by the time BOCC's capital level fell below the required threshold necessary to implement PCA, the bank's condition had deteriorated to the point at which the institution could not raise additional needed through its BOD or find other investors to assist in capitalizing the bank. Because the holding company was not publicly traded, options for additional capital funds were limited.

CORPORATION COMMENTS AND OIG EVALUATION

On July 31, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 3 of this report. In its response, DSC stated that it agreed with the OIG's finding that BOCC failed primarily due to management's aggressive pursuit of loan growth concentrated in CRE loans. DSC also stated that BOCC was unprepared and unable to effectively manage its operations given the rapid decline in real estate values within its local market area.

With respect to the FDIC's supervision of BOCC, DSC's response stated that the 2007 ROE demonstrated the level of FDIC supervisory concern by: (1) criticizing the increased volume of CRE/ADC lending and recommending the implementation of more robust risk management procedures and monitoring for CRE and (2) providing specific recommendations for strengthening credit administration and portfolio risk management processes. DSC also stated, "The *2006 Interagency Guidance on CRE Monitoring* does not establish specific limits or maximums on CRE or ADC lending activity, but sets forth broad supervisory expectations for banks that exceed certain thresholds." We agree that the 2006 interagency guidance does not establish limits, but rather supervisory criteria for identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny, as discussed in our report.

DSC agreed that it could have taken stronger supervisory actions such as enforcement actions and component rating downgrades after the 2007 examination.

⁸ Every national bank, state member bank, and insured state nonmember bank is required to file Call Reports. The Call Reports are normally filed as of the close of business of the last calendar day of each quarter (March, June, September, and December). The Call Reports must be completed in an accurate and consistent manner to reflect a fair presentation of the bank's financial condition and results of operations. Certain Call Report data is available to the public upon request. The federal agencies use data from the Call Reports to produce UBPRs. UBPRs are used by the regulatory agencies for offsite monitoring and during examinations as a source of financial analysis for the bank.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted the audit from February 6, 2009 through July 28, 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it may not have been feasible to address certain aspects of the standards, as described on the next page.

Scope and Methodology

The scope of this audit included an analysis of BOCC operations from February 8, 1999, until its failure on January 16, 2008. 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 procedures and techniques:

- Analyzed examination and visitation reports prepared by the FDIC and the WDFI examiners from 1999 to 2008.
- Reviewed the following:
 - Bank data and correspondence maintained at DSC's SFRO and Portland Field Office.
 - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.
 - External audit records provided by Moss Adams, LLP, BOCC's external auditors located in Portland, Oregon.

- Bank records maintained by DRR in the Dallas Regional office for information that would provide insight into the bank's failure.
- Pertinent DSC policies and procedures.
- Interviewed the following FDIC officials:
 - DSC management in Washington, D.C., and the SFRO.
 - DRR officials at the Dallas Regional Office.
 - FDIC examiners from the DSC Portland, Oregon, Field Office who participated in examinations or reviews of examinations of BOCC.
- Met with officials from the WDFI located in Olympia, Washington, to discuss the historical perspective of the institution, its examinations, state banking laws, and other activities regarding the state's supervision of the bank.
- Researched various banking laws and regulations, including Washington State laws.

We performed the audit field work at the DSC SFRO; DSC Portland, Oregon, Field Office; and DRR Dallas, Texas, Regional Office.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance With Laws and Regulations

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of BOCC's management controls pertaining to its operations as discussed in the finding section of this report.

For purposes of the audit, we did not rely on computer-processed data to support our significant findings and conclusions. Our review centered on interviews, ROEs and correspondence, and other evidence to support our audit.

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. For this material loss review, 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 is 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. The results of our tests were 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.

GLOSSARY OF TERMS

Term	Definition
Adversely Classified Assets	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.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of loan.
Bank Board Resolution (BBR)	A BBR is an informal corrective action recommended by the FDIC to a financial institution to obtain correction of noted safety and soundness or compliance deficiencies. BBRs are voluntary commitments made by a financial institution's BOD and are not legally enforceable or available to the public.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Prompt Corrective Action (PCA)	<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 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than "Adequately Capitalized." The following terms are used to describe capital adequacy: (1) "Well Capitalized," (2) "Adequately Capitalized," (3) "Undercapitalized," (4) "Significantly Undercapitalized," and (5) "Critically Undercapitalized."</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>
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of a bank's 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.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

July 31, 2009

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Bank of
Clark County, Vancouver, WA (Assignment No. 2009-017)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of the Bank of Clark County, Vancouver, Washington, which failed on January 16, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Audit Report received on July 17, 2009.

We agree with the OIG's findings that the Bank of Clark County failed primarily due to management's aggressive pursuit of loan growth concentrated in Commercial Real Estate (CRE) loans. Specific concentrations included residential Acquisition, Development, and Construction (ADC) loans funded with higher-cost wholesale deposits and borrowings coupled with inadequate loan portfolio and risk management controls. In addition, the rapid decline in real estate values within the local market area left the Bank of Clark County unprepared and unable to effectively manage operations in a declining economic market.

The Draft Audit Report states that the FDIC and the Washington Department of Financial Institutions conducted risk management examinations and offsite monitoring, identified problems, and prescribed appropriate corrective measures to the management of the Bank of Clark County. The 2007 Report of Examination demonstrates the level of FDIC supervisory concern, it criticized the increased volume of CRE/ADC lending, and recommended the implementation of more robust risk management procedures and monitoring for CRE. Examiners also provided specific recommendations for strengthening credit administration and portfolio risk management processes.

The *2006 Interagency Guidance on CRE Monitoring* does not establish specific limits or maximums on CRE or ADC lending activity, but sets forth broad supervisory expectations for banks that exceed certain thresholds. The 2007 Report of Examination notes that, despite the Bank of Clark County's apparently satisfactory financial condition, it had exceeded these thresholds and also had inadequate controls. We agree that we could have taken stronger supervisory actions such as enforcement actions and component rating downgrades after the 2007 examination.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
BOCC	Bank of Clark County
BOD	Board of Directors
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
CCO	Chief Credit Officer
CD	Certificate of Deposit
CFO	Chief Financial Officer
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FAS	Financial Accounting Standards
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SAER	Summary Analysis of Examination Report
SFRO	San Francisco Regional Office
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institution Rating System
WDFI	Washington Department of Financial Institutions