Office of Inspector General

March 2009
Report No. AUD-09-005

Material Loss Review of The Columbian Bank and Trust Company, Topeka, Kansas

AUDIT REPORT

Office of Audits

oig

Federal Deposit Insurance Corporation

Report No. AUD-09-005 March 2009

Material Loss Review of The Columbian Bank and Trust Company, Topeka, Kansas

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of The Columbian Bank and Trust Company (Columbian), Topeka, Kansas. On August 22, 2008, the State of Kansas, Office of the State Bank Commissioner (OSBC), closed Columbian and named the FDIC as receiver. On September 11, 2008, the FDIC notified the OIG that Columbian's total assets at closing were $726 million, with a material loss to the Deposit Insurance Fund (DIF) estimated at $61.5 million. As of December 31, 2008, the estimated loss to the DIF increased to $232 million.

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.

Background

Columbian, originally a national bank that became insured on October 2, 1978, was headquartered in Topeka, Kansas. The FDIC became the primary federal regulator of Columbian in December 1996. At closing, the bank had seven branches in Kansas and one in Missouri. Columbian was wholly owned by a two-bank holding company, which was wholly owned by an individual serving as a Director and a Vice President of Columbian.

Columbian's loan portfolio largely consisted of commercial real estate loans (CRE), with a significant concentration in land acquisition, development, and construction loans (ADC), many of which were brokered and/or out-of-territory. The federal financial regulatory agencies have recognized the increased risk that CRE and ADC loans present to financial institutions and issued guidance in December 2006 on a risk management framework that effectively identifies, measures, and controls CRE concentration risk. That framework should include effective oversight by bank management, including the board of directors (BOD) and senior executives, and sound loan underwriting, credit administration, and portfolio management practices.

Audit Results

Columbian failed primarily due to bank management's pursuit of rapid asset growth concentrated in high-risk CRE/ADC loans, without adequate loan underwriting and credit administration practices. Resulting losses due to asset quality deterioration and a downturn in the economy severely eroded capital, and in turn, the availability of wholesale funding sources used by the bank to fund its growth. As a result, the bank was unable to satisfy liquidity requirements, leading to its failure. Specifically:

Management. Columbian's BOD did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities or implemented timely corrective actions in response to examiner recommendations. In particular, Columbian did not adequately address recommendations included in FDIC and OSBC Reports of Examination related to enhancing liquidity and reducing risk exposure in identified problem assets. Further, the bank's performance bonus program created a cultural climate that emphasized asset growth and income without regard to loan quality.

Asset Quality. Columbian's loan portfolio consisted of a high concentration in CRE and ADC loans, many of which were brokered and/or out-of-territory. The bank's ADC loans as a percent of its loan portfolio was significantly above peer group averages from 2003 through 2008. Columbian did not follow sound loan underwriting and credit administration practices, including those pertaining to: (1) loan file documentation, (2) credit monitoring, and (3) accounting for interest reserves. Also, Columbian did not maintain a sufficient allowance for loan and lease losses (ALLL). As a result, asset quality declined, and losses, once recognized, reduced earnings and capital.

Liquidity. Columbian became increasingly dependent on higher cost and more volatile sources of liquidity, such as brokered deposits, Internet certificates of deposits, and Federal Home Loan Bank advances, to fund asset growth in excess of the growth in core deposits. Liquidity levels and funding strategies were deficient, and bank management did not implement the necessary controls for liquidity management, including an adequate contingency liquidity plan, until the bank had deteriorated to an overall unsatisfactory condition.

Supervision: The FDIC and OSBC conducted regular examinations of Columbian from 1996 until its closing in 2008. In 2005, OSBC reported weaknesses in Columbian's credit administration practices and noted the bank's first use of brokered deposits as a wholesale funding source. In 2006, in addition to identifying some of the weaknesses reported in the 2005 examination, the FDIC reported concerns regarding out-of-territory lending, rapid loan growth, and underfunding of the ALLL. As a result of the July 2007 examination, the OSBC, in consultation with the FDIC, downgraded Columbian's composite rating, and the FDIC expedited the 2008 examination. The FDIC did not issue a PCA Directive to Columbian because the bank had not become undercapitalized. In July 2008, the FDIC and OSBC jointly issued a Cease and Desist Order (C&D) in an attempt to stop Columbian from operating in an unsafe and unsound manner. Among the 19 provisions, the C&D called for improvements in the bank's liquidity and funds management, use of brokered deposits, concentrations of credit, use of interest reserves, maintenance of a sufficient ALLL, and loan policy.

Although FDIC and OSBC examinations identified the weaknesses in management, asset quality, and liquidity that ultimately led to Columbian's failure, supervisory action was not taken commensurate with the risks these weaknesses posed to the institution. Rather, Columbian's apparent strong earnings and lack of non-performing loans, which were attributable to such factors as an understated ALLL and the mismanagement of interest reserves, overshadowed supervisory concerns with Columbian's weaknesses until they became more pronounced based on changes in economic conditions. As a result, more timely supervisory action directed at Columbian's high-risk lending and weak credit underwriting and administration practices should have been taken. In particular, the institution continued to pay substantially increased dividends, accept brokered deposits, and originate CRE loans while the 2007 examination report was being processed from July to November 2007.

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

Management Response

The Division of Supervision and Consumer Protection (DSC) provided a written response to the draft report. DSC agreed with the OIG's conclusions regarding the causes of Columbian's failure and resulting material loss and the supervisory activities related to Columbian. DSC also agreed that increased supervisory action, commensurate with the risks these weaknesses posed to the institution, should have been implemented sooner.

To view the full report, go to www.fdicig.gov/2009reports.asp

Contents ***Page***

BACKGROUND	2
RESULTS IN BRIEF	4
MANAGEMENT	5
Failure of Columbian's Management to Address Examiner Concerns	6
Risk Management	7
Performance Bonus Program	8
Regulatory Supervision Related to Management	9
ASSET QUALITY	10
Examiner Concerns and Recommendations Regarding Asset Quality	11
Concentration in CRE and ADC Loans	12
Interest Reserves	14
Allowance for Loan and Lease Losses	14
Regulatory Supervision Related to Asset Quality	16
Concentrations of Credit	18
LIQUIDITY	19
Examiner Concerns and Recommendations Regarding Liquidity	20
Lack of an Adequate CLP	22
Brokered Deposit Restrictions	22
Regulatory Supervision Related to Liquidity	23
IMPLEMENTATION OF PCA	24
CORPORATION COMMENTS	25
APPENDICES	
1. OBJECTIVES, SCOPE, AND METHODOLOGY	26
2. GLOSSARY OF TERMS	29
3. CORPORATION COMMENTS	30
4. ACRONYMS IN THE REPORT	33
TABLES	
1. Financial Condition of Columbian	4
2. Examples of Examiner Comments and Recommendations Regarding Columbian's BOD and Management Performance	6
3. Columbian's Asset Classifications and ALLL	11
4. Examples of Examiner Comments and Recommendations Regarding Columbian's Asset Quality	12
5. Columbian Net Income, ALLL, and Dividends	16

Contents ***Page***

6. Examples of Examiner Comments and Recommendations Regarding Columbian's Liquidity 21

FIGURES

1. Columbian's Key CAMELS Ratings 3

2. ADC Loans as a Percent of Average Loans — Compared to Peer 13

3. ADC Loans as a Percent of Total Capital — Compared to Peer 17

4. CRE Loans as a Percent of Total Capital — Compared to Peer 17

5. Net Non-Core Funding Dependence — Compared to Peer 20

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

Office of Audits
Office of Inspector General

DATE: March 11, 2009

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

/Signed/

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of The Columbian Bank and Trust Company, Topeka, Kansas* (Report No. AUD-09-005)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of The Columbian Bank and Trust Company (Columbian), Topeka, Kansas. On August 22, 2008, the Kansas Office of the State Bank Commissioner (OSBC) closed the institution and named the FDIC as receiver. On September 11, 2008, the FDIC notified the OIG that Columbian's total assets at closing were $726 million, and the estimated loss to the Deposit Insurance Fund (DIF) was $61.5 million. As of December 31, 2008, the estimated loss to the DIF increased to $232 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 for preventing such loss in the future.

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[2] of the institution, including implementation of the PCA provisions of section 38. Appendix 1 contains details on our objectives, scope, and methodology, and Appendix 2 contains a glossary of terms. Acronyms used in the report are listed in Appendix 4.

---

[1] As defined by section 38 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 the 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 Columbian's failure and the FDIC's efforts to require Columbian's management to operate the bank in a safe and sound manner. A planned capping report will summarize 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 capping report will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

Columbian, formerly known as The Columbian Trust Company, was established and insured by the FDIC on October 2, 1978. The institution was renamed The Columbian Bank and Trust Company on December 1, 1996, and its primary federal regulator changed from the Office of the Comptroller of the Currency to the FDIC. Columbian, which was headquartered in Topeka, Kansas:

- had seven branches in Kansas and one in Missouri;
- provided traditional banking activities within its marketplace and engaged in brokered and out-of-territory lending; and
- specialized in commercial lending, with a concentration in commercial real estate (CRE), including acquisition, development, and construction (ADC) loans.

Columbian was a wholly owned subsidiary of Columbian Financial Corporation, which was a two-bank holding company. Columbian's local marketplace was the Greater Kansas City and Topeka, Kansas, metropolitan areas. The holding company was wholly owned by an individual who served as a Director and a Vice President of Columbian. In May 2006, Columbian merged with Keystone Bank (Keystone) of St. Louis, Missouri, to allow for the establishment of a branch office in Missouri. Additionally, in March 2007, the holding company purchased 100 percent of the common stock in The Bank, Weatherford, Texas (Affiliate). The Affiliate is a state nonmember institution that was established on June 11, 1987 and provides traditional banking services with a concentration in residential interim construction loans. The holding company purchased the Affiliate to provide a source of liquidity for loans originated by Columbian.

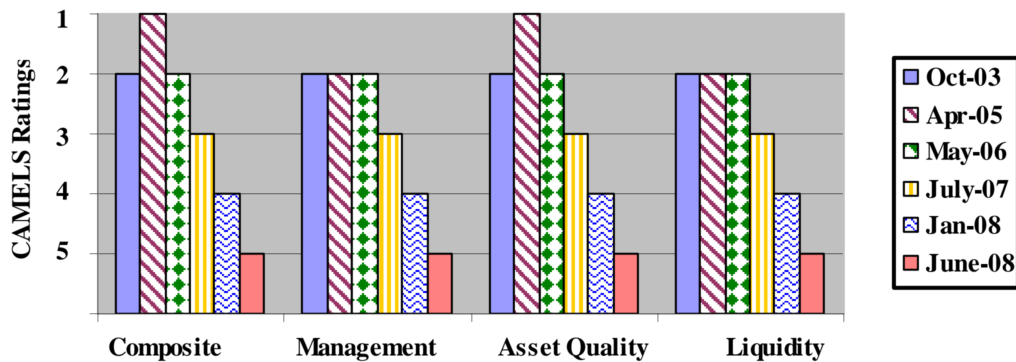
DSC's Kansas City Field Office (KCFO) and the OSBC alternated safety and soundness examinations of Columbian, conducting a total of five examinations from October 2003 through July 2008. DSC also conducted a joint visitation with the OSBC during June 2008. At the January 2008 examination, Columbian's CAMELS composite rating was downgraded to 4,[3] indicating unsafe and unsound practices or conditions and a distinct possibility of failure if such conditions and practices were not satisfactorily addressed and resolved. As a result of the June

[3] 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: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

2008 visitation, Columbian’s composite rating was downgraded to 5, indicating extremely unsafe and unsound practices or conditions; critically deficient performance, often with inadequate risk management practices; and great supervisory concern. Institutions in this category pose a significant risk to the DIF and have a high probability of failure.

Further, with respect to selected component ratings, as indicated in Figure 1 below, Columbian’s management, asset quality, and liquidity ratings were downgraded to 3 at the July 2007 examination and steadily decreased with each subsequent examination. At the following January 2008 examination, the same component ratings were downgraded to 4. As a result of the June 2008 visitation, examiners downgraded the component ratings to 5.

Figure 1: Columbian's Key CAMELS Ratings



Source: OIG review of Reports of Examination (ROE) and Problem Bank Memoranda.

In April 2008, the FDIC notified Columbian that the Corporation considered the bank to be in “troubled condition” and identified the institution as a “problem bank.” To address examination concerns, including apparent violations of laws and regulations, inadequate risk management controls, and other safety and soundness issues, the FDIC and OSBC subsequently issued a Cease and Desist Order (C&D) effective July 15, 2008 (discussed later in this report).

Details on Columbian’s financial condition, as of June 2008, and for the 5 preceding calendar years follow in Table 1.

Table 1: Financial Condition of Columbian

	30-June-08	31-Dec-07	31-Dec-06	31-Dec-05	31-Dec-04	31-Dec-03
Total Assets ($000s)	$735,071	$721,409	$528,816	$384,442	$269,048	$214,139
Total Deposits ($000)	$620,354	$566,794	$368,312	$275,851	$191,787	$165,463
Total Loans ($000s)	$638,504	$639,996	$479,638	$345,611	$244,865	$183,501
Net Loan Growth Rate	15.93%	33.39%	38.39%	41.68%	33.38%	15.34%
Net Income (Loss) ($000s)	$3	$15,545	$15,814	$8,203	$5,081	$4,210
Loan Mix (% of Avg. Gross Loans):						
All Loans Secured by Real Estate	**76.60%**	**69.29%**	**68.39%**	**70.75%**	**75.24%**	**76.67%**
Construction and Development	52.07%	43.67%	35.59%	30.14%	25.68%	19.75%
CRE - Nonfarm/ nonresidential	18.14%	17.85%	21.59%	24.82%	30.86%	37.68%
Multifamily Residential Real Estate	1.13%	0.93%	1.62%	1.62%	1.74%	1.70%
1-4 Family Residential – excluding Home Equity Lines of Credit	4.92%	6.47%	9.06%	13.35%	15.79%	16.13%
Home Equity Loans	0.22%	0.29%	0.46%	0.67%	1.00%	1.30%
Construction and Industrial Loans	23.18%	30.36%	30.87%	28.29%	22.55%	19.85%
Adverse Classifications Ratio	197%	86%	24%	7%	22%	22%

Source: Uniform Banking Performance Report (UBPR) and ROEs for Columbian.

RESULTS IN BRIEF

Columbian failed primarily due to bank management's pursuit of rapid asset growth concentrated in high-risk CRE/ADC loans without adequate loan underwriting and credit administration practices. Resulting losses due to asset quality deterioration and a downturn in the economy severely eroded capital and, in turn, the availability of wholesale funding sources used by the bank to fund its growth. As a result, the bank was unable to satisfy liquidity requirements, leading to its failure. Specifically:

Management. Columbian's board of directors (BOD) did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities or implemented timely corrective actions in response to examiner recommendations. In particular, Columbian did not adequately address recommendations included in the FDIC's ROEs related to enhancing liquidity and reducing risk exposure in identified problem assets. Further, the bank's performance bonus program created a cultural climate that emphasized growth and income without regard to loan quality.

Asset Quality. Columbian's loan portfolio consisted of a high concentration in CRE/ADC loans, many of which were brokered and/or out-of-territory. The bank's ADC loans as a percent of its loan portfolio was significantly above peer group averages from 2003 through 2008.[4] Columbian did not follow sound loan underwriting and credit administration practices, including those pertaining to:

[4] In December 2003 through December 2004, Columbian's peer group was composed of insured commercial banks with assets between $100 million and $300 million in a metropolitan area and with three or more full-service banking offices. From December 2005 through June 2008, Columbian's peer group was composed of insured commercial banks with assets between $300 million and $1 billion.

(1) loan file documentation, (2) credit monitoring, and (3) accounting for interest reserves. Also, Columbian did not maintain a sufficient allowance for loan and lease losses (ALLL). As a result, asset quality declined and losses, once recognized, reduced earnings and depleted capital.

Liquidity. Columbian became increasingly dependent on higher-cost and more volatile sources of liquidity, such as brokered deposits, Internet certificates of deposits (CD), and Federal Home Loan Bank (FHLB) advances to fund asset growth in excess of the growth in core deposits. Liquidity levels and funding strategies were deficient, and bank management did not implement the necessary controls for liquidity management, including an adequate contingency liquidity plan (CLP), before the bank had deteriorated to an overall unsatisfactory condition.

Supervision. The FDIC and OSBC conducted regular examinations of Columbian as of its charter as a state-nonmember bank in 1996 until its closing in 2008. In 2005, OSBC reported weaknesses in Columbian's credit administration practices and noted the bank's first use of brokered deposits as a wholesale funding source. In 2006, in addition to identifying some of the weaknesses reported in the 2005 examination, the FDIC reported concerns regarding out-of-territory lending, rapid loan growth, and underfunding of the ALLL. As a result of the July 2007 examination, the OSBC, in consultation with the FDIC, downgraded Columbian's composite rating to a 3, and the FDIC expedited the 2008 examination. The FDIC did not issue a PCA Directive to Columbian because the bank had not become undercapitalized. In July 2008, the FDIC and OSBC jointly issued a C&D in an attempt to stop Columbian from operating in an unsafe and unsound manner. Among the 19 provisions, the C&D called for improvements in the bank's liquidity and funds management, use of brokered deposits, concentrations of credit, use of interest reserves, maintenance of a sufficient ALLL, and loan policy.

Although the FDIC and OSBC examinations identified the weaknesses in management, asset quality, and liquidity that ultimately led to Columbian's failure, supervisory action was not taken commensurate with the risks these weaknesses posed to the institution. Rather, Columbian's apparent strong earnings and lack of non-performing loans, which were attributable to such factors as an understated ALLL and the mismanagement of interest reserves, overshadowed supervisory concerns with Columbian's weaknesses until they became more pronounced based on changes in economic conditions. As a result, more timely supervisory action directed at Columbian's high-risk lending and weak credit underwriting and administration practices should have been taken. In particular, the institution continued to pay substantially increased dividends, accept brokered deposits, and originate CRE loans while the 2007 examination report was being processed from July to November 2007.

MANAGEMENT

Examinations from 2003 to 2006 resulted in a 2 (or satisfactory) rating for Columbian's management. At subsequent examinations, the rating was progressively downgraded, indicating deficient BOD and management performance, inadequate risk management practices, and excessive risk exposure. Columbian's management provided a performance bonus program that emphasized asset growth without regard to loan quality. By 2007, Columbian's management rating indicated that the bank's problems and significant risks may have been inadequately identified, measured, monitored, or controlled, and by 2008, the management rating indicated

that the bank's problems required immediate action by the BOD and management to preserve the safety and soundness of the institution. Accordingly, examiners made a number of recommendations to improve loan quality and to address the increased risks inherent in the loan portfolio. However, Columbian's management did not address these concerns in a timely manner, leading to the bank's inability to meet liquidity requirements.

Failure of Columbian's Management to Address Examiner Concerns

Examiner concerns with Columbian's BOD and management were noted in the October 2003 examination, including issues related to aggressive loan growth, CRE/ADC high-risk lending, inadequate loan policies, and inadequate ALLL methodology. Issues in most of these areas continued to be identified in each examination until the bank was closed in 2008. In addition, beginning with the April 2005 examination, Columbian's examinations showed a continuing pattern of inadequate loan procedures, understaffing of the lending function, inadequate risk assessment practices, growing severity regarding the lack of loan documentation, and inadequate credit administration resulting in an increasing risk profile for the institution. The credit administration deficiencies were repeated and compounded as noted in the 2006, 2007, and 2008 examinations.

Although Columbian's annual loan growth exceeded 33 percent annually from 2004 through 2007, management did not adequately address examiner concerns to ensure sufficient staff to monitor and review existing loans. Each examination from 2005 to the bank's failure in 2008 made reference to the inadequacy of Columbian's loan review program, especially considering the increased risk of the loan portfolio, including brokered and/or out-of-territory ADC loans. From December 2004 to June 2008, the percentage of the loan portfolio committed to higher-risk ADC loans increased from 25.7 percent to 52.1 percent. Table 2 provides examples of examiner comments and recommendations related to Columbian's BOD and management. The table also indicates that many of these conditions existed for several years prior to the bank's closing.

Table 2: Examples of Examiner Comments and Recommendations Regarding Columbian's BOD and Management Performance

Examiner Comments	Examination Dates				
	Oct 2003	Apr 2005	May 2006	July 2007	Jan 2008
Overall conclusion on BOD and management performance					
• Satisfactory	✓	✓	✓		
• Improvement needed and failure to adequately identify, measure, monitor, and control risks				✓	✓
Compliance with laws and regulations					
• Apparent violations related to insider, affiliate, or Bank Secrecy Act activities	✓	✓		✓	✓
• Apparent violations related to loan underwriting and/or credit administration				✓	✓
Growth of Columbian's operations					
• Loan growth was aggressive, significant, or faster than anticipated	✓	✓	✓	✓	✓
• Loan growth supported by wholesale liquidity sources		✓	✓	✓	✓
• Loan portfolio was focused on CRE/ADC high-risk lending	✓		✓	✓	✓
• Loan concentrations in brokered and/or out-of-territory loans	✓		✓	✓	✓

Examiner Comments	Examination Dates				
	Oct 2003	Apr 2005	May 2006	July 2007	Jan 2008
Loan policy and procedures					
Inadequate loan policies	✓	✓	✓	✓	✓
• Inadequate loan underwriting and/or credit administration procedures		✓	✓	✓	✓
• Inadequate methodology for determining ALLL	✓	✓	✓	✓	✓
• Inadequate staffing of loan department and/or inadequate management succession plan		✓	✓	✓	✓
• Inadequate loan review program		✓	✓	✓	✓
Risk management					
• Inadequate internal audit program and/or related risk assessment process	✓	✓	✓	✓	✓
• Inadequate attention to, and implementation of, examiner recommendations			✓	✓	✓
• Inadequate strategic plan and/or performance bonus program				✓	✓
Examiner recommendations					
• Improve policies and procedures to ensure compliance with laws and regulations	✓	✓	✓		
• Improve loan policy and procedures to include appropriate internal controls	✓	✓	✓	✓	✓
• Improve oversight due to the increasing risk associated with continued aggressive growth			✓	✓	✓
• Improve the loan review program and/or related watch list		✓	✓	✓	✓
• Improve the audit program and related risk management activities	✓	✓	✓	✓	✓
• Improve the ALLL methodology	✓	✓	✓	✓	✓
• Improve loan underwriting and/ or credit administration procedures		✓	✓	✓	✓
• Take action to limit asset growth					✓
• Develop written management succession plan				✓	

Source: ROEs issued by the OSBC and the FDIC.

Risk Management

Columbian's management did not ensure that adequate risk management controls were implemented and followed and did not act in a timely manner to address deficiencies identified by examiners related to the bank's inadequate risk management controls for loan documentation, administration, and monitoring. Columbian's management fostered a culture of high-risk tolerance and rapid growth financed with wholesale funding without apparent regard for the overall safety and soundness of the institution.

Financial institutions with high concentrations of CRE loans require strong concentration risk management practices. Beginning in 2003, Columbian began rapidly acquiring and originating CRE/ADC loans with a significant number of out-of-territory loans. By the January 2008 examination, 25 loans, totaling approximately $130 million, had been purchased through a loan brokerage firm and carried interest rates as high as prime plus 4 percent as well as high origination and brokers' fees. In most instances, Columbian financed the fees and provided substantial interest reserves as part of the total loan commitment. In spite of its high-risk tolerance, Columbian management did not adequately staff the lending function, resulting in ongoing weaknesses in credit monitoring.

Beginning with the October 2003 examination, examiners reported concerns related to Columbian's risk management practices. The 2006 examination risk management assessment indicated that the bank's risk management policies and practices for the lending function needed to be improved. The ROE referenced Columbian's understaffed lending function, stating that the staff lacked the time to fully document and analyze borrower financial information such as cash flow and debt-service coverage ratios and that files generally lacked documented balance sheet and income information. Columbian's management rating was less than satisfactory in the 2007 ROE. The ROE stated that the bank had experienced a significant decline in asset quality due largely to management's weak oversight. Despite the criticisms in these examinations, Columbian's management failed to adequately address examiner concerns and paid substantially increased dividends totaling over $13 million in 2007.

The 2008 examination continued to report that inadequate staffing levels may have also accounted for the lack of adequate analyses of borrower financial conditions and collateral values both at origination and while servicing the portfolio. The ROE also noted that management had not adequately addressed the following ongoing criticisms and concerns from previous examinations:

- The lending function needed to be strengthened.
- The loan policy needed to be revised to address brokered and/or out-of-territory loans.
- The severity of the risk rating for loans on the watch list was a concern.
- The ALLL methodology needed to be revised to address accounting requirements for impaired loans.

Performance Bonus Program

According to the January 2008 ROE, Columbian management implemented performance bonus objectives that contributed to the institution's problems and high-risk tolerance by overemphasizing growth and income. The 2008 ROE and related work papers indicated that Columbian's 2007 performance bonus objectives were to:

- achieve asset footings of $700 million,
- obtain a net interest spread of 5.25 percent,
- achieve an efficiency ratio (which measures the proportion of revenues that are absorbed by overhead expenses) of 28,
- realize a 2.5 percent return on assets, and
- provide a return on equity of at least 30 percent.

There is no indication in the examination work papers that the performance bonus objectives included a qualitative component. Additional bonuses were available to certain employees based on the employees' contributions, as determined by the sole shareholder of the bank's holding company. The 2008 ROE noted that this performance bonus structure allowed some officers to receive bonuses in excess of 40 percent of their salary despite being responsible for originating the majority of the adversely classified loans.

To address this weakness, the 2008 ROE recommended that the bank's BOD and management: revise and realign the strategic plan, 2008 budget, and performance bonus objectives to meet the institution's need to return the bank to a satisfactory financial condition. Specific guidance on changes needed regarding the performance bonus objectives were not captured in the ROE. Although the bank's performance bonus program appears to have been in effect during at least 2006 and 2007, only the 2008 ROE contained a criticism of this program.

DSC's *Risk Management Manual of Examination Policies* (Examination Manual) states that the reasonableness of compensation policies is one of many factors used by examiners to rate the performance and capability of management and the BOD. In addition, the standard *Risk Management Examination Request List* (Request List) asks the bank to summarize loan officer and management incentive programs, if any. However, the documentation DSC provided to us did not include 2006 and 2007 Request List items; therefore, we were unable to determine what information about the bank's performance bonus program had been provided to the 2006 and 2007 examination teams.

Subsequent to the closing of Columbian, the FDIC took action to provide additional guidelines on the compensations policies. Specifically, on November 12, 2008 the FDIC, along with the other federal regulatory agencies, issued an interagency statement, which notes that:

> Poorly-designed management compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization. Management compensation policies should be aligned with the long-term prudential interests of the institution, should provide appropriate incentives for safe and sound behavior, and should structure compensation to prevent short-term payments for transactions with long-term horizons.

The statement emphasizes that banking organizations are expected to regularly review their management compensation policies to ensure they are consistent with the long-run objectives of the organization and sound lending and risk management practices. We consider performance bonus programs that do not address asset quality objectives to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Management

According to the Examination Manual, the quality of management is probably the single most important element in the successful operation of a bank. The BOD is responsible for formulating sound policies and objectives for the bank, effective supervision of its affairs, and promotion of its welfare, while the primary responsibility of senior management is implementing the BOD's policies and objectives in the bank's day-to-day operations. Also according to the manual, the capability and performance of management and the BOD is rated based upon, but not limited to, an assessment of compliance with laws and regulations.

Prior to the 2007 ROE, Columbian's management had been favorably rated since 1993. Although the 2005 and 2006 ROEs included examiner concerns and recommendations related to credit administration, the management rating was not downgraded because asset quality was described as being strong, or satisfactory, at that time.

In July 2007, the OSBC and FDIC conducted a joint examination of Columbian. Examiners originally told Columbian's management in late July that a preliminary composite and management rating of 2 would be assigned. However, OSBC and FDIC review of the draft ROE resulted in concerns with the trends and deterioration in the bank's condition, centering on the bank's CRE portfolio and inadequate risk identification, funding practices, and overall administration of operations. Columbian's management and BOD were notified in November 2007 that the final composite and management ratings had been downgraded to 3. Due to the extent of the regulators' concerns, in addition to the downgrade, the FDIC accelerated the next examination to commence in late January 2008. According to DSC officials, further supervisory action was considered but not taken, and Columbian management continued to grow the bank.

From July 1 through December 31, 2007, Columbian's CRE loans increased substantially, growing by $104 million—a 31 percent growth rate—while asset quality significantly deteriorated. Much of this growth occurred in the last quarter of 2007. In addition, during the last quarter of 2007, the bank continued to be heavily reliant on brokered deposits and Internet CDs to fund loan growth, and brokered deposits grew by $69.5 million. In response to the adverse examination findings in the 2008 ROE, the FDIC and OSBC jointly initiated formal enforcement action through a C&D, sent to Columbian's BOD in May 2008, that included provisions addressing the identified deficiencies. However, Columbian's BOD initially declined to stipulate to the proposed order.

The FDIC and OSBC conducted a limited-scope visitation beginning on June 26, 2008, to follow up on the 2008 examination. The visitation found that Columbian's management had done little to address regulatory concerns. Consequently, Columbian's management rating was downgraded to 5. Columbian's BOD subsequently stipulated to the C&D effective July 15, 2008. However, the bank's financial problems at this point were too severe for the C&D to have an effect on Columbian's financial condition, and Columbian was closed in August 2008.

ASSET QUALITY

Columbian's asset quality was rated either 1 or 2 at examinations in 2003, 2005, and 2006. The 2007 and 2008 examinations progressively downgraded asset quality to 3 and 4, respectively, indicating that the bank's level of risk and problem assets were significant and inadequately controlled, subjecting the bank to potential losses that threatened the viability of the institution. By the June 2008 visitation, FDIC examiners concluded that Columbian's asset quality was critically deficient and presented an imminent threat to the institution's viability.

Corresponding increases in Columbian's adversely classified assets and ALLL were also significant (see Table 3). In particular, Columbian's asset quality deteriorated as asset classifications significantly increased from $3.8 million in 2003 to over $203 million as of June 30, 2008, about 32 percent of the total loan portfolio. At the October 2003 examination, the adversely classified items were 22 percent of Tier 1 Capital plus the ALLL. By the June 2008 visitation, this amount rose to 285 percent of Tier 1 Capital plus the ALLL.

Table 3: Columbian's Asset Classifications and ALLL

	Asset Quality (Dollars in Thousands)					
	Asset Classifications				**Analysis of ALLL**	
Examination/ Visitation Date	**Substandard**	**Doubtful**	**Loss**	**Total Adversely Classified Items**	**ALLL Computed by Columbian**	**Increase in ALLL Required by Examiners**
Oct 03	$3,805	0	$52	$3,857	$2,215	0
April 05	$2,338	0	$31	$2,369	$2,679	0
May 06	$9,332	0	$218	$9,550	$3,897	$900
July 07	$44,050	$2,116	$806	$46,972	$7,152	0
Jan 08	$115,946	0	$7,330	$123,276	$8,127	$8,117
June 08	$203,374	$130	0	$203,504	$16,906	0

Source: ROEs and a 2008 Visitation Summary Memorandum.

Examiner Concerns and Recommendations Regarding Asset Quality

Examiner concerns regarding Columbian's asset quality related to its concentration in high-risk CRE/ADC loans and the bank's lack of adequate loan documentation, inadequate loan review, and monitoring of risk in the CRE/ADC loan concentrations (see Table 4). A significant portion of the CRE/ADC loan portfolio included high-risk terms, such as high loan-to-value ratios, interest-only payments, and interest reserves used to capitalize interest expense. We consider these high-risk indicators to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Table 4: Examples of Examiner Comments and Recommendations Regarding Columbian's Asset Quality

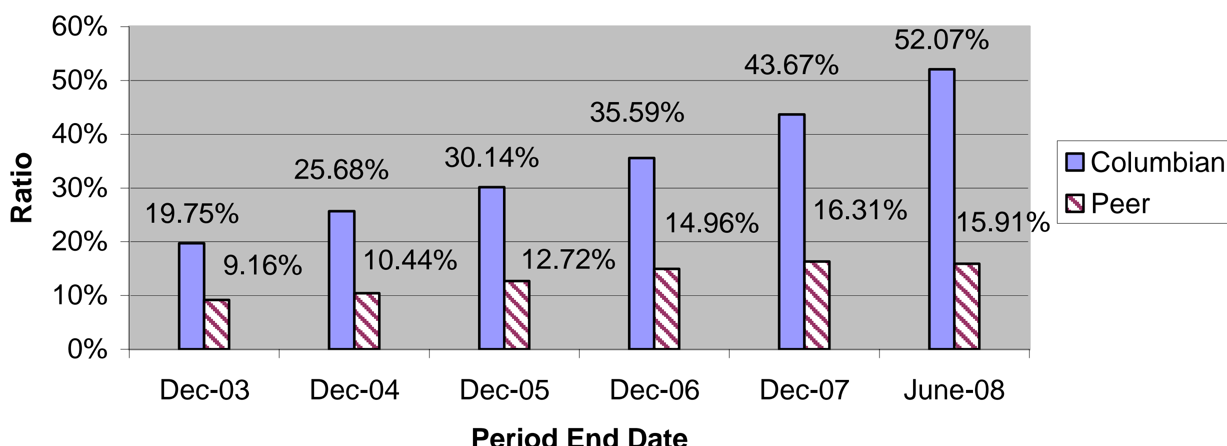
Examiner Comments	Examination Dates				
	Oct 2003	April 2005	May 2006	July 2007	Jan 2008
Overall conclusion on Columbian's asset quality					
• Strong or satisfactory	✓	✓	✓		
• Less than satisfactory				✓	✓
CRE and ADC loan concentrations					
• Concentration developing or already developed	✓		✓	✓	✓
• Impact of a declining economic environment noted				✓	✓
Adverse classifications					
• Noticeable loan quality deterioration/increase in adverse classifications	✓		✓	✓	✓
Assessment of asset management practices					
• Inadequate loan documentation	✓		✓	✓	✓
• Inadequate loan review write-ups		✓	✓	✓	✓
• ALLL not adequately funded			✓		✓
• Concern related to use of interest reserves			✓		✓
• Internal watch list did not adequately reflect all potential problem loans	✓		✓	✓	✓
• Inadequate categorization of out-of-territory loans				✓	
• Loan or asset mix outside of bank policy guidelines		✓		✓	✓
Examiner recommendations					
• Monitor risk in the CRE and ADC loan concentrations	✓			✓	✓
• Adequately fund the ALLL allowance			✓		✓
• Improve accounting for loans with interest reserves					✓
• Significantly reduce problem assets to more acceptable levels					✓
• Loan review write-ups should be more thorough		✓			

Source: ROEs for Columbian.

Concentration in CRE and ADC Loans

Columbian's asset quality declined as its loan portfolio became increasingly concentrated in ADC loans, many of which were brokered and/or out-of-territory. Figure 2, which follows, shows that Columbian's ADC loan portfolio, as a percent of average loans, was significantly above the bank's peer group results.

Figure 2: ADC Loans as a Percent of Average Loans - Compared to Peer



Source: UBPRs for Columbian.

From December 1999 through December 2003, Columbian's ratio of ADC loans to average loans increased less than 4 percentage points from 16.11 to 19.75 percent. However, beginning in 2004, such loans increased significantly, while nonfarm/nonresidential CRE and 1-to-4 family residential loans declined as a percentage of the portfolio. ROEs for 2005 through 2008 indicated that the growth in ADC lending was encouraged by the high yields on these products.

As of the July 2007 examination, CRE lending represented 523 percent of Tier 1 Capital, and by January 2008, CRE loans represented 973 percent of Tier 1 Capital. Over half of the CRE loans were to borrowers outside the states of Kansas and Missouri, which increased risk due to management's lack of familiarity with regional conditions.

On December 12, 2006, the federal banking agencies issued joint guidance on CRE lending entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* The guidance acknowledges that a concentration in CRE loans, coupled with weak loan underwriting and depressed CRE markets, has contributed to significant loan losses.[5] Contrary to this guidance, Columbian focused its loan portfolio in high-risk CRE loans, with an increasing emphasis on ADC loans, and failed to ensure that adequate risk management controls were developed and implemented. Columbian did not follow sound loan underwriting and credit administration practices and did not maintain a sufficient ALLL. Examiners recommended several actions to mitigate the bank's CRE risk. However, bank management failed to implement actions to adequately address those recommendations, and asset quality continued to decline. As shown previously in Table 3, beginning with the July 2007 examination and continuing through the June 2008 visitation, examiners identified an increasing level of adverse

[5] The FDIC also issued Financial Institution Letter (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 and ALLL and loan risk-management practices for state nonmember institutions with significant CRE and construction and development loan concentrations.

classifications. As asset quality declined and losses were recognized, Columbian's liquidity position became critical, and earnings and capital were eroded.

Interest Reserves. Columbian improperly accounted for interest reserves, which masked the condition of certain problem loans. As a result of the June 2008 visitation, FDIC examiners concluded that there appeared to be numerous loans that were "current" solely because of the bank's ongoing practice of adding interest payments to a note's principal. Adequate records had not been compiled by the bank; therefore, examiners could not determine the extent of inappropriately capitalized interest and fees (origination and broker fees) and thus the true earnings and capital positions of the bank. Regardless, examiners concluded that both earnings and capital were likely overstated.

The FDIC addressed the use of interest reserves within existing examiner guidance.[6] The guidance reinforces the importance of providing clear standards on the use of interest reserves as part of a bank's loan policy, monitoring the adequacy of the remaining interest reserve as part of an ADC lending project, and assessing the appropriateness of the use of interest reserves during the entire term of the loan. Further, an article in DSC's *Supervisory Insights*, Summer 2008, states that the Financial Accounting Standards Board has not issued standards focused specifically on accounting for interest reserves from the lender's standpoint. However, long-standing accounting concepts that govern the recognition of income are applicable to interest reserves[7] and state that, in general, interest that has been added to the balance of a loan through the use of an interest reserve should not be recognized as income if its collectibility is not reasonably assured.

Examiner concern about inappropriate use of interest reserves by the bank first appeared in the January 2008 ROE for Columbian. In particular, the ROE noted numerous instances where interest reserves had been improperly utilized to stabilize income-producing properties. The Examination Manual notes that, with some exceptions, the retention of work papers beyond one examination for well-rated banks is generally discouraged. Accordingly, DSC personnel indicated that the 2006 examination work papers had been destroyed. In addition, only a limited number of the 2007 examination work papers were available for our review. Therefore, we were unable to determine the extent to which concerns over the misuse of interest reserves may have been noted in the 2006 or 2007 examination work papers.[8] However, the 2006 ROE did caution management that, because loan terms often included the financing of origination and broker fees and the monthly interest payments through interest reserve accounts, many loans could deteriorate without detection unless management provided adequate ongoing monitoring.

Allowance for Loan and Lease Losses. Columbian's methodology for determining the ALLL did not comply with interagency policy. According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (FIL-105-2006), dated December 13, 2006, each

---

[6] FDIC Examination Module, *Construction, and Land Development Core Analysis Procedures*, November 1997.
[7] *Accounting Research Bulletin No. 43*, Chapter 1A, paragraph 1; *Accounting Principles Board Opinion No. 10*, paragraph 12; and *Statement of Financial Accounting Concepts No. 5*, paragraph 84(g).
[8] The OIG intends to review DSC's work paper retention policies in the near future.

institution must analyze the collectibility of its loans and maintain an ALLL at a level that is appropriate and determined to be in accordance with Generally Accepted Accounting Principles (GAAP).[9] An appropriate ALLL covers estimated loan losses on individually evaluated loans that are determined to be impaired as well as estimated loan losses inherent in the remainder of the loan and lease portfolio.

From 2003 to 2008, during a period when Columbian was engaging in higher-risk lending practices and paying dividends, examiner recommendations addressed either increasing Columbian's ALLL or improving the ALLL methodology as shown below.

- In 2003, examiners reported that the methodology for calculating an adequate ALLL was flawed and that it needed to be amended to reflect current accounting standards.
- In 2005, examiners recommended proper procedural guidelines for ensuring GAAP compliance.
- In 2006, examiners reported that the ALLL was underfunded by $600,000 - $900,000 as of March 31. Examiners recommended that the ALLL be increased commensurate with the additional credit and concentration risk exposure. By September 30, bank management had increased the ALLL by $2 million, which was 1.43 percent of total loans and leases.
- In 2007, examiners found that given the size, composition, and additional risk identified in the loan portfolio, the ALLL methodology needed improvement. In particular, between the 2006 and 2007 examinations, classified assets nearly quintupled; in contrast, the ALLL did not even double, and Columbian paid over $13 million in dividends in 2007—more than double any previous dividend. Examiners recommended that management revise the methodology to include a line-by-line dollar amount that represents the actual impairment within each loan.
- In 2008, examiners reported that the ALLL was significantly underfunded because a number of classified loans were not identified on management's watch list or were downgraded by examiners. As a result, an increase of $8.1 million was recommended.

As Columbian's assets deteriorated and the need to substantially increase the ALLL became apparent, 2007 earnings were significantly impacted (see Table 5). Specifically, Columbian's initially reported earnings of $23.4 million in 2007 were overstated based on the ALLL being underfunded. The increase in the ALLL and related provision for loan loss led to a $7.8 million reduction in earnings. These earnings did little to augment capital due to the significant dividends approved by the BOD and paid during 2007. In spite of a $1 million capital injection during December 2007, the bank's capital category declined to adequately capitalized as of year end 2007. An additional provision for loan loss and dividends during 2008 continued to erode earnings and capital.

---

[9] *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (FIL-105-2006), dated December 13, 2006, reiterates key concepts and requirements pertaining to the ALLL included in GAAP and existing supervisory guidance. In addition, the policy describes the nature and purpose of the ALLL; the responsibilities of BODs, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound loan grading system.

Table 5: Columbian Net Income, ALLL, and Dividends
(Dollars in Thousands)

	2003	2004	2005	2006	2007	June 2008
Net Income	$4,210	$5,081	$8,203	$15,814	$15,545	$3
ALLL	$2,517	$3,463	$3,603	$6,318	$8,642	$16,906
Dividends	$1,525	$3,125	$4,685	$5,825	$13,445	$5,200

Source: UBPRs for Columbian.

In January 2008, Columbian hired an outside consultant to assist with its lending program. Based on the consultant's work, by June 2008, Columbian had added $8.3 million (net) to the ALLL, increasing the total to $16.9 million, or 2.65 percent of total loans. The consultant's loan review in 2008 concluded that it is likely that Columbian's ALLL was underfunded not only because of the bank's inadequate methodology but also due to Columbian's inadequate internal loan review program due to the understaffing reported by examiners since 2005.

Regulatory Supervision Related to Asset Quality

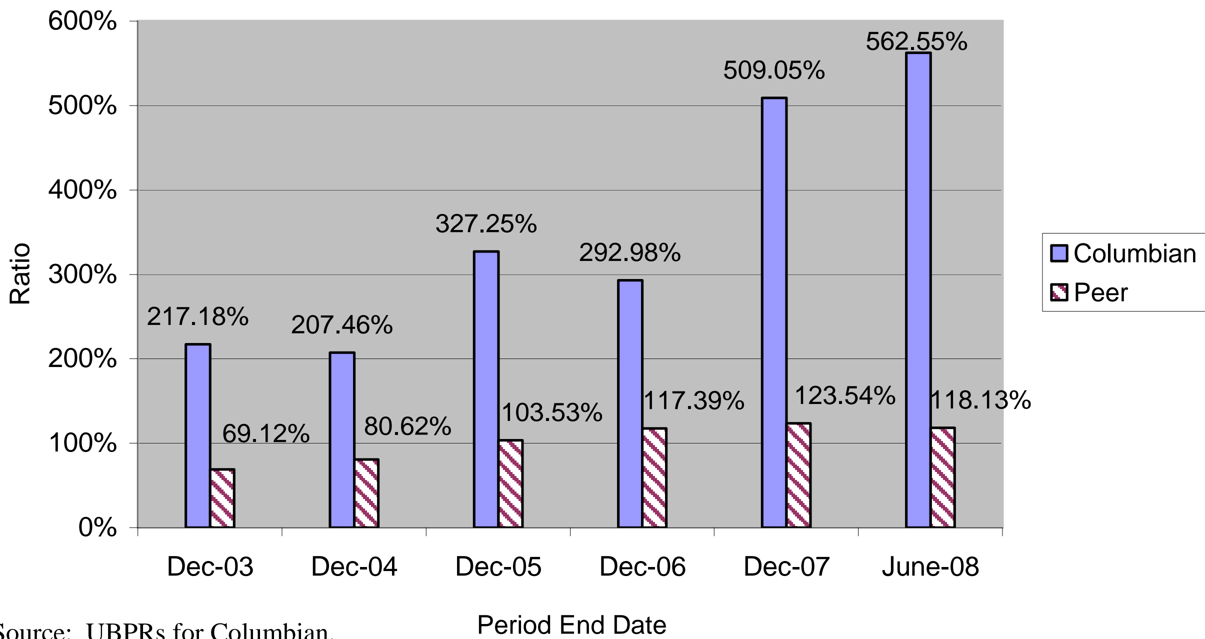
On December 12, 2006, the FDIC issued interagency guidance on CRE lending entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* According to the guidance, CRE lending in general, and construction lending in particular, may require a greater level of supervisory oversight. Specifically, the guidance states that an institution may be identified for further supervisory analysis of the level and nature of risk if it 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:

(1) total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or

(2) total CRE loans 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.

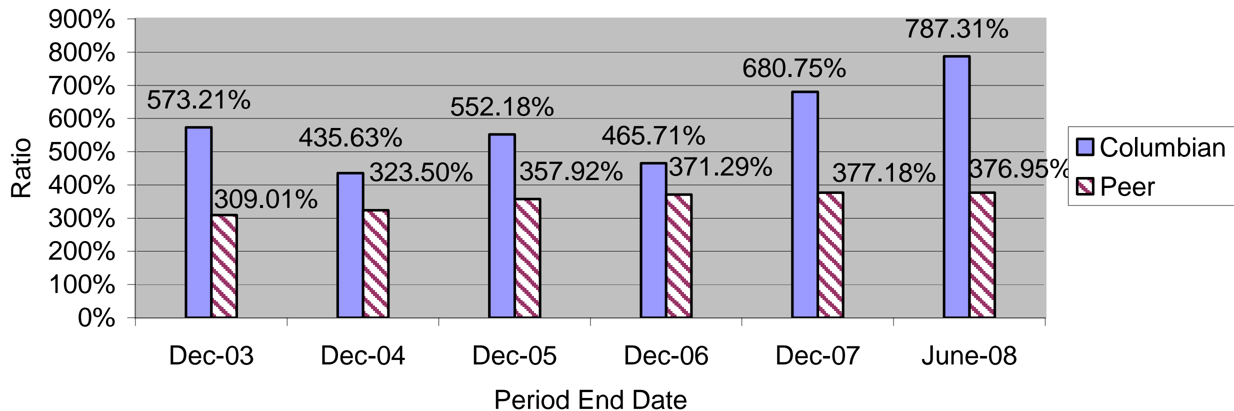
As noted in Figures 3 and 4, from 2003 to 2008, Columbian met both of the capital criteria thresholds for additional supervisory oversight. In addition, Columbian's ADC and CRE loans as a percentage of total risk-based capital were historically much higher than its peer group average.

Figure 3: ADC Loans as a Percent of Total Capital - Compared to Peer



Source: UBPRs for Columbian.

Figure 4: CRE Loans as a Percent of Total Capital - Compared to Peer



Source: UBPRs for Columbian.

The ROE for the 2003 examination assigned a 2 rating to asset quality yet highlighted the significant concentration of CRE lending at Columbian and the additional risk that this type of lending entailed and recommended that management closely monitor and consider that risk when formulating plans and policies. The 2005 ROE assigned a 1 rating to asset quality and did not identify CRE lending as a concentration or mention that such lending was a significant risk area.

However, all subsequent ROEs highlighted and emphasized the concentration of CRE and construction lending and the risks these loans held for Columbian.

Due to the bank's aggressive growth funding strategy of using brokered deposits to acquire brokered and out-of-territory loans, examiners expanded their procedures in the lending function during the 2006 examination. In addition, examiners focused on the internal control structure due to comments made by the external auditor in a management letter, which identified a general lack of current financial information on borrowers. Examiners noted that debt service coverage and financial and income information were not well-documented. The 2006 ROE noted control weaknesses related to ongoing credit monitoring due to understaffing of the lending function, which caused inadequate analysis of borrower financial information and inadequate documentation of credit files. However, examiners determined that these weaknesses were not severe enough to warrant a downgrade in asset quality based on the definitions in the Examination Manual.

Columbian's aggressive growth strategies and the increase in the complexity and volume of lending activities identified in the 2006 ROE should have resulted in more timely supervisory action directed at Columbian's high-risk lending, weak loan underwriting, and deficient credit administration practices. However, due to the limited dollar amount of classified assets identified during the 2006 examination, additional supervisory action was not taken, and the bank's high-risk lending, weak loan underwriting, and deficient credit administration practices continued. Identification of classified assets was impaired, in part, due to the use of interest reserves and lack of adequate loan monitoring by the institution.

The 2007 examination downgraded Columbian's asset quality to 3; however, after the exit conference with management in July 2007, the ROE required about 4 months of processing to revise the draft report to reflect the supervisory concerns of the FDIC's Regional Office and OSBC. Subsequently, examiners met with Columbian's management on November 15, 2007, to convey these revised conclusions and discuss the rating changes, and the final report was presented to the bank in December 2007. The ROE indicated that asset quality as of May 31, 2007 had deteriorated and was less than satisfactory. However, as previously stated, between June 2007 and January 2008, Columbian's CRE loan portfolio grew 31 percent; brokered deposits increased by $85.4 million; and additional dividends, totaling over $4 million, were declared and paid. Additionally, the ROE documents aspects of the bank's asset structure and culture that created a greater degree of risk for the bank. These same risks were identified in the 2006 examination. No supervisory action was taken at that time because the number and dollar value of loan classifications were still considered low.

Concentrations of Credit. The 2003 through 2007 examinations indicated that risk management processes related to asset concentrations were adequate, including monitoring and reporting of concentrations to the BOD. In particular, the 2007 ROE stated that "Management has developed adequate controls to monitor and manage the level of concentrations." Yet about 5 months later, in the 2008 ROE, examiners criticized concentration-related procedures, stating, "Examiners found no evidence that management stress tests its credit portfolio or individual loans to ascertain the impact of changes in interest rate or in economic conditions." The 2008 ROE also noted that market feasibility analysis for ADC loans was generally lacking and that

management information systems needed to be enhanced to accommodate the complexity of the loan portfolio. Stress tests, market analysis, and adequate management information systems are key elements in the December 2006 interagency guidance for monitoring concentration risk. FDIC concern about the bank's inability to monitor and manage its concentrations was so great that the July 2008 C&D required the bank to cease and desist engaging in hazardous concentration-related lending practices such as the:

- extension of credit with inadequate diversification of risk,
- failure to obtain market feasibility analyses for land ADC, and
- extension of out-of-territory or market area loans without adequate knowledge and expertise regarding the locality.

The C&D required the bank to prepare a written Concentration Plan for systematically reducing and monitoring the bank's portfolio of loans or other extensions of credit that, at a minimum, should include:

- dollar levels and percent of capital to which the bank shall reduce each concentration,
- timeframes for achieving the reduction in dollar levels, and
- provisions for the submission of monthly written progress reports to the bank's BOD.

Elevated and timely criticism in the 2007 ROE regarding the bank's management and monitoring of its loan concentrations may have encouraged earlier corrective action by bank management. We consider loan concentrations to be a significant concern, which we will address in our summary reports covering multiple bank failures.

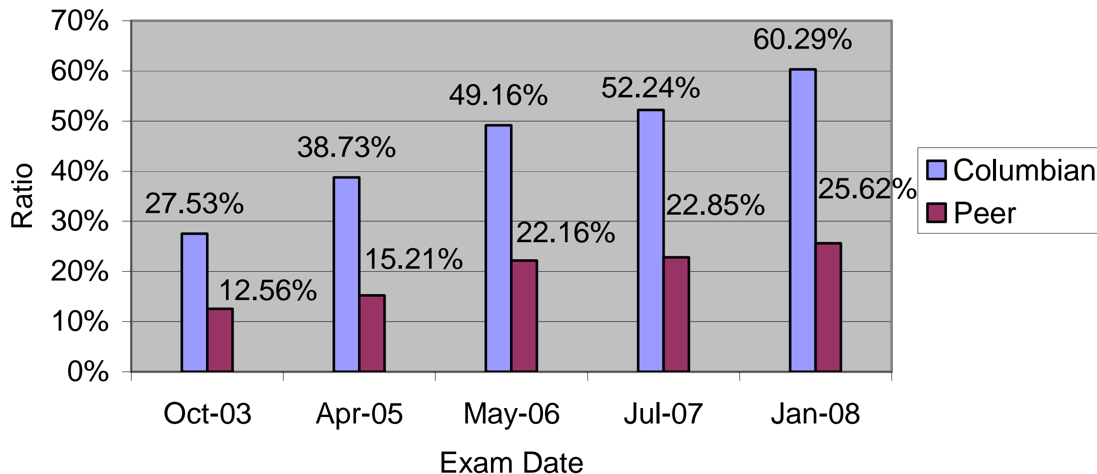
LIQUIDITY

Examiners for the 2003, 2005, and 2006 risk management examinations assigned a 2 component rating to liquidity. Columbian's liquidity rating was downgraded to a 3 at the July 2007 examination due to a continued increase in the bank's reliance on potentially volatile non-core funding sources. By the June 2008 visitation, liquidity had been downgraded to a 5, indicating that Columbian's liquidity levels or funds management practices were so critically deficient that the bank's continued viability was threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

A key metric of the risks related to a bank's liquidity management is the net non-core dependence ratio. This ratio indicates the degree to which the bank relies on non-core/potentially volatile liabilities, such as time deposits of more than $100,000; brokered deposits; and FHLB advances to fund long-term earning assets. Generally, the lower the ratio, the less risk exposure there is for the bank. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. As noted in Figure 5, which follows, during the five most recent examinations, Columbian's reliance on non-core/volatile liabilities exceeded its peer group average, with the variance continually increasing. This pattern was attributable to the considerable focus by the BOD and senior management on brokered deposits to provide liquidity. ROEs indicated that bank management

had considered brokered deposits less expensive than traditional forms of funding. The 2005 ROE notes that management began accepting brokered deposits as a funding source in March 2005, with an initial acquisition of $17.9 million. By the January 2008 examination, brokered deposits had soared to $261 million, or 46 percent of total deposits.

Figure 5: Net Non-Core Funding Dependence - Compared to Peer



Source: OIG review of ROEs for Columbian.

Examiner Concerns and Recommendations Regarding Liquidity

Although Columbian had an historically high reliance on non-core funding sources, the 2003 through 2006 ROEs rated Columbian's liquidity as satisfactory. In particular, the 2006 ROE noted that the bank's funds management practices were sound and that management satisfactorily monitored the bank's liquidity position and managed the bank's reliance on wholesale funding sources. However, the 2005 and 2006 ROEs highlighted a continuing pattern in which management and the BOD allowed Columbian to operate outside of liquidity-related parameters established for the bank.

Examiner concerns over Columbian's liquidity position were first emphasized in the 2007 ROE. This report concluded that liquidity was marginally adequate and encouraged management to continually evaluate the adequacy of its processes and procedures related to brokered deposits, including the acceptable level of such deposits. In addition, management was encouraged to develop strategies to retain and build new core deposit relationships to reduce the bank's reliance on non-core funding sources. Although examiners raised concern about the level of non-core funding, they concluded that the risks to liquidity were mitigated by "a generally adequate Funds Management Policy, a sound monitoring program, and vigilant oversight" performed daily by management.

Approximately 7 months after completion of the 2007 examination, the 2008 examination concluded that the bank's liquidity levels and funding strategies were deficient, considering the weakened financial condition of the bank as a result of asset quality deficiencies identified during the 2007 and 2008 examinations. The 2008 ROE highlighted the significant liquidity risks that could arise from the disclosure of negative financial results. In particular, bank management expressed concern about the bank's ability to retain several customers that controlled a large volume of deposits. Also, contract provisions with certain deposit brokers, the Bankers Bank of Kansas, and the FHLB, could have limited the availability of funds if the bank's financial condition continued to deteriorate. The 2008 ROE contained the same recommendations as the 2007 ROE, that is, to re-evaluate liquidity guidelines and reduce non-core funding. In addition, the ROE recommended that the bank develop a formal CLP to "address the downside risks associated with the bank's wholesale funding position and the limited availability of liquid assets."

A summary of examiner comments and recommendations related to liquidity follows in Table 6.

Table 6: Examples of Examiner Comments and Recommendations Regarding Columbian's Liquidity

Examiner Comments	Examination Dates				
	Oct 2003	Apr 2005	May 2006	July 2007	Jan 2008
Overall conclusion on Columbian's liquidity					
• Satisfactory	✓	✓	✓		
• Less than satisfactory				✓	✓
Assessment of liquidity management practices					
• Management closely monitors liquidity	✓	✓	✓	✓	
• Funds management practices are sound or adequate	✓	✓	✓	✓	
• Liquidity and funding strategies are deficient					✓
• Increased oversight needed for brokered deposits				✓	
• Operating outside the parameters established in liquidity policy and/or certain parameters are too liberal		✓	✓	✓	✓
Funding source risks					
• Increasing reliance on non-core funding sources	✓	✓	✓	✓	✓
• Primary reliance on FHLB borrowings for liquidity	✓	✓			
• Primary reliance on brokered deposits for liquidity			✓	✓	✓
• Several customers control a large volume of deposits	✓	✓			✓
• Contract provisions with deposit brokers, FHLB, and others impair availability of funds as financial condition deteriorates					✓
Examiner recommendations					
• Evaluate adequacy of guidelines for liquidity related parameters/ ratios		✓		✓	✓
• Continually evaluate adequacy of processes and procedures related to brokered deposits				✓	
• Develop plans to increase core deposit funding and reduce reliance on wholesale funding				✓	✓
• Develop a formal CLP					✓

Source: ROEs for Columbian.

Lack of an Adequate CLP. Columbian did not implement sound liquidity management controls that included a comprehensive CLP. As a result, when Columbian's liquidity position became severely critical in 2008, bank management was ineffective in obtaining sufficient liquidity for the institution. In particular, the August 2008 *Pre-Closing Strategic Resolution Plan,* issued by the Division of Resolutions and Receiverships (DRR), for Columbian noted that liquidity issues were the proximate cause for the closing of this bank. The FDIC had significant concern that the bank's largest depositor and other large depositors might withdraw their accounts from the bank and that Columbian may not have sufficient liquidity to fund these withdrawals.

According to the Examination Manual, CLPs should be in force and should include strategies for handling liquidity crises and procedures for addressing cash-flow shortfalls in emergency situations. The manual also states that financial institutions should have an adequate CLP in place to manage and monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources.

By the 2007 examination, Columbian demonstrated an increasing reliance on brokered deposits to fund asset growth and a significant decline in asset quality—two early-warning indicators that should have prompted Columbian of the need for a comprehensive CLP. In addition, DSC personnel noted that bank management had been expecting for some time that one of the bank's largest depositors (who controlled 12 percent of the bank's deposits as of the 2008 examination) had been planning to withdraw deposits from Columbian as a result of the depositor's 2006 merger with a foreign company. Bank management developed a CLP in response to a recommendation in the 2008 examination and subsequently updated the CLP in conjunction with the July 2008 C&D. However, the CLP was not adequate to prepare Columbian for the eventual loss of these deposits and other sources of funding.

Brokered Deposit Restrictions. The 2006, 2007, and 2008 ROEs noted that Columbian management relied on brokered deposits as a primary source of liquidity to fund the rapid, aggressive growth of high-risk CRE/ADC loans. The 2007 ROE noted that bank management preferred utilizing brokered deposits "due to the lower cost of funds when compared to offering higher deposit rates in the competitive, local market and because of the ability to match deposit amounts and maturities to specific loan needs."

The FDIC's Rules and Regulations, section 337.6, *Brokered Deposits*, restricts access to brokered deposits for banks that are adequately capitalized, stating that the insured depository institution may not accept, renew, or roll over any brokered deposit unless the bank has applied for and been granted a waiver of this prohibition by the FDIC. Therefore, Columbian's access to brokered deposits was restricted once the FDIC notified the bank of a decline in its capital category as required by the PCA-related provisions in the FDIC's Rules and Regulations

Part 325.[10] This notice effectively occurred on April 30, 2008, the date the 2008 ROE, which classified the bank as adequately capitalized, was mailed to the bank.

The last brokered deposit acquired or renewed by the bank was dated April 24, 2008, which was prior to the effective notice date for PCA purposes. On July 30, 2008, Columbian submitted a waiver application to the FDIC to acquire up to $88.4 million of additional brokered deposits. DSC personnel reviewed the application request and determined that it failed to include most items required by FDIC Rules and Regulations Section 303.243(c), *Brokered Deposit Waivers*. DSC notified the bank of the deficiencies on August 7, 2008. The bank provided an amended waiver application on August 20, 2008; however, no further action was taken by the FDIC as the bank was closed 2 days later.

Regulatory Supervision Related to Liquidity

Although Columbian exhibited early warning signs of the need for a comprehensive CLP, examiners did not criticize the bank for not having a formal written CLP until the January 2008 examination. As noted previously, contract provisions could restrict or deny access to funds if the financial condition of the bank deteriorated. In particular, the 2008 ROE documented bank management's concern that financial-related restrictions might negate the bank's ability to retain their top five core-deposit relationships, which comprised 14.5 percent of total deposits and about 32 percent of core deposits (as noted earlier, one of these depositors represented 12 percent of total deposits). The bank's reliance on several customers that controlled a large volume of deposits had been noted as early as the 2003 ROE.

As part of the July 2008 C&D, the FDIC required that the bank begin preparing, reviewing, and updating, on a daily basis, a written liquidity analysis and projection for the sources and uses of funds, to include "specific contingency plans in the event that anticipated events do not materialize, or in case of some other liquidity emergency."

On July 21, 2008, Columbian sent DSC the bank's first liquidity progress report pursuant to the C&D. However, subsequent action by Columbian evidenced a continued inability to effectively plan for the bank's liquidity needs. In particular, the bank repaid $37 million of FHLB advances on August 13, 2008 to reduce borrowing costs, with the presumption that these funds would be available to the bank in the future, if needed. On August 15, 2008, when the bank requested to draw $15 million in FHLB advances, the FHLB informed the bank that the line of credit had been temporarily frozen, restricting the bank's access to these funds and thereby cutting off a significant source of liquidity for the bank.

Subsequent to Columbian's failure, DSC issued additional guidance related to liquidity risk and CLPs. The FDIC's *Liquidity Risk Management* guidance, dated August 26, 2008, urged financial institutions to establish a formal CLP that establishes quantitative liquidity risk

[10] FDIC Rules and Regulations Part 325, Subpart B, *Prompt Corrective Action*, section 325.10, *Notice of Capital Category*, (a) & (b), notes that a bank shall be deemed to be within a given capital category for purposes of section 38 of the FDI Act as of the date the bank is notified of, or is deemed to have notice of, its capital category. This date can include the date a final ROE is delivered to the bank.

guidelines. The guidance also states that CLPs should identify the institution's liquidity risk profile and the types of stress events that may be faced including, but not limited to, a deterioration in asset quality, a capital position of less than well capitalized, the need to fund unplanned asset growth, loss of access to market funding sources, and the impact of negative press coverage. The guidance also reiterates several of the elements that Columbian's CLP did not include, as discussed earlier.

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 supervisory actions that are to be triggered by 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.

The FDIC evaluated Columbian's capital position and assigned capital component ratings; however, the bank was not categorized as undercapitalized prior to its failure; therefore, the FDIC did not issue a PCA Directive to Columbian. Columbian's May 2006 examination rated capital a 1 and concluded that Columbian's capital was strong for the level of risk identified. The July 2007 examination downgraded capital to a 2, although the bank remained in a well-capitalized position. However, due to Columbian's significant asset growth, problematic loan portfolio, and large dividend payments, the capital rating was downgraded in the January 2008 examination and June 2008 visitation to 4 and 5, respectively.

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 financial institution's Call Reports. Columbian's capital remained in the well capitalized to adequately 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, examiners considered the ALLL to be underfunded in May 2006 and January 2008, which overstated capital and earnings and underreported the deterioration of the loan portfolio. At those two examinations, the examiners recommended that the ALLL be increased by $900,000 and $8,117,000, respectively.

The last Call Report for the bank as of June 30, 2008, reported the following ratios:

- Tier 1 Leverage Capital 6.00 percent
- Tier 1 Risk Based Capital 6.27 percent
- Total Risk Based Capital 8.98 percent

All these ratios exceeded the regulatory minimums for a PCA categorization of adequately capitalized. As a result, the FDIC did not implement the PCA provisions for undercapitalized institutions prior to Columbian's failure in August 2008.

CORPORATION COMMENTS

On March 5, 2009, the Director, 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 agreed with the OIG's conclusions regarding the causes of Columbian's failure and the resulting material loss to the DIF and DSC's supervisory activities related to Columbian. DSC also agreed that increased supervisory action, commensurate with the risks posed to the institution, should have been implemented sooner.

DSC also stated that it has undertaken a number of initiatives related to the supervision of financial institutions that have high-risk lending activities, including concentrations in CRE and/or the use of interest reserves.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides 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 September 2008 to February 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 discussed further below.

Scope and Methodology

The scope of this audit included an analysis of Columbian's operations from January 1, 2003 until its failure on August 22, 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 OSBC examiners from 2003 to 2008.

- Reviewed the following:

  - Bank data and correspondence maintained at DSC's Kansas City Regional Office and Field Office.

  - Reports prepared by DRR and DSC relating to the bank's closure.

  - Columbian audit workpapers at the offices of Mayer Hoffman McCann, P.C., in Leawood, Kansas.

- Bank records maintained by DRR in Dallas for information that would provide insight into the bank's failure, various annual reports, and accompanying financial statements.

- Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in FDIC's Kansas City Regional Office.

  - DRR and contractor personnel at the Columbian Receivership Office Overland Park, Kansas.

  - DRR officials at the Dallas Regional Office.

  - FDIC examiners from the KCFO who participated in examinations or reviews of examinations of Columbian.

- Met with officials from the OSBC, Topeka, Kansas, to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

- Researched various federal banking laws and regulations.

We performed the audit field work at the FDIC's headquarters in Washington, D.C., and DSC Regional and Field Offices located in Kansas City, Missouri.

Our ability to evaluate the adequacy of DSC's supervisory efforts was restricted by the lack of FDIC examination work papers for the 2006 FDIC examination. We were informed that the 2006 examination work papers had been destroyed prior to the commencement of our review. Regional Directors Memorandum 01-039, *Guidelines for Examination Workpapers and Discretionary Use of Examination Documentation Modules*, dated September 25, 2001, and the Examination Manual notes that, with some exceptions, the retention of work papers beyond one examination is generally discouraged. In addition, only a limited number of 2007 examination work papers were available for our review.

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 Columbian'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, manage and measure results to justify appropriations and authorizations, and design budgets that reflect strategic missions. 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's operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and certain aspects of the FDI Act. 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) to three categories: • Substandard, • Doubtful, and • Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL level that is adequate to absorb the estimated credit 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 credit losses associated with off-balance sheet credit instruments such as standby letters of credit.
Cease and Desist Order (C&D)	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. 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.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the ROE. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve problems of insured institutions in order to prevent a failure or minimize resulting losses. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), establishing a framework of supervisory actions against insured nonmember banks that are not adequately capitalized. The capital categories are: Well Capitalized Adequately Capitalized Undercapitalized Significantly Undercapitalized Critically Undercapitalized
Uniform Bank Performance Report	The UBPR is an individual analysis of financial 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.

CORPORATION COMMENTS

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

Division of Supervision and Consumer Protection

March 4, 2009

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

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report titled, *Material Loss Review of The Columbian Bank and Trust Company* (Assignment No. 2008-042)

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 The Columbian Bank and Trust Company (Columbian), Topeka, Kansas, which failed on August 22, 2008. This memorandum represents the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received February 10, 2009.

We concur with your assessment that Columbian failed primarily due to bank management's pursuit of rapid asset growth concentrated in higher-risk Commercial Real Estate (CRE) and Acquisition, Development, and Construction (ADC) loans without adequate loan underwriting and credit administration practices.

We also concur with your assessment that although examinations conducted by the FDIC and the Kansas Office of the State Bank Commissioner identified weaknesses in management, asset quality, and liquidity which ultimately led to Columbian's failure, bank management did not appropriately respond to these criticisms. Furthermore, we concur with the OIG's assessment that increased supervisory action, commensurate with the risks these weaknesses posed to the institution, should have been implemented sooner.

In light of the economic deterioration and its impact on Columbian and other similarly situated institutions, DSC has undertaken these initiatives:

- In May 2007, DSC launched a call program for institutions with significant residential construction, subprime mortgage, or other higher-risk lending activities to identify problems early and initiate appropriate supervisory responses.
- DSC examiners authored an article titled *Managing Commercial Real Estate Concentrations* in the Winter 2007 edition of *Supervisory Insights*. This article was prompted by rapid CRE loan growth across the banking industry and elaborates on the authors' field examination experience with the 2006 CRE Guidance, issued by the FDIC, the Federal Reserve Board, and the Office of the Comptroller of the Currency on

December 6, 2006, titled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (2006 CRE Guidance).

- In January 2008, DSC conducted a horizontal review of CRE lending practices; outcomes include changes to the current supervisory approaches, such as an acceleration of the next scheduled examination or downgrades to composite ratings, where warranted.

- The FDIC issued a Financial Institution Letter on March 17, 2008, titled *Managing Commercial Real Estate Concentrations in a Challenging Environment* (2008 CRE FIL). The 2008 CRE FIL re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices and recommended several risk management processes to help institutions manage CRE and C&D concentrations. This FIL also articulated the FDIC's concern about interest reserves for C&D loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

- In July 2008, DSC developed a comprehensive CRE guidance repository in a Regional Director memorandum which updates and re-emphasizes CRE loan examination procedures in view of more challenging market conditions, particularly in C&D lending.

- DSC examiners authored an article titled *A Primer on the Use of Interest Reserves* in the Summer 2008 edition of *Supervisory Insights.*

- In August 2008, DSC issued revised examination instructions to collect information on market conditions and practices at banks potentially exposed to significant CRE concentration risk. These data will provide real-time information relating to CRE markets across the country and FDIC-supervised institutions operating in those markets and will be available for supervisory purposes.

- In September 2008, DSC made available to examiners a resource that provides for more detailed information on commercial and residential real estate markets and transactions. These data, which include estimated property values, comparable sales, leasing rates, capitalization rates, vacancy rates, title/deed documents, and other related information, may aid examiner analysis of market conditions during examinations of banks with significant CRE concentrations.

- The FDIC issued a Financial Institution Letter on November 12, 2008, titled *Interagency Statement on Responsible Lending* (FIL-128-2008). FIL-128-2008 encourages FDIC-supervised institutions to lend prudently and responsibly to creditworthy borrowers, adjust dividend policies to preserve capital and lending capacity, and implement compensation structures that encourage prudent lending. It further emphasizes that state nonmember institutions' adherence to these expectations will be reflected in examination ratings the FDIC assigns for purposes of assessing safety and soundness, compliance with

laws and regulations, and performance in meeting requirements of the Community Reinvestment Act.

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

3

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
C&D	Cease & Desist Order
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
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GAAP	Generally Accepted Accounting Principles
KCFO	Kansas City Field Office
MLR	Material Loss Review
OIG	Office of Inspector General
OSBC	Office of the State Bank Commissioner
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System