Office of Inspector General

September 2009
Report No. AUD-09-029

Material Loss Review of Security Savings Bank, Henderson, Nevada

AUDIT REPORT

Material Loss Review of Security Savings Bank, Henderson, Nevada

Federal Deposit Insurance Corporation

Why We Did The Audit

On February 27, 2009, the Nevada Department of Business and Industry, Financial Institutions Division (NFID) closed Security Savings Bank, Henderson, Nevada (Security Savings), and named the FDIC as receiver. On March 20, 2009, the FDIC notified the Office of Inspector General (OIG) that Security Savings' total assets at closing were $202 million and the estimated loss to the Deposit Insurance Fund (DIF) was $59 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 Security Savings.

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

Security Savings was a state-chartered industrial loan company that was insured on April 3, 2000. In addition to its main office, Security Savings had two full-service branch offices and three loan production offices in Virginia, Florida, and Texas. In September 2004, Security Savings was acquired by Stampede Holdings, Inc., a one-bank holding company. As a result, the bank was subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and higher capital maintenance standards.

Audit Results

CAUSES OF FAILURE AND MATERIAL LOSS

Security Savings failed because bank management did not adequately control the risks associated with its business strategy that focused on (1) rapid asset growth, (2) significant concentrations in ADC loans, (3) investments in lower-quality mortgage-backed securities, and (4) reliance on high-cost core deposits and volatile non-core funding. The deteriorating housing market in areas where Security held most of its loans led to significant loan and security losses that eroded the bank's capital and strained liquidity. Ultimately, Security Savings was closed by NFID due to the bank's capital insolvency.

OVERVIEW AND ASSESSMENT OF FDIC SUPERVISION

Over the life of Security Savings, the FDIC conducted risk management examinations in compliance with the examination frequency requirements of the FDI Act and made recommendations to Security Savings for improving areas of its operations, including identification and monitoring of loan concentrations, improving the allowance for loan and lease losses methodology and/or position, establishment of liquidity risk limits and contingency liquidity plans, and enhancement of the internal/external audit function. Examiners also identified and resolved a significant violation of Federal Reserve Board Regulation 23(a), related to covered transactions with affiliates that resulted in Security Savings removing $26 million in loan participations from the bank's loan portfolio. Of the $26 million, the FDIC estimated that 50 percent of the loan balances outstanding would have been classified as loss had they remained with Security Savings. Finally, examiners were successful in convincing bank management to halt Security Savings' continued growth of ADC lending and investment in lower-grade securities.

Notwithstanding those activities, the FDIC could have performed certain examination procedures and given greater attention to the bank's lending and funding activities that may have shed greater light on the extent of risks warranting supervisory concern. In addition, once loan underwriting and administration policy and procedure deficiencies were identified in 2007, examiner recommendations for improvement were well-intentioned but not immediately successful in prompting management to take actions that would prevent a further decline in the bank's financial position. In retrospect, a more forceful supervisory response to those deficiencies may have been warranted in light of the related risk associated with Security Savings' sizable concentrations and volatile funding.

With respect to PCA, the FDIC issued a notification to Security Savings alerting the bank of applicable restrictions under PCA when it fell below the Well Capitalized category, as required. However, the notification was not effective in preventing Security Savings' failure and the resulting material loss to the insurance fund, because Security Savings was not categorized as Critically Undercapitalized until just prior to its failure.

Background (cont.)

Security Savings had a unique wholesale business model. The bank engaged principally in purchasing commercial real estate (CRE) loans, including a significant concentration of acquisition, development and construction (ADC) loans, and loan participations that were all serviced by others. In addition, the bank acquired both loans and securities that provided higher yields and were higher-risk. The bank's lending activities were also centered in high-growth markets, three of which – Florida, California, and Nevada – experienced significant economic downturns starting in 2007.

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

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On September 16, 2009, the Director, DSC, provided a written response to the draft report. That response was included in its entirety as an appendix of this report.

DSC reiterated the OIG's conclusions regarding the cause of Security Savings' failure. With regard to our assessment of the FDIC's supervision of Security Savings, DSC summarized several supervisory actions taken in relation to the institution's activities. DSC also noted that a well-managed balance sheet with a diversified asset portfolio is a sound banking practice, and that effective supervision is necessary in the early stages for institutions developing asset concentrations or reliance on volatile funding. In that regard, DSC stated that it has issued updated guidance reminding examiners to take appropriate supervisory action when capital levels are inadequate for CRE concentrations or funding risks are imprudently managed.

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Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226
Office of Inspector General

DATE: September 18, 2009

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

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

SUBJECT: *Material Loss Review of Security Savings Bank, Henderson, Nevada* (Report No. AUD-09-029)

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 Security Savings Bank, Henderson, Nevada (Security Savings). On February 27, 2009, the Nevada Department of Business and Industry, Financial Institutions Division (NFID) closed the institution and named the FDIC as receiver. On March 20, 2009, the FDIC notified the OIG that Security Savings' total assets at closing were $202 million and the material loss to the Deposit Insurance Fund (DIF) was $59 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 supervision[2] 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.

[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.

Appendix 2 contains a glossary of terms, and Appendix 3 contains a list of acronyms used in the report.

This report presents the FDIC OIG's analysis of Security Savings' failure and the FDIC's efforts to ensure Security Savings' management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of DSC's supervision program and make recommendations, as warranted.

BACKGROUND

Security Savings was an FDIC-supervised state-chartered industrial loan company (ILC) established by the NFID and insured by the FDIC effective April 3, 2000. Security Savings, which was headquartered in Henderson, Nevada, had two full-service branch offices in Nevada, and three loan-production offices in Virginia, Florida, and Texas. The loan production offices and one branch were closed before the failure of the bank. The bank's business model was that of a wholesale operation focusing on purchasing loan participations from across the nation. In particular, Security Savings specialized in commercial real estate (CRE) lending, with concentrations in CRE and acquisition, development, and construction (ADC) loans. The bank also invested in lower-rated investment-quality securities. In addition, the bank was dependent on potentially volatile liabilities for its funding.

Security Savings was 100 percent owned by Stampede Holdings, Inc. (Stampede), Las Vegas, Nevada, a one-bank, non-commercial holding company. Stampede was a closely-held company with 41 shareholders. Stampede acquired the bank in September 2004. At the time of acquisition, Stampede replaced the bank's management team, injected capital, opened the three loan production offices, and implemented a high-growth strategy.

There was also an affiliate institution, which examiners determined to have been controlled by the principal shareholder of Stampede. (A matter related to an apparent violation of Federal Reserve Board (FRB) Regulation 23A, regarding covered transactions, is discussed later in this report.)

A summary of Security Savings' financial condition, as of December 2008, and for the 4 preceding calendar years follows in Table 1.

Table 1: Financial Condition of Security Savings

Uniform Bank Performance Report	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets ($000s)	$238,307	$273,291	$278,764	$202,061	$93,046
Total Deposits ($000)	$174,872	$179,545	$172,190	$115,837	$70,245
Net Loans & Leases ($000s)	$119,068	$180,240	$204,502	$127,451	$52,703
Net Income ($000s)	($28,501)	($1,991)	$2,472	$700	$20

Source: Uniform Bank Performance Reports (UBPR) for Security Savings.

CAUSES OF FAILURE AND MATERIAL LOSS

Security Savings failed because bank management did not adequately control the risks associated with its business strategy that focused on (1) rapid asset growth, (2) significant concentrations in ADC loans, (3) investments in lower-quality mortgage-backed securities, and (4) reliance on high-cost core deposits and volatile non-core funding. The deteriorating housing market in areas where Security held most of its loans led to significant loan and security losses that eroded the bank's capital and strained liquidity. Ultimately, Security Savings was closed by NFID due to the bank's capital insolvency.

Evidence of the cause of a bank's failure can often be seen in its adverse asset classifications. In the case of Security Savings, its adverse classifications resulted primarily from its portfolios of ADC loans and securities. As adverse asset classifications increased, earnings eroded, liquidity became strained, and capital became increasingly deficient.

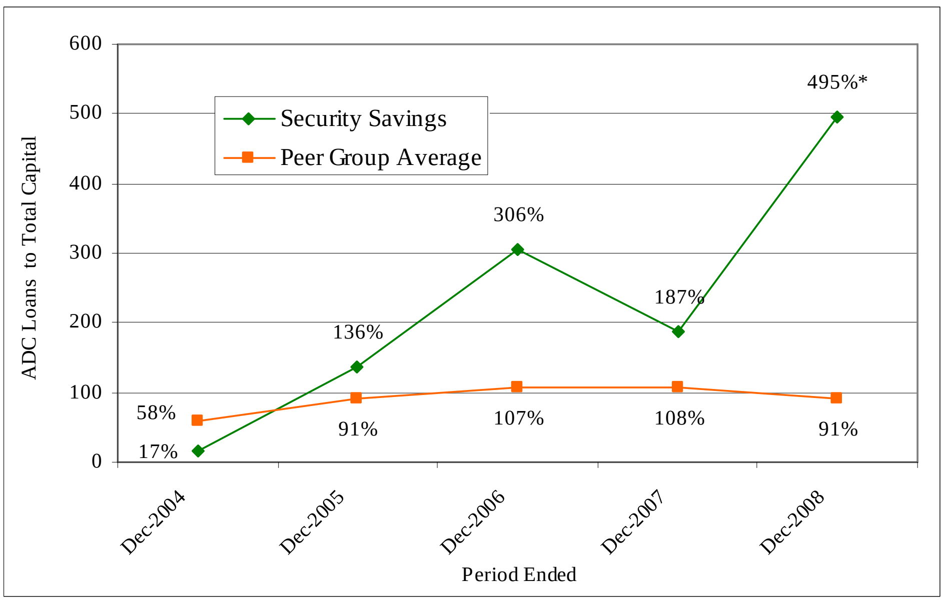
The bank's business model was that of a wholesale operation focused on purchasing loans and loan participations across the nation. Since year-end 2006, three of the bank's primary markets — Florida, California, and Nevada — experienced significant real estate price deterioration. As the deterioration in the housing market spread, Security Savings began to incur and recognize greater losses in its ADC loan portfolio. Specifically, adversely classified assets increased from $15.6 million reported in the June 2007 Report of Examination (ROE) to $40.9 million reported in the July 2008 ROE. The majority of adversely classified assets were purchased ADC loans to finance condominium and CRE construction projects in high-growth markets, including Florida, California, and Nevada. Further, for the periods ended December 2004 to December 2008, the bank's net loan charge-offs (losses) totaled $13.3 million, of which $11.9 million was in the ADC loan portfolio. Additionally, for the years ended December 2007 and 2008, the bank recognized $12.7 million in losses associated with its securities.

High-Risk Business Strategy

Security Savings' management employed a rapid-growth business strategy in which it concentrated assets in higher-risk ADC loans and securities, and funded its asset growth with higher-cost core deposits and potentially volatile liabilities, without sufficient mitigating controls. Security Savings' total assets increased 227 percent from December 2004 to September 2007, peaking at almost $304 million. Losses associated with this high-risk strategy were a significant contributing factor to the failure of Security Savings. In particular, the following concerns were noted.

ADC Loans and Other Mortgage-Backed Securities Concentrations. Security Savings' asset quality problems were exacerbated by the bank's rapid growth, emphasis in high-growth and dispersed national markets, and concentrations in ADC loans that were acquired from and serviced by others. In addition, the bank held concentrations in lower-quality securities that were not backed by the U.S. Government. Specifically, as of December 2008, the bank's ADC loans totaled 495 percent of total capital and its portfolio of Other Mortgage-Backed Securities[3] totaled 461 percent of total capital. Further, Security Savings' management permitted these loan and security concentrations to exist without adequate risk identification, measurement, monitoring, and control. As shown in Figure 1, which follows, the bank's ADC loans began to increase significantly in 2005 and exceeded the bank's peer group averages. In addition, the bank's concentrations in Other Mortgage-Backed Securities began in 2004, and equaled 224 percent of total capital as of December 2004. Both categories of assets remained major product segments into 2008.

Figure 1: ADC Loan Concentrations (Loans as a Percentage of Total Capital)



Source: OIG analysis of the UBPRs for Security Savings.
* The re-growth of the concentration level in 2008 is the result of increasing losses and declining capital levels, rather than asset growth.

Also of note, the FDIC issued joint guidance titled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, dated December 12, 2006 (2006 CRE Guidance), which emphasized the need for increased supervisory concern for those banks with significant CRE concentrations, and especially for institutions that focus on

[3] Other Mortgage Backed Securities is a specific line item in a bank's Report of Condition and Income (Call Report).

ADC lending. In particular, the 2006 CRE Guidance defined significant concentrations, in part, as total ADC loans representing 100 percent or more of total capital.

- **ADC Loan Portfolio:** Security Savings' risk profile was further heightened due to management's poor loan underwriting, administration, and risk analysis and recognition. Although ADC loans are typically considered a higher-risk loan product,[4] there were factors in Security Savings' ADC loan portfolio that further increased risk. Specifically, Security Savings' management pursued higher yielding loans by assuming a higher-risk position. In particular, management purchased some "mezzanine" loans that placed the bank in a subordinate position to other lien holders and subjected the bank to a first-loss position. Bank management also increased its participations in loans that the bank had internally identified as watch-list credits, which increased the bank's overall risk. Further, Security Savings also purchased low-quality loans from an affiliate that management did not fully disclose, resulting in violations of FRB Regulation section 23A regarding covered transactions with affiliates. With the collapse of the subprime mortgage market and the tightening of the mortgage credit market, the bank was subject to significant losses, as real estate values declined.

  As noted in the July 2008 ROE, many of the single family residential ADC projects securing the bank's loans were no longer viable because the projects experienced a substantial decline or a complete halt in sales as a result of the severe deterioration in residential markets. Furthermore, many of the projects lacked adequate secondary sources of repayment or borrower liquidity to fund shortfalls or make interest payments, leaving limited options outside of foreclosure. Such issues indicate poor underwriting of these ADC loans. The June 2007 and July 2008 ROEs also identified numerous documentation exceptions and loan risk identification and rating concerns.

- **Other Mortgage-Backed Securities Portfolio:** With respect to its portfolio of Other Mortgage-Backed Securities, after Security Savings' change of control in 2004, bank management began purchasing high yielding and higher-risk mortgage-backed securities. These investments were non-agency mortgage-backed securities, and some were lower-rated investment quality securities. At its peak, in September 2006, the bank held over $57 million in Other Mortgage-Backed Securities, which represented over 23 percent of total earning assets. Of these securities, as of June 2007, 72 percent were rated AAA, and 28 percent were rated BBB by the Standard & Poor's (S&P) credit rating agency, when purchased. Investments graded BBB are at the lowest end of the S&P's investment grade rating spectrum, and were reflective of the bank's higher risk tolerance. In addition, these securities were complex investment instruments, and several were issued by distressed originators noted by the FDIC for lax underwriting. The underlying collateral supporting these securities consisted of significant volumes

[4] As stated in the FDIC's Financial Institution Letter (FIL) FIL-110-98, dated October 8, 1998, "ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that this activity remains profitable."

of nontraditional mortgages predicated on low credit scores, limited documentation, second deeds of trusts, loan-to-value ratios in excess of 80 percent, and loans containing interest-only features.

Volatile Liability Funding Dependence. Security Savings' management employed a funding structure that was centered on high-cost, potentially volatile funds to support its rapid-growth strategy. The bank's funding structure relied on wholesale and high-cost funding sources, including:

- high-cost core deposits,
- brokered deposits,
- time deposits of $100,000 or greater,
- repurchase agreements, and
- Federal Home Loan Bank (FHLB) borrowings.

Further details on the bank's funding sources are presented in Table 2, which follows.

Table 2: Funding Sources

Period Ended	Core Deposits (Dollars in Thousands)	Non-Core Funding Sources (Dollars in Thousands)			
		Time Deposits of $100,000 or More	Brokered Deposits	Repurchase Agreements	FHLB Borrowings
Dec-08	$139,298	$35,574	$41,384	$40,000	$20,000
Dec-07	$146,045	$33,500	$30,991	$40,000	$25,000
Dec-06	$147,938	$24,251	$65,904	$40,000	$38,500
Dec-05	$45,271	$70,566	$59,451	$20,000	$48,000
Dec-04	$27,182	$43,063	$33,396	$0	$9,500

Source: UBPRs for Security Savings.

As stated in the DSC *Risk Management Manual of Examination Policies* (DSC Examination Manual), a heavy reliance on potentially volatile liabilities to fund asset growth is a risky business strategy because the availability and access to these funds may be limited in the event of deteriorating financial or economic conditions, and assets may need to be sold at a loss in order to fund deposit withdrawals and other liquidity needs. Management did not establish policies or controls that adequately limited or mitigated the level of risk related to these activities.

A bank's net non-core dependency ratio indicates the degree to which the bank is relying on non-core/volatile liabilities to fund long-term earning assets. Generally, a lower ratio reflects less risk exposure, whereas 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. For the years ended December 2004 to December 2008, the bank's net non-core dependency ratio indicated that the bank was moderately to highly dependent on volatile funding, as shown in Table 3.

Table 3: Net Non-Core Fund Dependence Ratios

Period Ended	Security Savings	Peer Group (By Asset Size)	PCT[a]	Custom Peer Group (By Charter)[b]	PCT[a]
Dec-08	41.69%	30.48%	71	41.33%	45
Dec-07	43.19%	21.01%	93	36.55%	50
Dec-06	37.51%	21.13%	78	39.80%	41
Dec-05	71.01%	19.20%	98	32.38%	72
Dec-04	56.86%	13.41%	98	33.32%	Not Available

Source: UBPRs for Security Savings.
[a] PCT represents the bank's percentile ranking within the bank's designated peer group average.
[b] As an ILC with assets greater than $100 million, the bank could not accept transaction accounts. This restriction could result in a net non-core funding dependence ratio for ILCs that is (on average) inherently higher than other (non-ILC) charter types.

The bank also increased its funding risk through the use of (1) high-rate and Internet core deposits and (2) long-term repurchase agreements.

- **High-Rate and Internet Core Deposits:** Security Savings generated high-rate core deposits, in part, through an Internet deposit rate posting service. For the years ended December 2005 to December 2006, the majority of the bank's core deposit growth was centered in time deposits of less than $100,000, with a remaining maturity of 1 year or less and, secondarily, in other savings accounts. The bank's time deposit rates did not appear significantly higher than its designated peer group average, as presented in the UBPR. However, based on a review of the bank's competitor rate survey, as of April 2007, the rates offered by Security Savings for time deposits of less than $100,000 exceeded the bank's designated local market by 76 to 146 basis points, depending on the term of the deposit's maturity. Further, the bank's competitor rate survey indicated that management positioned the bank as one of the highest nation-wide savings account and money market account rate payers within the rate posting service. As shown in Table 4, for the years ended December 2005 to December 2008, Security Savings was in the 96th to 99th percentile ranking of its peer group average for rates paid on other savings deposits. These percentile rankings mean that the bank's cost of other savings deposits was higher than almost all of the banks in its peer group. As a result, the bank's core deposits exhibited "brokered deposit like" traits due to the higher than peer group average rates paid for these deposits. Also, as shown in Table 4, in comparison to other ILC-chartered institutions, the interest rates paid on the bank's other savings deposits were substantially higher than the custom peer group averages.

According to the DSC Examination Manual, although out-of-area deposits obtained from an Internet listing service are included in core deposits under the UBPR definition, it is nevertheless likely that such deposits should not be viewed as a stable funding source. Consequently, although the bank's non-core dependency ratio declined, the bank's overall risk profile does not appear to have been significantly reduced.

Table 4: Cost of Deposits

Period Ended	Total - Interest Bearing Deposits					Other Savings Deposits				
	Rate	Peer Diff.[a]	PCT[b]	Custom Peer Diff.[c]	PCT[b]	Rate	Peer Diff.[a]	PCT[b]	Custom Peer Diff.[c]	PCT[b]
Dec-08	3.89	.69	84	.21	56	3.28	1.34	97	1.60	94
Dec-07	5.10	1.32	98	.51	62	4.87	2.27	99	2.32	87
Dec-06	4.69	1.09	97	.54	70	4.46	1.71	96	2.13	81
Dec-05	3.35	.88	95	.40	63	3.18	1.44	96	1.62	85
Dec-04	3.59	1.79	99	1.40	Not Avail.	2.03	.96	98	1.01	Not Avail.

Source: UBPRs for Security Savings.
[a] Peer Diff. represents the difference between the bank's rate and the peer group average's rate. This difference provides an indication of which deposit products are potentially "brokered like." For this assessment, a benchmark of 75 basis points is typically used.
[b]PCT represents the bank's percentile raking within the bank's designated peer group average.
[c] Custom Peer Diff. represents the difference between the bank's rate and the custom (designated by the bank's charter type) peer group average's rate.

- **Repurchase Agreements:** Security Savings also increased its non-core funding risk by selling securities under complex long-term repurchase agreements.[5] According to the July 2008 ROE, the agreements were entered into to replace long-term borrowings, overnight federal fund borrowing lines, and FHLB borrowings. During the quarter ending June 2005, the bank initially sold securities under short-term repurchase agreements. However, subsequently, three lots of securities were sold under long-term (7 to 8 years) repurchase agreements, in March 2006 for $10 million, in September 2006 for $20 million, and November 2006 for $10 million. These repurchase agreements contained features that protected the counterparty, including a charge (breakage fee) in case of cancellation of the agreement or contractual default by Security Savings.

According to the DSC Examination Manual, the majority of repurchase agreements used by institutions are short-term in nature, and institutions typically use them as short-term, relatively low-cost, funding mechanisms. In addition, properly administered repurchase agreements that are conducted within a comprehensive asset/liability management program are not generally a regulatory concern. However, repurchase agreements that are inadequately controlled may expose an institution to the risk of loss, and the FDIC will regard them as an unsuitable investment practice. In the case of Security Savings, bank management entered into the long-term repurchase agreements without establishing adequate policies and procedures, performing a formal pre-purchase analysis, and providing the board of directors (BOD) full disclosure of all of the terms and conditions of the agreements. Ultimately, when the bank's capital fell

[5] The DSC Examination Manual states that a securities repurchase agreement is created when an institution agrees to sell a security to a counterparty and simultaneously commits to repurchase the security at a mutually agreed upon future date, which is a form of secured borrowing. Most repurchase agreements are day-to-day (overnight) funding, but terms of up to 1 or 2 years are not uncommon.

below the PCA capital designation of Well Capitalized and/or was placed under a Cease and Desist Order (C&D) with a capital provision, the bank was in default of the repurchase agreements and subject to the $4 million charge described above. As of December 2008, the breakage fee represented 83 percent of the bank's Tier 1 Capital.

OVERVIEW AND ASSESSMENT OF FDIC SUPERVISION

Over the life of Security Savings, the FDIC provided supervisory oversight in many areas, including risk management examinations, visitations, and offsite monitoring.

Overview of FDIC Supervision

The FDIC and NFID performed joint safety and soundness examinations of Security Savings in compliance with the examination frequency requirements of the FDI Act. Since Security Savings' inception in 2000, the FDIC and NFID conducted a total of eight examinations and two visitations. After the bank underwent a change in control in September 2004, the FDIC and NFID conducted four examinations, as shown in Table 5, which follows. Security Savings' composite rating was downgraded to a 3, indicating increasing risk, in the June 2007 ROE. As a result of the July 2008 examination, Security Savings' composite rating was downgraded to a 5, indicating extremely unsafe and unsound practices or conditions, critically deficient performance, and inadequate risk management practices. Also of note, the FDIC performed the June 2006 and June 2007 examinations under challenging circumstances due to bank management's uncooperative behavior and adversarial demeanor.

Table 5: Examination History of Security Savings

Examination Date	Type	Supervisory Ratings (UFIRS)*
07/29/2008	Joint	455544/5
06/18/2007	Joint	333222/3
06/05/2006	Joint	222222/2
05/31/2005	Joint	222222/2
05/10/2004	Joint	222322/2

Source: ROEs for Security Savings.
* 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.

As a result of these examinations, the FDIC took various supervisory actions. In particular, within the ROEs, the FDIC made specific recommendations to Security Savings related to areas of its operations where improvements were needed. In the May 2005 to July 2008 ROEs, the FDIC recommended varying enhancements and/or improvements to the bank's allowance for loan and lease losses (ALLL) methodology, ALLL position, identification and monitoring of concentrations, and internal/external audit programs. In the June 2006 ROE, the FDIC also largely identified the bank's securities portfolio weaknesses and recommended various policy improvements.

Further, when the bank's adversely classified loans began to significantly increase, as reported in the June 2007 ROE, the FDIC identified more significant concerns with, and recommended improvements to, the bank's management and BOD supervision, loan underwriting and administration, ongoing assessment of the bank's securities portfolio, and volatile liability funding.

Supervisory action was effective in reducing certain risks and in mitigating losses to the DIF. During the June 2007 examination, these actions included the identification and resolution of a significant violation of FRB Regulation 23A, related to covered transactions with affiliates. Examiners identified an affiliated relationship that existed between the bank and a non-bank financial institution that bank management failed to fully disclose. As a result, examiners caused the removal of $26 million in loan participations from the bank's loan portfolio. Of the $26 million, the FDIC estimated that 50 percent of the loan balances outstanding would have been classified as loss had they remained with Security Savings. Another supervisory action included the examiners' convincing bank management to halt Security Savings' continued growth of ADC lending and investment in lower-grade securities.

Further, to address examiner concerns as documented in the June 2007 ROE, including apparent violations of laws and regulations, inadequate risk management controls, and other safety and soundness issues, the bank adopted a Bank Board Resolution (BBR) on July 19, 2007. Subsequently, the FDIC and NFID determined that a Memorandum of Understanding (MOU) would be more appropriate. The MOU became effective in May 2008 and contained 15 provisions addressing: management, capital, commercial real estate concentrations, the ALLL methodology, adversely classified assets, the strategic business plan, violations, investment and related-party transactions, and restrictions on non-agency mortgage-backed securities. The MOU also required Security Savings to maintain a Tier 1 Leverage Capital ratio of at least 9.75 percent, and for management to develop a plan to monitor and reduce the CRE loan portfolio concentration to 250 percent of total risk-based capital. In addition, the MOU contained a provision that addressed the bank's management, stating:

> … the Bank shall retain management acceptable to the Regional Director… Such management must include a chief executive officer and an appropriate number and type of senior officers, with the requisite knowledge, skills, ability, and experience…

According to the July 2008 ROE, the BOD hired a chief operating officer, a compliance officer, two additional asset managers, and two new information technicians. In addition, an outside consultant was hired to review bank management. The ROE also noted that the core executive management team remained the same and that the BOD did not have the power to employ or terminate an executive officer without unanimous consent of the

BOD, of which the bank's executive managers were members. Based on the FDIC's actions, the BOD obtained the power to hire and terminate executive management by a majority vote. Following the July 2008 examination, the executive management team was replaced.

The FDIC's final supervisory action before the bank was closed was the issuance of a C&D on February 3, 2009.

Assessment of FDIC Supervision

Although the FDIC's supervision was comprehensive and effective in mitigating certain losses to the DIF, we concluded that the Corporation could have performed certain additional analysis, exercised greater supervisory concern, and taken additional action to help mitigate the potential level of losses incurred.

ADC Loan Portfolio. In retrospect, the FDIC did not recognize the extent to which Security Savings had ADC loan underwriting and credit administration weaknesses on a timely basis. Beginning in 2005, management began purchasing higher yielding and higher-risk ADC loans. As noted previously, some of these loans were mezzanine loans, and 22 percent of the bank's total loan portfolio contained interest rates exceeding 10 percent, rates that were significantly higher than its competitors. Although these loans were in the bank's portfolio since the middle of 2005, the volume of higher yielding and higher-risk ADC loans was not raised as a concern until the June 2007 examination. Examiners told us that these loans were not raised as a concern due, in part, to the loans being current, relatively new, and/or unseasoned. However, based on our review of the June 2006 examination work papers, we noted that 5 of 15 ADC loans that were not adversely classified contained potential areas of concern, including apparent project delays and/or questionable collateral valuations.[6]

The FDIC also reported on numerous loan underwriting and administration deficiencies involving the bank's policies and procedures in the June 2007 examination. These weaknesses included such areas as the following:

- loan underwriting risk selection practices;
- financial statement and documentation standards, and documentation collection and verification procedures;
- establishment of guidelines for subsequent collateral evaluations;
- ongoing credit analysis of borrower repayment capacity;
- concentrations identification, monitoring, and limitation;
- establishment of interest reserve policies and guidelines;
- establishment of guidelines for recognition of non-accrual and charged-off loans; and

[6] It should be noted that we are not expressing an opinion on whether these five loans should have been adversely classified.

- enhancement of ADC loan administrative staff.

Had these issues been identified earlier, then FDIC could have taken earlier actions to reduce and/or mitigate the level of Security Savings' risk.

Other Mortgage-Backed Securities Portfolio. In the June 2006 ROE, the FDIC identified the excessive risk and weaknesses within Security Savings' securities portfolio and recommended to Security Savings various critical policy and procedural improvements. Specifically, the ROE cited a contravention of the *Supervisory Policy Statement on Investment Securities and End-User Derivatives*, noting that the BOD had not established risk tolerances for the type and quality of investments, criticizing the lack of independence within the investment function, and stating that the pre-purchase analysis should be strengthened and that this information should be provided to the board. However, it was not until the June 2007 examination that the FDIC recommended that bank management perform a more comprehensive (on-going) review of the higher-risk securities – beyond a verification of the ratings assigned. Had bank management developed a more comprehensive risk management process, it could have better anticipated and reacted to changing market conditions. For example, management could have discontinued its purchase of these higher-risk securities, or mitigated risk by selling securities in its portfolio or increasing capital. Security Savings purchased its last Other Mortgage-Backed Security in September 2006. However, bank management did not formally commit to halt its investment practices until May 2008 – in response to the June 2007 ROE and May 2008 MOU – and examiners continued to report managerial weaknesses over the bank's investment portfolio until just before the bank's failure.

The FDIC subsequently issued a FIL titled, *Risk Management of Investments in Structured Credit Products*, dated April 2009. The guidance re-emphasizes to banks the importance of monitoring the underlying collateral performance in structured investments. The guidance states:

> Institution must understand not only an investment's structural characteristics, but also the composition and credit characteristics of the underlying collateral. Management should conduct analysis at both the deal and pool level using information that sufficiently captures collateral characteristics. Such analysis should be conducted prior to acquisition and on an ongoing basis to monitor and limit risk exposures.

Volatile Liability Dependence. Since the May 2004 examination, the FDIC reported on the bank's level and trend of net non-core funding. Although the bank's net non-core funding dependence ratio fluctuated from a moderate level of 37 percent to a high of 73 percent, the FDIC noted that the bank's volatile liability dependence risk was mitigated based on one or more of the following:

- The bank's position was similar to the projected levels detailed within the bank's formally approved 2004 Change of Control Business Plan.
- The bank's business model inherently relied on the use of non-core funding, as industrial loan charters have limited access to demand deposits.

- Management's effective asset liability management and monitoring practices mitigate concerns related to high non-core funding.

Notwithstanding the above mitigating factors, the FDIC could have expressed a greater level of concern when the bank's net non-core funding dependence ratio was reported at 73 percent in the May 2005 ROE and 70 percent in the June 2006 ROE. In addition, based on our review of the 2004 Change of Control Business Plan, the clarity of the bank's future risk profile was not clearly established, and should not have been used as a mitigating factor. In particular, the volume of higher-risk ADC loans was understated and residential loans were overstated, the quality of investment grade securities was not detailed, and the use of long-term repurchase agreements was not discussed or accounted for within the bank's projected borrowings.

Further, the FDIC could have required the bank to improve its Asset/Liability Management Policies with regard to establishing reasonable volatility risk limits and creating/improving its contingency liquidity plan[7] to help mitigate the risk earlier. The FDIC did not require the bank to reduce its dependence on potentially volatile funding sources, set reasonable limits, or require the development of, or improvements to, a contingency liquidity plan until the July 2008 examination.

Long-Term Repurchase Agreements. Until the July 2008 examination, the FDIC did not review for, and the bank did not perform, a formal pre-purchase analysis of the bank's long-term repurchase agreements. Based on the sequence of transactions, one long-term repurchase agreement was initiated before, and two were initiated after, the completion of the June 2006 examination. However, during the June 2006 examination, the FDIC did not identify or assess the nature of the bank's repurchase agreements. As a result, the excessive and uncontrolled risk posed, in particular, by the long-term maturities of the agreements and breakage fees was undetected. As discussed earlier, the DSC Examination Manual discusses the risky nature of these long-term agreements. In addition, the Liquidity Examination Documentation Module suggests that examiners assess the reasonableness of the bank's use of wholesale and rate-sensitive funding sources, in part, by identifying and evaluating the sources, terms, and embedded options of all significant borrowings or market instruments (such as repurchase agreements) and by determining the extent and use of those funds. If the FDIC had reviewed for and detected these risks earlier, then the latter two transactions could have been halted and/or more conservative funding agreements urged. As a result, the FDIC could have prompted the bank to reduce its potential funding risk and loss exposure.

IMPLEMENTATION OF PCA

[7] DSC uses the terms contingency liquidity plan, liquidity contingency plan, and contingency funding plan interchangeably. For purposes of this report, we use contingency liquidity plan.

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.

PCA had limited impact in mitigating the bank's losses, because Security Savings was not categorized as Critically Undercapitalized until just prior to its failure. Specifically, based on the FDIC's analysis of the December 31, 2008 Call Report filed on January 30, 2009, the FDIC calculated the bank's key capital ratios as follows:

- Tier 1 Leverage Capital 1.91 percent
- Tier 1 Risk-Based Capital 3.56 percent
- Total Risk-Based Capital 4.84 percent
- Tangible Equity Capital 0.99 percent

Under PCA provisions in Part 325 of the FDIC's Rules and Regulations, a Tangible Equity Capital ratio at or below 2 percent reflects a Critically Undercapitalized capital category. As a result, on February 5, 2009, the FDIC presented Security Savings' BOD with a PCA Notification of Capital Category letter that notified the bank of its Critically Undercapitalized capital category. In addition, the letter notified bank management that Security Savings was required to submit a capital restoration plan, was subject to certain mandatory restrictions, and was required to obtain the FDIC's written approval before engaging in certain activities.

Subsequent to the June 2007 examination, Security Savings did attempt to obtain additional capital to strengthen the bank's balance sheet. Specifically, the bank identified potential investor groups willing to provide capital. However, according to senior officials in the FDIC's San Francisco Regional Office, the FDIC ultimately determined with the concurrence of the NFID that such sources were not viable or appropriate solutions to address the bank's worsening financial condition.

It should be noted that 2 days prior to the bank's official PCA notification of Capital Category, the bank was subject to a formal action that contained a capital provision. Specifically, based on the results of the July 2008 examination, the FDIC and NFID issued a joint C&D on February 3, 2009 that contained a capital provision that directed Security Savings to maintain its Tier 1 Leverage Capital ratio to 10 percent. As a result of the C&D provision, Security Savings was subject to certain PCA restrictions, including those related to increasing the amount of brokered deposits.

CORPORATION COMMENTS AND OIG EVALUATION

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On September 16, 2009, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 3 of this report.

DSC reiterated the OIG's conclusions regarding the cause of Security Savings' failure. With regard to our assessment of the FDIC's supervision of Security Savings, DSC summarized several supervisory actions taken in relation to the institution's activities. DSC also noted that a well-managed balance sheet with a diversified asset portfolio is a sound banking practice, and that effective supervision is necessary in the early stages for institutions developing asset concentrations or reliance on volatile funding. In that regard, DSC stated that it has issued updated guidance reminding examiners to take appropriate supervisory action when capital levels are inadequate for CRE concentrations or funding risks are imprudently managed.

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, 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 this performance audit from March to September 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of Security Savings Bank's operations, which opened on April 3, 2000 until its failure on February 27, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by the FDIC and the NFID from 2005 to 2008.

- Analyzed available examination work papers prepared by the FDIC and the NFID from 2006 to 2008.

- Reviewed the following:

  - Bank data and correspondence maintained at the DSC's San Francisco Regional Office and Phoenix Field Office.
  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.
  - Reports from the bank's external auditors, McGladrey and Pullen, CPAs, Las Vegas, Nevada, and Mayer Hoffman McCann P.C., Salt Lake City, Utah.
  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C.; and San Francisco, California.
  - FDIC examiners from the DSC Phoenix and Orange County Field Offices who participated in Security Savings examinations.

- Interviewed officials from the NFID of Las Vegas, Nevada, to discuss their historical perspective of the institution, its examinations, and other activities regarding the NFID's supervision of the bank.

We performed our audit field work at the OIG offices in Arlington, Virginia.

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

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

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

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

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the 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.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
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)	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, *Prompt Corrective Action*, 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. 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.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The Federal Financial Institutions Examination Council produces the report quarterly, from banks' Call Report data, for use by banking supervisors, bankers, and the general public.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

September 16, 2009

TO: Steven M. Beard
Assistant Inspector General for Material Loss Reviews

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Security Savings Bank, Henderson, Nevada (Assignment No. 2009-031)

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 Security Savings Bank (Security), which failed on February 27, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Audit Report (Report) received on August 28, 2009.

The OIG found that Security failed primarily due to management's pursuit of rapid growth in Acquisition, Development, and Construction (ADC) loans and lower quality mortgage-backed securities, funded with higher cost core deposits and volatile wholesale sources. With the significant real estate price declines in Florida and Nevada, two of Security's primary markets, and general economic downturn that accelerated in 2007, operating losses eroded earnings and capital, straining liquidity to the magnitude that led to capital insolvency and ultimately failure.

The Report concludes that the FDIC and Nevada Department of Business and Industry, Financial Institutions Division (NFID) made specific recommendations and took various supervisory actions related to improving Security's operations as early as 2005. Furthermore, the Report notes that supervision was effective in reducing certain risks through the issuance of an enforcement action following the 2007 examination. This action halted the growth of ADC lending and investments in lower-graded securities. Examiners also identified a significant regulatory violation, resulting from transactions with a previously unreported affiliate, which resulted in the removal of $26 million in loan participations from Security's portfolio, thereby mitigating the ultimate loss to the Deposit Insurance Fund.

A well managed balance sheet, with a diversified asset portfolio, is a sound banking practice. Effective supervision is necessary in the early stages for institutions developing asset concentrations or reliance on volatile funding. DSC has issued updated guidance reminding examiners to take appropriate supervisory action when capital levels are inadequate for CRE concentrations or funding risks are imprudently managed.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
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
FRB	Federal Reserve Board
ILC	Industrial Loan Company
MOU	Memorandum of Understanding
NFID	Nevada Department of Business and Industry, Financial Institutions Division
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institution Rating System