Office of Inspector General

March 2009
Report No. AUD-09-008

Material Loss Review of Silver State Bank, Henderson, Nevada

AUDIT REPORT

Office of Audits

Office of Audits

OIG

Federal Deposit Insurance Corporation

Why We Did The Audit

On September 5, 2008, the Nevada Financial Institutions Division (NFID) closed the Silver State Bank (SSB), Henderson, Nevada, and named the FDIC as receiver. On September 30, 2008, the FDIC notified the Office of Inspector General (OIG) that SSB's total assets at closing were $1.887 billion, with a material loss to the Deposit Insurance Fund (DIF) estimated at $505 million. As of December 31, 2008, the estimated loss to the DIF increased to $553 million. As required by section 38(k) of the Federal Deposit Insurance Act, the OIG conducted a material loss review of the failure of SSB.

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, in order to make recommendations for preventing such loss in the future.

Background

SSB was a state-chartered, nonmember bank that was established and insured on July 1, 1996. SSB was headquartered in Henderson, Nevada. When the bank failed, it operated 17 full-service branches in Nevada and Arizona.

SSB's loan portfolio was concentrated in commercial real estate (CRE) loans, and acquisition, development, and construction (ADC) loans. The FDIC has recognized the increased risk that these loans present to financial institutions and updated and re-emphasized bank guidance in March 2008. In particular, this guidance re-emphasized the importance of strong capital, an adequate allowance for loan and lease losses (ALLL), and robust credit risk management practices. The guidance also re-emphasized the interagency guidance provided to banks in December 2006 that provided a framework for assessing CRE concentrations. The FDIC also updated and re-emphasized CRE loan examination guidance to examiners in July 2008. The guidance focused on examiner understanding of concentrations, market conditions, underwriting and credit risk management, and capital and ALLL adequacy.

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Audit Results

SSB failed primarily due to bank management's high-risk business strategy. SSB pursued aggressive loan growth, concentrating in higher-risk CRE loans, and relied on funding from high-cost and volatile sources. This business strategy, coupled with weak risk management practices and controls, left the bank unprepared and unable to effectively manage operations in a declining economic environment. As loan losses increased, earnings and capital eroded. SSB experienced a severe liquidity crisis as depositors withdrew their funds, and the bank was at significant risk of not being able to meet its obligations when it was closed by the NFID. Specifically:

Management. SSB's board of directors allowed bank management to pursue a high-risk business strategy without adequate risk management practices and controls. Also, two individuals dominated bank management and controlled lending operations, thereby weakening board oversight. In addition, certain compensation arrangements led to loan growth that was based on volume rather than quality. Management failed to effectively implement audit and examination recommendations or to ensure that, as the bank grew, the sophistication of the bank's risk identification and monitoring systems also expanded to effectively identify, measure, monitor, and control bank operations and risks.

Asset Quality. SSB concentrated its lending in higher-risk CRE loans in rapidly growing markets. SSB did not establish appropriate concentration limits or controls to mitigate risk. In addition, SSB had liberal loan underwriting standards, ineffective loan administration procedures, poor loan risk management practices, and an inadequate ALLL. Additionally, the FDIC's Division of Supervision and Consumer Protection (DSC) also noted SSB's inappropriate use and renewal of interest reserves when the underlying real estate projects were not performing as expected.

Liquidity. SSB relied on high-cost volatile sources of funding, such as brokered deposits; time deposits of $100,000 or more; Internet deposits; high-rate core deposits; and Federal Home Loan Bank borrowings to fund asset growth. Due to SSB's pursuit of loan growth and high returns, any available funding source was used to support the bank's growth. Use of these volatile funding sources increased the bank's risk that such sources would be quickly withdrawn in a deteriorating market or if the bank's financial position declined. According to FDIC personnel, it appeared that bank management did not understand the nature or level of risk that they created by using these volatile funding sources.

Supervision. The FDIC could have exercised greater supervisory concern and taken additional action to help prevent the bank's failure and/or to mitigate the potential level of losses incurred. Specifically, although the FDIC identified SSB's loan concentrations and funding sources as potential high-risk areas of concern in examinations completed as early as 2005, the FDIC took limited actions to mitigate the bank's aggregate level of risk exposure. With respect to SSB's CAMELS ratings, DSC assigned SSB a composite 2 rating as recently as the May 2007 examination, and only first identified SSB as a potential supervisory concern during the March 2008 visit to SSB as part of DSC's Commercial Real Estate Lending Visitation Program. DSC did not downgrade the bank's ratings until the following examination in July 2008 – SSB's last examination before the bank failed. Further, aside from placing a Bank Board Resolution in 2005, which included provisions related to CRE loan concentrations, the FDIC did not place any other supervisory or corrective actions on the bank, including PCA directives.

Based on our review of the FDIC's Reports of Examination (ROE) and available corresponding working papers and discussions with FDIC and NFID personnel, we identified several concerns regarding the FDIC's supervision of SSB. Specifically, DSC could have done more to: recognize and/or analyze risk, set a proper tone in the ROEs; appropriately consider risk in CAMELS ratings; ensure that proper controls and risk limitation and/or mitigation strategies were established and appropriately implemented; identify in a timely manner SSB's increasing risk profile, including concentrations in targeted market areas, as a potential concern; and deal assertively with bank management on examination findings and recommendations.

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 SSB and other FDIC-supervised banks at that time, including with regard to implementation of PCA provisions.

Management Response

DSC provided a written response to the draft of this report. DSC generally agreed with the OIG's conclusions regarding the causes of SSB's failure. However, DSC stated that SSB management was receptive to examiner recommendations and identified positive actions that SSB took to improve its operations in response to the 2007 examination. DSC indicated that asset quality deteriorated quickly in 2008. Nonetheless, our view remains that DSC could have exercised greater supervisory concern and taken additional action to address SSB conditions and risks.

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

Office of Audits
Office of Inspector General

DATE: March 30, 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 Silver State Bank, Henderson, Nevada*
(Report No. AUD-09-008)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Silver State Bank (SSB), Henderson, Nevada. On September 5, 2008, the Department of Business and Industry, Financial Institutions Division, State of Nevada (NFID), closed SSB and named the FDIC as receiver. On September 30, 2008, the FDIC notified the OIG that SSB's total assets at closing were $1.887 billion, and the estimated loss to the Deposit Insurance Fund (DIF) was $505 million. As of December 31, 2008, the estimated loss to the DIF increased to $553 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; Appendix 2

[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 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.

contains a glossary of terms; the FDIC's response to the draft of this report is in Appendix 3; and acronyms used in the report are listed in Appendix 4.

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

BACKGROUND

SSB was a state-chartered, nonmember bank established in July 1996 by the NFID and insured by the FDIC effective July 1, 1996. SSB, which was headquartered in Henderson, Nevada:

- had 12 branch offices in Clark County, Nevada; 4 branch offices in Maricopa County, Arizona; and a total of 12 loan production offices in Nevada, California, Washington, Oregon, Utah, Colorado, and Florida;

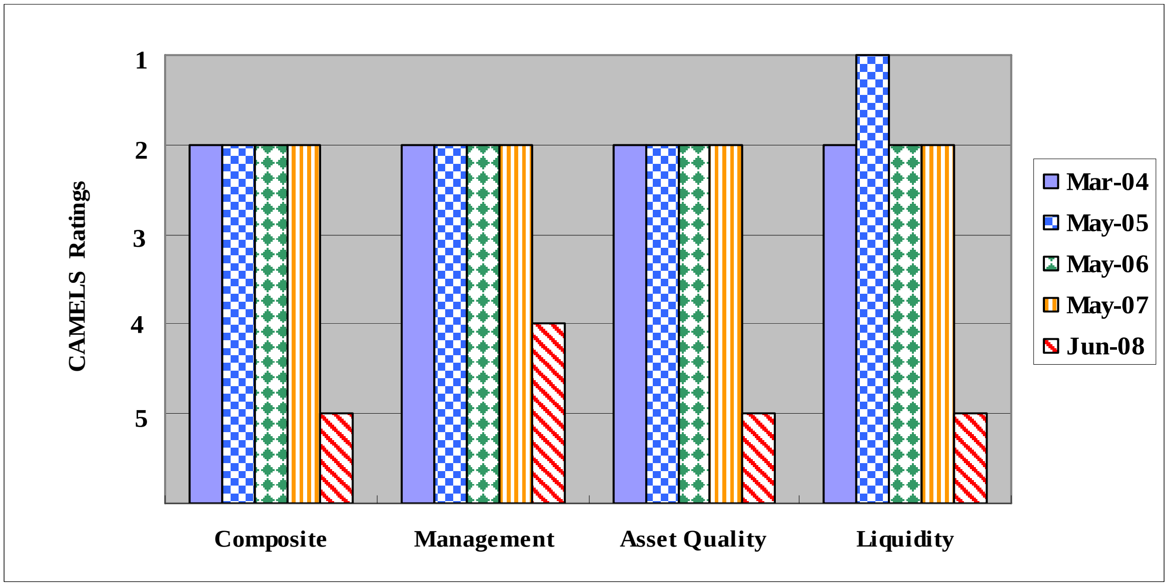
- provided traditional banking activities within its marketplace; and

- specialized in commercial lending, with concentrations in commercial real estate (CRE), including acquisition, development, and construction (ADC) loans.

SSB was wholly owned by its parent holding company, Silver State Bancorp, Henderson, Nevada, which was formed in 1999. SSB was the holding company's major operating entity; however, in September 2006, Silver State Bancorp acquired Choice Bank, Scottsdale, Arizona, a state-charted, nonmember bank. In April 2008, Choice Bank merged with SSB. SSB's local marketplace was, at one time, characterized by rapidly appreciating real estate values. However, real estate values experienced a significant downturn, negatively impacting the real estate construction industry and causing a severe deterioration in SSB's asset quality.

DSC's San Francisco Regional Office and the NFID performed joint safety and soundness examinations of SSB, conducting six examinations from June 2003 through June 2008. Additionally, DSC conducted a visitation in March 2008. At the June 2008 examination, as indicated in the figure that follows, SSB's composite rating was downgraded to 5,[3] indicating extremely unsafe and unsound practices or conditions; critically deficient performance, and inadequate risk management practices. Institutions in this category pose a significant risk to the DIF and have a high probability of failure.

SSB's Key CAMELS Ratings



Source: OIG's analysis of SSB's Reports of Examination (ROE).

To address examination concerns, including apparent violations of laws and regulations and inadequate risk management controls, the NFID and the FDIC requested SSB to adopt a Bank Board Resolution (BBR), which the bank's board of directors (BOD) adopted in August 2005. The BBR included provisions related to the CRE loans, including the following:

- Within 90 days of the adoption of the BBR, the BOD shall develop, adopt, and implement a well-defined business strategy that explicitly acknowledges concentration risk, the need to maintain an adequate capital structure, and a sufficient allowance for loan and lease losses (ALLL). In developing the strategy, the bank should perform an analysis of the potential effect of a downturn in the applicable real estate markets on both profitability and capitalization. The strategy should also include a contingency plan, clearly outlining the possible actions, by segment of the CRE market, that the bank should consider in response to adverse market conditions.

[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.

- Within 120 days of the adoption of the BBR, the BOD shall improve its oversight and monitoring of portfolio concentrations and, specifically, concentrations of a speculative nature. The oversight and monitoring of such concentrations shall include a process for conducting specific stress testing of its CRE portfolio in order to properly quantify the impact of adverse economic scenarios on the quality of the CRE portfolio, and ultimately, its profitability and capital position.

DSC subsequently terminated the BBR in September 2006 after the May 2006 examination, based, in part, on the examiner's conclusion that CRE monitoring had improved. Although the BBR was terminated, as discussed later in the report, these issues were not effectively resolved. In addition, in August 2008, the FDIC drafted a proposed Cease and Desist Order (C&D) to address SSB's deteriorating condition. However, the FDIC did not issue the C&D because the bank failed in September 2008 before the C&D could be placed.

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

Table 1: Financial Condition of SSB

Uniform Bank Performance Report	**June 08**	**Dec 07**	**Dec 06**	**Dec 05**	**Dec 04**
Total Assets ($000s)	$1,957,120	$1,529,629	$1,042,185	$805,487	$700,490
Total Deposits ($000s)	$1,733,091	$1,229,811	$863,838	$646,771	$576,322
Total Loans ($000s)	$1,639,110	$1,420,126	$926,066	$658,459	$532,920
Net Loan & Lease Growth Rate	32.11%	53.23%	40.85%	23.40%	36.43%
Net Income (Loss) ($000s)	($85,740)	$26,424	$22,513	$16,419	$9,269
Loan Mix, % Avg. Gross Loans:					
Total Real Estate Secured Loans	**90.27%**	**88.75%**	**87.97%**	**88.04%**	**85.61%**
Construction & Development (ADC)	66.63%	64.40%	46.72%	30.37%	21.39%
Non-Farm Non-Residential (CRE)	18.67%	20.75%	34.81%	48.15%	53.66%
Multifamily	0.64%	0.72%	2.11%	3.67%	4.90%
1-4 Family Residential – excluding Home Equity Loans	2.34%	0.71%	2.46%	4.69%	5.18%
Home Equity Loans	2.00%	2.16%	1.87%	1.16%	0.47%
Commercial & Industrial Loans	**9.39%**	**10.82%**	**11.39%**	**11.28%**	**13.35%**
Funding:					
Net Non-Core Dependency Ratio	50.23%	49.69%	25.52%	11.01%	9.33%
Examination Date	**June 08**	**May 07**	**May 06**	**May 05**	**Mar 04**
Adv. Classified Items Coverage Ratio	178.59%	20.60%	18.49%	18.53%	29.89%

Source: OIG's analysis of SSB's Uniform Bank Performance Reports (UBPR) and ROEs.

RESULTS IN BRIEF

SSB failed primarily due to bank management's high-risk business strategy. SSB pursued aggressive loan growth, concentrating in higher-risk CRE loans, and, beginning in 2006, became increasingly dependent upon funding from high-cost and volatile sources. This business strategy, coupled with weak risk management practices and controls, left the bank unprepared and unable to effectively manage operations in a declining economic environment. As loan losses increased, earnings and capital eroded. SSB experienced a severe liquidity crisis as depositors withdrew their funds, and the bank was at significant risk of not being able to meet its obligations when it was closed by the NFID. Specifically:

Management. SSB's BOD allowed bank management to pursue a high-risk business strategy without adequate risk management practices and controls. Also two individuals dominated bank management and controlled lending operations, thereby weakening BOD oversight. In addition, certain compensation arrangements led to loan growth that was based on volume rather than quality. Management failed to effectively implement audit and examination recommendations or to ensure that, as the bank grew, the sophistication of the bank's risk identification and monitoring systems also expanded to effectively identify, measure, monitor, and control bank operations and risks.

Asset Quality. SSB concentrated and significantly grew its lending in higher-risk CRE loans in rapidly growing markets. Historically, the bank maintained a significant concentration in higher-risk CRE loans; however, from year end 2005 to year end 2006, SSB significantly altered the bank's loan mix by aggressively growing the ADC loan portfolio. As a result, the bank went from a high-risk CRE loan profile to a higher-risk ADC loan profile. Furthermore, SSB did not establish appropriate concentration limits or controls to mitigate risk. In addition, SSB had liberal loan underwriting standards, ineffective loan administration procedures, poor loan risk management practices, and an inadequate ALLL. In March 2008, when examiners visited SSB as part of DSC's Commercial Real Estate Lending Visitation Program (hereafter, CRE Lending Visitation Program), DSC noted SSB's inappropriate use and renewal of interest reserves when the underlying real estate projects were not performing as expected.

Liquidity. In 2006, SSB became increasingly dependent upon high-cost and volatile sources of funding, such as brokered deposits; time deposits of $100,000 or more; Internet deposits; high-rate core deposits; and Federal Home Loan Bank (FHLB) borrowings to fund asset growth. Use of these volatile funding sources increased the bank's liquidity risk because such funding sources are subject to quick withdrawals in a deteriorating market or a reported decline in the bank's financial position. According to FDIC personnel, it appeared that bank management did not understand the nature or level of risk that they created by using these volatile funding sources.

Supervision. The FDIC could have exercised greater supervisory concern and taken additional action to help prevent the bank's failure and/or to mitigate the potential level of losses incurred. Specifically, the FDIC identified SSB's loan concentrations and funding sources as potential high-risk areas of concern in examinations completed as early as 2005. However, the FDIC took limited actions to mitigate the bank's aggregate level of risk exposure. With respect to DSC's CAMELS ratings, FDIC examiners assigned SSB a composite 2 rating as recently as the May 2007 examination and only first identified SSB as a potential supervisory concern during the March 2008 visit as part of the CRE Lending Visitation Program. Examiners did not downgrade the bank's ratings until the following examination in July 2008–SSB's last examination before the bank failed. Aside from placing a BBR in 2005, which included provisions related to CRE loan concentrations, the FDIC did not place any other supervisory or corrective actions against the bank.

Based on our review of the FDIC's Reports of Examination (ROE) and available corresponding working papers and discussions with FDIC and NFID personnel, we identified several concerns regarding the FDIC's supervision of SSB. Specifically, DSC could have done more to:

- Recognize and/or analyze risk, set a proper tone in the ROEs, or appropriately consider risk in CAMELS ratings.
- Ensure that proper controls and risk limitation and/or mitigation strategies were established and appropriately implemented.
- Identify in a timely manner SSB's increasing risk profile, including concentrations in targeted market areas, as a potential concern.
- Deal assertively with bank management on examination findings and recommendations.

DSC conducted an internal analysis in late 2008 of the supervisory review process related to SSB and concluded that the CAMELS composite rating of 2 assigned at the 2007 examination was appropriate. However, DSC also concluded that the bank's capital and liquidity components should have been rated 3 rather than 2 at the 2007 examination and that the tone of the ROE was not consistent with the bank's risk profile. Specifically, DSC stated in its analysis that "comments in the 2007 examination report could have been much more critical of management's continued push to aggressively grow the CRE portfolio, to a great extent with non-core funding, and when [SSB's] own stress test results were suggesting a downturn in SSB's real estate markets was underway."

MANAGEMENT

Examinations in 2003 through 2007 resulted in a 2 rating for SSB management. At the last full-scope examination, dated June 2008, the rating was downgraded to a 4, indicating deficient BOD and management performance, risk management practices that were inadequate, and excessive risk exposure. By 2008, the examiners determined that the bank's problems and significant risks had not been adequately identified, measured, monitored, or controlled and required immediate action by SSB's BOD and management to preserve the safety and soundness of the institution.

SSB's Management

SSB's management was a key factor in the failure of the institution. Specifically, SSB's BOD created or permitted an environment that included: a high-risk business strategy, operations controlled by two dominant management officials, and weak risk-management practices. Furthermore, SSB management routinely failed to effectively implement audit and examination recommendations and to ensure that, as the bank grew, the sophistication of the bank's risk identification and monitoring systems expanded to effectively identify, measure, monitor, and control bank operations and risks.

High-Risk Business Strategy. SSB management operated the bank under a BOD-approved business operating plan. Nevertheless, SSB management used a high-risk business strategy. This strategy was evident in two primary areas: excessive growth in high-risk lending and a high-risk funding structure. With respect to lending, SSB exhibited uncontrolled growth and high concentrations in the highest-risk CRE products, liberal underwriting strategies, and inappropriate use of interest reserves.[4]

Specifically, based on available Consolidated Reports of Condition and Income (Call Report) data, SSB grew from a $700 million bank in December 2004 to a $2 billion bank in June 2008 (reflecting an approximate 190-percent increase in total assets over a period of 42 months). The total asset growth is even more striking considering the growth in the concentration of risky ADC loans. SSB management grew this category of loans from 21 percent of gross loans and leases in December 2004 to about 67 percent of such loans and leases in June 2008. Further, SSB employed a liberal underwriting strategy that relied mainly on liquidating the underlying loan collateral as opposed to requiring the borrower to provide other sources of repayment. Finally, bank management used interest reserve loans inappropriately for extending lending arrangements and for land loans. (These issues are more fully discussed in the *Asset Quality* section of this report.)

SSB management also employed a high-risk funding structure, which centered on high-cost volatile deposits. With respect to SSB's funding sources, while its core deposits grew from $534 million in December 2004 to $1.3 billion in June 2008 (an increase of 140 percent), its non-core funding grew from $106 million to $1 billion over the same period (an increase of about 882 percent). Such a heavy reliance on non-core deposits to fund asset growth is a risky business strategy because it is generally recognized that such deposits are a more volatile source of funding. (These issues are discussed more fully in the *Liquidity* section of this report.)

Dominant Bank Officials. Two key officials dominated SSB management. Specifically, the President and Chief Executive Officer (CEO) and the Executive Vice President (EVP) for Real Estate Lending controlled lending operations and drove funding

[4] The FDIC's *Supervisory Insights* article titled, *A Primer on the Use of Interest Reserves*, for Summer 2008, states, in part, that "the use of interest reserves in the following situations may not be appropriate…loans on projects that have experienced development or construction delays…or are otherwise not performing according to the original loan agreement and have inadequate collateral support; and loans used to purchase real estate with no immediate or defined plans for development or construction…."

decisions. The CEO founded SSB along with the former bank Chairman who resigned in January 2006. The CEO was not challenged by the BOD concerning the reasonableness of his “vision” for the bank. Moreover, with the assistance of the EVP, the CEO was responsible for SSB’s period of extensive asset growth; 29 percent in 2006 and 47 percent in 2007. Additionally, he changed the focus of the bank’s loan portfolio from CRE lending to higher-risk ADC lending. ADC lending posses a greater level of risk because there is more uncertainty in the eventual repayment of such loans – due to the collateral dependency of the loans and the reliance on the completion and liquidation of the related projects. From 2005 to 2007, SSB’s ADC loan portfolio grew from 30 percent to 64 percent of average gross loans and leases. This increasing concentration in ADC loans is even more significant because total assets were also increasing during this time.

Executive Compensation. A significant portion of the EVP’s compensation was based on loans he originated. In addition to a salary, the EVP, along with his loan officers, received a production-based incentive of 10 percent of any loan origination fees and a 3-percent annual bonus on their average outstanding balances. These compensation arrangements did not emphasize loan quality. Bank management also relied on the EVP to provide economic data and conduct presentations to the BOD related to the economy and real estate market, which limited the objectivity of the information and analysis he presented. According to the June 2008 ROE, it was quite unusual for an executive officer to be paid a commission on the loans he originated. We consider executive compensation 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.

Risk Management Controls. SSB’s weak risk management practices were exhibited in several areas:

- **Systems of Internal Control:** SSB did not ensure that adequate risk management controls were implemented and followed and did not implement corrective actions in a timely manner to adequately address risk management control deficiencies identified by examiners and auditors related to loan documentation, administration, and monitoring. For example, examiners reported in 2008 that internal controls over construction loan funding were weak. During a review of construction loans, examiners determined that almost all of the construction withdrawals were funded without accompanying inspection reports addressing progress on the project. Further, the examiners determined that two loans for constructions of pre-sold homes had been approved and partially funded (approximately $3 million in construction loan withdrawals) even though the bank’s inspection report indicated that no construction on the homes had begun. The bank placed all three loans in a non-accrual status and began foreclosure actions. SSB had established written procedures for the administration of construction loan withdrawals; however, management did not identify the deficiencies due to significant control weaknesses over construction loan withdrawals.

- **Assessment of the Economic Environment:** SSB did not implement a systematic economic review and analytical process that would have been appropriate for the bank's size, complexity, and risk profile. Specifically, SSB did not perform a systematic economic review that utilized key market indicators and that were tied to specific strategic action plans in case of deteriorating conditions. The bank's analysis of the economy appeared to be limited to reviewing various economic reports, forecasts, and articles and discussing economic events and the potential impact the economy could have on the bank's markets.

  Based on the May 2006 examination, examiners noted that the bank did not document its analysis of the economy and recommended that the BOD be provided a periodic written analysis of the general economic, banking, and real estate markets of the bank's trade areas. In addition, examiners recommended that the bank evaluate approved CRE concentration limits in relationship to current and expected market conditions and acceptable risk tolerance levels. However, this recommendation was not effectively implemented. Although bank management monitored and reported on the deterioration in the bank's primary markets and general economy, it took no effective actions to limit or mitigate the potential negative economic effects on the bank.

- **Methodology for Calculating the Bank's ALLL:** SSB's ALLL methodology was inadequate. Specifically SSB management did not establish appropriate loan administration procedures or maintain a sufficient ALLL. For example, in evaluating management's adjustments for environmental factors for the 5-month period ending May 31, 2008, examiners determined that the increases did not adequately reflect the significantly increased risks associated with the level and trend in loan payment delinquencies and the deterioration in local economic and industry conditions. Because the bank's risk management and loan administration practices were inadequate, the BOD was slow to recognize the increasing risk in SSB's loan portfolio and lending program as residential real estate values started to decline.

- **Stress Testing:** As the bank's risk profile grew, management did not implement an adequate stress testing model to identify, measure, monitor, and control risk. In 2008, the significant deterioration of the overall condition of the bank indicated that bank management was not adequately able to quantify the level of risk associated with the business operating plan. For example, although CRE concentrations represented 990 percent of Tier 1 Capital in May 2008, stress testing simulations outlining the current level of the deterioration in real estate values at that time were understated. Specifically, stress testing for the bank's CRE worst-case scenario assumed that values for commercial and residential properties could fall by 35 percent. However, examiners determined that values for commercial and residential properties in the Phoenix and Las Vegas markets had actually fallen 40 to 60 percent. Therefore, SSB's worst-case scenario of a decrease of 35 percent (over an extended period) underestimated the actual deterioration in market value by up to 25 percentage points. In summary, management did not adjust its assumptions and adequately monitor the bank's CRE concentrations to reflect current and expected market conditions.

We consider inadequate risk management controls to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Implementation of Examiner and Auditor Recommendations. SSB management's failure to effectively implement examiner recommendations may have contributed to the severity of the loss to the DIF. Specifically, over several examination cycles, SSB did not effectively implement examiner recommendations related to the bank's repetitive contraventions of the FDIC's Rules and Regulations related to loan-to-value (LTV) limits and policy considerations; lack of loan policies for limits on the use of interest reserves; and failure to identify, measure, and monitor loan concentrations and interest reserves, as follows:

- Bank management failed to comply with the FDIC's Rules and Regulations Part 365, *Real Estate Lending Standards*, Appendix A, *Interagency Guidelines for Real Estate Lending Policy*. In particular, management did not establish a system of controls to adequately ensure that the bank's LTV ratios were correct when underwriting loans. At the June 2008 FDIC examination, examiners identified three loans in which funds were extended to the borrower in excess of the appropriate LTV guideline. The loan officer used the incorrect appraised value to calculate the LTV for these loans. In addition, bank management did not notify the BOD of the exceptions for these loans as required by Part 365. Examiners also identified similar problems associated with the bank's LTV compliance and reporting during the March 2003 and March 2004 examinations. The May 2006 examination determined that bank management failed to establish adequate loan policies and limits for the use of interest reserve loans. Related concerns were also identified at the May 2007 and June 2008 FDIC examinations.

- Examiners reported that SSB was maintaining substantial concentrations in CRE and higher-risk ADC loans. In 2005, the NFID and the FDIC requested SSB to adopt a BBR that contained provisions related to maintaining an adequate capital structure and sufficient ALLL, developing a contingency plan for adverse market conditions, and improving the bank's oversight and monitoring of its concentrations – including stress testing and establishing meaningful concentration limits. However, in subsequent examinations, examiners continued to report concerns with the bank's concentration levels and with the need for management to assess the appropriateness of internal risk limits and to enhance monitoring and reporting practices for concentrations—including stress testing and economic analysis.

- For the 2006, 2007, and 2008 examinations, examiners reported that SSB's interest reserve policy did not address limits on the use of interest reserves and that management had not established a system to monitor the volume of loans being paid with interest reserves. Examiners recommended that management enhance risk identification and monitoring procedures by establishing a system to monitor and report the volume of loans with interest reserves and establish standards or benchmarks to monitor those reserves.

Senior management's failure to address these concerns contributed to the bank's increase in adversely classified loans and, ultimately, to the failure of the bank.

Examiner Concerns and Recommendations Regarding Management

Examiner concerns with SSB's BOD and management were identified as early as January 2002 and continued through June 2008. As summarized in Table 2, which follows, examiners expressed concern about the bank's concentrations in CRE and higher-risk ADC loans, high-loan growth, underwriting and loan administration weaknesses, and apparent violations or contraventions of the FDIC's Rules and Regulations. In addition, the FDIC's ROEs recommended that bank management improve its measuring, monitoring, and reporting of concentrations; internal routines and controls; loan underwriting and administration; and compliance with the FDIC's Rules and Regulations. The ROEs for examinations in 2006 through 2008 also recommended that management improve the monitoring and reporting of its economic environment and the policies and procedures covering interest reserve loans.

Table 2: Examiner Comments and Recommendations Regarding Management

Examiner Comments	Mar 2003	Mar 2004	May 2005	May 2006	May 2007	June 2008
Overall conclusion on BOD and management performance						
• BOD and management are satisfactory/effective	✓	✓	✓	✓	✓	
• Appropriate internal controls are in place	✓	✓	✓	✓	✓	
• Failure to adequately identify, measure, monitor, and control risks						✓
High-Risk Business Strategy						
• Concentrations in higher-risk ADC lending	✓	✓	✓	✓	✓	✓
• Significant loan growth noted – however, not described as uncontrolled	✓	✓	✓			✓
• Weak loan underwriting and administration	✓			✓		✓
• High-risk funding strategy						✓
Risk Management Practices						
• Inadequate system of internal controls						✓
• Weak oversight of economic environment						✓
• Lack of responsiveness to examiner and auditor recommendations						
• Inadequate or enhancement needed for the ALLL methodology	✓	✓				✓
Dominant Management Team						
• CEO and EVP for Real Estate Lending dominated management						✓
• Unusual executive compensation						✓
Compliance with laws and regulations						
• Apparent contravention of Part 365 – Appendix A (related to LTV limits and interest reserve loan standards and limits)	✓	✓		✓	*	✓
• Apparent violation of Part 323 – *Appraisals*	✓	✓		✓		
• Repeat contravention of Part 365 noted		✓				
Examiner recommendations						
• Improve measuring, monitoring, and reporting of concentrations		✓	✓	✓		✓
• Improve monitoring and reporting of economic environment				✓		✓
• Correct violations of laws and regulations (as identified above)	✓	✓		✓		✓
• Improve policies for interest reserve loans				✓	✓	✓
• Improve/enhance loan underwriting and administration	✓	✓		✓		
• Improve internal routines and controls	✓		✓	✓	✓	✓

Source: OIG's analysis of SSB's ROEs.
* Note: ROE comments noted that the bank did not have a system in place to monitor the volume of loans being paid with interest reserves and that management did not establish policies with interest reserve standards or benchmarks to monitor those reserves. However, the examiner did not cite an apparent contravention of Part 365, Appendix A.

Regulatory Supervision Related to Management

Examiners assigned management a 2 rating for examinations in 2002 through 2007. At the June 2008 examination, management was downgraded to a 4 rating. We concluded that the regulatory supervision of SSB could have been improved. The following summarizes the areas in which improvements could have been made:

- **High-risk Business Strategy:** From the March 2003 examination until the final examination in June 2008, examiners noted SSB's concentrations in CRE and higher-risk ADC lending. This strategy was consistently mentioned in the ROEs; however, supervisory action was limited to recommendations for SSB to improve the bank's measuring, monitoring, and reporting of its concentrations in risky lending. Excluding the June 2008 examination, examiners made no recommendations related to limiting concentrations or mitigating the bank's risk by requiring SSB to increase its capital levels. Although SSB's reliance on higher-cost and volatile (higher-risk) funding had been noted in several examinations, only the June 2008 ROE mentioned concern in this area. Examiners could have downgraded capital or liquidity component ratings, recommended specific concentration limits, and/or specified the need for higher capital levels earlier.

- **Dominant Management:** Our discussions with examiners showed that they were aware of the dominant nature of the CEO and EVP for Real Estate Lending; however, dominance was not addressed until the June 2008 ROE. Specifically, the June 2008 ROE noted that two of the bank's controlling shareholders (with 35.5 percent of the holding company's shares) provided "very strong" support to the bank's former CEO. The examiners also reported that the BOD, as a whole, did not sufficiently challenge the reasonableness of the CEO's vision for the bank and that the CEO allowed the EVP for Real Estate Lending unsupervised control of lending operations. As a result, the EVP led the significant growth of the CRE and higher-risk ADC loan portfolio. Based on the bank's risk profile and significant growth strategies, examiners should have shown greater and more-timely supervisory concern regarding the dominance of the bank by two individuals.

- **Compensation:** Examiners did not address any commission-based compensation arrangements until noting in the confidential section[5] of the June 2008 ROE that the EVP was paid a commission on the loans he originated, which the examiners considered an unusual practice. In addition, DSC senior management stated that neither the bank's senior management nor BOD disclosed to examiners that the EVP was receiving a commission, until the 2008 examination. Regardless, examiners should have shown greater and more-timely supervisory concern for the SSB's compensation arrangements.

[5] The confidential section of an ROE is not shared with bank management.

Examination guidance instructs examiners to consider executive compensation arrangements when assessing management. Examiner guidance on assessing bank compensation programs for reasonableness and appropriateness and for ensuring that bank compensation promotes behaviors that are consistent with portfolio objectives and risk tolerances is provided, in part, in the DSC Examination Manual; DSC's *Management and Internal Control Evaluation* Examination Documentation Module; and DSC's Regional Directors Memorandum entitled, *Subprime Lending Examination Procedures* (Transmittal 00-004), dated January 24, 2000. Further, on November 12, 2008, the FDIC issued institution guidance in the form of a Financial Institution Letter (FIL) titled, *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* (FIL-128-2008), which encourages banks to employ compensation structures that encourage prudent lending.

- **Risk Management Practices:** Examiner comments and analysis concerning the bank's economic risk management practices were lacking. Examiners routinely addressed (and responded favorably to) the ROE's *Risk Management Assessment* question, "Are risk management processes adequate in relation to economic conditions and asset concentrations?" However, the examiners' responses typically did not address the bank's economic environment or how the bank planned to respond to a potential deterioration in its key market areas. In the May 2006 and May 2007 ROEs, examiner comments noted that management discusses and monitors the economy and, in response, makes revisions to lending products, strategies, and policies and the ALLL methodology. However, examiners did not identify, as a concern, the bank's lack of a systematic review and analytical process that would have been appropriate for the bank's size, complexity, and risk profile. As noted previously, SSB did not perform a systematic economic review that utilized key market indicators and that were tied to specific strategic action plans in case of deteriorating conditions.

Based on our discussions with examiners, it was apparent that weaknesses in the Phoenix and Las Vegas markets were affecting asset valuations; however, no mention of the economic environment was made in the May 2007 ROE, the year preceding SSB's failure. Furthermore, bank management ignored changing and/or deteriorating economic conditions, and the bank continued to grow even though key market indicators were deteriorating and other financial institutions were scaling back lending. As discussed earlier, examiners could have more fully reviewed and assessed the bank's economic analysis and identified the lack of a systematic and analytical review of the economy.

- **Implementation of Examiner Recommendations:** Generally, SSB promised corrective actions to identified deficiencies, and examiners generally followed up on recommendations at the next examination. However, as shown in Table 2 earlier, the examiners reported the same concerns in several ROEs related to the bank's measuring, monitoring, and reporting of concentrations and the economic environment; correction of apparent violations and contraventions; and improvement of policies and procedures for interest reserve loans, loan underwriting, and loan administration. As a result, examiners did not assertively address examination findings that were repeated areas of concern. Continuing patterns of inadequate management practices should heighten the level of supervisory concern in order to ensure these findings are corrected in a timely manner.

As noted earlier, examiners did not identify the repetitive nature of the bank's noncompliance with the FDIC's Rules and Regulations. Specifically, the March 2003, March 2004, May 2006, and June 2008 ROEs noted concerns regarding apparent contraventions of Appendix A to Part 365 in relation to LTV limitations and interest reserve standards and limits. In addition, examiners cited apparent violations of Part 323, *Appraisals*, in several ROEs, including, for one loan, SSB's failure to provide documentation that an appraisal had been reviewed and was in conformance with regulatory guidelines. Due to the significance and importance of these regulations, greater supervisory emphasis could have been placed on the bank's failure to ensure full compliance.

Overall, we concluded that earlier and more assertive attention to SSB's management would have improved the regulatory supervision of the bank. In particular, when needed, a more progressively stringent supervisory tone was not presented in the ROEs, and actions were not taken.

ASSET QUALITY

Examinations in 2003 through 2007 resulted in a 2 rating for asset quality. DSC's March 2008 CRE Lending Visitation Program showed that SSB's asset quality had progressively worsened, indicating that the bank's level of risk and problem assets were significant and inadequately controlled and subjected the bank to potential losses that threatened the viability of the institution. By the June 2008 examination, examiners rated asset quality a 5, which indicated that SSB's asset quality was critically deficient and presented an imminent threat to the institution's viability.

SSB's Asset Quality

SSB's asset quality was a critical factor that led to the failure of the bank and material loss to the DIF. In particular, SSB's asset quality deteriorated significantly as the real estate market and economy slowed. Within a short period, loan classifications increased, from $17.9 million in May 2007 to over $403 million in June 2008, as shown in Table 3, which follows. The bank's adversely classified items coverage ratio (Adversely Classified Items to Tier 1 Leverage Capital and ALLL) increased from approximately 21 percent to 179 percent. Also, based on a review of the bank's net charge-offs from January 2001 to June 2008, losses were centered in the bank's commercial and residential

ADC loans. During this period, the bank's net charge-offs for ADC loans totaled $39.5 million and represented 89 percent of the bank's net charge-off history.

Table 3: SSB's Loan Classifications and ALLL

	Asset Quality (Dollars in Thousands)					
	Loan Classifications				**Analysis of ALLL**	
Examination Date	**Substandard**	**Doubtful**	**Loss**	**Total Classified Items**	**ALLL Calculated by SSB**	**Increase in ALLL Required by Examiners**
June 08	$384,793	0	$18,260	$403,053	$40,792	$20,208
May 07	$17,929	0	0	$17,929	$11,641	0
May 06	$14,097	0	$1	$14,098	$9,072	0
May 05	$11,571	0	$34	$11,605	$6,650	0

Source: OIG's analysis of SSB's ROEs.

CRE and Higher-Risk ADC Concentrations. SSB's volume of CRE and higher-risk ADC loans constituted a very high-risk lending structure. The bank had always operated with concentrations in CRE and ADC loans; however, the total value and level of these loans began to grow significantly from December 2002 to June 2008. During that period, ADC loans, as a percentage of total capital, grew from approximately 135 percent to 689 percent, as shown in Table 4 below. In addition, the bank's growth in higher-risk ADC lending represented a significant change in the loan mix from CRE and commercial and industrial lending.

Table 4: SSB's Concentrations (Loans and Leases as a Percent of Total Capital)

Period Ended	**ADC (Construction & Development) (%)**	**1-4 Family Residential (%)**	**Commercial Real Estate (%)**	**Commercial and Industrial (%)**
June 08	689.68	68.78	187.92	93.63
Dec 07	524.63	22.13	152.88	74.83
Dec 06	500.17	25.72	192.11	101.26
Dec 05	246.57	49.78	355.47	80.62
Dec 04	236.95	52.49	432.03	101.61
Dec 03	173.64	35.39	514.15	148.53
Dec 02	135.49	19.19	526.66	168.72
Dec 01	130.86	35.70	304.14	145.39

Source: OIG's analysis of SSB's UBPRs.

Interest Reserve Loans. SSB underwrote ADC loans with corresponding interest reserve loans/provisions, which allowed borrowers to fund their interest payments through a borrowing line with the bank. The May 2006 examination addressed the bank's lack of appropriate interest reserve loan policies and controls. In particular, SSB's loan policy did not include standards for the acceptability of, and limits on, the use of interest reserve loans. Furthermore, SSB had not established a system to measure, monitor, and control the volume of loans being underwritten with interest reserves. Based on ROE comments, as of March 31, 2007, approximately 31 percent of the outstanding loan portfolio included interest reserves. Furthermore, during the FDIC's March 2008 visitation, examiners determined that approximately 60 percent of the ADC loans included interest reserves that had not yet been exhausted. The value of such interest reserve loans was over 325 percent of Tier 1 Capital. During the June 2008 examination, examiners determined that SSB was masking the borrowers' inability to meet their repayment obligations and was allowing borrowers to draw on the reserves until they were depleted even if the intended real estate development project had ceased and the primary source of repayment had been affected. In addition, interest reserve loans were being modified and extended to bring potentially delinquent borrowers current. As a result, the bank's use of interest reserve loans was masking the deterioration of the loan portfolio and the bank's earnings.

The FDIC issued FIL-22-2008 on March 17, 2008, titled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. 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 ADC concentrations. This guidance also articulated the FDIC's concern about interest reserves for ADC loans stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

Allowance for Loan and Lease Losses. Given the bank's higher-risk lending structure, liberal underwriting standards, and relaxed loan administration procedures, the bank's ALLL and capital levels appeared to be marginal at best. Historically, SSB's ALLL fluctuated slightly at just above or below the bank's peer group average. As of June 2008, the ALLL had significantly increased to 4.81 percent of total loans and leases. Prior to June 2008, the examiners determined that the ALLL was adequate and justified the allowance by the low level of adverse asset classifications, net losses, and loan portfolio's inherent risk. In June 2008, examiners reported that SSB's ALLL was inadequate and that SSB had not increased the allowance to adequately reflect the significantly increased risks associated with the level and trend in delinquencies and the deterioration in local economic and industry conditions. Additionally, from 2002 to 2007, the period of significant ADC loan growth, the bank's capital levels generally grew, but the total risk-based capital ratio remained below the bank's peer group average. Table 5, which follows, provides details on the bank's ALLL and total risk-based capital ratios in comparison to peer group averages and past-due ratios.

Table 5: SSB's ALLL and Total Risk-Based Capital Ratios

Period Ended	ALLL to Total Loans and Leases			Total Risk-Based Capital to Risk-Weighted Assets			Total Past Due Loans and Leases to Total Loans & Leases (%)
	Bank (%)	Peer (%)	PCT*	Bank (%)	Peer (%)	PCT*	
June 08	4.81	1.35	98	8.86	11.68	1	16.10
Dec 07	1.20	1.22	52	11.33	11.83	53	1.17
Dec 06	1.12	1.16	48	10.67	11.99	18	0.02
Dec 05	1.26	1.22	61	11.87	12.95	45	0.29
Dec 04	1.14	1.27	37	10.53	13.06	13	0.75
Dec 03	1.22	1.36	40	9.47	13.21	0	1.45
Dec 02	1.22	1.38	40	9.58	13.14	1	2.44
Dec 01	1.29	1.35	52	12.53	13.06	56	2.36

Source: OIG's analysis of SSB's UBPRs.
* PCT represents the bank's percentile ranking within the bank's designated peer group average.

Examiner Concerns and Recommendations Regarding Asset Quality

Examiners routinely concluded that SSB's asset quality, ALLL, and capital levels were generally satisfactory until significant concerns were identified at FDIC's March 2008 visitation and June 2008 examination. In addition, since March 2003, examiners routinely reported on the bank's increasing concentration in CRE and higher-risk ADC loans, and examiners made recommendations to improve the identification, measuring, monitoring, and reporting of the concentrations. However, examiners did not make recommendations to limit the level of the concentrations or to mitigate the degree of risk taken by increasing capital levels until the June 2008 examination. Further, the bank's use of interest reserve loans and the lack of appropriate policies and controls over these types of loans were first noted in the May 2006 ROE. However, examiners did not raise significant concerns on how these assets were being used and controlled until the June 2008 examination. Table 6, which follows, shows areas of examiner comments and recommendations related to SSB's asset quality.

Table 6: Examiner Comments and Recommendations Regarding Asset Quality

Examiner Comments	Examination and Visitation Dates						
	Mar 2003	**Mar 2004**	**May 2005**	**May 2006**	**May 2007**	**Mar 2008***	**June 2008**
Overall conclusion on SSB Asset Quality							
• Generally satisfactory	✓	✓	✓	✓	✓		
• Deteriorating loan quality and increasing adverse classifications						✓	✓
• Critically deficient							✓
CRE and ADC concentrations							
• Loan portfolio was concentrated in higher-risk CRE loans	✓	✓	✓	✓	✓	✓	✓
• Concentrations not adequately measured, monitored, and reported			✓	✓		✓	✓
• Economic downturn is impacting the bank's loan portfolio and risk profile						✓	✓
Interest Reserve Loans/Provisions							
• Inadequate policy for interest reserve loans				✓	✓	✓	✓
• Loans masking delinquencies						✓	✓
• Inappropriate underwriting and product utilization							✓
• Inadequate measuring and monitoring systems							✓
Allowance for Loan and Lease Losses and Capital Adequacy							
• Capital was adequate based on PCA capital designation of "Well Capitalized"			✓	✓	✓		
• Inadequate reserve allocation for environmental risk factors							✓
• ALLL methodology needs improvement		✓					✓
• ALLL was inadequate						✓	✓
Assessment of risk management practices							
• Risk management practices are inadequate or need improvement		✓	✓	✓	✓	✓	✓
• Loan documentation and underwriting needed improvement	✓	✓		✓			✓
Examiner recommendations							
• Improve measuring, monitoring, and reporting of concentrations		✓	✓	✓		✓	✓
• Develop CRE Business Strategy Plan			✓				✓
• Improve policies for interest reserve loans				✓	✓		✓
• Improve ALLL methodology		✓					✓

Source: OIG's analysis of SSB's ROEs.
* In March 2008, DSC conducted a visitation as part of its CRE Lending Visitation Program. SSB was included in the visitation program based on a request from the FDIC's Field Office Supervisor.

Regulatory Supervision Related to Asset Quality

SSB's concentrations, use of interest reserve loans, and determinations of ALLL and capital adequacy should have warranted greater supervisory concern long before the bank's asset quality and financial positions began to deteriorate. Furthermore, DSC failed to adequately pursue corrective actions during its examinations of SSB in order to ensure that SSB management corrected repeat deficient practices related to CRE and higher-risk ADC concentrations and the use of interest reserves.

Loan Concentrations. Examiners identified SSB's loan concentrations as a potential high-risk area of concern in examinations completed as early as March 2003. Nonetheless, DSC took limited actions to mitigate the bank's aggregate level of risk exposure. Rather than assessing SSB's aggregate concentration risk, examiners appeared to have placed more emphasis on breaking down the concentration into various categories to demonstrate mitigated risk through apparent diversification. A BBR was adopted in 2005, which included provisions related to the bank's CRE loan concentrations. Specifically, in the BBR, SSB agreed to develop and implement a well-defined business strategy that explicitly acknowledged concentration risk, improve the bank's oversight and monitoring of portfolio concentrations, and conduct a stress test of the loan portfolio. Subsequently, DSC terminated the BBR based on the May 2006 examination view that the bank's CRE concentration monitoring had improved. However, in the May 2006 examination, examiners continued to note deficiencies with the bank's ability to monitor and report on the bank's concentrations. The May 2006 examination also noted that the level of ADC concentrations required continued scrutiny.

Despite repeated assurances by management that it would take corrective actions, no comprehensive action was taken. As a result, the ROEs noted that continued deficiencies existed in the bank's monitoring and reporting processes for concentrations. Given the repetitive nature of the examiners' concerns, examiners could have questioned more closely management's ability to effectively manage its concentrations. Examiners could have presented their findings related to CRE and higher-risk ADC lending concentrations as repeated areas of concern in order to heighten the level of management concern and to encourage action.

Based on our discussions with FDIC and NFID examiners, we concluded that additional supervisory guidance and training may be needed on assessing a bank's concentrations and in formulating recommendations or other supervisory actions that either limit the risks posed by a bank's concentration levels or ensure that other mitigating controls or factors are in place. We consider loan concentrations without adequate risk management controls to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Interest Reserve Loans. SSB had engaged in ADC lending before the March 2003 examination; however, examiners did not express concern regarding the bank's use of interest reserve loans until the May 2006 examination. As a result, it appears that examiners did not identify the bank's lack of appropriate controls to use and track interest reserves until the economy and financial condition of the bank started to deteriorate. Furthermore, at the May 2006 examination, examiners identified the bank's lack of adequate policies and controls in contravention to Part 365, Appendix A, *Interagency Guidelines for Real Estate Lending Policy*. However, examiners did not take assertive corrective action when the bank repeatedly failed to implement appropriate policies and controls – especially given the fact that the use of interest reserves was integral to the bank's main product line of ADC lending. As a result, examiners expressed repeated concerns—but did not identify them as repeated areas of concern—and made recommendations in the ROEs for the May 2007 and June 2008 examinations to amend the bank's loan policy. SSB failed to address the issue in any significant manner, and the bank's continued use of interest reserves masked the deterioration of SSB's loan and earnings performance.

Examiners performed an assessment of the quality of the bank's earnings performance without analyzing the level of interest income that was derived from interest reserve loans. Although the bank may have accounted for the interest income correctly, the borrowers had not made interest payments. As a result, the certainty of the bank's receipt of such interest, through the borrowers' payoff of the loans, was not assured. Examiners could have recast the bank's earnings performance based on the amount of interest income that was actually received and then measured the potential risk to earnings of interest reserves. We consider inadequate controls over the use and reporting of interest reserves to be a significant concern, which we will address in our summary reports covering multiple bank failures.

ALLL and Capital Adequacy. Examiners repeatedly reported that the bank's ALLL and capital levels were adequate. However, the bank and examiners did not note increased concern related to the sufficiency of the ALLL and capital based on the aging and deteriorating economic expansion, changing loan product mix, and significant loan growth in ADC lending. Examiners also did not note increased concern for capital ratios that were consistently maintained at a level that was below their peer group average (by 50 to 374 basis points).

Environmental factors are one of several areas of consideration that examiners review to determine the adequacy of ALLL and capital. The ROEs and examination workpapers provided limited analysis and review of the bank's environmental factors in determining the adequacy of the bank's ALLL and capital levels. Although the bank's ALLL methodology addressed certain environmental factors, examiners did not provide a documented analysis of the adequacy or appropriateness of the bank's environmental factors. Based on our review of the bank's ALLL calculation (as presented in the May 2007 examination workpapers), examiners did not assign risk weights to some factors, or differences to the factors, for variances by product line. Ultimately, bank management is responsible for determining and supporting the appropriateness of the bank's ALLL, and examiners are responsible for reviewing management's methodology for appropriateness. However, examiners typically stated that they found it difficult to review for, and argue against, the reasonableness of a bank's assigned risk weights if a bank had any type of support.

Based on our discussions with FDIC and NFID examiners and senior DSC management, the bank should have been required to maintain a significantly greater level of capital than the level it maintained. For example, the NFID Commissioner stated that the bank's total equity capital ratio should have been significantly higher. Similarly, senior DSC regional management indicated that they now expect banks to maintain more capital based on their risk profile. Furthermore, as previously stated, DSC's internal analysis of its supervision of SSB concluded that the May 2007 examination capital rating should have been a 3 rather than a 2 and that the tone of the ROE was not consistent with the bank's risk profile. DSC's analysis concluded that although a composite 2 rating was appropriate, a 3 rating should have been assigned to capital based on the bank's elevated risk profile and wholesale funding and concentration levels. We consider the determination of capital and ALLL adequacy to be a significant concern, which we will address in our summary reports covering multiple bank failures.

LIQUIDITY

Examinations in 2003 through 2007 resulted in a 1 or 2 rating for liquidity. At the last full-scope examination, dated June 2008, the rating was downgraded to a 5, indicating that SSB's liquidity levels or funds management practices were so critically deficient that the bank's continued viability was threatened. By 2008, examiners determined that the bank required immediate external financial assistance to meet maturing obligations or other liquidity needs.

SSB's Liquidity

Liquidity represents the ability to fund assets and meet obligations as they become due. SSB relied on high-cost sources of funding to support its asset growth. The increased interest expense associated with these funding sources reduced earnings. SSB's volatile liability dependence and lack of available liquidity were key factors in the failure of the institution. Specifically, SSB's BOD utilized a high-risk strategy to fund CRE and higher-risk ADC loans while significantly restricting available liquidity. Furthermore, SSB's BOD did not ensure that prudent operating limits and parameters were established or that sufficient mitigating measures were employed to limit the level of risk taken.

Volatile Liability Dependence. A bank's net non-core dependency ratio indicates the degree to which the bank is relying on non-core/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. SSB's non-core/volatile funds and high-cost deposits represented a significant source of funding for the bank's loan growth. In particular, as early as May 2006, the bank utilized and relied on various volatile funding sources such as deposits concentrated in a few large depositors, Internet deposits, high-rate deposits, and FHLB borrowings. However, the bank's use of brokered deposits, which began in the 4th quarter of 2006, significantly increased after the May 2007 examination. Overall, from December 2005 to June 2008, the bank became increasingly dependent on high-cost and non-core funds, and the bank's associated dependency ratio significantly exceeded its peer group average in December 2007 (see Table 7).

Table 7: SSB's Non-Core Funding Sources and Net Non-Core Dependency Ratios

Period Ended	Non-Core Funding Sources (Dollars in Thousands)			Net Non-Core Dependency Ratios (Percent)	
	Time Deposits of $100,000 or More*	Brokered Deposits	FHLB	SSB	Peer Group
June 08	$415,440	$594,218	$77,000	50.23	33.92
Dec 07	$218,574	$427,281	$84,000	49.69	29.32
Dec 06	$201,451	$190,308	$55,000	25.52	27.27
Dec 05	$80,462	$0	$54,000	11.01	22.29
Dec 04	$42,246	$0	$42,000	9.33	21.30
Dec 03	$61,737	$0	$47,000	22.87	19.93
Dec 02	$47,564	$0	$42,600	28.29	18.39
Dec 01	$40,193	$0	$24,100	17.82	18.14

Source: OIG's analysis of SSB's UBPRs.
* Time deposits of $100,000 or more may include brokered deposits.

SSB became more reliant on core deposits that exhibited "brokered deposit-like" traits due to the interest rates paid for these deposits. The rates SSB paid on its Interest Bearing Deposits and Other Saving Deposits began to increase and significantly exceeded the bank's peer group averages in 2004 and 2005. After 2005, the rates continued to significantly exceed the peer group averages until June 2008. In addition, the bank's cost of deposits was often in the 90th percentile of its peer group average. As a result of SSB's reliance on brokered and other high-rate deposits and borrowings, when the bank's financial condition began to deteriorate, its funding sources began to disappear.

Available Liquidity. From December 2004 through December 2007, SSB's available liquidity began to shrink as the bank funded an elevated level of net loans. In June 2008, SSB's available liquidity subsequently deteriorated beyond its ability to meet its future obligations. The bank experienced a significant outflow of deposits, the bank's FHLB borrowing line was reduced (and fully extended), and unsecured federal funds borrowing lines were closed. In addition, due to the recognition of loan losses, increasing provisions to the ALLL, and increasing non-accrual loans, the bank's liquidity was further strained, and its capital deteriorated to adequately capitalized as of June 2008. As a result, the bank was restricted from accepting and renewing brokered deposits; the interest rates it could pay on certain deposits were also restricted. These circumstances prevented bank management from utilizing its primary funding sources.

In September 2008, before the bank was closed, the bank's available liquidity consisted of cash and "due from" balances totaling $30.4 million, while brokered deposits totaled over $608.5 million. Further, the bank's available secondary sources of liquidity, which totaled $114 million in March 2006 and $74 million in March 2007, were gone. Due to restrictions placed on the bank regarding acceptance or renewal of brokered deposits and limits on interest rates, available liquidity was insufficient to meet funding needs. Bank management was unable to raise additional capital and to sell off its assets without incurring significant losses. Table 8 shows SSB's liquidity ratio in comparison to its peer group average.

Table 8: SSB's Net Loans and Leases to Total Assets Ratio

Period Ended	Net Loans and Leases/Assets (%)	
	SSB	**Peer Group**
June 08	79.72	72.75
Dec 07	91.73	72.12
Dec 06	87.86	71.30
Dec 05	80.71	69.42
Dec 04	75.21	68.28
Dec 03	78.99	65.89
Dec 02	75.50	65.52
Dec 01	57.22	65.71

Source: OIG's analysis of SSB's UBPRs.

Examiner Concerns and Recommendations Regarding Liquidity

From March 2003 to May 2007, examinations consistently determined that the bank's overall liquidity risk management and funding positions were either adequate or strong. However, examinations did not always identify or discuss (individually or in the aggregate) the following potential sources of funding risk:

- deposit concentrations in a few customers,
- Internet deposits,
- high-rate deposits, and
- brokered deposits.

The ROEs identified FHLB borrowings but did not discuss them as a potential source of funding risk. Examiners typically noted the following: management was not dependent on one particular funding source listed above, rates were cheaper than local core deposits, and accounts were monitored. For some examinations, examiners did not make specific mitigating comments. Examiner concerns over SSB's funding positions were first reported at the last examination in June 2008, right before the bank failed. Even though a significant shift toward more volatile funding sources was evident throughout 2007, at the May 2007 examination, examiners did not assertively criticize the bank's funding strategies and level of risk. However, at that examination, examiners did identify the following funding weaknesses:

- **Management did not appropriately identify and report brokered deposits.** Examiners determined that SSB did not accurately report brokered deposits in its March 2007 Call Reports. As a result, the examiners recalculated the net non-core funding ratio, as presented in the UBPR, from 25.4 percent to 44.2 percent. Examiners recommended that the bank amend its December 2006 and March 2007 Call Reports to reflect the accurate level of brokered deposits.

- **Management failed to comply with its approved policy funding limitation.** Examiners provided no recommended action. Subsequently, SSB management increased the bank's policy limitation for the net non-core funding ratio from 25 percent to 40 percent.

- **Management failed to provide adequate wholesale funding strategy guidelines and parameters or limits for various wholesale funding products.** Examiners recommended that bank management expand the bank's policies to address various funding sources (by setting prudent parameters) and to provide funding guidelines for various potential liquidity stress events. Management agreed to revise the bank's Liquidity Risk Policy. However, the revisions made the bank's policies and controls weaker. For example, management eliminated one available liquidity measure, increased the net non-core funding ratio, and established a liberal wholesale funding policy limitation. In particular, the policy allowed the bank to maintain a maximum ratio of 50 percent for wholesale funding sources to total assets. Examiners did not address these policy limitations at the subsequent examination in June 2008 but did report significant deficiencies with the bank's liquidity and net non-core funding dependency positions and contingency liquidity plans.

At the last risk management examination in June 2008, examiners identified significant concerns and criticized the bank's overall liquidity risk management, funding positions, available liquidity, and contingency liquidity plans. The examiners stated that the bank's liquidity position was critically deficient due to a dependence on wholesale funding sources, a low level of available liquidity, the concentration of large depositors, decreasing availability of borrowing sources, the inability to fully implement the bank's contingency liquidity plan, and continued significant loan growth. Furthermore, examiners noted that the bank's Chief Operating Officer did not fully understand the risk of the bank's funding strategies. Examiners made recommendations to (quantifiably) improve the bank's available liquidity and to reduce the bank's dependence on volatile deposits. Management agreed to increase available liquidity by increasing brokered deposits – thereby ignoring the recommendation to reduce volatile deposits.

Table 9, which follows, includes examples of examiner comments and recommendations on liquidity.

Table 9: Examiner Comments and Recommendations Regarding Liquidity

Examiner Comments	Examination Dates					
	Mar 2003	**Mar 2004**	**May 2005**	**May 2006**	**May 2007**	**June 2008**
Overall Conclusions on Liquidity						
• Strong or satisfactory	✓	✓	✓	✓	✓	
• Adequate risk management: identifies, measures, monitors, and controls	✓	✓	✓	✓	✓	
Non-core Funding Sources						
• Overly reliant on potentially volatile funding sources						✓
• Increasing reliance on non-core funding sources	✓				✓	✓
• Internet deposits used as a funding source		✓		✓		✓
• Brokered deposits used as a funding source					✓	✓
• High-rate deposits used as a funding source				✓		
• Deposits concentrated in a few large depositors	✓		✓	✓		✓
• FHLB borrowings used as a funding source	✓	✓	✓	✓		✓
Available Liquidity						
• Critically deficient or declining levels of liquidity						✓
• Low level of available liquidity						✓
Contingency Liquidity Plans						
• Sufficient secondary sources of funds to meet anticipated/unanticipated needs	✓	✓	✓	✓		
• Internet deposits serve as a secondary source of funds	✓					
• Non-pledged U.S. Treasury securities serve as a secondary source of funds			✓	✓		
• Unused borrowing lines serve as a secondary source of funds	✓	✓	✓	✓		
• Inability to fully implement contingency liquidity plans: use of brokered deposits, secured and unsecured borrowing lines, and loan sales						✓
Examiner recommendations						
• Re-establish the bank's *Funding Sources and Uses Report*				✓		
• Expand Liquidity Risk Policy to adequately address wholesale funding strategies, parameters, and risk limits (set prudent parameters for Internet deposits, borrowings, and other wholesale funding strategies)					✓	
• Expand the bank's contingency liquidity plans to include discussions and funding guidelines for various potential liquidity stress events					✓	
• Increase available liquidity, reduce total loans to total assets, develop a plan to significantly reduce the dependence on brokered and Internet deposits						✓

Source: OIG's analysis SSB's ROEs.

Regulatory Supervision Related to Liquidity

Examiners performed an assessment of liquidity at each examination, documented an individual liquidity component rating, and provided an overall conclusion for the adequacy of the bank's liquidity and risk management practices. However, the bank's policies, lack of development and implementation of contingency liquidity plans, and reliance on non-core/potentially volatile funding sources should have warranted greater supervisory concern.

Supervisory Guidance. The DSC Examination Manual states that liquidity is rated based upon, but not limited to, examiner assessment of the following:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets.
- The trend and stability of deposits.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

In addition, the manual states that each institution's liquidity policy should have a contingency plan that addresses alternative funding if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises.

The DSC Examination Manual also states that examiners should recognize that UBPR liquidity ratio analysis might not provide an accurate picture of the institution's liquidity position. Characteristics and behavior of asset and liability accounts should be scrutinized prior to analyzing liquidity ratios. For example, the *UBPR User Guide* defines the types of deposit accounts included in "core deposits." Core deposits are generally considered stable, low-cost funding sources; however, at a particular institution, core deposit account balances might fluctuate significantly or might be more prone to run-off. For example, out-of-area Certificates of Deposit of less than $100,000 that were obtained from an Internet listing service are included in core deposits under the UBPR definition. However, such deposits should not be viewed as a stable funding source.

Bank Policy Parameters and Contingency Liquidity Plans. ROEs for March 2003 through June 2008 and the May 2007 and June 2008 examination workpapers showed that examiners did not thoroughly discuss and/or critique the bank's established operating parameters and contingency liquidity plans before the bank began to experience a liquidity crisis. Examiners concluded on the adequacy of the bank's liquidity risk management; however, only the ROE for the May 2007 examination detailed the bank's policy parameters. In addition, none of the ROEs discussed the long-term feasibility of the bank's business strategy (higher-risk earnings and funding structure) – which relied on volatile deposits to fund CRE and higher-risk ADC loans. The May 2007 examination workpapers provided a copy of the bank's Liquidity Risk Policy and indicated that examiners had assessed the bank's performance relative to the bank's policy limitations, but the examiners did not assess the limitations for reasonableness. For example, the examiners could have compared the limitations to peer group averages, which are shown in Table 10 below.

Table 10: SSB's Policy Limitations in Comparison to Peer Group Averages

	SSB Policy Limitation	**Peer Group Averages** (for the Years Ending December 2003 to December 2007)
Short-Term Investments to Total Assets Ratio	1% or greater	3% to 5%
Available for Sale, Net Pledged, to Total Assets Ratio	5% or greater	Not available
Loans to Deposits Ratio	110% or less	82% to 95%
Net Non-Core Funding Dependence	25% or less	20% to 29%
Brokered Deposits to Total Deposits Ratio	40% or less	2% to 6%

Source: OIG's analysis of DSC's examination workpapers and SSB's UBPRs.

Based on a comparison of SSB's policy limitations to the available peer group averages, the bank's policy parameters were more liberal than the financial positions taken by their peers, except for the bank's net non-core funding dependence ratio, which the bank's BOD increased to 40 percent after the May 2007 examination. In addition, the bank's Liquidity Risk Policy did not provide a detailed discussion of the bank's contingency liquidity plans but did list various alternative sources of funds, such as FHLB advances and brokered deposits. This lack of policy was not criticized until the May 2007 examination. Additionally, the June 2008 ROE contained the only specific policy recommendation that encouraged reducing the bank's volatile liability dependency. The recommendation required the bank to reduce its ratio of brokered and Internet deposits to total deposits to 30 percent or less.

Aggregate Non-core Funding Analysis. Our review of the ROEs from March 2003 through June 2008 and the May 2007 and June 2008 examination workpapers showed that examiners could have better identified the bank's volatile liability dependence, as impacted by Internet deposits, high-rate deposits, concentrations of large depositors, and FHLB borrowings. In addition, examiners could have performed a more comprehensive analysis of the bank's non-core funding dependency by aggregating data and recasting the bank's financial ratios to depict the bank's potential risk level. To ensure a proper understanding of the nature and level of risk, examiners need to perform an appropriate level of analysis. Without this analysis, the potential impact on the bank's financial position is unclear. If this analysis was included, then examiners could have provided a more meaningful depiction of the bank's level of dependency.

Based on our discussions with FDIC and NFID examiners, we identified that additional supervisory guidance and training may be needed in assessing volatile liability dependence and in formulating and pursuing recommendations that ensure appropriate funding policy limitations and contingency liquidity plans are established in a timely manner. This is a significant area of concern, which we will address in our summary reports covering multiple bank failures.

Capital Considerations. The ROEs for examinations completed for March 2003 through June 2008 and the May 2007 and June 2008 examination workpapers relating to capital adequacy contained limited discussion and analysis of the appropriateness of existing capital based on the bank's liquidity and funding risk profile. Neither these ROEs nor workpapers contained a qualitative nor quantitative analysis to indicate that examiners had assessed capital levels based on the level of risk resulting from the bank's funding structure. Examiner comments were limited to the recognition of management's assertions and intentions to maintain a well capitalized designation and did not address environmental factors. The last examination in June 2008 discussed the need to maintain (and exceed) the PCA capital category designation of well capitalized.

IMPLEMENTATION OF PCA

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

The FDIC evaluated SSB's capital position and assigned capital component ratings; however, SSB was not rated as undercapitalized prior to its failure. Therefore, the FDIC did not issue a PCA Directive to SSB. SSB received a capital component rating of 2 for each of the seven examinations conducted from November 2000 to May 2007. The capital component was downgraded to a 4 rating in the June 2008 examination. The reason provided for the downgrade in June 2008 was that the bank's capital adequacy was deficient given the bank's level of deteriorating asset quality and overall high-risk profile.

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. SSB's capital fell into the adequately capitalized category after its operations had begun to deteriorate because of problems related to management, asset quality, and liquidity. In particular, the ALLL was significantly underfunded, which overstated capital and underreported the deterioration of the loan portfolio.

The last UBPR for SSB, as of June 30, 2008, reported the following ratios:

- Tier 1 Leverage Capital 6.56 percent
- Tier 1 Risk-Based Capital 7.57 percent
- Total Risk-Based Capital 8.86 percent

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

CORPORATION COMMENTS AND OIG EVALUATION

On March 25, 2009, the Director, DSC, provided a written response to the draft of this report. DSC's response is presented in its entirety in Appendix 3. In its response, DSC agreed with the OIG's assessment that SSB failed primarily due to bank management's aggressive asset growth strategy concentrated in higher-risk ADC loans coupled with weak risk management practices and controls. It is important to note that we also identified SSB's increasing dependency on non-core funding sources as a contributing factor in its failure.

DSC stated that the 2007 examination of SSB indicated that SSB management had been receptive to examiner recommendations, implemented improved CRE monitoring practices, and adopted portfolio limits by product type. Also, DSC indicated that, during the 2007 examination, SSB developed a report to monitor the volume of loans with interest reserves. DSC further stated that significant developments after the 2007 examination heightened SSB's risk profile, contributing to its ultimate failure. These developments included using new capital and non-core funding to take on additional concentration risk in ADC lending during the same period that its real estate markets softened significantly. DSC indicated that SSB's asset quality deteriorated quickly in 2008, severely eroding capital and leading to its failure and material loss to the DIF.

Nonetheless, our view remains that DSC could have exercised greater supervisory concern in the 2007 and prior examinations regarding SSB's management, asset quality and liquidity and taken additional action to address both the conditions and risks in these areas. We found that bank management did not effectively implement key examiner recommendations over several examination cycles regarding such controls as loan-to-value limits, interest reserve policies, stress testing and establishing meaningful concentration limits, and maintenance of a sufficient ALLL and adequate capital structure. Examiners repeatedly identified some of these areas of concern. Regarding the developments cited by DSC after the 2007 examination, bank management significantly increased reliance on non-core funding, starting in 2006, and had ADC loan concentrations greater than 500 percent that same year in its real estate markets. More important, the risks associated with use of interest reserves absent appropriate policies, liberal underwriting and weak credit administration, poor risk management practices and an insufficient ALLL were identified in examinations prior to 2007 but were not fully addressed by bank management. Although the deterioration in the bank's financial condition was severe in 2008, the underlying risks were evident in the preceding years.

DSC's response further stated that the composite rating at the 2007 examination was determined to be accurate. DSC made this determination as part of its own internal analysis in late 2008. It is important to note that the OIG did not conclude on specific examination ratings. Rather, we evaluated the FDIC's overall supervision of the institution. We found that examiners could have performed additional analyses covering such areas as SSB's asset concentrations and funding strategies, ALLL and capital adequacy, and aggregate non-core funding to further develop areas of risk. Also, DSC's response discusses the post-mortem analysis it performed of its supervision of SSB. This analysis concluded that (1) the composite 2007 examination rating was accurate but that several component ratings should have been lower and (2) the overall tone of the examination report was not consistent with the bank's risk profile. These results are in line with our conclusions regarding the level of supervisory concern exhibited in the 2007 examination and the need for additional supervisory action.

DSC also stated that, in light of the economic deterioration and its impact on SSB and other similarly situated institutions, the division has undertaken a number of initiatives, listed in its response, related to the supervision of such institutions.

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, in order to make recommendations for preventing such loss in the future.

We conducted the audit from September 2008 to March 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 was not feasible to address certain aspects of the standards, as described on the next page.

Scope and Methodology

The scope of this audit included an analysis of SSB's operations, which opened on July 1, 1996, until its failure on September 5, 2008. Our review also entailed an evaluation of the regulatory supervision of the institution over the period 2002 to 2008.

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

- Analyzed examination and visitation reports and examination work papers prepared by the FDIC and the NFID from 2003 to 2008.

- Reviewed the following:

    - Bank data and correspondence maintained at DSC's Phoenix Field Office.

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

    - Records of the bank's external auditor, McGladrey & Pullen, LLP, Las Vegas, Nevada.

    - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C.; San Francisco, California; and Phoenix, Arizona.

  - FDIC examiners from the DSC Phoenix Field Office who participated in SSB examinations.

- Met with officials from the NFID to discuss their historical perspective of the institution, its examinations, state banking laws, and other activities regarding the NFID's supervision of the bank.

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 SSB'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 or 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 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. 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 ROE. 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 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.
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 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), 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: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS

FDIC

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

Division of Supervision and Consumer Protection

March 24, 2009

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

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, *Material Loss Review of Silver State Bank* (Assignment No. 2008-046)

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 Silver State Bank (SSB), Henderson, Nevada, which failed on September 5, 2008. This memorandum represents the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received March 5, 2009.

We agree with the OIG's assessment that SSB failed primarily due to management's aggressive asset growth strategy concentrated in higher-risk acquisition, development, and construction (ADC) loans coupled with weak risk management practices and controls, and we offer the following comments.

The FDIC and the Nevada Financial Institutions Division conducted timely annual examinations of SSB, and risk-focused visits targeting SSB's management of commercial real estate (CRE) concentrations were conducted in 2002 and 2008. An informal enforcement action was entered into following the 2005 examination to address examiner recommendations for improved CRE concentration monitoring. At the 2006 examination, SSB had a plan in place to reduce CRE exposures, and the Board committed not to increase limits. Further, SSB enhanced its monitoring of the existing concentration to incorporate a semi-annual stress test by a third party vendor. The test simulated the potential impact of changing economic conditions on the bank's CRE portfolio. Examiners recommended that SSB further enhance the data used in quarterly and monthly CRE concentration reports. The 2007 examination indicated that, SSB management had been receptive to examiner recommendations, implemented improved CRE monitoring practices and adopted portfolio limits by product type. SSB management developed a report during the 2007 examination to monitor the volume of loans with interest reserves.

As noted in the Draft Report, the composite rating at the 2007 examination was determined to be accurate. We also note that significant developments occurred after the 2007 examination, which heightened SSB's risk profile, contributing to its ultimate failure. SSB management raised new capital after the examination and used the new capital and increased non-core funding to take on additional concentration risk in ADC lending during the same period that its real estate markets softened significantly. Asset quality deteriorated quickly in 2008, severely eroding

SSB's capital and leading to the Bank's failure and a material loss to the Deposit Insurance Fund.

As noted by the OIG, DSC conducted a post-mortem analysis of its supervision of SSB. DSC believes that conducting this type of analysis in tandem with the benefit of the OIG's assessment facilitates the development of incremental improvements to the supervisory process. OIG notes the FDIC has taken special steps to supervise financial institutions that have concentrations in ADC loans and use interest reserves. In light of the economic deterioration and its impact on SSB and other similarly situated institutions, DSC has undertaken a number of initiatives:

- In May 2007, DSC launched a call program for institutions with significant residential construction, subprime mortgage, or other higher-risk lending activities. A goal of the program was to identify problems early and initiate appropriate supervisory responses.

- DSC examiners authored an article entitled *Managing Commercial Real Estate Concentrations* in the Winter 2007 edition of *Supervisory Insights*. This article was prompted by rapid CRE loan growth in the banking industry and elaborates on the authors' field examination experience with the principles set forth in 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, entitled *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 (FIL) on March 17, 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment* (2008 CRE FIL). The 2008 CRE FIL re-emphasizes 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 ADC concentrations. This FIL also articulates the FDIC's concern about the use of interest reserves for ADC 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 ADC lending.

- DSC examiners authored an article entitled *A Primer on the Use of Interest Reserves* in the Summer 2008 edition of *Supervisory Insights*. This article focuses on the use of interest reserves in ADC lending, examines the risks this underwriting practice presents, and reviews regulatory guidance on the use of interest reserves. The article identifies "red flags" that should alert lenders to potential problems at each stage of the ADC cycle and reinforces the importance of evaluating the appropriateness of interest reserves when ADC projects become troubled.

- 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 August 2008, DSC issued a FIL entitled *Liquidity Risk Management*. The FIL provides guidance on the importance of contingency funding plans, pro-forma cashflow analysis, and low probability/high impact event risk. The FIL directs examiners to assess institutions' adherence to the guidance when analyzing liquidity.

- 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.

- In November and December 2008, examiners conducted on-site visitations of certain banks in Georgia, Florida, and California with high ADC concentrations. Ratings were downgraded as appropriate, and corrective programs initiated.

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

ACRONYMS IN THE REPORT

Acronym	**Definition**
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
BOD	Board of Directors
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
C&D	Cease and Desist Order
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
EIC	Examiner-in-Charge
EVP	Executive Vice President
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
LTV	Loan-to-Value
NFID	Department of Business and Industry, Financial Institutions Division, State of Nevada
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SSB	Silver State Bank
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institution Rating System