# Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-005

## Material Loss Review of Westsound Bank, Bremerton, Washington

December 2009

Office of Inspector General

# Executive Summary

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## Why We Did The Audit

On May 8, 2009, the Washington State Department of Financial Institutions (DFI) closed Westsound Bank (Westsound), Bremerton, Washington, and named the FDIC as receiver. On June 5, 2009, the FDIC notified the Office of Inspector General (OIG) that Westsound's total assets at closing were $324.1 million and the estimated loss to the Deposit Insurance Fund (DIF) was $106.2 million. As of November 13, 2009, the estimated loss had increased to $106.4 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Westsound.

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

## Background

Westsound was an FDIC-supervised state nonmember bank that was insured by the FDIC on March 12, 1999. The bank was headquartered in Bremerton, Washington, and had eight branches. Westsound engaged principally in commercial real estate (CRE) and acquisition, development, and construction (ADC) lending within its local market area, which began experiencing an economic downturn in 2007. Westsound was 100-percent owned by the WSB Financial Group, Bremerton, Washington, which was publicly traded.

## Audit Results

### Causes of Failure and Material Loss

Westsound failed because its board of directors (Board) and management did not implement risk management practices commensurate with rapid asset growth and a loan portfolio with significant concentrations in higher-risk ADC loans. Specifically, weak loan underwriting and credit administration practices associated with ADC concentrations became apparent as the local real estate market deteriorated. As loan losses related to the ADC loans were recognized, capital eroded and liquidity became strained. A contributing factor to the losses was an inadequately designed and monitored incentive compensation program under which one bank official generated the vast majority of the poor quality loans. Westsound's viability was also impacted by negative publicity associated with a shareholder lawsuit filed in October 2007, which prompted depositors to leave the bank. The DFI ultimately negotiated a return of the bank's charter with Westsound's Board and management before the bank became critically undercapitalized or experienced a liquidity crisis, and closed the institution on May 8, 2009.

### The FDIC's Supervision of Westsound

The FDIC and DFI provided continuous supervisory oversight of Westsound from the bank's inception in March 1999 until the bank was closed in May 2009. Beginning with the March 2000 examination, examiners consistently identified the increasing concentrations in its ADC and CRE loan portfolios and/or weaknesses in Westsound's loan underwriting and credit administration and made recommendations to address these risks. Not until 2007, however, after looking into allegations regarding lending irregularities, were examiners able to fully determine the financial impact of, and pursue supervisory action to address, the long-standing concentrations and weaknesses. Further, examiners reported concerns and made recommendations regarding Westsound's liquidity management, over three examinations conducted from 2005 to 2007, which bank management did not adequately address. We recognize that the examiners' actions were reasonable at the time, given that financial indicators were satisfactory and management had committed to correcting noted concerns. However, in hindsight, earlier, more aggressive supervisory action to ensure management corrected various deficient lending and liquidity policies and practices and curtailed growth in high-risk loans that contributed to the bank's failure, could have mitigated, to some extent, the losses to the DIF.

With respect to PCA, the FDIC properly implemented applicable PCA provisions of section 38; however, PCA's role in mitigating the losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure. Based on the results of the October 2007 examination, the FDIC issued a Cease and Desist Order (C&D) in March 2008 that included, among other things, a capital provision that directed Westsound to maintain the following capital ratios: (1) Tier 1 Capital of 8 percent, (2) Tier 1 Risk-Based Capital of 10 percent, and (3) Total Risk-Based Capital of 13 percent. Such ratios were greater than the minimum required by PCA for Well Capitalized institutions. As a result of the C&D, Westsound became subject to certain restrictions defined in PCA, including a prohibition on the acceptance, renewal, or rollover of brokered deposits without the FDIC's approval.

## Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On November 30, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

DSC reiterated the OIG's conclusions regarding the causes of Westsound's failure. With regard to our assessment of the FDIC's supervision of Westsound, DSC's response cites several supervisory activities, discussed in our report, that were taken to address key risks in Westsound. DSC's response also states that it has provided guidance reminding examiners to take appropriate action when concentration risks are imprudently managed, and issued guidance on structuring compensation, which directed bank management to develop policies that are aligned with the institution's long-term prudential interests.

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FDIC
Federal Deposit Insurance Corporation
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**DATE:** December 2, 2009

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

/**Signed**/

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

**SUBJECT:** *Material Loss Review of Westsound Bank, Bremerton, Washington* (Report No. MLR-10-005)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the FDIC Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Westsound Bank (Westsound), Bremerton, Washington. The Washington State Department of Financial Institutions (DFI) closed Westsound on May 8, 2009 and named the FDIC as receiver. On June 5, 2009, the FDIC notified the OIG that Westsound's total assets at closing were $324.1 million and the estimated loss to the Deposit Insurance Fund (DIF) was $106.2 million. As of November 13, 2009, the estimated loss was increased to $106.4 million.

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

The objectives of this material loss review were to: (1) determine the causes of Westsound's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of Westsound, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Westsound's failure and the FDIC's efforts to ensure that Westsound's Board of Directors (Board) and

[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.

management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our material loss reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of DSC's supervision program and make recommendations, as warranted. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of key terms; and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

## Background

Westsound was an FDIC-supervised state nonmember bank that was insured on March 12, 1999 in Bremerton, Washington. In addition to its main office, Westsound had eight branch offices. The institution was 100-percent owned by WSB Financial Group, Inc. (WSB), Bremerton, Washington, a publicly-owned, one-bank holding company. Westsound did not have any principal shareholders but had one affiliate. The majority of Westsound's lending was in commercial real estate (CRE), with a significant concentration in acquisition, development, and construction (ADC) loans. Table 1 provides details on Westsound's financial condition as of March 31, 2009 and for the 4 preceding calendar years.

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

| Financial Measure | 03/31/2009 | 12/31/2008 | 12/31/2007 | 12/31/2006 | 12/31/2005 |
|---|---|---|---|---|---|
| Total Assets ($000s) | $334,608 | $364,960 | $489,008 | $385,969 | $250,042 |
| Total Deposits ($000s) | $304,464 | $330,178 | $422,216 | $316,078 | $224,509 |
| Gross Loans & Leases ($000s) | $260,047 | $284,626 | $413,917 | $344,739 | $210,015 |
| Net Income ($000s) | ($4,320) | ($30,940) | ($4,189) | $4,282 | $2,596 |

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

## Causes of Failure and Material Loss

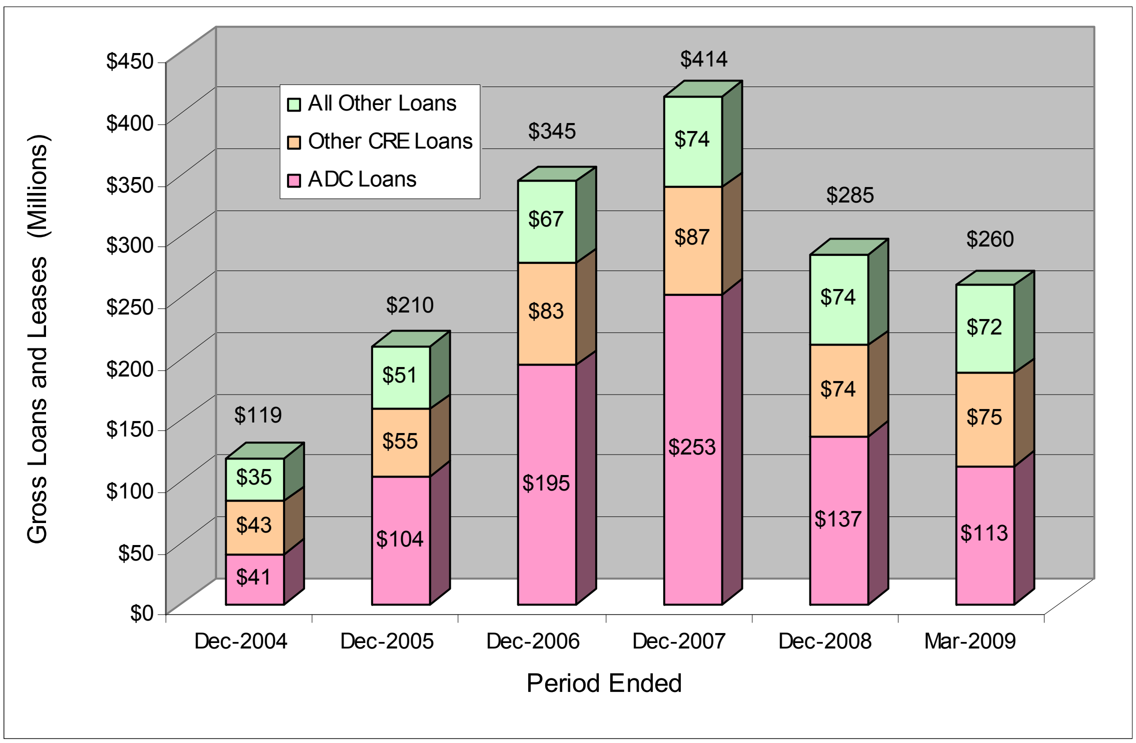
Westsound failed because its Board and management did not implement risk management practices commensurate with rapid asset growth and a loan portfolio with significant concentrations in higher-risk ADC loans. Specifically, weak loan underwriting and credit administration practices associated with ADC concentrations became apparent as the local real estate market deteriorated. As loan losses related to the ADC loans were recognized, capital eroded and liquidity became strained. A contributing factor to the losses was an inadequately designed and monitored incentive compensation program under which one bank official generated the vast majority of the poor quality loans. Westsound's viability was also impacted by negative publicity associated with a shareholder lawsuit filed in October 2007, which prompted depositors to leave the bank. The DFI ultimately negotiated a return of the bank's charter with

Westsound's Board and management before the bank became critically undercapitalized or experienced a liquidity crisis, and closed the institution on May 8, 2009.

**Risk Management Practices Associated with Rapid Growth**

Westsound management aggressively pursued rapid growth in higher risk ADC and CRE lending without implementing and monitoring sound lending practices. Doing so left the bank vulnerable to declining real estate values and imprudent lending activities of its loan officers. From 2001 to 2007, Westsound's assets increased from $32.5 million to $489 million as it grew its loan portfolio predominantly with higher risk ADC and CRE loans. This growth was particularly aggressive in 2004 and 2005 when the bank experienced an average asset growth rate of over 80 percent each year. The figure below illustrates the general composition and growth of Westsound's loan portfolio in the years preceding the institution's failure. As reflected in the figure, concentrations in ADC and other CRE loans were substantial.

**Figure: Composition and Growth of Westsound's Loan Portfolio**




Source: OIG analysis of Call Reports for Westsound.

Examiners reported in the February 2006 Report of Examination (ROE) that the risk profile of the loan portfolio was elevated by rapid growth, high concentrations in ADC and CRE loans, and the large volume of high loan-to-value credits. Examiners also noted that the bank's lending policies had not kept pace with the growth and increasing complexity of the portfolio. Bank management agreed to improve the credit policy, establish and track concentration limits, and improve loan-quality reporting capabilities. However, in February 2007, examiners found that weaknesses in loan administration and risk management still posed a significant concern. Examiners stated that extended absences on the part of key senior management officials who were promoting the bank in anticipation of its 2006 initial public offering (IPO)[3] contributed to the bank's problems. The IPO generated approximately $40 million in capital.

Senior management's extended absences became even more apparent in August 2007, when the FDIC and DFI conducted a visitation to investigate claims raised by two members of the community regarding lending irregularities at one of the bank's branches. Examiners found that management oversight and supervision were deficient and risk management practices were inadequate given the nature of the institution's operations.

Based on the issues identified at the August 2007 visitation, FDIC and DFI officials scheduled an examination for October 2007. At the October 2007 examination, Westsound's asset quality had significantly deteriorated with adversely classified assets representing 191 percent of the total of Tier 1 Capital and the allowance for loan and lease losses (ALLL). Examiners attributed the asset quality deterioration to inadequate Board oversight and supervision over ADC lending, particularly at one of the bank's branches, where one loan officer originated the majority of the adversely classified ADC loans.

Examiners also faulted Westsound's Board and management strategy of generating loan volume while over-relying on collateral and a continued strong Seattle-area real estate market, instead of implementing prudent lending practices. As the real estate market began to deteriorate in 2007, Westsound was unable to sell its problem loans at face value, which led to continuing declines in liquidity and capital.

### ADC and CRE Loan Concentrations

Westsound's management failed to effectively measure and monitor the higher risk in concentrating the bank's loan portfolio in ADC and CRE lending. From 2001 to 2007, the percentage of ADC and CRE loans was increasing, compounding the bank's risk. As Table 2 shows, during this period, Westsound ranked higher than almost all banks in its peer group with respect to ADC loans as a percent of total capital and as a percent of total loans.

**Table 2: Westsound's ADC Concentrations Compared to Peers**

| Period Ended | ADC Loans as a Percent of Total Capital | | | ADC Loans as a Percent of Total Loans | | |
|---|---|---|---|---|---|---|
| | Westsound | Peers | Westsound Percentile | Westsound | Peers | Westsound Percentile |
| Dec 2004 | 289.50 | 80.62 | 95 | 34.66 | 11.14 | 95 |
| Dec 2005 | 393.74 | 91.09 | 98 | 49.41 | 12.81 | 98 |
| Dec 2006 | 269.34 | 117.39 | 89 | 56.57 | 18.83 | 98 |
| Dec 2007 | 368.21 | 123.60 | 95 | 61.31 | 16.49 | 99 |
| Dec 2008 | 377.61 | 111.07 | 96 | 48.36 | 14.47 | 98 |

Source: UBPR data for Westsound.

[3] An IPO is a corporation's first offer to sell stock to the public.

The FDIC's December 2006 guidance entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, recognizes that there are substantial risks posed by CRE concentrations, and in particular ADC concentrations. Such risks include unanticipated earnings and capital volatility during a sustained downturn in the real estate market. The guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land development, and other land representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. Due to the risks associated with CRE and ADC lending, regulators consider institutions with significant CRE and ADC concentrations to be of greater supervisory concern.

Prior to 2006, examiners did not express concern with Westsound's loan concentrations and noted that the level of adversely classified items was low. At the 2006 examination, they reported that asset quality was satisfactory, as evidenced by the low levels of adverse classifications and past due loans. However, given the bank's elevated risk profile due to high ADC loan concentrations, examiners recommended improvements to risk management processes in relation to economic conditions and asset concentrations.

The poor quality of many of the ADC and CRE loans began to manifest itself when loan classifications increased from $128,000 in December 2005, to nearly $10.9 million in December 2006, and to $144.5 million by September 2007. Examiners commented in the October 2007 ROE that the concentrations in ADC and CRE lending far exceeded regulatory thresholds, concentration monitoring did not comply with regulatory guidance, and adversely classified assets had increased to an unacceptable level at 191 percent of the total of the institution's Tier 1 Capital and the ALLL, compared to 15 percent at the February 2007 examination. Examiners also noted in the October 2007 ROE that 83 percent of the loans and contingent liabilities classified substandard were attributed to loans originating at one of the bank's branches and the ALLL needed to be increased by $13.3 million.

In August 2008, examiners found that the bank's poor asset quality threatened its viability, as the volume of items subject to adverse classification rose to a crippling 226 percent of the total of Tier 1 Leverage Capital and the ALLL. Delinquent loans represented 41 percent of gross loans and nonaccrual loans represented 30 percent of total loans. Seventy-nine percent of the loans subject to adverse classifications were ADC loans originating out of the branch discussed above. As discussed in the next sections, the risks associated with Westsound's loan concentrations were the result of weak loan underwriting and credit administration practices and an excessive compensation program.

### Loan Underwriting and Credit Administration Practices

Westsound's Board and management did not implement sound loan underwriting and credit administration practices, which contributed to the asset quality problems that developed in the institution's loan portfolio as the bank's local real estate market began to deteriorate in 2007.

For FDIC-supervised institutions, Part 365 of the FDIC Rules and Regulations requires each institution to adopt and maintain written real estate lending policies that are consistent with sound lending principles, appropriate for the size of the institution and the nature and scope of its operations. Within these general parameters, the regulation specifically requires an institution to establish policies that include:

- portfolio diversification standards;
- prudent underwriting standards, including loan-to-value limits;
- loan administration procedures;
- documentation, approval, and reporting requirements; and
- procedures for monitoring real estate markets within the institution's lending area.

As early as the March 2000 examination, examiners began raising concerns about Westsound's credit administration practices, in particular, loan documentation deficiencies and inconsistencies in the loan policy. The next several examinations concluded that Westsound had overall satisfactory credit quality and practices but included recommendations to enhance practices in this area. Specifically, in 2002, examiners cited the need for additional improvement in loan underwriting. In 2003, examiners recommended that management improve debt service analysis for income property loans and real estate collateral valuations. At the 2005 examination, examiners again recommended that management improve debt service analysis for income property loans.

Further, the February 2006, February 2007, and October 2007 ROEs cited numerous concerns regarding loan underwriting and credit administration, which included inadequate:

- loan policies,
- concentration risk management practices,
- monitoring and control over loan disbursements,
- risk management practices related to collecting and analyzing borrowers' financial information, and
- ALLL methodology.

The October 2008 ROE stated that management had made improvements to enhance credit administration practices but improvement was still needed in the areas of: implementing recommendations from the previous examination regarding improving the loan policy, completing problem asset servicing reports, and employing experienced lending staff.

### Incentive Compensation Program

Westsound's management did not adequately design and oversee its incentive compensation program, which led to a significant volume of adversely classified loans being generated by one of the bank's officials. The program provided incentive compensation based on loan production without any consideration of asset quality and included incentives for renewals and extensions of loans that failed to pay off at maturity.

On November 12, 2008, an *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* (FIL-128-2008) included guidance on structuring compensation.[4] Specifically, the guidance states that poorly-designed management compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization. Management compensation policies should be aligned with the long-term prudential interests of the institution; provide appropriate incentives for safe and sound behavior; and structure compensation to prevent short-term payments for transactions with long-term horizons.

At the October 2007 joint FDIC/DFI examination, examiners attributed the precipitous decline in the institution's financial condition to one bank official, who received over $1.2 million in total compensation from 2005 to 2007, as shown in Table 3, for generating construction loans. Of these loans, approximately 83 percent were adversely classified and were mainly responsible for the additional $13.3 million needed to restore the ALLL to an adequate level.

**Table 3: Westsound Official's Compensation**

| Year | Salary | Incentive Compensation | Total Compensation |
|---|---|---|---|
| 2005 (6 months) | $30,000 | $45,211 | $75,211 |
| 2006 (12 months) | $60,000 | $459,267 | $519,267 |
| 2007 (7 months) | $35,000 | $572,691 | $607,691 |
| Total (25 months) | $125,000 | $1,077,169 | $1,202,169 |

Source: October 2007 ROE for Westsound.

## The FDIC's Supervision of Westsound Bank

The FDIC and DFI provided continuous supervisory oversight of Westsound from the bank's inception in March 1999 until the bank was closed in May 2009. Beginning with the March 2000 examination, examiners consistently identified the increasing concentrations in its ADC and CRE loan portfolios and/or weaknesses in Westsound's loan underwriting and credit administration and made recommendations to address these risks. Not until 2007, however, after looking into allegations regarding lending irregularities, were examiners able to fully determine the financial impact of, and pursue supervisory action to address, the long-standing concentrations and weaknesses. Further, examiners reported concerns and made recommendations regarding Westsound's liquidity management, over three examinations conducted from 2005 to 2007, which bank management did not adequately address. We recognize that the examiners' actions were reasonable at the time, given that financial indicators were satisfactory and management had committed to correcting noted concerns. However, in hindsight, earlier,

[4] The policy was not in place at the time Westsound designed its compensation program but illustrates that banks should review compensation policies to ensure they are consistent with the longer-run objectives of the organization and sound lending and risk management practices.

more aggressive supervisory action to ensure management corrected various deficient lending and liquidity policies and practices and curtailed growth in high-risk loans that contributed to the bank's failure, could have mitigated, to some extent, the losses to the DIF.

### Supervisory History

From October 1999 through August 2008, the FDIC and the DFI conducted nine safety and soundness examinations and three visitations of Westsound. From April 2001 through February 2007, the bank consistently received a composite "2" CAMELS rating.[5] The bank's ratings declined precipitously in subsequent examinations. With respect to informal and formal corrective actions, Westsound's management agreed to adopt a Bank Board Resolution (BBR) after the February 2007 examination and stipulated to a Cease and Desist Order (C&D) after the October 2007 examination. Table 4 summarizes Westsound's supervisory history.

**Table 4: Westsound's Supervisory History, 1999-2008**

| Examination Start Date | Agency | Supervisory Ratings (UFIRS) | Supervisory Action |
|---|---|---|---|
| 08/25/2008 | FDIC/DFI | 454542/5 | Institution closed on 5/08/2009. |
| 10/01/2007 | FDIC/DFI | 344442/4 | C&D issued on 3/10/2008. |
| 08/06/2007 | FDIC/DFI Visitation | No Ratings Assigned | None. |
| 02/20/2007 | DFI | 123222/2 | BBR adopted on 5/16/2007. |
| 02/13/2006 | FDIC | 222222/2 | None. |
| 01/05/2005 | DFI | 222222/2 | Supervisory Directive related to Information Technology (IT) adopted on 2/15/2005. BBR regarding IT adopted on 2/21/2006. |
| 07/21/2003 | FDIC | 222222/2 | None. |
| 02/19/2002 | FDIC | 222222/2 | None. |
| 04/09/2001 | FDIC/DFI | 223322/2 | None. |
| 10/05/2000 | FDIC Visitation | 223322/3 | None. |
| 03/13/2000 | DFI | 223332/3 | Supervisory Directive issued on 4/18/2000. |
| 10/25/1999 | FDIC Visitation | 223222/2 | None. |

Source: FDIC ViSION system and ROEs for Westsound.

Although Westsound received a composite "2" CAMELS rating for the February 2007 examination, DFI downgraded management to a "3" because of significant risks posed by weak underwriting and credit administration practices and encouraged the Board to adopt a BBR effective May 2007. In July 2007, as previously mentioned, two members of the

[5] 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.

community informed the DFI about lending irregularities at one of the bank's branches, and the FDIC and DFI conducted a joint visitation in August 2007 to investigate. The visitation revealed significant asset quality problems, and a full-scope examination was accelerated to October 2007.

As a result of the significant deterioration in Westsound's condition found during the October 2007 examination, the FDIC and the DFI downgraded the bank to a composite "4" CAMELS rating and issued a C&D on March 10, 2008 to address unsafe and unsound practices. The order required the institution to, among other things, increase Board and management oversight, adopt an adequate employee compensation plan, develop a plan to reduce adversely classified and criticized assets, and maintain minimum capital ratios. The order also restricted the institution from soliciting, retaining, or rolling over brokered deposits without a waiver. Also, after the October 2007 examination, the FDIC placed the bank on daily liquidity monitoring, which continued until the bank was closed.

A final examination, conducted in August 2008, found that the bank's condition had further deteriorated since October 2007, resulting in a downgrade of the bank to a composite "5" CAMELS rating. Examiners stated that bank management had made efforts to comply with the C&D but that continued efforts were needed going forward to, in particular, ensure compliance with the brokered deposit provision. Following the August 2008 examination, the FDIC remained concerned about the bank's liquidity given the shareholder lawsuits and negative publicity.

## Supervisory Concerns and Actions

### 2006 Examination

In addition to significant weaknesses identified in the bank's loan administration and credit underwriting practices, the February 2006 ROE noted that the lending policies and practices had not kept pace with the growth and increasing complexity of the bank's loan portfolio; portfolio concentration limits were not in place; adherence to the existing land loan concentration and diversification limits had not been tracked and reported; the ALLL analysis should be enhanced; and ADC and CRE concentrations were 633 percent and 232 percent of Tier 1 Capital, respectively. Examiners, however, stated that the Board satisfactorily oversaw the affairs of the bank and adapted to changing conditions and consequently gave management a component rating of "2." Further, examiners gave the asset quality component a "2" rating and did not recommend that the bank diversify its loan portfolio.

The Chairman of the Board provided a response to the FDIC on April 17, 2006, which contained a 54-point plan of action to address the recommendations. FDIC officials told us that the bank's response was deemed sufficient, so there was no follow-up until the next examination. Notwithstanding the response, the risks identified in the 2006 ROE seem to be in contrast with the broader definition of a "2" rating for the management and asset quality components, which indicate that (1) bank management is satisfactory with respect to risk management practices relative to the institution's size, complexity, and risk profile and (2) weaknesses in asset quality and credit administration practices warrant a limited level of supervisory attention.

Although bank management agreed to implement corrective action to address the concerns identified in the 2006 examination, Westsound continued to engage in risky lending practices. Specifically, after the 2006 examination:

- Loans increased by over $96 million for the last three quarters of 2006 and by $85 million during the first three quarters of 2007.
- Concentrations of ADC and CRE loans as a percentage of total loans continued to increase in 2006 through the third quarter of 2007.
- Adverse loan classifications grew from $128,000 in December 2005 to nearly $10.9 million in December 2006, and to $144 million by the October 2007 examination.

Further, in addition to Westsound's risky lending practices, its reliance on brokered deposits increased by over $9 million during the last three quarters of 2006 and by over $17 million during the first three quarters of 2007.

Of significance is the fact that the Board focused on raising additional capital to fund loan growth in 2006 and was able to raise an additional $40 million via an IPO. Examiners had commented in the February 2006 ROE that Westsound's growth had been adequately accommodated by new stock issuances in 2003 and 2004 and $7.9 million in trust-preferred securities in 2005, and that if growth exceeded the 2006 budget pace, additional capital may be required. In the February 2007 ROE, examiners noted that (1) asset quality was satisfactory as a result of the $40 million capital injection and (2) management had demonstrated its ability to raise capital and could do so again if necessary. In hindsight, regulators may have placed too much reliance on bank management's ability to raise capital rather than focusing on the increased risk posed by rapid growth in the higher-risk ADC and CRE loan portfolios.

In hindsight, consideration of a downgrade in the management and asset quality ratings and related supervisory action in 2006 might have curtailed the Board's pursuit of growth at the expense of sound lending practices and prompted the Board to correct the deficiencies, strengthen the bank's loan portfolio, and be in an improved position when the real estate market started its decline in 2007.

Incentive Compensation Program

The FDIC identified the need to review Westsound's incentive compensation program in its pre-examination planning memorandum for the 2006 examination and conducted a limited review of the program. However, we identified key documents in the 2006 examination work papers that should have elevated the FDIC's concern regarding the program and prompted a more thorough analysis. Specifically,

- The profit/loss statement showed that the bank had paid out over $817,000 in loan commissions in 2004, and over $1.8 million in loan commissions in 2005.
- One bank official produced approximately 83 percent of loans for one of the branches from September 2005 through December 2005 and over 92 percent of loans in January 2006. As discussed earlier, these loans were identified as the primary cause of the deterioration in asset quality.

Although the amount of commissions paid in 2005 should have warranted greater supervisory concern and review at the 2006 examination, at the time, DSC's focus was on excessive Board compensation. Further, DSC officials noted that the extent of commissions paid did not, in and of themselves, seem inconsistent with an active mortgage banking operation like that of Westsound.

On November 12, 2008, the Department of the Treasury, the FDIC, and the Federal Reserve jointly issued FIL-128-2008, entitled *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*. The FIL was issued to provide guidance to banking organizations for ensuring the adequacy of their capital base, engaging in appropriate loss mitigation strategies and foreclosure prevention, and reassessing the incentive implications of their compensation policies. Specifically, compensation policies should:

- be aligned with the long-term prudential interests of the institution,
- provide appropriate incentives for safe and sound behavior,
- structure compensation to prevent short-term payments for transactions with long-term horizons, and
- balance the ongoing earnings capacity and financial resources of the banking organization.

### Liquidity

From the April 2001 through the February 2007 examinations, Westsound's liquidity component was rated a "2." At the 2006 examination, however, examiners noted that the bank had funded most of its liquidity needs by offering the highest rates in the nation for money market accounts and considered these deposits as core deposits. At year-end 2006, Westsound's net interest margin had declined due to expensive Certificates of Deposit specials that reached 6 percent. The bank's high cost of funds also impacted its net interest income in that the bank's liability structure was largely comprised of time deposits. The high interest rates the bank paid on these time deposits could have been considered volatile and, therefore, the time deposits would have increased the bank's net non-core dependency ratio.

DFI examiners stated in February 2007 that Westsound was operating outside of its primary liquidity and dependency limits for much of 2006. Examiners recommended that the Board enhance the contingency liquidity plan (CLP) to include the identification of the risk of a liquidity crisis, triggers and indicators of a liquidity crisis, and available contingent funding sources.

The October 2007 examination noted that liquidity was deemed deficient and management might not be able to meet liquidity needs. Examiners further stated that Westsound was unable to secure any lines of credit or borrow from the Federal Home Loan Bank due to the bank's financial condition. In light of increasing volatile deposits, depositors would most likely continue to leave the bank since it could no longer pay above market rates, and a significant amount of maturing brokered deposits could not be renewed.

FDIC officials told us during interviews that they were very concerned about Westsound's liquidity and had placed the bank on daily liquidity monitoring after the October 2007 examination. As shown in Table 5, Westsound's brokered deposits initially decreased after the C&D was issued in March 2008.

**Table 5: Westsound's Brokered Deposits History, 2007-2009**

| Date | Amount |
|---|---|
| 06/30/07 | $37,792,000 |
| 09/30/07 | $38,214,000 |
| 12/30/07 | $65,149,000 |
| 03/31/08 | $57,556,000 |
| 06/30/08 | $30,313,000 |
| 09/30/08 | $28,139,000 |
| 12/31/08 | $55,212,000 |
| 03/31/09 | $46,837,000 |

Source: UBPRs for Westsound.

It should be noted that the increase in brokered deposits during the latter part of 2008 was primarily due to Westsound's reclassification of high-rate deposits as brokered deposits, at the insistence of the FDIC. This reclassification came about as a result of an investigation by the FDIC of rates being paid by the bank.

Our review of Westsound's May 2007 and July 2008 CLPs found that the bank's plans did not address many criteria suggested in the FDIC's Examination Manual, such as a periodic review of the bank's deposit structure, a method for computing the bank's cost of funds, ensuring an independent and periodic review of the liquidity management process, and a process for measuring and monitoring liquidity. The July 2008 CLP provided a more detailed plan for the use of brokered deposits even though the bank had been precluded from accepting, renewing, or rolling over brokered deposits per the March 2008 C&D.

In March 2009, 2 months prior to Westsound's failure, The FDIC issued additional guidance related to liquidity (FIL-13-2009) entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*, which informed financial institutions that the FDIC monitors "1"- and "2"-rated institutions to identify characteristics that may indicate a heightened risk of future problems. The guidance notes that aggressive growth strategies or reliance on non-core liabilities to fund riskier assets will result in heightened off-site monitoring and on-site examinations that are more extensive than those applicable to other institutions and may result in higher deposit insurance premiums.

An FDIC official told us that the Corporation has changed the way brokered deposit restrictions are handled. The FDIC now issues a letter to the bank requesting that the bank refrain from using brokered deposits as a funding source, particularly when the FDIC knows the bank will be placed under a C&D that will trigger Part 337.6 of the FDIC Rules and Regulations, which restricts the use of brokered funds.

Examiners recognized the risk in the weakness of the bank's asset and liability policy as early as January 2005. Examiners recommended updates to this policy and the CLP in the January 2005, February 2007, October 2007, June 2008, and August 2008 ROEs. Bank management failed to appropriately and effectively implement these recommendations, which caused an increased strain on liquidity. Had Westsound implemented these recommendations earlier, its liquidity might not have been as tenuous. Further, had the FDIC been more forceful with these recommendations before specific liquidity ratios were mandated in the March 2008 C&D, the bank might have been more proactive in updating this policy, and thus better prepared for the liquidity crisis it eventually experienced as a result of the significant and continuing decline in asset quality.

### 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. Part 325 of the FDIC's Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. However, in the case of Westsound, PCA's role in mitigating losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure.

Based on the results of the October 2007 examination, the FDIC issued a C&D in March 2008 that included, among other things, a capital provision that directed Westsound to maintain the following capital ratios: (1) Tier 1 Capital of 8 percent, (2) Tier 1 Risk-Based Capital of 10 percent, and (3) Total Risk-Based Capital of 13 percent. Such ratios were greater than the minimum required by PCA for Well Capitalized institutions, as shown in Table 6 below. As a result of the C&D, Westsound became subject to certain restrictions defined in PCA, including a prohibition on the acceptance, renewal, or rollover of brokered deposits without a waiver approval from the FDIC. Although, according to the FDIC, the bank never formally applied for a waiver, examiners found during the August 2008 examination that the bank had apparently violated the C&D by offering deposits that exceeded a market average by more than 75 basis points. The FDIC required Westsound to identify and reclassify those deposits as brokered deposits and to amend any Call Reports the bank had filed to include the brokered deposits.

As shown in Table 6, Westsound's capital ratios met the PCA definitions of Well Capitalized until it was closed. Nevertheless, increasing losses in the loan portfolio were rapidly depleting capital.

**Table 6: Westsound's Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions**

| Capital Ratio | Well Capitalized Threshold | October 2007 Examination | August 2008 Examination | March 2009 Call Report |
|---|---|---|---|---|
| Tier 1 Leverage Capital | 5% or more | 13.52% | 9.73% | 8.02% |
| Tier 1 Risk-Based Capital | 6% or more | 14.25% | 13.53% | 9.64% |
| Total Risk-Based Capital | 10% or more | 15.54% | 14.82% | 10.93% |

Source: OIG Analysis of UBPRs and the August 2008 ROE for Westsound, as well as Section 38 of the FDI Act and 57 Federal Register 44866-01.

## Corporation Comments

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On November 30, 2009, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

DSC reiterated the OIG's conclusions regarding the causes of Westsound's failure. With regard to our assessment of the FDIC's supervision of Westsound, DSC's response cites several supervisory activities, discussed in our report, that were taken to address key risks in Westsound. DSC's response also states that it has provided guidance reminding examiners to take appropriate action when concentration risks are imprudently managed, and issued guidance on structuring compensation, which directed bank management to develop policies that are aligned with the institution's long-term prudential interests.

# Objectives, Scope, and Methodology

## Objectives

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

The objectives of this material loss review were to: (1) determine the causes of Westsound Bank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Westsound, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

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

## Scope and Methodology

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

- Analyzed examination and visitation reports prepared by the FDIC and the DFI from 2000 to 2008.

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

- Reviewed the following:

  - Bank data contained in UBPRs and Call Reports.
  - Correspondence maintained at the DSC's San Francisco Regional Office and Seattle Field Office.
  - Reports prepared by the Division of Resolutions and Receiverships and DSC relating to the bank's closure.
  - Pertinent DSC policies and procedures.

## Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:

  - DSC management in San Francisco, California, and Seattle, Washington.
  - FDIC examiners from the DSC Seattle Field Office who participated in Westsound examinations.

- Interviewed DFI officials from Tacoma, Washington, to discuss their historical perspective of the institution, its examinations, and other activities regarding the DFI's supervision of the bank.

We performed our audit field work at OIG offices in Arlington, Virginia, and Dallas, Texas.

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

Consistent with our audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC's systems, reports, ROEs, and interviews of examiners to obtain an understanding of Westsound's management controls pertaining to the causes of failure and material loss as discussed in the body of this report. Although we obtained information from various FDIC systems, we determined that the controls pertaining to these systems were not significant to the audit objectives, and therefore, did not evaluate the effectiveness of information system controls. We relied on information from various sources, including ROEs, correspondence files, and testimonial evidence, to corroborate data obtained from systems that were used to support our audit conclusions.

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

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

# Glossary of Terms

| Term | Definition |
|---|---|
| **Adversely Classified Assets** | Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss. |
| **Allowance for Loan and Lease Losses (ALLL)** | Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of loan. |
| **Bank Board Resolution (BBR)** | A BBR is an informal commitment, adopted by a financial institution's Board, directing the institution's personnel to take corrective action regarding specific noted deficiencies. |
| **Call Report** | Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry. |
| **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. |
| **Federal Home Loan Bank (FHLB)** | The Federal Home Loan Bank System provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to its members. Advances are available to members with a wide variety of terms to maturity, from overnight to long term, and are collateralized. Advances are designed to prevent any possible loss to FHLBs, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail. To protect their position, FHLBs have a claim on any of the additional eligible collateral in the failed bank. In addition, the FDIC has a regulation that reaffirms FHLB priority, and FHLBs can demand prepayment of advances when institutions fail. |
| **Loan-to-Value** | A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. |

# Glossary of Terms

| | |
|---|---|
| **Prompt Corrective Action (PCA)** | The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq, implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 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: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized.<br><br>A PCA Directive is a formal enforcement action seeking corrective action of compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions. |
| | |
| **Uniform Bank Performance Report (UBPR)** | The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The 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 data reported in Consolidated Reports of Condition and Income submitted by banks. |

# Acronyms

| | |
|---|---|
| ADC | Acquisition, Development, and Construction |
| ALLL | Allowance for Loan and Lease Losses |
| BBR | Bank Board Resolution |
| C&D | Cease and Desist Order |
| CAMELS | **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk |
| CLP | Contingency Liquidity Plan |
| CRE | Commercial Real Estate |
| DFI | Washington State Department of Financial Institutions |
| DIF | Deposit Insurance Fund |
| DSC | Division of Supervision and Consumer Protection |
| FDI | Federal Deposit Insurance |
| FHLB | Federal Home Loan Bank |
| FIL | Financial Institution Letter |
| IPO | Initial Public Offering |
| IT | Information Technology |
| OIG | Office of Inspector General |
| PCA | Prompt Corrective Action |
| ROE | Report of Examination |
| UBPR | Uniform Bank Performance Report |
| UFIRS | Uniform Financial Institutions Rating System |
| WSB | WSB Financial Group, Inc. |

# Corporation Comments

**FDIC**

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

Division of Supervision and Consumer Protection

November 30, 2009

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

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Westsound Bank, Bremerton, Washington
(Assignment No. 2009-048)

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 Westsound Bank (Westsound) which failed on May 8, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on November 2, 2009.

The Report concludes Westsound failed because its Board and management did not implement risk management practices commensurate with rapid asset growth and a loan portfolio consisting of higher risk commercial real estate (CRE) loans with significant concentrations in acquisition, development and construction (ADC). Westsound maintained weak loan underwriting and credit administration practices, which became apparent as the local real estate market deteriorated. Also contributing to the poor quality of loans was an inadequately designed and monitored incentive compensation program, which led to a significant volume of adversely classified loans being generated by one of the bank's officials. As loan losses related to the ADC loans were recognized, capital eroded and liquidity became strained. Westsound's viability was also impacted by negative publicity associated with a shareholder lawsuit.

Westsound's lending policies did not keep pace with the growth and increasing complexity of the loan portfolio, particularly in 2004 and 2005, when loan growth exceeded 80 percent. FDIC examiners reported in February 2006, that the risk profile of the loan portfolio was elevated by rapid growth, high concentrations in ADC and CRE loans, and by the volume of high loan-to-value credits. Examiners recommended improvements to risk management processes in relation to economic conditions and asset concentrations, and management agreed to improve the credit policy, establish and track concentration limits, and improve loan quality reporting capabilities.

Following the February 2007, examination, FDIC examiners conducted a supervisory visit in August 2007, to investigate lending irregularities. This visit uncovered deficient risk management controls and prompted a joint full-scope examination in October 2007, resulting in a Cease and Desist Order to address Westsound's weaknesses. In July 2008, DSC issued guidance reminding examiners to take appropriate action when concentration risks are imprudently managed. Additionally in November 2008, DSC issued guidance on structuring compensation, which directed bank management to develop policies that are aligned with the institution's long-term prudential interests.

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