Office of Inspector General

Office of Audits
Report No. AUD-11-010

In-Depth Review of the Failure of Washington First International Bank, Seattle, Washington

June 2011

Office of Inspector General

Executive Summary

In-Depth Review of the Failure of Washington First International Bank, Seattle, Washington

Report No. AUD-11-010
June 2011

Why We Did The Audit

On June 11, 2010, the Washington State Department of Financial Institutions (WDFI) closed Washington First International Bank (Washington First), and the FDIC was appointed receiver. On August 20, 2010, the FDIC notified the Office of Inspector General (OIG) that Washington First's total assets at closing were $500 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $153.6 million. As of April 30, 2011, the estimated loss to the DIF had decreased to $136.1 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the material loss review (MLR) threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Although the estimated loss for Washington First does not meet the amended threshold requiring an MLR, the OIG determined that there were unusual circumstances involving parent/affiliate relationships and that an in-depth review (IDR) of the loss was warranted as authorized by the Financial Reform Act.

The objectives of the review were to (1) determine the causes of Washington First's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Washington First, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. A primary area of focus during the review was the bank's relationships with its parent holding company and other related affiliates.

Background

Washington First, headquartered in Seattle, Washington, was established as a state nonmember bank and insured in 1990. The bank was 100-percent owned by Washington First Financial Group, Inc. (WFFG), a one-bank holding company. In addition to Washington First, WFFG had another operating subsidiary, Washington First Capital, Inc. (WFC), that was formed to provide bridge financing secured by real estate and other lending considered too untraditional for the bank. Both WFFG and WFC had concentrations of high-risk, speculative real estate loans and often lent to Washington First customers whose borrowing relationships had reached the bank's legal lending limit. WFC's portfolio consisted primarily of "hard-money" loans – a term often applied to non-creditworthy borrowers whose loans are based primarily on estimated real estate loan-to-value ratios rather than the ability of the borrower to repay.

Audit Results

Causes of Failure and Loss

Washington First's Board of Directors (Board) and management were primarily responsible for the bank's overall poor financial condition because they failed to provide appropriate oversight of the institution's lending activities during a period of declining real estate market conditions. The FDIC attributed the institution's problems to concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans, coupled with poor credit administration, rapid asset quality deterioration, deficiencies in loan underwriting and the allowance for loan and lease losses methodology, and reliance on non-core funding. Two other factors that contributed to the bank's elevated credit risk and, ultimately, to the institution's failure were: (1) a concentration of large borrowing relationships with a small number of bank customers and (2) interrelationships among borrowers of the bank and the bank's affiliates.

Further, Washington First's relationship with WFFG and WFC also increased risk at the bank and negatively impacted the bank's financial condition. Specifically, both WFFG and WFC were heavily involved in real estate lending. Lending at WFFG was generally to accommodate Washington First customers whose borrowing relationships had reached the bank's legal lending limit. In addition, WFC engaged in lending activities that were considered too untraditional for the bank's portfolio and were characterized by higher-than-normal risk and complexity.

The WDFI closed Washington First on June 11, 2010 because the bank was operating in an unsafe and unsound condition.

The FDIC's Supervision of Washington First

We reviewed the supervisory oversight of Washington First from 2004 through 2010. During this period, the FDIC and/or the WDFI conducted six onsite risk management examinations and two visitations of the institution. Further, the FDIC monitored emerging issues at the bank through its offsite review program and reviewed the Federal Reserve Bank's holding company inspection reports pertaining to the bank's affiliates. Through these supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the attention of the bank's Board and management through examination reports and other correspondence. In addition, the regulators downgraded certain supervisory component ratings and the institution's composite rating and imposed enforcement actions in 2005 and 2009 to address problems identified at the December 2004 and March 2009 examinations, respectively.

As it relates to the focus of our review, the FDIC identified and reported significant concerns pertaining to Washington First's controls over affiliate relationships during the December 2004 examination. Examiners subsequently determined during the January 2006 examination that the bank's affiliate relationships were acceptable, and no serious concerns in this area were raised again until the March 2009 examination. Based on the examination working papers that were available for our review, we were unable to conclude on the sufficiency of the procedures performed regarding affiliate relationships prior to 2009. However, the sharp decline in the bank's ratings that paralleled the deterioration in the institution's financial condition underscores the risks associated with the affiliate relationships in the years preceding the economic downturn. At a minimum, consistent with forward-looking supervision, greater emphasis in the examination reports on those risks and the adequacy of mitigating controls may have been warranted.

With respect to PCA, the FDIC had implemented supervisory actions that were consistent with relevant provisions of section 38.

Management Response

On June 10, 2011, the Director, Division of Risk Management Supervision (RMS), provided a written response to the draft report. In the response, the Director reiterated the OIG's conclusions regarding the causes of Washington First's failure and described key supervisory actions that the FDIC and WDFI took to address the bank's deteriorating financial condition. The response also stated that in recognition that strong supervisory attention is necessary for institutions with high ADC and CRE concentrations and volatile funding sources, as was the case with Washington First, RMS issued updated guidance reminding examiners to take appropriate actions when those risks are imprudently managed. Additionally, the response referenced institution guidance that had been issued in 2008 and 2009 re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and the reliance on volatile non-core funding.

With respect to the issue described in the report pertaining to the bank's affiliate relationships, RMS concurred with the report's observations relating to risks posed by affiliates and the need for appropriate supervisory attention. Additionally, the response stated that examiners followed long-standing guidance in the *Risk Management Manual of Examination Policies* and that, as with prior in-depth review reports by the OIG, RMS found the report to be instructive and indicated that they will consider it as they continually evaluate and revise, as appropriate, existing examination guidance.

Contents

	Page
Background	2
Washington First's Financial Condition in the Years Preceding Its Failure	3
Washington First's Affiliate Relationships	3
Causes of Failure and Loss	3
The FDIC's Supervision of Washington First	5
Supervisory History	6
Supervisory Response to Risks Related to Affiliate Relationships	9
Implementation of PCA	13
OIG Evaluation of Corporation Comments	14
Appendices	
1. Objectives, Scope, and Methodology	16
2. Glossary of Terms	19
3. Acronyms	23
4. Corporation Comments	25
Tables	
1. Selected Financial Information for Washington First, 2004 - 2010	3
2. Washington First's Examination and Enforcement Action History	6
3. FRB Inspection and Enforcement Action History for WFFG and WFC	8

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

Office of Audits
Office of Inspector General

DATE: June 20, 2011

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

FROM: **/Signed/**
Mark F. Mulholland
Assistant Inspector General for Audits

SUBJECT: *In-Depth Review of the Failure of Washington First International Bank, Seattle, Washington*
(Report No. AUD-11-010)

The Washington State Department of Financial Institutions (WDFI) closed Washington First International Bank (Washington First) on June 11, 2010, and the FDIC was named as receiver. On August 20, 2010, the FDIC notified the Office of Inspector General (OIG) that Washington First's total assets at closing were $500 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $153.6 million. As of April 30, 2011, the estimated loss to the DIF had decreased to $136.1 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the threshold for a material loss review (MLR) from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that may warrant an in-depth review of the loss. Although the estimated loss for Washington First does not meet the amended threshold requiring an MLR, the OIG determined that there were unusual circumstances involving parent/affiliate relationships and that an in-depth review (IDR) of the loss was warranted as authorized by the Financial Reform Act.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Washington First's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. A primary focus of our review was the bank's relationships with its parent holding company and other related subsidiaries (collectively referred to as "affiliates" in this report).

This report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss and in-depth reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System (UFIRS, otherwise known as CAMELS ratings). Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on a draft of this report.

Background

Washington First, headquartered in Seattle, Washington, was established as a state nonmember bank and insured in 1990. The bank was 100-percent owned by Washington First Financial Group, Inc. (WFFG), a one-bank holding company that was formed in July 2001. In addition to Washington First, WFFG had another operating subsidiary, Washington First Capital, Inc. (WFC), which was formed in April 2002 to provide bridge financing[2] secured by real estate and other lending that was not offered by the bank. Both WFFG and WFC had concentrations of high-risk, speculative real estate loans and often lent to Washington First customers whose borrowing relationships had reached the bank's legal lending limit.[3] WFC's portfolio primarily consisted of "hard-money" loans, a term often applied to non-creditworthy borrowers whose loans were based primarily on estimated real estate loan-to-value (LTV) ratios rather than the ability of the borrower to repay.

Management of the bank, WFFG, and WFC were collectively controlled by the bank's Co-Chief Executive Officers, a husband-and-wife team. The Co-Chief Executive Officers were the largest shareholders of the parent company, with the husband owning 6.8 percent and the wife owning 6.7 percent. Washington First operated four branches in the greater Seattle area of King County, Washington. The main office, located in Seattle, held nearly half of the bank's deposits.

---

[1]A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of the report.
[2] Bridge financing is a term that includes temporary loans used by borrowers to bridge the time between redemption of one debt security and the issuance of another.
[3] Legal lending limits are the aggregate maximum dollar amounts that a single bank can lend to a given borrower. Legal lending limits vary by state.

Washington First's Financial Condition in the Years Preceding Its Failure

Table 1 summarizes selected financial information for Washington First as of March 2010 and for the 6 preceding calendar years.

Table 1: Selected Financial Information for Washington First, 2004 - 2010

Financial Measures ($000s)	Mar 2010	Dec 2009	Dec 2008	Dec 2007	Dec 2006	Dec 2005	Dec 2004
Total Assets	520,887	548,490	654,049	571,435	525,027	514,894	470,431
Total Loans	397,188	408,517	522,885	455,537	353,897	363,149	344,224
Total Deposits	441,362	477,418	517,232	443,469	426,891	420,798	383,985
Net Income (Loss)	(4,669)	(57,947)	(8,741)	8,316	7,937	7,694	6,999

Source: Uniform Bank Performance Reports (UBPR) for Washington First.

Washington First's Affiliate Relationships

According to the FDIC's Division of Supervision and Consumer Protection (DSC)[4] *Risk Management Manual of Examination Policies*:

> The relationship of a bank with its affiliated organizations is important to the analysis of the condition of the bank itself. Because of the commonality of ownership or management that exists, transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties. Also, affiliates offer an opportunity to engage in types of business endeavors that are prohibited to the bank itself yet those endeavors may affect the condition of the bank.

WFFG had a total of 24 subsidiaries. Of the 24 subsidiaries, 2 operated as lenders – Washington First and WFC – while the remaining 22 subsidiaries were formed to dispose of Other Real Estate Owned (OREO). We focused our review on Washington First's relationships with affiliates that could have significantly affected the bank's operations and overall financial condition. Accordingly, we concentrated our review on Washington First and its relationships with WFFG and WFC. We did not perform detailed audit procedures related to the remaining 22 subsidiaries.

Causes of Failure and Loss

Washington First's Board of Directors (Board) and management were primarily responsible for the bank's overall poor financial condition because they failed to provide appropriate oversight of the institution's lending activities during a period of declining real estate market conditions. The FDIC attributed the institution's problems to concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans, coupled with poor credit administration, rapid asset quality

[4] Effective February 13, 2011, the Chairman of the FDIC announced several organizational changes as a result of the Financial Reform Act. One such change was to re-name the Division of Supervision and Consumer Protection as the Division of Risk Management Supervision (RMS).

deterioration, deficiencies in loan underwriting and the allowance for loan and lease losses (ALLL) methodology, and reliance on non-core funding. Two other factors that contributed to the bank's elevated credit risk and, ultimately, to the institution's failure were: (1) a concentration of large borrowing relationships with a small number of bank customers and (2) interrelationships among borrowers of the bank and the bank's affiliates.

Regarding the bank's concentration of credit in large borrowing relationships, the March 2009 examination report stated that the level of lending to a relatively small number of borrowers engaged in real-estate-related activities amplified CRE and ADC concentration risks. According to the examination report, CRE and ADC loans measured 478 percent and 295 percent of Total Risk-Based Capital, respectively. Examiners reported that a group of 12 borrowers, in the aggregate, represented exposure equivalent to 243 percent of Tier 1 Leverage Capital, with 1 borrowing relationship representing 29 percent of the same capital measure. Further, the March 2009 examination report indicated that $95.5 million of the $177 million (or 54 percent) in total adversely classified assets related to the 12 borrowers.

With respect to interrelated borrowing relationships, the FDIC's March 2009 examination report stated:

> Further adding to the already elevated credit risk is a concentration in interrelated borrowers. This concentration is comprised of seven different borrowing entities at the institution totaling approximately $65 million, or 97 percent of Tier 1 Leverage Capital, that potentially exposes the institution to undue risk. The concentration centers around [a borrower] and all the interrelated entities have ongoing business transactions amongst each other. With [the borrower] being the primary conduit of this business relationship, any weakness with [that] business could potentially affect the other borrowers and create additional credit stress within the portfolio on top of the current problems. The [borrower] relationship is adversely classified Substandard, and many of the borrowers within this concentration are also adversely classified in this Report. Management and the Board should monitor this concentration closely and make efforts to reduce the exposure these relationships present. ***Several of these borrowers also borrow from affiliate Washington First Capital Inc., thereby increasing overall organizational risk on a consolidated basis***. [Emphasis added.]

The March 2009 examination report also provides evidence that Washington First's relationship with WFFG and WFC increased risk at the bank and negatively impacted the bank's financial condition. Specifically, the examination report states:

> The quality of capital is also impacted by issues at the holding company level. The parent, Washington First Financial Group (WFFG), is not considered a source of strength. The holding company has one non-bank subsidiary, Washington First Capital (WFC). Both WFFG and WFC are heavily involved in real estate lending. Lending at the holding company, WFFG, is generally to

accommodate bank customers whose borrowing relationships have reached the bank's legal lending limit. WFC engages in lending activities considered too untraditional for the bank's portfolio, and are characterized by higher than normal risk and complexity.

The WDFI closed Washington First on June 11, 2010 because the bank was operating in an unsafe and unsound condition.

The FDIC's Supervision of Washington First

We reviewed the supervisory oversight of Washington First from 2004 through 2010. During this period, the FDIC and/or the WDFI conducted six onsite risk management examinations and two visitations of the institution. Further, the FDIC monitored emerging issues at the bank through its offsite review program and reviewed the Federal Reserve Bank's (FRB) holding company inspection reports pertaining to the bank's affiliates. Through these supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the attention of the bank's Board and management through examination reports and other correspondence. In addition, the regulators downgraded certain supervisory component ratings and the institution's composite rating and imposed enforcement actions in 2005 and 2009 to address problems identified at the December 2004 and March 2009 examinations, respectively.

As it relates to the focus of our review, the FDIC identified and reported significant concerns pertaining to Washington First's controls over affiliate relationships during the December 2004 examination. Examiners subsequently determined during the January 2006 examination that the bank's affiliate relationships were acceptable, and no serious concerns in this area were raised again until the March 2009 examination. Based on the examination working papers that were available for our review, we were unable to conclude on the sufficiency of the procedures performed regarding affiliate relationships prior to 2009.[5] However, the sharp decline in the bank's ratings that paralleled the deterioration in the institution's financial condition underscores the risks associated with the affiliate relationships in the years preceding the economic downturn. At a minimum, consistent with forward-looking supervision, greater emphasis in the examination reports on those risks and the adequacy of mitigating controls may have been warranted.

---

[5] According to the FDIC, in conformance with the FDIC's practices regarding workpaper retention, generally, prior examination workpapers are destroyed unless the bank is subject to an enforcement action.

Supervisory History

Table 2 summarizes key supervisory information for Washington First from 2004 to 2010.

Table 2: Washington First's Examination and Enforcement Action History

Examination/ Visitation Start (Completion) Date	Regulators	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken[a]
December 6, 2004 (February 4 2005)	FDIC	233222/3	Supervisory Directive by the WDFI, dated May 20, 2005.
August 22, 2005 (September 9, 2005)	FDIC (Visitation)	None	None.
January 17, 2006 (February 9, 2006)	FDIC/WDFI	232222/2	BBR, dated June 16, 2006.[b]
February 5, 2007 (February 27, 2007)	FDIC	122221/2	None.
February 25, 2008 (March 14, 2008)	WDFI	122121/2	None.
March 9, 2009 (April 14, 2009)	FDIC	454543/5	C&D, dated September 1, 2009.
October 19, 2009 (October 30, 2009)	FDIC (Visitation)	555543/5	2009 C&D was still in effect.
May 10, 2010 (June 4, 2010)	FDIC/WDFI	555555/5	2009 C&D was still in effect.

Source: The FDIC's Virtual Supervisory Information on the Net (ViSION) System and examination and visitation reports for Washington First.
[a] Informal enforcement actions often take the form of Bank Board Resolutions (BBR) or Memoranda of Understanding (MOU). Formal enforcement actions often take the form of Cease and Desist Orders (C&D), but under severe circumstances, can take the form of insurance termination proceedings.
[b] Enforcement action related to the Bank Secrecy Act.

Offsite Reviews

Washington First was flagged for offsite review three times between December 2007 and September 2008. Two of these reviews were triggered by asset growth but did not result in a substantial shift in the FDIC's supervisory strategy. The third offsite review, which was on September 30, 2008, identified material deterioration in the bank's overall financial condition due to the institution's exposure to ADC lending. As a result of the September 30, 2008 offsite review, the FDIC downgraded the bank to a composite "3" rating on December 10, 2008.

Enforcement Actions

The WDFI and the FDIC each pursued enforcement actions to address weak risk management practices identified by examiners. A brief summary of these enforcement actions follows.

May 2005 Supervisory Directive. The WDFI issued a Supervisory Directive based on less-than-satisfactory conditions identified at the bank by the FDIC during the December

2004 examination. The Supervisory Directive, which became effective on May 20, 2005, required that the bank:

- address apparent violations and contraventions of regulations;
- maintain an adequate ALLL;
- develop a plan to ensure an accurate loan-grading system;
- evaluate loan department staffing;
- correct loan administration weaknesses pertaining to such areas as construction inspection disbursement procedures, appraisal policies, and credit analysis practices – including loans to outside borrowers and affiliates;
- evaluate concentrations of credit and establish appropriate policy limits for concentrations;
- reduce the level of adversely classified assets; and
- enhance the internal audit function so that these deficiencies would be corrected.

September 2009 C&D. During the March 2009 FDIC examination, Washington First's condition was found to be unsatisfactory and, as a result, the FDIC initiated a C&D against the bank. Among other things, the C&D required the bank's Board and management to develop and implement plans to reduce ADC concentrations; maintain Tier 1 Capital at levels of not less than 10 percent; maintain adequate lending policies; and govern the relationship between the bank, its holding company, and its affiliates.

The FRB's Assessment of Affiliate Performance

The RMS *Case Manager Procedures Manual* provides guidance regarding the FDIC's coordination with other agencies, such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve Banks, and State Authorities for Federal Reserve member banks. Such coordination is important because the FDIC relies on the reports of other regulators to monitor the financial condition of institutions not supervised by the FDIC and to assess risks to the DIF. The primary goal in reviewing these reports is to determine whether problems and risks have been identified and appropriate corrective actions are being taken.

The FRB of San Francisco had primary supervisory and regulatory responsibility for Washington First's holding company, WFFG, and the holding company's operating subsidiary, WFC. From August 2005 to May 2010, the FRB performed six inspections of the holding company and subsidiary. The FDIC considered the results of these inspections in its supervisory activities pertaining to Washington First. Table 3 summarizes key supervisory information for WFFG and WFC, as reported by the FRB.

Table 3: FRB Inspection and Enforcement Action History for WFFG and WFC

Inspection Start Date	Risk Management Rating	Financial Condition Rating	Impact Rating	Composite Rating	Depository Institution Rating	Enforcement Action
August 1, 2005	3	2	2	3	3	Cure Agreement dated June 20, 2005
July 24, 2006	2	2	2	2	2	None
August 15, 2007	2	2	2	2	2	None
November 4, 2008	3	3	4	3	2	MOU dated December 24, 2008
July 20, 2009	5	5	5	5	5	None
May 6, 2010	5	5	5	5	5	None

Source: FRB Inspection Reports for WFFG and WFC.

Under the FRB's rating system, a composite rating is based on an evaluation and rating of risk management, financial condition, and the impact of the parent company and its non-depository subsidiaries on the subsidiary depository institutions. A fourth component in the rating system, Depository Institution, generally mirrors the primary supervisor's assessment of the subsidiary deposit institution(s). As is the case with the UFIRS, FRB's rating scale ranges from "1" to "5," with a "5" rating indicating the highest degree of risk.

The following summarizes the issues identified by the FRB during its inspections of WFFG and WFC.

- An inspection of WFFG conducted by the FRB in August 2005 resulted in an overall "3" (fair) rating, primarily because the holding company's bank, Washington First, was in less than satisfactory condition as reported by the FDIC in its December 2004 examination report. On June 20, 2005, WFFG entered into a Cure Agreement with the FRB, requiring the parent to correct the deficiencies identified by the FDIC. In addition, the FRB reported in the August 2005 inspection report that WFFG's and WFC's risk management practices pertaining to management oversight, loan underwriting, and risk monitoring needed improvement. The FRB concluded that, in addition to the problems identified at the bank in the FDIC's December 2004 examination, the parent company's weak risk management practices presented concerns given the higher-risk funding and lending activities conducted by the parent and WFC. However, FRB examiners reported that despite the bank's poor rating and weak risk management practices at the affiliates, the WFFG served as a source of strength to Washington First.

- The FRB concluded in its July 2006 inspection of WFFG that the parent company's overall condition had improved from fair to satisfactory based primarily on the condition and improvement in Washington First's performance. FRB examiners concluded that WFFG and WFC were profitable, had sufficient cash flows, and were separately capitalized at levels commensurate with the risk of their activities. However, FRB examiners did note that WFFG's and WFC's lending activities could heighten the legal and reputational risks of the consolidated organization, which could, in turn, impact Washington First. For example, the FRB concluded that WFFG and WFC did not evaluate the ability of

borrowers to repay their loans and did not perform onsite inspections of construction projects subsequent to funding the associated loans.

- The FRB's August 2007 offsite inspection primarily addressed the FDIC's April 2007 examination findings. FRB examiners noted that there was a limited likelihood that the parent company or WFC would have a significant negative financial impact on Washington First.

- In the November 2008 inspection report, FRB assigned an overall "3" rating to WFFG. The report concluded that the financial condition of WFFG and WFC would likely have a significant negative impact on Washington First and that the parent company was not a source of strength to the bank. Matters requiring immediate attention included ineffective risk management and high levels of adversely classified ADC loans. FRB examiners noted that lending generally accommodated existing bank customers whose borrowing relationships had reached the State's legal lending limit. The FRB entered into an MOU with WFFG on December 24, 2008 to address the holding company's issues.

- In the July 2009 and May 2010 FRB inspection reports, FRB examiners assigned WFFG an overall "5" (or unsatisfactory) rating. Generally, WFFG's and WFC's issues mirrored the problems identified by the FDIC during its March 2009 examination of Washington First. In the July 2009 inspection report, FRB examiners adversely classified $6.6 million and $51 million of WFFG's and WFC's loans, respectively. According to the FDIC, approximately $17 million of the $57.6 million in combined classifications consisted of over-line loans.[6] Further, affiliates held an additional $11.5 million in loans classified as Special Mention.[7] Overall, FRB examiners concluded, in both the July 2009 and May 2010 inspection reports, that the parent company was not a source of strength to Washington First.

In summary, the results of the FRB's inspection reports of WFFG and WFC were relevant to the FDIC's assessment of risk at Washington First. Specifically, as indicated above, beginning with the FRB's November 2008 inspection report, FRB examiners reported deterioration in WFFG's and WFC's financial condition and were concluding that the parent company was no longer a source of strength to Washington First. We saw evidence in the March 2009 examination report that FDIC examiners considered these results in their assessment of Washington First.

Supervisory Response to Risks Related to Affiliate Relationships

A synopsis of the FDIC's and WDFI's supervisory activities related to Washington First's affiliate relationships between 2004 and 2010 follows.

---

[6] Over-line loans refer to loans made by WFFG or WFC to Washington First borrowers who had reached their State legal lending limits with the bank.
[7] Special mention loans are characterized as loans exhibiting potential weaknesses, which may result in further deterioration if left uncorrected.

December 2004 FDIC Examination

Examiners assigned the bank a composite "3" rating and reported that bank management's controls over affiliate relationships were unacceptable and posed elevated risk to the bank. Examiners noted that WFC's lending activities (e.g., hard-money lending/bridge loans) were high-risk and posed a potential threat to the institution. Examiners noted bank management's need to ensure that affiliate activities and risks were independently managed and absorbed by the parent company without reliance on the bank. The examination report also noted the following concerns:

- WFC elevated its risk profile by expanding its lending policies to include bridge loans.
- Collateral pledged by WFC for a $4 million line of credit from Washington First did not meet minimum loan quality standards as required by section 23A of the Federal Reserve Act.
- Examiners identified two borrowers of the bank having over-line loans totaling $7.4 million with the parent company. Examiners noted underwriting and credit administration deficiencies with the borrowers' loans with Washington First.
- Washington First's Board minutes did not address the potential impact of affiliate activities on bank borrowers.

FDIC examiners concluded that the high-risk lending activities undertaken by the affiliates made Washington First vulnerable and recommended that management begin tracking borrowers common to the bank and its affiliates. Examiners also concluded that, because of these risks, the parent was not considered a source of strength to the institution. Consequently, examiners recommended that management ensure that affiliate activities and risks were independently managed and absorbed by the parent company without reliance on the bank. As discussed previously, the WDFI issued a Supervisory Directive in May 2005 to address the weaknesses identified by the FDIC during the December 2004 examination. The directive required the bank to correct violations of laws and regulations and credit administration weaknesses, including those related to WFC.

January 2006 Joint Examination

This joint FDIC/WDFI examination resulted in a composite "2" rating, which was an upgrade from the previous examination. Examiners noted that the bank's loan policy limited the amount of loans to any individual borrower to 35 percent of capital. In addition, loans in excess of the State legal lending limit were sold to the bank's parent company, affiliate, or third-party participants. Further, the examination report stated that WFFG borrowed $25.9 million from individual investors in order to fund over-line financing that WFC provided to Washington First borrowers. In our view, such borrowing reduced WFFG's ability to be a source of strength for Washington First. Examiners concluded that the bank's controls over affiliate relationships were acceptable and adequately addressed in various company agreements and policies. In response to the May 2005 Supervisory Directive, bank management stated that the bank had ceased

funding WFC's over-line lending. However, WFC continued making these high-risk loans, including to Washington First's existing customers, with funds from other sources.

February 2007 FDIC Examination

The 2007 FDIC examination again resulted in a composite "2" rating, with three component ratings – Capital, Asset Quality, and Sensitivity to Market Risk – showing improvement. Examiners did not report issues related to the bank's affiliate relationship and noted that the parent company generated sufficient earnings to fund WFC's operations and, therefore, did not rely on Washington First for cash dividends. In addition, the examination report noted that WFC maintained a $50 million line of credit with the parent company in order to make loans with higher interest rates to borrowers who were also customers of the bank (who had the over-line loans). In our view, such lending negatively impacted the ability of WFFG to be a source of strength for Washington First.

February 2008 WDFI Examination

At this examination, WDFI examiners again assigned the bank a composite "2" rating, while indicating improvement in the Earnings component rating. Examiners concluded that affiliate relationships were acceptable and that the parent holding company was an additional source of strength to the institution. Examiners also noted that the parent was profitable and was not reliant on dividends from Washington First to service debt.

March 2009 FDIC Examination

The March 2009 FDIC examination report stated that the bank was in an unsatisfactory condition and operating with undesirable and objectionable conditions and practices. As shown previously in Table 2, this examination resulted in the bank being downgraded to a composite "5" rating, along with component "5" ratings for Asset Quality and Earnings. In the report, examiners stated that the bank needed to improve its controls over the risks to the bank from holding company and affiliate activities and transactions, such as over-line loans. Examiners noted that WFFG was not a source of strength to the bank because both the parent company and WFC were heavily involved in real estate lending to accommodate borrowers who had reached their legal lending limit at Washington First, resulting in elevated risk to the bank. In fact, the March 2009 examination report indicated that $41 million in adversely classified loans was attributable to three borrowers who also had loans with the bank's affiliates that were adversely classified.[8]

Following the March 2009 examination, the FDIC conducted a visitation in October 2009. The visitation report states that Washington First and its parent company were in a critically deficient condition, highly leveraged, and unprofitable and were operating with strained liquidity. Further, the visitation report concluded that WFFG could not support the bank.

[8] These 3 borrowers were part of the concentration of 12 large borrowing relationships, discussed earlier, which accounted for $95.5 million in adversely classified assets during the May 2009 examination.

May 2010 Joint Examination

The bank's financial condition had further deteriorated at the time of the May 2010 joint examination. This examination report provided the bank with component and composite ratings of "5" and concluded that the bank's distressed condition was due to management and a Board, common to the bank and its affiliate, that pursued and approved a high-risk concentration of ADC lending compounded by over-line lending by the bank's WFC affiliate. Examiners noted that many of these credits defaulted and that the consolidated entity suffered large loan losses. An example from the May 2010 examination report follows.

> Construction costs for a large residential condominium project exceeded the bank's legal lending limit so affiliate, WFC, advanced additional notes to cover the remaining costs. However, due to its own liquidity constraints, WFC was unable to fund the remaining construction draws for the project. As of the May 2010 examination, the construction loan that was originated in June 2007 totaled approximately $13 million and was included in the bank's adverse classifications totaling $145 million.

As noted earlier, there was a dramatic decline in the supervisory ratings of Washington First between the February 2008 (and earlier examinations) and the March 2009 examination, which resulted in a composite "5" rating.[9] Based on the examination reports leading up to 2009, it appears that there was limited change in the organizational risk and practices related to Washington First's affiliate relationships except for (1) the significant deterioration in the quality of the loans associated with those relationships caused by a weakening economy and (2) the manner in which the loans were funded. More specifically, although bank management asserted during the January 2006 examination that it had ceased funding WFC's over-line lending, all of the FDIC examination reports that followed indicated that WFC continued such lending. None of the examination reports included concerns about the high-risk nature of this lending program undertaken by the management team and Board common to the bank, WFFG, and WFC until after the loans began to deteriorate.

As it relates to the focus of our review, the FDIC identified and reported significant concerns pertaining to Washington First's controls over affiliate relationships during the December 2004 examination. Examiners subsequently determined during the January 2006 examination that the bank's affiliate relationships were acceptable, and no serious concerns in this area were raised again until the March 2009 examination. Based on the examination working papers that were available for our review, we were unable to conclude on the sufficiency of the procedures performed regarding affiliate relationships prior to 2009. However, the sharp decline in the bank's ratings that paralleled the

---

[9] Between the February 2008 and March 2009 onsite examinations, the FDIC lowered Washington First's composite ratings on two occasions. Specifically, the FDIC assigned the bank a composite "3" rating as a result of the previously mentioned offsite review completed on December 10, 2008. Further, in a letter to the bank dated March 31, 2009, the FDIC informed the bank that it was being downgraded to a composite "4" rating based on the preliminary results of the March 2009 examination.

deterioration in the institution's financial condition underscores the risks associated with the affiliate relationships in the years preceding the economic downturn. At a minimum, consistent with forward-looking supervision, greater emphasis in the examination reports on those risks and the adequacy of mitigating controls may have been warranted.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to Washington First, we determined that the FDIC properly implemented applicable PCA provisions of section 38. A summary of the relevant PCA actions follows.

The bank was considered *Well Capitalized* for PCA purposes until September 1, 2009. The bank fell to *Adequately Capitalized* at that time as a result of the issuance of a joint C&D that contained a capital provision directing Washington First to increase its Tier 1 Capital "in such an amount as to equal or exceed 10 percent" of the bank's total assets. Section 325.103 of the FDIC Rules and Regulations states that a bank is deemed *Well Capitalized* if it meets or exceeds the capital ratios defined in the section and is not subject to a written agreement, order, capital directive, or PCA directive issued by the FDIC pursuant to section 8 of the FDI Act. As an *Adequately Capitalized* institution, Washington First was restricted from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. The C&D further stated that the level of Tier 1 Capital to be maintained during the life of the C&D would be in addition to a fully funded ALLL.

On December 2, 2009, the FDIC notified Washington First that it was *Undercapitalized* based on the institution's September 30, 2009 Reports of Condition and Income (Call Report). Further, the FDIC informed Washington First that, as of December 2, 2009, the bank was subject to the mandatory requirements of section 38, which included the submission of a capital restoration plan and restrictions on asset growth, acquisitions, new activities and branches, the payment of dividends, other capital distributions, and management fees. Washington First submitted a capital restoration plan on January 20, 2010, and the FDIC notified the bank on March 26, 2010 that the

plan was inadequate. Due to the bank's failure to submit an acceptable capital plan, it was subject to mandatory restrictions and actions embodied in section 38 of the FDI Act.

On March 29, 2010, the FDIC notified Washington First that it was *Significantly Undercapitalized* based on the institution's amended December 31, 2009 Call Report. The FDIC also informed Washington First that in addition to being subject to the mandatory requirements of section 38 on December 2, 2009, the FDIC imposed restrictions on affiliate transactions and on the interest rates paid on deposits, along with requiring the recapitalization or the sale of the bank. The FDIC issued a Supervisory PCA Directive on April 1, 2010, requiring bank management to, among other things, recapitalize the bank within 30 days; refrain from obtaining, renewing, or rolling over any brokered deposits; restrict the interest rates that the bank paid on deposits; and refrain from making any capital distributions or dividend payments to the parent company or any affiliate of the bank or its parent.

On May 6, 2010, the FDIC notified Washington First that it was *Critically Undercapitalized* based on the institution's March 31, 2010 Call Report. The FDIC also informed Washington First that, in addition to being subject to the mandatory requirements of section 38, on April 1, 2010, the FDIC imposed restrictions requiring bank management to obtain the FDIC's written approval prior to, among other things, entering into any material transaction other than in the usual course of business; extending credit for any highly-leveraged transaction; amending the bank's charter or bylaws; paying excessive compensations or bonuses; and making any principal or interest payment on subordinate debt beginning 60 days after becoming *Critically Undercapitalized*.

OIG Evaluation of Corporation Comments

On June 10, 2011, the Director, RMS, provided a written response to the draft report. In the response, the Director reiterated the OIG's conclusions regarding the causes of Washington First's failure and described key supervisory actions that the FDIC and WDFI took to address the bank's deteriorating financial condition. The response also stated that in recognition that strong supervisory attention is necessary for institutions with high ADC and CRE concentrations and volatile funding sources, as was the case with Washington First, RMS issued updated guidance reminding examiners to take appropriate actions when those risks are imprudently managed. Additionally, the response referenced institution guidance that had been issued in 2008 and 2009 re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and the reliance on volatile non-core funding.

With respect to the issue described in the report pertaining to the bank's affiliate relationships, RMS concurred with the report's observations relating to risks posed by affiliates and the need for appropriate supervisory attention. Additionally, the response stated that examiners followed long-standing guidance in the *Risk Management Manual of Examination Policies* and that, as with prior in-depth review reports by the OIG, RMS

found the report to be instructive and indicated that they will consider it as they continually evaluate and revise, as appropriate, existing examination guidance.

Objectives, Scope, and Methodology

Objectives

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act). The Financial Reform Act amends section 38(k) of the FDI Act by increasing the threshold for a material loss review from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that may warrant an in-depth review of the loss. Although the estimated loss for Washington First no longer met the threshold requiring an MLR, the OIG determined that an in-depth review of the failure of Washington First was warranted as authorized by the Financial Reform Act.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Washington First's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Washington First, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. We focused our review on the bank's relationships with affiliates that could have significantly affected the bank's operations and overall financial condition.

We conducted this performance audit from November 2010 to February 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of Washington First's operations from 2004 until its failure on June 11, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Reviewed and/or analyzed examination reports issued by the FDIC and the WDFI examiners from 2004 to 2010.

- Reviewed the following:

    - Bank data contained in UBPRs and Call Reports.

Objectives, Scope, and Methodology

- Excerpts of correspondence files from RMS's San Francisco Regional and Seattle Field Offices.
- Examination workpapers related to the bank's activities regarding its affiliate relationships.
- Reports prepared by the FDIC's Division of Resolutions and Receiverships and RMS relating to the bank's closure.
- Pertinent RMS policies and procedures and various banking laws and regulations.
- RMS's ViSION Modules, including Supervisory Tracking and Reporting.

We interviewed FDIC examiners who participated in the various examinations of Washington First and an FDIC Field Office official responsible for supervisory oversight. We also contacted officials from the WDFI to discuss the institution's examinations and other activities regarding the state's supervision of the bank.

We performed the audit work at the OIG office in Arlington, Virginia.

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

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

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, 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 IDR, we did not assess the strengths and weaknesses of RMS' annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. RMS' compliance with the Results Act is reviewed in program audits of RMS operations.

Objectives, Scope, and Methodology

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

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. In addition, the OIG issued an audit report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and Federal regulators' use of the Prompt Regulatory Act provisions of the FDI Act (section 38, *Prompt Corrective Action* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction and that provide interim financing for residential or commercial structures.
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.
Affiliate	Under section 23A of the Federal Reserve Act (12 United States Code (U.S.C.), section 371c), an affiliate generally includes, among other things, a bank subsidiary or a company that (1) controls the bank and any other company that is controlled by the company that controls the bank, (2) is sponsored and advised on a contractual basis by the bank, or (3) is controlled by or for the benefit of shareholders who control the bank or in which a majority of directors holds similar positions in the bank.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the ALLL in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Bank Secrecy Act (BSA)	The Congress enacted the BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file certain reports, including cash transactions over $10,000 via the Currency Transactions Reports. These reports are used in criminal, tax, or regulatory investigations or proceedings.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.

Glossary of Terms

Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C., section 1818, to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
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.
FDIC's Supervision Program	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 institutions. The FDIC's RMS (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.
Financial Holding Company	A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The FRB is responsible for supervising the financial condition and activities of financial holding companies.
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.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.

Glossary of Terms

Memorandum of Understanding (MOU)	An MOU is an informal agreement between the institution and the FDIC that is signed by both parties. The State Authority may also be party to the MOU. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
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 (C.F.R.), section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C., section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Section 23A	Section 23A (1) establishes limits on the amount of "covered transactions" between a member bank and its affiliates (any one affiliate and in the aggregate as to all affiliates); (2) requires that all covered transactions between a member bank and its affiliates be on terms and conditions that are consistent with safe and sound banking practices; (3) prohibits the purchase of low-quality assets from an affiliate; and (4) requires that extensions of credit by a member bank to an affiliate, and guarantees on behalf of affiliates, be secured by statutorily defined amounts of collateral.
Substandard	One of three types of classifications used by examiners to describe adversely classified assets. The term is generally used to describe an asset that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Glossary of Terms

Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
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 FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the 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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
BSA	Bank Secrecy Act
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
C.F.R.	Code of Federal Regulations
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FRB	Federal Reserve Bank
IDR	In-Depth Review
LTV	Loan-to-Value
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
RMS	Division of Risk Management Supervision

Acronyms

UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.C.	United States Code
ViSION	Virtual Supervisory Information on the Net
WDFI	Washington Department of Financial Institutions
WFC	Washington First Capital, Inc.
WFFG	Washington First Financial Group, Inc.

Corporation Comments

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Risk Management Supervision

June 10, 2011

TO: Mark Mulholland
Deputy Assistant Inspector General for Audits

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, In-Depth Review of the Washington First International Bank, Seattle, Washington (Assignment No. 2010-080)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted an In-Depth Review of Washington First International Bank (Washington First), which failed on June 11, 2010. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on April 15, 2011.

Washington First failed primarily because of the Board's and management's inadequate oversight of risk management practices, specifically those risks associated with the concentrations of commercial real estate (CRE) and acquisition, development and construction (ADC) loan portfolios. Washington First was also dependent on non-core funding sources, primarily high-cost large deposits and Federal Home Loan Bank borrowings, to support operations. Washington First continued to originate ADC loans while the real estate markets were weakening which led to significant loan-related losses, poor earnings, and erosion of capital.

From 2004 through 2010, the FDIC and the Washington State Department of Financial Institutions conducted six risk management examinations, two onsite visitations and on-going offsite reviews. The 2009 FDIC examination found that Washington First's overall condition had rapidly deteriorated, earnings performance was critically deficient and capital levels did not support its risk profile. As a result, examiners downgraded Washington First and issued a cease and desist order. Washington First was unable to raise capital from external sources to support its operations and remain viable.

In regards to the supervisory activities related to Washington First's parent and affiliate relationships, examiners followed long standing guidance of the *Risk Management Manual of Examination Policies*. We concur with the Report's observations relating to risks posed by affiliates and the need for appropriate supervisory attention. As with prior in-depth review reports by the OIG, we find the Report to be instructive and will consider it as we continually evaluate and revise, as appropriate, our examination guidance.

Corporation Comments

In recognition that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as Washington First, RMS issued updated guidance reminding examiners to take appropriate actions when those risks are imprudently managed. RMS also issued a Financial Institution Letter (FIL) to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. Additionally, RMS issued a FIL in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance our supervision of institutions with concentrated CRE/ADC lending and reliance on volatile non-core funding.

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