Office of Inspector General

August 2009
Report No. AUD-09-021

Material Loss Review of MagnetBank, Salt Lake City, Utah

AUDIT REPORT

Office of Audits

oig

Federal Deposit Insurance Corporation

Why We Did The Audit

On January 30, 2009, the Utah Department of Financial Institutions (UDFI) closed MagnetBank, Salt Lake City, Utah, and named the FDIC as receiver. On February 24, 2009, the FDIC notified the Office of Inspector General (OIG) that MagnetBank's total assets at closing were $286.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $119.4 million. The estimated loss to the DIF had increased to $129.3 million as of August 7, 2009. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of MagnetBank.

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

MagnetBank was an industrial bank insured on September 29, 2005. On July 24, 2007, with UDFI and FDIC approval, the bank changed its charter to a state nonmember commercial bank. As a de novo bank, MagnetBank was subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency. With no branch offices and four loan production offices, MagnetBank engaged principally in commercial real estate lending activities within Georgia, Utah, North Carolina, California, Idaho, Florida, Arizona and, Nevada, which experienced significant economic downturns starting in 2007 and early 2008. MagnetBank had no holding company, subsidiaries, or affiliates.

MagnetBank's assets consisted principally of commercial real estate (CRE) loans, including a significant concentration in residential acquisition, development and construction (ADC) loans. FDIC guidance issued to financial institutions describes a risk management framework to effectively identify, measure, monitor, and control CRE concentration risk. That framework includes effective oversight by bank management, including the Board of Directors (BOD) and senior executives, and sound loan underwriting, administration, and portfolio management practices.

Report No. AUD-09-021 **August 2009**

Material Loss Review of MagnetBank, Salt Lake City, Utah

Audit Results

Causes of Failure and Material Loss - MagnetBank failed due to management's aggressive pursuit of CRE/ADC lending concentrated in high-growth markets, coupled with weak risk management controls, that left the bank unprepared to deal with declining markets. MagnetBank's business plan was to expand into a $530 million bank within its first 3 years of operations, funded by brokered deposits. To achieve this goal, MagnetBank pursued CRE/ADC lending through regulator-approved loan production offices in multiple states and loan participations purchased from other banks. As a result of these lending efforts, the bank had reached $459 million in assets by the end of its first 15 months of operations, committing the bank to a highly concentrated CRE/ADC loan portfolio that was negatively affected when the economy declined.

The bank's operations were characterized by wide-spread weaknesses in loan underwriting and approvals; poor credit administration; high production-focused compensation for loan officers; inadequate due diligence for participations purchased; untimely recognition of problem assets; and, as the economy turned, high levels of adversely classified assets and losses without an adequate allowance for loan and lease losses. Due to the losses in the loan portfolio, the bank's capital eroded and liquidity became strained, ultimately leading to the failure of the bank, 40 months after opening.

Assessment of FDIC Supervision - Based on our review, we concluded that the FDIC provided ongoing supervision of MagnetBank; identified key concerns for attention by bank management, including the problems that led to the bank's failure; and, together with the UDFI, pursued enforcement action as the bank's financial condition deteriorated in 2008 prior to the bank's failure. The FDIC's off-site monitoring identified the need for additional oversight, resulting in a visitation and subsequent acceleration of the 2008 examination. The April 2008 examination included a thorough analysis of asset quality and other problems at the bank, and the FDIC followed up on two resulting Cease and Desist Orders in December 2008.

However, the FDIC could have provided additional supervisory attention and taken additional action regarding MagnetBank. In particular, the 2007 examination could have more fully considered the risks associated with the rapid growth of a de novo institution concentrated in CRE/ADC lending that was funded almost exclusively with wholesale funding sources. Examiners emphasized heavily the past experience of MagnetBank's management team rather than the growing risk to the institution from its aggressive business strategy and weak risk management controls. Between the August 2007 and April 2008 examinations, MagnetBank went from well rated to the worst composite rating assigned, and numerous critical deficiencies were identified in risk management controls by the latter examination. The FDIC should have ensured that examiners followed the supervision strategy for the 2007 examination, developed in conjunction with the FDIC's approval of the bank's revised business plan, that specified a 60-percent loan sample, which might have identified additional asset quality and risk management control problems. In addition, supervisory actions could have been timelier, resulting in earlier action by the bank to address its problems. With respect to PCA, the FDIC notified the bank of its PCA status in a timely manner.

The FDIC OIG plans to issue a series of summary reports on our observations on the major causes, trends, and common characteristics of financial institution failures resulting in a material loss to the DIF. Recommendations in the summary reports will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

Management Response

On August 20, 2009 the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. In its response, DSC stated that MagnetBank failed due to management's aggressive pursuit of ADC loans concentrated in high-growth markets funded with higher-cost wholesale deposits. DSC also stated that this profile, coupled with weak management controls, left MagnetBank unprepared to deal with declining markets. In addition, the Director stated that DSC (1) had implemented a supervisory strategy of planned annual examinations, interim 6-month visitations, and quarterly off-site monitoring in 2007 and (2) agreed that a higher-loan sample at that time may have uncovered additional problems that could have led to earlier supervisory action.

Contents ***Page***

BACKGROUND 2

CAUSES OF FAILURE AND MATERIAL LOSS 5
- **Aggressive Growth Strategy** 5
  - **Concentration in CRE/ADC Loans** 6
  - **Use of Brokered Deposits** 8
- **Risk Management Controls** 9
  - **Credit Underwriting and Administration** 9
    - **Underwriting Deficiencies** 9
    - **Loan Policies and Practices** 10
    - **Credit and Documentation Review** 10
    - **Participations Purchased** 11
    - **Role of the Bank's Chairman and CEO** 12
  - **Compliance with Regulatory Orders** 13
- **Effects of Growth Strategy Coupled with Weak Risk Management Controls** 14
  - **Suspicious Activity** 15
  - **Summary** 15

ASSESSMENT OF SUPERVISION 15
- **Historical Snapshot of Supervision** 16
- **OIG Assessment of FDIC Supervision** 19
  - **Supervision Strategy for 2007** 20
  - **Cease and Desist Orders** 20
- **Actions Taken Subsequent to MagnetBank's Failure** 20

IMPLEMENTATION OF PCA 21

CORPORATION COMMENTS AND OIG EVALUATION 21

APPENDICES
1. **OBJECTIVES, SCOPE, AND METHODOLOGY** 22
2. **EXAMPLES OF PARTICIPATIONS PURCHASED BY MAGNETBANK** 24
3. **EXAMPLES OF MAGNETBANK EXAMINER COMMENTS AND RECOMMENDATIONS RELATED TO ASSET QUALITY** 25
4. **GLOSSARY OF TERMS** 26
5. **CORPORATION COMMENTS** 27
6. **ACRONYMS IN THE REPORT** 28

TABLES
1. **Financial Condition of MagnetBank** 4
2. **MagnetBank's CRE/ADC Concentrations Compared to Peer** 6
3. **MagnetBank's Loan Classifications and ALLL** 15

Contents ***Page***

FIGURES

1. **MagnetBank's Asset Growth in the First 15 Months of Operations** 3
2. **MagnetBank's Asset Growth Compared to Original Business Plan** 5
3. **Total Loans vs. Classified Loans** 8

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

Office of Audits
Office of Inspector General

DATE: August 24, 2009

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

/Signed/

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of MagnetBank, Salt Lake City, Utah* (Report No. AUD-09-021)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of MagnetBank, Salt Lake City, Utah. On January 30, 2009, the Utah Department of Financial Institutions (UDFI) closed the institution and named the FDIC as receiver. On February 24, 2009, the FDIC notified the OIG that MagnetBank's total assets at closing were $286.4 million and the estimated material loss to the Deposit Insurance Fund (DIF) was $119.4 million. As of July 17, 2009, the estimated loss to the DIF from MagnetBank's failure had increased to $129.3 million.

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

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38 of the FDI Act. Appendix 1 contains details on our objectives, scope, and methodology.

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[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices, including internal control systems; and compliance with applicable laws and regulations; and (2) issues related guidance to institutions and examiners.

Appendix 4 contains a glossary of terms. A list of acronyms used in this report can be found in Appendix 6.

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

BACKGROUND

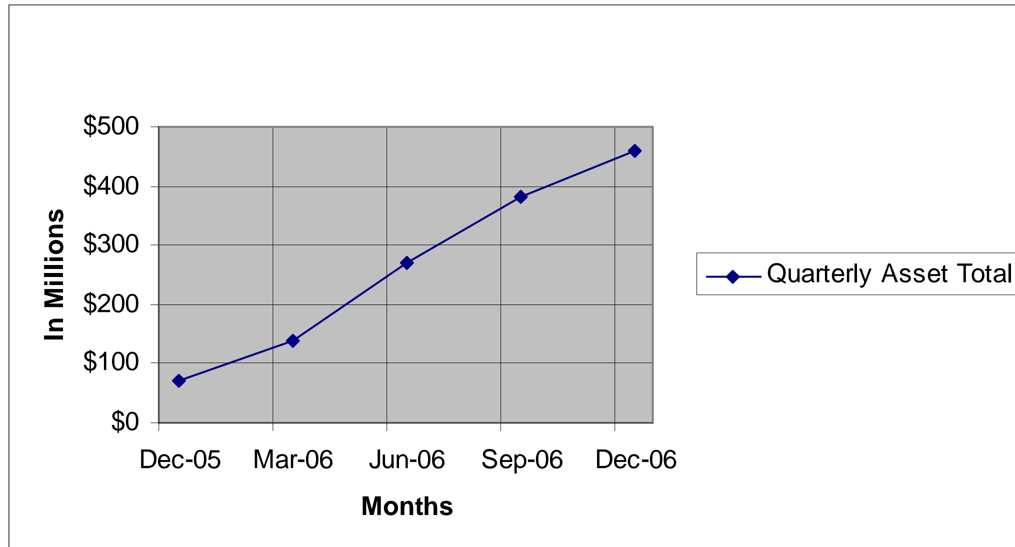
MagnetBank was a Utah-chartered industrial bank insured by the FDIC effective September 29, 2005[3] and headquartered in Salt Lake City, Utah. As part of its original regulator-approved business plan, MagnetBank's board of directors (BOD) indicated that funding would be primarily through less-overhead-intensive nontraditional sources such as brokered deposits[4] and other wholesale sources. The bank did not plan on having branches or offering traditional banking products such as savings, checking, or other demand-deposit accounts. Specifically, the bank's business model corresponded with industrial bank restrictions in the Bank Holding Company Act in that the bank could "not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties."[5] In its 3-1/2-year history, MagnetBank:

- had no branches;
- had four loan production offices (LPO) located in Salt Lake City, Utah; Atlanta, Georgia; Boise, Idaho; and Raleigh, North Carolina;
- had assets in many geographical areas of the United States, including Georgia, Utah, North Carolina, California, Idaho, Florida, Arizona, and Nevada;
- did not have a holding company, subsidiaries, or affiliates; and
- specialized in commercial lending activities, including CRE/ADC loans, by offering business loans of $2 million to $10 million, funded primarily through brokered deposits.

[3] In making its determination to approve MagnetBank's application for insurance, the FDIC prepared a Report of Investigation, as outlined in the FDIC Statement of Policy on Applications for Deposit Insurance and Part 303 Subpart B – *Deposit Insurance*, of the FDIC Rules and Regulations.
[4] Brokered deposits are non-core funding sources that can be volatile because of the ease of moving large sums from the bank if financial conditions worsen. Other non-core funding sources include federal funds purchased, Federal Home Loan Bank (FHLB) advances, and certificates of deposit (CD) of more than $100,000.
[5] 12 United States Code 1841(c).

From its inception, MagnetBank grew at an extremely rapid rate, reaching $380 million in assets by the end of the first year of operations in September 2006, which far exceeded its original business plan projection of $249 million by the end of its first year. The bank focused on commercial real estate (CRE), including acquisition, development and construction (ADC) lending resulting in significant concentrations by loan type and geographic area. The bank's assets increased by another $79 million during the next quarter to total $459 million by the end of December 2006, 15 months after starting operations (see Figure 1, which follows).

Figure 1: MagnetBank's Asset Growth in the First 15 Months of Operations



Source: Uniform Bank Performance Report (UBPR) data for MagnetBank.

At the August 2006 MagnetBank BOD meeting, which included a discussion of the August 2006 examination results, the BOD discussed raising additional capital to continue to grow the bank and reduce the bank's concentrations in CRE/ADC lending. On October 11, 2006, the bank filed a notice requesting FDIC permission to modify its business plan to accomplish these goals. The UDFI approved the bank's proposed amendments to the business plan on December 19, 2006. However, only the FDIC's Board of Directors could act on this filing because the delegation of authority to the FDIC's DSC for approval of all applications and notices with respect to industrial banks and industrial loan companies was suspended pursuant to July 28, 2006 and January 31, 2007 FDIC Board Resolutions. On June 18, 2007, MagnetBank filed a Change in General Character of Business application with the FDIC to convert from an industrial bank charter to a Utah commercial bank charter. According to the FDIC Board Case, dated July 18, 2007, MagnetBank's business plan modification request, which included the injection of an additional $50 million in capital, provided DSC with an opportunity to clarify FDIC expectations regarding the bank's risk profile, including the importance of maintaining a diversified loan portfolio and adherence to its business plan. As a condition of approval, MagnetBank was required to enter into a Capital and Liquidity Agreement (CLA) with the FDIC. The CLA required MagnetBank to maintain capital ratios at 12 percent, maintain liquidity ratios at 10 percent of total assets, and abide by

revised financial projections. The bank's revised business plan and charter change approvals were granted by the FDIC's Board of Directors on July 24, 2007, and the CLA was signed on July 25, 2007.

Details on MagnetBank's financial condition, as of September 2008, and for the 3 preceding calendar years follow in Table 1.

Table 1: Financial Condition of MagnetBank

	30-Sept.-08	**31-Dec.-07**	**31-Dec.-06**	**31-Dec.-05**
Total Assets ($000s)	$300,674	$458,361	$458,699	$71,136
Total Deposits ($000)	$282,578	$409,982	$406,326	$25,296
Total Brokered Deposits ($000)	$282,154	$401,476	$404,841	$24,796
Brokered Deposits as a % of Total Deposits	**99.8%**	**98.0%**	**99.6%**	**98.0%**
Brokered Deposits as a % of Average Assets	91%	88%	80%	21%
Total Loans ($000s)	$252,762	$416,189	$360,965	$36,034
Net Loan and Lease Growth Rate	*-41.29%*	*13.25%*	*906.61%*	*N/A*
Net Income (Loss) ($000s)	($24,251)	($7,269)	$1,129	($2,993)
Return on Assets (%)	(8.16%)	(1.48%)	.44%	(22.46%)
Tier 1 Leverage Capital Ratio	4.84%	8.35%	11.36%	77.23%
Loan Mix (% of Loans):				
All Loans Secured by Real Estate	**88.14%**	**86.12%**	**89.82%**	**89.75%**
Construction and Development	80.16%	78.29%	80.88%	75.53%
CRE - Nonfarm/nonresidential	7.92%	7.67%	8.30%	14.23%
Multifamily Residential Real Estate	.07%	.15%	.63%	.00%
Commercial and Industrial Loans	**8.46%**	**6.86%**	**5.53%**	**10.25%**
Lease Financing Receivables	**3.39%**	**7.02%**	**4.65%**	**.00%**
Examination Date/Conducted By:[a]	**12-08-2008 UDFI and FDIC**	**04-07-2008 FDIC and UDFI**	**08-06-2007 UDFI and FDIC**	**08-07-2006 FDIC and UDFI**
Component/Composite Ratings[b]	555555/5	554544/5	222222/2	222323/2
Adverse Classifications Ratio	555.52%	218.83%	28.72%	No Adverse Classifications

Source: UBPR and Reports of Examination (ROE) for MagnetBank.

[a] All examinations were conducted jointly by the FDIC and UDFI. The lead examination agency is listed first in the table.

[b] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

As a de novo bank for its first 3 years in operation, MagnetBank was subjected to additional supervisory oversight and regulatory controls, such as adherence to conditions set forth in granting deposit insurance, including operating within the parameters of the business plan, and increased examination frequency. The FDIC's DSC has recognized that de novo institutions can pose additional risk to the DIF, including where there is dependence on wholesale funding and CRE/ADC concentrations.

CAUSES OF FAILURE AND MATERIAL LOSS

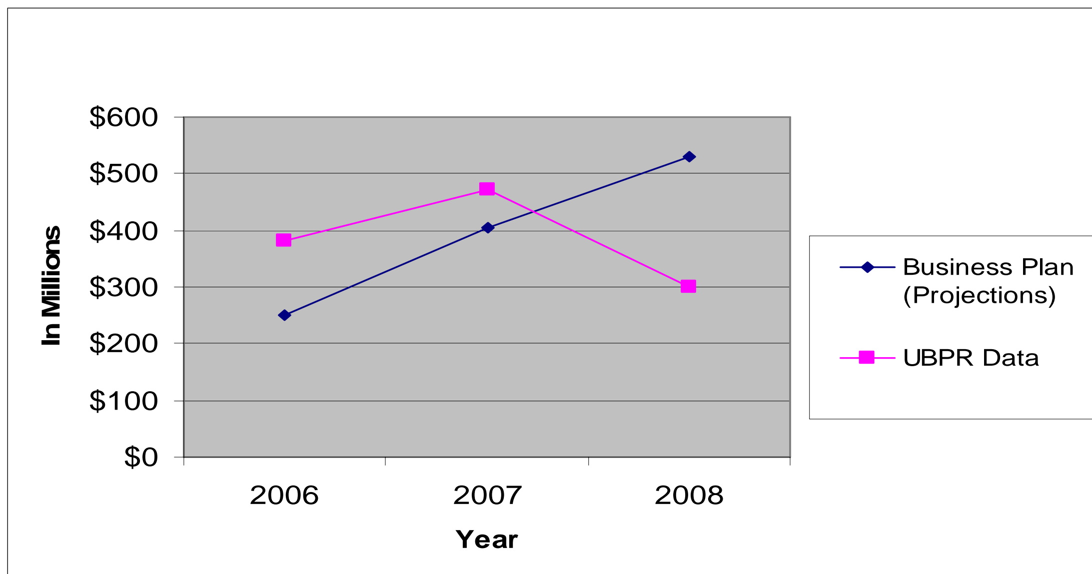
Aggressive Growth Strategy

MagnetBank failed due to management's aggressive pursuit of CRE/ADC lending concentrated in high-growth markets, coupled with weak risk management controls that left the bank unprepared to deal with declining markets. MagnetBank's business plan was to expand into a $530 million bank within its first 3 years of operations, funded by brokered deposits. To achieve this goal, MagnetBank pursued CRE/ADC lending through regulator-approved LPOs in multiple states and loan participations purchased from other banks. As a result of these lending efforts, the bank had reached $459 million in assets by the end of its first 15 months of operations, committing the bank to a highly concentrated CRE/ADC loan portfolio that was negatively affected when the economy declined.

The bank's operations were characterized by wide-spread weaknesses in loan underwriting and approvals; poor credit administration; high production-focused compensation for loan officers; inadequate due diligence for participations purchased; untimely recognition of problem assets; and as the economy turned, high levels of adversely classified assets and losses without an adequate allowance for loan and lease losses (ALLL). Due to the losses in the loan portfolio, the bank's capital eroded and liquidity became strained, ultimately leading to the failure of the bank, 40 months after opening, and an initial estimated loss to the DIF of $119.4 million.

As indicated in Figure 2, which follows, MagnetBank's initial efforts to expand the bank were successful, well beyond those described in the original business plan, until asset growth declined due to new loan origination restrictions imposed by bank management and loan losses.

Figure 2: MagnetBank's Asset Growth Compared to Original Business Plan



Source: The bank's Business Plan and UBPR data for MagnetBank.

To pursue its business strategy, MagnetBank opened LPOs in out-of-territory markets that the bank considered high-loan-growth-potential markets. MagnetBank hired loan officers from local communities who knew their respective markets. However, as noted in the April 2008 ROE, the bank's compensation agreements with the loan officers focused on loan production/development, rather than asset quality. Another aspect of the bank's business strategy included participating in loans from or to correspondent banks. As of June 30, 2007, the bank had participations purchased totaling about $99 million, or about 23 percent of the total loan and lease portfolio, while participations sold represented $139 million. By December 2008, participations purchased totaled $78 million, or about 31 percent of the bank's loan and lease portfolio because total loans and leases had declined, while participations sold represented $41 million. Among the correspondent banks with which MagnetBank did business were several banks that have since been closed by the state chartering agency and put into FDIC receivership. As noted in the material loss review reports issued on those banks,[6] each institution had poor loan underwriting practices, which could, and in some cases did, ultimately lead to losses for the loan purchaser as adverse market conditions arose or other factors caused loan quality to suffer.

Concentration in CRE/ADC Loans. MagnetBank's loan production efforts led the bank to high concentrations in CRE/ADC lending, which bank management found to be an easy market for asset growth. Concentrations in CRE/ADC lending consistently were at the 98th or 99th percentile of the bank's peer group. As shown in Table 2, below, MagnetBank's concentration in CRE/ADC loans as a percentage of Tier 1 Capital was noted in each examination report.

Table 2: MagnetBank's CRE/ADC Concentrations Compared to Peer

ROE Date	Percent of Tier 1 Capital	Percentile Ranking
August 7, 2006	350%	98
August 6, 2007	742%	98
March 3, 2008*	698%	99
April 7, 2008	863%	99
December 8, 2008	1,451%	99

Source: MagnetBank ROEs and UBPR data.
* Visitation.

The FDIC issued Financial Institution Letter 104 -2006 (FIL-104-2006) on December 12, 2006 titled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. The regulatory agencies were concerned that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. The guidance acknowledges that a concentration in CRE loans, coupled with weak loan underwriting and depressed CRE markets, may

[6] The banks were Integrity Bank, Alpharetta, Georgia (FDIC OIG Report AUD-09-006, dated March 17, 2009) and Alpha Bank and Trust, Alpharetta, Georgia (FDIC OIG Report AUD-09-010, dated May 1, 2009). Also, a review is in-process for FirstCity Bank, Stockbridge, Georgia (FDIC OIG Assignment No. 2009-033).

contribute to significant loan losses.[7] The guidance reminds banks that their "… risk management practices and capital levels should be commensurate with the level and nature of their CRE concentration risk." In addition, the guidance provides the following supervisory criteria for identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny:

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

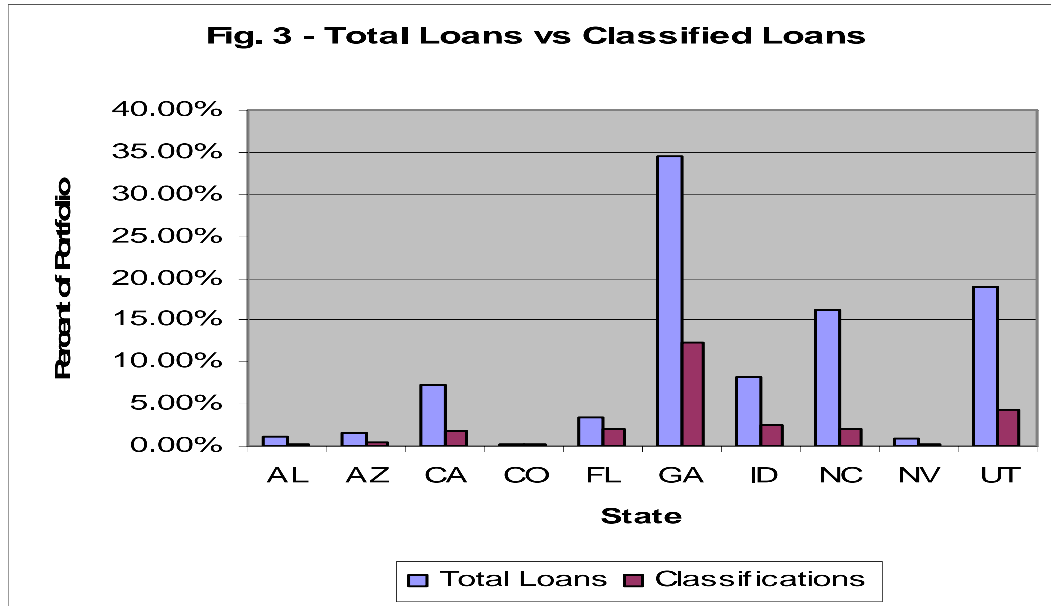
- total commercial real estate loans that represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Both the bank and the FDIC acknowledged that MagnetBank met the supervisory criteria. The August 2007 examination concluded that management understood the concentration risk and had appropriate monitoring and controls that mitigated some of the risk. The examination report concluded that the bank had adequate BOD and management oversight, portfolio management and stress testing, management information reporting, underwriting standards, and credit review in accordance with the December 2006 Interagency Guidance. However, examiners made five recommendations for management to enhance its management of concentration risk as discussed later in the *Assessment of Supervision* section of this report.

Rather than follow its regulator-approved business plan for a diversified loan portfolio that included acquisition and development, CRE, consumer real estate, and commercial and industrial loans, the bank concentrated its lending in CRE/ADC loans. As of May 31, 2007, real-estate-related loans comprised about 85 percent of MagnetBank's loan portfolio. Most of these loans were originated in the four states (Utah, Georgia, North Carolina, and Idaho) in which MagnetBank had the LPOs.

Although the bank's portfolio had geographic diversity as of April 2008, which could help alleviate some concentration risk, the bank's concentrations were largely in rapid-growth markets. When the economy suddenly declined in those markets, particularly in the 4th quarter of 2007 and 1st quarter of 2008, the bank's loan portfolio experienced significant increases in adverse classifications as identified in the April 2008 examination (see Figure 3, which follows).

[7] Additionally, the FDIC issued FIL-22-2008 on March 17, 2008 entitled, *Managing Commercial Real Estate Concentrations In a Challenging Environment*, which re-emphasized the importance of strong capital, ALLL, and loan risk management practices for state nonmember institutions with significant CRE and construction and development loan concentrations.



Source: April 2008 ROE.

Use of Brokered Deposits. In keeping with its original business plan to use wholesale funding sources such as brokered deposits, MagnetBank established relationships with several brokerage desks to obtain funding. The bank's brokered deposits averaged about 99 percent of all deposits during the life of the bank. Inherent in the use of brokered deposits is the need for a bank to maintain sound financial conditions, including adequate capital. Absent sound financial conditions, the volatility and higher cost of brokered deposit funding could put an institution at risk.

As of the April 2008 ROE, MagnetBank had $365 million in brokered CDs and $28 million in brokered money market accounts representing almost 100 percent of total deposits. MagnetBank had lengthy maturities on its brokered CDs; however, the renewal or roll-over of the CDs as they matured and the receipt of new accounts was restricted by DSC under PCA provisions because the bank had fallen into the "adequately capitalized" category with the filing of the March 2008 Report of Condition and Income (Call Report). As a result, the FDIC imposed a restriction on the acceptance or renewal of brokered deposits. The bank submitted a brokered deposit waiver request to the FDIC on April 9, 2008, in order to continue obtaining and renewing brokered deposits.[8] On June 5, 2008, the bank president withdrew the waiver application, stating that the bank had sufficient liquidity to meet its obligations through June 2008. Examiners who had conducted both the March 2008 visitation and April 2008 examination agreed that the bank had met the liquidity requirements (liquidity equaling 10 percent of total assets) in the CLA. The liquidity requirement was achieved primarily through borrowing lines with other banks, which required either collateral from MagnetBank or compliance with financial condition covenants. However, at both examinations, examiners reported concerns related to the bank's deteriorating asset quality and capital levels, which could

[8] A financial institution that is "adequately capitalized" cannot accept, renew, or roll over brokered deposits without a waiver from the FDIC.

have jeopardized the bank's ability to maintain its funding sources. The April 2008 examination also noted that the bank did not have a contingency liquidity plan.

The December 2008 ROE states that liquidity had become critically deficient because of the increasing level of non-performing assets and diminishing cash flows. Cease and Desist Orders (C&D), issued in September and October 2008, prohibited the bank from renewing any brokered deposits. Further, all lines of credit previously available to the bank had been cancelled by lenders, and MagnetBank had difficulty in providing sufficient funding to cover $15 million in brokered CDs when they matured on December 19, 2008. These factors led to the insolvency of the institution and its failure on January 30, 2009.

Risk Management Controls

Management pursued its aggressive growth strategy without implementing risk management controls commensurate with the risk in CRE/ADC concentrations. Examiners found weaknesses in controls related to (1) credit underwriting and administration and (2) compliance with regulatory orders. The lack of sound controls adversely affected MagnetBank's ability to handle the market downturn that subsequently materialized.

Credit Underwriting and Administration. The April 2008 examination identified that the BOD failed to formulate and implement a credit risk control environment that would engender a conservative credit culture within the bank. The BOD's emphasis, from the creation of the bank to the third quarter of 2007, was rapid growth. This growth was accomplished without effective controls over underwriting, loan policies, credit and documentation reviews, and participations purchased. Also, additional control was warranted regarding the role of the Chairman and Chief Executive Officer (CEO) of the institution. By the first quarter of 2008, the bank had significant asset quality problems resulting from its continued growth without sufficient attention to underlying controls. Specifically, examiners identified the following deficiencies in the bank's risk management controls related to credit underwriting and administration.

- **Underwriting Deficiencies**. The BOD permitted the hiring of loan officers for their production abilities rather than sound credit judgment. Examiners concluded that this fact helped foster a "broker" mentality among many of the bank's loan officers, meaning that the loan officers focused more on business development than sound underwriting. Further, the bank's compensation agreements with the loan officers focused on loan production/development rather than asset quality. The April 2008 ROE states that there were few controls established to prevent "abuses" in loan origination and servicing of the bank's loan portfolio. Examiners concluded that this lack of controls allowed loan officers to understate the risks of the credits that they originated and presented to the bank's Loan Committee. Examiners also concluded that the BOD had exposed the bank to greater credit risk by making loan officers responsible not only for business development but also for credit review and loan collection, thereby undermining a key internal control—the separation of duties. The bank did not have the controls or the staffing to verify the quality of credit

underwriting, the accuracy of grading assigned by loan officers to loans they originated, and the effectiveness of collection efforts.

- **Loan Policies and Practices.** Although the 2006 and 2007 examinations stated that the bank's risk management processes were generally adequate in relation to economic conditions and asset concentrations, the examinations identified several improvements needed in the bank's loan policies. The improvements identified in the August 2006 examination included strengthening the bank's loan policies for limiting CRE lending, considering geographic restrictions, and analyzing the effects of a downturn in the real estate markets. The August 2007 examination further recommended revising the loan policy to limit total exposure to 25 percent or less for all loan types for each state with an LPO. However, according to the April 2008 examination, MagnetBank's BOD failed to adequately implement and enforce a sound loan policy. Specifically, higher-risk lending, such as speculative construction loans and residential and commercial acquisition and development loans, was not appropriately limited. Also, examiners concluded that the bank's credit practices encouraged real estate lending based on inflated loan-to-value ratios rather than lending to borrowers with cash equity in projects. For many loans, the only equity in the project was value appreciation based on rapidly escalating real estate markets because the BOD did not require that credit staff ensure that borrowers were also placing their own capital at risk. The BOD also allowed stated income construction loans, particularly for 1-4 family owner occupied residences.

- **Credit and Documentation Review**. According to the April 2008 ROE, the BOD did not create and appropriately staff an effective loan review function. Additionally, we concluded that the bank did not conduct routine independent credit and documentation reviews. MagnetBank engaged an independent, limited-scope review of the commercial loan portfolio as of May 31, 2007. The review report, dated July 6, 2007, concluded that the loan portfolio of the bank was properly underwritten and monitored. Further, the bank had a rigorous process that provided reasonable assurance of timely and accurate credit risk rating. In October 2007, the bank conducted an extensive analysis of its portfolio and contracted for an independent review of the results. The December 2007 report on a second independent review stated that 42 percent of the bank's loan portfolio had issues, either causing concern or already defined as a problem, and that only a small number of these loans had been identified as problem loans by the loan officers. The August 2007 ROE - 2 months prior to the bank's review - identified asset classifications of 29 percent of the total loan portfolio. The independent reviewers noted that, in many cases, documentation such as financial statements was stale and that loans appeared to have little or no review prior to the bank's analysis in October 2007. The bank's failure to promptly and accurately identify problem loans resulted in the ALLL being underfunded by $7 million as noted in the April 2008 ROE and by $19.3 million as noted in the December 2008 ROE. Table 3 on page 15 contains more details on the bank's adversely classified items and ALLL.

  A September 25, 2007 internal memorandum from the president of the bank to the BOD cited examples where loan officers had provided incomplete or erroneous

information about individual credits presented to management and/or the Loan Committee for approval. We were able to determine that some actions by the loan officers led to losses on some of the cited credits. The bank's internal communications contained some examples of inappropriate loan officer actions at various LPOs as shown in the excerpts below.

> **Boise LPO** – A transaction was presented as a viable project to the Directors' Loan Committee by a loan officer with the concurrence of the LPO manager, because of a competing project purported to be fully leased when, in fact, the adjacent retail property was only two-thirds leased and the presentation ignored 13 vacant office units.
>
> **Atlanta LPO** – A loan officer originated a lease transaction for an individual previously jailed for fraudulent leases. Another loan officer misrepresented facts and permitted the sale of a controlling interest in a borrowing entity without approval. A third loan officer falsified third-party inspections on real estate collateral. A fourth loan officer misrepresented the facts on more than one acquisition and development transaction.
>
> **Raleigh LPO** – A loan officer falsified third-party inspections.
>
> **Salt Lake City LPO** – A loan officer knew a project was not viable, yet he originated the transaction and got it approved. The transaction involved likely fraud by the borrowers and others, which is being investigated by law enforcement.

- **Participations Purchased**. MagnetBank also engaged in a high volume of participations purchased ($99 million as of June 2007 and $78 million as of December 2008). Most of these participations were with institutions that were not in Utah and were primarily originated in once-growing real estate markets, such as Atlanta, Georgia. Generally, participations purchased are a quick method of growth for a bank because the loan origination and underwriting is conducted by the selling bank. However, each loan participation purchaser should conduct adequate due diligence procedures to ensure that credit risk is identified and accepted. A bank generally sells a participation in a loan as a means of staying within legal lending limits and diversifying risk. Many of these participations were with banks that subsequently failed in 2008 and 2009 and involved allegations of improper or negligent loan underwriting practices by the originating bank, as well as weak due diligence by MagnetBank loan officers (see Appendix 2). A MagnetBank *Participations Purchased* schedule, dated June 2007, shows that the bank had purchased its largest percentage of loans from FirstCity Bank in Stockbridge, Georgia (an Atlanta suburb), which failed in March 2009. These loans, totaling $34 million, represented 71 percent of MagnetBank's capital and 29 percent of MagnetBank's total participations purchased and added to its concentration in that market where MagnetBank had an LPO.

  MagnetBank developed a methodology for determining the amount of loans it would purchase from another bank. The methodology focused more on assigning a rating to a bank than the credit worthiness of individual loans and included evaluating the participant bank's financial condition, using a rating service and then assigning an overall credit quality/underwriting grade determined by MagnetBank. Also, we noted

that MagnetBank conducted the credit quality rating for only half of the banks with which it did business.

Once these two factors were evaluated, MagnetBank would determine the level of capital exposure the bank would accept. For example, in the first quarter of 2007, Integrity Bank, Alpharetta, Georgia (another Atlanta suburb), which failed in 2008, had been assigned the highest financial rating category and the highest credit quality grade; therefore, MagnetBank could expose up to 90 percent of its capital in participations purchased from Integrity Bank. By the second quarter of 2007, Integrity Bank had the lowest financial rating category and the second to lowest credit quality grade, which, according to MagnetBank's rating system, indicated that the bank should have zero capital exposure from Integrity Bank. However, by that time, MagnetBank already had nearly a 10-percent capital exposure with Integrity Bank. Similarly, FirstCity Bank, which failed in April 2009, was rated in the highest financial category along with the second highest credit quality rating, which indicated that the bank could have a 75 percent level of capital exposure. By the second quarter of 2007, FirstCity Bank's financial rating was still rated in the highest category, but its credit quality rating was in the second to lowest category, limiting MagnetBank's acceptable capital exposure to 25 percent. However, by the second quarter, MagnetBank already had about a 60-percent capital exposure in participations purchased from FirstCity Bank.

The September 25, 2007 internal memorandum from the president of MagnetBank to the BOD also stated the following, "Participation deals have been closed and/or disbursed differently than approved. For example, a participating bank switched collateral without MagnetBank approval at the closing of a transaction. MagnetBank had to file suit in order to get out of the transaction. In addition, the correspondent business has carried a higher degree of risk than originally assumed." The president's letter identified some examples of MagnetBank's deficiencies in risk mitigation relative to its correspondent business, as presented below:

1. Monitoring by a depository institution, which failed in 2009, has been poor and occasionally misleading.
2. A non-bank entity was a poor servicer of loans.
3. A bank sold MagnetBank two lot loans that went immediately into default.

As indicated in Appendix 2 of this report, many of the participations that MagnetBank purchased ultimately became substandard and resulted in losses to the institution.

- **Role of the Bank's Chairman and CEO.** In the April 2008 ROE, examiners concluded that the BOD failed to maintain reasonable control over the activities of the former Chairman and CEO, who resigned his bank positions in January 2008 and failed to heed warnings by several senior officers that loan officers were acting more like loan brokers than bank employees in trying to meet growth targets. Examiners concluded that "the Board appears to have turned over control to the former CEO by giving him an excessive lending limit, thus allowing him to approve large loans with

inadequate controls over the lending function." In the April 7, 2008 ROE, examiners reported that the BOD failed to minimize credit and concentration risk and relied on the former Chairman and CEO to control the risk. The examiners noted that, based on their discussions with bank management and their review of BOD meeting minutes, the BOD had placed unquestioned reliance on information provided by the former CEO, who was pushing to expand the loan portfolio in residential acquisition and development loans in the Atlanta, Georgia, market, despite warning signs that this area was becoming overbuilt. In its July 30, 2008 response to the April 2008 examination, MagnetBank's BOD conceded that "the Directors believe they were, at times, misled by the bank's former Chairman and Chief Executive Officer."

DSC and MagnetBank management met on April 3, 2008 where bank management disclosed the following information about certain loan approvals by the former CEO:

1. A follow-up review of the Atlanta market loans revealed that in some cases the actual project funded was not consistent with the project description in the loan documentation.
2. There appears to be a pattern of loans made in the Atlanta area just under the size limit for referral to the bank's loan committee. The former CEO had granted a number of loans just under his individual lending authority, which were experiencing distress. The credit underwriting documentation was "misleading."
3. The documentation on one loan was "fictitious."

In a July 1, 2008 letter to the bank's outside Counsel, DSC's Director for the San Francisco Regional Office (SFRO) denied an April 9, 2008 request, filed on behalf of MagnetBank, seeking FDIC approval to make a payment to the former bank Chairman and CEO. The response letter concluded that this would constitute a "golden parachute" payment subject to the provisions of section 359.1(f) of the FDIC Rules and Regulations, because the FDIC had previously declared the bank in "troubled condition." In support of this denial decision, DSC noted that from the date of the individual's employment until his resignation on January 24, 2008, he had served as the bank's Chairman and CEO, positions which placed him in a high degree of fiduciary responsibility to the bank. The denial decision emphasized that during the individual's tenure as Chairman and CEO, the overall condition of the bank deteriorated to the point that its viability was in question. The decision concluded that the former Chairman and CEO was viewed as being principally responsible for the bank's declining condition.

Compliance with Regulatory Orders. As part of a condition in the FDIC Order Granting Insurance and Utah Department of Financial Institution Order, MagnetBank was required to operate within the parameters of its approved business plan. MagnetBank's original business plan established a goal of a diversified asset portfolio that contained a mix of acquisition and development, CRE, consumer real estate, and commercial and industrial loans. However, bank management did not achieve that goal due to the bank's pursuit of rapid growth in CRE/ADC lending. In its April 2007 revised business plan, the bank again established diversified portfolio goals, including equipment leasing and Small Business Administration lending, to reduce its CRE/ADC

concentration. The bank was to use additional capital to achieve the portfolio diversification. Again, the bank did not achieve a diversified portfolio. According to the April 2008 ROE, the BOD acknowledged the existence of the *Interagency Guidance on Concentrations in Commercial Real Estate* in both the BOD and Loan Committee minutes but did not establish any meaningful concentration limits based on loan types or geography. Had the BOD set such limits, some of the risks caused by the concentrations in CRE/ADC lending, including in certain geographic markets, could have been at least partially mitigated.

As part of the approval for MagnetBank's business plan modification and charter change to a commercial bank, and to address the FDIC's concerns with the bank's operations, MagnetBank signed a CLA on July 25, 2007. Among other provisions, the bank agreed to maintain capital levels at 12 percent of risk-based capital and inject an additional $50 million in capital. This additional capital would facilitate the bank's growth and diversification and ensure compliance with the minimum capital requirement. According to FDIC officials, the bank was not able to achieve these capital levels because financial markets had cooled by the time the proposed stock offering was approved by the FDIC, and the decline in the bank's financial condition made ownership in the bank less desirable. After 2007 year-end financial data was submitted by the bank, the SFRO sent a letter in March 2008, notifying the bank of its violation of the CLA's provisions for obtaining additional capital, maintaining capital ratios, and diversifying the balance sheet. The FDIC and MagnetBank management exchanged numerous letters and, according to FDIC officials, engaged in many discussions about improving the bank's capital position. However, the bank did not raise the agreed-to capital. The agreement also called for the bank to maintain a 10-percent liquidity-to-assets ratio. The bank was initially able to achieve this liquidity ratio through brokered deposits and available lines of credit, until increasing levels of non-performing assets and diminishing cash flows and capital caused brokered deposits to be restricted and the lines of credit to be canceled.

Effects of Growth Strategy Coupled with Weak Risk Management Controls

MagnetBank's asset quality deteriorated as loan classifications significantly increased, from zero in 2006 to over $103 million and $138 million in April and December 2008, respectively. We also noted that some of the participated loans became adversely classified and resulted in losses for the bank. At the April 2008 and December 2008 examinations, adversely classified loans represented 219 percent and 556 percent of capital, respectively. Progressive increases in the ALLL were required by examiners in April and December 2008 (see Table 3) even though the bank's loan portfolio was declining significantly due to the fact that the bank had essentially ceased the origination of new loans across all product lines.

Table 3: MagnetBank's Loan Classifications and ALLL (Dollars in $000)

Examination Date	Asset Classifications				Analysis of ALLL	
	Substandard	Doubtful	Loss	Total Adversely Classified Items	ALLL Computed by the Bank	Increase in ALLL Required by Examiners
August 2006	0	0	0	0	$2,176	0
August 2007	$15,575	0	0	$15,575	$5,435	0
March 2008 *	$55,413	$308	$5,519	$61,240	$9,389	0
April 2008	$89,804	0	$13,673	$103,477	$14,413	$7,020
December 2008	$112,868	0	$25,172	$138,040	$8,737	$19,346

Source: ROEs and UBPRs for MagnetBank.
* Visitation.

Suspicious Activity. In the bank's final months of operation, MagnetBank officials reported to the Treasury's Financial Crimes Enforcement Network over $66 million in suspicious activity related to transactions by bank insiders. Those suspicious activities ranged from failure to disclose information to incorrect description of properties and allegations of mortgage fraud. Such activity may have been made possible by bank management's lack of controls over the credit function.

Summary. According to the FDIC's *Risk Management Manual of Examination Policies*, the quality of management is probably the single most important element in the successful operation of a bank. The BOD is responsible for formulating sound policies and objectives for the bank, effective supervision of its affairs, and promotion of its welfare, while the primary responsibility of senior management is implementing the BOD's policies and objectives in the bank's day-to-day operations. In addition, according to the DSC C*ase Manager Procedures Manual*, the safety and soundness risk posed by any particular institution is a function of the business plan pursued, management's competency in administering the institution's affairs, and the quality and implementation of risk management programs. In the case of MagnetBank, all three of these areas had significant weaknesses that led to the bank's failure.

ASSESSMENT OF SUPERVISION

DSC's Salt Lake City Field Office and the UDFI conducted four joint safety and soundness examinations of MagnetBank, a de novo institution, from August 2006 through December 2008, and the FDIC conducted two visitations, the first of which was the initial "new bank" visitation. As a result of problems identified through the FDIC's off-site monitoring, the FDIC conducted a visitation in March 2008 and then accelerated the next examination to April 2008, which resulted in C&Ds being issued in September and October 2008. The last examination of MagnetBank was in December 2008. Each examination report contained comments for improving the safety and soundness of the bank.

Historical Snapshot of Supervision

Examiners expressed concern regarding MagnetBank's significant concentrated growth in its first 15 months of operation. Specifically, the first two examinations of MagnetBank in August 2006 and August 2007 identified the concentration risks and outlined actions to improve controls over the concentration. As early as the August 2006 examination, the examiners recommended that the bank monitor and control risk in the CRE/ADC loan concentrations, including clarifying the concentrations policy and enhancing risk management reporting to limit concentrations exposure. Examiners were also concerned about the bank's failure to formulate and implement an appropriate credit risk control environment (see Appendix 3 for examples of examiner comments.)

The August 2007 ROE and supporting work papers addressed MagnetBank's compliance with the December 12, 2006, Interagency Guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. According to the guidance, the FDIC and the other federal regulatory agencies have acknowledged that a concentration in CRE loans, coupled with weak loan underwriting and depressed markets, has contributed to significant loan losses. The work papers indicated that the bank had total CRE exposures, as of June 30, 2007, at $366 million or 674.88 percent of total capital, and of that exposure, construction and land development lending was $333 million or 614.96 percent of total capital. The examination work papers state that these very high ratios, well in excess of the supervisory criteria in the Interagency Guidance, identify MagnetBank as having significant CRE concentration risk. Under these circumstances, the Interagency Guidance discusses additional focus on risk management practices and capital levels commensurate with the concentration risk.

The August 2007 ROE concluded that bank management understood the concentration risk and had implemented appropriate monitoring and controls that mitigated some of that risk. Examiners concluded that the bank's risk management practices were generally adequate in relation to economic conditions and asset concentrations. Also, capital was well-rated, and the 2007 ROE discussed an additional capital infusion that had not yet occurred. However, the examiners stated that the bank's Concentrations Policy and management reporting should be clarified and enhanced, and the *Risk Management Assessment* section of the ROE presented five specific recommendations to accomplish that objective.

Recommendations:

1. Management should consider revising the lending policy to limit total exposure to 25 percent or less for all loan types for each state with a loan production office.
2. The bank should develop reporting that measures and monitors the primary repayment sources. At a minimum the reports should track the penetration and absorption rates where the bank has exposure (i.e., residential lots or commercial square footage).
3. Based on the results of the enhanced reporting, Management should consider additional concentration limits based on county or zip code, if warranted.
4. Management should also consider information gathering services on secondary guarantee sources.

5. Management reporting should also identify the largest borrowing exposures.

Nevertheless, examiners indicated that the bank had adequate risk mitigation, including:

- a geographically diverse portfolio across several states, minimizing the impact of local economic downturns;
- previous relationships and experience with many borrowers;
- conservative underwriting practices; and
- well-developed lending policies with strong controls for CRE lending.

Examiners also cited the competence and capabilities of the management team, giving management a 2 rating. According to the August 2007 ROE:

> . . . risks are consistently and effectively identified, measured, monitored, and controlled. The level of depth and experience from both Senior Management and the Board of Directors results in strong risk management oversight and conservative and prudent banking practices. Management has adapted the [revised] business plan to better diversify the loan portfolio and reduce CRE concentration risk. They also converted to a commercial bank charter to facilitate raising additional capital for the purpose of funding growth and operations.

MagnetBank was well-rated as a result of the August 2007 examination. However, as a result of off-site monitoring of the bank's 2007 year-end Call Report financial data, the FDIC commenced a visitation in March 2008 that focused heavily on the quality of the bank's loan portfolio. The visitation identified a precipitous decline in asset quality. Loans internally classified represented over 200 percent of Tier 1 Capital. Non-performing assets were approximately 20 percent of total assets. Further, the bank had not achieved compliance with the CLA between the bank and the FDIC. The visitation's results prompted the acceleration of the next annual examination to April 2008.

The April 2008 examination found that adversely classified loans had increased dramatically due primarily to MagnetBank's CRE concentrations in the midst of a precipitously declining real estate market. The ROE states that the excessive volume of problem assets had negatively impacted earnings and liquidity, capital was critically deficient due to CRE losses, and the viability of the bank was threatened by poor asset quality due to a lack of diversification in the loan portfolio. The report indicates that the bank was in violation of the capital provision in 2005 order granting deposit insurance and had never complied with the capital requirement in the 2007 CLA. The report states that the bank's ALLL was underfunded and that underlying loan grading by loan officers was suspect because their incentive pay could be negatively affected by poor performing loans. The report also indicates that the bank did not have a contingency funding plan. In addition to a composite rating of 5 indicating extremely unsafe and unsound practices and probable failure, capital, asset quality and earnings also received 5 ratings. Examiners were critical of bank management for failing to diversify the loan portfolio and concluded that immediate capital augmentation was required.

The April 2008 ROE, in contrast to the August 2007 examination, stated that the BOD had not fulfilled its primary fiduciary responsibility to ensure that the institution was operated in a safe and sound manner. Accordingly, bank management, which includes the BOD and senior executive management, was considered unsatisfactory. The report cited a number of issues with MagnetBank's BOD including:

- failure to comply with the Order Granting Federal Deposit Insurance and Amended Order Approving Charter;
- failure to comply with the CLA;
- failure to control concentration risk and implement the business plan to diversify the loan portfolio;
- failure to maintain control over a dominant CEO and Chairman of the Board;
- failure to adhere to the approved business plan; and
- failure to document Executive Sessions of the BOD meetings.

In its response to the April 2008 ROE, MagnetBank's BOD highlighted the marked differences between the August 2007 examination and the April 2008 examination. In its response, the BOD noted that as early as the first and second quarters of 2007, members of the BOD were beginning to independently question certain credit and management decisions even in light of a glowing August 2007 examination of the bank by the FDIC and UDFI which appeared to indicate all was well. The response further stated that the BOD believed that many of the criticisms of the bank and directors contained in the 2008 ROE were being made with the benefit of hindsight. The bank's BOD concluded that the FDIC's use of hindsight was apparent when the April 2008 ROE is compared to the August 2007 ROE. In the August 2007 ROE, just 8 months prior to the April 2008 ROE, the BOD's oversight of the bank was almost uniformly praised by the FDIC and UDFI.

Of particular note in MagnetBank's response to the 2008 examination, the bank's BOD expressed concern that its business plan amendment, filed on October 11, 2006, that included a primary element to raise an additional $50 million in Tier 1 Capital, was not approved by the FDIC until July 24, 2007. The bank's BOD stated that delays in regulatory approval of the business plan amendment, coupled with changing financial markets, prevented the bank from raising the capital necessary to support anticipated growth and portfolio diversification outlined in the business plan. During this time, the FDIC had announced a moratorium on industrial loan company (ILC) activities, including industrial banks such as MagnetBank, and extended the moratorium through January 2008. The moratorium was meant to address the evolution of the ILC industry and concerns related to the potential risks from mixing banking and commerce. The imposition of a moratorium on FDIC actions related to (1) applications for deposit insurance submitted to the FDIC by or on behalf of an ILC and (2) changes in bank control notices submitted to the FDIC with respect to any ILC. As a result, applications and notices required FDIC Board of Director's approval.

The final examination of MagnetBank in December 2008 identified the bank as being insolvent. The examination focused on the bank's status in addressing the two outstanding C&Ds from the UDFI and FDIC. Among the actions required in the

September and October 2008 C&Ds were requirements for the bank to: (1) achieve and maintain minimum capital levels, (2) formulate and adopt a comprehensive business/strategic plan, (3) reduce and monitor the bank's loan portfolio and any extensions of credit to CRE borrowers, (4) replenish the ALLL, and (5) review and revise loan policies and procedures to strengthen the bank's asset quality and lending functions. The bank was in noncompliance with all of these requirements as of the December 2008 examination. Also, the bank had not been able to attain mandated capital ratios. The bank indicated that unless a recapitalization of the bank was realized, a strategic plan was meaningless. The bank was closed the following month.

OIG Assessment of FDIC Supervision

Based on our review, we concluded that the FDIC provided ongoing supervision of MagnetBank; identified key concerns for attention by bank management, including the problems that led to the bank's failure; and, together with the UDFI, pursued enforcement action as the bank's financial condition deteriorated in 2008 prior to the bank's failure. The FDIC's off-site monitoring identified the need for additional oversight, resulting in a visitation and subsequent acceleration of the 2008 examination. The April 2008 examination included a thorough analysis of asset quality and other problems at the bank, and the FDIC and UDFI followed up on the resulting two enforcement actions in December 2008.

However, the FDIC could have provided additional supervisory attention and taken additional action regarding MagnetBank. In particular, the 2007 examination could have more fully considered the risks associated with the rapid growth of a de novo institution concentrated in CRE/ADC lending, funded almost exclusively with wholesale funding sources. Additional risks included the need for loan portfolio diversification contained in the recent business plan change, significant involvement in loan participations in high-growth markets and weak loan review activities. As is normal for a de novo institution, the bank had losses in its first 2 years in operation (2005 and 2006). Further, the bank reported losses of over $7 million for 2007. Therefore, the bank, which started operations in 2005, did not have a strong record of financial performance. Examiners emphasized heavily the past experience of MagnetBank's management team rather than the growing risk to the institution from its aggressive business strategy and weak risk management controls.

Between the August 2007 and April 2008 examinations, MagnetBank went from well rated to the worst composite rating assigned, and numerous critical deficiencies were identified in risk management controls by the latter examination. As discussed earlier in this report, the contrast between the August 2007 examination and subsequent visitation, examination, off-site monitoring, and loan review activities indicate that underlying problems existed that warranted supervisory attention. The FDIC should have ensured that examiners followed the supervision strategy for the 2007 examination, developed in conjunction with the FDIC's approval of the bank's revised business plan, that specified a 60-percent loan sample, which might have identified additional asset quality and risk management control problems. Also, delays occurred in processing C&Ds after the April

2008 examination. Earlier detection of the underlying problems at MagnetBank could have led to timelier supervisory actions as well as corrective action by the bank to address its problems.

Supervision Strategy for 2007. As part of the FDIC approval process for the bank's revised business plan, the FDIC's Washington Office asked the SFRO to develop a bank supervision strategy. In April 2007, the SFRO submitted its supervision strategy for MagnetBank, which planned for annual examinations, interim 6 month visitations, and quarterly offsite monitoring, including an extensive, 60 percent or greater loan portfolio sample for the 2007 examination. However, the actual loan sample was less than half of the 60 percent targeted amount. The Pre-Examination Planning (PEP) Report contained in the examination work papers for the August 2007 joint examination indicated that the loan review sample would be between 25 and 30 percent. The UDFI, which prepared the PEP Report as the lead agency, had not been informed by the FDIC of the supervisory strategy to sample 60 percent of the loan portfolio. Examiners for the August 2007 examination conducted a loan review of 27 percent of the loan portfolio. Greater supervisory concern during the August 2007 examination regarding MagnetBank's asset quality could have led to earlier supervisory action, particularly in light of its de novo status and business plan revisions.

Cease and Desist Orders. As a result of the April 2008 examination, the FDIC met with MagnetBank officials on June 25, 2008 to present the examination results. At the meeting, the FDIC informed the bank that a C&D would be issued. In July 2008, the FDIC's DSC requested that a C&D be prepared by the Legal Division. The Legal Division, in consultation with the UDFI, developed a 25-point C&D to require corrective action in response to examination concerns reported in the April 2008 ROE. There was a disagreement between the FDIC and the UDFI related to which regulator had the authority to rescind the C&D. As a result of the disagreement, two C&Ds were issued, the UDFI's C&D in September 2008 and the FDIC's C&D in October 2008. Each C&D contained the same content, except for the language related to the rescission of the order, to: retain qualified management, increase BOD participation, formulate and adopt a business/strategic plan, achieve and maintain minimum capital levels, and reduce the size of the CRE/ADC loan portfolio. The delay in issuing the C&D resulted in untimely enforcement action against the bank and delayed the UDFI in preparing its case for closing the institution. A final assessment of the bank's status in responding to a C&D aids the UDFI in obtaining a possessory judgment to close a bank in the state of Utah.

Actions Taken Subsequent to MagnetBank's Failure

DSC has established a corporate performance objective that formal corrective action be presented to an institution within 60 days after an examination completion date. Additionally, DSC has begun issuing an examination exit letter advising 4 or 5 composite-rated institutions that they must notify the FDIC prior to any material change in their balance sheet, including large brokered deposit acquisitions. The SFRO has also taken steps to strengthen off-site monitoring of financial data by enhancing current off-site monitoring with reports that identify and rank institutions with characteristics that

include concentrations and high levels of wholesale funding. Also, DSC has developed a *De Novo Performance Report*, which compares a de novo bank's approved business plan to quarterly Call Report data. Deviations are identified for follow-up by the Case Managers. This report is a useful off-site monitoring tool that will help DSC identify future deviations by de novo banks from their approved business plans as well as concentration risks.

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 PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized. For MagnetBank, the FDIC followed PCA guidance. The March 2008 FDIC visitation found significant deterioration in asset quality, resulting in increased losses and depletion of capital. These results were further developed in the April 2008 examination. On June 25, 2008, the FDIC notified MagnetBank of its PCA status, "Undercapitalized," on the transmittal letter that accompanied the April 2008 ROE. The bank was required to submit a capital restoration plan and restrict asset growth. The bank was unable to raise additional capital, and on January 6, 2009, the FDIC notified MagnetBank of its "Critically Undercapitalized" status, under PCA provisions, and the bank subsequently failed on January 30, 2009.

CORPORATION COMMENTS AND OIG EVALUATION

On August 20, 2009 the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC's response is provided in its entirety in Appendix 5 of this report. In its response, DSC stated that MagnetBank failed due to management's aggressive pursuit of ADC loans concentrated in high-growth markets funded with higher-cost wholesale deposits. DSC also stated that this profile, coupled with weak management controls, left MagnetBank unprepared to deal with declining markets.

In addition, the Director stated that in 2007, DSC had implemented a supervisory strategy of planned annual examinations, interim 6-month visitations, and quarterly off-site monitoring. However, DSC agreed that, in 2007, a higher loan sample may have uncovered additional problems that could have led to earlier supervisory action. DSC also stated that the examiner loan review did identify several significant problem loans that led to actions by MagnetBank management. A revised business plan and financial model had been adopted by MagnetBank when the August 2007 examination commenced, leaving limited time to perform under the revised plan. Additionally, DSC noted that MagnetBank management was not able to raise the $50 million in capital related to implementation of the new plan and was not able to achieve goals set for diversification of the loan portfolio and funding sources due to rapid deterioration in asset quality and in the institution's markets.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

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

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

We conducted the audit from February 24, 2009 to July 10, 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it may not have been feasible to address certain aspects of the standards, as described on the next page.

Scope and Methodology

The scope of this audit included an analysis of MagnetBank's operations from September 29, 2005 until its failure on January 30, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by the FDIC and the UDFI examiners from 2006 to 2008.

- Reviewed the following:
  - Bank data and correspondence maintained at DSC's SFRO and Salt Lake City, Utah, Field Office.

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed bank records maintained by DRR in Dallas, Texas, for information that would provide insight into the bank's failure, as well as various annual reports and accompanying financial statements.

  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:
  - DSC management in Washington, D.C., and the SFRO, California.
  - DRR officials at the Dallas Regional Office.
  - FDIC examiners from the DSC Salt Lake City, Utah, Field Office who participated in examinations or reviews of examinations of MagnetBank.
- Met with current and former officials of the UDFI in their Salt Lake City, Utah, office and at an FDIC office in Dallas, Texas, to discuss the historical perspective of the institution, its examinations, state banking laws, and other activities regarding the state's supervision of the bank.
- Researched various banking laws and regulations, including laws related to ILCs and industrial banks.

We performed the audit field work at DRR offices in Dallas, Texas, and DSC offices in San Francisco, California, and Salt Lake City, Utah.

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

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of MagnetBank's management controls pertaining to its operations as discussed in the finding section of this report.

For purposes of the audit, we did not rely on computer-processed data to support our significant findings and conclusions. Our review centered on interviews, ROEs and correspondence, and other evidence to support our audit.

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

EXAMPLES OF PARTICIPATIONS PURCHASED BY MAGNETBANK

Loan No./ Date	Loan Amount	Participation Purchased and Amount	ROE Date Noting Adverse Classification	ROE Adverse Classification Amount
Loan A 6-14-06	$1,601,000	100% Participation Purchased of $1,601,000 from a bank closed by regulators in 2009	April 7, 2008 March 3, 2008	Substandard = $1,000,000 Loss = $601,000 Substandard = $1,151,000 Loss = $450,000
Loan B 9-25-06	$6,000,000	Participation Purchased of $6,000,000 from a bank closed by regulators in 2008	April 7, 2008	Substandard = $3,500,000 Loss = $2,500,000
Loan C 4-6-06	$1,599,000 with $57,000 in Accrued Interest	100% Participation Purchased of $1,599,000 from a bank closed by regulators in 2009	December 8, 2008 March 3, 2008	Substandard = $1,599,000 Substandard = $1,599,000 + $57,000 Accrued Interest
Loan D 9-11-06	$3,942,000 Owned Real Estate (ORE)	100% Participation Purchased of $3,942,000 from a bank closed by regulators in 2009	December 8, 2008 March 3, 2008	ORE amount = $3,637,000 Substandard = $3,500,000 Loss = $137,000 ORE amount = $2,878,000 Substandard = $2,472,000 Loss = $406,000
Loan E 8-14-07	$2,500,000	Participation Purchased of $2,500,000 from a bank closed by regulators in 2008	December 8, 2008	Loss = $2,500,000
Loan F 3-23-06	$4,477,000	80% Participation Purchased of $6,000,000 from a bank closed by regulators in 2009	December 8, 2008 April 7, 2008	Substandard = $2,316,000 Loss = $2,161,000 Special Mention = $4,477,000 .
Loan G Approx. 3-2-07	$1,890,016	Participation Purchased of $1,890,016 from a bank closed by regulators in 2009	December 8, 2008	ORE amount = $1,425,000 Substandard = $1,425,000

Source: ROEs and DRR records on MagnetBank.

EXAMPLES OF MAGNETBANK EXAMINER COMMENTS AND RECOMMENDATIONS RELATED TO ASSET QUALITY

Examiner Comments	Examination Dates				
	Aug 2006	Aug 2007	Mar 2008 Visit	Apr 2008	Dec 2008
Overall conclusion on MagnetBank's asset quality					
• Satisfactory	✓	✓			
• Rapid deterioration in asset quality threatens bank's viability or critically deficient			✓	✓	✓
CRE and ADC loan concentrations					
• Concentration developing or already developed	✓	✓	✓	✓	✓
• Risk mitigated by conservative underwriting practices supported by a robust credit policy	✓	✓			
• Impact of a declining economic environment, particularly in the Southeast U.S. real estate market		✓	✓	✓	✓
Adverse classifications					
• No adverse classifications	✓				
• Progressive increases in adverse classifications noted		✓	✓	✓	✓
Assessment of risk management practices					
• Underwriting and credit administration practices are adequate	✓	✓			
• Failure to formulate and implement a credit risk control environment, which includes appropriate risk selection, credit risk limits by product and geography, effective internal controls, and appropriate supervision of credit risk management				✓	✓
• Inadequate loan document review function		✓		✓	
• Adequate loan file documentation	✓	✓			
• ALLL not adequately funded			✓	✓	✓
• ALLL policy establishes a concise and appropriate reserve methodology based on internally classified loans and estimated credit losses over the next 13 months	✓	✓	✓		
• Internal watch list did not adequately reflect all potential problem loans - loan officers assigned loan grades to their own individual credits without periodic review of those assignments				✓	
• The portfolio composition primarily consists of real estate construction and land development loans, which deviates from the original and revised business plan	✓	✓	✓		
• Credit culture emphasizes rapid growth				✓	
Examiner recommendations					
• Monitor and control risk in the CRE/ADC loan concentrations, including clarifying the concentrations policy and enhancing risk management reporting to limit concentrations exposure, and eliminating high-risk CRE/ADC lending programs in states with poorly performing real estate markets	✓	✓		✓	
• Adequately fund the ALLL allowance				✓	
• Create an independent loan review function to ensure loan grading policies are followed, underwriting criteria and documentation is executed properly, loan loss reserve policy is observed, and reserve levels are adequate				✓	

Source: ROEs for MagnetBank.

GLOSSARY OF TERMS

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of loan.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Golden Parachute	A "golden parachute payment" is generally considered to be any payment to an institution-affiliated party (IAP) that is contingent on the termination of that person's employment and is received when the insured depository institution making the payment is troubled or, if the payment is being made by an affiliated holding company, either the holding company itself or the insured depository institution employing the IAP is troubled.
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. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS

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

Division of Supervision and Consumer Protection

August 20, 2009

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

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of MagnetBank, Salt Lake City, Utah (Assignment No. 2009-021)

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 MagnetBank, Salt Lake City, Utah, which failed on January 30, 2009. The Division of Supervision and Consumer Protection (DSC) received the OIG's Draft Audit Report on August 6, 2009, providing information on the cause of failure and an assessment of the FDIC's supervision of MagnetBank.

We agree with the OIG's findings that MagnetBank failed primarily due to management's aggressive pursuit of Acquisition, Development, and Construction (ADC) loans concentrated in high-growth markets funded with higher-cost wholesale deposits. This profile coupled with weak management controls left MagnetBank unprepared to deal with declining markets.

In 2007, DSC implemented a supervisory strategy of planned annual examinations, interim six-month visitations, and quarterly off-site monitoring. However, the Draft Audit Report notes, and DSC agrees, that a higher loan review penetration may have uncovered additional problems that could have led to earlier supervisory action. The examiner loan review did identify several significant problem loans which led to actions by MagnetBank management. A revised business plan and financial model had been adopted by MagnetBank at the time the August 2007 examination commenced, leaving limited time to perform under the revised plan.

The Draft Audit Report further finds that the FDIC and the Utah Department of Financial Institutions conducted on-going supervision through risk management examinations and off-site monitoring. The OIG findings note that examiners identified key concerns for attention by MagnetBank's management and pursued enforcement action as MagnetBank's financial condition deteriorated in 2008. As noted, MagnetBank's loan portfolio was reduced by more than 40 percent during the first nine months of 2008; however, management was not able to raise the $50 million in capital related to implementation of the new plan. Additionally, MagnetBank was unable to achieve the goals set forth for diversification of the loan portfolio and funding sources due to rapid deterioration in asset quality and in the institution's markets.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CLA	Capital and Liquidity Agreement
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
IAP	Institution-Affiliated Party
ILC	Industrial Loan Company
LPO	Loan Production Office
OIG	Office of Inspector General
ORE	Owned Real Estate
PCA	Prompt Corrective Action
ROE	Report of Examination
SFRO	San Francisco Regional Office
UBPR	Uniform Bank Performance Report
UDFI	Utah Department of Financial Institutions
UFIRS	Uniform Financial Institution Rating System