Office of Inspector General

September 2009
Report No. AUD-09-023

Material Loss Review of Silver Falls Bank, Silverton, Oregon

AUDIT REPORT

Office of Audits

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oig

Federal Deposit Insurance Corporation

Report No. AUD-09-023 September 2009

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Why We Did The Audit

On February 20, 2009, the Oregon Department of Consumer and Business Services (ODCBS) closed Silver Falls Bank, Silverton, Oregon (Silver Falls) and named the FDIC as receiver. On March 4, 2009, the FDIC notified the Office of Inspector General (OIG) that Silver Falls' total assets at closing were $138.7 million and the material loss to the Deposit Insurance Fund (DIF) was $48.6 million. Silver Falls was the first FDIC-insured bank to fail in Oregon since 1987. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Silver Falls.

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 of the FDI Act.

Background

Silver Falls, headquartered in Silverton, Oregon, was a state-chartered bank that commenced operations on May 1, 2000. The bank operated two branches, one in Salem, Oregon, and the other in Oregon City, Oregon (near Portland). Silver Falls stock was quoted on the Over the Counter Bulletin Board stock exchange, although there was no active market for its shares, and most trading was done through limited private transactions. The bank's board of directors controlled about 24 percent of the outstanding stock. The bank did not have a holding company and did not pay any cash dividends during its existence.

From its inception, the bank's business strategy and primary emphasis was in originating acquisition, development, and construction (ADC) loans with a focus on single-family residential lending. The bank experienced significant growth from 2004 to 2007 - almost tripling its loan portfolio from $45 million to $131 million during that time. By September 30, 2008, approximately 96 percent of the bank's loan portfolio consisted of loans secured by real estate throughout the state of Oregon.

Audit Results

Causes of Failure and Material Loss - Silver Falls failed due to a significant lack of risk management controls. Bank management had an aggressive risk appetite toward speculative ADC loans without adequate underwriting and credit administration practices and without regard to the risks posed by its ADC concentration. Silver Falls' management rapidly increased its ADC loan portfolio through weak underwriting and out-of-area lending and relied on non-core funding to fuel the growth. By 2007, ADC lending comprised 71 percent of the bank's loan portfolio and represented 696 percent of total capital. This ADC concentration ranked Silver Falls the highest in the state of Oregon and the 4th highest of all FDIC-insured institutions in the country. Despite the elevated risk profile, the bank's allowance for loan and lease losses and capital levels were typically below those at its peer institutions. When the real estate housing market in the bank's lending areas began declining in the latter part of 2007, the bank was slow to recognize the downturn and continued originating ADC loans. As the Oregon real estate market continued spiraling downward in 2008, the result was the swift decline of the bank as losses mounted and capital was depleted. At a January 2009 examination, the FDIC found significant deterioration of the bank's condition and determined that the bank was not viable without a capital infusion, leading to its closure in February 2009.

Assessment of FDIC Supervision and Implementation of PCA - Over the history of Silver Falls, the FDIC and ODCBS provided supervisory oversight in many ways, including risk management examinations, visitations, and offsite monitoring. Generally, we found that examiners identified the emerging risks in the bank's loan portfolio as early as 2003 through examinations and offsite monitoring and made numerous recommendations to bank management to diversify the loan portfolio and better manage the risks. The bank was well-rated at the 2004, 2005, and 2007 examinations although the loan portfolio had underwriting weaknesses and significant concentrations in ADC lending. From 2002 through the latter part of 2007, the Oregon real estate market was robust, which helped to mask the fact that the bank's risk level was elevated.

Overall, the FDIC brought to management's attention the critical matters that contributed to the bank's failure. For the most part, bank management did not fully implement examiner recommendations and continued increasing its ADC portfolio into 2008 when market conditions caused the bank to curtail its risky lending. Because the bank was reporting high net income and capital along with a low level of adversely classified assets, examiners did not take additional supervisory actions to help address the bank's risk prior to 2008. At the April 2008 examination, after Silver Falls' loan portfolio began experiencing financial problems, the bank's composite rating was downgraded, and eventually, the bank stipulated to a Cease and Desist Order (C&D) that addressed the excessive concentrations in ADC loans, liberal loan underwriting practices, inadequate credit administration, and other safety and soundness issues. The FDIC has authority to take a wide range of supervisory actions. Earlier supervisory actions may have been warranted to address Silver Falls' elevated risk profile before the problems became severe in 2008.

The FDIC complied with the PCA provisions of the FDI Act in its notifications to Silver Falls regarding deteriorating capital levels. Nevertheless, PCA was not effective in preventing Silver Falls' failure or limiting the loss to the DIF due, in part, to the precipitous decline in the bank's financial condition in 2008 that limited the bank's options for raising capital.

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

Management Response

On August 28, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. In its response, DSC stated that Silver Falls failed due a significant lack of risk management controls and an aggressive risk appetite for speculative ADC lending without adequate underwriting and credit administration practices. DSC's statement was consistent with the OIG's finding of the cause of failure.

With respect to the FDIC's supervision of Silver Falls, DSC stated that FDIC and ODCBS examiners identified the emerging risks in Silver Falls' loan portfolio, as early as 2003, and made numerous recommendations to diversify the loan portfolio and better manage risk. DSC also noted that examiners took action in 2008 by downgrading Silver Falls' ratings, based on its deteriorating financial condition, and executing a C&D that addressed ADC concentrations, liberal loan underwriting practices, and inadequate credit administration. DSC acknowledged our findings that earlier supervisory action may have been warranted based on Silver Falls' high-risk profile.

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

Office of Audits
Office of Inspector General

DATE: September 1, 2009

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

/Signed/
FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Silver Falls Bank, Silverton, Oregon* (Report No. AUD-09-023)

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 Silver Falls Bank (Silver Falls), Silverton, Oregon. On February 20, 2009, the Oregon Department of Consumer and Business Services (ODCBS) closed the institution and named the FDIC as receiver. On March 4, 2009, the FDIC notified the OIG that Silver Falls' total assets at closing were $138.7 million and the material loss to the Deposit Insurance Fund (DIF) was $48.6 million. Silver Falls was the first FDIC-insured bank to fail in the state of Oregon since 1987.

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. Appendix 2 contains a glossary of terms, and Appendix 5 contains a list of acronyms used in the report.

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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.

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

BACKGROUND

Silver Falls was a state-chartered bank that began operations on May 1, 2000. Silver Falls, which was headquartered in Silverton, Oregon:

- operated two branches, one in Salem, Oregon, and the other in Oregon City, Oregon (near Portland);

- was listed on the Over the Counter Bulletin Board stock exchange, although there was no active market for its shares, and most trading was done through limited private transactions;

- did not have a holding company and did not pay any cash dividends during its existence; and

- specialized in commercial real estate (CRE) lending with a particular focus on single family residential acquisition, development, and construction (ADC) loans.

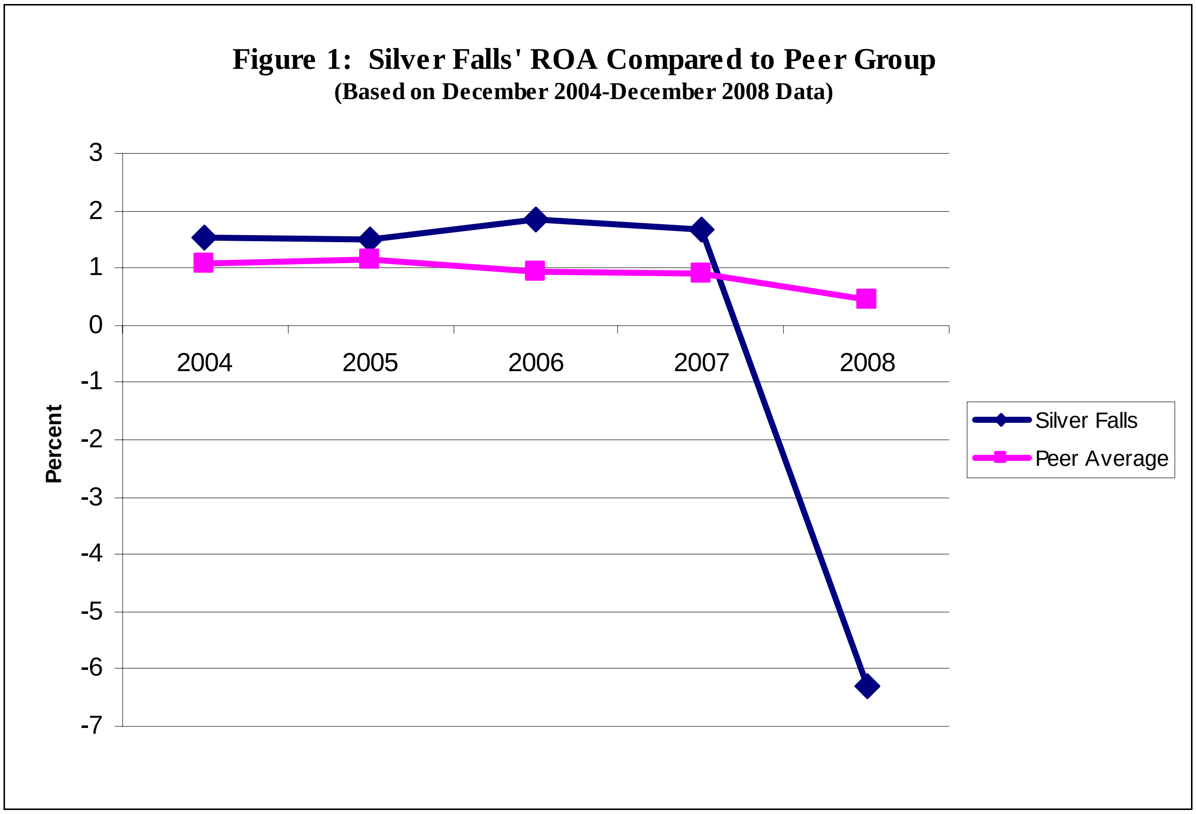
A snapshot of Silver Falls' financial condition, as of December 2008, and for the 4 preceding calendar years is presented in Table 1, which follows.

Table 1: Snapshot of Silver Falls' Financial Condition

	12/31/2008	12/31/2007	12/31/2006	12/31/2005	12/31/2004
Total Assets ($000s)	$134,206	$139,220	$99,635	$83,003	$56,975
Total Loans ($000s)	$113,967	$131,154	$92,484	$73,957	$45,745
Total Deposits ($000)	$115,976	$109,596	$80,841	$69,363	$49,336
Loan Growth Rate	*(18)%*	*42%*	*25%*	*62%*	*8%*
Tier 1 Leverage Capital Ratio (%)	2.05	8.81	10.33	10.11	12.68
Return on Assets (%)	(6.31)	1.66	1.85	1.50	1.52
Past-Due & Nonaccrual Loans/Avg. Loans	36.09%	4.34%	1.71%	1.12%	0.00%
Net Loss/Avg. Total Loans & Leases	4.16%	0.19%	0.00%	0.07%	0.02%
Loan Mix (% of Loans):					
All Loans Secured by Real Estate	**95.17%**	**91.63%**	**91.15%**	**87.40%**	**84.66%**
Construction and Development	63.66%	62.53%	52.31%	42.89%	27.70%
CRE - Nonfarm/Nonresidential	14.05%	9.90%	13.07%	16.74%	21.72%
Multifamily Residential Real Estate	6.67%	14.30%	18.88%	18.61%	21.11%
1-4 Family Residential	10%	4%	6%	8%	11%
Commercial and Industrial Loans	**4%**	**7%**	**7%**	**11%**	**13%**
Funding:					
Net Loans & Leases/Deposits	91.61%	118.27%	113.30%	105.56%	91.54%
Core Deposits/Total Assets	64.63%	63.16%	66%	67.32%	75.02%
Examination Information	4/14/08	4/23/07	9/26/05	4/5/04	3/17/03
Component/Composite Ratings	444442/4	222122/2	222122/2	222222/2	233332/3
Adversely Classified Loans/Total loans	10.31%	0.76%	1.39%	4.44%	6.67%

Source: Uniform Bank Performance Report (UBPR) data and Reports of Examination (ROE).

Prior to 2008, Silver Falls' financial results were largely favorable as the Oregon housing market continued to realize a healthy annual appreciation. From 2004 through 2007, Silver Falls' return on assets (ROA) ranged from 1.52 percent to 1.85 percent, which was well above its peer group average, as shown in Figure 1, which follows.



Source: UBPRs.

When the residential real estate market throughout Oregon began declining in the latter half of 2007, Silver Falls' loan portfolio quickly began experiencing problems due to its high dependency on the real estate market. In 2008, loan losses were severe, and the bank's ROA plummeted.

CAUSES OF FAILURE AND MATERIAL LOSS

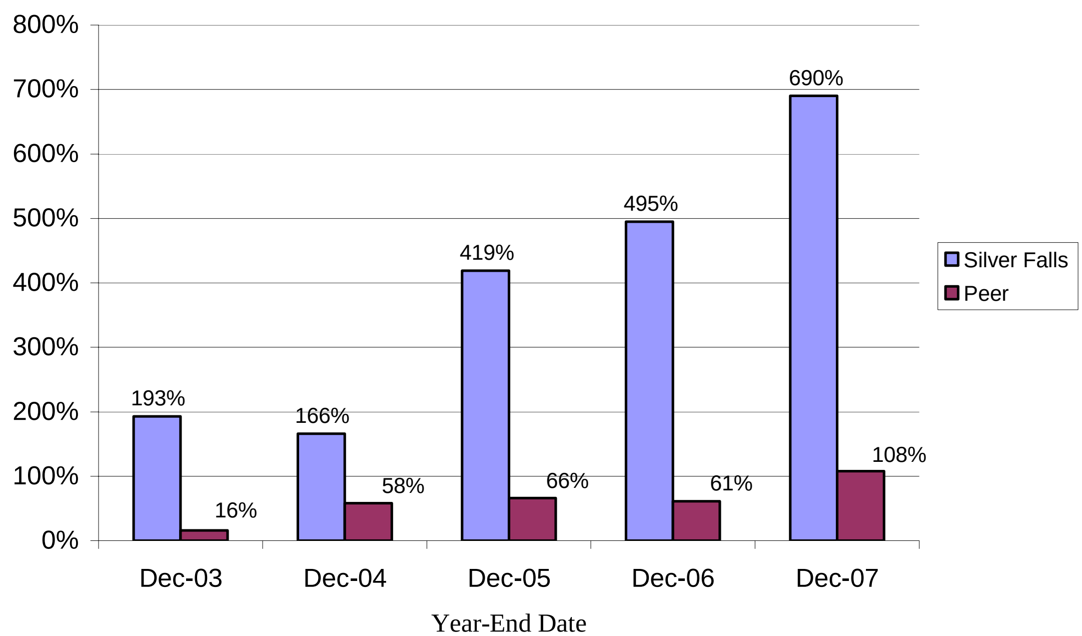
Silver Falls failed due to a significant lack of risk management by its board of directors (BOD) and senior management. Bank management had an aggressive growth strategy focused on increasing its ADC loan portfolio and, as a result, the bank became heavily concentrated in, and very dependent on, the housing market in Oregon. Further, the bank's risk profile was increased by weak underwriting and credit administration practices. Because the loan portfolio was highly concentrated in CRE, the bank was sensitive to the fluctuations in the real estate market. Additionally, to a significant degree, Silver Falls used high-cost non-core deposits and borrowings to fund its ADC loan portfolio. When the Oregon housing market performed well, as it did from 2000 until 2007, the bank was reporting high earnings. However, when the housing market experienced a precipitous decline beginning in the fourth quarter of 2007, adversely classified loans increased, losses mounted, and capital became strained in 2008. In January 2009, regulators determined that the bank was Critically Undercapitalized, for PCA purposes, and the bank was subsequently closed in February 2009.

Lack of Risk Diversification

Our analysis of Silver Falls' loan portfolio, from 2001 until it failed, indicated that bank management did not provide adequate attention to risk diversification, and, as a result, excessive concentrations occurred in the bank's ADC loan portfolio. Specifically, Silver Falls' ADC loan portfolio increased from $10.7 million in 2001 to approximately $82 million by year-end 2007. This concentration in a higher-risk market segment, coupled with weak underwriting standards and poor credit administration practices, led to significant losses in Silver Falls' ADC portfolio when the Oregon real estate market deteriorated.

Silver Falls' management rapidly increased its ADC loan portfolio, without due regard to the risks associated with that business strategy. In 2001, shortly after commencing operations, ADC loans represented about 44 percent of its loan portfolio and about 230 percent of the bank's total capital. These percentages were very high in comparison to Silver Falls' peer group. For example, in 2001, ADC loans averaged 9 percent of the loan portfolio and about 46 percent of total capital for banks in Silver Falls' peer group. By 2004, Silver Falls' ADC portfolio represented 419 percent of total capital, and bank management continued the business strategy of concentrating its portfolio in high-risk ADC loans through 2007. Figure 2, which follows, shows Silver Falls' increasing concentration of ADC loans as a percentage of total capital, compared to its peer group.

Figure 2: Comparison of the Bank's ADC Loans as a Percentage of Total Capital



Source: UBPRs.

According to examiner statements in the April 2008 ROE, the bank's ADC concentration was the highest in Oregon, by a 2-to-1 margin; the highest in the FDIC's San Francisco Region; and the fourth highest in the nation.

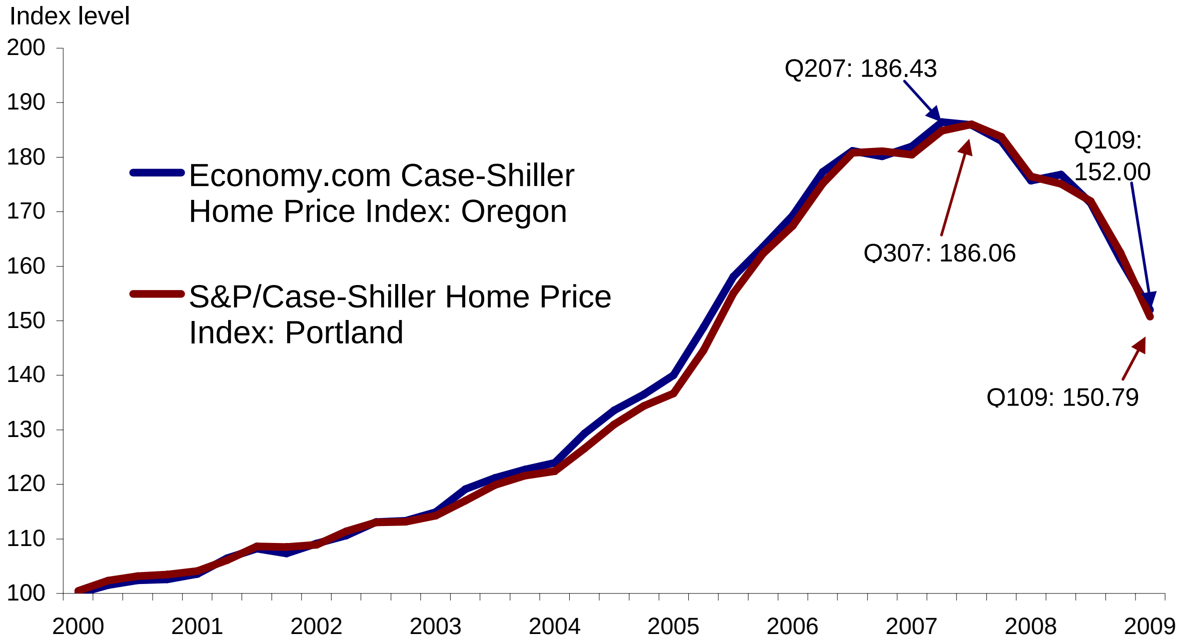
The FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) provides the following guidance to examiners regarding banks' concentrations of credit:

> Concentrations generally are not inherently bad, but do add a dimension of risk which the management of the institution should consider when formulating plans and policies. In formulating these policies, management should, at a minimum, address goals for portfolio mix and limits within the loan and other asset categories. The institution's business strategy, management expertise and location should be considered when reviewing the policy. Management should also consider the need to track and monitor the economic and financial condition of specific geographic locations, industries and groups of borrowers in which the bank has invested heavily. All concentrations should be monitored closely by management and receive a more in depth review than the diversified portions of the institution's assets. Failure to monitor concentrations can result in management being unaware how significant economic events might impact the overall portfolio. This will also allow management to consider areas where concentration reductions may be necessary. Management and the board can monitor any reduction program using accurate concentration reports. If management is not properly monitoring concentration levels and limits, examiners may consider criticizing management.

Our review of examiner workpapers and interviews with FDIC and ODCBS examiners shows that Silver Falls' management was not adequately monitoring and controlling its concentration risks. Further, Silver Falls did not adequately address goals for its portfolio mix and limits as described in its loan policy. When examinations before 2008 noted that ADC loans exceeded the bank's internal limits, bank management would increase its internal limits to promote compliance rather than reduce its ADC concentration. Examiners found during the 2008 examination that the ADC concentration was 528 percent of total capital, which exceeded even the "liberalized" 490 percent internal maximum established by bank management.

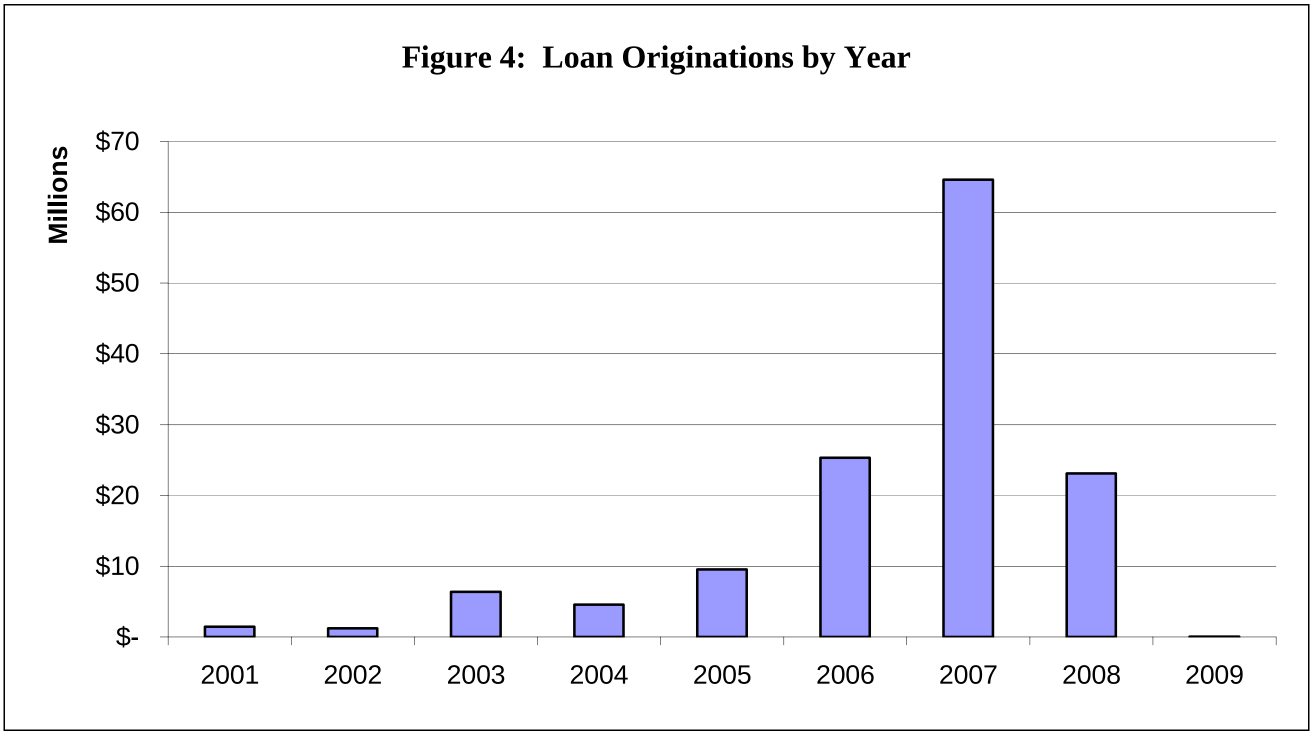
With the bank's high level of real estate loans, management had positioned the bank to be vulnerable to a downturn in the real estate market. From 2000 until the third quarter of 2007, the Oregon real estate market experienced continuing increases in home prices. As a result, the bank's strategy of focusing on ADC lending appeared to work well as loans were paying off, properties were selling, and little-to-none of its loan portfolio experienced loss. However, in the middle of 2007, the Oregon real estate market peaked and began a precipitous drop, with real estate values dropping about 20 percent in a little over a year, as shown in Figure 3, which follows.

Figure 3: Price Index of Oregon Homes



Source: Economy.com, S&P/Haver Analytics.
Note: S&P/Case-Shiller Home Price Index: (Jan-00=100).

Silver Falls continued to increase its loan portfolio – primarily ADC loans – during 2007, increasing it by 40 percent even as market conditions were declining. Shortly after the bank failed, we reviewed the bank's loan trial balance as of February 2009 and determined that over 64 percent of the loans on the bank's books had been originated in either 2007 or 2008 – at the peak of the market or shortly after the market had begun to decline in Oregon (see Figure 4, which follows).



Source: Silver Falls' loan trial balance.

In hindsight, such an increase in loan originations, just at the time of a market correction, exacerbated Silver Falls' already troubled ADC loan portfolio. During this period, real estate values used to establish loan-to-value (LTV) ratios were at or near their peak, and as the collateral values decreased, many loans became troubled.

Many of the loans in Silver Falls' real estate loan portfolio were considered speculative because much of the real estate was unleased or unsold at the time of the loan commitment. As a result, the bank was dependent on the market's abilities to absorb the unleased or unsold properties for borrower repayment. This risky strategy meant that in order to avoid loan problems, the bank would need to be especially vigilant about its underwriting standards.

Weak Underwriting and Poor Loan Administration

Weaknesses in loan underwriting and credit administration used by bank management to extend and monitor credit in the CRE and ADC markets was a contributing factor to the bank's failure. Because the majority of the bank's portfolio was originated with weak underwriting protection, much of the risk associated with the loan portfolio tended to rest with the bank rather than the borrower. ROEs, as early as 2003, indicated that bank management needed to strengthen its loan underwriting and credit administration practices. The 2007 and 2008 ROEs made specific recommendations that management place more emphasis on prudent loan underwriting and monitoring.

Regarding ADC lending, FDIC guidance to examiners stresses that prudent lending practices should include, among other things, the following:

- Feasibility studies, risk analyses, and sensitivity of income projections to economic variables.

- Minimum requirement for initial investment and equity maintained by the borrower.

- Standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.

- Standards for the use of interest reserves or stipulation that interest reserves will not be used.

- Standards for the level of loans on speculative properties relative to capital.

- Pre-sale and minimum unit release requirements for non-income producing property loans.

- Minimum covenants for loan agreements, such as financial statement requirements.

- Value and marketability of the mortgaged property.

- Secondary sources of repayment.

Our review of ROEs and interviews with FDIC and ODCBS examiners and FDIC resolution personnel indicated that, to varying degrees, Silver Falls' management did not adequately implement these prudent lending practices. For example, the bank made a $1.7 million loan for 1 year in November 2006 for the construction of a 20-unit condominium project. In the April 2008 ROE, examiners noted the following loan underwriting and administration deficiencies with respect to this loan:

- The project was not completed within the year, and the loan was extended and kept current by allowing the borrower to service the debt with another construction line of credit.

- Site inspection reports were not always in the file. One inspection report described the project as 95-percent complete, but an appraisal performed after the inspection report described the project as 80-percent complete.

- The loan file lacked information to assess the financial capacity of the borrower and guarantor. Also, the file raised questions about the borrower's cash flow.

- Even though the project was past-due and the collateral appeared deficient, the bank had not developed a collateral analysis or action plan to correct the problems.

Moreover, according to FDIC resolution personnel, as of July 31, 2009, not a single condominium unit had been sold, and construction was only about 80 to 85 percent complete.

Based on our review, the deficiencies noted above were not uncommon in Silver Falls' ADC portfolio. Further, according to examiners, even though 96 percent of the bank's loans were real estate-related, bank management did not adequately monitor the real estate markets and local economic conditions within its trade areas to ensure that real estate lending policies and practices were appropriate for market conditions until 2008, when it was too late.

According to the 2008 ROE, Silver Falls' management did not institute practices to ensure that credit analysis at loan origination was commensurate with the complexity and risk of the credit. The ROE also noted that improvements were needed to ensure management had the tools necessary to monitor and measure the risks inherent to construction lending. Specifically, management did not develop policies, procedures, and reports to better control out-of-area lending and the use of loan brokers, interest reserves, and loan extensions. Although Silver Falls had appropriate policy guidelines, they were not always followed for activities such as construction draw procedures, loan extensions, and environmental risk assessments. Based on the significant volume of risk-rating downgrades and the number and severity of systemic criticisms, management failed to implement a more effective loan review system to better monitor all activities within the lending function, including loan grading. Of particular concern was the bank's lack of an effective problem loan report to address loan problems early. Although the bank had a *Problem Loan* report, examiners noted that the report was rarely populated with information necessary to get a clear depiction of credit relationships and was often void of any written plan of action.

Examiners also identified weaknesses in monitoring construction projects. Specifically, Silver Falls did not always perform periodic inspections during the construction phase and did not have adequate funds disbursement controls. As opportunities for growth were limited in its primary lending area, the bank expanded its lending to other parts of Oregon, which made monitoring projects more difficult. To illustrate, the bank was located just north of Salem, Oregon (see Figure 5, which follows).

Figure 5: Location of Silver Falls Bank

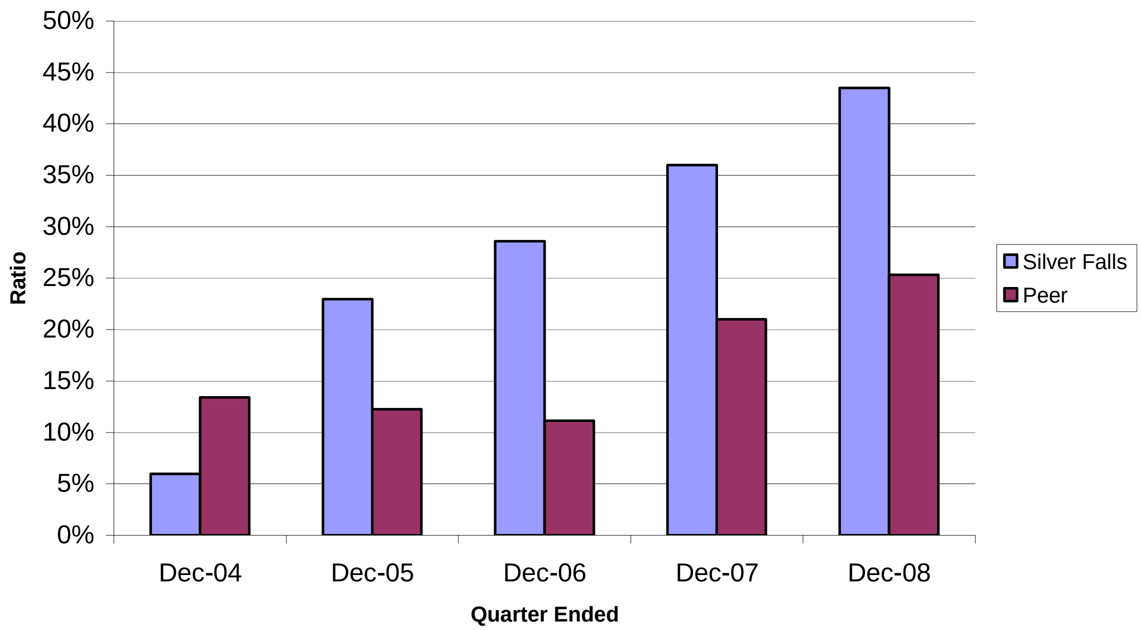
Source: Google Maps.

However, in 2008, about 11 percent of the bank's loan portfolio was to borrowers in the Bend, Oregon, market (approximately 130 miles away), and 9 percent of the portfolio was in the Medford, Oregon, market (approximately 240 miles away). The bank also had 11 percent of its loans concentrated on the Oregon coast and 21 percent in Portland, which examiners indicated were outside the bank's trade area. Examiners also indicated that the number of loan administration problems was higher for the out-of-area loans.

Heavy Reliance on Wholesale Funding

Beginning in 2005, Silver Falls became increasingly dependent on non-core deposits to fund its aggressive loan growth. By December 31, 2007, the bank's loan-to-deposit ratio was 118 percent, which indicates that Silver Falls needed to borrow money to fund its loans. Further, as shown in Figure 6, which follows, Silver Falls' non-core funding dependency was consistently higher than its peer group average from 2005 until it failed.

Figure 6: Comparison of the Bank's Net Non-Core Funding Dependence Ratio to Peer



Source: UBPRs.

Moreover, Silver Falls' extensive use of non-core deposits resulted in a higher cost of funds[3] than its peers, as shown in Table 2, which follows. Specifically, from 2005 until it failed, Silver Falls' cost of funds ranged from 53 to 106 basis points higher than its peer group. The bank's cost of funds was also higher than the average cost for banks in Oregon. For example, in 2007, the average cost of funds for the banks in Oregon was 2.80 percent, while Silver Falls averaged 3.96 percent – 116 basis points higher. In our opinion, Silver Falls' higher cost of funds negatively impacted the bank's profitability and appeared to have encouraged higher-risk lending to be profitable.

[3] As used in this report, the cost of funds was determined by using interest expense as a percentage of average earning assets.

Table 2: The Bank's Cost of Funds Compared to Peer Group

Year End	Interest Expense as a Percent of Average Assets – Silver Falls	Peer Group Average	Average for Banks in Oregon
2003	1.91%	1.45%	1.31%
2004	1.60%	1.40%	1.08%
2005	2.30%	1.77%	1.58%
2006	3.27%	2.30%	2.41%
2007	3.96%	2.90%	2.80%
2008	3.34%	2.30%	2.14%

Source: UBPRs.

ASSESSMENT OF FDIC SUPERVISION

Over the life of Silver Falls, the FDIC and ODCBS provided supervisory oversight in many ways, including risk management examinations, visitations, and offsite monitoring. Overall, the FDIC drew bank management attention to critical matters that contributed to the failure; however, the FDIC did not ensure that the bank addressed its risks before the bank began experiencing financial deterioration. Generally, we found that examiners identified emerging risks in the bank's loan portfolio as early as 2003, through examinations and offsite monitoring, and made numerous recommendations to bank management to diversify the loan portfolio and better manage the risks associated with its ADC lending. For the most part, bank management did not fully implement examiner recommendations and continued increasing its ADC portfolio through the use of non-core deposits and lending in areas outside its trade area.

Historical Snapshot of Supervision

The FDIC complied with examination frequency requirements of the FDI Act and, in conjunction with the ODCBS, conducted seven examinations and three visitations during the history of the bank, as shown in Table 3, which follows.

Table 3: Supervisory History of Silver Falls

Date	Supervisory Activity	Supervisory Ratings (UFIRS)*
January 2009	Visitation	555552/5
April 2008	Joint Examination	444442/4
April 2007	State Examination	222122/2
September 2005	FDIC Examination	222122/2
April 2004	Joint Examination	222222/2
October 2003	Visitation	233332/3
March 2003	FDIC Examination	233332/3
February 2002	State Examination	122122/2
March 2001	Joint Examination	122212/2
August 2000	Visitation	Not rated

Source: The FDIC's Virtual Supervisory Information on the Net database.
*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.

After the 2003 examination, the bank agreed to a Memorandum of Understanding (MOU) to address management and asset quality weaknesses, including poor loan policies, underwriting and credit administration weaknesses, and a lack of risk diversification due to the bank's concentration of ADC loans. After the 2004 examination, the FDIC terminated the MOU when examiners found that oversight by Silver Falls' BOD had improved and asset quality and underwriting practices were strengthened. Additionally, the 2004 ROE noted that management had prepared a risk segmentation analysis of its construction and land development portfolio in order to better assess risk and reminded the bank that this type of analysis should be ongoing. The bank received a composite 2 rating at the 2004, 2005, and 2007 examinations. At each of these examinations, FDIC and ODCBS examiners made numerous recommendations, largely addressing risk management deficiencies at the bank, including the high concentration of ADC loans and weak underwriting and loan administration practices (see Appendix 3 for details of examiner comments and recommendations).

During the April 2008 examination, in which the bank was downgraded to a composite 4 rating, FDIC and state examiners noted that the bank's overall condition was unsatisfactory due to inadequate BOD and management oversight. The ROE also noted that "the latent risk in the bank's portfolio has been realized with the downturn in the housing market." The bank was presented with a Cease and Desist Order (C&D) in June 2008 to address, among other things, its ADC concentrations and poor underwriting and credit administration practices. Bank management initially resisted signing the C&D but eventually stipulated to it in November 2008. Also, in November 2008, the bank submitted an application to the Troubled Asset Relief Program (TARP) Capital Purchase

Program. After reviewing the application and other materials provided, the FDIC asked the bank to withdraw its application due to the significant financial deterioration of the bank and its likely inability to raise capital.

In January 2009, examiners performed a targeted loan review (visitation) and concluded that the deterioration of the loan portfolio was capsizing the bank as the volume of adversely classified assets and loan losses had depleted the bank's allowance for loan and lease losses (ALLL) and was straining its capital. Further, examiners noted that the institution's deterioration was largely the result of operating with a high level of ADC lending in a declining real estate market. As of November 30, 2008, ADC lending represented over 750 percent of Tier 1 Capital. The bank's problems were compounded by wholesale credit administration deficiencies due to management's failure to strengthen oversight of the credit function. As a result of this review, on February 2, 2009, the FDIC notified the bank that its PCA category was Critically Undercapitalized. With no prospects of a capital infusion, the bank was closed on February 20, 2009.

OIG Assessment of FDIC Supervision

Although FDIC and ODCBS examiners recognized early warning signs and continually reported on the risky practices used by the bank, it was allowed to continue its concentration of ADC loans until after the April 2008 examination. In our opinion, earlier corrective action was needed before serious asset quality problems developed in the loan portfolio. Until the 3rd quarter of 2007, the Oregon real estate market had been performing well, which masked the bank's elevated risks. Further, because the bank was reporting high net income and capital along with a low level of adversely classified assets, the FDIC and ODCBS rated the bank a composite 2 and did not take stronger supervisory actions to curtail the bank's risk appetite and ADC concentrations until the April 2008 examination when Silver Falls' loan portfolio began experiencing financial problems. By 2008, the bank's problems had become severe, and failure appeared unavoidable, absent a massive capital infusion.

Examiners identified Silver Falls' loan concentrations as a potential high-risk area of concern in ROEs and meetings with bank management as early as 2003. However, despite repeated assurances by Silver Falls' management that it would take corrective actions, no comprehensive action was taken. For example, the April 2004 ROE stated that risk management processes were inadequate related to economic conditions and concentrations. Based on our review, we concluded that Silver Falls did not give adequate attention to its concentration risk and continued positioning the bank to be exposed in an economic downturn. Examiners we interviewed mentioned that deficiencies continually existed in the bank's monitoring and reporting processes for concentrations. However, as previously noted, when examiners criticized the bank for exceeding its own liberal ADC limits, bank management would increase policy limits to promote compliance rather than reduce the risk profile. Nonetheless, the FDIC could have taken stronger actions before 2008 to mitigate the bank's ADC risk exposure inherent in its ADC loan portfolio.

Despite the poor risk management practices, most of the ADC loans at the bank were paying as agreed to by the borrower or had sufficient collateral protection until the end of 2007. For example, the bank reported no non-current loans in 2005 and 2006. However, by 2008, non-current loans totaled over $30.4 million (almost 30 percent of the loan portfolio). The precipitous decline in real estate values in Oregon, particularly those involving ADC loans, had a tremendous effect on the bank. In our opinion, the bank's high-risk profile warranted earlier administrative actions such as requiring the bank to implement more stringent underwriting standards or requiring additional capital. We compared the bank's ADC concentration, ALLL coverage, and Tier 1 Capital to banks in its peer group as shown in Table 4, which follows.

Table 4: ADC, ALLL, and Tier 1 Capital Ratios Compared to Peer

	ADC Concentrations as a Percentage of Total Loans			ALLL Coverage as a Percentage of Total Loans			Tier 1 Capital		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Silver Falls Bank	42.89%	52.31%	62.53%	0.99%	0.96%	1.17%	10.11%	10.33%	8.81%
Peer Group	9.32%	8.80%	15.00%	1.30%	1.22%	1.19%	10.22%	9.82%	9.60%

Source: UBPRs.

As Table 4 shows, Silver Falls' ADC loan concentrations as a percentage of total loans in 2005 through 2007 were four to six times that of the bank's peer group. In addition, as previously discussed in this report, underwriting and credit administration at the bank were weak. Despite its risky profile, Silver Falls' ALLL coverage was less than coverage by banks in its peer group for all 3 years. Moreover, its Tier 1 Capital ratio for 2 of the 3 years was less than peer. In our opinion, the combination of ADC concentrations and weak underwriting and credit administration practices should have resulted in a higher ALLL and/or increased capital. Prior to the 2008 ROE, examiners were generally not critical of the bank's ALLL or capital.

In conclusion, although examiners recognized and reported on the risks inherent in Silver Falls' loan portfolio, in retrospect, more could have been done to ensure that timely supervisory was taken to address the bank's inherent risks before financial deterioration occurred.

IMPLEMENTATION OF PCA

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the DIF. PCA provides federal banking agencies with the authority to take certain actions when an institution's capital drops to certain levels. We concluded that the FDIC used this authority in an appropriate and timely manner under

PCA. The April 2008 ROE stated that the bank's capital ratio had declined to 8.25 percent, which was well below the bank's internal minimum threshold of 9.0 percent. Similarly, the Total Risk-Based Capital ratio had declined to 9.65 percent. As a result of the Total Risk-Based Capital ratio falling below 10.0 percent, the bank was categorized as Adequately Capitalized for PCA purposes and was notified that it may not accept, renew, or roll over any brokered deposit unless the institution had been granted a waiver by the FDIC. As a result of the January 2009 targeted loan review, the FDIC notified the bank on February 2, 2009 that it was considered Critically Undercapitalized and was subject to the mandatory requirements of section 38(k) of the FDI Act, including submission of a capital restoration plan. Specifically, the bank's ratios were:

Tier 1 Leverage	1.38%
Tier 1 Risk-Based Capital Ratio:	1.41%
Total Risk-Based Capital Ratio:	2.70%

Although the FDIC complied with the PCA provisions of the FDI Act, PCA was not effective at limiting the loss to the DIF. PCA's focus is on capital, and capital can be a lagging indicator of an institution's financial health as was the case with Silver Falls. Bank management delayed the recognition of problems and ultimately the deterioration of earnings and capital. By the time Silver Falls' capital level fell below the required threshold necessary to implement stronger PCA provisions at the end of 2008, the bank's condition had deteriorated to the point at which the institution was not viable absent a massive capital infusion.

CORPORATION COMMENTS

On August 28, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 4 of this report. In its response, DSC stated that Silver Falls failed due to a significant lack of risk management controls and an aggressive risk appetite for speculative ADC lending without adequate underwriting and credit administration practices. DSC's statement was consistent with the OIG's finding of the cause of failure.

With respect to the FDIC's supervision of Silver Falls, DSC stated that FDIC and ODCBS examiners had identified the emerging risks in the bank's loan portfolio, as early as 2003, and made numerous recommendations to diversify the loan portfolio and better manage risk. DSC also noted that examiners took appropriate action in 2008 by downgrading Silver Falls' ratings, based on its deteriorating financial condition, and executing a C&D Order that addressed ADC concentrations, liberal loan underwriting practices, and inadequate credit administration. DSC acknowledged our findings that earlier supervisory action may have been warranted based on Silver Falls' high-risk profile.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

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

We conducted the audit from March 2009 to August 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 in the sections that follow.

Scope and Methodology

The scope of this audit included an analysis of Silver Falls' operations from April 24, 2000 until the bank's failure on February 20, 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 ROEs and visitation reports prepared by the FDIC and ODCBS examiners from 2001 to 2008.

- Reviewed the following:

    - Bank data and correspondence maintained at the FDIC's San Francisco Regional Office (SFRO) and Portland Field Office.

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

    - Bank records maintained by DRR in the Dallas, Texas, Regional Office for information that would provide insight into the bank's failure, 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.

  - DRR officials at the Dallas Regional Office and at the receivership site.

  - FDIC examiners from the DSC Portland Field Office, Portland, Oregon, who participated in examinations or reviews of examinations of Silver Falls.

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

- Researched various banking laws and regulations, including State of Oregon laws.

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 Silver Falls' management controls pertaining to its operations as discussed in 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.

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.
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.
Memorandum of Understanding (MOU)	An informal corrective administrative action for institutions considered to be of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, an MOU is to be considered for all institutions rated a composite 3.
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 of compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from data reported in Reports of Condition and Income submitted by banks.

SUMMARY OF ROE FINDINGS AND RECOMMENDATIONS

FDIC Report of Examination, dated March 17, 2003

Conclusions:

- BOD oversight has been ineffective.
- This ineffectiveness has led to unsatisfactory asset quality and the need for significant provisions to ALLL.
- Asset quality deterioration because of management's ineffective risk controls.

Recommendations:

- Management needs to more proactively identify portfolio risk and recognize losses.
- Management should implement an effective loan review function.
- Management needs to strengthen weak loan underwriting and credit administration practices, increase the ALLL to an adequate level, document liquidity strategies, and address examination recommendations.
- Management needs to focus on addressing identified deficiencies to build a solid foundation before continuing to grow the bank.
- Management's credit analysis and presentation in the Loan Approval Sheets require improvement.
- Management should follow its loan policy, including reporting individual and aggregate policy exceptions. For construction lending, the bank should (1) consistently perform inspections to validate draw requests and document the inspections in the loan file; (2) maintain records for the interest reserve separate from general construction proceeds to help maintain control over disbursements; (3) determine reasons why pre-sold projects are not selling, document the reason, and inform the Loan Committee of the change in risk profile; and (4) establish reports that monitor the construction and development lending concentration.

In addition, the bank was cited for a contravention of Part 365, Appendix A – *Regulatory Real Estate Lending Standards*, in that loans in excess of the bank's Loan Policy LTV ratio must be aggregated and reported to the BOD at least quarterly. Several instances were noted in which policy limitations were exceeded, but loans were not tracked and aggregated for reporting to the BOD.

Joint Report of Examination, dated April 5, 2004

Conclusions:

- Overall condition of the bank is satisfactory.
- Oversight by the BOD is improved.
- Asset quality and underwriting practices are better.
- Capital levels are adequate.
- Risk management processes are inadequate related to economic conditions and concentrations.

Recommendations:

- Loan policies need the following refinements to further reduce the potential for undesirable risk.
    1) Expand guidelines to incorporate the desired quality of financial information.
    2) Develop guidelines for granting unsecured credit to commercial borrowers.
    3) Refine guidelines to improve the required content of real estate evaluations in accordance with the *Statement of Policy on Interagency Appraisal and Evaluation Guidelines.*
    4) Expand appraisal review guidelines to include the procedures for correcting identified weaknesses and ordering reappraisals.
    5) Revise construction inspection guidelines to require photographs of the inspected work.
    6) Revise other real estate guidelines to require an updated appraisal of real estate at the time of acquisition if the existing appraisal is more than 6 months old.
    7) Develop desired minimum debt service coverage guidelines for nonfarm nonresidential real estate and commercial loans.
    8) Establish desired limitations for loan concentrations of credit based on a percentage of Tier 1 Capital.
    9) Expand credit review criteria, beyond a credit review at origination, to periodically validate risk grade.

FDIC Report of Examination, dated September 26, 2005

Conclusions:

- Overall condition of the bank remains satisfactory.
- While the bank has chosen to focus lending in some areas that may be considered higher risk, including speculative construction, adversely classified assets have continued to decline as a percentage of capital over the prior two examination cycles.

Recommendations:

- Management will need to strengthen policies and procedures to continue operating at or near adequate liquidity levels.
- Establish a policy limit for net non-core funding dependence.
- Refine policy guidance on requiring a loan review when the loan-to-deposit ratio exceeds 90 percent for three consecutive quarters.

State Report of Examination, dated April 23, 2007

Conclusions:

- The overall performance of the BOD and management is satisfactory.
- Higher-risk lending practices require additional monitoring and controls.
- The high level of loans is secured by CRE.
- There is a lack of support for primary and secondary sources of repayment.
- There are large numbers of borrowers and projects located outside the bank's primary market area.
- There are higher levels of documentation and underwriting deficiencies.
- Management has not reduced the risk inherent in high concentrations.
- Management has numerous technical exceptions, poor supporting documentation, and errors in the loan files.
- Loan policy limitations for CRE loans, as a percentage of total loans, have been exceeded in all reporting periods since the prior examination.

Recommendations:

- Management's higher-risk lending practices require additional monitoring and controls.
- Increased emphasis needs to be placed on prudent underwriting and monitoring.
- Management is encouraged to implement practices to eliminate the violation of rules and regulations.

Joint Report of Examination, dated April 14, 2008

Conclusions:

- Management's aggressive risk appetite has elevated the bank's risk profile to an unsatisfactory level.
- Management's desire for growth and earnings has resulted in an excessive concentration of ADC loans.
- Risk resulted from out-of-area lending, use of loan brokers, inappropriate interest reserve practices, liberal collection processes, and poor risk identification.
- Borrowers are beginning to exhibit traits that indicate a growing inability to perform according to the terms of their debt.
- Although management's actions to mitigate risks were viewed as positive, the recognition was late in the cycle.
- The administration of the bank's construction loan portfolio is less than satisfactory.
- Apparent violation of Part 364 of the FDIC Rules and Regulations as BOD and management did not comply with several minimum standards for safety and soundness regarding Subsection C, *Loan Documentation*, and Section F, *Asset Growth*. Loan presentations did not appropriately address all factors needed to make an informed loan decision, and the loan portfolio grew at a rapid pace, requiring reliance on wholesale funding sources and leveraging capital to

unsatisfactory level. Growth was concentrated in residential construction and development loans, which have deteriorated to the extent that asset quality is now unsatisfactory.

Recommendations:

- Management should enhance their reporting practices by further segmenting some of the loan types and including “guidelines” in the Quarterly Segmentation Report.
- Management should establish additional guidelines for speculative versus pre-sold residential loans, aggregate construction loans, and aggregate CRE loans.
- Documentation of BOD oversight should be enhanced to improve the level of concentration risk assumed.
- Credit analysis should be expanded to incorporate the borrowers’ and guarantors’ global cash flow.
- Appraisal review practices should be improved.
- Management needs to better define the bank’s trading area, permissibility of speculative lending, acceptable levels of construction concentrations, accounting treatment of non-accrual loans, internal risk grades, insider overdraft levels, and the useful life of an appraisal.
- Management should adhere to the internal loan policies, such as guidance pertaining to acceptable timeframes for extensions.
- The BOD should properly oversee the activities of the bank, including obtaining additional information on risk indicators such as loan delinquency.

CORPORATION COMMENTS

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

Division of Supervision and Consumer Protection

August 28, 2009

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Silver Falls Bank, Silverton, Oregon (Assignment No. 2009-025)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Silver Falls Bank (SFB), which failed on February 20, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Audit Report (Report) received on August 14, 2009.

SFB failed due to a significant lack of risk management controls and an aggressive risk appetite for speculative acquisition, development, and construction (ADC) loans without adequate underwriting and credit administration practices. The Report states the FDIC and the Oregon Department of Banking and Finance provided supervisory oversight of SFB through risk management examinations, visitations, and offsite monitoring. During these events, examiners identified the emerging risks in SFB's loan portfolio, as early as 2003, and made numerous recommendations to diversify the loan portfolio and better manage risk. The Report notes that FDIC brought to management's attention the critical matters that contributed to SFB's failure; however, SFB's management did not fully implement examiner recommendations and continued to increase its ADC portfolio.

The Report notes that examiners took appropriate action in 2008 by downgrading SFB's ratings, based on its deteriorating financial condition, and executing a Cease and Desist Order that addressed ADC concentrations, liberal loan underwriting practices, and inadequate credit administration. However, we acknowledge the Report's findings that earlier supervisory action may have been warranted based on SFB's high-risk profile. The Report also notes that the FDIC complied with the Prompt Corrective Action provisions of the Federal Deposit Insurance Act in its notifications to SFB regarding restrictions and requirements associated with deteriorating capital levels.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
LTV	Loan-to-Value
MOU	Memorandum of Understanding
ODCBS	Oregon Department of Consumer and Business Services
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROA	Return on Assets
ROE	Report of Examination
SFRO	San Francisco Regional Office
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System