Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-045

Material Loss Review of Horizon Bank, Bellingham, Washington

August 2010

Office of Inspector General

Executive Summary

Material Loss Review of Horizon Bank, Bellingham, Washington

Report No. MLR-10-045
August 2010

Why We Did The Audit

On January 8, 2010, the Washington State Department of Financial Institutions (DFI) closed Horizon Bank (Horizon), Bellingham, Washington and named the FDIC as receiver. On March 1, 2010, the FDIC notified the Office of Inspector General (OIG) that Horizon's total assets at closing were $1.19 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $514.5 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure. As of June 30, 2010, the estimated loss to the DIF had increased to $527.4 million.

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

Background

Horizon was organized in 1922 as a state-chartered savings and loan association in Bellingham, Washington. The FDIC became the institution's primary federal regulator in 1979, when Horizon converted to a state-chartered savings bank. Prior to 1999, Horizon's lending activities focused primarily on 1-4 family residential properties. In 1999, the institution changed its lending strategy to focus on commercial and commercial real estate (CRE) loans. By 2005, Horizon had converted to a commercial bank charter and was placing considerable emphasis on acquisition, development, and construction (ADC) lending. A substantial portion of this ADC lending was secured by real estate in Horizon's primary market area of northwest Washington. As of March 31, 2009, Horizon operated 18 full-service office locations, four commercial loan centers, and four real estate loan centers in its primary market area.

Horizon was wholly-owned by the Horizon Financial Corporation, a publicly-traded, one-bank holding company headquartered in Bellingham, Washington. The institution's directors collectively owned less than 4 percent of Horizon Financial Corporation's outstanding shares as of October 5, 2009, and no individual owned more than 3 percent of the holding company's stock. Horizon had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act. The institution owned one subsidiary, Westward Financial Services, Inc., whose principal business was residential and land development in northwest Washington.

Audit Results

Causes of Failure and Material Loss

Horizon failed primarily because its Board and management did not effectively manage the risks associated with the institution's heavy concentration in ADC loans. Notably, the institution did not establish prudent ADC lending limits or conduct stress testing of its loan portfolio to assess the impact that various economic scenarios might have on its asset quality, capital, earnings, and liquidity. Adding to the risk in the loan portfolio were concentrations of credit in large borrowing relationships. Weak loan underwriting and credit administration practices in some areas contributed to the asset quality problems that developed when Horizon's lending markets deteriorated. Further, Horizon's capital levels trended lower between 2003 and 2008 while risk in the loan portfolio was increasing. Horizon's declining capital

levels limited the institution's ability to absorb losses due to unforeseen circumstances and contributed to the relatively high loss to the DIF.

By the close of 2008, the quality of Horizon's loan portfolio had declined significantly, with the majority of problems attributable to ADC loans. This decline accelerated during 2009, and by the year's end, the associated provisions had resulted in significant losses, which depleted capital and strained liquidity. The DFI closed Horizon because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

The FDIC's Supervision of Horizon

The FDIC, in coordination with the DFI, provided ongoing supervisory oversight of Horizon through regular on-site risk management examinations, one visitation, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified key risks at Horizon and brought these risks to the attention of the institution's Board and management. Such risks included the institution's significant ADC loan concentration, weak loan underwriting and credit administration practices, and, in 2008, the need for higher capital levels. Prior to the September 2008 examination, the FDIC relied primarily on recommendations to address the weak risk management practices identified at Horizon. In March 2009, the FDIC and the DFI issued a joint Cease and Desist Order (C&D) to address the institution's rapidly deteriorating financial condition identified during the September 2008 examination.

In retrospect, a more proactive supervisory approach during earlier examinations may have been prudent given the institution's growing risk profile. Such an approach could have included a more aggressive pursuit of the institution establishing and maintaining prudent limits on its growing ADC loan concentration and/or higher capital levels, and increased emphasis on the institution's risk management practices. Increased monitoring of Horizon, particularly after the July 2007 examination, may also have been beneficial. Although regulators issued a C&D in March 2009, by that time, the institution's lending markets were rapidly deteriorating, making remedial efforts difficult. A more proactive supervisory approach during earlier examinations may have influenced Horizon to curb its ADC lending, strengthen its risk management controls, and hold more capital before its lending markets deteriorated, potentially reducing the institution's loss to the DIF.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons it has learned from institution failures during the financial crisis. With respect to the issues discussed in the report, the FDIC has, among other things, reiterated broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations to its supervised institutions and examiners. The FDIC has also recently provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. Horizon was unsuccessful in raising needed capital and was subsequently closed on January 8, 2010.

Management Response

On August 24, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Horizon's failure. With regard to our assessment of the FDIC's supervision of Horizon, DSC summarized the supervisory history, including offsite monitoring activities, described in our report. Further, DSC noted that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations, such as Horizon, and noted that it has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

Contents

	Page
Background	2
Causes of Failure and Material Loss	3
ADC Loan Concentration and Related Risk Management Practices	3
ADC Loan Underwriting and Credit Administration	8
Capital Levels Compared to Risk Profile	10
The FDIC's Supervision of Horizon	12
Supervisory History	12
Supervisory Oversight of ADC Loan Concentration	14
Supervisory Oversight of ADC Loan Underwriting and Credit Administration	15
Supervisory Oversight of Capital	16
Implementation of PCA	17
Corporation Comments	18
Appendices	
1. Objectives, Scope, and Methodology	19
2. Glossary of Terms	22
3. Acronyms	25
4. Corporation Comments	26
Tables	
1. Selected Financial Information for Horizon, 2004 - 2009	3
2. Horizon's Tier 1 Capital Ratios Compared to Other Washington Banks	11
3. On-site Examinations and Visitation of Horizon	13
4. Horizon's Capital Levels, 2005 - 2009	17
Figures	
1. Composition and Growth of Horizon's Loan Portfolio	4
2. Horizon's ADC Loan Concentration Compared to Peer Group	5
3. Horizon's ADC Loan Concentration Compared to Banks in Washington and the U.S.	6
4. Trend in Horizon's Tier 1 Capital Ratio Relative to ADC Loans	11

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

Office of Material Loss Reviews
Office of Inspector General

DATE: August 30, 2010

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

/Signed/

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

SUBJECT: *Material Loss Review of Horizon Bank, Bellingham, Washington* (Report No. MLR-10-045)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Horizon Bank (Horizon), Bellingham, Washington. The Washington State Department of Financial Institutions (DFI) closed the institution on January 8, 2010 and named the FDIC as receiver. On March 1, 2010, the FDIC notified the OIG that Horizon's total assets at closing were $1.19 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $514.5 million. The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act. As of June 30, 2010, the estimated loss had increased to $527.4 million (or 44 percent of Horizon's total assets at closing).

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

The objectives of this material loss review were to (1) determine the causes of Horizon's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Horizon, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Horizon's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of

specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

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

Background

Horizon was organized in 1922 as a state-chartered savings and loan association in Bellingham, Washington. The FDIC became the institution's primary federal regulator in 1979, when Horizon converted to a state-chartered savings bank. Prior to 1999, Horizon's lending activities focused primarily on 1-4 family residential properties. In 1999, the institution changed its lending strategy to focus on commercial and commercial real estate (CRE) loans. By 2005, Horizon had converted to a commercial bank charter and was placing considerable emphasis on acquisition, development, and construction (ADC) lending. A substantial portion of this ADC lending was secured by real estate in Horizon's primary market area of northwest Washington. As of March 31, 2009, Horizon operated 18 full-service office locations, four commercial loan centers, and four real estate loan centers in its primary market area.

Horizon was wholly-owned by the Horizon Financial Corporation, a publicly-traded, one-bank holding company headquartered in Bellingham, Washington. The institution's directors collectively owned less than 4 percent of Horizon Financial Corporation's outstanding shares as of October 5, 2009, and no individual owned more than 3 percent of the holding company's stock. Horizon had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act. The institution owned one subsidiary, Westward Financial Services, Inc. (Westward), whose principal business was residential land development in northwest Washington. Table 1 summarizes selected financial information pertaining to Horizon for the year ended 2009 and for the preceding 5 calendar years.

[1]A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of this report.

Table 1: Selected Financial Information for Horizon, 2004 - 2009

Financial Measure	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets ($000s)	1,188,956	1,471,821	1,390,882	1,254,123	1,083,606	931,271
Gross Loans and Leases ($000s)	939,075	1,214,550	1,211,091	1,063,652	908,636	756,112
Total Deposits ($000s)	1,049,063	1,196,078	1,010,148	953,578	814,911	693,942
Net Income (Loss) ($000s)	(106,143)	(3,120)	20,413	18,865	15,144	13,473
Return on Average Assets	(7.68%)	(0.22%)	1.57%	1.61%	1.50%	1.55%
Tier 1 Leverage Capital Ratio	.80%	8.00%	9.18%	9.35%	10.02%	11.35%

Source: Uniform Bank Performance Reports (UBPR) for Horizon.

Causes of Failure and Material Loss

Horizon failed primarily because its Board and management did not effectively manage the risks associated with the institution's heavy concentration in ADC loans. Notably, the institution did not establish prudent ADC lending limits or conduct stress testing of its loan portfolio to assess the impact that various economic scenarios might have on its asset quality, capital, and earnings. Adding to the risk in the loan portfolio were concentrations of credit in large borrowing relationships. Weak loan underwriting and credit administration practices in some areas contributed to the asset quality problems that developed when Horizon's lending markets deteriorated. Further, Horizon's capital levels trended lower between 2003 and 2008 while risk in the loan portfolio was increasing. Horizon's declining capital levels limited the institution's ability to absorb losses due to unforeseen circumstances and contributed to the relatively high loss to the DIF.

By the close of 2008, the quality of Horizon's loan portfolio had declined significantly, with the majority of problems attributable to ADC loans. This decline accelerated during 2009, and by the year's end, the associated provisions had resulted in significant losses, which depleted capital and strained liquidity. The DFI closed Horizon on January 8, 2010 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

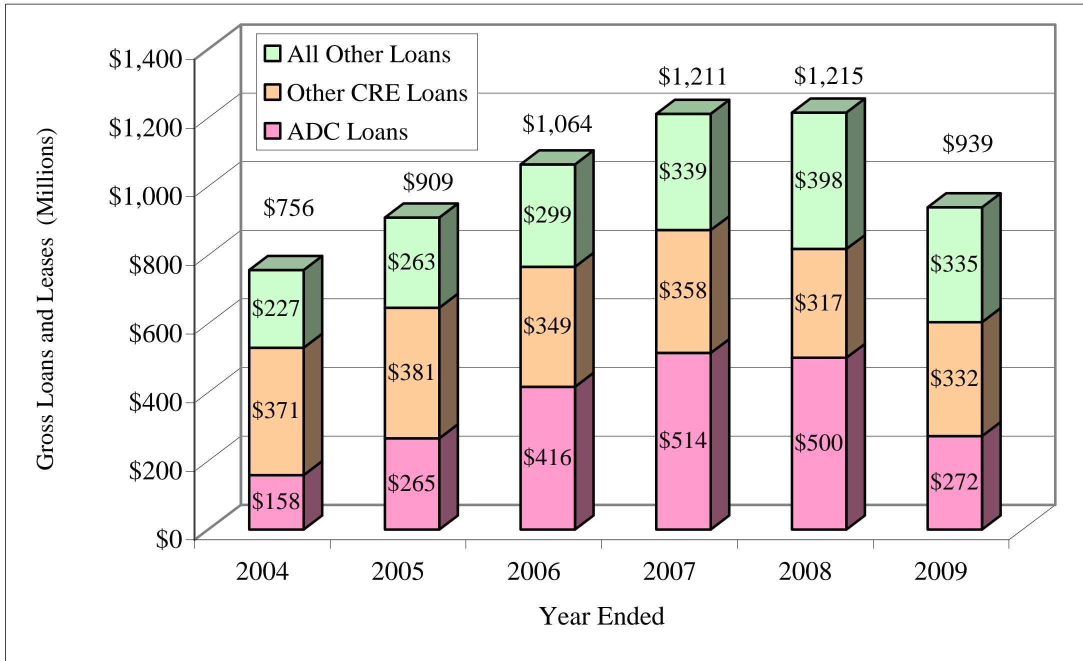
ADC Loan Concentration and Related Risk Management Practices

From 2004 to 2007, Horizon more than tripled its ADC loan portfolio. In addition, the institution had a number of large ADC borrowing relationships that significantly contributed to the loan problems that developed when the institution's lending markets declined. Further, Horizon did not have concentration risk management controls commensurate with its aggressive ADC lending.

ADC Loans

In the years leading to its failure, Horizon emphasized ADC lending in response to a strong real estate market. Horizon grew its ADC loan portfolio from $158 million (or 21 percent of total loans) at year-end 2004 to $514 million (or 42 percent of total loans) at year-end 2007. Much of Horizon's ADC lending consisted of land and land development loans, many of which were for speculative[2] development projects in northwest Washington. Figure 1 illustrates the general composition and growth of Horizon's loan portfolio in the years preceding the institution's failure.

Figure 1: Composition and Growth of Horizon's Loan Portfolio



Source: OIG analysis of Consolidated Reports of Condition and Income (Call Reports) for Horizon.

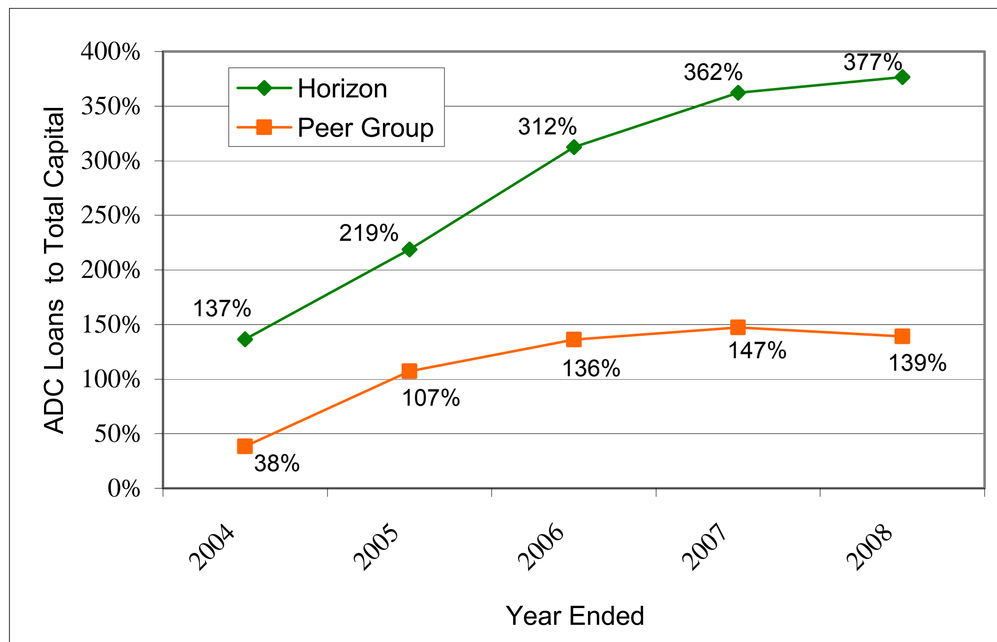
According to its *2008 Annual Report on Form 10-K* (Annual Report) filed with the Securities and Exchange Commission, Horizon was attracted to ADC lending because it offered the opportunity of achieving higher interest rates and fees and shorter terms to maturity than other types of real estate lending. In the Annual Report, Horizon recognized that ADC lending involved a greater degree of risk than permanent financing for finished residences or commercial buildings. These risks included adverse changes in market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans. The Annual Report also noted that an economic downturn in the Pacific Northwest could have a significant impact on the institution's performance, especially in its higher-risk construction loans.

---

[2] Speculative construction lending involves the financing of projects for which a buyer has not yet been identified.

Horizon's concentrations in CRE and ADC loans were well above the institution's peer group[3] averages. Figure 2 illustrates the trend in Horizon's ADC loan concentration relative to total capital as compared to the institution's peer group.

Figure 2: Horizon's ADC Loan Concentration Compared to Peer Group



Source: UBPRs for Horizon.

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). Although the Joint Guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint Guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

- Total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

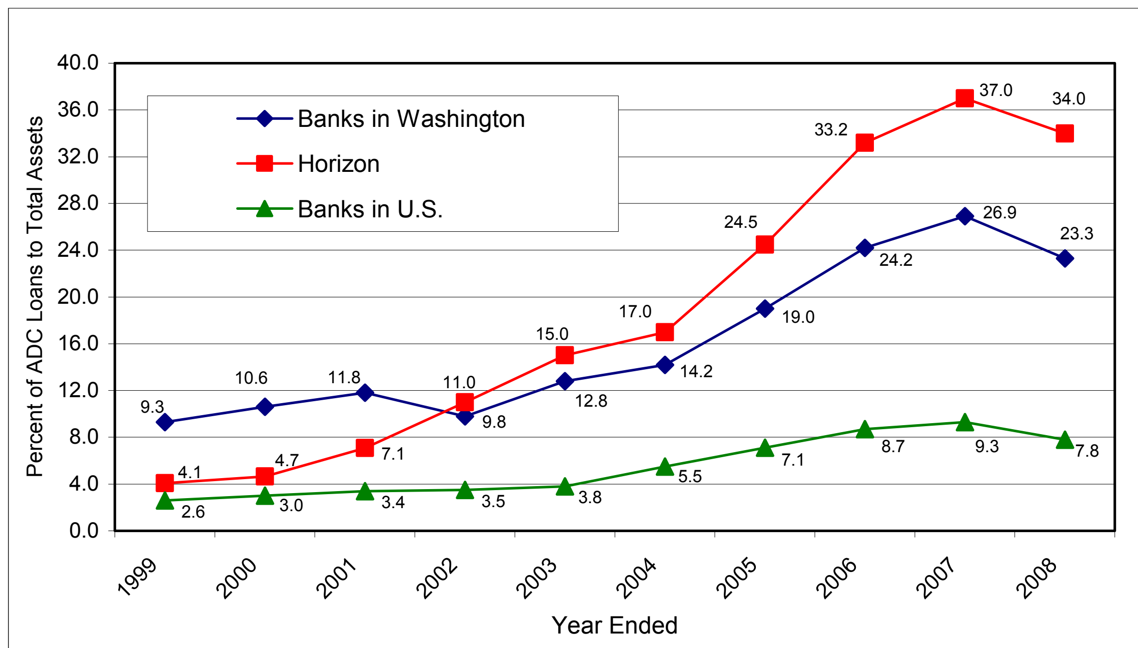
---

[3] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. Horizon's peer group included insured commercial banks having assets between $1 billion and $3 billion.

As of December 31, 2007, Horizon's non-owner occupied CRE and ADC loans represented 552 percent and 362 percent, respectively, of the institution's total capital. Both of these levels are significantly higher than the criteria defined in the Joint Guidance as possibly warranting further supervisory analysis.

Horizon's ADC loans relative to total assets also exceeded both national and state averages. Figure 3 illustrates the trend in Horizon's ADC loans relative to total assets as compared to other state-chartered banks in Washington and the United States. Notably, from 2006 until its failure, Horizon's percentage of ADC loans to total assets was approximately 4 times the average for all state-chartered banks in the U.S.

Figure 3: Horizon's ADC Loan Concentration Compared to Banks in Washington and the U.S.



Source: OIG analysis of information provided by the DFI.

<u>Large Borrowing Relationships</u>

Adding to the risk in Horizon's loan portfolio were concentrations of credit in large borrowing relationships. These relationships consisted of real estate developers, and their related interests, who had also borrowed funds from other financial institutions to finance numerous construction projects. Horizon provided financing to these developers due to their experience and demonstrated financial capability to perform on their loans. However, extensive exposure to ADC projects made these relationships particularly vulnerable to a downturn in the real estate market. As of March 31, 2008, Horizon's 25 largest ADC borrowing relationships accounted for $394 million (or about 75 percent) of the institution's $520 million in ADC loans. Each of these 25 borrowing relationships had outstanding loan commitments representing 10 to 20 percent of the institution's total capital. Horizon's large borrowing relationships accounted for the majority of loan quality problems that developed when the institution's lending markets deteriorated.

Concentration Risk Management Controls

Horizon's concentration risk management controls included providing the Board with regular reports on loan concentrations and limiting the amount of loans that could be held by collateral type. However, the institution had not established or implemented the following important controls.

- **Prudent ADC Lending Limits.** Horizon established loan concentration limits based on the type of collateral securing its loans. Specifically, management tracked and reported to the Board various types of collateral, each with its own limit ranging from 12.5 percent to 200 percent of Tier 1 Capital.[4] However, Horizon did not establish an aggregate limit for ADC loans, allowing the institution's overall ADC loan concentration to grow to imprudent levels and exposing the institution to adverse market conditions.

- **Portfolio Stress Testing.** Horizon did not conduct stress testing of its loan portfolio to determine the impact that various economic scenarios might have on the institution's asset quality, capital, earnings, and liquidity. The Joint Guidance notes that an institution with CRE concentrations should perform stress testing on its loan portfolio. Horizon's lack of stress testing limited the institution's ability to effectively assess its exposure to a downturn in the real estate market.

- **Contingency Planning.** Horizon did not develop a formal contingency plan to mitigate the risks associated with its ADC loan concentration in the event of adverse market conditions. The Joint Guidance recommends that institutions develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse market conditions. Such strategies could include loan participations, loan sales, and securitizations to mitigate concentration risk. A portfolio valuation conducted by the FDIC's Division of Resolutions and Receiverships (DRR) prior to Horizon's closing noted that loan files often cited refinancing as the sole exit strategy in the event of problems. The lack of adequate contingency planning resulted in Horizon being more reactionary than proactive to adverse market conditions.

Horizon continued to originate ADC loans during 2008 while its real estate markets were weakening and other real estate markets in the country were significantly declining. According to Horizon's trial loan balance at the time of its closure, the institution originated over $58 million in ADC-related loans during 2008. Most of these loans experienced problems soon after they were originated. During 2008, Horizon charged off $19.6 million in loans, of which $19.3 million (or 98 percent) were ADC-related. Similarly, during 2009, the institution charged off $99.0 million in loans, of which $77.3 million (or 78 percent) were ADC loans. In its December 31, 2009 Call Report, Horizon reported that more than 12 percent of its total loan portfolio was in non-accrual status and that losses for calendar year 2009 totaled $106.1 million.

---

[4] For example, 1-4 family residential loans and lot loans were limited to 200 percent and 125 percent of capital, respectively.

ADC Loan Underwriting and Credit Administration

Weak loan underwriting and credit administration practices contributed to the asset quality problems that developed when Horizon's lending markets deteriorated. Specifically, controls over appraisals were not adequate, the feasibility of ADC projects was not always fully assessed before funds were disbursed, and global cash flow analyses for large borrowing relationships were not always sufficient. In addition, the institution frequently renewed, extended, or modified its large ADC loans, which in some cases delayed the recognition of problems. A brief summary of these loan underwriting and credit administration weaknesses follows.

Appraisals

Horizon's real estate appraisals were often based on faulty assumptions. For example, in 2007, examiners:

- noted that appraisals for five ADC loans, with combined commitments of $36.5 million, did not reflect appropriate deductions and discounts for holding and marketing costs. Examiners cited the lack of the deductions and discounts as apparent violations of Part 323, *Appraisals*, of the FDIC Rules and Regulations. Three of the five loans, totaling $24.7 million, were subsequently classified.

- classified a $16.7 million CRE loan due, in part, to an appraisal on additional pledged collateral being based on the "extraordinary assumption" that zoning for the property could be converted from a density of one dwelling per five acres to four dwellings per acre.

In addition, examiners noted in 2007 that Horizon's appraisal reviews generally consisted of completing a simple checklist without regard to the size, risk, and complexity of the project. Such reviews limited Horizon's assurance that faulty appraisal assumptions would be detected. Horizon's lack of a comprehensive appraisal review process was cited by examiners as an apparent contravention of interagency appraisal guidelines.

In 2008, examiners classified four ADC loans totaling more than $19 million because the underlying appraisals "were generally of questionable quality." The appraisals, which were performed during June and July 2008, did not address the current inventory of finished lots or houses in the area of the properties.

Relying on appraisals with overly optimistic assumptions can result in inflated property valuations, understated loan-to-value (LTV) ratios, and inaccurate assessments of the true credit risk of the loans. In addition, Horizon's loan policy did not address minimum borrower equity requirements for ADC loans. As a result, borrowers were not always required to provide equity when the loans were originated, which exposed the institution to additional credit risk for loans supported by faulty appraisals.

Feasibility Assessments

Horizon did not always ensure that the feasibility of ADC projects was fully assessed before disbursing funds. As a result, Horizon incurred losses that may have been avoided when some projects experienced significant delays. Two examples follow.

- Horizon originated a $7.8 million loan in 2006 to develop residential building lots with an anticipated completion in the summer of 2007. According to Horizon's loan files, delays in obtaining needed permits, a difficult topography, and unexpected problems with soil conditions negatively impacted progress on the project. The project was never completed. Horizon recognized losses exceeding $3 million on this loan during 2008 and 2009.

- Horizon originated a $6 million loan in August 2007 for the purchase and development of 89 acres of land. The primary repayment source for the loan was the sale of the developed land. Examiners noted during the October 2009 examination that although part of the land had been sold, additional planning was needed to further develop the remaining land for sale. At the time of the examination, the loan guarantors were working with the U.S. Army Corps of Engineers to move a stream on the land in order to make the property more desirable. The entire loan was classified during the 2009 examination.

Global Cash Flow Analyses for Large Borrowing Relationships

The complexity of Horizon's large borrowing relationships made it difficult to properly assess their true global financial condition, including the impact that problems on projects financed at other institutions might have on projects financed by Horizon. To illustrate this point, one of Horizon's large borrowing relationships had five loans totaling over $17 million (or 15 percent of total capital) as of December 31, 2008. According to court bankruptcy filings, the borrower associated with this relationship had financing arrangements totaling over $400 million at more than 30 other financial institutions to support numerous real estate projects.

The June 2006 examination report noted that Horizon did not always assess borrower liabilities at other institutions when extending credit. Further, an independent loan review of Horizon conducted in early 2008 noted that the institution's cash flow analysis practices needed to be improved. The lack of sufficient global cash flow analyses for large borrowing relationships increased Horizon's credit risk exposure.

Loan Renewals, Extensions, and Modifications

Our review of Horizon's records indicated that the institution frequently renewed, extended, or modified its large ADC loans without taking adequate steps to ensure that the borrower had the capacity to repay the loan or identifying viable exit strategies. In some cases, the renewals, extensions, and modifications delayed the recognition of problems. Notably, Horizon's loan policy did not address how and when loans could be renewed, extended, or modified. At the time of its failure, Horizon had 70 ADC loans valued at $1 million or more on an individual basis and $198 million on a collective

basis. Sixty of these loans (or 86 percent) had been renewed, extended, or modified at least once and 30 of the loans had been renewed, extended, or modified 4 or more times. Many of these loans were experiencing delays prior to their renewal, extension, or modification.

For example, Horizon originated an $11.4 million loan in May 2008 for a 27-lot subdivision. The real estate was appraised at $14.6 million in March 2008, and subsequently appraised for $8.7 million in April 2009. Horizon renewed the loan five times without recognizing any loan impairment until examiners classified the loan at the October 2009 examination. Examiners noted that the loan had weak collateral coverage and questionable debt service capacity. According to DRR loss share records, more than $4.1 million of this loan had been charged off as of March 31, 2010.

Illustration—Joint Venture Real Estate Investment

One project financed by Horizon illustrates several of the weak underwriting and credit administration practices discussed herein. In October 2004, Horizon's Westward subsidiary entered into a speculative joint venture project with a real estate developer to develop 739 residential units on 85 acres of land. Although the purchase price of the property was $16 million, Horizon provided two loans for the project totaling $17.5 million, of which $7.1 million was unsecured. No borrower equity was provided for the project and the LTV ratio exceeded 100 percent.

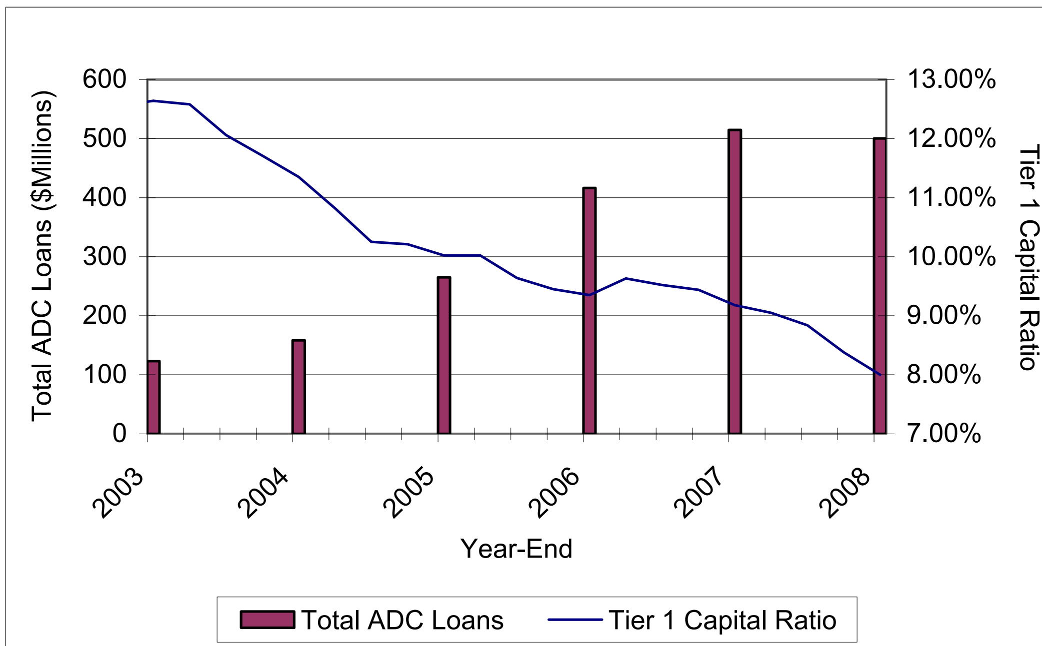
Horizon renewed the loans four times between 2005 through 2009. During this period, the combined loan amounts increased from $17.5 million to $24 million to cover interest payments and other costs related to carrying the land while the owners attempted to obtain land entitlements and conducted environmental impact assessments. Development of the land never took place as necessary permits and approvals for the project could not be obtained. According to DRR loss share records, $16.3 million of the underlying loans had been charged off.

Capital Levels Compared to Risk Profile

While risk in Horizon's ADC loan portfolio increased significantly between 2003 and 2008, the institution's capital ratios decreased during the same period. Horizon's capital ratios declined primarily due to growth in the loan portfolio. The declining capital levels limited Horizon's ability to absorb losses due to unforeseen circumstances and contributed to the relatively high loss to the DIF.[5] Figure 4 illustrates the trend in Horizon's Tier 1 Capital ratio relative to ADC loans.

[5] Horizon's estimated loss rate of 44 percent is much higher than the average estimated loss rate of 24 percent for all insured institutions that failed between January 1, 2008 and June 1, 2010. (The average loss rate does not include the failure of Washington Mutual.) Horizon's loss rate also exceeds the average estimated loss rate of 33 percent for institutions in the state of Washington that failed between January 1, 2008 and June 1, 2010.

Figure 4: Trend in Horizon's Tier 1 Capital Ratio Relative to ADC Loans



Source: UBPRs for Horizon.

Although Horizon's capital levels were generally comparable to its peer group averages in the years leading to its failure, the institution's capital levels were at times significantly below the average of other insured banks in Washington. Table 2 reflects Horizon's Tier 1 Capital ratios compared to other insured banks in Washington for the 5-year period ending 2008.

Table 2: Horizon's Tier 1 Capital Ratios Compared to Other Washington Banks

Bank	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08
Horizon	11.35%	10.02%	9.35%	9.18%	8.00%
Washington Banks (average)	10.42%	11.02%	13.06%	11.58%	10.08%

Source: UBPRs for Horizon.

The FDIC's *Risk Management Manual of Examination Policies* states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed. In addition, the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for purposes of PCA. Had Horizon maintained higher capital ratios commensurate with its risk profile, the institution's loan growth may have been constrained and the losses to the DIF mitigated to some extent.

The FDIC's Supervision of Horizon

The FDIC, in coordination with the DFI, provided ongoing supervisory oversight of Horizon through regular on-site risk management examinations, one visitation, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified key risks at Horizon and brought these risks to the attention of the institution's Board and management. Such risks included the institution's significant ADC loan concentration, weak loan underwriting and credit administration practices, and, in 2008, the need for higher capital levels. Prior to the September 2008 examination, the FDIC relied primarily on recommendations to address the weak risk management practices identified at Horizon. In March 2009, the FDIC and the DFI issued a joint Cease and Desist Order (C&D) to address the institution's rapidly deteriorating financial condition identified during the September 2008 examination.

As discussed below, a more proactive supervisory approach during earlier examinations may have been prudent given the institution's growing risk profile. Such an approach could have included a more aggressive pursuit of the institution establishing and maintaining prudent limits on its growing ADC loan concentration and/or higher capital levels and increased emphasis on the institution's risk management practices. Increased monitoring of Horizon, particularly after the July 2007 examination, may also have been beneficial. Although regulators issued a C&D in March 2009, by that time, the institution's lending markets were rapidly deteriorating, making remedial efforts difficult. A more proactive supervisory approach during earlier examinations may have influenced Horizon to curb its ADC lending, strengthen its risk management controls, and hold more capital before its lending markets deteriorated, potentially reducing the institution's losses.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons it has learned from institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, reiterated broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations to its supervised institutions and examiners. The FDIC has also recently provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

Supervisory History

The FDIC and the DFI conducted six on-site risk management examinations and one visitation of Horizon from 2004 until its failure. Table 3 summarizes key supervisory information pertaining to these activities.

Table 3: On-site Examinations and Visitation of Horizon

Examination Start Date	Type of Examination	Regulator	Supervisory Ratings	Informal or Formal Action Taken
10/05/09	Risk Management	FDIC/DFI	555554/5	C&D Still In Effect
06/01/09	Visitation	FDIC/DFI	555555/5	Interim Rating Change Effective 9/22/09
09/15/08	Risk Management	FDIC/DFI	444433/4	C&D Effective 03/03/09
07/09/07	Risk Management	FDIC/DFI	222121/2	None
06/06/06	Risk Management	FDIC/DFI	222121/2	None
05/02/05	Risk Management	DFI	122121/2	None
02/17/04	Risk Management	FDIC	122111/2	None

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for Horizon.

The FDIC's offsite monitoring procedures generally consisted of contacting the institution's management from time to time to discuss current and emerging business issues, and using automated tools[6] to help identify potential supervisory concerns. The FDIC's offsite monitoring initially identified serious financial problems at Horizon based on an analysis of the institution's June 30, 2008 Call Report. Specifically, the analysis identified a sharp increase in nonperforming assets largely concentrated in the institution's ADC portfolio. The FDIC conducted an on-site examination of the institution in September 2008, at which time examiners followed up on the issues identified through the offsite monitoring of the June 30, 2008 Call Report. Based on the findings of that examination, the FDIC issued a C&D that became effective on March 3, 2009. Among other things, the C&D required the institution to:

- strengthen Board oversight of management and operations,
- develop a plan to reduce the amount of construction and land development loans,
- restrict new ADC loan originations and other extensions of credit,
- enhance policy and procedures for determining the adequacy of the Allowance for Loan and Lease losses (ALLL), and
- increase Tier 1 Capital to no less than 10 percent of the institution's total assets.

[6] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating system and the Growth Monitoring System. Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

The June 2009 joint visitation found that although Horizon had made some progress in complying with the provisions of the C&D, the condition of the institution continued to deteriorate. As a result, the FDIC downgraded Horizon's composite rating to a "5" effective in September 2009. Based on the results of the October 2009 examination, the FDIC and the DFI determined that the institution was no longer viable absent significant and immediate outside financial assistance. The DFI closed the institution on January 8, 2010 because Horizon was unable to raise sufficient capital.

Supervisory Oversight of ADC Loan Concentration

During the period 2004 through 2007, conditions in Horizon's lending markets were generally favorable. In addition, the institution's earnings performance was strong and adversely classified assets were at manageable levels.[7] Based on these (and other) factors, examiners determined that Horizon's overall financial and operational condition during that period was generally satisfactory and assigned composite ratings of "2". Notwithstanding these results, examination reports issued between 2004 and 2007 also identified the increasing risk pertaining to Horizon's growing ADC loan concentrations and included a number of recommendations intended to mitigate the risks associated with the concentrations. A brief summary of the examiner comments and recommendations follows.

- **February 2004**. The examination report identified Horizon's growing ADC loan concentrations, stating "rapid growth in the higher risk segments of the loan portfolio has produced notable concentration exposure…" The report also included recommendations to develop and implement systems for identifying, monitoring, and reporting on the institution's loan concentrations. Among other things, the report recommended that management establish appropriate concentration risk limits since the concentrations "may pose economic risks beyond management's ability to control or mitigate."

- **May 2005.** The examination report noted that Horizon had established loan concentration limits by collateral type following the previous examination and that the limits had not been exceeded. However, the report recommended that the concentration limits be incorporated into the institution's Board-approved loan policy. The report also noted that risk in the loan portfolio was increasing due to management's emphasis on CRE lending, especially for construction projects. The report recommended that management strengthen its practices for measuring and monitoring borrower concentrations.

[7] For example, Horizon's adversely classified assets at the time of the February 2004 examination were $21.9 million, or 19.7 percent of Tier 1 Capital and the ALLL. Horizon's adversely classified assets at the time of the July 2007 examination were $36.6 million, or 27 percent of Tier 1 Capital and the ALLL.

- **June 2006.** The examination report noted that Horizon's ADC loan concentrations continued to increase due to management's emphasis on construction and land development lending. The report noted that concentrations were "still within Board approved limits" and that controls for monitoring Horizon's concentrations were adequate. The report included several recommendations to improve the institution's concentration monitoring practices.

- **July 2007.** The examination report noted that Horizon's CRE loan concentration monitoring and reporting (including for large and related borrowers) needed to be enhanced. The report recommended that Horizon strengthen its concentration monitoring and reporting and implement stress testing of the loan portfolio.

By the September 2008 examination, many of Horizon's residential real estate construction borrowers were experiencing cash flow problems due to the ongoing downturn in the real estate market. Examiners became sharply critical of Horizon's concentration risk management practices at that time. For example, the September 2008 examination report noted that management had allowed its ADC loan concentrations to grow to "imprudent levels" and recommended that the Board amend the loan policy to establish more prudent guidelines and parameters. The report also noted that the institution had failed to stress test its commercial and residential loan portfolios as recommended during the prior examination. The results of such testing may have alerted management and the Board to the risk posed by the concentrations. Based on the results of the September 2008 examination, examiners downgraded the institution's composite rating to a "4" and, together with the DFI, issued a C&D in March 2009. Among other things, the C&D required management to develop a plan for reducing its ADC loan concentration. Although Horizon made some progress in reducing its ADC loans in the months that followed, the institution's financial condition continued to deteriorate until it was closed.

In retrospect, a more proactive supervisory approach to addressing the institution's weak concentration risk management practices during earlier examinations may have been prudent. Such action, which may have been taken as early as the June 2006 examination, could have included more aggressively pursuing the institution establishing and maintaining an aggregate limit on its ADC loans and stress testing of the loan portfolio to assess the impact that various economic scenarios might have on asset quality, earnings, capital, and liquidity. Increased monitoring of Horizon's concentration risk management practices after the June 2006 examination may also have been beneficial. Although Horizon began working with its borrowers in 2008 to address problems in its loan portfolio, the ongoing decline in the real estate market made remedial actions difficult to effectively implement.

Supervisory Oversight of ADC Loan Underwriting and Credit Administration

Examiners identified various loan underwriting and credit administration weaknesses at Horizon in the years preceding the institution's failure and made recommendations to the Board and management for improvement. Examination reports issued prior to 2009 noted that, with few exceptions, the Board and management were responsive to examiner

recommendations. With respect to the loan underwriting and credit administration weaknesses discussed in this report, a more proactive supervisory approach may have been prudent. For example, examination reports issued prior to 2008 could have emphasized the need for robust global cash flow analyses and market feasibility studies when originating ADC loans. Examination reports also could have raised concern regarding the extent to which Horizon was renewing, extending, and modifying its ADC loans, particularly when the institution's lending markets were deteriorating. Collectively, such actions may have mitigated the asset quality problems that developed when Horizon's lending markets deteriorated.

Supervisory Oversight of Capital

Prior to the June 2006 examination, examiners considered Horizon's capital position to be strong as reflected in the supervisory component ratings of "1" assigned to Capital. These ratings reflected the institution's favorable capital levels relative to the PCA thresholds for *Well Capitalized* institutions as well as Horizon's strong earnings and manageable levels of adversely classified assets. Examiners lowered Horizon's Capital rating to a "2" during the June 2006 examination due, in part, to the institution's growing CRE and ADC loan concentrations and rising adverse asset classifications.

Although Horizon was still *Well Capitalized* for PCA purposes at the time of the September 2008 examination, examiners determined that the institution's capital levels were not adequate given its rapidly deteriorating financial condition. As a result, examiners downgraded Horizon's Capital rating to a "4" and recommended that the institution develop a capital contingency plan to address the possibility of further financial deterioration. The FDIC and the DFI issued a joint C&D in March 2009 that addressed, among other things, the need for higher capital levels. The FDIC closely monitored Horizon's capital position following the September 2008 examination until the institution failed.

As discussed earlier in this report, Horizon's capital levels trended lower between 2003 and 2008 while risk in the loan portfolio was increasing. In retrospect, examiners could have pursued having the Board and management maintain higher capital levels as early as the June 2006 examination. At that time, Horizon was placing considerable emphasis on higher-risk ADC lending, and the institution's long-term projections indicated that capital levels would continue to decline going forward. By the September 2008 examination, the institution's financial condition had deteriorated significantly and opportunities for attracting new capital were limited due to disruptions in the credit markets. Higher capital levels may have influenced Horizon's Board and management to curb its aggressive ADC lending and mitigated, to some extent, the loss incurred by the DIF.

Implementation of PCA

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

Based on the supervisory actions taken with respect to Horizon, the FDIC properly implemented applicable PCA provisions of section 38. Among other things, the FDIC issued timely notices related to the institution's capital category, reviewed and monitored the institution's Call Reports, and conducted periodic discussions with the institution's management regarding compliance with the restrictions imposed under each PCA capital category. Table 4 illustrates Horizon's capital levels relative to the PCA thresholds for *Well Capitalized* institutions from 2005 through 2009.

Table 4: Horizon's Capital Levels, 2005 - 2009

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well Capitalized Thresholds	**5% or more**	**6% or more**	**10% or more**	
Horizon's Capital Levels				
Dec-05	10.02	11.16	12.70	*Well Capitalized*
Dec-06	9.35	10.36	11.86	*Well Capitalized*
Dec-07	9.18	9.64	11.00	*Well Capitalized*
Dec-08	8.00	8.99	10.27	*Well Capitalized*
Mar-09	6.11	7.29	8.58	*Adequately Capitalized*
Jun-09	3.17	3.97	5.28	*Significantly Undercapitalized*
Sep-09	0.77	0.99	1.98	*Critically Undercapitalized*
Dec-09	0.80	0.99	1.97	*Critically Undercapitalized*

Source: UBPRs for Horizon.

Horizon was considered *Well Capitalized* for PCA purposes until March 3, 2009. The institution fell to *Adequately Capitalized* at that time as a result of the issuance of a joint C&D which contained a capital provision directing the institution to increase and

maintain a Tier 1 Capital ratio of no less than 10 percent of the institution's assets.[8] On August 27, 2009, the FDIC notified Horizon that, based on an analysis of its June 30, 2009 Call Report, the institution had fallen to *Significantly Undercapitalized*. The notification advised Horizon that it was required to file a written capital restoration plan with the FDIC and to outline specific steps taken to comply with the mandatory restrictions defined in section 38 for *Significantly Undercapitalized* institutions by October 12, 2009.

Horizon submitted a capital restoration plan on October 13, 2009. Based on a preliminary review of the plan, the FDIC determined that the plan was unacceptable because it lacked specific information about a proposed capital infusion and lacked details regarding how the institution planned to comply with the restrictions in section 38. On November 20, 2009, the FDIC notified Horizon that, based on an analysis of its September 30, 2009 Call Report, the institution had fallen to *Critically Undercapitalized.* The FDIC requested that Horizon provide appropriate changes or addendums to its original capital restoration plan by January 6, 2010, to address the continued financial deterioration at the institution. The FDIC also requested that Horizon provide a summary of the specific steps taken to comply with the mandatory restrictions of section 38 by January 5, 2010. Horizon never submitted an updated capital restoration plan or a summary of the steps taken to comply with the mandatory restrictions of section 38.

On December 2, 2009, the FDIC issued a *Supervisory Prompt Corrective Action Directive* (PCA Directive) to Horizon that outlined the mandatory restrictions imposed on the institution based on its capital category and discretionary sanctions under section 38 for failing to submit an acceptable capital restoration plan. In response to the PCA Directive, Horizon's management notified the FDIC on December 22, 2009 that it was experiencing further declines in its capital and that prospects for raising new capital or selling the institution were poor. The DFI closed the institution on January 8, 2010.

Corporation Comments

On August 24, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Horizon's failure. With regard to our assessment of the FDIC's supervision of Horizon, DSC summarized the supervisory history, including offsite monitoring activities, described in our report. Further, DSC noted that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations, such as Horizon, and noted that it has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

---

[8] The FDIC did not formally notify Horizon of its new PCA capital category because FDIC policy does not require written notification to institutions when they fall to *Adequately Capitalized*. However, FDIC policy does require written notification to institutions when they fall to *Undercapitalized*, *Significantly Undercapitalized*, or *Critically Undercapitalized*.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, and as amended by the Financial Reform Act, which provides, in general, that if the DIF 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 Horizon's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Horizon, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

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

Scope and Methodology

The scope of this audit included an analysis of Horizon's operations from 2004 until it failed on January 8, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution during the same period. To accomplish the objectives, we performed the following procedures and techniques:

- Analyzed examination reports and other supervisory documents prepared by the FDIC and the DFI from 2004 through July 2009.
- Reviewed the following:
    - Institution data in Call Reports, UBPRs, and other reports.
    - FDIC and DFI correspondence, including correspondence maintained in DSC's San Francisco Regional Office.
    - Relevant reports prepared by DRR and DSC relating to the institution's closure, including records maintained by DRR in the Irvine, CA office.
    - Pertinent FDIC regulations, policies, procedures, and guidance.

Objectives, Scope, and Methodology

- Interviewed DSC personnel in the Washington, D.C., San Francisco, and Seattle offices.
- Interviewed DFI examiners and managers to obtain their perspectives and discuss their role in the supervision of the institution.

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

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

We obtained data from various FDIC systems, but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that was used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment 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 the provisions of PCA. We performed limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations. The results of our tests are discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional material loss review reports related to failures of FDIC-supervised institutions and these reports can be found at http://www.fdicig.gov/index.html. In June 2010, the OIG

Objectives, Scope, and Methodology

initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent material loss reviews.

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

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and providing interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Annual Report on Form 10-K	An annual report required by the Securities and Exchange Commission that provides a comprehensive summary of a public company's performance. The report includes information such as company history, organizational structure, executive compensation, equity, subsidiaries, and audited financial statements, among other information.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's 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.

Glossary of Terms

Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. 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 determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Section 23A	Section 23A (1) establishes limits on the amount of ''covered transactions'' between a member bank and its affiliates (any one affiliate and in the aggregate as to all affiliates); (2) requires that all covered transactions between a member bank and its affiliates be on terms and conditions that are consistent with safe and sound banking practices; (3) prohibits the purchase of low quality assets from an affiliate; and (4) requires that extensions of credit by a member bank to an affiliate, and guarantees on behalf of affiliates, be secured by statutorily defined amounts of collateral.

Glossary of Terms

Tier 1 (Core) Capital	In general, this term is defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable marketvalues); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the 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.
Uniform Financial Institutions Rating System (UFIRS)	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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
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
DFI	Department of Financial Institutions
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
LTV	Loan-to-Value
OIG	Office of Inspector General
PCA	Prompt Corrective Action
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

August 23, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Horizon Bank, Bellingham, Washington (Assignment No. 2010-020)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Horizon Bank, Bellingham, Washington (Horizon), which failed on January 8, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on July 29, 2010.

The principal factors that led to the rapid deterioration in Horizon's financial condition and failure were the decision of its Board of Directors' (Board) and management to concentrate the loan portfolio in acquisition, development and construction (ADC) loans; its inability to manage the risks associated with these loans which were primarily for residential land development and single-family home development; and its inability to raise capital while loan losses were steadily increasing. Horizon continued to originate ADC loans during 2008 while its real estate markets were weakening. Adding to the losses was the concentration of loans to large real estate development borrowers, who were unable to meet their obligations when real estate market conditions rapidly deteriorated.

From 2004 through its closure in January 2010, the FDIC and the Washington State Department of Financial Institutions (DFI) jointly and separately conducted six full-scope examinations and one visitation. In addition, the FDIC's offsite monitoring program identified serious financial problems and a sharp increase in non-performing ADC loans based on an analysis of Horizon's June 30, 2008 Call Report. At the September 2008 FDIC and DFI joint examination, Horizon's loan assets had further deteriorated to a level that raised significant regulatory concern and posed considerable risk, resulting in the implementation of a formal enforcement action in March 2009. The June 2009 joint visitation found that the condition of Horizon had continued to deteriorate, and Horizon was downgraded to a composite "5" rating. Based on the results of the October 2009 examination, the FDIC and DFI determined that Horizon was no longer viable without an immediate capital infusion. Horizon was unable to raise capital and was closed by DFI.

In recognition that strong supervisory attention is necessary for institutions with high commercial real estate and ADC concentrations, such as Horizon, DSC has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

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