

Office of Inspector General



Office of Material Loss Reviews
Report No. MLR-11-003

**Material Loss Review of City Bank,
Lynnwood, Washington**

November 2010



Why We Did The Audit

On April 16, 2010, the Washington State Department of Financial Institutions (DFI) closed City Bank, Lynnwood, Washington and named the FDIC as receiver. On May 14, 2010, the FDIC notified the Office of Inspector General (OIG) that City Bank's total assets at closing were \$964 million and the estimated loss to the Deposit Insurance Fund (DIF) was \$321 million. As of September 30, 2010, the estimated loss to the DIF had decreased to \$271 million. As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of City Bank.

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

Background

City Bank was a state-chartered nonmember bank insured by the FDIC on April 15, 1974, and headquartered in Lynnwood, Washington, which is 14 miles north of downtown Seattle, Washington. Nearly 88 percent of the bank's total deposits were held in Snohomish County, where the main office was located. City Bank pursued a community banking business plan that was centered on commercial real estate (CRE) and, in particular, acquisition, development, and construction (ADC). City Bank had no holding company and was publically traded. The largest shareholder was the managing officer of the bank since its formation. This individual served as the Chief Executive Officer and Chairman of the Board and was a dominant influence behind the bank's business strategy.

Audit Results

Causes of Failure and Material Loss

City Bank's failure can be attributed to the Board and management's high-risk strategy that centered on increasing levels of ADC lending, funded through non-core deposits, in pursuit of higher earnings. The bank's lending strategy had historically been profitable and the bank maintained higher levels of capital to mitigate risk associated with its strategy. However, as the bank's risk profile increased, the Board and management failed to implement prudent risk management practices necessary to monitor and manage the bank's loan portfolio. In addition, the Board and management repeatedly disregarded key regulations related to appraisals and loan-to-value requirements. Collectively, these factors heightened the bank's risk profile and the bank's vulnerability to adverse economic conditions, which led to significant loan-related losses, poor earnings, and the erosion of the bank's capital when market conditions deteriorated. DFI closed the bank on April 16, 2010.

The FDIC's Supervision of City Bank

Our review focused on FDIC and DFI supervisory oversight of City Bank between 2006 and 2010. The FDIC and DFI conducted timely and regular examinations of City Bank, as required. City Bank was also subjected to periodic offsite monitoring. Prior to 2008, the FDIC and DFI consistently concluded that the

bank's ADC risk exposure was mitigated by strong Board and management oversight, strong earnings, and significant capital. Further, although examiners identified various risk management practices that needed to be strengthened, examiners did not consider identified weaknesses to be significant in light of the bank's sound financial condition and capital levels. Accordingly, neither the FDIC nor DFI considered City Bank to be a cause for supervisory concern even when the economy began to weaken in 2007.

However, the level of supervisory concern changed dramatically in 2008 when the bank's ADC concentrations, combined with deficient risk management practices and a downturn in the real estate market, resulted in a dramatic rise in delinquent and nonperforming assets and significant deterioration in the bank's overall condition. Based on the 2008 examination findings, the FDIC and the DFI acted aggressively to downgrade the bank's composite and component ratings, issue a formal supervisory enforcement action, and closely monitor City Bank's condition. However, despite the increased supervisory attention following that examination and City Bank's efforts to address deficiencies, the condition of the bank continued to decline and became critically deficient.

A lesson learned with respect to ADC concentrations is that early supervisory intervention is prudent, even when an institution has significant capital and few classified assets. In hindsight, a more forward-looking assessment of City Bank's risk profile would likely have resulted in earlier downgrades and possibly led to the issuance of an informal enforcement action in 2007. Such an approach would have reinforced supervisory expectations, increased supervisory oversight, and required the Board to commit to a plan and a timeline for implementing corrective actions before the deterioration of economic conditions made corrective action more difficult to achieve.

The FDIC has taken a number of actions to increase supervisory attention to banks that have risk profiles similar to City Bank, including instituting a training initiative on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations, appraisals, and funds management.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On November 12, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of City Bank's failure. With regard to our assessment of the FDIC's supervision of City Bank, DSC's response discussed the number of examinations conducted between 2006 and 2010 described in our report. Further, DSC's response reiterated that City Bank's loan portfolio had deteriorated to a level that raised significant supervisory concern at the December 2008 joint examination, resulting in a composite "5" rating and the issuance of a Cease and Desist Order in June 2009. In the February 2010 examination, the FDIC and DFI determined that City Bank was no longer viable without an immediate capital infusion, which failed to materialize. DSC also indicated that it recognizes strong supervisory attention is necessary for institutions with high CRE and ADC concentrations, such as City Bank, and referenced guidance that the Division has issued to remind examiners to take appropriate action when risks associated with those concentrations are imprudently management. DSC also stated that supervisory guidance has been issued to financial institutions to re-emphasize the importance of robust credit risk-management practices for institutions with concentrated CRE exposures.

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Federal Deposit Insurance Corporation

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Office of Material Loss Reviews
Office of Inspector General

DATE: November 12, 2010

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

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

SUBJECT: *Material Loss Review of City Bank, Lynnwood, Washington*
(Report No. MLR-11-003)

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 City Bank, Lynnwood, Washington. The Washington State Department of Financial Institutions (DFI) closed the institution on April 16, 2010, and named the FDIC as receiver. On May 14, 2010, the FDIC notified the OIG that City Bank's total assets at closing were \$964 million and the estimated loss to the Deposit Insurance Fund (DIF) was \$321 million. As of September 30, 2010, the estimated loss to the DIF had decreased to \$271 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.

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 City Bank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of City Bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of City Bank'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

City Bank was a state-chartered nonmember bank insured by the FDIC on April 15, 1974, and headquartered in Lynnwood, Washington, which is 14 miles north of downtown Seattle, Washington. Nearly 88 percent of the bank’s total deposits were held in Snohomish County where the main office was located. City Bank pursued a community banking business plan that was centered on commercial real estate (CRE) and, in particular, acquisition, development, and construction (ADC). City Bank had no holding company and was publically traded. The largest shareholder was the managing officer of the bank since its formation. This individual served as the Chief Executive Officer (CEO) and Chairman of the Board and was a dominant influence behind the bank’s business strategy. Table 1 provides details on City Bank’s financial condition as of December 2009 and for the 4 preceding calendar years.

Table 1: Financial Information for City Bank, 2005 to 2009

Financial Measure (\$000)	Dec 2009	Dec 2008	Dec 2007	Dec 2006	Dec 2005
Total Assets	1,129,154	1,325,541	1,239,032	1,077,689	832,039
Total Loans	596,306	1,071,270	1,161,755	970,237	749,486
Total Deposits	1,020,494	1,088,091	864,489	763,486	510,863
Brokered Deposits	351,747	604,235	297,734	211,340	57,862
FHLB Borrowings	65,000	85,000	130,400	90,400	101,191
Net Income (Loss)	(119,500)	(60,843)	41,495	37,000	51,478

Source: Uniform Bank Performance Reports (UPBR) for City Bank.

Causes of Failure and Material Loss

City Bank’s failure can be attributed to the Board and management’s high-risk strategy that centered on increasing levels of ADC lending, funded through non-core deposits, in pursuit of higher earnings. The bank’s lending strategy had historically been profitable and the bank maintained higher levels of capital to mitigate risk associated with its strategy. However, as the bank’s risk profile increased, the Board and management failed to implement prudent risk management practices necessary to monitor and manage the

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

bank's loan portfolio. In addition, the Board and management repeatedly disregarded key regulations related to appraisals and loan-to-value requirements. Collectively, these factors heightened the bank's risk profile and the bank's vulnerability to adverse economic conditions, which led to significant loan-related losses, poor earnings, and the erosion of the bank's capital when market conditions deteriorated. DFI closed the bank on April 16, 2010.

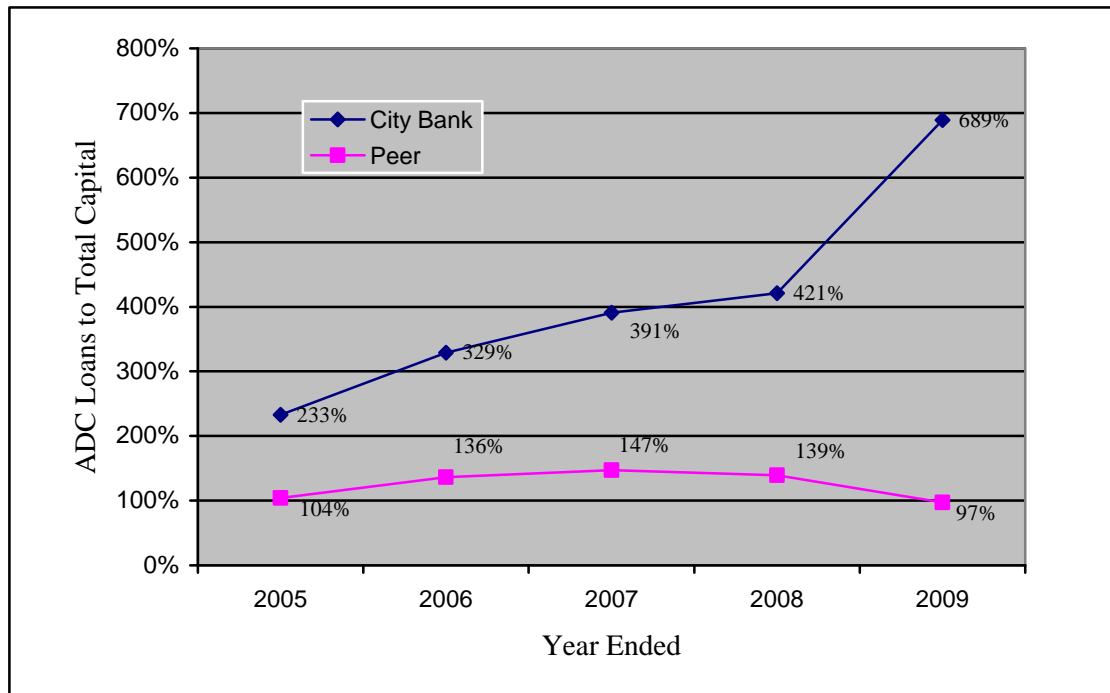
Board and Management's High-Risk Strategy

The Board and management, largely influenced by the bank's CEO and Chairman, carried out a high-risk lending and funding strategy that, coupled with a weakened real estate market, caused the bank's financial condition to deteriorate.

Lending Strategy

City Bank had always carried a large concentration in ADC loans, focusing on single-family residential development and construction lending. Historically, the bank experienced relatively nominal losses even during prior economic downturns. However, from December 2005 to December 2008, the bank grew almost 60 percent, and that growth was principally focused in ADC lending. This strategy increased the risk profile of the bank. Figure 1 illustrates that City Bank's ADC concentrations compared to Total Capital were well above the bank's peer group.²

Figure 1: City Bank's ADC Loan Concentrations Compared to Peer Group



Source: UBPRs for City Bank.

² City Bank's peer group included insured commercial banks with assets between \$1 billion and \$3 billion.

Indeed, the Board and management intentionally sought higher than normal concentrations of CRE and ADC loans, confident that their experience and knowledge of the Seattle market would lead to maximum returns. From the Board and management's perspective, their record of strong earnings supported the soundness of their longstanding lending strategy, and maintenance of significant capital levels provided a cushion for the associated risks. As discussed later in this report, City Bank maintained capital levels that were significantly above peer and, for many years, City Bank's capital levels were in the top 10 percent of commercial banks nationwide. Further, the bank viewed the fact that many of its ADC loans were to established residential developers in the Seattle area, who were longtime customers, as a risk mitigation factor. Examiners consistently acknowledged that management was experienced and knowledgeable of the Seattle real estate market but also cautioned the bank about its increasing risk profile and the need to strengthen risk management practices.

In December 2006, federal banking regulatory agencies issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) that reinforces existing regulations and guidelines for real estate lending and safety and soundness.³ The guidance was issued because the agencies had observed that CRE concentrations had been rising and could create safety and soundness concerns in the event of a significant downturn. Due to the risks associated with CRE and ADC lending, regulators consider institutions with significant CRE and ADC concentrations to be of greater supervisory concern. The Joint Guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. City Bank's ADC concentrations were well in excess of thresholds warranting supervisory concern.

Further, the Joint Guidance states that rising CRE concentrations can expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Earlier supervisory guidance emphasized that ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that this activity remains profitable.⁴ Supervisory guidance also states that an institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk.

City Bank's business strategy led to high profitability through 2007 in comparison to its peer group. Specifically, based on June 2007 financial data, City Bank's Return on Average Assets (ROA) was 3.81 percent, which was well above the peer group average of 1.17 percent. By 2008, however, the bank's ROA had dropped to .42 percent as a

³ The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).

⁴ Financial Institution Letter (FIL)-110-98, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, dated October 8, 1998.

result of the downturn in the economy. The substantial drop in earnings was associated with an increased loan loss provision and a high volume of nonearning assets. The nonearning assets also adversely affected future earnings and rapidly dissipated capital levels.

FDIC officials stated that the State of Washington real estate market began to experience dramatic deterioration in 2008. According to DFI officials, raw land and development values decreased 30 to 40 percent and, in some cases, as much as 50 to 60 percent. Snohomish County, where City Bank had significant exposure, was one of the hardest hit in terms of devaluation. Accordingly, as discussed in the 2008 examination report, the deterioration in the real estate market coupled with City Bank's significant concentration in ADC loans, resulted in the precipitous rise in delinquent and nonperforming assets and predisposed City Bank's asset quality to further deterioration given the economic climate. Additionally, examiners noted in 2008 that the bank was slow to respond to the changing economic conditions and questioned the bank's decision to originate new ADC loans and make new loan advances to borrowers who had loans that were already internally classified as Substandard in the last two quarters of 2008, despite a rapidly deteriorating real estate market.

The increase in nonperforming loans in City Bank's ADC loan portfolio resulted in substantial increases to adversely classified assets by the fourth quarter of 2008. The majority of City Bank's adversely classified loans were ADC loans that financed speculative residential construction and land development projects. City Bank's Adversely Classified Items Coverage Ratio increased from 8 percent to approximately 343 percent from June 30, 2007 to September 30, 2008. This ratio is a measure of the asset risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and less ability for the bank's capital to absorb any losses associated with those assets. By December 31, 2009, the bank's Adversely Classified Items Coverage ratio had increased to around 976 percent.⁵

In response to the 2008 examination report, the bank stated that despite always maintaining a very high level of capital as a shock absorber for an economic downturn, it was not fully prepared for the severity of the decline in the overall economy and the related real estate values. City Bank outlined the steps it was taking to address the deterioration of the bank, including executing a strategy to, among other things, reduce nonperforming assets and the bank's overall risk profile by reducing the levels of real estate construction lending and brokered deposits.

In 2009, bank management was able to considerably reduce the inventory of homes and lots in its loan and other real estate owned (OREO) portfolio. City Bank's strategy for overall problem asset resolution was to gain control of properties from problem borrowers and engage home builders to construct speculative single family homes on bank-owned lots on a fee basis and then sell the completed homes. Management

⁵ The increase in risk exposure from ADC loans in December 2009 was due primarily to the decline in the bank's capital level.

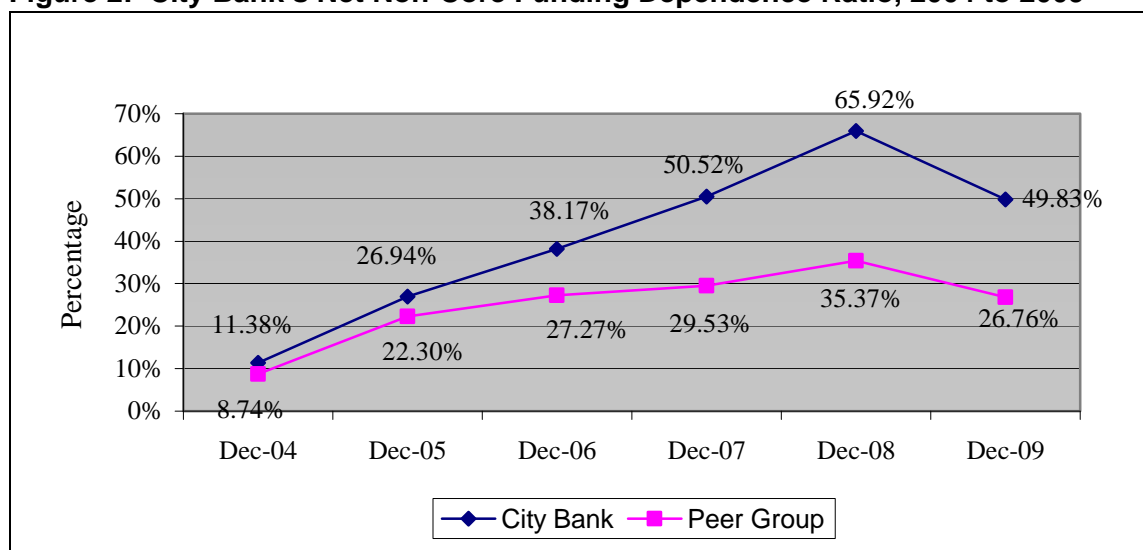
implemented its “Fee Builder Program” to maximize the potential sale of assets thinking that finished homes were more likely to sell than vacant land. However, examiners concluded this strategy was essentially real estate speculation more indicative of a builder than a bank and cited the bank for an apparent violation of Section 24, *Activities of Insured State Banks*, of the FDI Act, which prohibits any state bank from engaging as principal in any activity not permissible for national banks unless: (a) the FDIC determines that the activity poses no significant risk to the insurance fund; and (b) the bank is in compliance with applicable capital standards.

Funding Strategy

To fund its ADC growth strategy, City Bank increased its reliance on non-core funding sources, including jumbo certificates of deposit, FHLB borrowings, and brokered deposits beginning in 2005. Management considered this type of funding to be less expensive. The 2008 examination report stated the bank’s non-core funding levels had increased to imprudent levels. Further, the bank’s excessive reliance on brokered deposits combined with poor asset quality and the absence of off-balance sheet funding sources was threatening the bank’s viability. Although management took action to reduce its reliance on brokered deposits and the bank’s liquidity remained sufficient for its short-term needs, the poor condition of the bank exposed the bank’s ability to retain or replace maturing deposits. As discussed in more detail in the PCA section of the report, the FDIC issued a letter in January 2009 advising the bank not to accept, renew, or roll over any brokered deposits. Then, in June 2009, the bank was officially prohibited from doing so as a result of the Cease and Desist Order (C&D) without a brokered deposit waiver.

The *FDIC Risk Management Manual of Examination Policies* (Examination Manual) states that the non-core funding dependence ratio is a key measure of the degree to which the bank relies on potentially volatile liabilities, such as, but not limited to, certificates of deposit over \$100,000 and brokered deposits to fund long-term earning assets. Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher ratios reflect reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. Figure 2 illustrates City Bank’s net non-core funding dependence ratio compared to its peer group, from 2004 to 2009.

Figure 2: City Bank's Net Non-Core Funding Dependence Ratio, 2004 to 2009



Source: UBPRs for City Bank.

Risk Management Practices

Weak risk management practices were also a factor in the deterioration of City Bank's financial condition. According to the Joint Guidance, history has demonstrated that real estate markets can experience fairly rapid changes and an institution's ability to withstand difficult market conditions depends on the adequacy of its risk management practices and capital levels. In its response to the 2008 examination, management acknowledged that the bank's declining condition was exacerbated by deficiencies cited in its lending risk management practices, which, if more robust, may have been able to provide the bank with an earlier warning of the magnitude of the deterioration in housing. In fact, as the bank's risk profile increased, examiners cautioned the bank about its exposure to adverse economic conditions and identified a number of risk management practices that needed to be strengthened, including the need for the bank to:

- Enhance industry concentration reports to include a more detailed breakout of each loan type.
- Improve monitoring and tracking of market conditions in the bank's lending area to assess whether the bank's CRE and ADC lending strategy continued to be appropriate in light of changes in market conditions.
- Monitor the borrower's capacity to repay on an ongoing basis. In 2008, examiners stated that the loan policy approved by the bank and implemented by management did not provide sufficient guidance to establish clear and measurable criteria of the borrower's overall financial condition and resources.
- Strengthen various credit administration practices such as credit write-ups and loan documentation. City Bank's credit memoranda were brief and failed to adequately address the financial capacity of the borrower or guarantor to carry a construction

project or acquisition loan to term. Further, the documents lacked critical information such as project feasibility, which became increasingly critical when the real estate market deteriorated.

- Improve internal loan grading, including the need to have definitions that comply with regulatory definitions and the need to recognize loan deterioration in a timely manner.
- Implement portfolio stress testing/sensitivity analysis to analyze the potential effect of elevated loss rates on the CRE and ADC portfolios and the effect on the bank's earnings and capital levels.
- Develop a contingency plan to reduce or mitigate concentrations in the event of adverse market conditions.
- Inspect OREO and establish guidelines for periodic inspections.

According to supervisory guidance related to ADC and CRE lending, management's ability to identify, measure, monitor, and control portfolio risk through effective underwriting policies, systems, and internal controls is crucial to a sound ADC lending program. The magnitude of the slump in credit and housing markets was a significant factor in the rapid decline of the bank's asset quality. However, risk control and risk identification practices and underwriting were within the control of the individuals governing the bank and the deficiencies in these processes contributed to the rise in asset classifications.

Violations and Contraventions

City Bank also repeatedly ignored examiners' recommendations to comply with key regulatory requirements designed to ensure that institutions have adequate collateral protection and are not over-exposed to an excessive level of risk. According to the Examination Manual, it is important for a financial institution's Board to ensure that bank management is cognizant of applicable laws and regulations, develops a system to effect and monitor compliance and, when violations do occur, makes corrections as quickly as possible. According to examiners, City Bank did not demonstrate strength in this regard, opting, to its own detriment, to do business its own way. Management's response to the 2007 examination report was reflective of management's attitude to supervisory concerns. The CEO stated that the bank strove to be in compliance with regulations but that a significant part of the issue was the lack of clarity in the regulations. Further, management stood by the bank's history and its underwriting policy and procedures, which had not caused the bank to experience any significant losses or loan defaults.

The 2008 examination report stated the repetitive nature of the apparent violations and contraventions was illustrative of management and the Board's unwillingness to comply with governing regulations and their cavalier attitude toward regulatory compliance. Further, examiners reminded the bank that civil monetary penalties could be assessed for the violation of any law or regulation. According to the 2008 examination report,

apparent contraventions of Part 365 *Real Estate Lending Standards*, Appendix A, *Interagency Guidelines for Real Estate Lending Policies*, had been cited in the last five examination reports and was again a concern in the 2008 examination. These guidelines are intended to assist institutions in the formulation and maintenance of real estate lending policy that is appropriate to the size of the institution and the nature and scope of its individual operations. One aspect of the guidelines establishes supervisory loan-to-value (LTV) limits for loans secured by real estate. The bank's policy was to advance up to 80 percent of the appraised retail value for speculative 1-4 family construction projects as opposed to using the regulatory threshold of 85 percent of discounted value, which resulted in substantially more exposure to losses when the market declined. In addition, the aggregate amount of all loans originated in excess of supervisory LTV limits should not exceed 100 percent of Total Capital. Examiners found that City Bank exceeded this limit in 2006, 2007, 2008, and 2010.

With regard to apparent violations of Part 323 of the FDIC Rules and Regulations, *Appraisals*, and contravention of *Interagency Appraisal and Evaluation Guidelines*, the bank did not, in some cases, obtain updated appraisals before making a loan or transferring the asset to other real estate. In other cases, the methodology used for the appraisal was inconsistent with requirements. Further, the bank had not implemented an effective appraisal review program. The 2008 report stated that appraisal-related violations and contraventions had been cited in three of the last five examinations and were again identified during the examination. According to examiners, the bank's excessive levels of LTV exceptions and failure to comply with appraisal requirements exposed the bank to higher losses during the economic downturn.

In 2008, the collective deficiencies found by examiners led them to conclude that City Bank was in contravention of Part 364, *Standards of Safety and Soundness*, of the FDIC's Rules and Regulations, Appendix A, *Interagency Guidelines Establishing Standards for Safety and Soundness*. These guidelines establish, among other things, operational and managerial standards, including standards related to credit underwriting, asset growth, and asset quality. Examiners also found that management had not implemented appropriate safeguards regarding the bank's compensation structure. In the 2010 examination, examiners also cited City Bank for an apparent violation of Part 359, *Golden Parachute and Indemnification Payments*, even though the bank had been reminded of the applicable requirements in December 2008.

Lastly, in 2007, 2008, and 2009, examiners cited City Bank for being in apparent contravention of the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL Policy Statement), which reiterates key concepts and requirements related to generally accepted accounting principles and existing supervisory guidance for maintaining and supporting an appropriate level for ALLL.⁶ The following summarizes examiners' concerns:

⁶ Statement of Financial Accounting Standards (FAS) No. 5, *Accounting for Contingencies*, and FAS No. 114, *Accounting by Creditors for Impairment of a Loan*, as then in effect, provide accounting guidance for loss contingencies on a pool basis and impairment of loans on an individual basis, respectively.

- In 2007, examiners had concerns with the bank's loan review system, but the level of ALLL was considered appropriate given the risk profile of the loan portfolio.
- In 2008, examiners found that City Bank's ALLL process was not supported by an appropriate ALLL policy and the ALLL was inadequate for the high-risk profile of the loan portfolio. Further, the documented ALLL analysis was overly dependent upon the institution's historical loss experience without clear consideration of the changes in national, regional, and local economic conditions and developments; loan volume trends; delinquencies; restructurings; or concentrations. Examiners again had concerns with the effectiveness of the loan grading system.
- In 2009, examiners found that there were weaknesses in management's process for determining the impairment portion of the ALLL and specifically noted that appraisal quality and internal control procedures needed improvement. During a 2009 visitation, examiners concluded that City Bank's loan loss reserve was underfunded due to these weaknesses and additional provisions of \$8 million were recommended. Examiners determined that \$19.5 million in additional provisions were needed at the February 2010 examination.

The FDIC's Supervision of City Bank

Our review focused on FDIC and DFI supervisory oversight of City Bank between 2006 and 2010. The FDIC and DFI conducted timely and regular examinations of City Bank, as required. City Bank was also subjected to periodic offsite monitoring. Prior to 2008, the FDIC and DFI consistently concluded that the bank's ADC risk exposure was mitigated by strong Board and management oversight, strong earnings, and significant capital. Further, although examiners identified various risk management practices that needed to be strengthened, examiners did not consider identified weaknesses to be significant in light of the bank's sound financial condition and capital levels. Accordingly, neither the FDIC nor DFI considered City Bank to be a cause for supervisory concern even when the economy began to weaken in 2007.

However, the level of supervisory concern changed dramatically in 2008 when the bank's ADC concentrations, combined with deficient risk management practices and a downturn in the real estate market, resulted in a dramatic rise in delinquent and nonperforming assets and significant deterioration in the bank's overall condition. Based on the 2008 examination findings, the FDIC and the DFI acted aggressively to downgrade the bank's composite and component ratings, issue a formal supervisory enforcement action, and closely monitor City Bank's condition. However, despite the increased supervisory attention following that examination and City Bank's efforts to address deficiencies, the condition of the bank continued to decline and became critically deficient.

A lesson learned with respect to ADC concentrations is that early supervisory intervention is prudent, even when an institution has significant capital and few classified assets. In hindsight, a more forward-looking assessment of City Bank's risk profile

would likely have resulted in earlier downgrades and possibly led to the issuance of an informal enforcement action in 2007. Such an approach would have reinforced supervisory expectations, increased supervisory oversight, and required the Board to commit to a plan and a timeline for implementing corrective actions before the deterioration of economic conditions made corrective action more difficult to achieve.

The FDIC has taken a number of actions to increase supervisory attention to banks that have risk profiles similar to City Bank, including instituting a training initiative on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations, appraisals, and funds management.

Supervisory History

Between 2006 and 2010 the FDIC and DFI conducted four onsite safety and soundness examinations, as required by the FDI Act.⁷ In addition, in 2008, the FDIC and DFI conducted a joint visitation based on offsite analysis of City Bank’s financial data. Table 2 summarizes City Bank’s examination history from 2006 to 2010, including the supervisory ratings and enforcement actions taken.

Table 2: Examination History of City Bank, 2006 to 2010

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Enforcement Action
08/21/2006	06/30/2006	State	111121/1	None
10/09/2007	06/30/2007	Joint	122121/2	None
12/29/2008	09/30/2008	Joint	454453/5*	C&D – Effective June 29, 2009
07/15/2009 Visitation	06/30/2009	Joint	None	2009 C&D still in effect
02/28/2010	12/31/2009	Joint	555545/5	2009 C&D still in effect

Source: Examination reports and enforcement actions for City Bank.

*As discussed below, City Bank was downgraded to a composite “3” rating prior to the start of this examination based on offsite analysis.

City Bank was not flagged for review by the FDIC’s offsite monitoring system prior to 2007.⁸ As such, the FDIC’s offsite monitoring procedures generally consisted of contacting the institution’s management as part of examination pre-planning efforts. However, following the October 2007 examination, City Bank was subject to quarterly offsite reviews because financial models used as part of the FDIC’s offsite monitoring system indicated that City Bank was likely to be downgraded at the next examination.

⁷ Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, onsite examinations of every state nonmember bank at least once during each 12-month period and allows for 18-month intervals for certain small institutions (total assets of less than \$500 million) if certain conditions are satisfied.

⁸ The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Offsite reviews are performed for each bank that appears on the system-generated Offsite Review List.

As part of its quarterly offsite reviews, FDIC officials contacted bank officials to evaluate the level of risk and risk trends. Although the reviews noted City Bank's progressive deterioration, the bank's capital position was still probably one of the highest in the country during this period. Nonetheless, before the start of the 2008 examination, the FDIC processed an interim downgrade, assigning the bank a composite "3" rating based on the results of its offsite review to reflect the bank's current condition and substantial exposure to ADC lending. Financial institutions assigned a "3" exhibit some degree of supervisory concern, are generally less capable of withstanding business fluctuations, and are more vulnerable to outside influences. The offsite review also resulted in examiners formally designating City Bank as a "troubled" institution subject to closer regulatory supervision.

In July 2009, City Bank was flagged as an institution with a potentially underfunded ALLL, which prompted the July 2009 visitation. During the visitation, examiners found that the level of problem assets remained extremely high, and as previously discussed in this report, the ALLL was inadequate, liquidity risk was excessive, and capital was deteriorating and inadequate to support the bank's risk profile. Examiners recommended that the Board and management continue ongoing efforts to improve City Bank's condition, controls, and risk profile and noted that outside capital was urgently needed.

Supervisory Response to Key Risks

City Bank received "1" and "2" composite ratings in 2006 and 2007, respectively, indicating that the bank gave no cause for supervisory concern, and weaknesses identified were considered moderate and well within the Board and management's capabilities and willingness to correct. Further, although examiners cited City Bank for repeat apparent contraventions of FDIC LTV and appraisal policy statements and violations of appraisal regulations, the bank's lack of adherence was not judged to warrant heightened supervision at that time. Supervisory attention increased dramatically in 2008 when the severity of the economic downturn became apparent and the financial condition of the bank significantly deteriorated.

2006 and 2007 Examinations

The 2006 and 2007 examination reports highlighted the risks associated with the bank's ADC lending and its increasing reliance on non-core funding sources. These examination reports also made recommendations to strengthen key risk management practices. In 2007, examiners downgraded City Bank's composite rating from a "1" to "2" to reflect the bank's increasing risk exposure and the bank's need to improve compliance with regulations and policy statements specific to real estate lending.

Examiners considered City Bank's risk profile to be buffered by the experience of the management team, the bank's financial performance, and the bank's high capital levels. According to the 2007 examination report, the financial performance of the bank had been among the top 10 percent of the industry on a consistent basis, and capital levels were maintained at levels sufficient to mitigate management's risk tolerance. Further,

management readily acknowledged that the concentrations warranted a high capital base. Table 3 shows that City Bank’s capital ratios exceeded its peer group until 2009.

Table 3: City Bank’s Total Risk-Based Capital Ratio to Peer Group, 2005 to 2009

Period Ending	Tier 1 Leverage Capital		Tier 1 Risk-Based Capital		Total Risk-Based Capital	
	Bank	Peer	Bank	Peer	Bank	Peer
December 2005	21.90	8.88	21.69	11.78	22.95	12.95
December 2006	18.55	8.69	18.58	10.75	19.58	11.97
December 2007	17.44	8.73	17.62	10.68	18.57	11.83
December 2008	10.72	8.41	11.61	10.41	12.88	11.70
December 2009	1.80	8.33	2.32	11.18	3.57	12.53

Source: UBPRs for City Bank.

With regard to the bank’s apparent contravention of Appendix A to Part 365, *Real Estate Lending Standards*, the 2006 examination report noted that bank management had made some changes in response to issues raised at prior examinations concerning the tracking and reporting of supervisory LTV exceptions but remained in apparent contravention. The 2007 examination report stated that compliance with regulations related to lending needed improvement and was the basis for downgrading the Management and Asset Quality component ratings and overall composite rating. As discussed later in the *Supervisory Lessons Learned* section of this report, earlier downgrades may have been prudent given the overall risk profile of the bank, irrespective of the bank’s financial condition and capital levels.

2008 Examination

The December 2008 examination first identified the extent of rapid deterioration in City Bank’s overall condition. Examiners stated that the bank’s excessive risk appetite, coupled with deficient risk management practices, led to the poor asset quality that threatened the viability of the bank. Adversely classified assets totaled 63 percent of total assets. Examiners deemed management and Board oversight to be lax, noting that management had failed to respond to early signs of market deterioration. Further, as previously discussed in this report, examiners concluded that the number of apparent violations and contraventions identified at this examination reflected poorly on management and the board. Examiners also stated that while the bank’s business model had demonstrated past profitability, the downturn in the real estate market had exposed weaknesses in that model.

The bank’s deficient risk management practices, reliance on unsustainable funding sources, and the gradual erosion of capital support were collectively found to create an untenable risk profile. Accordingly, examiners downgraded the bank’s composite rating to a “5”. As a result of the concerns identified in the December 2008 examination, a

C&D was issued on June 29, 2009. The C&D required the bank to, among other things:

- Retain qualified management, including a chief executive officer and senior lending officer;
- Obtain an independent management study;
- Increase Board participation;
- Develop a capital plan, including projections for asset growth;
- Increase and maintain capital at minimum levels described in the Order;
- Maintain an adequate ALLL;
- Charge off all assets classified as Loss;
- Make no further advances to adversely classified relationships without prior regulatory approval;
- Revise and adopt adequate loan policies, including standards for concentrations and a plan to reduce ADC concentrations;
- Correct all violations and contraventions of interagency policy statements; and
- Reduce non-core funding sources, including brokered deposits.

2010 Examination

The February 2010 examination found that the overall condition of the bank had continued to deteriorate and the bank's viability was jeopardized. Asset quality was found to be critically deficient due to an excessive level of nonperforming assets centered in ADC. As discussed earlier in this report, the ALLL was underfunded by \$19.5 million due to losses and additional risk identified during the examination, which as discussed in the PCA section of this report, resulted in the bank becoming classified as *Critically Undercapitalized*. Board oversight was considered to be lax although management had reduced the level of problem assets considerably since the prior examination. Examiners found the management team lacked sufficient depth and a viable strategy to restore the bank to satisfactory condition and that the bank still needed to among other things: comply with all provisions of the C&D, increase capital to a satisfactory level, reduce the level of adversely classified assets, restore the bank to profitability, and correct apparent violations of law and contraventions of regulatory guidance and ensure future compliance.

Further, the Chairman/CEO was found to be a dominant figure in the operations of the bank, and decision-making at all levels of the organization was tightly held by the Chairman/CEO. A management study done in response to a provision of the C&D

recommended that the Chairman/CEO's role be reduced to improve reporting to the Board. In November 2009, the bank proposed and was granted permission by the FDIC to appoint a new President/CEO to reduce the role of the current Chairman/CEO who had been with the bank for 34 years. The Chairman/CEO indicated that he would resign from the bank but intended to remain as Chairman for a transitional period. Despite management's efforts to raise capital, comply with the C&D, and implement the recommendations made by examiners, the condition of the bank continued to deteriorate and City Bank was closed by DFI on April 16, 2010.

Supervisory Lessons Learned

According to the Examination Manual, the quality of an institution's management, including its Board and executive officers, is perhaps the single most important element in the successful operation of a bank. The Board has overall responsibility and authority for formulating sound policies and objectives for the bank and for effectively supervising the institution's affairs. The Examination Manual further states that

...to effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking...when corrective action is not taken until conditions have deteriorated it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

In hindsight, greater emphasis on management practices and more aggressive supervisory action, including earlier downgrades of the Management, Asset Quality, and Liquidity component ratings and the composite rating, and/or pursuing an informal supervisory enforcement action⁹ sooner may have been prudent taking into consideration City Bank's risk exposure in 2007, as evidenced by:

- increasing ADC concentrations,
- a funding strategy increasingly reliant on non-core funding sources,
- deficient risk management practices, and
- disregard of key regulations and policies.

A more proactive supervisory approach in 2007 would have reinforced supervisory expectations, increased supervisory oversight, and required the Board to commit to a plan and a timeline for implementing corrective actions at a critical time. In light of City Bank's financial performance and condition at that time, we recognize that the FDIC

⁹ Options for informal supervisory actions include a Bank Board Resolution or Memorandum of Understanding.

would have faced considerable challenges convincing the Board and management that their strategy and practices were creating unwarranted risk that needed to be constrained and mitigated.

The FDIC has taken a number of actions to increase supervisory attention to banks that have risk profiles similar to City Bank. Of note, in March 2010, the FDIC completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The FDIC has also issued updated guidance to examiners regarding (1) CRE loan examination procedures in view of more challenging market conditions, particularly in ADC lending, and (2) supervisory expectations for FDIC-supervised institutions to update real estate appraisals and evaluations. In March 2010, the banking agencies also issued guidance, *Policy Statement on Funding and Liquidity Risk Management*, which reiterates the importance of effective risk management.

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

Based on supervisory actions taken with respect to City Bank, the FDIC properly implemented applicable PCA provisions of section 38. Table 4 illustrates City Bank's capital levels relative to the PCA thresholds for *Well Capitalized* Institutions.

Table 4: City Bank’s Capital Levels Relative to PCA Thresholds for *Well Capitalized* Institutions

Period Ending	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based	Capital Classification
<i>Well Capitalized Threshold</i>	5% or more	6% or more	10% or more	
June 2006	20.97	20.54	21.65	<i>Well Capitalized</i>
June 2007	18.57	19.08	20.01	<i>Well Capitalized</i>
September 2008	12.18	12.41	13.73	<i>Well Capitalized</i>
September 2009	6.19	7.64	8.95	<i>Adequately Capitalized*</i>
December 2009	3.04	4.13	5.38	<i>Significantly Undercapitalized</i>
February 2010	1.36	1.86	3.12	<i>Critically Undercapitalized</i>

Source: UBPRs and examination reports for City Bank and Part 325 of the FDIC Rules and Regulations.

*Once City Bank became subject to a C&D that addressed the capital level in 2009, by definition, the bank became *Adequately Capitalized*.

Although City Bank was considered *Well Capitalized* under PCA standards based on its capital levels at the 2008 examination, the examination report advised management that the bank’s capital levels were deficient taking into consideration the bank’s weakened financial condition and high-risk profile. Examiners also reminded management that under FDIC policy, capital adequacy for safety and soundness purposes may differ significantly from PCA capital levels. Further, regardless of its numerical capital levels, examiners noted that City Bank would no longer be *Well Capitalized* under Part 325, by definition, once the bank was subject to a formal enforcement action. The FDIC also sent a letter to City Bank in January 2009 reiterating that, given the bank’s pronounced deterioration, a formal corrective program was likely, which might include the requirements and restrictions associated with brokered deposits and interest rates paid on deposits pursuant to Section 337.6 of FDIC Rules and Regulations. Accordingly, the letter advised the bank that, effectively immediately, City Bank should not accept, renew, or roll over any brokered deposits, and any such activities would be viewed unfavorably by the FDIC.

As discussed earlier, the FDIC issued a C&D effective June 29, 2009, that included a capital provision requiring City Bank to within 90 days of the effective date of the order: (1) maintain Tier 1 Capital in such an amount as to equal or exceed 12 percent of the bank’s total assets and (2) develop and adopt a plan to meet and thereafter maintain the minimum risk-based capital requirements. With regard to the capital plan required by the C&D, management met with the FDIC in August 2009 to discuss its plan to raise capital, and in October 2009, the bank submitted its capital plan to the FDIC and DFI. The FDIC advised management that its capital plan did not address regulatory concerns and in the 2010 examination report noted that prospects for raising sufficient capital within an acceptable timeframe appeared unlikely given the bank’s troubled condition.

On February 17, 2010, the FDIC notified City Bank that it was *Significantly Undercapitalized* based on its December 31, 2009 Call Report and it was required to submit a capital restoration plan by April 2, 2010. The PCA notification letter outlined the mandatory and discretionary actions permitted by the FDIC pursuant to Part 325.

Prior to the submission of the capital restoration plan, given the bank's critically low capital levels due to the further deterioration in the bank's financial condition and the anticipation of an unacceptable capital restoration plan, the FDIC decided to issue a PCA Directive on March 10, 2010. The directive required the bank to raise capital or accept an offer to sell the bank within 30 days; refrain from accepting or renewing brokered deposits; restrict interest rates to comply with Section 337.6; restrict growth; refrain from making capital distributions or dividend payments; refrain from increasing compensation; and refrain from branching. Finally, on April 14, 2010, the FDIC notified City Bank that its capital category was *Critically Undercapitalized* based on the February 2010 examination.

The bank had elected not to apply for funds under the Troubled Asset Relief Program. Ultimately, the bank was unsuccessful in its efforts to raise capital and was closed by DFI on April 16, 2010.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On November 12, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of City Bank's failure. With regard to our assessment of the FDIC's supervision of City Bank, DSC's response discussed the number of examinations conducted between 2006 and 2010 described in our report. Further, DSC's response reiterated that City Bank's loan portfolio had deteriorated to a level that raised significant supervisory concern at the December 2008 joint examination, resulting in a composite "5" rating and the issuance of a C&D in June 2009. In the February 2010 examination, the FDIC and DFI determined that City Bank was no longer viable without an immediate capital infusion, which failed to materialize. DSC also indicated that it recognizes that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations, such as City Bank, and referenced guidance that the division has issued to remind examiners to take appropriate action when risks associated with those concentrations are imprudently management. DSC also stated that supervisory guidance has been issued to financial institutions to re-emphasize the importance of robust credit risk-management practices for institutions with concentrated CRE exposures.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. 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 this performance audit from June 2010 to October 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 City Bank's operations from 2006 until its failure on April 16, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination reports prepared by the FDIC and the DFI examiners from 2006 to 2010.
- Reviewed the following:
 - Bank data and correspondence maintained at DSC's San Francisco Regional Office and Seattle Field Office.
 - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.
 - Pertinent DSC policies and procedures and various banking laws and regulations.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:
 - DSC management in Washington, D.C., and the San Francisco Regional Office and Seattle Field Office.
 - DRR officials at the Irvine Field Office.
 - FDIC examiners from the DSC San Francisco Regional Office and Seattle Field Office, who participated in examinations or reviews of examinations of City Bank.
- Interviewed officials from the DFI to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

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, examination reports, and interviews of examiners to understand City Bank's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that 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 provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC's Rules and Regulations. The results of our tests were discussed, where appropriate, in the report. Additionally, we

Objectives, Scope, and Methodology

assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

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

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action 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 that provide interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
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.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
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.

Glossary of Terms

Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's 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.
Federal Home Loan Bank (FHLB)	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.
Financial Holding Company	A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The Federal Reserve Board is responsible for supervising the financial condition and activities of financial holding companies.
Loan-to-Value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of \$200 million.

Glossary of Terms

Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.
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.
Peer Group	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.
Problem Bank Memorandum	A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented and is also used to effect interim rating changes on the FDIC's systems.
Prompt Corrective Action (PCA)	<p>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, <i>Prompt Corrective Action</i>, 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.</p> <p>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.</p>
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).

Glossary of Terms

Substandard	One of three types of classifications used by examiners to describe adversely classified assets. The term is generally used to describe an asset that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as The sum of: <ul style="list-style-type: none"> • Common stockholder’s equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; Minus: <ul style="list-style-type: none"> • 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).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
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	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity and <u>S</u> ensitivity to Market Risk
CEO	Chief Executive Officer
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DFI	Washington State Department of Financial Institutions
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
LTV	Loan-to-Value
OIG	Office of Inspector General
OREO	Other Real Estate Owned

Acronyms

PCA	Prompt Corrective Action
TARP	Troubled Asset Relief Program
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

November 10, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: /Signed/
Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of City Bank, Lynnwood, Washington (Assignment No. 2010-059)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of City Bank, Lynnwood, Washington (City Bank), which failed on April 16, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on October 18, 2010.

City Bank failed primarily because of the Board's and management's decision to concentrate the loan portfolio in acquisition, development and construction (ADC) loans, and its failure to implement prudent risk management practices necessary to monitor and manage its loan portfolio. City Bank continued to originate ADC loans during 2008 and 2009 while its real estate markets were weakening which led to significant loan-related losses, poor earnings, and erosion of capital.

From 2006 through April 2010, the FDIC and the Washington State Department of Financial Institutions (DFI) jointly and separately conducted four full-scope examinations and one visitation. At the December 2008 joint examination, City Bank's loan portfolio had deteriorated to a level that raised significant regulatory concern. City Bank's deficient management practices and its reliance on unsustainable non-core funding sources posed considerable risk, resulting in a composite "5" rating and a Cease and Desist order in June 2009. Based on the results of the February 2010 examination, the FDIC and DFI determined that City Bank was no longer viable without an immediate capital infusion which failed to materialize.

We recognize that strong supervisory attention is necessary for institutions with high commercial real estate and ADC concentrations, such as City Bank, and we have issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed. DSC issued a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures.

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