

Office of Inspector General



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

**In-Depth Review of the Failure of
Centennial Bank, Ogden, Utah**

November 2010



Why We Did The Audit

The Utah Department of Financial Institutions (UDFI) closed Centennial Bank (Centennial), Ogden, Utah, on March 5, 2010, and named the FDIC as receiver. The FDIC notified the Office of Inspector General (OIG) on April 1, 2010, that Centennial's total assets at closing were \$226 million and that the estimated loss to the Deposit Insurance Fund (DIF) was \$88.5 million. As of August 20, 2010, the estimated loss to the DIF had decreased to \$52.7 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), which amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the threshold for a material loss review (MLR) from \$25 million to \$200 million for losses that occur for the period January 1, 2010, through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that might warrant an in-depth review (IDR) of the loss. At the time the Financial Reform Act was enacted, our fieldwork and a draft of this report were substantially complete. As a result, we decided to complete the audit as an in-depth review and issue this report.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Centennial's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Centennial, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

Centennial was established on April 2, 1997, as a state-chartered nonmember bank. The bank operated a full-service community bank headquartered in Ogden, Utah, and maintained five offices in four counties near the Salt Lake City metropolitan area. The institution's lending activities focused primarily on acquisition, development, and construction (ADC), with an emphasis on single-family residential construction.

Centennial was wholly-owned by Centennial Bankshares, Inc., a privately-held, one-bank holding company. The Board controlled over 40 percent of the holding company's stock, with the largest stockholder, a director, holding 16 percent of the outstanding stock. Centennial had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act.

Audit Results

Causes of Failure and Loss

Centennial failed because its Board and management did not effectively manage the risks associated with the institution's significant concentration in ADC loans. The institution's ADC loan portfolio consisted primarily of single-family residential real estate, much of which was concentrated in pre-sold construction loans, large residential loans over \$500,000, and stated income loans. Limited loan underwriting on a substantial portion of Centennial's loan portfolio and deficient credit administration and related monitoring practices also contributed to Centennial's failure. Some of these practices and their apparent

significant impact on the failure of Centennial are the subject of ongoing investigative activities. Although not a primary cause of failure, Centennial relied heavily on brokered deposits to fund its ADC lending activities and maintain adequate liquidity. When the institution's financial condition deteriorated, access to this funding source was restricted, placing a strain on the bank's liquidity.

Weaknesses in Centennial's lending markets began to negatively affect the quality of the institution's loan portfolio in late 2007. By the close of 2008, the quality of the loan portfolio had become critically deficient, primarily due to the poor performance of ADC loans. The deterioration in the loan portfolio continued into 2009, and by early 2010, the associated losses and provisions had depleted Centennial's capital, rendering the institution insolvent. Despite considerable efforts undertaken by bank management and the Board to attract capital from external sources that commenced in late 2008 and continued into 2009, the bank was unable to raise sufficient capital to support its operations. Consequently, the UDFI closed Centennial on March 5, 2010.

The FDIC's Supervision of Centennial Bank

The FDIC, in coordination with the UDFI, provided ongoing supervisory oversight of Centennial through regular onsite risk management examinations and visitations. Further, the FDIC conducted offsite reviews of Centennial. The FDIC and the UDFI consistently advised management of the need to adequately monitor the high-risk lending profile of the institution. Examiners identified problems such as (1) increasing growth and concentrations, (2) the institution's failure to set limitations on certain loan segments, and (3) the bank's reliance on brokered deposits and made recommendations to strengthen the institution's controls and practices in the areas of concentrations and limitations on loan segments. In hindsight, and consistent with recently issued guidance on special funding sources, the level of Centennial's brokered deposits identified during the October 2007 examination may have warranted greater supervisory concern in light of the declining real estate market and the potential that access to those funds could become restricted.

The FDIC and the UDFI downgraded certain supervisory component ratings and the institution's composite rating during three consecutive examinations from 2007 to 2009. The FDIC and the UDFI also imposed enforcement actions in January 2008 and June 2009 to address problems identified at the October 2007 and October 2008 examinations as the institution's financial condition weakened.

With respect to PCA, based on the supervisory actions taken, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

Management Response

On November 19, 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 Centennial's failure, including its heavy reliance on non-core funding sources. With regard to our assessment of the FDIC's supervision of Centennial, DSC's response discussed the number of examinations conducted between 2006 and 2010 described in our report. DSC also indicated that it recognizes that strong supervisory attention is necessary for institutions with high ADC and non-core funding concentrations, such as Centennial, and referenced guidance that the division has issued to remind examiners to take appropriate action when risks associated with those concentrations are

imprudently managed. 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 ADC and liquidity exposures.

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Federal Deposit Insurance Corporation

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Office of Material Loss Reviews
Office of Inspector General

DATE: November 23, 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: *In-Depth Review of the Failure of Centennial Bank,
Ogden, Utah (Report No. IDR-11-003)*

The Utah Department of Financial Institutions (UDFI) closed Centennial Bank (Centennial) on March 5, 2010, and named the FDIC as receiver. The FDIC notified the Office of Inspector General (OIG) on April 1, 2010, that Centennial's total assets at closing were \$226 million and that the estimated loss to the Deposit Insurance Fund (DIF) was \$88.5 million. As of August 20, 2010, the estimated loss to the DIF had decreased to \$52.7 million.

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Consistent with the Financial Reform Act and the FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Centennial's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Centennial, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. This report presents our analysis of Centennial'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 and in-depth reviews, we will communicate those to FDIC management for its consideration. As resources allow, we

may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.¹

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of 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

Centennial was established on April 2, 1997, as a state-chartered nonmember bank. The bank operated a full-service community bank headquartered in Ogden, Utah, and maintained five offices in four counties near the Salt Lake City metropolitan area. The institution's lending activities focused primarily on acquisition, development, and construction (ADC), with an emphasis on single-family residential construction.

Centennial was wholly-owned by Centennial Bankshares, Inc., a privately-held, one-bank holding company. The Board controlled over 40 percent of the holding company's stock, with the largest stockholder, a director, holding 16 percent of the outstanding stock. Centennial had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act. Table 1 summarizes selected financial information for Centennial for the calendar year ended 2009 and for the 6 preceding calendar years-end.

Table 1: Selected Financial Information for Centennial, 2003-2009

Financial Measure (\$000s)	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09
Total Assets	88,845	118,807	165,887	196,954	234,066	215,322	212,839
Total Deposits	80,367	107,351	147,830	176,301	210,738	193,307	205,076
Brokered Deposits	5,465	48,041	69,293	87,298	116,773	110,937	57,727
Total Loans	74,689	105,674	132,067	169,992	194,235	166,203	133,162
Net Income (Loss)	892	10,292	2,760	4,368	3,640	(3,743)	(14,346)

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

Causes of Failure and Loss

Centennial failed because its Board and management did not effectively manage the risks associated with the institution's significant concentration in ADC loans. The institution's ADC loan portfolio consisted primarily of single-family residential real estate, much of

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

which was concentrated in pre-sold construction loans,² large residential loans over \$500,000, and stated income loans.³ Limited loan underwriting on a substantial portion of Centennial's loan portfolio and deficient credit administration and related monitoring practices also contributed to Centennial's failure. Some of these practices and their apparent significant impact on the failure of Centennial are the subject of ongoing investigative activities. Although not a primary cause of failure, Centennial relied heavily on brokered deposits to fund its ADC lending activities and maintain adequate liquidity. When the institution's financial condition deteriorated, access to this funding source was restricted, placing a strain on the bank's liquidity.

Weaknesses in Centennial's lending markets began to negatively affect the quality of the institution's loan portfolio in late 2007. By the close of 2008, the quality of the loan portfolio had become critically deficient, primarily due to the poor performance of ADC loans. The deterioration in the loan portfolio continued into 2009, and by early 2010, the associated losses and provisions had depleted Centennial's capital, rendering the institution insolvent. Despite considerable efforts undertaken by bank management and the Board to attract capital from external sources that commenced in late 2008 and continued into 2009, the bank was unable to raise sufficient capital to support its operations. Consequently, the UDFI closed Centennial on March 5, 2010.

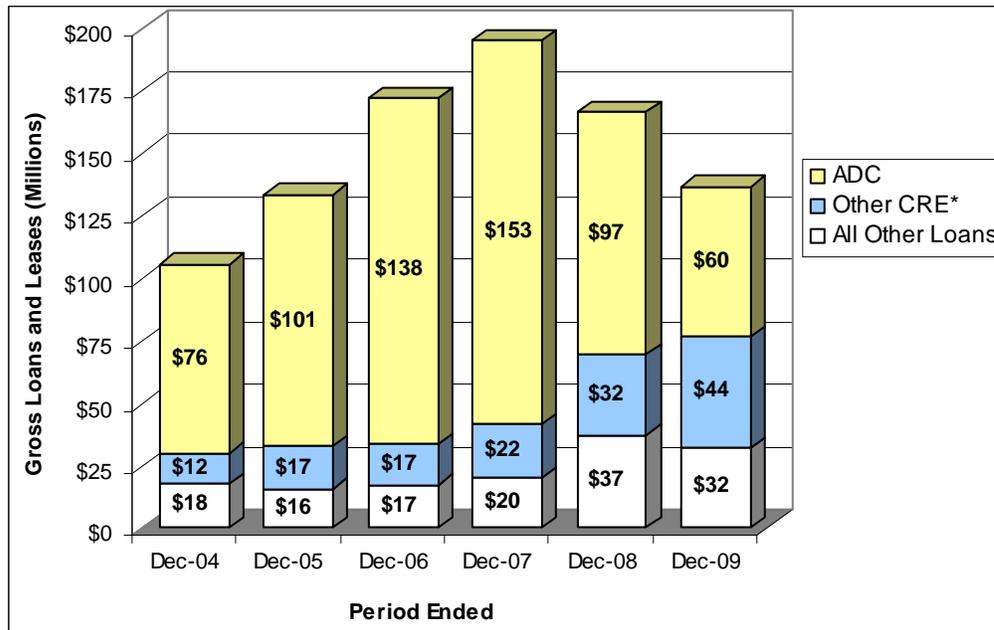
Concentrations in ADC Loans

In the years leading to its failure, Centennial developed a significant concentration in high-risk ADC loans. Between year-end 2004 and year-end 2007, Centennial doubled its ADC loans from \$76 million to \$153 million. Much of this loan growth was fueled by brokered deposits, which increased from \$48 million at year-end 2004 to \$117 million at year-end 2007. Figure 1 illustrates the general composition and growth of Centennial's loan portfolio during the 5-year period ended December 31, 2009.

² Residential construction loans are made on either a speculative basis, where homes are built to be sold later in the general market, or on a pre-sold basis for specific buyers. Pre-sold construction loans include take-out commitments that provide written promises by lenders to provide long-term financing (permanent financing) arrangements to replace interim, short-term loans, usually when projects reach specified milestones or stages such as the completion of a house. Many of Centennial's pre-sold construction loans were also large residential loans and stated income loans.

³ A stated income loan is a specialized mortgage loan where the mortgage lender verifies employment and assets, but not income. Instead, an income amount is simply stated on the loan application.

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



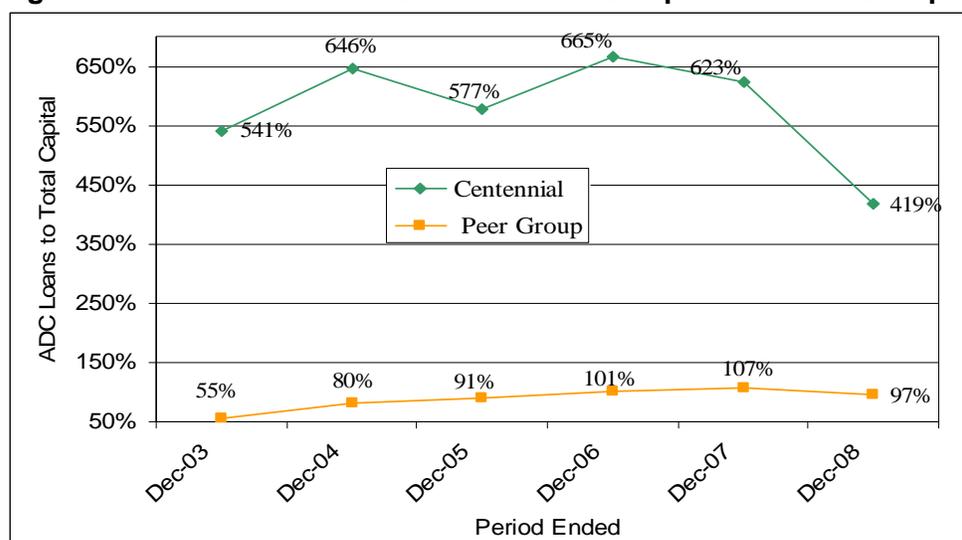
*Commercial Real Estate (CRE)

Source: Reports of Condition and Income (Call Reports) for Centennial.

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued guidance entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The Joint Guidance states that total loans for ADC representing 100 percent or more of total capital could expose institutions to significant risk, including unanticipated earnings and capital volatility in the event of adverse changes in the real estate market. Accordingly, such institutions may be subject to further supervisory analysis of the level and nature of their CRE concentration risk.

As shown in Figure 2, Centennial's ADC loan concentration ranged from 541 percent to 623 percent of the bank's total capital during the period from December 2003 through December 2007 and peaked at 665 percent of total capital in December 2006. These figures substantially exceeded Centennial's peer group averages and, subsequent to December 2006, the levels defined in the Joint Guidance as possibly warranting further supervisory analysis.

Figure 2: Centennial's ADC Concentration Compared to Peer Group



Source: UBPRs for Centennial.

Centennial's ADC concentration included the following subconcentrations.⁴

- **Pre-sold Construction Loans.** At the time of the March 2006 examination, pre-sold construction loans totaled \$111.4 million or 638 percent of total capital. By the October 2007 examination, pre-sold construction loans had decreased to \$83 million, or 358 percent of total capital.
- **Large Residential Loans.** At the time of the October 2007 examination, Centennial had loan commitments for homes valued at \$500,000 or more totaling \$68.6 million, or 295 percent of total capital. Of the \$28 million in adversely classified loans identified during the October 2008 examination, approximately \$20.5 million, or 73 percent, pertained to large residential loans.
- **Stated Income Loans.** At the time of the October 2007 examination, stated income loans totaled \$84.2 million, or 363 percent of total capital, and represented 58 percent of the bank's residential real estate portfolio. Of the \$11 million in adversely classified loans reported during the October 2007 examination, approximately \$6.8 million, or 62 percent, were stated income loans.

In addition, examiners reported in 2006 and 2007 that some of the institution's pre-sold construction loans were actually speculative loans. Mortgage brokers presented construction loans to Centennial that implied that the borrowers would occupy the properties as their primary residences. However, examiners reported that the borrowers had no intention of taking out long-term financing on the residential properties and occupying the dwellings as originally represented to the bank. Our review of the institution's records indicated that these loans totaled approximately \$12.3 million as of

⁴ As indicated on page 3, the pre-sold, large residential, and stated income loans were not mutually exclusive. Certain loans had characteristics of two or all three categories.

August 2007 and approximately \$18.5 million by the end of August 2008. Some of these practices and their apparent significant impact on the failure of Centennial are the subject of ongoing investigative activities.

Adversely classified assets increased from \$2.4 million during the March 2006 examination to \$15.7 million during the October 2007 examination. The majority of these classifications pertained to ADC loans. Although management took steps following that examination to reduce its ADC loan exposure, adversely classified assets rose to \$44 million during the October 2008 examination. Approximately \$22 million of this amount (or 50 percent of adversely classified loans) were stated income, brokered, and/or large residential loans. By the November 2009 examination, adversely classified assets had risen to \$82.6 million, or 604 percent of Tier 1 Capital and Reserves. At the same time that Centennial's asset quality was declining, its Other Real Estate (ORE) was increasing. Between the October 2007 and November 2009 examinations, the bank's adversely classified ORE increased from \$3 million to \$35.2 million. By the close of 2009, Centennial's substantial losses and inability to generate earnings from non-performing assets resulted in the bank falling to a *Critically Undercapitalized* position.

ADC Loan Underwriting

Limited loan underwriting practices added to the loan quality problems that developed when the institution's real estate lending markets deteriorated in 2007 and 2008. Centennial originated a significant number of stated income construction loans, which by their nature and definition, would have received limited underwriting because the borrower's income was not verified. Centennial's September 2007 Credit Policy included guidelines for approving stated income loans, such as reviewing the borrowers' credit scores and work experiences, and ensuring that their assets supported their stated incomes. In addition, to mitigate the risk, Centennial's September 2007 Credit Policy required that stated income loans were also pre-sold construction loans.

Centennial also relied on third-party mortgage brokers to perform assessments of borrowers' creditworthiness when approving a large number of pre-sold construction loans without performing adequate oversight and quality control checks of these brokers. In addition, Centennial's September 2007 Credit Policy did not include guidelines that addressed oversight of these brokers. As previously discussed, a large amount of stated income loans, brokered loans, and/or large residential loans were adversely classified during the October 2008 examination. Some of these underwriting practices and their apparent significant impact on the failure of Centennial are the subject of ongoing investigative activities. Centennial changed its policies to prohibit stated income loans and the use of certain mortgage brokers after examiners raised concern about the practice during the October 2007 examination.

Credit Administration and Related Monitoring

Centennial exhibited various credit administration and related monitoring weaknesses, which contributed to the ADC loan quality problems that developed when the institution's lending markets declined. Such weaknesses included:

- Inadequate loan stratification for categories of high ADC concentrations.
- Failure to identify, monitor, and establish limits for loan segments (e.g., large residential loans, stated income loans, and mortgage broker loans).
- Failure to perform adequate stress tests on the real estate lending portfolio that estimated potential credit losses and changes in interest income resulting from fluctuations in both collateral values and interest rates.

Reliance on Brokered Deposits

In the years preceding its failure, Centennial became increasingly reliant on wholesale funding sources, primarily brokered deposits, to fund its rapid loan growth and maintain adequate liquidity. When properly managed, wholesale funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, wholesale funding sources also present potential risks, such as higher costs and increased volatility. Placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs. The following points illustrate Centennial's increasing reliance on brokered deposits.

- Between December 31, 2003 and December 31, 2007, Centennial's brokered deposits increased from approximately \$5.5 million (or 6.8 percent of total deposits) to \$117 million (or 55.4 percent of total deposits). By year-end 2008, Centennial's brokered deposits totaled almost \$111 million, representing 57 percent of total deposits.
- Centennial was in the 99th percentile of its peer group for brokered deposits from December 2004 until December 2008. Such rankings indicate that Centennial's dependence on brokered deposits was higher than that of almost all of the other institutions in its peer group.
- From December 31, 2005 to December 31, 2009, Centennial's net non-core funding dependence ratio ranged from a negative 2.96 percent to 60.2 percent and exceeded the bank's peer group for 4 of the 5 years.

In anticipation of receiving a C&D with a capital provision,⁵ Centennial's management requested a brokered deposit waiver from the FDIC in a letter dated March 24, 2009. In the letter, Centennial reported that 51 percent of its \$210 million in total deposits were

⁵ Section 29 of the FDI Act, implemented by Part 337 of the FDIC Rules and Regulations, limits the use of brokered deposits. Section 29 provides that, among other things, institutions that are subject to an order containing a capital provision are prohibited from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC.

brokered deposits and that a waiver would allow the bank to renew an estimated \$70.9 million in brokered deposits scheduled to mature during the following 12 months. On June 18, 2009, the FDIC requested that Centennial revise its brokered deposit waiver request to cover a 3-month (or less) period of time. The FDIC also requested that the term of any brokered deposits rolled over not exceed 1 year.

On June 26, 2009, the FDIC issued a C&D against Centennial that contained a provision requiring that Centennial maintain Tier 1 Capital at not less than 10 percent. The C&D had the effect of lowering the bank's PCA capital category from *Well Capitalized* to *Adequately Capitalized*. As a result, Centennial was restricted from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. The C&D also required that the bank submit a written plan for eliminating its reliance on brokered deposits and provide written progress reports detailing the level, source, and use of brokered deposits with specific reference to progress under the bank's plan. Centennial withdrew its March 24, 2009 brokered deposit waiver request on October 14, 2009. During the 4-month period between the C&D issuance and the time the bank withdrew its waiver request, Centennial reported to the Division of Supervision and Consumer Protection (DSC) and the UDFI that the bank had not renewed any brokered deposits due to the C&D.

The FDIC's Supervision of Centennial

The FDIC, in coordination with the UDFI, provided ongoing supervisory oversight of Centennial through regular onsite risk management examinations and visitations. Further, the FDIC conducted offsite reviews of Centennial. The FDIC and the UDFI consistently advised management of the need to adequately monitor the high-risk lending profile of the institution. Examiners identified problems such as (1) increasing growth and concentrations, (2) the institution's failure to set limitations on certain loan segments, and (3) the bank's reliance on brokered deposits and made recommendations to strengthen the institution's controls and practices in the areas of concentrations and limitations on loan segments. In hindsight, and consistent with recently issued guidance on special funding sources, the level of Centennial's brokered deposits identified during the October 2007 examination may have warranted greater supervisory concern in light of the declining real estate market and the potential that access to those funds could become restricted.

The FDIC and the UDFI downgraded certain supervisory component ratings and the institution's composite rating during three consecutive examinations from 2007 to 2009. The FDIC and the UDFI also imposed enforcement actions in January 2008 and June 2009 to address problems identified at the October 2007 and October 2008 examinations as the institution's financial condition weakened.

Supervisory History

Centennial received satisfactory supervisory ratings until the June 2002 examination, when examiners lowered the bank's composite rating to a "3" due to weak asset quality,

earnings, internal controls, and management. Examiners determined during the March 2003 examination that Centennial’s condition had further deteriorated and downgraded the bank’s composite rating to a “4”. The FDIC and UDFI issued a C&D on March 17, 2003, requiring, among other things, that the Bank retain qualified management. As a result, the Board replaced the President and Chief Executive Officer (CEO) and the Senior Loan Officer with more qualified executives. The March 2004 examination reported that Centennial’s management and overall financial condition was improving. Further, the FDIC upgraded the bank’s composite rating to a “3” and replaced the C&D with a Memorandum of Understanding (MOU) in August 2004. By the February 2005 examination, Centennial’s overall financial and operational condition was determined to be satisfactory and the MOU was terminated.

Between February 2005 and the institution’s failure, the FDIC and the UDFI conducted five onsite risk management examinations and two visitations of Centennial. Table 2 summarizes key supervisory information for Centennial.

Table 2: Centennial’s Examination and Enforcement Action History

Examination Start Date	Regulator	Supervisory Ratings (UFIRS)	
		UFIRS	Informal or Formal Action Taken*
2/07/2005	FDIC/UDFI	222222/2	None
3/20/2006	FDIC/UDFI	222212/2	None
10/09/2007	FDIC/UDFI	333222/3	MOU effective January 22, 2008
7/7/2008	FDIC/UDFI (Visitation)	None	None
10/20/2008	FDIC/UDFI	343433/4	C&D** issued by the UDFI effective June 1, 2009 and C&D issued by the FDIC effective June 26, 2009 Problem Bank Memorandum dated January 16, 2009
5/11/2009***	FDIC/UDFI (Visitation)	353533/4 553533/5	Problem Bank Memorandum dated May 11, 2009 Problem Bank Memorandum dated August 31, 2009
11/09/2009	FDIC/UDFI	555555/5	Problem Bank Memorandum dated February 1, 2010

Source: OIG analysis of examination reports and other VISION information.

*Informal enforcement actions often take the form of Bank Board Resolutions (BBR) or MOUs. Formal enforcement actions often take the form of C&Ds but under severe circumstances can also take the form of insurance termination proceedings.

**The UDFI issued a separate C&D on June 1, 2009, so that it could perform certain actions independent of the FDIC such as modification or termination actions relating to a C&D.

***Visitation targeted as asset quality and allowance for loan and lease losses (ALLL) review.

Offsite Reviews

The FDIC’s offsite reviews identified supervisory concerns and potential problems. Centennial was flagged for offsite reviews five times between June 2005 and September 2009 because of the risk associated with its increasing asset growth. The offsite review performed by the FDIC in the fall of 2007 indicated that Centennial’s financial condition continued to weaken based on the institution’s September 30, 2007 call report data. Centennial’s CRE concentrations were consistently in the higher percentiles of its peer group, and these concentrations had caused a dramatic increase in adversely classified assets. The 2007 offsite review report also noted that the institution’s management had

taken steps to address its exposures in the local real estate market. During the June 2009 offsite review, the FDIC prepared a problem bank memorandum dated August 31, 2009, that included downgrades of the Capital component rating and the composite rating to “5” because the institution had not obtained capital from a prospective outside investor.

According to DSC officials, there were considerable efforts on the part of Centennial management and its Board to attract capital from external sources that started subsequent to the October 2008 examination and continued into 2009. The initial prospective investor submitted a proposal in early 2009 but ultimately withdrew it following difficulties in meeting Federal Reserve Board bank holding company requirements related to the structure of the transaction. The second prospective investor signed a letter of intent in April 2009 but ultimately ran out of time to bring the necessary external capital infusion to fruition before the bank’s capital situation became dire.

Supervisory Response to Key Risks

The FDIC’s and the UDFI’s February 2005 through November 2009 examination reports identified concerns and included recommendations related to the risks associated with Centennial’s significant ADC concentrations and credit risk-management practices. In addition, the FDIC and the UDFI imposed enforcement actions in 2008 and 2009 that addressed those risks. Further, the 2009 enforcement action addressed Centennial’s risks related to the bank’s reliance on brokered deposits.

February 2005 Examination

At the time of the February 2005 examination, economic conditions in Centennial’s lending markets were favorable. The examiners concluded that the bank’s overall condition was satisfactory and assigned the bank a composite “2” rating. ADC loans represented 698 percent of Tier 1 Capital, up considerably from the prior examination. However, examiners concluded that bank management actively monitored the risks inherent in those loans. Examiners also reported that the institution had increased its reliance on brokered deposits, but as with the ADC loans, bank management was managing the funds effectively. Consequently, the FDIC and the UDFI terminated the August 2004 MOU, as previously discussed in the Supervisory History section. In addition, the examiners reported that the institution increased its capital by \$2.4 million through the sale of the holding company’s common stock.

On March 2, 2005, the FDIC’s San Francisco Regional Office issued a memorandum entitled *Concentrations of Credit in Commercial Real Estate Examination Methodologies and Best Practices* intended to expand and clarify guidance for identifying and reporting concentrations of credit in examination reports to ensure consistent treatment. In particular, the guidance states that institutions’ policies should set ADC loan limits relative to Tier 1 Capital and that if these limits are not commensurate with the size and risk profile of the concentration, the Capital Adequacy, Asset Quality, and Management component ratings will be affected. As discussed below, examiners made recommendations in the March 2006 examination report regarding enhancing policies to include ADC loan limits relative to Tier 1 Capital, as suggested in this guidance.

March 2006 Examination

Examiners reported that Centennial's overall condition was satisfactory and assigned the bank a composite "2" rating. Examiners, however, expressed the following concerns:

- The bank's adversely classified assets had increased from 6.85 percent to 13.98 percent of Tier 1 Capital since the 2005 examination. Examiners noted, however, that the increase was not a major concern because of bank management's conservative underwriting and loan classification procedures.
- The bank was still maintaining large concentrations in ADC lending, which represented 609 percent of Tier 1 Capital. However, bank management continued to have appropriate controls in place to monitor its ADC loans. Mitigating factors included the fact that many of these ADC loans were pre-sold construction loans and that management had knowledge and experience in the real estate industry. However, as previously discussed in this report, bank management identified pre-sold loans that were actually speculative loans because the borrowers did not plan on occupying the homes.
- In accordance with the March 2, 2005 San Francisco regional guidance, examiners recommended that Centennial enhance its concentration policies to include diversification limits that were based on a percentage of Tier 1 Capital for various price levels of real estate. Centennial revised its September 2007 Credit Policy to generally comply with the recommendation.
- Examiners recommended that, although Centennial management had continued to effectively manage its liquidity position, management should enhance liquidity reporting to the Board. As of December 31, 2005, brokered deposits totaled \$69.3 million, representing approximately 47 percent of total deposits.
- Capital levels had increased since the last examination, and the institution continued to be *Well Capitalized*. However, examiners also noted that a capital infusion might become necessary if asset growth outpaced earnings.

October 2007 Examination

At this examination, examiners:

- reported that the overall condition of the institution was less than satisfactory due to a rapid deterioration in the loan portfolio and a dramatic increase in adversely classified items;
- concluded that management's decision to originate a significant dollar amount of stated income residential construction loans without setting formal limits greatly contributed to the institution's poor condition; and

- noted that even though Centennial’s risk management practices and policies were adequate, given the severity of economic conditions, bank management should have tightened risk management controls sooner based on signs of deterioration in the real estate market.

Examiners further noted that the institution held a substantial amount of brokered deposits to fund its liquidity needs, but concluded that Centennial’s liquidity position was adequately monitored, measured, and controlled by management and rated Liquidity a “2”. Our review of the examination workpapers indicated that Centennial’s Funds Management Policy provided that the bank should establish ratios as guidelines in maintaining adequate liquidity levels. This policy contained six different ratios with acceptable ranges, including a “Time Certificates of Deposit of \$100,000 or more to Deposit Ratio” ranging from 0 percent to 50 percent. We also observed that Centennial had a 1-page brokered deposit policy that did not include a limit for brokered funds.

The October 2007 examination workpapers stated that Centennial’s Funds Management Policy was thorough and adequate, and included acceptable risk limits for the institution. The workpapers further indicated that broker deposits were approximately 47 percent of total deposits as of June 30, 2007. Section 6.1 of the Examination Manual provides guidance for examining a bank’s non-core funding sources and identifies potential “red flags” that may indicate the need to take supervisory action to ensure that risks associated with brokered deposits or other rate sensitive funding sources are managed appropriately. Two of the “red flags” mentioned – (1) the absence of adequate policy limitations on brokered deposits and other potentially volatile funding sources and (2) high delinquency rate or deterioration in other asset quality indicators – were existing conditions at Centennial at the time of the 2007 examination. However, we noted that examiners did not comment on the brokered deposit policy or recommend that Centennial establish a ratio for brokered deposits as part of the bank’s liquidity guidelines, despite the fact that the bank’s level of brokered deposits placed it in the 99th percentile of its peer group and the bank’s funding was concentrated in brokered deposits.

Capital was considered fair, with a Tier One Leverage Capital ratio of 10.31 percent. However, examiners concluded that the level of capital was compromised because the institution’s risk profile had increased due to large amounts of classified assets.

As a result of their findings, examiners downgraded the institution’s composite rating, and its Asset Quality, Management, and Capital component ratings to a “3”. Examiners also reported that bank management was responding quickly and aggressively to changes in the real estate market and was contacting each borrower to assess intentions and plans for long-term financing. Examiners commented that bank management had improved its underwriting standards and that risk management processes appeared to be adequate for the current market environment. The examiners noted that management agreed to continue identifying possible problems in the loan portfolio.

On January 22, 2008, Centennial’s Board entered into an MOU with the FDIC and the UDFI in which it agreed to:

- Maintain at least a 10-percent Tier 1 Leverage Capital ratio.
- Identify, monitor, and establish limits for high-risk loan segments (e.g., large residential loans, stated income loans, and mortgage broker loans).
- Conduct stress testing on the real estate lending portfolio.
- Charge off all loans identified as a loss at this examination.
- Adjust an ORE property's book value to ensure compliance with Utah state laws.
- Provide quarterly progress reports to the FDIC and the UDFI.

In response to the MOU, bank management agreed to improve concentration monitoring reports to track the various loan segments and set appropriate risk limits by prohibiting stated income loans and the use of certain mortgage brokers. We noted that the MOU did not contain a provision related to liquidity and funds management. In hindsight, and consistent with recently issued guidance on special funding sources, the level of Centennial's brokered deposits may have warranted greater supervisory concern in light of the declining real estate market and the potential that access to the funds could become restricted.

July 2008 Visitation and October 2008 Examination

The FDIC and the UDFI conducted a visitation in July 2008 to review the bank's progress in complying with the January 2008 MOU. Examiners reported that although the bank had made improvements, significant asset quality problems related to the institution's ADC concentrations continued. Examiners reported that adverse classifications more than tripled from the October 2007 examination to \$48.3 million or 184 percent of total capital.

By the October 2008 examination, the institution's risk profile had increased. Examiners concluded that the institution's financial condition would most likely continue to deteriorate. Examiners acknowledged that the Board and bank management had acted diligently but recommended that the institution take additional actions. Although the institution had taken steps to reduce concentration risk and improve asset quality, capital, and reserves, the present level of capital did not adequately mitigate the existing and potential risk created by the bank's distressed condition.

In regard to brokered deposits, the October 2008 examination reported that approximately 55 percent of total deposits were brokered deposits and that 56 percent of these deposits would be maturing in 12 months. The examiners also noted that Centennial would have to either replace the funds or offer market interest rates to retain the funds, which would pressure the institution's earnings. Examiners concluded, however, that Centennial's Funds Management Policy remained adequate.

In their January 22, 2009 transmittal of the October 2008 examination report, the FDIC and the UDFI advised Centennial's Board that the bank would be contacted regarding a formal corrective program outlining actions necessary to restore the bank to satisfactory condition, and that such a program may result in the bank's PCA category being

downgraded. The FDIC and the UDFI stated in the transmittal letter that they expected the bank not to increase the use of brokered deposits in the interim. We noted that Centennial acquired nearly \$19 million in brokered deposits in March and April 2009, after the January 2009 transmittal of the October 2008 examination report.

Centennial's holding company injected \$2 million of new capital during the examination, which raised the institution's Tier 1 Capital to over 10 percent. Examiners downgraded the institution's Asset Quality, Earnings, and composite ratings to a "4" and downgraded Liquidity and Sensitivity to Market Risk to a "3". Consequently, in their January 22, 2009 transmittal of the October 2008 examination report, the FDIC and the UDFI informed the Board and bank management that the institution had been formally designated a "problem" institution and, as such, would be subject to a C&D. As discussed below, the FDIC issued its C&D on June 26, 2009, approximately 5 months after the problem bank memorandum was approved by the FDIC's Washington Office.

DSC officials acknowledged that the C&D was delayed but explained that subsequent to the end of the October 2008 examination, Centennial's parent company provided the bank \$2 million in capital, which returned the bank to the agreed-upon 10-percent level in the existing MOU. While DSC was working to put the C&D in place, the bank continued to operate under the MOU, which had similar conditions as proposed for the C&D. DSC also attributed delays in finalizing the C&D to a focus on the capital proposals being considered at the time and the UDFI's efforts to issue its own C&D rather than a joint C&D with the FDIC.

May 2009 Visitation and November 2009 Examination

During the May 2009 visitation, the FDIC and the UDFI reported that Centennial's asset quality and ALLL continued to deteriorate, with adversely classified ORE increasing to approximately \$31 million. The examiners also noted that the institution had fallen below its required capital level and was awaiting recapitalization from an outside investor. The examiners concluded that the level of classified assets and associated losses clearly warranted a downgrade to a "5" rating in the bank's Asset Quality and Earnings. In addition, the UDFI and the FDIC issued identical C&Ds on June 1, 2009 and June 26, 2009, respectively. Among other things, the C&Ds required Centennial to maintain Tier 1 Capital at levels not less than 10 percent, improve its funds management practices, and enhance liquidity monitoring.

On August 31, 2009, the FDIC downgraded the institution again as conditions continued to deteriorate. The examiners downgraded the Capital component and the composite rating from a "3" and a "4", respectively, to "5" because the institution's capital level had fallen below minimum levels required by the C&D. To address this decline, Centennial's Board and management had hoped to, but ultimately did not, obtain funds from an outside investor who had planned to recapitalize Centennial.

By the November 2009 examination, Centennial was critically deficient, with a Tier 1 Capital ratio of negative 0.17 percent. The November 2009 examination concluded that Centennial's liquidity was critically deficient and earnings were negative. Examiners

noted that the institution's primary source of ongoing funding came from \$65 million in volatile Internet Certificates of Deposit (CD) that replaced maturing brokered deposits. The majority of these CDs were scheduled to mature during the first 6 months of 2010. In addition, the November 2009 examination concluded that Centennial management needed to reevaluate the institution's liquidity strategies given the declining asset quality, continuing downward real estate values, lack of funding diversity, and the current C&D requirements. Examiners noted in the workpapers a need for bank management to (1) review bank goals and policy limits in light of the declining economy, nonperforming assets, and heavy reliance on non-core deposits funding to ensure that policy limits provided adequate liquidity for the present needs of the bank and (2) develop a contingency liquidity plan, consistent with regulatory mandates. However, these recommendations were not included in the November 2009 examination report.

High loan losses decimated capital despite management's efforts to contain the ADC loan losses. Examiners acknowledged that the Board and bank management had attempted to save the institution through concentration reduction plans and ORE sales. However, their efforts were hindered by further deterioration in the economy. As a result, Centennial was unable to obtain the capital necessary to meet the provisions of the June 2009 C&Ds and ultimately failed on March 5, 2010.

Implementation of PCA

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

On January 22, 2008, Centennial's Board entered into an MOU with the FDIC and the UDFI to correct noted safety and soundness deficiencies. The MOU, which was in effect from January 2008 through the June 2009 C&D, contained a total of eight provisions. One such provision required the bank to maintain a Tier 1 Leverage Capital ratio of at least 10 percent after establishing an adequate ALLL. As an informal agreement, the MOU was not legally enforceable under section 8 of the FDI Act. In addition, the MOU did not have the effect of lowering the bank's PCA capital category pursuant to section 325.103. Further, the MOU did not contain a provision requiring Centennial to establish limits on increasing its brokered deposits. As a result, Centennial was not restricted from

accepting, renewing, or rolling over brokered deposits. Between April 2008 and April 2009, Centennial increased its brokered deposits by about \$73 million. This increase in brokered deposits had the effect of elevating the bank's liquidity risk profile.

Centennial was considered *Well Capitalized* for PCA purposes until June 2009. The bank fell to *Adequately Capitalized* at that time as a result of the issuance of a joint C&D that contained a capital provision directing Centennial to achieve and maintain a Tier 1 Capital ratio "in such an amount as to equal or exceed 10 percent" of the bank's total assets. Section 325.103 of the FDIC Rules and Regulations states that a bank is deemed *Well Capitalized* if it meets or exceeds the capital ratios defined in the section and is not subject to a written agreement, order, capital directive, or prompt corrective action directive issued by the FDIC pursuant to section 8 of the FDI Act.⁶ As an *Adequately Capitalized* institution, Centennial was restricted from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. The C&D further stated that the level of Tier 1 Capital to be maintained during the life of the Order would be in addition to a fully funded ALLL. On December 22, 2009, the FDIC notified Centennial that it was *Critically Undercapitalized* based on the results of the November 2009 examination. Accordingly, Centennial was subject to the mandatory requirements of section 38, including the submission of a capital restoration plan and restrictions on asset growth, acquisitions, new activities, and payment of dividends.

Supervisory Lessons Learned

The FDIC elevated its supervisory concerns as Centennial developed a high-risk profile due to its significant ADC concentrations. Following the October 2007 and October 2008 examinations, the FDIC issued enforcement actions after identifying significant deterioration in Centennial's asset quality primarily caused by sub-concentrations of high-risk residential construction loans. Despite these actions, Centennial was unable to withstand an economic downturn in the real estate market that eroded its capital levels. In hindsight, the level of Centennial's brokered deposits identified during the 2007 examination may have warranted greater supervisory concern in light of the declining real estate market and the potential that restrictions might be placed on the funds. For example, the FDIC could have included a liquidity and funds management provision in the 2008 enforcement action requiring Centennial to establish limits on its brokered deposits and to develop an adequate contingency liquidity plan.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons learned from failures during the financial crisis.

- In 2008 the FDIC issued a Financial Institution Letter (FIL-22-2008), *Managing Commercial Real Estate Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risk associated

⁶ The minimum capital ratios defined in section 325.103 for *Well Capitalized* institutions are: (1) Total Risk-Based Capital of 10 percent or higher; (2) Tier 1 Risk-Based Capital of 6 percent or higher; and (3) Leverage Capital of 5 percent or greater. Actions under section 8 of the FDI Act constitute formal proceedings against respondents.

with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and robust credit risk management practices.

- On March 3, 2009, the FDIC issued FIL-13-2009, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*, which states, among other things, that aggressive asset growth strategies or reliance on non-core liabilities to fund riskier asset classes will result in heightened offsite monitoring and onsite examinations that are more extensive than those applicable to other institutions.
- Joint Guidance was issued in April 2010 that provides sound practices for managing funding and liquidity risk and strengthening liquidity risk management practices.⁷ The policy statement emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal, well-developed contingency funding plan as primary tools for measuring and managing liquidity risk. The agencies expect each financial institution to manage funding and liquidity risk using processes and systems that are commensurate with the institution's complexity, risk profile, and scope of operations.

Corporation Comments

On November 19, 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 Centennial's failure, including its heavy reliance on non-core funding sources. With regard to our assessment of the FDIC's supervision of Centennial, DSC's response discussed the number of examinations conducted between 2006 and 2010 described in our report. DSC also indicated that it recognizes that strong supervisory attention is necessary for institutions with high ADC and non-core funding concentrations, such as Centennial, and referenced guidance that the division has issued to remind examiners to take appropriate action when risks associated with those concentrations are imprudently managed. 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 ADC and liquidity exposures.

⁷ FIL-13-2010, entitled, *Funding and Liquidity Risk Management Interagency Guidance*, dated April 5, 2010.

Objectives, Scope, and Methodology

Objectives

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 Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that might warrant an in-depth review of the loss. At the time the Financial Reform Act was enacted, our fieldwork and a draft of this report were substantially complete. Although the estimated loss for Centennial Bank no longer met the threshold requiring an MLR, the OIG decided to complete the audit and issue this report as an in-depth review.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of Centennial's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Centennial, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from April 2010 to August 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 Centennial's operations from 2005 until its failure on March 5, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Reviewed and/or analyzed examination reports prepared by the FDIC and the UDFI examiners from 2002 to 2009.
- Reviewed the following:
 - Bank data contained in UBPRs and Call Reports.
 - Excerpts of correspondence files from DSC's San Francisco Regional and Salt Lake City Field Offices.

Objectives, Scope, and Methodology

- Examination workpapers related to loan policy, Board and management activities, and liquidity.
- Reports prepared by the Division of Resolutions and Receiverships and DSC relating to the bank's closure.
- Pertinent DSC policies and procedures and various banking laws and regulations.
- DSC's ViSION Modules, including Supervisory Tracking & Reporting.

We also interviewed FDIC examiners who participated in the various examinations of Centennial and an FDIC Salt Lake City Field Office official responsible for supervisory oversight.

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

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

Consistent with the audit objectives, we did not assess 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 Centennial'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. The results of our tests were discussed,

Objectives, Scope, and Methodology

where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at www.fdicig.gov. In 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
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.
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.
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 insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.

Glossary of Terms

Term	Definition
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.
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>
Stated Income Loans	A stated income mortgage loan is a specialized mortgage loan where the mortgage lender verifies employment and assets, but not income. Instead, an income is simply stated on the loan application (the stated income on the application should be realistic for the employment type).

Glossary of Terms

Term	Definition
Tier 1 (Core) Capital	<p>Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as</p> <p>The sum of:</p> <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; <p>Minus:</p> <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).
Uniform Bank Performance Report (UBPR)	<p>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</p>
Uniform Financial Institutions Rating System (UFIRS)	<p>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: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity 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.</p>

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CD	Certificates of Deposit
CEO	Chief Executive Officer
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
IDR	In-Depth Review
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
ORE	Owned Real Estate
PCA	Prompt Corrective Action
UBPR	Uniform Bank Performance Report
UDFI	Utah Department of Financial Institutions
UFIRS	Uniform Financial Institutions Rating System
ViSION	Virtual Supervisory Information on the Net

Corporation Comments

**Federal Deposit Insurance Corporation**

550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

November 18, 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, In-Depth Review of Centennial Bank, Ogden, Utah (Assignment No. 2010-048)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted an In-Depth Review of Centennial Bank, Ogden, Utah (Centennial), which failed on March 5, 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 13, 2010.

Centennial failed primarily because of the Board of Director's (Board) and management's decision to concentrate the loan portfolio in acquisition, development and construction (ADC) loans, and its failure to manage the risks associated with these loans. Centennial's poor underwriting practices, overall weak loan administration, and deterioration of the real estate markets resulted in increased delinquencies and non-performing assets and a significant decline in loan quality. Additionally, Centennial relied heavily on non-core funding sources, including brokered deposits and short term Internet Certificates of Deposits, contributing to its liquidity problems and subsequent failure.

From 2006 through March 2010, the FDIC and the State of Utah Department of Financial Institutions (UDFI) jointly and separately conducted five full-scope examinations and two visitations. At the October 2007 joint examination, Centennial's loan quality had deteriorated to a level that raised significant regulatory concern, and examiners downgraded Centennial's composite rating to "3", resulting in a Memorandum of Understanding being issued in January 2008. Throughout 2008 and 2009, Centennial's asset quality problems related to its ADC concentrations persisted and ratings were further downgraded. In June 2009, the UDFI and FDIC issued separate Cease and Desist orders, with which Centennial was not able to comply. Centennial was further downgraded to a composite "5" rating in November 2009, and was unable to raise capital from external sources to support its operations.

We recognize that strong supervisory attention is necessary for institutions with high ADC and non-core funding concentrations, such as Centennial, 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, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that re-emphasizes the importance of robust credit risk-management practices and appropriate capital levels for institutions with concentrated ADC and liquidity exposures.

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