

Office of Inspector General



Office of Material Loss Reviews
Report No. MLR-10-027

**Material Loss Review of First State Bank,
Flagstaff, Arizona**

March 2010



Why We Did The Audit

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review of First State Bank, Flagstaff, Arizona.

On September 4, 2009, the Arizona Department of Financial Institutions (AZ DFI) closed First State Bank (FSB) and named the FDIC as receiver. On September 25, 2009, the FDIC notified the Office of Inspector General (OIG) that FSB's total assets at closing were \$109.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was \$46.1 million. As of January 29, 2010, the estimated loss to the DIF had increased to \$47.4 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act to conduct a material loss review of the failure of FSB and retained KPMG for this purpose.

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

Background

FSB was established as a state-chartered institution, member of the Federal Reserve System, on September 9, 1998. In 2004, FSB switched primary federal regulators, becoming a state nonmember bank supervised by the FDIC. The bank was wholly-owned by Arizona Bancshares, Inc., and had no subsidiaries or other affiliates. As of June 30, 2008, FSB operated seven offices in two Arizona counties, Coconino and Gila.

FSB's assets were concentrated in commercial real estate (CRE) lending, with a significant portion of those loans extended for acquisition, development and construction (ADC) projects. To fund asset growth from 2006 to 2008, FSB became more dependent upon Federal Home Loan Bank borrowings, brokered deposits, and other non-core funding sources.

Audit Results

Causes of Failure and Material Loss

FSB's failure can be attributed to poor asset quality stemming from high CRE loan concentrations in ADC projects, purchases of risky loan participations, weak management and Board oversight, high overhead expenses, and asset growth funded by non-core sources at a critical juncture in the bank's operations. The Board's strategy, starting in 2006, to pursue asset growth partially funded by non-core deposits, created a strategic risk for FSB. Subsequently, ineffective limits on the ADC concentration, coupled with a failure to adequately address supervisory concerns, exposed the bank to unacceptable levels of risk. The level of problem loans in the ADC-concentrated loan portfolio was responsible for FSB's deteriorating asset quality, financial decline, and eventual failure.

The FDIC's Supervision of FSB

Through its supervisory activities, the FDIC identified key risks in FSB's operations and brought these to management's attention. Concerns noted by examiners included significant ADC loan concentrations, growth strategies through the purchase of loan participations that failed to perform, general weak management and Board oversight, high overhead expenses, and reliance on non-core funding sources.

The FDIC conducted one visitation in June 2004 and jointly conducted four on-site examinations with the AZ DFI beginning in September 2004. Until May 2009, the FDIC relied on a combination of discussions with management relative to areas of concern identified by examiners, and commitments from management and the Board to address all problems and examiner recommendations. The FDIC first imposed a supervisory action related to safety and soundness when a Cease and Desist Order was instituted in May 2009 as a result of the December 2008 examination.

Based on FDIC and AZ DFI observations during the 2008 examination, a stronger supervisory response at earlier examinations may have been prudent given the nature and extent of the risks taken by bank management. Stronger supervisory action during the institution's high-growth period may have influenced FSB's Board and management to limit the significant level of risks assumed, established a more appropriate supervisory tone, and prompted FSB's Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions. However, capital levels turned out to be a lagging indicator of FSB's financial condition. Other factors, including earnings, asset quality, and management, identified in earlier examinations, were better indicators that the bank's viability was in question.

Management Response

After we issued our draft report, we met with FDIC management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 22, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of FSB's failure and the FDIC's supervision of the bank. DSC stated that FSB's Board and management were expected to identify and control the third-party risks arising from participatory relationships to the same extent as if the activity, such as lending, were handled within the institution. The FDIC issued a Financial Institution Letter on *Managing Third-Party Risks* in June 2008, which outlined the basic elements for effective third-party risk management. Moreover, the FDIC's *Summer 2007 Supervisory Insights* provided risk management procedures for performing due diligence specifically on purchased loan participations.



DATE: March 25, 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 First State Bank, Flagstaff, Arizona*
(Report No. MLR-10-027)

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. The report did not contain recommendations, thus a response was not required. However, the Division of Supervision and Consumer Protection provided a written response on March 22, 2010. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mike Lombardi, Audit Manager, at (703) 562-6328. We appreciate the courtesies extended to the audit staff.

Attachment

cc: Stan Ivie, Regional Director, DSC
Christopher E. Drown, Chief, Office of Internal Control and Review, DSC
James H. Angel, Jr., Director, OERM

Table of Contents

Part I

Report by KPMG LLP	I-1
<i>Material Loss Review, First State Bank, Flagstaff, Arizona</i>	

Part II

OIG Evaluation of Management Response	II-1
Corporation Comments	II-2

Part I

Report by KPMG LLP



**Material Loss Review
First State Bank
Flagstaff, Arizona**

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

March 25, 2010

KPMG LLP
2001 M Street, NW
Washington, DC

Table of Contents

Executive Summary	I-1
Background	I-3
Causes of Failure and Material Loss	I-4
Concentration in CRE and ADC Lending	I-4
Asset Growth Through Purchased Participation Loans	I-6
Management and Board Oversight	I-7
Overhead Expenses	I-9
Funding Strategies	I-10
The FDIC's Supervision of FSB	I-11
Supervisory History	I-12
Supervisory Concerns and Response to FSB's Asset Quality	I-13
Supervisory Concerns and Response to FSB's Board and Management	I-18
Supervisory Concerns and Response to FSB's Funding	I-19
Effectiveness of Offsite Review of FSB	I-19
Implementation of PCA	I-21
Appendices	I-23
1. Objectives, Scope, and Methodology	I-23
2. Glossary of Terms	I-26
3. Acronyms	I-28
Tables	
1. Financial Condition of FSB	I-4
2. Examination History of FSB from June 2004 to December 2008	I-12
3. Supervisory Responses to CRE Concentrations for FSB	I-14
4. FSB's PCA Capitalization Categories	I-21
Figures	
1. Comparison of FSB's ADC Concentrations to its Peer Group	I-5
2. Comparison of FSB's Total Non-interest Expenses as a Percentage of Average Assets to Peer Group	I-10
3. Comparison of FSB's Non-core Funding Dependence to Peer Group	I-11



KPMG LLP
2001 M Street, NW
Washington, DC 20036

March 25, 2010

Executive Summary

Stephen M. Beard
Assistant Inspector General for Material Loss Reviews
Federal Deposit Insurance Corporation
3501 North Fairfax Drive
Arlington, VA 22226

Material Loss Review Report for First State Bank, Flagstaff, Arizona

Dear Mr. Beard:

This is our performance audit report on the results of the Material Loss Review for First State Bank (FSB), Flagstaff, Arizona. The objectives of this performance audit were to (1) determine the causes of FSB's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of FSB, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Causes of Failure

FSB's failure was due to poor asset quality stemming from high CRE and ADC loan concentrations, purchases of risky loan participations, weak management and Board of Directors (Board) oversight, high overhead expenses, and asset growth funded by non-core sources at a critical juncture in the bank's operations. The Board's strategy, starting in 2006, to pursue asset growth partially funded by non-core deposits created a strategic risk for FSB. Ineffective limits on the ADC concentration, coupled with a failure to adequately address supervisory concerns, exposed the bank to unacceptable levels of risk. The level of problem loans in the ADC-concentrated loan portfolio was responsible for the deterioration of the bank's asset quality, which in 2008 caused the decline in FSB's financial condition.

Evaluation of Supervision

Through its supervisory efforts, the FDIC identified key risks in FSB's management practices and operations and brought these risks to the attention of the institution's Board and management team through regular discussions and correspondence, examination reports, a visitation, and a supervisory action. Regulators conducted one visitation in June 2004 after the bank switched primary Federal regulators from the Federal Reserve Bank (FRB) to the FDIC, and four on-site risk management examinations beginning in 2004.

From 2004 through 2007, FSB's Risk Management composite rating remained a "2", and the institution's safety and soundness was deemed satisfactory. Nevertheless, during this period the FDIC identified risks that eventually led to the failure of the bank, and made recommendations to the Board and management to address these concerns. The ultimate impact of management's



failure to reduce concentration levels and to manage and monitor its CRE and ADC concentrations, as was recommended by examiners, was not fully exposed until the real estate market slowed. Given that institutions with high ADC concentrations are particularly vulnerable to economic downturns, more prompt and stronger supervisory attention to FSB's lending practices and the risks associated with the bank's growth strategy may have been warranted.

Prompt Corrective Action

The FDIC followed PCA guidance. However, capital levels turned out to be a lagging indicator of the institution's financial condition. By the time the bank's PCA capital category fell from *Well Capitalized* to *Adequately Capitalized* in December of 2008, the financial condition of the bank had severely deteriorated. Although FSB stipulated to a Cease and Desist Order (C&D) in May of 2009, FSB was at serious risk of failure by the time the order was issued. As of June 30, 2009 the bank was *Significantly Undercapitalized* for PCA purposes.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the performance 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.

The information included in this report was obtained during our fieldwork, which occurred during the period from December 2009 through February 2010.

Very truly yours,

KPMG LLP

Background

On September 4, 2009, the Arizona Department of Financial Institutions (AZ DFI) closed First State Bank (FSB) and named the FDIC as receiver. On September 25, 2009, the FDIC notified the Office of Inspector General (OIG) that FSB's total assets at closing were \$109.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was \$46.1 million. As of January 29, 2010, the estimated loss had increased to \$47.4 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act to conduct a material loss review of the failure of FSB, and retained KPMG for this purpose.¹

FSB was established as a state-chartered institution, member of the Federal Reserve System, on September 9, 1998. In 2004, the bank switched primary federal regulators from the Federal Reserve Bank of San Francisco (FRB) to the FDIC and became a state non-member bank. The bank operated seven offices in two Arizona counties, Coconino and Gila, as of June 30, 2008.² Nearly 96 percent of the institution's total deposits were held in its six Coconino County offices.³ These offices held a combined market share of about 8 percent in the county, among the lowest of the eight institutions with branch offices in the county. The bank's deposit market share in Gila County was less than 1 percent and the lowest among eight institutions operating in the county. The bank was wholly-owned by Arizona Bancshares, Inc. The institution had no subsidiaries or other affiliates.

FSB's assets were concentrated in Commercial Real Estate (CRE), with a significant portion of those loans extended for Acquisition, Development and Construction (ADC) projects. To fund asset growth between 2006 and 2008, FSB became more dependent upon Federal Home Loan Bank (FHLB) borrowings, brokered deposits, and other non-core funding sources.

Table 1 provides details on FSB's financial condition as of December 2008, and for the 3 preceding calendar years.

¹ In conducting this performance audit and preparing this report, KPMG relied primarily on information provided by the FDIC OIG and the Division of Supervision and Consumer Protection (DSC). Appendix I, Objectives, Scope, and Methodology, describes in greater detail the procedures used by KPMG.

² According to FDIC Summary of Deposits, one of the Coconino County offices was a limited service mobile office and its deposits were consolidated with other branches. In August 2008, FSB closed one of its Coconino County offices.

³ Deposit data are as of June 30, 2008 from the FDIC Summary of Deposits.

Table 1: Financial Condition of FSB

Financial Data (\$000s)	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets	121,247	111,458	83,088	69,590	\$58,719
Total Loans	94,851	87,989	59,391	53,699	\$46,568
CRE Loans	73,215	65,015	39,073	38,137	35,946
Loan Growth	7.80%	48.15%	10.60%	15.31%	22.31%
Total Deposits	101,100	82,230	67,161	57,740	47,659
Brokered Deposits/Total Liab.	14.35%	9.97%	3.15%	0.00%	0.00%
Tier 1 Capital Ratio	7.19%	10.66%	13.62%	9.96%	10.49%
Total Risk-Based Capital Ratio	9.22%	11.69%	17.35%	12.54%	12.81%
Asset Growth	8.79%	34.14%	19.40%	18.52%	22.31%
Past Due + Nonaccrual Loans/Gross Loans	10.13%	0.96%	0.90%	0.02%	0.00%
Return on Average Assets	-3.36%	0.27%	0.92%	1.09%	0.83%
Real Estate Loans/Total Assets	67.36%	64.98%	53.22%	63.24%	68.76%

Source: Uniform Bank Performance Report (UBPR) for FSB.

Causes of Failure and Material Loss

FSB's failure was due to poor asset quality stemming from high CRE and ADC loan concentrations, purchases of risky loan participations, weak management and Board of Directors (Board) oversight, high overhead expenses, and asset growth funded by non-core sources at a critical juncture in the bank's operations. The Board's strategy, starting in 2006, to pursue asset growth partially funded by non-core deposits created a strategic risk for FSB. Ineffective limits on the ADC concentration, coupled with a failure to adequately address supervisory concerns, exposed the bank to unacceptable levels of risk. The level of problem loans in the ADC-concentrated loan portfolio was responsible for the deterioration of the bank's asset quality, which in 2008 caused the decline in FSB's financial condition.

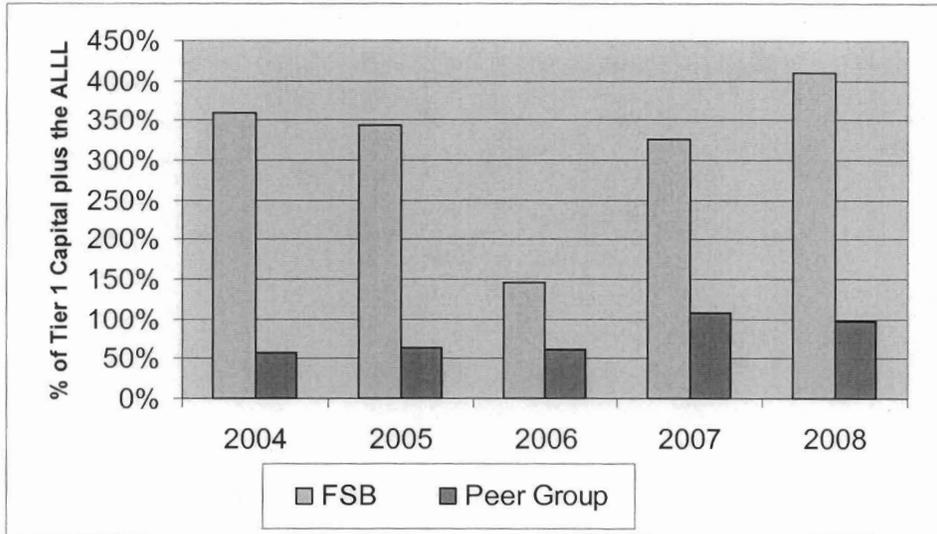
Concentration in CRE and ADC Lending

As early as the 2002 Joint examination conducted by the FRB and AZ DFI, examiners noted a high and increasing concentration of CRE loans. This concentration represented 434 percent of Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL). The CRE concentration level continued to increase and reached 580 percent of Tier 1 Capital plus the ALLL by the September 2003 Joint examination conducted by the FRB and AZ DFI. The majority of the CRE portfolio was ADC loans. Examiners indicated that management needed to develop a more comprehensive system to monitor its CRE concentrations. The high concentration level continued, as evidenced by the results of the September 2004 Joint⁴ examination where it was noted that, as of June 30, 2004, CRE loans represented 506 percent of Tier 1 Capital plus the ALLL. The 2004 Report of Examination (ROE) noted that management adequately monitored concentrations of credit by using multiple reports that segregated real estate loans by property, type, and occupancy. On a monthly basis, management provided the Board with three reports that showed the concentrations in various loan categories and the bank's compliance with the Board-established limits.

⁴ The September 20, 2004 examination was the first examination conducted by FDIC after FSB switched primary federal regulators from FRB to FDIC.

Figure 1 shows FSB's ADC concentration levels compared to its peer group⁵ by the end of each calendar year from 2004 to 2008. As represented below, from 2004 to 2008 FSB's loan concentration was consistently higher than its peer group.

Figure 1: Comparison of FSB's ADC Concentrations to its Peer Group



Source: UBPRs for FSB.

During the October 2007 Joint examination, examiners noted that FSB continued to maintain a significant concentration in CRE loans that represented 619 percent of Tier 1 Capital plus the ALLL as of September 30, 2007. The report also noted that enhanced concentration monitoring should: 1) include underfunded commitments in calculating exposure; 2) segment the CRE portfolio into smaller sectors such as office, retail, industrial, and hotels; 3) identify and monitor geographic concentrations; 4) present comprehensive concentration reports to the Board on an ongoing basis; and 5) address variances from Board-approved limits in the minutes of the Board meetings.

The December 2008 Joint examination reported that despite softness in the overall real estate market since the prior examination, total CRE exposure, including unfunded commitments, had climbed to 794 percent as of October 31, 2008. Of this amount, non-owner occupied CRE totaled \$52.4 million, or 463 percent of Tier 1 Capital plus the ALLL, of which speculative lending accounted for 365 percent of Tier 1 Capital plus the ALLL. During the same examination it was noted that due to the high level of operational losses, problem assets, and CRE exposure, capital was deficient relative to the bank's risk profile. In addition, examiners reported that

⁵ Based on the definition from the UBPR Report, December 2008, FSB's peer group included all insured commercial banks having assets between \$100 million and \$300 million in a metropolitan area with three or more full service offices.

measurement and monitoring of the bank's CRE exposure level was inadequate. Specific examples of these deficiencies included:

- Inadequate discussion by the Board regarding the justification for the bank's decision to hold CRE loan totals above various Board-approved CRE limitations and/or approval by the Board of the over-limit conditions;
- Absence of Board discussion concerning when the bank should reduce CRE exposure; and
- Need to stratify the portfolios into smaller lending sectors.

As discussed in December 2006 guidance issued jointly by the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. It appears that adverse changes in the CRE market impacted FSB negatively. In comparison with the bank's peer group, FSB's level of CRE concentration was high and made the bank vulnerable to any downturn in the CRE market.

Asset Growth Through Purchased Participation Loans

The October 2007 Joint examination noted that management had purchased 13 loan participations from Marshall Bank First Corporation (Marshall) with commitments totaling more than \$12 million. Examiners indicated that management failed to document appraisal reviews on credits purchased from Marshall. At the time of this examination, the bank was experiencing a high-growth period, largely as a result of these loan participations. From December 2006 to December 2007, FSB's loans and assets grew 48 percent and 34 percent, respectively.

In the subsequent Joint examination in December 2008, examiners noted that loan participations purchased from Marshall represented 47 percent of total classified loans and 68 percent of loans classified as losses. Further, examiners indicated that due to the decline in regional and national real estate markets, approximately 80 percent of the ADC loan participations that were purchased from Marshall in 2006 and 2007 were non-performing. The majority of these loans were located outside of FSB's local market and their total balance equaled 107 percent of Tier 1 Capital plus the ALLL as of October 31, 2008. While FSB's concentration levels were high and put the bank at risk, these poorly performing participations accelerated the decline of the bank's financial condition.

The FDIC's *Supervisory Insights*, Summer 2007 issue, discusses the risks that community banks can incur by using third-party arrangements. This article indicates that banks often "buy" the types of loans they cannot originate in their normal trade area, and those institutions may lack lenders with sufficient expertise to analyze the participation loans. A financial institution's Board and management are ultimately responsible for identifying and controlling the risks arising from participation relationships. The institution's responsibility is no different than if the activity was handled directly by the institution.

The article also suggests that institutions entering into participation agreements can avoid common pitfalls by:

- Conducting a thorough risk assessment to ensure that the proposed relationship is consistent with the institution's strategic plan and overall business strategy;
- Conducting a thorough due diligence to focus on the third party's financial condition, relevant experience, reputation, and the scope and effectiveness of its operations and controls;
- Reviewing applicable accounting guidance to determine if the participation agreement meets the criteria for a loan sale or a secured borrowing; and
- Developing a comprehensive monitoring program.

From examination findings in October of 2007 and December of 2008, it is apparent that FSB did not follow such prudent practices before entering into its participation agreements. As a result, these poorly managed loan participations became an important factor in the eventual failure of the bank.

Management and Board Oversight

Business Strategies

The December 2008 Joint examination noted that the combination of the Board-approved business plan and drastic changes in the economy had significant negative consequences on the financial condition of the bank. At the examination, it was noted that the majority of the bank's problems were a by-product of the high-risk business operating plan approved by the Board and implemented by management. Examiners indicated that the Board-approved business strategies had allowed management to operate the bank with an elevated risk profile. Negative elements from these strategies as noted by examiners included:

- Origination and purchase of a high volume of CRE loans, including residential and commercial construction loans funded for speculative purposes, and out-of-territory CRE loan participations;
- Utilization of an increasing and elevated level of potentially volatile liabilities to fund loan growth;
- Operation of the bank with a low level of on-balance sheet liquidity; and
- Investing an excessively high volume of capital in fixed assets.

As a result of the 2008 Joint examination, examiners concluded that since the last examination in October 2007, management's policies and practices had led directly to the following:

- A sharp increase in the level of problem loans held by the bank;
- Significant losses in the third and fourth quarters of 2008 and anticipated operational losses in 2009;
- A marked decline in all capital ratios and overall capital adequacy;
- A decline in the bank's liquidity position and a reduction in available liquidity; and

- Violations of the FDI Act and FDIC Rules and Regulations, and contraventions of regulatory policy guidelines.

At the December 2008 Joint examination, examiners emphasized that, given weaknesses in the real estate markets, management's decision to continue funding a high level of loan growth was questionable. Examiners noted further that if adequate analysis of the local markets had been undertaken, management may have decided to significantly reduce loan growth.

Apparent Violations and Contraventions of Policy

At the September 20, 2004 Joint examination, examiners noted that management was generally in compliance with FDIC Rules and Regulations; however, two inadvertent contraventions of regulatory statements of policy were cited, related to a Policy Statement on the ALLL Methodologies and a Policy Statement on Interest Rate Risk (IRR). In addition, an apparent violation of the State of Arizona Revised Statutes relative to corporate insurance was identified. The report also indicated that management proactively resolved these contraventions and the apparent violation during the examination.

During the March 2006 Joint examination, examiners noted that management was generally in compliance with laws, regulations and statements of policy. However, two apparent violations of the FDIC's Rules and Regulations 12 Code of Federal Regulations (CFR) Part 323 were identified. 12 CFR Part 323.3(b) requires evaluations for real estate-related financial transactions of \$250,000 or less that do not require the services of a state certified or licensed appraiser. Examiners noted two CRE loans below \$250,000 that lacked a corresponding evaluation for the respective properties securing the loans.

In the October 2007 Joint examination, examiners noted that management was generally in compliance with laws and regulations, although multiple apparent violations of 12 CFR Part 323 were cited for lack of written appraisal reviews on purchased participations from Marshall. 12 CFR Part 323.5 (b)(2)(ii) of the FDIC's Rules and Regulations states that, "a financial institution may accept an appraisal prepared for another financial services institution, if: (ii) the accepting institution determines that the appraisal conforms to the requirements of this part and is otherwise acceptable." Four purchased loans were listed in apparent violation of this regulation. Appraisals were conducted by the originating institution; however, FSB management did not conduct an appraisal review prior to funding the loans as required by the regulation.

During the 2008 Joint examination, examiners noted an apparent contravention to the Interagency Policy Statement on the ALLL. The Policy states that management is responsible for maintaining the ALLL at an appropriate level. The Policy further states that management should evaluate the ALLL reported on the balance sheet as of the end of each quarter, or more frequently if warranted, and charge or credit the Provision for Loan and Lease Losses (PLLL) to bring the ALLL to an appropriate level as of each evaluation date. Examiners noted that although management analyzed, prepared and presented its ALLL analysis to the Board for the periods ending September 30, October 31, and November 30, 2008, the Board failed to approve the recommended PLLL to maintain the ALLL at an appropriate level and, because of this lack of approval, management failed to maintain the ALLL at an appropriate level. During this

examination, the ALLL was found to be inadequate by \$1.65 million as of September 30, 2008. The failure to maintain an adequate ALLL as of the September 30, 2008 reporting period resulted in the required amended filing of the September 30, 2008 Report of Condition and Income (Call Report).

During the same examination, it was noted that FSB was again in violation of 12 CFR Part 323.5(b)(2) of the FDIC Rules and Regulations in four loans. In addition, examiners noted that an independent review of the bank's IRR management process had not been conducted for nearly 18 months. The Joint Policy Statement on IRR states that a bank's senior management and its Board or a Board committee should receive reports on the bank's IRR profile at least quarterly. The policy also notes that the bank should conduct periodic reviews of its risk management process to ensure its integrity, accuracy and reasonableness. The absence of an annual independent review and quarterly IRR calculations were both contraventions of the policy statement.

While not always willful or significant, these apparent violations of laws, rules and regulations throughout the course of various examinations provide an indication of management's and the Board's failure to administer the bank in a safe and sound manner, despite repeated examiners' concerns.

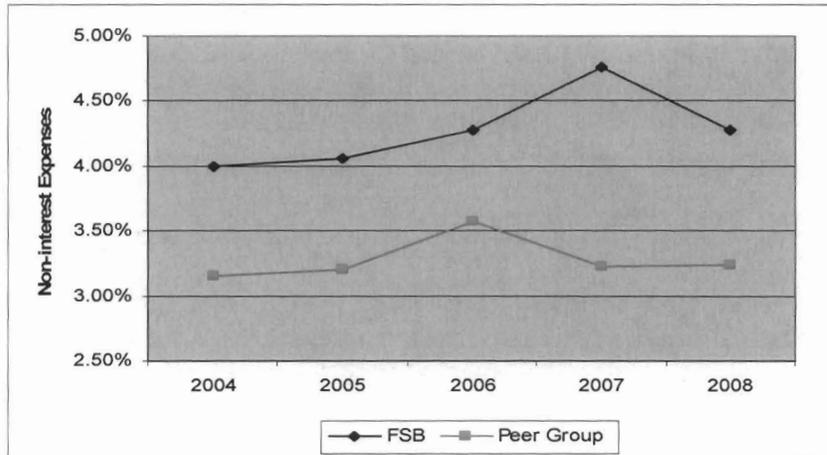
Overhead Expenses

From 2001 through 2003, FRB and AZ DFI examiners concluded that the bank was unprofitable or marginally profitable for most of this period due to non-interest expenses, as overhead expenses represented nearly twice the level of peer institutions. According to examiners, management expected overhead expenses to remain high until an asset size commensurate with the bank's infrastructure was attained.

Throughout the 2004 to 2007 period, earnings continued to be hampered by high overhead expenses as a result of branch expansion. The October 2007 ROE indicated that in July and October of 2007, management opened new branches in Cottonwood and Payson, Arizona. Further, in 2007 management relocated and expanded the main headquarters/branch in Flagstaff, Arizona. The branching and expansion plans were anticipated with the exception of the Payson branch which unexpectedly became available for acquisition. Nonetheless, the increased staff needed to operate the new branches resulted in additional personnel costs and caused the ratio of total overhead expense to average assets to increase. Examiners also noted that earnings performance had declined and needed improvement. Net income as of June 30, 2007 totaled \$193,000 compared to \$401,000 as of June 30, 2006. The resulting Return on Average Assets (ROAA) totaled .44 percent, down 57 basis points from the previous year. According to examiners, among the primary contributors to decreased profitability was the increase in overhead expenses. Given the addition of the Payson branch and the unanticipated interest expense associated with the increasing volume of non-core funding sources, management anticipated that a .35 percent ROAA was more likely at year-end 2007, versus the projected .55 percent.

Figure 2 shows FSB's non-interest expenses were consistently higher than its peer group from 2004 to 2008.

Figure 2: Comparison of FSB's Total Non-interest Expenses as a Percentage of Average Assets to Peer Group



Source: UBPRs for FSB.

The December 2008 Joint ROE noted that earnings were critically deficient and insufficient to support operations and maintain appropriate capital and allowance levels. The level of loss represented a distinct threat to the viability of the institution through capital erosion. The bank's earnings performance had deteriorated significantly since the previous examination. A major factor in this deterioration was high overhead expense. Examiners indicated that as of September 30, 2008, overhead expenses as a percentage of average assets were high at 4.38 percent in comparison to the peer level of 3.22 percent. According to examiners, the main reason for the large increase in non-interest expense over the last 2 years was the investment in fixed assets associated with the opening of two new branches and the occupation of the new headquarters building.

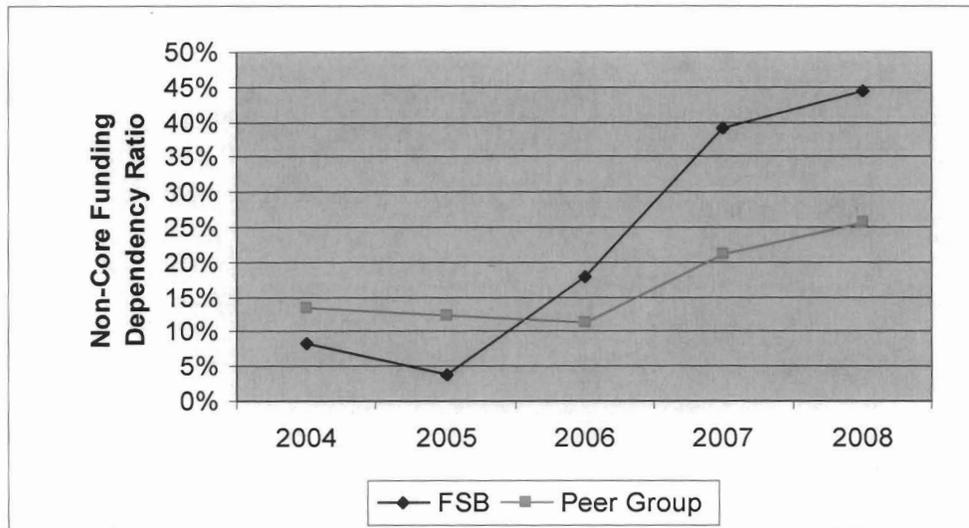
Funding Strategies

During the October 2007 Joint examination, examiners noted that loan growth had outpaced deposit growth and, as a result, management had increased their reliance on borrowings and brokered deposits. The net non-core funding dependency ratio⁶ climbed from 3.76 percent as of December 31, 2005 to 36.67 percent as of June 30, 2007.

Figure 3 illustrates the trend of increased reliance on non-core funding sources by FSB. In 2004 and 2005, this ratio was lower than the peer group; however, by 2007, FSB's ratio was nearly double the peer group average.

⁶ This ratio measures the degree to which the bank is funding longer-term assets (loans, securities that mature in more than one year, etc.) with non-core funding. Non-core funding includes funding that can be very sensitive to changes in interest rates such as brokered deposits, Certificates of Deposit greater than \$100,000, and borrowed money. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Figure 3 : Comparison of FSB's Non-core Funding Dependence to Peer Group



Source: UBPRs for FSB.

At the December 2008 Joint examination, examiners noted that the liquidity position was significantly deficient as the bank was relying on a high level of non-core sources to fund its operations. Specifically, examiners reported that the bank maintained limited on-balance sheet liquidity and continued to rely on FHLB borrowings, brokered deposits, and other non-core funding sources. Examiners noted that those practices, coupled with an eroding and deficient capital position, and the anticipated supervisory action that would have constrained some of these sources, threatened the sustainability of the bank's funding structure and ability to maintain adequate liquidity. In addition, funds management practices were considered inadequate. During the period following the departure of a senior official in May 2008, and the beginning of the on-site examination, the bank did not have a functioning Asset/Liability Committee. The ROE indicated that as the bank had an elevated level of non-core funding sources, constant supervision of the liquidity position was paramount.

The FDIC's Supervision of FSB

Through its supervisory activities, the FDIC identified key risks in FSB's operations and brought them to the attention of bank management. Concerns noted by examiners included significant loan concentrations, growth strategies through the purchase of loan participations that failed to perform, generally weak management and Board oversight, high overhead expenses, and reliance on non-core funding sources. The FDIC conducted one visitation in June 2004, and jointly conducted four on-site examinations with the AZ DFI beginning in September 2004.

Until May 2009, the FDIC relied on a combination of discussions with management relative to areas of regulatory concern identified by examiners, and commitments from management and the Board to address all problems and recommendations outlined in the ROEs. The FDIC first imposed a supervisory action related to safety and soundness when a Cease and Desist Order

(C&D) was instituted in May 2009 as a result of the December 2008 Joint examination. FSB stipulated to the C&D on April 30, 2009 and it became effective May 1, 2009.

Based on the FDIC and State observations during the 2008 Joint examination, it appears that closer supervisory oversight following the 2007 examination, such as an earlier on-site visitation, may have been prudent given the nature and extent of the risks taken by bank management. Additional oversight during the institution's high-growth period may have influenced FSB's Board and management to limit the significant level of risks assumed. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate actions to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

Supervisory History

In 2004, after FSB switched primary federal regulators, the FDIC in conjunction with AZ DIF, provided ongoing supervision of FSB through regular on-site risk management examinations, one on-site visitation and offsite reviews. Table 2 summarizes key information pertaining to the onsite risk management examinations and a visitation conducted from June 2004 until the institution failed.

Table 2 : Examination History of FSB from June 2004 to December 2008

Examination Start Date	Examination Type	Examination as of Date	On-Site Supervisory Effort	Supervisory Ratings* (UFIRS)	Informal or Formal Action** Taken
06/29/04	Visitation	03/31/04	FDIC	No Ratings	None
09/20/04	Examination	06/30/04	FDIC/AZ DFI	222322/2	None
03/20/06	Examination	12/31/05	FDIC/AZ DFI	212222/2	None
10/22/07	Examination	06/30/07	FDIC/AZ DFI	222322/2	None
12/08/08	Examination	09/30/08	FDIC/AZ DFI	445553/5	Cease & Desist Order (May 1, 2009)

Source: ROEs for FSB and DSC supervisory documents.

*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.

**Informal actions often take the form of Bank Board Resolutions (BBR) or Memorandums of Understanding (MOU). Formal enforcement actions often take the form of Prompt Corrective Actions (PCA) or C&D, but under severe circumstances can also take the form of insurance termination proceedings.

An on-site CRE/ADC visitation was initially planned for the week of December 8, 2008. However, during the pre-planning phase, the visitation was converted into a full-scope examination based upon the significant level of deterioration noted in the CRE/ADC portfolio. On December 12, 2008, an interim downgrade to a composite "4" rating was issued. The bank was formally designated a troubled institution and was notified in writing of the downgrade and its troubled institution designation. Results of the examination indicated that the bank's overall condition had deteriorated significantly and was now critically deficient.

May 2009 C&D. Based on the results of the December 2008 Joint examination, the FDIC instituted a C&D, effective May 1, 2009. The C&D required FSB to, among other things:

- Raise Tier 1 Capital by no less than \$2 million and to maintain Tier 1 Capital at such amount as to equal or exceed 10 percent of the bank's total assets within 120 days;
- Develop a plan to meet and thereafter maintain the minimum risk-based capital requirement as described in Appendix A to 12 CFR Part 325 of the FDIC Rules and Regulations⁷ within 60 days from the effective date of the C&D;
- Retain qualified management;
- Increase Board participation;
- Develop, adopt, and implement a written plan for the reduction and collection of delinquent loans; and
- Revise, adopt, and implement written lending and collection policies to provide effective guidance and control over the bank's lending function.

The C&D noted some of the following unsafe and unsound banking practices that were identified during the 2008 Joint examination:

- Operating with management whose policies and practices were detrimental to the bank;
- Operating with inadequate capital in relation to the kind and quality of assets held by the bank;
- Operating with a large volume of poor quality loans;
- Engaging in unsatisfactory lending and collection practices;
- Operating with inadequate provisions for liquidity, including an elevated reliance on non-core funding sources; and
- Operating with inadequate internal routine and control policies.

Although a C&D was appropriate based on the risks that were identified, the ultimate viability of the institution was already in serious question by the time the C&D was issued. By this time, due to the rapid deterioration of the bank's asset quality, failure of the bank was imminent.

On September 4, 2009, the AZ DFI closed FSB due to the deteriorating asset quality, inadequate earnings and capital erosion, and named the FDIC as receiver.

Supervisory Concerns and Response to FSB's Asset Quality

Loan Concentrations

During the October 2007 Joint examination, examiners noted that comprehensive CRE concentration reports had not been submitted to the Board since the beginning of 2007.

⁷ Capital adequacy is one of the critical factors that the FDIC is required to analyze when taking action on various types of applications and when conducting supervisory activities related to the safety and soundness of individual banks and the banking system. Appendix A to 12 CFR Part 325—Statement of Policy on Risk-Based Capital sets forth (1) minimum standards of capital adequacy for insured state nonmember banks and (2) standards for determining when an insured bank is in an unsafe or unsound condition by reason of the amount of its capital.

Management had previously prepared monthly reports that stratified the CRE portfolio by property type and occupancy, with comparison made to the Board-approved limits. As noted in the ROE, management prepared a *Loan by Type* report that segmented the portfolio into diverse categories; however, this report did not include unfunded loan commitments, and did not compare performance to Board-approved limits. Examiners subsequently calculated total concentration exposure as of September 30, 2007 and determined that the commercial land development and residential construction segments were outside policy limits. These policy variances were not presented to the Board. The 2006 Joint Guidance encouraged management to perform portfolio-level stress tests and consider the sensitivity of portfolio segments with common risk characteristics to potential market conditions. At the time of this examination, management had yet to conduct stress testing.

Table 3 summarizes FSB's concentrations and examiner comments for examinations performed from 2004 to 2008.

Table 3 : Supervisory Responses to CRE Concentrations for FSB

Examination Date	Asset Quality Component Rating	CRE Concentration as a Percentage of Tier 1 Capital Plus the ALLL	Examiner Comment
9/20/2004	2	506%	<ul style="list-style-type: none"> • Management appropriately diversified the CRE portfolio among various industries and 75 percent of the portfolio was owner-occupied. • It was suggested that management monitor these industry concentrations as a percentage of Tier 1 Capital, rather than just outstanding loan balances.
3/20/2006	1	380%	<ul style="list-style-type: none"> • Concentrations of construction and development loans were high; however the portfolio was adequately diversified. • Management tracked CRE concentrations by industries on a quarterly basis and provided this report to the Board for review. • The Board was well-informed regarding asset concentrations. • Management should expand policies regarding credit concentrations to better define concentrations and reflect current reporting practices. In addition, management should ensure that the amended policies set limits relative to Tier 1 Capital and measurement of concentrations should include both funded and unfunded commitments.

Examination Date	Asset Quality Component Rating	CRE Concentration as a Percentage of Tier 1 Capital Plus the ALLL	Examiner Comment
10/22/2007	2	619%	<ul style="list-style-type: none"> Comprehensive CRE concentration reports had not been presented to the Board since the beginning of 2007. Concentration and default risk was generally mitigated through a diverse loan portfolio, guarantor support, and sufficient debt service coverage. Management should enhance concentration monitoring to fully comply with Joint Guidance issued on December 12, 2006. CRE Lending Guidance also requires that management perform portfolio-level stress tests, which management had yet to conduct. A repeat recommendation was made at this examination to include unfunded loan commitments in concentration reports.
12/8/2008	4	794%	<ul style="list-style-type: none"> The level of CRE exposure, in relation to the thresholds established in the Joint Guidance was deemed excessive. Measurement and monitoring of the bank's CRE exposure level was inadequate. A repeat recommendation from the previous examination to undertake portfolio-level stress testing was not implemented. If management had conducted stress testing of the CRE portfolio, the resulting analysis would likely have noted the bank held insufficient capital to adequately withstand a significant aggregate change in the underlying value of loan collateral and/or cash flow available to service many loans.

Source: ROEs for FSB.

During the 2007 Joint examination, examiners noted the following regarding the Asset Quality component:

- Adversely classified items increased from \$103,000 to \$1,811,000 at this examination.
- CRE climbed from 380 percent of Tier 1 Capital plus the ALLL during the 2006 Joint examination to 619 percent.
- Management failed to document its appraisal reviews on purchased credits.

- Management became aware that a specific credit had well-defined weaknesses. Management should have immediately reported the credit on the bank's Watch List, conducted an impairment analysis, and appropriately reflected the exposure in the ALLL methodology.
- Management should enhance concentration monitoring to fully comply with the Joint Guidance.
- A repeat recommendation is made again at this examination to support ALLL loss factors.

In relation to CRE concentrations, the Joint Guidance states the following:

An institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
- Total commercial real estate loans as defined in this Guidance represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

The Joint Guidance further states that "because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria do not constitute limits on an institution's lending activity but rather serve as high-level indicators to identify institutions potentially exposed to CRE concentration risk."

Through its examinations, it appears that examiners appropriately informed management of the need to monitor and report concentration levels as required by the Joint Guidance. However, the guidance specifically informs examiners that "the guidance is not intended to limit banks' CRE lending." Hence, as mentioned by examiners during interviews, no additional steps were taken to limit the excessive level of CRE concentrations that threatened the safety and soundness of FSB.

Loan Participations

The FDIC *Risk Management Manual of Examination Policies* (Examination Manual) indicates that examiners are responsible for evaluating and reporting the extent to which an institution assesses and mitigates third-party risk. This risk includes the reliance on another institution to properly underwrite and administer a loan in which an institution has a participation interest. The criteria for participation loans should be consistent with that for similar direct loans. Institutions that purchase participation loans (1) must make a thorough, independent evaluation of the transaction and the risks involved before committing any funds and (2) should apply the same standards of prudence, credit assessment, approval criteria and "in-house" limits that would be employed if the purchasing organization were originating the loan.

FSB's growth in purchased participation loans resulted in heightened supervisory concern during the October 2007 Joint examination. At the time, the loan participation portfolio consisted of 13 loans totaling \$12.9 million, and represented 111 percent of Tier 1 Capital plus the ALLL. Examiners made a number of observations for managing the participations portfolio. These included:

- Conduct ongoing due diligence on the originating institution;
- Monitor the economic conditions in the applicable markets; and
- Conduct sufficient ongoing credit monitoring to ensure loans are appropriately administered and risk graded.

According to examiners, these loan participations were part of the Shared National Credit (SNC) Program⁸ and therefore the grades assigned to these loans at the SNC Review remained in effect at the 2007 examination.

During the December 2008 Joint examination, regulators expressed increased concern regarding the loan participations, including:

- Loan participations represented 47 percent of total classified loans and 68 percent of loans classified Loss; and
- Approximately 80 percent of the ADC loan participations purchased from Marshall in 2006 and 2007 were non-performing.

Supervisory Response to Asset Quality Concerns. The Examination Manual defines an Asset Quality rating of "2" as "satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention." The number and extent of the issues identified by examiners during the October 2007 Joint examination regarding asset quality, the nature of recommendations in regard to the loan participations, and the high loan concentrations, appear to be in contrast with that definition. In that regard, DSC officials indicated that the "2" rating was supported by the fact that:

- Classifications represented only 15 percent of Tier 1 Capital plus the ALLL and one loan made up nearly \$900,000, or one-half, of the total adversely classified loans,
- collateral values were well-supported by new appraisals,
- credit underwriting and credit administration practices were deemed "overall" adequate,
- the ALLL was adequately funded, and
- non-current loans were at a low level.

Further, DSC officials explained that it was the examiners' view at the time that FSB's Chief Credit Officer and loan officer were strong and management appeared willing and able to

⁸ The SNC program was established in 1977 by the Board of Governors of the Federal Reserve System, the FDIC, and the Office of the Comptroller of the Currency to provide an efficient and consistent review and classification of any large syndicated loan. Today, the program covers any loan or loan commitment of at least \$20 million that is shared by three or more supervised institutions. The agencies' review is conducted annually, usually in May and June.

implement recommendations included in the examination report to enhance credit underwriting and credit administration.

Unfortunately, following the 2007 examination, management continued to increase the number of risky loans in its portfolio and did not implement all of the recommendations made at the 2007 examination. These actions, coupled with the deteriorating economy in the bank's market, led to a further decline in asset quality as discussed earlier in this report.

Supervisory Concerns and Response to FSB's Board and Management

Management Team

DSC's Supervisory History document noted that during the first three examinations, which were performed by the FRB and the AZ DFI prior to the bank's change in regulator to the FDIC in 2004, a senior official was found to be dominating bank strategies, policies, and operations.

From 2004 through 2007, when three onsite examinations were performed, no references were made in ROEs to a dominant figure at the bank. Examiners indicated that, during this time frame, the Board was comprised of individuals with varying business perspectives who were not unduly persuaded by one individual. However, the December 2008 Joint examination noted that a senior official had been involved with the majority of decisions that were impacting the overall condition of the bank at the time. Further, the DSC Supervisory History, in regard to this examination, noted that the affairs of the bank again were dominated by this senior official and a member of the Board.

Business and Risk Mitigation Strategies

At the 2004, 2005, and 2007 examinations, examiners did not criticize FSB's business operating plan. The 2007 Joint examination, however, made recommendations to address portfolio-level stress tests or sensitivity analysis in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital; and to develop contingency plans to reduce or mitigate concentrations in the event of adverse CRE market conditions.

During the 2008 Joint examination, examiners noted that FSB's business practice of originating and purchasing a high volume of CRE loans, including residential and commercial properties, was considered high risk. Management had not conducted stress tests as recommended in October of 2007. Examiners noted that supervision of the bank by the Board and management was deficient and that the majority of the bank's problems were a by-product of the high-risk business operating plan. Examiners recommended the supervisory action of a C&D including a provision on reducing CRE loan concentrations. However, by the time the C&D was instituted, the financial condition of the bank was extremely precarious.

Supervisory Response to Board and Management Concerns. With respect to business and risk mitigation strategies, recommendations associated with stress testing and reducing concentrations made in October of 2007 may have been more effective if the ROE had stipulated

them as requirements. Stronger supervisory actions may have helped prevent some of the financial deterioration of the institution if implemented at that time.

Supervisory Concerns and Response to FSB's Funding

At the March 2006 Joint examination, examiners noted that liquidity and funds management practices were satisfactory and that the non-core funding dependency ratio was minimal at 3.76 percent. At the October 2007 examination, examiners indicated that loan growth had outpaced deposit growth and as a result, management had increased their reliance on non-core deposits. The net non-core funding ratio was up to 36.67 percent. Examiners noted that management should enhance liquidity planning and monitoring given the bank's changing funding sources. In addition, examiners made recommendations to strengthen funds management procedures.

As of the December 2008 Joint examination, examiners noted that FSB maintained limited on-balance sheet liquidity and continued to rely upon FHLB borrowings, brokered deposits, and other non-core funding sources. These practices, together with eroding capital, deficient capital positions, and the anticipated enforcement action (the C&D issued subsequently in May 2009), threatened the sustainability of the bank's funding structure and ability to maintain adequate liquidity.

Supervisory Response to Funding Concerns. Based on the rapid increase in the bank's net non-core funding dependency between the 2006 and 2007 examinations, a stronger supervisory response may have been warranted at the 2007 examination. A stronger response may have included further criticism of management and a possible downgrade in the management component rating to reflect management's decision to fuel asset growth through non-core deposits and/or a supervisory action that required the bank to limit its reliance on non-core funding sources.

Effectiveness of Offsite Review of FSB

The 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. Offsite reviews must be completed and approved 3 ½ months after each Call Report date. This generally provides 45 days to complete the offsite reviews once Call Report data is finalized.

The system-generated Offsite Review List includes only institutions rated “1” and “2” that are either:

- Identified by the Statistical CAMELS Offsite Rating (SCOR) system as having a 35 percent or higher probability of downgrade to “3” or worse⁹, or
- Identified in the Growth Monitoring System (GMS) as having a growth percentile of 98 or 99¹⁰.

During the 2007 Joint examination, examiners noted that with management’s increasing reliance on borrowings and brokered deposits to fund loan growth, the bank’s cost of funds had steadily increased and totaled 3.75 percent as of June 30, 2007, up from 2.97 percent as of June 20, 2006. Examiners also noted that the bank maintained a significant concentration in CRE loans that represented 619.17 percent of Tier 1 Capital plus the ALLL as of September 30, 2007. Even though emerging risks such as reliance on non-core funding and high loan concentration levels were identified by the end of 2007, the Offsite Review List, which is triggered by data coming from the Call Report, did not identify these risks until March 2008.

The March 31, 2008 offsite review noted that earnings were negative. This was primarily due to high overhead expenses and increased provisions to the ALLL. The level of past due and nonaccrual loans had risen dramatically, primarily due to loans purchased from Marshall. The offsite review also indicated that the bank was in the process of finalizing a private capital offering to current shareholders to help absorb potential losses and shore up capital if needed.

The June 30, 2008 offsite review noted that the level of past due and nonaccrual loans continued to increase, primarily due to loan participations and CRE market deterioration. The bank’s previous expansion activities had negatively impacted earnings, and at this point, asset quality problems were hindering the bank’s ability to return to profitability. Examiners noted that the FDIC’s San Francisco Regional Office would continue to monitor the bank’s condition and that the next examination was scheduled for the second quarter of 2009 and would be accelerated if necessary.

The September 30, 2008 offsite review noted that, based on concerns related to deterioration noted in the bank’s second quarter Call Reports, the FDIC’s Phoenix Field Office conducted an on-site visitation to review the bank’s ADC portfolios during the fourth quarter. Given the deterioration noted in these portfolios, the visitation was converted to a full-scope examination during the pre-planning phase. Preliminary examination findings indicated that the bank had incorrectly filed its September 30, 2008 Call Report. If filed correctly, the bank’s PCA capital category would have been *Adequately Capitalized*. The offsite review report indicated that the bank needed to raise equity capital by \$3 million to return the bank to a PCA capital category of *Well Capitalized*.

⁹ SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.

¹⁰GMS is an offsite rating tool that identifies institutions experiencing rapid growth and/or having a funding structure highly dependent on non-core funding sources.

FSB had increasing risk indicators in 2007 with high concentration levels and asset growth, partially in the form of purchased loan participations, and an increased reliance on non-core funding to fuel this growth. However, the offsite review program was not triggered until 2008, when FSB's growth had already been realized and the condition of the bank had deteriorated significantly.

Implementation of PCA

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. 12 CFR Part 325 of the FDIC Rules and Regulations implements the PCA requirements of section 38 of the FDI Act by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions. However, capital levels turned out to be a lagging indicator of the institution's financial condition. Other factors, including earnings, asset quality, and management that were identified in earlier examinations, were better indicators that the bank's viability was in question.

Table 4 illustrates that FSB was considered *Well Capitalized* for PCA purposes until the 2008 Joint examination when the institution was already in serious jeopardy of failing.

Table 4: FSB's PCA Capitalization Categories

Examination as of Date	Capitalization Category	Informal or Formal Action Taken
6/30/2004	Well Capitalized	None
12/31/2005	Well Capitalized	None
6/30/2007	Well Capitalized	None
9/30/2008	Adequately Capitalized	Cease & Desist Order 5/01/2009
*	Significantly Undercapitalized	Institution Closed 9/04/2009

Source: ROEs for FSB and DSC Supervisory Documentation.

* Based on FDIC PCA Notification as of 6/30/2009 Call Report.

During the December 2008 Joint examination, examiners noted that due to the high level of additional provision expenses, FSB's adjusted Tier 1 Capital ratio and Total Risk-Based capital ratios were 7.4 percent and 8.7 percent respectively. The ROE noted that without a large capital injection prior to December 31, 2008, the bank's capitalization category would remain *Adequately Capitalized*. Examiners noted that due to the level of problem loans and nonaccrual assets, the possible migration of assets identified as substandard to more severe risk categories, and the implication of operating without a PCA category of *Well Capitalized*, the adjusted capital levels did not adequately support the bank's risk profile. The DSC Supervisory History indicated that at the conclusion of the examination, the Board initiated a sale of additional stock, which resulted in a capital injection of \$2.2 million into the bank. The capital position improved somewhat as a result of the capital injection; however, the bank remained *Adequately Capitalized* for PCA purposes.

The C&D, signed on May 1, 2009, ordered the bank to raise Tier 1 Capital by no less than \$2 million and to maintain Tier 1 Capital at such amount as to equal or exceed 10 percent of the bank's total assets within 120 days. The C&D also ordered, within 60 days from the effective date of the order, the development of a plan to meet and thereafter maintain the minimum risk-based capital requirement as described in Appendix A to 12 CFR Part 325 of the FDIC Rules and Regulations.

The FDIC issued a PCA notification to FSB on August 12, 2009, based on the analysis of the June 30, 2009 Call Report, and the examiners' determination that the bank fell within the *Significantly Undercapitalized* capital category. The key capital ratios in the notification were Total Risk-Based Capital Ratio of 5.72 percent, Tier 1 Risk-Based Capital Ratio of 4.46 percent and Tier 1 Leverage Ratio of 3.95 percent. The bank was then required to file a written capital restoration plan and provide a summary of the specific steps taken by management to comply with the mandatory restrictions required under section 38 within 45 days of receipt of the notification. Pursuant to the FDIC's regulations, this notification constituted written notice of FSB's capital category for purposes of the PCA provisions of section 38. The bank was unable to submit an adequate capital restoration plan and on September 4, 2009, the AZ DFI closed FSB due to its deteriorating asset quality, inadequate earnings and capital erosion, and named the FDIC as receiver.

Objectives, Scope, and Methodology

Objectives

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

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38. We evaluated whether capital was an adequate indicator of safety and soundness and the FDIC's compliance with PCA guidelines.

We conducted this performance audit from December 2009 to February 2010 in accordance with Generally Accepted Government Auditing Standards (GAGAS). 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, as described in the Scope and Methodology section, 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 FSB from April 2004, when the FDIC became the institution's primary Federal regulator, until its failure on September 4, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by FDIC and AZ DFI examiners from June 2004 to December 2008.
- Reviewed the following documentation:
 - Financial institution data and correspondence maintained at DSC's San Francisco Regional Office and Phoenix Field Office, as provided to KPMG by DSC.

Appendix 1

- Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.
- Pertinent DSC policies and procedures.
- Interviewed the relevant FDIC officials having supervisory responsibilities pertaining to FSB, which included DSC examination staff in the San Francisco Region.
- Interviewed appropriate officials from the AZ DFI to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.
- Researched various banking laws and regulations, including state laws.

KPMG relied primarily upon the materials provided by the FDIC OIG and DSC, including information and other data collected during interviews. KPMG did not perform specific audit procedures to ensure the information and data were complete and accurate. KPMG is, however, aware that Circular 12000.1, Cooperation with the Office of Inspector General, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the FDIC and the bank. KPMG relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

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, ROEs, and interviews of examiners to understand FSB'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

Appendix 1

information system controls. We relied on our analysis of information from various sources, including ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that were 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 OIG's 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 are discussed, where appropriate, in this report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Reports) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. 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.
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.

Appendix 2

Term	Definition
Participation Loans	A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. Loan participations allow selling banks to (1) accommodate large loan requests which would otherwise exceed lending limits, (2) diversify risk, and (3) improve liquidity.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 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 1831o, by establishing a framework for taking prompt corrective supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
Uniform Bank Performance Report (UBPR)	The UBPR is an 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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
AZ DFI	Arizona Department of Financial Institutions
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CFR	Code of Federal Regulations
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FRB	Federal Reserve Bank
FSB	First State Bank
GAGAS	Generally Accepted Government Auditing Standards
GMS	Growth Monitoring System
IRR	Interest Rate Risk
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PLLL	Provision for Loan and Lease Losses
ROAA	Return on Average Assets
ROE	Report of Examination
SCOR	Statistical CAMELS Offsite Rating
SNC	Shared National Credit
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

OIG Evaluation of Management Response

OIG Evaluation of Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 22, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of FSB's failure and the FDIC's supervision of the bank. DSC stated that FSB's Board and management were expected to identify and control the third-party risks arising from participatory relationships to the same extent as if the activity, such as lending, were handled within the institution. The FDIC issued a Financial Institution Letter on *Managing Third-Party Risks* in June 2008, which outlined the basic elements for effective third-party risk management. Moreover, the FDIC's *Summer 2007 Supervisory Insights* provided risk management procedures for performing due diligence specifically on purchased loan participations.

Corporation Comments



Federal Deposit Insurance Corporation

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

Division of Supervision and Consumer Protection

March 22, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: /Signed/
Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of First State Bank, Flagstaff, Arizona (Assignment 2010-009)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of First State Bank, Flagstaff, Arizona (FSB) which failed on September 4, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on March 4, 2010.

The Report concludes that FSB failed due to high commercial real estate (CRE) loan concentrations, particularly acquisition, development and construction (ADC) projects, risky loan participation purchases, weak management and Board Oversight, high overhead expenses, and asset growth funded by non-core sources. The Report indicates that FSB's strategy to pursue asset growth funded with non-core deposits, coupled with ineffective limits on the ADC concentrations and a failure to address supervisory concerns, created unacceptable levels of risk for FSB.

FDIC and Arizona Department of Financial Institutions examiners conducted four joint examinations from 2004 to 2008, after it converted to a state non-member bank. The Report states that through its supervisory activities, FDIC identified key risks in FSB's operations and brought them to the attention of bank management. While FSB maintained an elevated risk profile prior to 2007, its strategy to purchase out-of-territory participation ADC loans largely contributed to its failure. Review of the June 2008 Offsite Review List, which was completed in October 2008, indicated that FSB's past due and non-accrual loan levels had increased significantly. DSC scheduled an onsite visitation for December 2008; however, based upon the deterioration in FSB's overall condition, the visitation was converted to a full scope joint examination. Approximately 80 percent of the ADC loan participations were non-performing during the December 2008 examination, resulting in the issuance of a Cease and Desist order that became effective May 2009.

FSB's Board and management were expected to identify and control the third-party risks arising from participatory relationships to the same extent as if the activity, such as lending, were handled within the institution. FDIC issued a Financial Institution Letter on *Managing Third Party Risks* in June of 2008, which outlined the basic elements for effective third-party risk management. Moreover, FDIC's *Summer 2007 Supervisory Insights* provided risk management procedures for performing due diligence specifically on purchased loan participations.

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