Board of Governors of the Federal Reserve System

Material Loss Review of Community First Bank

Office of Inspector General

March 2010

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

March 12, 2010

The Honorable Daniel K. Tarullo
Chairman
Committee on Supervisory and Regulatory Affairs
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of Community First Bank (Community First). The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) is material—that is, it exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

- review the institution's supervision, including the agency's implementation of Prompt Corrective Action;
- ascertain why the institution's problems resulted in a material loss to the DIF; and
- make recommendations for preventing any such loss in the future.

Community First was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Oregon Division of Finance and Corporate Securities (State). The bank opened in 1980 and had as many as eight branches in central Oregon, including a lending office in Bend, Oregon. The State closed Community First on August 7, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On September 15, 2009, the FDIC Inspector General notified us that Community First's failure would result in an estimated loss to the DIF of $44.4 million, or 22 percent of the bank's total assets of $199.8 million.

Community First failed because its Board of Directors and management did not adequately control the risks associated with a high concentration in the construction and land development (CLD) loan component of the bank's commercial real estate (CRE) portfolio. The bank developed a high CLD concentration when the Bend, Oregon, real estate market was experiencing rapid growth and extraordinarily high price appreciation. A swift decline in the local real estate market—coupled with management's inadequate response to weakening market conditions—led to deteriorating asset quality and significant losses, particularly in the CLD portfolio. Mounting loan losses eliminated the bank's earnings, depleted capital, and eventually led to the bank's failure. Community First was closed by the State on August 7, 2009, and the FDIC was appointed as receiver.

With respect to supervision, FRB San Francisco complied with the frequency of safety and soundness examinations prescribed in regulatory guidance, and conducted off-site monitoring commensurate with concerns and risks identified during the examinations. During the period covered by our review, the State and FRB San Francisco (1) conducted seven examinations, a visitation, and an off-site assessment; and (2) executed two formal enforcement actions in the form of Written Agreements. Even though Community First's financial condition and asset quality improved from 2005 to 2007, examiners continued to cite the risks associated with the bank's high CRE and CLD concentrations. In response to 2008 regulatory reports that revealed deteriorating credit quality and weakening earnings, FRB San Francisco also (1) prepared internal Watch List reports, (2) conducted a joint off-site assessment of Community First's CAMELS ratings in August 2008, and (3) began a full scope examination one month later. Despite these supervisory actions, Community First subsequently failed.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted an earlier or alternative supervisory action. Accordingly, in our opinion, the magnitude of financial and market declines that examiners encountered leading up to and during the summer of 2008, when they conducted the off-site assessment and downgraded Community First's CAMELS composite rating to 3 (fair), offered an early opportunity to provide written notice urging the Board of Directors and management to begin raising capital to a level commensurate with the bank's deteriorating financial condition. Specifically, examiners noted the significant deterioration in (1) the local real estate market and (2) Community First's financial condition. Declining credit quality severely weakened earnings, and the bank reported a year-to-date loss in the second quarter of 2008. Examiners also reported that Community First's capital was considerably lower than its peer group and was not commensurate with the bank's risk profile. Finally, examiners found that bank management was not complying with its policy for obtaining appraisals when "obvious and material changes in market conditions are present or when real estate loans become past due, impaired, or otherwise internally classified." Examiners indicated that current appraisals were necessary to assess the soundness of loans that fit the criteria outlined in the bank's policy. However, in light of the rapid deterioration of the local real estate market, it is not possible to determine if an earlier or alternative supervisory action would have affected Community First's subsequent decline or the failure's cost to the DIF.

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad conclusions, we believe that the failure of Community First offers a valuable "lesson learned" that Federal Reserve examiners and managers may find useful in planning and conducting future examinations of banks with similar characteristics. Community First's failure illustrates that rapid growth of the CLD portfolio in real estate markets experiencing extraordinarily high price appreciation is an extremely risky strategy that significantly increases a bank's vulnerability to any subsequent market downturn and requires

(1) heightened supervisory attention, and (2) immediate supervisory action when signs of market deterioration or credit administration weaknesses first appear.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. Overall, the Director agreed with our conclusions and lesson learned. His response is included as Appendix 3.

We appreciate the cooperation that we received from FRB San Francisco and Board staff during our review. The principal contributors to this report are listed in Appendix 4. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

Elizabeth A. Coleman

Elizabeth A. Coleman
Inspector General

cc: Chairman Ben S. Bernanke
Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Governor Kevin M. Warsh
Mr. Stephen R. Malphrus
Mr. Patrick M. Parkinson
Mr. Stephen M. Hoffman

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Background

Community First Bank (Community First), headquartered in Prineville, Oregon, was a state member bank of the Federal Reserve System. Community First opened in 1980 and had as many as eight branches in central Oregon, including a lending office in Bend, Oregon, which was experiencing rapid growth. Community First was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Oregon Division of Finance and Corporate Securities (State).

The State closed Community First on August 7, 2009, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that the bank's failure would result in a $44.4 million loss to the Deposit Insurance Fund (DIF), or 22 percent of the bank's $199.8 million in total assets. In a letter dated September 15, 2009, the FDIC Inspector General advised us that the FDIC had determined that Community First's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

When a loss to the DIF is considered material, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency

- review the agency's supervision of the failed institution, including the agency's implementation of Prompt Corrective Action (PCA);
- ascertain why the institution's problems resulted in a material loss to the DIF; and
- make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected data from the Board in Washington, D.C.; FRB San Francisco; and the State. We also reviewed bank reports, correspondence, surveillance reports, enforcement actions, Reports of Examination (examination reports) issued between 2004 and 2009, and examination work papers prepared by FRB San Francisco. Appendixes at the end of this report contain a glossary that defines key banking and regulatory terms, and a description of the CAMELS rating system.[1] We conducted our fieldwork from September 2009 through December 2009, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

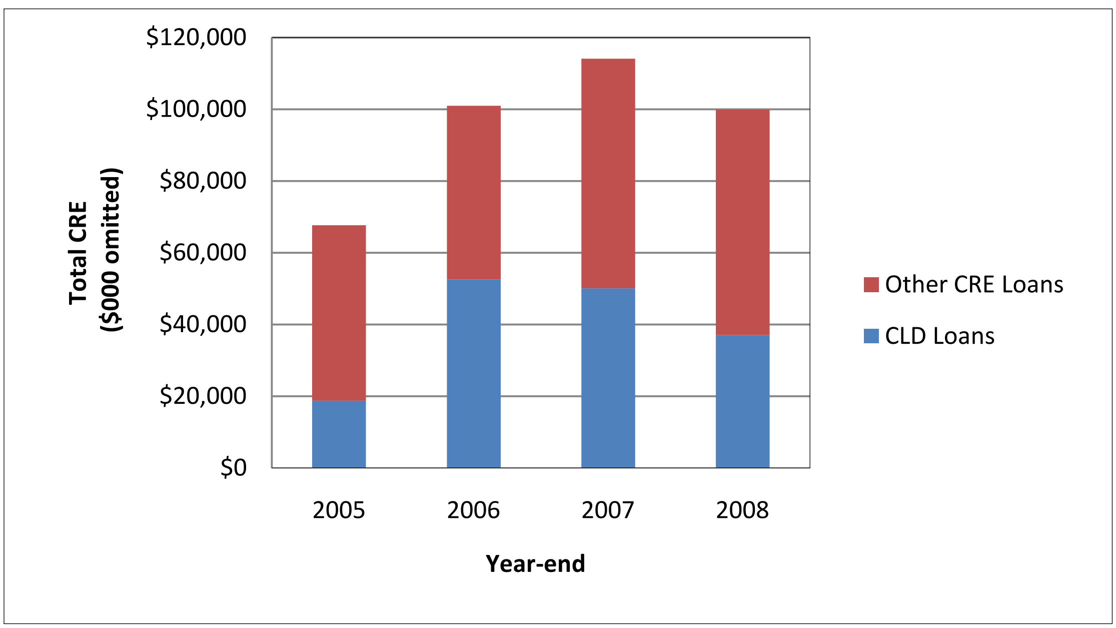
[1] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Cause of the Failure

Community First failed because its Board of Directors and management did not adequately control the risks associated with a high concentration in the construction and land development (CLD) loan component of the bank's commercial real estate (CRE) portfolio. The bank developed a high CLD concentration when the Bend, Oregon, real estate market was experiencing rapid growth and extraordinarily high price appreciation. A swift decline in the local real estate market—coupled with management's inadequate response to weakening market conditions—led to deteriorating asset quality and significant losses, particularly in the CLD portfolio. Mounting loan losses eliminated the bank's earnings, depleted capital, and eventually led to the bank's failure. Community First was closed by the State on August 7, 2009, and the FDIC was appointed as receiver.

Since 2002, Community First's loan portfolio featured significant growth and a high concentration in CRE that consistently exceeded 400 percent of total capital. In 2006, the bank began to transform the composition and risk profile of its CRE portfolio by significantly increasing CLD loans, which resulted in a high concentration of CLD loans. In commenting upon Community First's high level of CRE concentration, examiners highlighted CLD loans as the "more risky" CRE component. As shown in Chart 1, the bank's CLD loans almost tripled from \$18.7 million in 2005, to \$52.6 million in 2006. Community First funded its CLD loan portfolio growth with non-core funding, including brokered deposits, because core deposit growth had not kept pace with asset growth.[2]

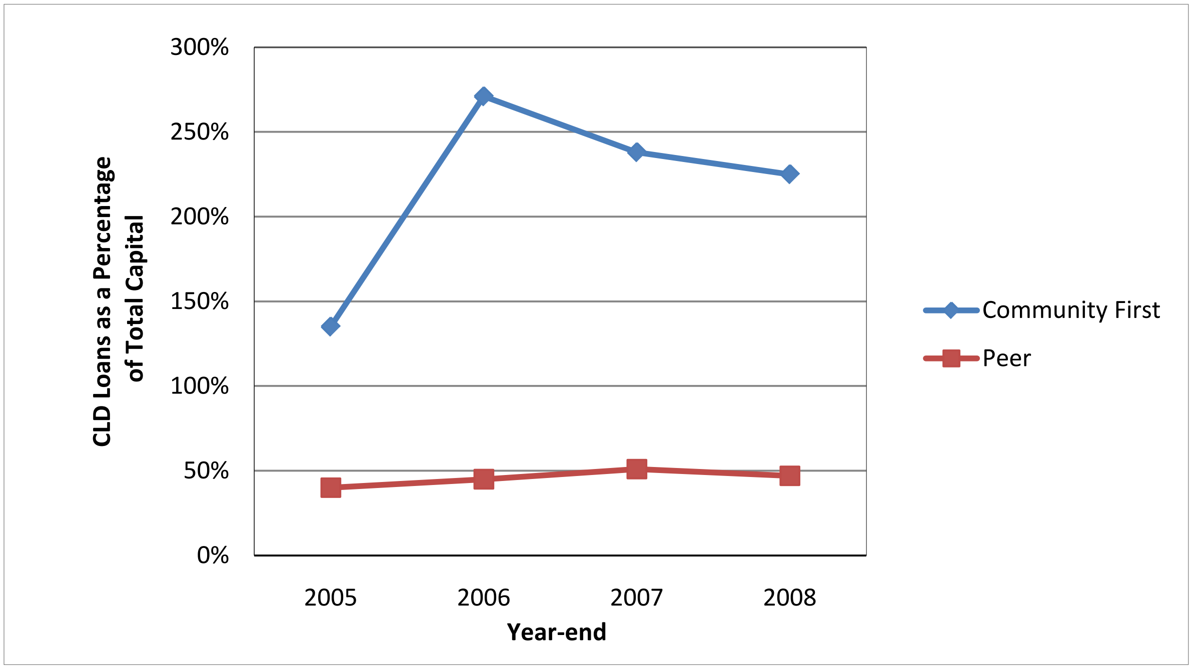
Chart 1: Growth in CLD Loans



[2] Brokered deposits can have a significant negative effect on liquidity because these funds may not be available in times of financial stress or adverse changes in market conditions. Although Community First's use of non-core funding was noted by examiners, liquidity was not a primary factor in Community First's failure.

As shown in Chart 2, the bank's CLD concentration as a percent of total capital doubled from 135 percent in 2005 to 271 percent in 2006. In addition, Community First's CLD loan concentration was significantly higher than its peers.[3] In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the inherent risks in individual loans.

Chart 2: Concentration in CLD Loans



Community First's asset quality declined significantly as the local real estate market deteriorated. As shown in Table 1, in 2006, the Bend, Oregon, Metropolitan Statistical Area was ranked first in the entire country for housing price appreciation (21.39 percent), but then fell to 250th place (-15.14 percent) by 2008.[4] In addition, the number of housing permits issued decreased 45 percent from 3,284 in 2006, to 1,785 in 2007, and dropped another 57 percent to 755 by 2008. Correspondingly, Community First's classified assets increased from $1.6 million in 2007, to $38.5 million in 2008.

[3] Peer group data included all insured commercial banks having assets between $100 million and $300 million in a non-metro area with three or more full service offices.

[4] Metropolitan Statistical Areas are geographic entities defined by the U.S. Office of Management and Budget for use by federal statistical agencies in collecting, tabulating, and publishing federal statistics.

Table 1: Selected Economic Data for Bend, Oregon

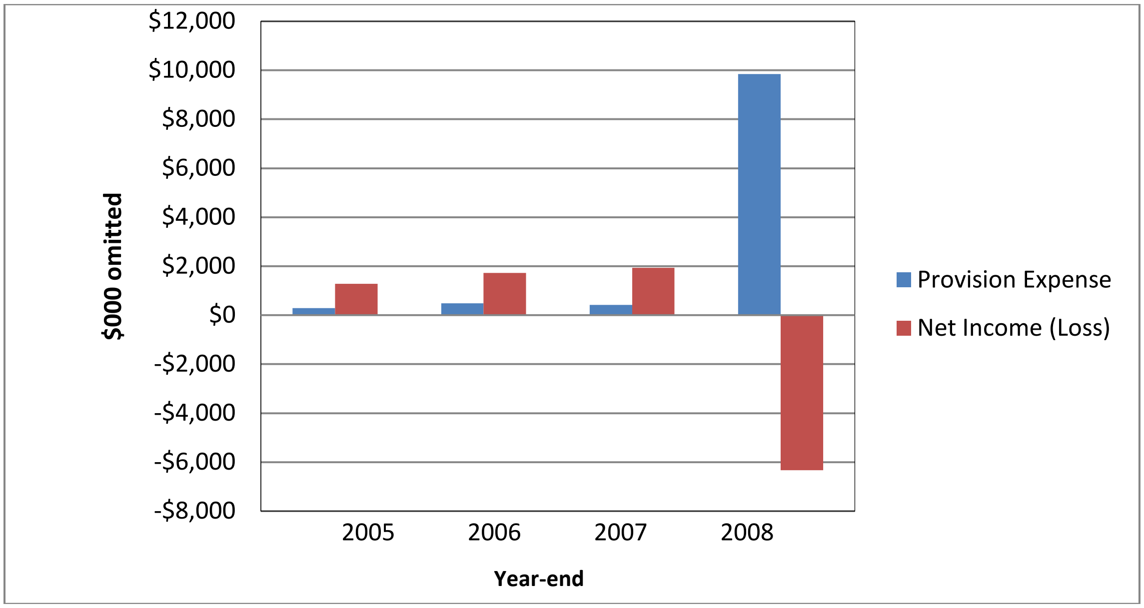
	2005	2006	2007	2008	2009[a]
Percentage change for past year in housing prices	29.34	21.39	-2.84	-15.14	-17.96
National ranking of Metropolitan Statistical Areas for price appreciation each year[b]	17	1	236	250	281
Total housing permits issued	4,461	3,284	1,785	755	204

[a] All 2009 data compiled through the second quarter
[b] The Federal Housing Finance Agency ranked 296 locations

Community First's Board of Directors and management failed to recognize the extent of the local real estate downturn, and were slow to respond as housing prices fell and construction projects stalled. In addition, management was unable to correct deficiencies or implement actions necessary to stabilize or improve the bank's condition. An examination initiated in September 2008 revealed that almost 20 percent of total CLD loans were either 90 days past due or in nonaccrual status.[5] According to examiners, management's response to the economic downturn was "relatively passive" and "not appropriate" for a bank with a high CLD concentration.

The growth in classified assets prompted corresponding increases in Community First's allowance for loan and lease losses and loan loss provision expense (provision). As shown in Chart 3, the provision totaled $420,000 in 2007. By the end of the following year, the provision increased 2,223 percent to $9.8 million, contributing to the bank's 2008 net loss of $6.3 million. The loss significantly reduced Community First's retained earnings and capital.

Chart 3: Provision Expense Compared to Earnings



[5] Nonaccrual status means loans with overdue interest payments and uncertainty regarding collection of principal. The loan's interest cannot be credited to the bank's revenue account until it has actually been received.

Community First's deteriorating capital position invoked the PCA provisions of the FDI Act. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled depository institutions. FRB San Francisco implemented PCA and made timely notifications when the bank reached various PCA capital categories. On December 2, 2008, FRB San Francisco notified Community First that the bank's capital position had declined to *adequately capitalized* as a result of the bank's third quarter 2008 regulatory report. The notification letter also advised the bank that it was prohibited from accepting, renewing, or rolling over any brokered deposits unless a waiver was granted by the FDIC.

Five months later, on May 14, 2009, FRB San Francisco notified Community First that its capital level had fallen to the *undercapitalized* PCA category. In June 2009, FRB San Francisco notified Community First that its capital level had dropped to *significantly undercapitalized*. On June 16, 2009, the State issued a letter requiring Community First to develop and implement, within 30 days, a plan for being "acquired by another qualified banking institution." A subsequent asset quality target examination report prompted a July 2009 notification that the bank had reached the *critically undercapitalized* PCA category. The State of Oregon closed Community First Bank on August 7, 2009, and named the FDIC as receiver after the bank filed a regulatory report that revealed that the bank was insolvent.

Supervision of Community First Bank

During the five-year period preceding Community First's failure in 2009, FRB San Francisco and the State (1) conducted seven examinations, an on-site visitation, and an off-site assessment; and (2) executed formal enforcement actions in the form of Written Agreements in 2004 and 2009. As shown in Table 2, the bank's safety and soundness through 2005 was rated a CAMELS composite 3 (fair). The bank was upgraded to a CAMELS composite 2 (satisfactory) rating in 2006, and the 2004 Written Agreement was lifted. A 2007 State examination not only assigned a CAMELS composite 2 rating, but also raised Community First's asset quality component rating to a 1 (strong).

FRB San Francisco and the State began an off-site supervisory assessment of Community First's CAMELS rating in August 2008, after regulatory reports filed for the first two quarters of 2008 revealed that the bank's financial condition had deteriorated. Examiners downgraded Community First to a CAMELS composite 3 rating and began a full scope examination in September 2008. The full scope examination resulted in a double downgrade to a CAMELS composite 5 rating, which indicates that failure is highly probable. A Written Agreement was executed in April 2009, and a target examination, also begun in April 2009, resulted in another CAMELS composite 5 rating.

Table 2: Supervisory Overview of Community First Bank

Examination			Agency Conducting the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
05/03/2004	08/20/2004	Full Scope	Joint FRB San Francisco – State	3	3	3	4	3	2	3	Written Agreement
02/28/2005	04/22/2005[a]	Written Agreement Compliance Target	Joint FRB San Francisco – State	n/a							
06/27/2005	09/06/2005	Full Scope	Joint FRB San Francisco – State	3	3	2	2	3	2	2	
03/20/2006	06/02/2006	Full Scope	Joint FRB San Francisco – State	2	2	2	2	2	2	2	
09/07/2006	n/a[b]	Visitation	FRB San Francisco	n/a							Written Agreement lifted 10/18/2006
08/07/2007	09/21/2007	Full Scope	State	2	2	1	2	2	2	2	
08/20/2008	09/08/2008	Off-site Assessment	Joint FRB San Francisco – State	3	3	3	2	3	3	2	
09/29/2008	01/22/2009	Full Scope	Joint FRB San Francisco – State	5	4	5	5	5	4	3	Written Agreement
04/13/2009	07/06/2009[c]	Target	Joint FRB San Francisco – State	5	5	5	5	5	5	4	

[a] The target examination was for compliance with the Written Agreement.

[b] The visitation was conducted to test and verify compliance with a Written Agreement provision covering "loan-to-value" exception reporting.

[c] The target examination focused on asset quality, overall financial condition, liquidity, contingency planning, and progress achieved for correcting previous examination findings.

Supervision History from 2004 through 2005

In May 2004, FRB San Francisco and the State began a full scope examination that resulted in a CAMELS composite 3 rating, with the management component rated a 4. The examination report, issued in August 2004, found that financial information presented in a March 31, 2004, regulatory report was unreliable and that internal controls over financial reporting had deteriorated. Examiners attributed Community First's weaknesses to a poorly executed January 2004 information technology system conversion.

As a result of the May 2004 examination, a Written Agreement was executed in December 2004, requiring the Board of Directors to submit a written plan to strengthen board oversight of bank management and operations. Community First was also required to submit written plans to address a variety of issues, including internal audit, information technology, business continuity, loan policies and procedures, asset/liability management policies and procedures, and internal loan review.

In February 2005, FRB San Francisco and the State conducted a joint target examination to evaluate the Board of Directors' and management's progress in complying with the Written Agreement. The target examination report issued in April 2005 stated that the bank was making satisfactory progress in complying with the Written Agreement provisions and in addressing concerns identified in the 2004 full scope examination. For example, the bank had (1) developed a five-year strategic plan and budget that addressed growth and earnings improvement, (2) strengthened information security controls, (3) updated its business continuity plan, (4) revised its loan policy, and (5) contracted with a consultant to perform semiannual loan reviews. Examiners stated that a complete assessment would be conducted at the next full scope examination.

FRB San Francisco and the State began a full scope examination in June 2005 that resulted in another CAMELS composite 3 rating. CAMELS component ratings for asset quality, management, and sensitivity to market risk each were upgraded to 2. Examiners noted that the overall condition of Community First had improved since the last examination. Oversight and direction provided by the Board of Directors was deemed "adequate," and examiners concluded that the bank was in substantial compliance with the Written Agreement and that risk management policies and practices had "improved materially." Examiners stated that Community First's CRE lending activities represented a significant part of Community First's credit operations and labeled the potential risk exposure as "noteworthy," but added that they were mitigated by, among other things, adequate control procedures. While Community First's loan quality was deemed satisfactory, examiners identified certain credit administration practices that required management's attention.

March 2006 Full Scope Examination Resulted in an Upgrade to a CAMELS Composite 2 Rating

In March 2006, FRB San Francisco and the State began a joint full scope examination, and the June 2006 examination report upgraded Community First to a CAMELS composite 2 rating, with each component rated a 2. According to examiners, the bank's satisfactory condition was the result of the Board of Directors' and management's efforts to improve the bank's financial condition and address prior examination findings related to risk management. Examiners noted that the bank was in full compliance with all but one provision in the Written Agreement regarding loan-to-value limit exceptions reported to the Board of Directors.

Examiners concluded that asset quality was satisfactory and appeared stable because local real estate markets continued to "perform well." Examiners noted that the bank's asset mix was changing from lower yielding one-to-four family residential loans to higher yielding CRE loans. The examination report indicated that CLD loans served to increase the risk profile of the CRE portfolio. According to examiners, CRE risk was mitigated by (1) sufficient diversification within the portfolio, (2) generally conservative underwriting standards, and (3) adequate control procedures. Nevertheless, examiners noted credit administration deficiencies and recommended that the bank make improvements to, among other things, internal loan underwriting, collateral valuation processes, and loan approval documentation.

September 2006 Visitation Focused on the Last Open Item from the 2004 Written Agreement

FRB San Francisco conducted a visitation in September 2006 to follow up on the last outstanding item from the 2004 Written Agreement, which, as noted above, pertained to the process for identifying and reporting loan-to-value limit exceptions to the Board of Directors. Examiners conducted a detailed analysis, which included reviewing reports that identified loans exceeding loan-to-value limits and testing a sample of CRE loans originated in 2006. A September 2006 internal memorandum documenting the visitation concluded that (1) bank management had sufficiently upgraded the processes for reporting loan-to-value limit exceptions, and (2) Community First was in full compliance with the Written Agreement. The Written Agreement was terminated in October 2006.

August 2007 State Examination Resulted in a CAMELS Composite 2 Rating

In August 2007, the State began a full scope examination of Community First, which resulted in a CAMELS composite 2 rating. Examiners noted that bank management made “noticeable” progress in improving the bank’s overall financial condition. Asset quality was upgraded from 2 to 1 because of a decline in classified and delinquent loans. Credit administration and lending practices were labeled as sound, and examiners stated that the Board of Directors and management were providing “satisfactory oversight, direction, and control of the bank.” However, examiners expressed concern over Community First’s significant CRE concentration in “a market that shows signs of weakening.”

August 2008 Joint Off-Site Assessment Resulted in a Downgrade to a CAMELS Composite 3 Rating

FRB San Francisco put Community First on an internal Watch List in May 2008 after the bank’s first quarter 2008 regulatory report revealed a decline in asset quality and earnings.[6] The Watch List noted weakening in the Central Oregon economy and housing market and stated that the bulk of the bank’s problem loans were concentrated in the CLD component of the CRE portfolio. Examiners held a number of discussions with bank management in May 2008 and scheduled an asset quality target examination for September 2008. Subsequently, the second quarter 2008 regulatory report showed that Community First’s earnings were severely weakened by the bank’s deteriorating credit quality.

The bank’s declining financial condition prompted FRB San Francisco and the State to begin a joint off-site assessment in August 2008 that included an on-site meeting with bank management. In a September 2008 letter to Community First’s Board of Directors, examiners stated that they had reduced the bank’s CAMELS composite rating to 3. Component ratings for asset quality, earnings, liquidity, and capital were each also downgraded to 3. According to examiners, management was not complying with bank policies related to obtaining appraisals when “obvious and material changes in market conditions are present or when real estate loans become past due, impaired, or otherwise internally classified.” In addition, examiners cautioned that

[6] State member banks are required to report financial data “as of” the close of business on the last calendar day of each calendar quarter. The data must be submitted no more than 30 calendar days after the report date.

capital levels did not fully support the bank's risk profile and were "considerably below peer." The letter also cited significant deterioration in the local real estate market and noted that Community First was "particularly exposed" to CLD loans, which constituted 33 percent of the bank's total loan portfolio. Based on the assessment results, FRB San Francisco and the State decided to begin a full scope examination in September 2008 rather than the planned target examination.

September 2008 Full Scope Examination Resulted in a Double Downgrade to a CAMELS Composite 5 Rating

In September 2008, FRB San Francisco and the State began a full scope examination of Community First that resulted in a double downgrade to a CAMELS composite 5 rating. Banks in this group exhibit extremely unsafe and unsound practices or conditions and pose a significant risk to the DIF because failure is highly probable. The examination report, which was issued in January 2009, stated that immediate outside financial or other assistance was needed for the bank to be viable.

The examination report noted that Community First's financial condition had deteriorated rapidly and that (1) the bank's capital was deficient; and (2) asset quality, earnings, and management were critically deficient. Examiners expressed concern over Community First's concentration in CLD loans because the concentration was five times higher than the average level seen in the bank's peer group. In addition, examiners noted that almost 20 percent of total CLD loans were either 90 days past due or in nonaccrual status. Community First's risk grading process was cited as "unreliable," and examiners criticized management for not obtaining appraisals on real estate collateral as required by regulation.

Examiners stated that management had been slow to respond to deteriorating real estate market conditions and was unaware of the extent that the bank's asset quality and financial condition had deteriorated until examination findings were brought forward. According to examiners, the Board of Directors and management failed to recognize and take appropriate action as the real estate market slowed, housing prices fell, and construction projects stalled. Examiners concluded that management's response to the economic downturn had been passive and not appropriate for a bank with a high CLD concentration.

Written Agreement Executed in April 2009

In response to Community First's troubled condition and as a result of the September 2008 full scope examination, a Written Agreement was executed in April 2009. It required the Board of Directors to address, within 60 days, a variety of issues, including credit risk management, credit administration, loan review, real estate appraisal, asset improvement, and liquidity. The Board of Directors also was required to (1) submit a written plan to strengthen the Board of Directors' oversight of management and operations of the bank, and (2) conduct an analysis and assessment of bank management and staffing needs.

April 2009 Target Examination Resulted in Another CAMELS Composite 5 Rating

FRB San Francisco and the State began a joint target examination in April 2009 that, among other things, focused on Community First's overall financial condition and progress made in correcting prior examination findings. The July 6, 2009, target examination report resulted in another CAMELS composite 5 rating. Examiners noted further weakening in the bank's already critically deficient asset quality, "strained earnings," and "extreme levels of operating losses." As a result, examiners required the bank to charge off $5.3 million in deferred tax assets after determining that these assets were not "bankable."[7] According to examiners, continued projected losses and questions over Community First's future viability raised concerns that the bank's deferred tax assets could not be realized. The examination report warned that impending charge-offs would render the bank insolvent without an immediate and substantial infusion of capital. The State of Oregon closed Community First Bank on August 7, 2009, and named the FDIC as receiver after the bank filed a regulatory report revealing that the bank was insolvent.

Conclusions and Lesson Learned

Community First failed because its Board of Directors and management did not adequately control the risk associated with a high concentration in the CLD loan component of the bank's CRE portfolio. The bank developed a high CLD concentration when the Bend, Oregon, real estate market was experiencing rapid growth and extraordinarily high price appreciation. A swift decline in the local real estate market—coupled with management's inadequate response to weakening market conditions—led to deteriorating asset quality and significant losses, particularly in the CLD portfolio. Mounting loan losses eliminated the bank's earnings, depleted capital, and eventually led to the bank's failure. Community First was closed by the State on August 7, 2009, and the FDIC was appointed as receiver.

With respect to supervision, FRB San Francisco complied with the frequency of safety and soundness examinations prescribed in regulatory guidance, and conducted off-site monitoring commensurate with concerns and risk identified during the examinations. During the period covered by our review, the State and FRB San Francisco (1) conducted seven examinations, a visitation, and an off-site assessment, and (2) executed two formal enforcement actions in the form of Written Agreements. Even though Community First's financial condition and asset quality improved from 2005 to 2007, examiners continued to cite the risks associated with the bank's high CRE and CLD concentrations. In response to 2008 regulatory reports that revealed deteriorating credit quality and weakening earnings, FRB San Francisco also (1) conducted a joint off-site assessment of Community First's CAMELS ratings in August 2008, and (2) began a full scope examination one month later. Despite these supervisory actions, Community First subsequently failed.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted an earlier or alternative supervisory action. Accordingly, in our opinion, the magnitude of financial and

[7] A deferred tax asset is an asset that is used to reduce the amount of tax that a company will have to pay in a later tax period. It is often associated with a loss carryover and is used as a future write-off if the next tax period is expected to produce positive earnings.

market declines that examiners encountered leading up to and during the summer of 2008, when they conducted the off-site assessment and downgraded Community First's CAMELS composite rating to 3, offered an early opportunity to provide written notice urging the Board of Directors and management to begin raising capital to a level commensurate with the bank's deteriorating financial condition. Specifically, FRB San Francisco's Watch List reports and the letter sent to the bank's Board of Directors communicating the off-site assessment results noted significant deterioration in (1) the local real estate market and (2) Community First's financial condition. Declining credit quality resulted in severely weakened earnings, and the bank reported a year-to-date loss in the second quarter of 2008. Examiners noted that Community First's capital was considerably lower than its peer group and was not commensurate with the bank's risk profile. Finally, examiners found that bank management was not complying with its policy for obtaining appraisals when "obvious and material changes in market conditions are present or when real estate loans become past due, impaired, or otherwise internally classified." Examiners indicated that current appraisals were necessary to assess the soundness of loans that fit the criteria outlined in the bank's policy. However, in light of the rapid deterioration of the local real estate market, it is not possible to determine if an earlier or alternative supervisory action would have affected Community First's subsequent decline or the failure's cost to the DIF.

Lesson Learned

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad conclusions, we believe that the failure of Community First offers a valuable lesson learned that Federal Reserve examiners and managers may find useful in planning and conducting future examinations of banks with similar characteristics. Community First's failure illustrates that rapid growth of the CLD portfolio in real estate markets experiencing extraordinarily high price appreciation is an extremely risky strategy that significantly increases a bank's vulnerability to any subsequent market downturn and requires (1) heightened supervisory attention, and (2) immediate supervisory action when signs of market deterioration or credit administration weaknesses first appear.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. In his response, included as Appendix 3, the Director concurred with the report's conclusions and lesson learned. He noted that in August 2008, FRB San Francisco appropriately downgraded the bank based on off-site information when financial deterioration emerged, and immediately accelerated the next full scope examination to the following month. He agreed that the magnitude of financial and market declines leading up to and during the summer of 2008, when the bank's rating was downgraded based on off-site information, provided an earlier opportunity for FRB San Francisco to provide written notice urging the bank's Board of Directors and management to immediately commence capital raising efforts.

The Director commented that our report highlighted an important lesson learned. Specifically, he stated that rapid growth of the CLD portfolio in real estate markets experiencing extraordinarily high price appreciation is an extremely risky strategy that significantly increases a bank's vulnerability to any subsequent market downturn and requires (1) heightened supervisory attention; and (2) immediate supervisory action when signs of market deterioration or credit administration weaknesses first appear. The Director welcomed the report's observations and contribution to understanding the reasons for Community First's failure. He noted that the events described in the report are a vivid reminder to all supervisors of the dangers of high concentrations in risky assets that are subject to dramatic and swift market swings that may ultimately be beyond the bank's ability to overcome.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
The ALLL is a valuation reserve established and maintained by charges against the financial institution's operating income. As a valuation reserve, it 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. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.

Classified Assets
Classified assets are loans that exhibit well-defined weaknesses and a distinct possibility of loss. The term "classified" is divided into more specific subcategories ranging from least to most severe: "substandard," "doubtful," and "loss." An asset classified as "substandard" is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. An asset classified as "doubtful" has all the weaknesses inherent in one classified as "substandard," with the added characteristic that the weaknesses make full collection or liquidation highly questionable and improbable. An asset classified as "loss" is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE) Loans
CRE loans are land development and construction loans (including one-to-four family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm, nonresidential property where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Concentration
A concentration is a significantly large amount of credit, assets, or other obligations, with similar risk characteristics that a financial institution has committed to a particular area, industry, person, or group. These assets are similarly affected by adverse economic, financial, or business conditions, and in the aggregate, may pose a risk to the institution.

Construction and Land Development (CLD) Loans
CLD loans are the subset of commercial real estate loans that provide funding for acquiring and developing land for future development and/or construction and provide interim financing for residential or commercial structures.

Deferred Tax Asset
A deferred tax asset is an asset that is used to reduce the amount of tax that a company will have to pay in a later tax period. It is often associated with a loss carryover and is used as a future write-off if the next tax period is expected to produce positive earnings.

Appendix 1 (continued)

Enforcement Actions
The Federal Reserve Board has a broad range of enforcement powers that include formal or informal enforcement actions that may be taken, typically after the completion of an on-site bank examination. Formal enforcement actions consist of Cease-and-Desist Orders, Written Agreements, and PCA Directives, while informal enforcement actions include Commitments, Board Resolutions, and Memoranda of Understanding.

Liquidity
Liquidity is the ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

Prompt Corrective Action (PCA)
PCA is a framework of supervisory actions, set forth in 12 U.S.C. 1831o, for insured depository institutions whose capital positions have declined below certain threshold levels. It was intended to ensure that action is taken when an institution becomes financially troubled, in order to resolve the problems of the institution at the least possible long-term loss to the DIF. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

Underwriting
Underwriting is part of a bank's lending policies and procedures that enable the bank's lending staff to evaluate all relevant credit factors. These factors include the capacity of the borrower or income from the underlying property to adequately service the debt; the market value of the underlying real estate collateral; the overall creditworthiness of the borrower; the level of the borrower's equity invested in the property; any secondary sources of repayment; and any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

Written Agreement
A Written Agreement is a formal, legally enforceable, and publicly available enforcement action to correct practices that are believed to be unlawful, unsafe, or unsound. All Written Agreements must be approved by the Board's Director of the Division of Banking Supervision and Regulation and the Board's General Counsel.

Appendix 2 – CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These components address the adequacy of *capital*, the quality of *assets*, the capability of *management*, the quality and level of *earnings*, the adequacy of *liquidity*, and the *sensitivity* to market risk (CAMELS). Evaluation of the components takes into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definition

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the Board of Directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences, such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institutions' size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For financial institutions to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the Board of Directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institutions' size, complexity, and risk profile. There are no material supervisory concerns; and, as a result, the supervisory response is informal and limited.

Appendix 2 (continued)

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institutions' size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the Board of Directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the DIF. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institutions' size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institutions to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the DIF, and failure is highly probable.

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: March 9, 2010

To: Elizabeth A. Coleman, Inspector General

From: Patrick M. Parkinson, Director ***/signed/***

Subject: Draft "Material Loss Review of Community First Bank"

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Community First Bank (Community First), Prineville, Oregon that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report states that Community First failed because its Board of Directors and management did not adequately control the risk associated with a high concentration in construction and land development (CLD) loans. Additionally, the bank's Board of Directors and management failed to recognize the extent of the local real estate downturn and were slow to respond as housing prices fell and construction projects stalled. The bank was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco) under delegated authority from the Board.

We concur with the conclusions and lesson learned contained in the report. As noted in the report, FRB San Francisco complied with the frequency of safety and soundness examinations prescribed in regulatory guidance, and conducted off-site monitoring commensurate with concerns and risk identified during the examinations. In August, 2008, FRB San Francisco appropriately downgraded the bank based on off-site information when financial deterioration emerged, and immediately accelerated the next full scope examination to the following month. We also concur that the magnitude of financial and market declines leading up to and during the summer of 2008, when the bank's rating was downgraded based on offsite information, provided an earlier opportunity for FRB San Francisco to provide written notice urging the bank's Board of Directors and management to immediately commence capital raising efforts. Whether such efforts would have been successful cannot be known, but the prospects are generally more favorable before severe deterioration is evident. The report illustrates an important lesson learned in that rapid growth of the CLD portfolio in real estate markets experiencing extraordinarily high price appreciation is an extremely risky strategy that significantly increases a bank's vulnerability to any subsequent market downturn and requires (1) heightened supervisory attention; and (2) immediate supervisory action when signs of market deterioration or credit administration weaknesses first appear.

Board staff very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for Community First's failure. The events described in the report are a vivid reminder to all supervisors of the dangers of high concentrations in risky assets that are subject to dramatic and swift market swings that may ultimately be beyond the bank's ability to overcome.

Appendix 4 – Principal Contributors to this Report

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