



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

OFFICE OF INSPECTOR GENERAL

May 18, 2012

Mr. Michael S. Gibson  
Director, Division of Banking Supervision and Regulation  
Board of Governors of the Federal Reserve System  
Washington, D.C. 20551

Dear Mr. Gibson:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act, 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Office of Inspector General of the Board of Governors of the Federal Reserve System (Federal Reserve Board) conducted a material loss review of Community Banks of Colorado (CBC). Under section 38(k) of the Federal Deposit Insurance Act, as amended, a material loss to the Deposit Insurance Fund (DIF) is defined as an estimated loss in excess of \$200 million. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. The Federal Deposit Insurance Act requires that we

- ascertain why the institution's problems resulted in a material loss to the DIF
- review the agency's supervision of the failed institution, including the agency's implementation of prompt corrective action
- make recommendations for preventing any such loss in the future

CBC was supervised by the Federal Reserve Bank of Kansas City (FRB Kansas City), under delegated authority from the Federal Reserve Board, and by the Colorado Division of Banking. The Federal Reserve Board appointed the Federal Deposit Insurance Corporation (FDIC) as receiver for CBC on October 21, 2011. On November 18, 2011, the FDIC Office of Inspector General notified our office that CBC's failure would result in a \$225 million loss to the DIF, or 17.3 percent of the bank's \$1.3 billion in total assets at closing. This material loss required a review by our office.

CBC failed because its board of directors and management did not adequately control the risks associated with the bank's growth strategy. The bank expanded within Colorado by merging with multiple banks and establishing new branch locations from 2003 to 2007. This strategy significantly increased the bank's commercial real estate (CRE) lending activities, particularly in construction, land, and land development loans. The board of directors' and

management's failure to effectively manage CBC's CRE credit risk, coupled with weakening real estate markets, led to asset quality deterioration. Mounting losses depleted earnings and eroded capital, which prompted the Federal Reserve Board to appoint the FDIC as receiver on October 21, 2011.

With respect to supervision, FRB Kansas City complied with the examination frequency guidelines for the time frame we reviewed, 2007 through 2011, and conducted regular off-site monitoring. Our analysis of FRB Kansas City's supervision of CBC revealed that FRB Kansas City identified the bank's heightened credit risk and its potential threat to capital but should have taken earlier supervisory action to address those issues. Specifically, we believe that during the November 2007 examination

- FRB Kansas City should have closely scrutinized CBC's risk management practices and its credit risk exposure due to CBC's elevated credit concentration, Colorado's declining real estate market conditions, and examiners' acknowledgement of the risks to CBC's capital. In addition, FRB Kansas City should have assessed the bank's asset quality using a forward-looking examination approach that considered potential risks to CBC's overall financial condition in a declining economy, as well as the current condition of the bank's asset quality. We believe that such an approach would have resulted in a component downgrade for the bank's asset quality. In our opinion, FRB Kansas City's triple downgrade for CBC's asset quality component assigned during the October 2008 examination supports that more aggressive action during the November 2007 examination was needed.
- FRB Kansas City should have strongly encouraged CBC to raise additional capital commensurate with the bank's credit risk exposure. FRB Kansas City officials noted to us, in hindsight, the need for additional capital to mitigate CBC's increasing credit risk. In our opinion, the bank's window of opportunity to raise additional capital closed after the November 2007 examination.

We also believe that the November 2009 full-scope examination provided an opportunity for stronger supervisory action. In our opinion, FRB Kansas City should have downgraded the management component rating to 5 and considered the need for an independent assessment of CBC management's qualifications and the need for additional managerial resources. In our opinion, the examination report showed that management (1) failed to comply with the written agreement, (2) created an unacceptable capital plan that lacked realistic loan loss projections or firm commitments for new capital, (3) failed to demonstrate the ability to resolve problems or fully implement effective risk management practices, and (4) failed to create a culture that encouraged problem loan recognition.

In our opinion, when FRB Kansas City approved a February 2010 application from CBC's bank holding company to merge an affiliated state member bank, Community Banks of Northern California, into CBC, FRB Kansas City appropriately analyzed the effect of the proposed merger and made a reasonable decision to allow the merger, which afforded the bank holding company additional time to attempt to raise capital.

While we believe that FRB Kansas City had opportunities for earlier supervisory responses, we cannot predict the effectiveness or outcome of any measures that might have been taken. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected CBC's financial deterioration or the ultimate cost to the DIF.

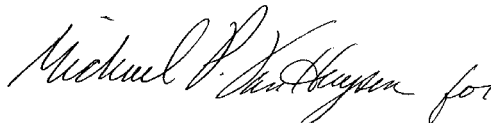
We believe that CBC's failure offers lessons learned that can be applied to those who supervise banks with similar characteristics and circumstances. CBC's failure illustrates (1) a bank's vulnerability to changes in real estate markets when the bank's strategy features a high concentration in CRE loans, (2) the importance of a bank timely implementing a robust credit risk management program designed to facilitate the identification and management of concentrations, and (3) the importance of a forward-looking examination approach that assesses various risk factors that could affect a bank's condition.

We provided a draft of our report to the Federal Reserve Board's Division of Banking Supervision and Regulation for review and comment. The Division Director stated that Banking Supervision and Regulation staff concurred with the conclusions and lessons learned in the report. His response is included as appendix 3.

We appreciate the cooperation that we received from FRB Kansas City and Federal Reserve Board staff during our review. The principal contributors to this report are listed in appendix 4.

This report will be added to our public website 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,

A handwritten signature in cursive script, appearing to read "Michael P. Castaldo for".

Anthony J. Castaldo  
Associate Inspector General  
for Inspections and Evaluations

cc: Chairman Ben S. Bernanke  
Vice Chair Janet L. Yellen  
Governor Daniel K. Tarullo  
Governor Elizabeth A. Duke  
Governor Sarah Bloom Raskin  
Mr. Kevin L. Moore



# Office of Inspector General

## Material Loss Review of Community Banks of Colorado



**Board of Governors of the Federal Reserve System**

May 2012



## Abbreviations

ALLL	Allowance for Loan and Lease Losses
California DFI	California State Department of Financial Institutions
CBC	Community Banks of Colorado
CBNC	Community Banks of Northern California
CLD	Construction, Land, and Land Development
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
FDI Act	Federal Deposit Insurance Act, as amended
FDIC	Federal Deposit Insurance Corporation
Federal Reserve Board	Board of Governors of the Federal Reserve System
FRB Kansas City	Federal Reserve Bank of Kansas City
OIG	Office of Inspector General
PCA	Prompt Corrective Action
SR Letter	Supervision and Regulation Letter
State	Colorado Division of Banking





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## Background

Community Banks of Colorado (CBC) was a state member bank headquartered in Greenwood Village, Colorado. CBC had as many as 37 branches in Colorado and 4 branches in California. CBC's business activities focused on commercial real estate (CRE) lending, specifically construction, land, and land development (CLD) lending, in the state of Colorado, particularly in the Denver metropolitan area and the surrounding mountain resort markets.

CBC was wholly owned by Community Bankshares, Inc. Community Bankshares owned two other banks in Colorado (Community Banks of Southern Colorado and Community Banks of the Rockies), which were merged into CBC in 2004, and one in California (Community Banks of Northern California (CBNC)), which was merged into CBC in 2010. The Federal Reserve Bank of Kansas City (FRB Kansas City), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and the Colorado Division of Banking (State) supervised CBC.

Due to FRB Kansas City's concerns about the continued viability of CBC given its deteriorating capital position, the Federal Reserve Board appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on October 21, 2011. The FDIC estimated that CBC's failure would result in a \$225 million loss to the Deposit Insurance Fund (DIF), or 17.3 percent of the bank's \$1.3 billion in total assets at closing. On November 18, 2011, the FDIC Office of Inspector General (OIG) notified our office that CBC's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act, as amended (FDI Act), a material loss to the DIF is defined as any estimated loss in excess of \$200 million. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. 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

- ascertain why the institution's problems resulted in a material loss to the DIF
- review the agency's supervision of the failed institution, including the agency's implementation of prompt corrective action (PCA)
- make recommendations for preventing any such loss in the future

The remainder of this report consists of five major sections. The Objectives, Scope, and Methodology section describes the purpose of our review, the review period, and the standards governing our review. The Cause of the Failure section contains our assessment of the contributing causes that led to the bank's failure. The Supervision of CBC section provides an examination-by-examination description of FRB Kansas City's and the State's supervision of the institution and assesses FRB Kansas City's supervisory approach. The Conclusions and Lessons Learned section summarizes the results of our analysis and describes the lessons to be learned from this failure. The Analysis of Comments section includes an assessment of our findings and observations by the Director of the Federal Reserve Board's Division of Banking Supervision

and Regulation. Appendixes at the end of this report include a glossary of key banking and regulatory terms and a description of the CAMELS rating system.<sup>1</sup>

## **Objectives, Scope, and Methodology**

This evaluation sought to determine why CBC's failure resulted in a material loss to the DIF and to assess FRB Kansas City's supervision of CBC during our period of review, 2007 through 2011. We conducted our fieldwork from December 2011 through March 2012 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Kansas City, the State, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by CBC, examination reports issued from 2007 through 2011, examination work papers prepared by FRB Kansas City, and relevant FDIC documents.

We coordinated our review with the FDIC OIG. The FDIC OIG provided assistance by (1) establishing the facts and circumstances surrounding the FDIC's involvement in the supervisory activities related to CBC and (2) assessing the FDIC's application of the least-cost test that was performed for purposes of determining a resolution strategy.<sup>2</sup>

## **Cause of the Failure**

CBC failed because its board of directors and management did not adequately control the risks associated with the bank's growth strategy. The bank expanded within Colorado by merging with multiple banks and establishing new branch locations from 2003 to 2007. This strategy significantly increased the bank's CRE lending activities, particularly in CLD loans. The board of directors' and management's failure to effectively manage CBC's CRE credit risk, coupled with weakening real estate markets, led to asset quality deterioration. Mounting losses depleted earnings and eroded capital, which prompted the Federal Reserve Board to appoint the FDIC as receiver on October 21, 2011.

### **Growth Strategy Contributed to Concentrations in CBC's Loan Portfolio**

CBC pursued a growth strategy that included acquiring other institutions through merger activity and expanding its branch network. In 2004, CBC's board of directors and management consolidated and merged into CBC two affiliated Colorado state member banks, Community Banks of Southern Colorado and Community Banks of the Rockies, which expanded the bank's

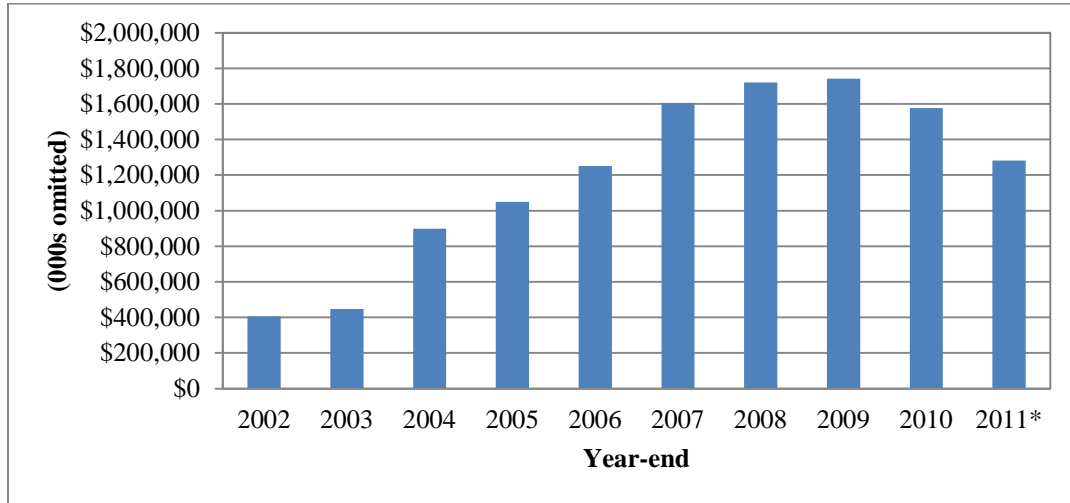
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<sup>1</sup> The CAMELS acronym represents six components: capital adequacy, asset quality, management practices, earnings performance, liquidity position, and sensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 indicating the least regulatory concern and 5 the greatest concern.

<sup>2</sup> In determining the least costly approach of liquidating any depository institution, the FDIC evaluates alternatives, documents that evaluation, and selects the least costly action based on the analysis.

branch network. In addition, CBC opened 15 new branches throughout Colorado from 2003 to 2007. According to the bank’s 2007 five-year growth and performance plan, CBC intended to double its size by 2012 with additional branches and acquisitions. As shown in chart 1, the bank’s total assets more than quadrupled from approximately \$406 million in 2002 to a peak of \$1.7 billion by year-end 2009. CBC also added 4 branches in California in 2010 when CBNC merged into it.

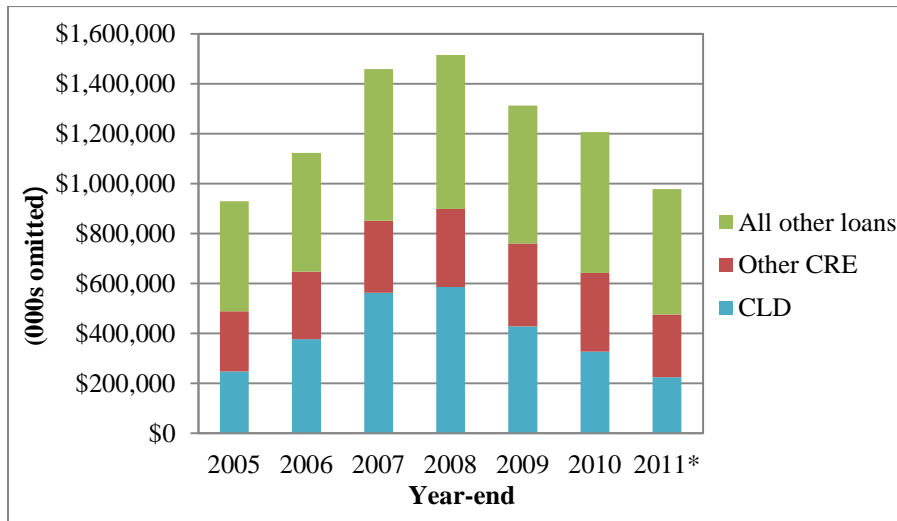
**Chart 1: CBC’s Total Assets, 2002–2011\***



\*As of September 30, 2011.

As the board of directors and management executed CBC’s growth strategy, the bank’s loan portfolio—primarily its real estate loan portfolio—grew. From 2005 through 2008, CBC’s total loans increased from \$930 million to \$1.5 billion. During this time period, CRE loans increased 84 percent, from \$488 million to \$898 million, and CLD loans increased 137 percent, from \$247 million to \$586 million. As illustrated in chart 2 on the next page, by 2008 CRE and CLD loans accounted for nearly 60 percent of CBC’s loan portfolio. In addition, a significant portion of the bank’s loan portfolio was further concentrated in residential, condominium, and mixed-use real estate properties located in various Colorado mountain resort markets and in the Denver metropolitan area.

**Chart 2: CBC's Loan Portfolio Composition, 2005–2011\***



\*As of September 30, 2011.

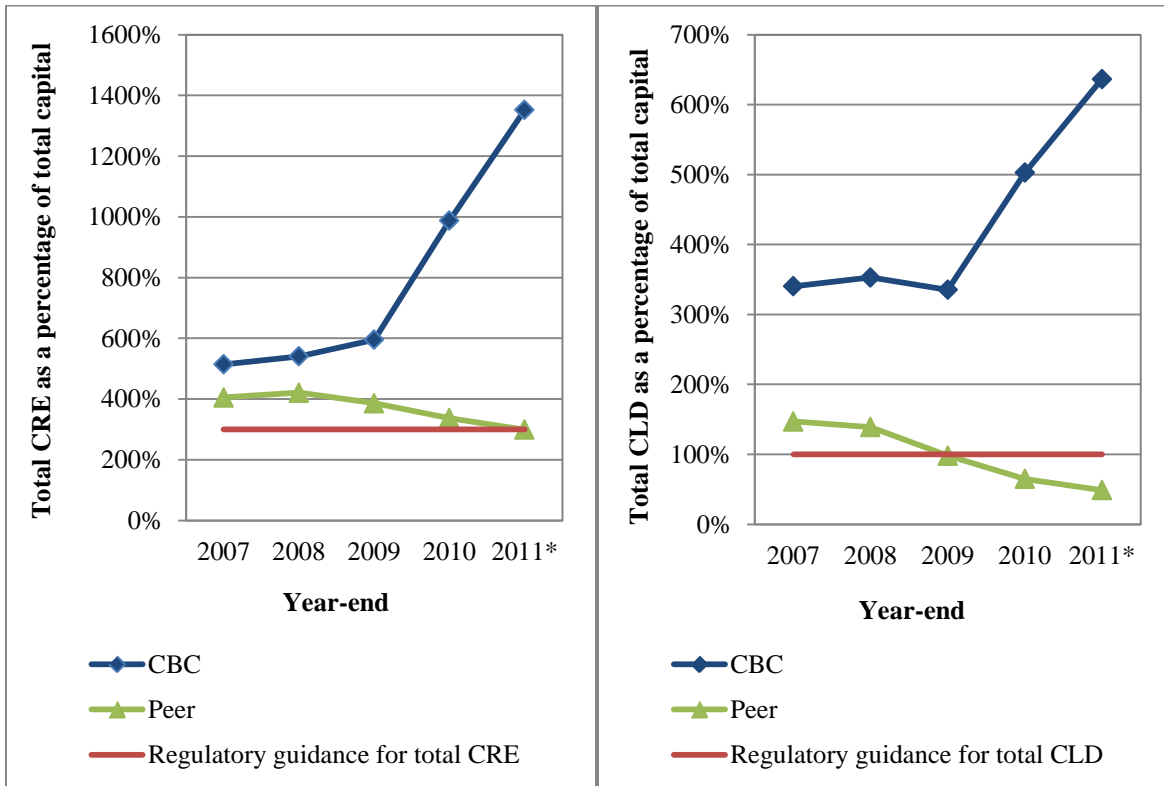
As CBC's loan portfolio grew, the bank's CRE and CLD loan concentrations consistently presented an elevated concentration risk.<sup>3</sup> As shown in chart 3a on the next page, CBC's CRE loan concentration as a percentage of total capital ranged from 514 percent to 596 percent during 2007–2009, exceeding its peer-group average.<sup>4</sup> As illustrated in chart 3b on the next page, the bank's CLD loan concentration also consistently exceeded its peer-group average and remained above 330 percent. In 2010 and 2011, while CBC's CRE and CLD loans decreased due to loan write-offs, a substantial decline in the bank's capital caused its loan concentrations to spike because total capital is the denominator used to calculate concentration percentages. In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans.

<sup>3</sup> According to the Federal Reserve Board's Supervision Regulation Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate Lending*, an institution presents potential significant CRE concentration risk if (1) total reported CLD loans represent 100 percent or more of an institution's total capital or (2) total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

<sup>4</sup> CBC was in peer group 2 from 2007 to 2011. Peer group 2 consisted of all insured commercial banks having assets of \$1 billion–\$3 billion.

**Chart 3a: Total CRE Loan Concentration**

**Chart 3b: Total CLD Loan Concentration**



\*As of September 30, 2011.

\*As of September 30, 2011.

### **Weak Credit Risk Management Practices, Coupled with Local Economic Declines, Led to Increased Classified Assets**

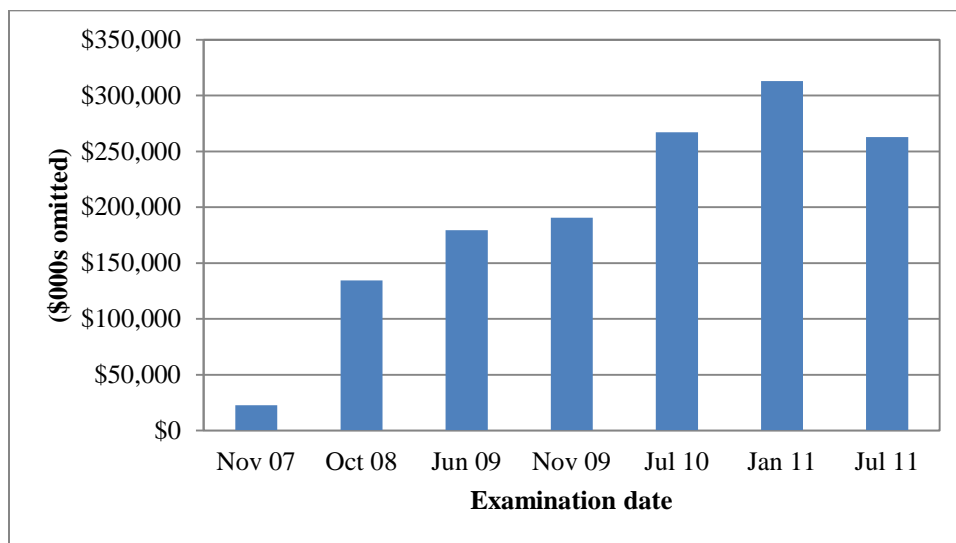
According to examiners, CBC’s credit risk management practices did not adequately identify, measure, monitor, and control risks. Despite CBC’s early efforts to implement the CRE risk management practices described in Supervision and Regulation Letter (SR Letter) 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate Lending*, examiners repeatedly cited weaknesses and deficiencies in the bank’s CRE risk management program and stress-testing practices.<sup>5</sup> Examiners added that management needed to reduce the bank’s CRE exposure and implement strategies to improve loan portfolio diversification. In addition, examiners expressed “grave concern” regarding (1) deficiencies in identifying problem loans, (2) an ineffective loan review process, and (3) inaccurate internal loan grading.

Beginning in 2008, declining economic conditions in the bank’s market areas resulted in significant asset quality deterioration. Examiners stated that the distressed condition of the loan portfolio resulted from strategic decisions of CBC’s board of directors and management that

<sup>5</sup> The Federal Reserve Board, the Office of the Comptroller of the Currency, and the FDIC issued final interagency guidance that preceded the release of SR Letter 07-1. 71 Fed. Reg. 74,580 (2006). SR Letter 07-1 indicates that the previously issued guidance applies to state member banks.

caused excessive concentrations in CRE and CLD loans, which were adversely affected by declining real estate market conditions. As shown in chart 4, CBC’s classified assets increased from \$23 million to \$135 million, or 487 percent, from the November 2007 examination to the October 2008 examination. Examiners noted that CBC’s classified assets as a percentage of the bank’s tier 1 capital and allowance for loan and lease losses (ALLL) continued to increase, from 14 percent during the November 2007 examination to 353 percent during the July 2011 examination. We believe that the absence of appropriate risk management practices, including effective credit administration, increased CBC’s risk profile and vulnerability to declines in the real estate market.

**Chart 4: Classified Assets**



**March 2010 Merger of CBNC into CBC Led to Increased Classified Assets**

In February 2010, FRB Kansas City received an application outlining Community Bankshares’ plan to merge another affiliated institution, CBNC, into CBC. CBNC, a California state member bank with \$146 million in total assets, was supervised by FRB Kansas City, under delegated authority from the Federal Reserve Board, and by the California State Department of Financial Institutions (California DFI). According to examiners, CBNC was in “poor condition,” with a CAMELS composite 5 rating.<sup>6</sup> The California DFI issued a cease-and-desist order in October 2009 that required CBNC to increase capital by not less than \$10 million or enter into a definitive agreement to merge or sell the bank. Despite Community Bankshares’ effort to raise capital, it was only able to provide \$4.5 million. The California DFI determined that CBNC was in imminent danger of failure and requested that FRB Kansas City immediately act on the merger application under emergency procedures.

<sup>6</sup> FRB Kansas City conducted a target examination of CBNC in November 2009 and assigned a CAMELS composite 5 rating.

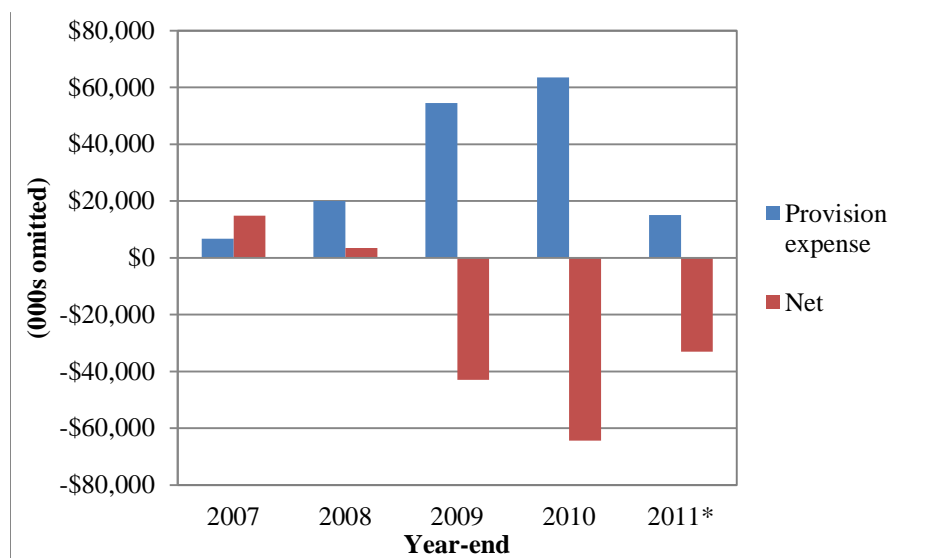


The merger application required in-depth analysis because by February 2010, CBC’s condition had also deteriorated, and it had a CAMELS composite 4 rating.<sup>7</sup> FRB Kansas City concluded that merging CBNC into CBC would (1) not significantly impact CBC’s condition due to CBNC’s size relative to CBC, (2) address potential liability under the FDIC’s cross-guarantee provisions if CBNC were to fail,<sup>8</sup> and (3) allow Community Bankshares more time to raise capital. FRB Kansas City approved the merger on February 24, 2010, and the merger of the two banks became effective on March 1, 2010. In our opinion, FRB Kansas City appropriately analyzed the effect of the proposed merger; however, the merger further increased CBC’s classified assets.

### Asset Quality Deterioration Resulted in Increased Loan Loss Provisions and Depleted Capital

The growth in classified assets required corresponding increases in CBC’s loan loss provisions and adversely affected the bank’s earnings. As shown in chart 5, CBC experienced substantial losses in 2009 and 2010. A 2009 loan loss provision of \$55 million eliminated the bank’s earnings and resulted in a net loss of \$43 million, and a 2010 loan loss provision of \$64 million led to a net loss of \$64 million. These net losses significantly eroded CBC’s capital.

**Chart 5: Impact of Provision Expense on Earnings**



\*As of September 30, 2011.

<sup>7</sup> FRB Kansas City and the State began a full-scope examination in November 2009. FRB Kansas City’s February 2010 merger work paper indicated the preliminary result of the examination was a CAMELS composite 5 rating.

<sup>8</sup> As part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Congress adopted amendments to the FDI Act implementing the cross-guarantee provisions that allow the FDIC to recoup losses to the DIF by assessing a claim against insured institutions under common control for losses caused by the failure of an affiliated insured depository institution.

FRB Kansas City implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. In September 2009, FRB Kansas City notified CBC that the bank had fallen from *well capitalized* to *adequately capitalized* under the PCA guidelines, due to the large loss in 2009.

In November 2010, FRB Kansas City notified CBC that it had become *undercapitalized* and required it to submit a capital restoration plan. FRB Kansas City considered CBC's capital restoration plan to be unacceptable due to management's overly optimistic projections and a lack of firm investor commitments. In February 2011, FRB Kansas City notified the bank that it had fallen to *significantly undercapitalized*. The Federal Reserve Board issued a PCA directive on February 8, 2011, that, among other things, required CBC to raise additional capital to achieve the *adequately capitalized* PCA designation or be acquired by or merge with another depository institution.

CBC's financial condition continued to deteriorate, and in August 2011, FRB Kansas City deemed the bank *critically undercapitalized*. FRB Kansas City notified CBC that unless the bank improved its PCA status, the Federal Reserve Board would appoint a receiver in 90 days. CBC's board of directors and management could not correct the bank's capital deficiencies and, on October 21, 2011, the Federal Reserve Board appointed the FDIC as receiver.

## **Supervision of CBC**

FRB Kansas City complied with the examination frequency guidelines for the time frame we reviewed, 2007 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Kansas City and the State conducted four full-scope examinations, three target examinations, and one CRE review; executed two enforcement actions—a written agreement and a PCA directive; and implemented the applicable PCA provisions.

Our analysis of FRB Kansas City's supervision of CBC revealed that FRB Kansas City identified the bank's heightened credit risk and its potential threat to capital but should have taken earlier supervisory action to address those issues.

**Table 1: CBC Supervisory Overview**

Examination				CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope	Agency Conducting Examination		Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
11/26/2007	02/27/2008	Full	FRB	2	2	1	2	2	2	1	
10/27/2008	02/02/2009 <sup>a</sup>	Full	Joint	4	4	4	4	3	3	3	Written agreement
		CRE review	FRB	not applicable							
06/08/2009	09/23/2009	Target	FRB <sup>b</sup>	4	4	4	4	5	4	3	
11/30/2009	03/30/2010	Full	Joint <sup>b</sup>	5	5	4	4	5	4	4	
07/19/2010	12/10/2010	Target	FRB <sup>b</sup>	5	5	5	5	5	5	4	
01/24/2011	06/20/2011	Full	Joint <sup>b</sup>	5	5	5	5	5	5	5	PCA directive
07/11/2011	09/30/2011	Target	FRB <sup>b</sup>	5	5	5	5	5	5	5	

<sup>a</sup> A CRE review was performed in conjunction with the full-scope examination.

<sup>b</sup> The FDIC participated in this examination.

### **November 2007 Full-Scope Examination Resulted in a CAMELS Composite 2 Rating**

In November 2007, FRB Kansas City began a full-scope examination of CBC that resulted in a CAMELS composite 2 (satisfactory) rating. CBC received 1 ratings for the asset quality and sensitivity to market risk components, and all other components received 2 ratings. The examination report, issued in February 2008, stated that CBC’s financial condition was satisfactory, that CBC had well-defined policies and an effective information and communication system, and that management had established a sound internal control environment supported by an active board of directors and senior management team.

Examiners stated that CBC’s asset quality and credit risk management remained strong. According to examiners, while CBC’s credit risk was inherently high due to its CRE concentration, the bank’s sound risk management practices moderated the risk. Examiners noted that the board of directors developed a comprehensive CRE risk assessment and monitoring system designed to track the size of the bank’s CRE loan portfolio and its risks and to address key elements in SR Letter 07-1. Examiners also commented that the board of directors established guidance for acceptable risk limits by loan, property type, and geographic area and formalized reasonable risk tolerance limits. In addition, examiners noted that CBC implemented stress testing for changes in loan values and certain ratios as a part of its CRE procedures. Further, examiners stated that CBC’s ALLL was adequately funded, and its methodology was consistent with accounting standards.

While examiners acknowledged CBC's efforts to enhance its risk management practices, examiners expressed concerns about the bank's sizeable CRE concentration and its "potential risk" to capital. A significant portion of CBC's loan portfolio consisted of residential, condominium, and mixed-use real estate properties located in various Colorado mountain resorts. Examiners noted that management anticipated "possible price volatility" in the mountain resort markets because of declining real estate conditions. The examination report also stated that the bank's capital required close supervision in 2007 because of (1) high asset growth, (2) increased risk, and (3) fluctuating capital ratios. Examiners also noted that management planned to limit asset growth in 2008 to reduce the strain on capital.

In our opinion, the November 2007 examination presented an opportunity for an earlier supervisory response. We believe that the bank's elevated credit concentration, Colorado's declining real estate market conditions, and examiners' acknowledgement of the risks to the bank's capital warranted closer examiner scrutiny of CBC's risk management practices and its credit risk exposure. In our view, examiners should have assessed CBC's asset quality using a forward-looking examination approach that considered potential risks to the bank's overall financial condition in a declining economy, as well as the current condition of the bank's asset quality.<sup>9</sup> We believe such an approach would have resulted in a component downgrade for CBC's asset quality. We also believe that FRB Kansas City should have strongly encouraged CBC to raise additional capital commensurate with its credit risk exposure. FRB Kansas City officials noted to us, in hindsight, the need for additional capital to mitigate CBC's increasing credit risk. In our opinion, the bank's window of opportunity to raise additional capital closed after this examination.

### **October 2008 Joint Full-Scope Examination Resulted in a Double Downgrade to a CAMELS Composite 4 Rating and a Written Agreement**

In October 2008, the State led a joint full-scope examination of CBC that resulted in a double downgrade to a CAMELS composite 4 (poor) rating. Examiners downgraded the bank's earnings and liquidity components to 3 and double downgraded the capital and management components ratings from 2 to 4 and the sensitivity to market risk rating from 1 to 3. Examiners also triple downgraded the asset quality component rating from 1 to 4. The examination report, issued in February 2009, stated that CBC's overall condition had weakened due to a high level of adverse classifications and inadequate capital in relation to the bank's heightened risk profile.

The bank's asset quality deteriorated significantly, as classified assets increased from \$23 million to \$135 million in 12 months. Although examiners found CBC's credit administration generally adequate, they noted increased loan portfolio risk due to the bank's high CRE concentration. Examiners stated that declining real estate prices and borrowers' financial difficulties adversely affected the bank's CRE portfolio; CRE loans accounted for approximately 72 percent of classified loans. Examiners also noted that the bank's CRE risk management practices and stress testing, mentioned in the February 2008 examination report, needed to include an overall portfolio analysis. Further, examiners stated that CBC's ALLL methodology

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<sup>9</sup> In September 2011, our office issued a report titled *Summary Analysis of Failed Bank Reviews*, which analyzed failed state member bank reports that we issued between June 29, 2009, and June 30, 2011. In the report, we noted the need for "forward-looking" examinations to timely address risks in deteriorating economic conditions.

was flawed because it did not reflect the heightened risk in the bank's loan portfolio and required an additional \$11 million loan loss provision.

While the bank remained *well capitalized*, examiners determined that CBC's capital was deficient relative to its risk profile. Examiners stated that the bank's capital position weakened due to its CRE concentration, a significant increase in classified assets, and limited financial support from the bank holding company. Examiners noted that CBC paid \$11 million in dividends during 2008 to support the bank holding company's cash needs and stated that future capital from the holding company was unlikely.

Concurrent with the full-scope examination, FRB Kansas City conducted a CRE review, which focused on the bank's CRE exposures, the risk to capital from CRE lending, the reliance on revenue from CRE loans, and the potential risks to CBC's liquidity due to deteriorating loan quality. The CRE review report stated that (1) the bank was not identifying problem loans in a timely manner, (2) the Colorado mountain resort real estate markets were declining, and (3) the bank had limited experience in problem loan workout. The CRE review also identified management's failure to adhere to its own policies. Examiners stated that the bank's stress-testing methodology did not assess the CRE portfolio risks to capital. Moreover, examiners criticized management for merely focusing on keeping the bank *well capitalized* and not considering the bank's increasing CRE concentration in its capital planning.

Due to deteriorating asset quality and the findings of the October 2008 full-scope examination, CBC entered into a written agreement, which is a formal enforcement action, with FRB Kansas City and the State in March 2009. The written agreement required CBC to, among other things, (1) enhance overall risk management practices; (2) strengthen the board of directors' oversight of the management and operations of the bank; (3) enhance credit risk management practices, including stress-testing methodology and procedures; (4) improve asset quality; (5) review and revise the ALLL; (6) maintain sufficient capital; (7) address contingency funding plans; (8) improve earnings; (9) restrict dividend payments and debt issuance; and (10) forecast cash sources and uses.

In our opinion, the findings from this examination and the CRE review demonstrated that the risk management practices examiners characterized as "strong" and "sound" during the November 2007 examination did not fare well under stressed economic conditions. CBC's ineffective identification of problem loans, inadequate ALLL methodology, and insufficient stress testing resulted in rapid asset quality deterioration. While we acknowledge that FRB Kansas City implemented a formal enforcement action as a result of the October 2008 examination, we note that the poor performance of these risk management processes under stressed economic conditions further supports our opinion that more aggressive supervisory action during the November 2007 examination was needed. The triple downgrade for the bank's asset quality component strongly suggests that a more forward-looking examination approach and closer scrutiny of the bank's risk management practices were needed during the 2007 examination.

## **June 2009 Target Examination Maintained a CAMELS Composite 4 Rating**

In June 2009, FRB Kansas City conducted a target examination that focused on assessing overall asset quality and the effectiveness of credit administration practices; reviewing capital, earnings, and liquidity; and determining the bank's compliance with the written agreement. Examiners maintained the bank's CAMELS composite 4 rating. The capital, asset quality, and management components retained their 4 ratings, and the sensitivity to market risk component remained 3. Examiners downgraded the liquidity component to 4 and double downgraded the earnings component to 5.

Examiners characterized CBC's asset quality as unsatisfactory and considered credit risk high and increasing. The bank's classified assets increased \$44 million in seven months, from \$135 million to \$179 million. Although examiners noted improvements in CBC's internal loan grading system and problem loan workout practices, nonperforming loans continued to increase. CBC's CRE exposure also remained significant, as CRE loans represented 84 percent of total classified assets. Examiners noted that despite some improvement in management information systems to help identify high-risk CRE loans, the bank did not fully implement portfolio-level stress testing to quantify the effect of changing economic conditions. In addition, examiners noted that CBC had a significantly higher risk profile than its peer group because of its increasing problem loans and loan losses and that the bank's ALLL did not keep pace with the loss inherent in the portfolio. As a result, examiners required an additional loan loss provision of \$30 million.

Examiners deemed the bank's earnings critically deficient based on a \$4 million net loss for first quarter 2009. According to examiners, the bank's earnings prospects for the year were poor due to additional loan loss provisions, tightening interest income, and increasing nonperforming loans. Consequently, examiners considered CBC's capital position deficient and stated that the bank's capital neither supported its heightened CRE risk exposure nor appropriately reflected the increased risk in deteriorating asset quality. Examiners noted that CBC would fall to *adequately capitalized* after the required \$30 million loan loss provision and urged management to raise additional capital.

While acknowledging efforts by management and the board of directors to comply with the March 2009 written agreement, FRB Kansas City determined that CBC only partially complied with the provisions of the formal enforcement action. Examiners noted that the bank had not satisfied the written agreement's provisions relating to (1) earnings performance improvement, (2) classified asset reduction, (3) adequate loan loss reserves, and (4) capital-level maintenance. Examiners required the board of directors and management to become fully compliant with the written agreement.

## **November 2009 Joint Full-Scope Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating**

In November 2009, FRB Kansas City led a joint full-scope examination that downgraded CBC's CAMELS composite rating to 5 (critically deficient). The capital and earnings components received 5 ratings, and all other components received 4 ratings. Examiners expressed concerns

about CBC's critically deficient condition and stated that the bank's viability was threatened. In the examination report, issued in March 2010, examiners urged management to take aggressive action to return the bank to a satisfactory condition and raise additional capital.

CBC's asset quality was unsatisfactory, as classified assets increased from \$179 million to \$190 million in six months. Examiners attributed the bank's deteriorating asset quality to deficiencies in credit underwriting and management oversight and declining market conditions. Although examiners acknowledged management's efforts to reduce problem loans, examiners cautioned management because loans worth a total of \$111 million were listed as special mention, which signaled potential future deterioration.<sup>10</sup> Additionally, examiners noted the bank's significant concentration in CLD loans and required CBC to improve CRE risk management practices. Examiners reminded management to implement portfolio-wide stress testing as required by the March 2009 written agreement. Examiners also required management to recognize credit weaknesses in a timely manner and update loan grades to accurately reflect the quality of the loans. CBC's ALLL balance was again determined to be inadequate; as a result, examiners required an additional \$4 million loan loss provision.

Poor asset quality and earnings performance eroded the bank's capital and resulted in a critically deficient capital position. Examiners deemed CBC *adequately capitalized* and, consequently, required the bank to maintain capital commensurate with its significant CRE concentration and high volume of problem loans. Examiners stated that CBC's capital plan lacked realistic projections of loan loss provisions or firm commitments for new capital. Examiners commented that the board of directors and management did not demonstrate the ability to resolve problems and fully implement effective risk management practices. Examiners also recommended that management develop a culture that promoted problem loan recognition. Further, examiners noted that CBC's efforts to comply with the written agreement were inadequate and urged the bank once again to fully comply with its terms.

In our opinion, because of the multiple management failures noted during this examination, FRB Kansas City should have downgraded the bank's management component rating to 5 and considered the need for an independent assessment evaluating the qualifications of CBC's management and the need for additional managerial resources.

### **FRB Kansas City Approved Merger of CBNC, Affording Community Bankshares More Time to Raise Capital**

In February 2010, FRB Kansas City received a merger application outlining Community Bankshares' plan to merge an affiliated institution, CBNC, into CBC. At the time, CBNC was in a critically deficient condition and had a CAMELS composite 5 rating. The California DFI issued a cease-and-desist order in October 2009 that required CBNC to increase capital by not less than \$10 million or enter into a definitive agreement to merge or sell the bank. Despite Community Bankshares' effort to raise capital, the holding company was only able to provide \$4.5 million. The California DFI determined that CBNC was in imminent danger of failure and

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<sup>10</sup> Assets categorized as special mention have weaknesses that deserve management's close attention, but the extent of risk to which they expose an institution does not warrant adverse classification.

requested that FRB Kansas City immediately act on the merger application under emergency procedures.

The merger application required in-depth analysis because, by February 2010, CBC's condition had also deteriorated, and it had a CAMELS composite 4 rating that was downgraded to a 5 in March 2010. FRB Kansas City approved the merger because it concluded that merging CBNC into CBC would (1) not significantly impact CBC's condition due to CBNC's size relative to CBC, (2) address potential liability under the FDIC's cross-guarantee provisions if CBNC were to fail, and (3) allow Community Bankshares more time to raise capital.

In our opinion, FRB Kansas City appropriately analyzed the effect of the proposed merger. We believe that, had FRB Kansas City disapproved the merger, CBNC would have failed, triggering the cross-guarantee provisions and thereby placing further strain on 4-rated CBC. In our opinion, given the constraints of the situation, FRB Kansas City made a reasonable decision that afforded Community Bankshares additional time to attempt to raise capital.<sup>11</sup>

### **July 2010 Target Examination Maintained a CAMELS Composite 5 Rating**

In July 2010, FRB Kansas City conducted a target examination that focused on CBC's asset quality, credit administration, capital, earnings, liquidity, and compliance with the March 2009 written agreement. The examination resulted in another CAMELS composite 5 rating. While the capital and earnings components retained their 5 ratings and the sensitivity to market risk component remained 4, FRB Kansas City downgraded the asset quality, management, and liquidity components to 5 ratings. Examiners stated that CBC's condition remained critically deficient and emphasized the need for an immediate capital injection, strong board and management oversight, improved credit risk management, and robust contingency funding planning.

CBC's asset quality continued to deteriorate and, according to examiners, presented "a growing threat" to the bank's viability. Classified assets increased from \$190 million to \$267 million, and an additional \$131 million in loans were listed as special mention during the examination. The bank's CRE loan concentration remained high, and declining real estate market conditions continued to affect CBC's loan portfolio. Examiners criticized the bank's credit risk management practices for inadequately identifying, measuring, monitoring, and controlling risks. Examiners also concluded that CBC's loan review was ineffective and its loan grading was inaccurate. Examiners again reminded management of the importance of timely recognizing credit weaknesses and accurately grading loans to reflect the current quality of the loans. In addition, examiners concluded that the bank's ALLL methodology was flawed and required a minimum loan loss provision of \$28 million.

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<sup>11</sup> SR Letter 98-28, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*, establishes the criteria for conducting safety and soundness examinations of depository institutions seeking to become, or merge into, a state member bank, as well as of the state member bank itself. FRB Kansas City did not require any examinations pursuant to this SR letter because both CBNC and CBC were state member banks under common control, so the requirements of the letter did not apply.



A December 2010 examination report stated that the bank's earnings remained critically deficient and resulted in a net loss of \$36 million for the first six months of 2010. According to examiners, CBC's earnings forecasts were based on an unrealistic assessment of the bank's risk profile and did not provide adequate information for the board of directors and senior management to oversee CBC's financial performance. Examiners also noted the importance of realistic earnings projections in developing an acceptable capital plan and cautioned that risks in the bank's loan portfolio must be properly identified in the capital plan to be accurate and acceptable. Examiners deemed the bank *undercapitalized* and stressed the critical need for an immediate capital injection commensurate with the bank's increased risk profile.

### **January 2011 Joint Full-Scope Examination Resulted in Another CAMELS Composite 5 Rating and a PCA Directive**

In January 2011, the State led a joint full-scope examination that determined CBC's overall condition to be unsound and resulted in all CAMELS components receiving 5 ratings. The June 2011 examination report stated that CBC had (1) rapidly declining asset quality, (2) critically deficient earnings performance, (3) elevated credit risk, (4) inadequate capital, and (5) unsatisfactory board of directors' oversight. Examiners noted that the bank's risk exposures were not adequately measured, monitored, or controlled and required the board of directors to promptly implement corrective measures to restore CBC to a sound condition.

Continued asset quality deterioration resulted in an increase in the bank's classified assets in the five months since the prior examination, from \$267 million to \$313 million. Examiners attributed the bank's critical condition to the board of directors' strategic decision to focus on CRE and CLD loans and urged management to reduce the bank's CRE loan exposure. In addition, examiners stated that the board of directors and management failed to implement timely recognition of problem loans and that ineffective credit administration policies and procedures caused significant loan grading inaccuracies. Examiners criticized CBC for failing to properly assess the adequacy of its ALLL and stressed a need to incorporate all risk factors in the methodology.

Earnings remained negative due to critically deficient asset quality, leading to a net loss of \$64 million for year-end 2010. According to examiners, negative earnings represented a distinct threat to the bank's viability through the erosion of capital. CBC fell to *significantly undercapitalized* due to additional loan loss provisions in 2010. As a result, on February 8, 2011, the Federal Reserve Board issued a PCA directive requiring the bank to resolve its capital deficiencies.

### **July 2011 Target Examination Maintained a CAMELS Composite 5 Rating**

In July 2011, FRB Kansas City began a target examination that focused on asset quality, credit administration, the ALLL, capital adequacy, earnings performance, and liquidity. In the September 2011 examination report, examiners maintained CBC's CAMELS composite 5 rating, and all components remained 5 ratings. Examiners expressed strong concerns about CBC's condition and stated that without significant and immediate capital argumentation, "failure is imminent."

CBC's asset quality remained critically deficient. Since the January 2011 examination, CBC's classified assets had decreased from \$313 million to \$263 million, but they increased as a percentage of tier 1 capital and the ALLL, from 273 percent to 353 percent, due to CBC's rapidly declining capital level. Classified assets consisted primarily of CRE loans located in the Colorado mountain resort markets and Denver metropolitan area, and the bank's CRE exposure heightened as its capital eroded. Examiners encouraged management to continue to improve its credit risk management practices, including identification of problem loans and development of workout strategies. Examiners again concluded that the bank's ALLL methodology was flawed and required an additional \$8 million loan loss provision for the first half of 2011.

Continuous losses from deteriorating asset quality severely depleted capital, and FRB Kansas City notified CBC that it fell to *critically undercapitalized* in August 2011. Examiners stated that the bank's capital planning remained unacceptable due to unrealistic earnings projections based on unreasonable loan loss expectations. Examiners noted that CBC had a plan to sell 16 branches and a significant volume of performing loans and deposits and, if successful, the bank projected that the sale would result in approximately \$10 million additional capital, bringing the bank to an *undercapitalized* PCA designation. In addition, Community Bankshares submitted a business plan to fund a \$7.5 million capital injection; however, Community Bankshares only provided \$1 million.

### **FDIC Disapproved CBC's Plan to Sell Branches and Became Receiver for CBC**

Because CBC was deemed *critically undercapitalized* in August 2011, section 38 of the FDI Act required that CBC receive written approval from the FDIC to enter into any material transaction other than those entered into in the usual course of business.<sup>12</sup> Consequently, the FDIC processed CBC's application for the proposed sale of 16 branches to determine whether the proposed sale would result in a viable bank. As a part of its review, the FDIC determined that after the proposed transaction, CBC would have (1) a high-risk profile, (2) inadequate capital, (3) a large concentration of problem assets, and (4) deficient earnings. In addition, the FDIC concluded that CBC would fail regardless of whether the transaction was approved or denied and that the estimated loss to the DIF after the branch sale would significantly exceed the loss associated with liquidating CBC without the branch sale. Thus, on October 19, 2011, the FDIC notified CBC that it would not approve the bank's proposed transaction. The FDIC OIG reviewed the FDIC's handling of this matter and concluded that (1) the FDIC processed CBC's application for the material transaction consistent with its internal procedures and (2) the FDIC followed its resolution processes and procedures as established in its manual.

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<sup>12</sup> A material transaction is an activity that is not in the usual course of business. Such activities include any investment, expansion, acquisition, sale of assets, or other similar action for which a bank would have to notify the appropriate federal banking agency.

CBC's board of directors and management could not correct the bank's capital deficiencies. On October 20, 2011, FRB Kansas City confirmed that the State would not object to the Federal Reserve Board appointing the FDIC as receiver for CBC,<sup>13</sup> which the Federal Reserve Board subsequently did on October 21, 2011.

## Conclusions and Lessons Learned

CBC failed because its board of directors and management did not adequately control the risks associated with the bank's growth strategy. The bank expanded within Colorado by merging with multiple banks and establishing new branch locations from 2003 to 2007. This strategy significantly increased the bank's CRE lending activities, particularly in CLD loans. The board of directors' and management's failure to effectively manage CBC's CRE credit risk, coupled with weakening real estate markets, led to asset quality deterioration. Mounting losses depleted earnings and eroded capital, which prompted the Federal Reserve Board to appoint the FDIC as receiver on October 21, 2011.

Our mandate under section 38(k) of the FDI Act provides us an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. We determined that FRB Kansas City complied with the examination frequency guidelines for the time frame we reviewed, 2007 through 2011, and conducted regular off-site monitoring. However, our analysis of FRB Kansas City's supervision of CBC revealed that FRB Kansas City identified the bank's heightened credit risk and its potential threat to capital but should have taken earlier supervisory action to address those issues. Specifically,

- In the November 2007 examination, we believe that the bank's elevated credit concentration, Colorado's declining real estate market conditions, and examiners' acknowledgement of the risks to the bank's capital warranted closer examiner scrutiny of CBC's risk management practices and its credit risk exposure. The poor performance of CBC's risk management processes under stressed economic conditions, as noted in the CRE review conducted concurrently during the October 2008 examination, further supported our view regarding the need for more aggressive supervisory action during the November 2007 examination. In our opinion, examiners should have assessed the bank's asset quality using a forward-looking examination approach that considered potential risks to CBC's overall financial condition in a declining economy, as well as the current condition of the bank's asset quality. We believe such an approach would have resulted in a component downgrade for the bank's asset quality. In our opinion, the triple downgrade for the asset quality component assigned during the October 2008 examination supports our belief that a more aggressive action during the November 2007 examination was needed. We also believe that FRB Kansas City should have strongly encouraged CBC to raise additional capital commensurate with the bank's credit risk exposure. FRB Kansas City officials noted to us, in hindsight, the need for additional

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<sup>13</sup> According to correspondence between the State and FRB Kansas City, the State interpreted Colorado Revised Statutes § 11-103-802(3)(b) to limit the exercise of the Colorado Commissioner's emergency resolution authority to situations involving insolvency or a liquidity failure, neither of which applied to CBC at the time.

capital to mitigate CBC's increasing credit risk. In our opinion, the bank's window of opportunity to raise additional capital closed after the November 2007 examination.

- The multiple management failures noted during the November 2009 full-scope examination suggested, in our opinion, that FRB Kansas City should have downgraded the management component rating to 5 and considered the need for an independent assessment to evaluate CBC management's qualifications and the need for additional managerial resources.

In our opinion, in February 2010, FRB Kansas City appropriately analyzed the effect of the proposed merger of affiliates CBC and CBNC, and made a reasonable decision to allow the merger, which afforded Community Bankshares additional time to attempt to raise capital.

While we believe that FRB Kansas City had opportunities for earlier supervisory responses, it is not possible for us to predict the effectiveness or outcome of any measures that might have been taken. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected CBC's financial deterioration or the ultimate cost to the DIF.

### **Lessons Learned**

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that CBC's failure offers lessons learned that can be applied by those supervising banks with similar characteristics and circumstances. CBC's failure illustrates (1) a bank's vulnerability to changes in real estate markets when the bank's strategy features a high concentration in CRE loans, (2) the importance of a bank timely implementing a robust credit risk management program designed to facilitate the identification and management of concentrations, and (3) the importance of a forward-looking examination approach that assesses various risk factors that could affect a bank's condition.

### **Analysis of Comments**

We provided a copy of our report to the Federal Reserve Board's Division of Banking Supervision and Regulation for review and comment. The Division Director stated that Banking Supervision and Regulation staff concurred with the conclusions and lessons learned in the report. His response is included as appendix 3.

## **Appendixes**



## **Appendix 1—Glossary of Banking and Regulatory Terms**

### **Allowance for Loan and Lease Losses (ALLL)**

A valuation reserve established and maintained by charges against the bank'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. The reserve must be sufficient to absorb probable losses inherent in the institution's loan and lease portfolio.

### **Cease-and-Desist Order**

A formal supervisory enforcement action against a financial institution or an institution-affiliated party that violates a law, rule, regulation, written commitment, or written agreement or that is engaged in unsafe or unsound business practice. The order may require a financial institution or institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The provisions of a cease-and-desist order and the problems found at the institution are more severe than those of a written agreement, which is the least severe type of formal supervisory enforcement action.

### **Classified Assets**

Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Classified assets are 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**

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 significant amount of direct or indirect extensions of credit and contingent obligations that possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations.

## **Appendix 1 (continued)**

### **Construction, Land, and Land Development (CLD) Loans**

A subset of CRE loans, secured by real estate (including nonagricultural vacant land), for (1) on-site construction of industrial, commercial, residential, or farm buildings and (2) land development, including preconstruction preparatory work such as laying sewer and water pipes.

### **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 written agreements, temporary cease-and-desist orders, cease-and-desist orders, prohibition and removal orders, and prompt corrective action directives; informal enforcement actions include commitments, board resolutions, and memorandums of understanding.

### **Nonperforming Loans**

The sum of (1) the total of loans and lease financing receivables past due 90 or more days and still accruing interest, (2) the total of nonaccrual loans and lease financing receivables, and (3) the total of other real estate owned.

### **Prompt Corrective Action (PCA)**

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. The framework was intended to ensure that action is taken to resolve the problems of a financially troubled 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*.

### **Supervision and Regulation Letters (SR Letters)**

SR letters are issued by the Federal Reserve Board's Division of Banking Supervision and Regulation. They address significant policy and procedural matters of continuing relevance to the Federal Reserve Board's supervisory effort. SR letters are for distribution to supervised institutions as well as Federal Reserve Banks.



## **Appendix 1 (continued)**

### **Tier 1 Capital**

The sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

### **Underwriting**

Detailed credit analysis preceding the granting of a loan based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history; and the lender's evaluation of the borrower's credit needs and ability to pay.

### **Written Agreement**

A formal supervisory enforcement action that is generally issued when a financial or institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Federal Reserve Board or a Federal Reserve Bank that may require the financial institution or the institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. A written agreement is the least severe of the formal enforcement actions.



## 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 the institution's financial condition and operations:

- adequacy of capital
- quality of assets
- capability of management
- quality and level of earnings
- adequacy of liquidity
- sensitivity to market risk

Evaluations of the components take 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 1–5 numerical scale. The highest rating, 1, indicates the strongest performance and risk management practices and the least degree of supervisory concern, while 5 indicates the 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 their size, complexity, and risk profile and give no cause for supervisory concern.

## **Appendix 2 (continued)**

### **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. As there are no material supervisory concerns, the supervisory response is informal and limited.

### **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 board of directors and management are not satisfactorily addressing or resolving weaknesses and problems. Financial institutions in this group generally are not capable of withstanding business fluctuations and may be significantly noncompliant with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required; 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.

## **Appendix 2 (continued)**

### **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 for these 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

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**Date:** May 17, 2012  
**To:** Anthony J. Castaldo, Associate Inspector General for Inspections and Evaluations  
**From:** Michael S. Gibson, Director, Banking Supervision and Regulation  
**Subject:** Material Loss Review of Community Banks of Colorado

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The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Community Banks of Colorado (Community), Greenwood Village, Colorado prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act, as amended. The report finds that Community failed because its Board of Directors and management did not adequately control the risks associated with the bank’s growth strategy, which resulted in the bank’s concentrations in CRE and, particularly, CLD lending. Bank management’s failure to effectively manage its credit risks combined with weakening real estate markets resulted in asset quality deterioration, which impaired bank earnings and capital. Community was supervised by the Federal Reserve Bank of Kansas City (FRB Kansas City) under delegated authority from the Board.

The report notes that FRB Kansas City complied with examination frequency guidelines for the time period that was reviewed, 2007 through 2011. Further, supervisors executed two enforcement actions, a Written Agreement and a PCA Directive, and implemented all applicable PCA provisions. The report recognizes that examiners identified heightened credit risks that contributed to the bank’s failure, but concludes that FRB Kansas City did not take early enough supervisory action to address those weaknesses. However, the report recognizes that it is not possible to predict whether any earlier supervisory actions would have affected Community’s financial deterioration. The report also states that FRB Kansas City appropriately analyzed requests to merge a failing affiliated bank into Community early in 2010. That merger afforded Community additional time to raise capital.

Banking Supervision and Regulation staff concurs with the conclusions and lessons learned in the report. Community’s failure illustrates the risks associated with aggressive growth and high concentrations of credit. It further illustrates the importance of establishing appropriate credit risk management practices, and it reinforces the importance of a forward-looking examination approach.





## **Appendix 4—Principal Contributors to This Report**

Chie N. Hogenmiller, Project Leader and Senior Auditor

Rachel Lucero, Auditor

Michael P. VanHuysen, Senior Office of Inspector General Manager