

Board of Governors of the Federal Reserve System

Material Loss Review of SolutionsBank



Office of Inspector General

June 2010



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

OFFICE OF INSPECTOR GENERAL

June 30, 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 SolutionsBank (Solutions). 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 (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.

Solutions was supervised by 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 by the Office of the State Bank Commissioner of Kansas (State). The State closed Solutions in December 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On January 4, 2010, the FDIC Inspector General notified us that Solutions' failure would result in an estimated loss to the DIF of \$119.0 million, or 23.3 percent of the bank's \$510.1 million in total assets.

Solutions failed because its Board of Directors and management did not control the risks associated with an aggressive growth strategy, funded by non-core deposit sources, that expanded the scope of the bank's traditional activities. This strategy resulted in the bank developing a significant loan concentration in commercial real estate (CRE), including construction, land development, and other land (CLD), that made the bank particularly vulnerable to real estate market declines. As real estate markets served by the bank weakened, asset quality deterioration strained earnings and depleted capital.

In October 2009, the Federal Reserve Board executed a PCA Directive that, among other things, required Solutions to strengthen its capital position. Issuance of this formal enforcement action resulted in net deposit withdrawals. Because of the decline in deposits and the unavailability of alternative funding sources, Solutions sought liquidity support from the Federal Reserve System's Discount Window. After obtaining sufficient collateral, FRB Kansas City granted the bank access to the Discount Window to facilitate an orderly closing of the bank. On December 11, 2009, the bank's liquidity was insufficient to meet its operating needs, and the State declared Solutions insolvent and appointed the FDIC as receiver. On December 14, 2009, the next business day, the bank that assumed Solutions' liabilities as part of an acquisition fully repaid the liquidity support provided to ensure the bank's orderly closure.

FRB Kansas City complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. FRB Kansas City and the State conducted four full scope examinations, an asset quality target examination, and a supervisory assessment before Solutions failed in December 2009. In addition, the bank was subject to two formal enforcement actions—a Written Agreement and a PCA Directive.

Fulfilling our mandate under section 38(k) of the FDI Act provides 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 loss to the DIF. Our analysis of FRB Kansas City's supervision of Solutions revealed that examiners had an opportunity in early 2008 for an earlier and more forceful supervisory action given the bank's aggressive growth strategy. In its January 2008 examination report, FRB Kansas City commented on softness in the nationwide real estate market and noted that the bank's loan portfolio included a large concentration of CRE and CLD loans. Examiners also observed that the bank's already below peer capital ratios had declined, and that the bank increased its reliance on non-core funding sources. In our opinion, these findings presented an opportunity to question the advisability of management's continued aggressive growth strategy. However, FRB Kansas City only required the bank to develop a more robust capital plan and to enhance its CRE risk management processes. The case for a stronger supervisory response in the early 2008 timeframe is supported by a January 2009 examination report, which concluded that management's decision to execute an aggressive growth strategy without the support of adequate capital resulted in the bank's unsatisfactory financial condition.

While we believe that FRB Kansas City had an opportunity for an earlier and more forceful supervisory action, it is not possible for us to predict the effectiveness or impact of any corrective measures. Therefore, we cannot evaluate the degree to which an earlier or more forceful supervisory response might have affected Solutions' financial deterioration or the ultimate cost to the DIF.

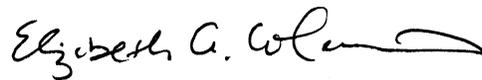
Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Solutions' failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. First, a community bank with large CRE and CLD loans relative to its total assets is particularly vulnerable to real estate market declines. Second, the failure underscores the risk of pursuing a new business strategy that features growth in high-risk lending outside of an institution's

traditional market area. Finally, we believe the failure demonstrates that examiners should assess capital needs based on an institution's strategy and growth targets, in addition to the quantitative regulatory capital levels established by PCA.

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director concurred with our conclusion and lessons learned. 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 Office of Inspector General 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
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. Kevin L. Moore

Board of Governors of the Federal Reserve System

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Background

SolutionsBank (Solutions), headquartered in Overland Park, Kansas, began operations in 1881 as a national bank focused on agricultural lending in south-central Kansas. In February 2002, the bank became a state chartered member bank supervised by 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 by the Office of the State Bank Commissioner of Kansas (State). In 2004, Solutions expanded the scope of its business activities to include commercial lending to businesses in the Kansas City metropolitan area and regional real estate developers.

The State closed Solutions on December 11, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a \$119.0 million loss to the Deposit Insurance Fund (DIF), or 23.3 percent of the bank's \$510.1 million in total assets. In a letter dated January 4, 2010, the FDIC Inspector General advised us that the FDIC had determined that Solutions' 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 FRB Kansas City, State, and Federal Reserve Board staff and collected relevant data from FRB Kansas City records. We also reviewed correspondence, surveillance reports, regulatory reports filed by Solutions, examination reports issued from 2004 through 2009, and examination work papers prepared by FRB Kansas City. Appendixes at the end of this report contain a glossary of key banking and regulatory terms and a description of the CAMELS rating system.¹ We conducted our fieldwork from January 2010 through June 2010, 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: 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 having the least regulatory concern.

Cause of the Failure

Solutions failed because its Board of Directors and management did not control the risks associated with an aggressive growth strategy, funded by non-core deposit sources, that expanded the scope of the bank's traditional activities. This strategy resulted in the bank developing a significant loan concentration in commercial real estate (CRE), including construction, land development, and other land (CLD), that made the bank particularly vulnerable to real estate market declines. As real estate markets served by the bank weakened, asset quality deterioration strained earnings and depleted capital.

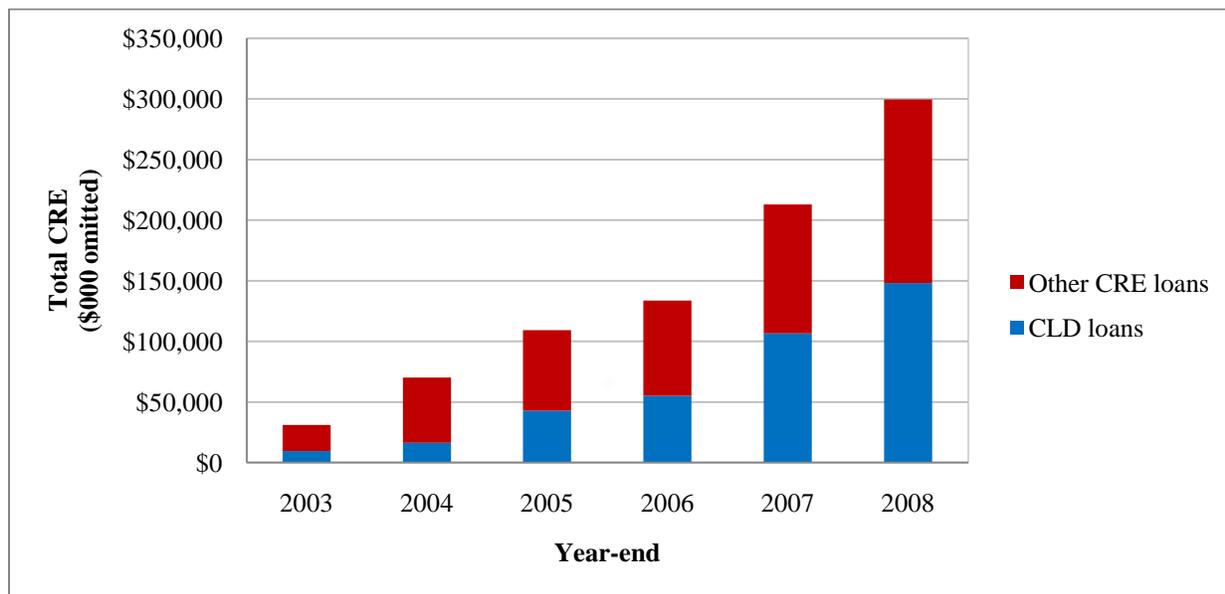
In October 2009, the Federal Reserve Board executed a PCA Directive that, among other things, required Solutions to strengthen its capital position. Issuance of this formal enforcement action resulted in net deposit withdrawals. Because of the decline in deposits and the unavailability of alternative funding sources, Solutions sought liquidity support from the Federal Reserve System's Discount Window. After obtaining sufficient collateral, FRB Kansas City granted the bank access to the Discount Window to facilitate an orderly closing of the bank. On December 11, 2009, the bank's liquidity was insufficient to meet its operating needs, and the State declared Solutions insolvent and appointed the FDIC as receiver. On December 14, 2009, the next business day, the bank that assumed Solutions' liabilities as part of an acquisition fully repaid the liquidity support provided to ensure the bank's orderly closure.

Strategy Change Resulted in Rapid Growth and CRE and CLD Concentrations

Solutions experienced rapid asset growth between 2004 and 2008 as it transitioned from agricultural lending to a community bank focused on lending to businesses and real estate developers. The bank's 2005 strategic plan established a goal of reaching \$500 million in total assets by December 31, 2009. The bank surpassed \$500 million in total assets by year-end 2008—one year earlier than the goal established in the strategic plan—with annual growth rates of 34.2 percent in 2005, 16.4 percent in 2006, 31.6 percent in 2007, and 39.5 percent in 2008.

Management's growth strategy focused on CRE and CLD lending and emphasized large loans for real estate development projects that were often outside the bank's market area. As shown in Chart 1, Solutions' CRE loan portfolio alone increased \$268.6 million, or 866 percent, from \$31.0 million in 2003 to \$299.6 million in 2008. In addition, the CLD loan portfolio increased 1,460 percent from \$9.5 million to \$148.2 million over the same time period.

Chart 1: Growth in CRE and CLD Loans



Solutions' growth strategy led to high concentrations in CRE and CLD loans.² In general, concentrations of credit increase a bank's vulnerability to changes in the marketplace and, therefore, may pose a substantial risk to a financial institution. As shown in Chart 2a on the next page, the bank's CRE loan concentration was approximately 462 percent of total risk-based capital as of December 31, 2004, and reached 668 percent by December 31, 2008. Historically, the bank's CRE loan concentration was well above its peer group average. As illustrated in Chart 2b, Solutions' CLD loan concentration also consistently exceeded its peer group average and reached 330 percent by December 31, 2008.

² According to the Federal Reserve Board's Supervision and Regulation Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate*, an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported loans for construction, land development, and other land 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.

Chart 2a: CRE Loan Concentration

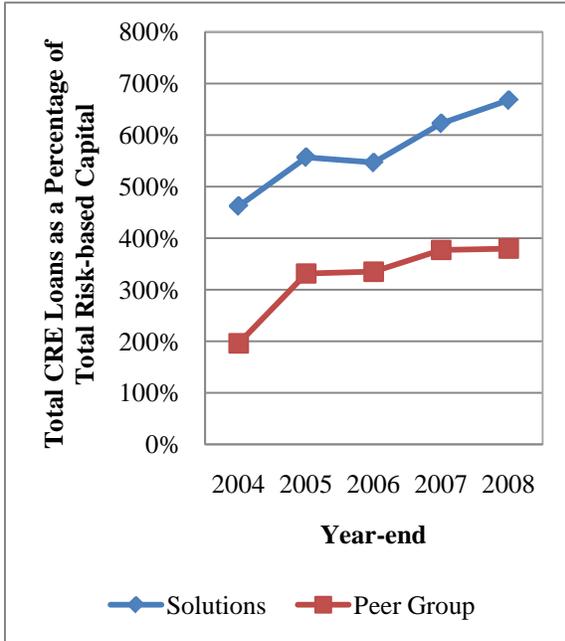
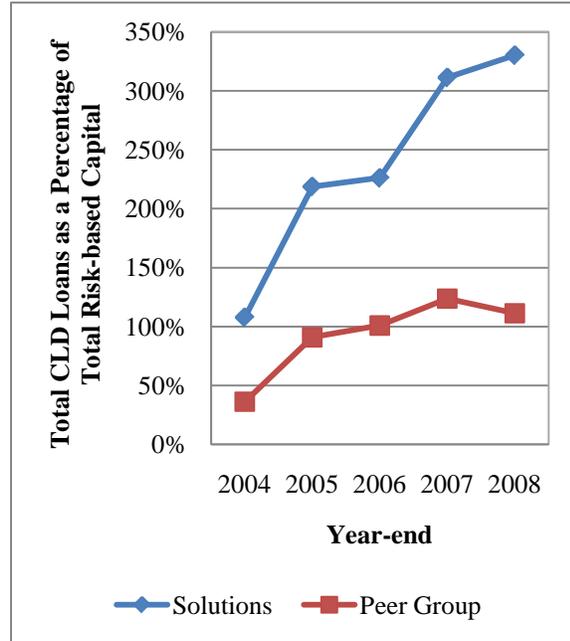


Chart 2b: CLD Loan Concentration

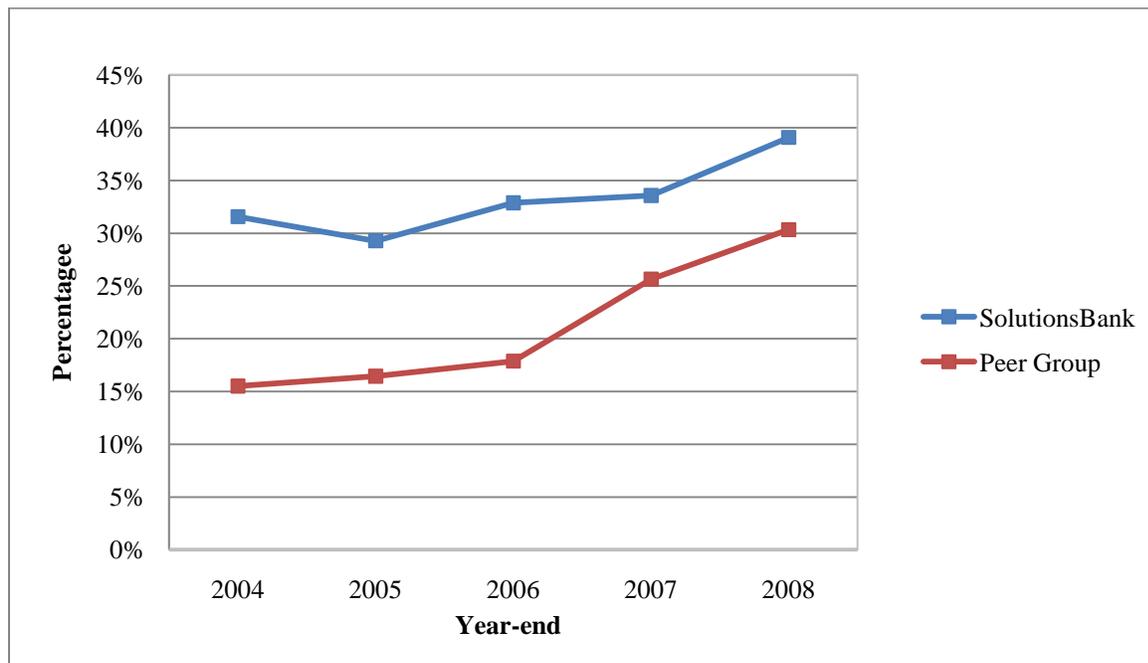


Management Relied on Non-core Funding Sources to Fund Loan Growth

Solutions funded its loan growth with non-core funding sources, primarily high-rate certificates of deposit (CDs) over \$100,000, supplemented by Federal Home Loan Bank (FHLB) borrowings and brokered deposits. As shown in Chart 3, Solutions’ net non-core funding dependence ratio consistently exceeded its peer group average.³ Reliance on non-core funding from high rate CDs over \$100,000 and brokered deposits is considered a risky strategy that can have a significant negative effect on liquidity. These depositors typically have no other relationship with the bank and are only seeking the highest possible return on investment. In general, non-core funding sources may not be available in times of financial stress or adverse changes in market conditions.

³ The net non-core funding dependence ratio measures the extent to which banks fund assets with non-core funding. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Chart 3: Net Non-core Funding Dependence Ratio



Real Estate Market Decline Led to Loan Portfolio Deterioration

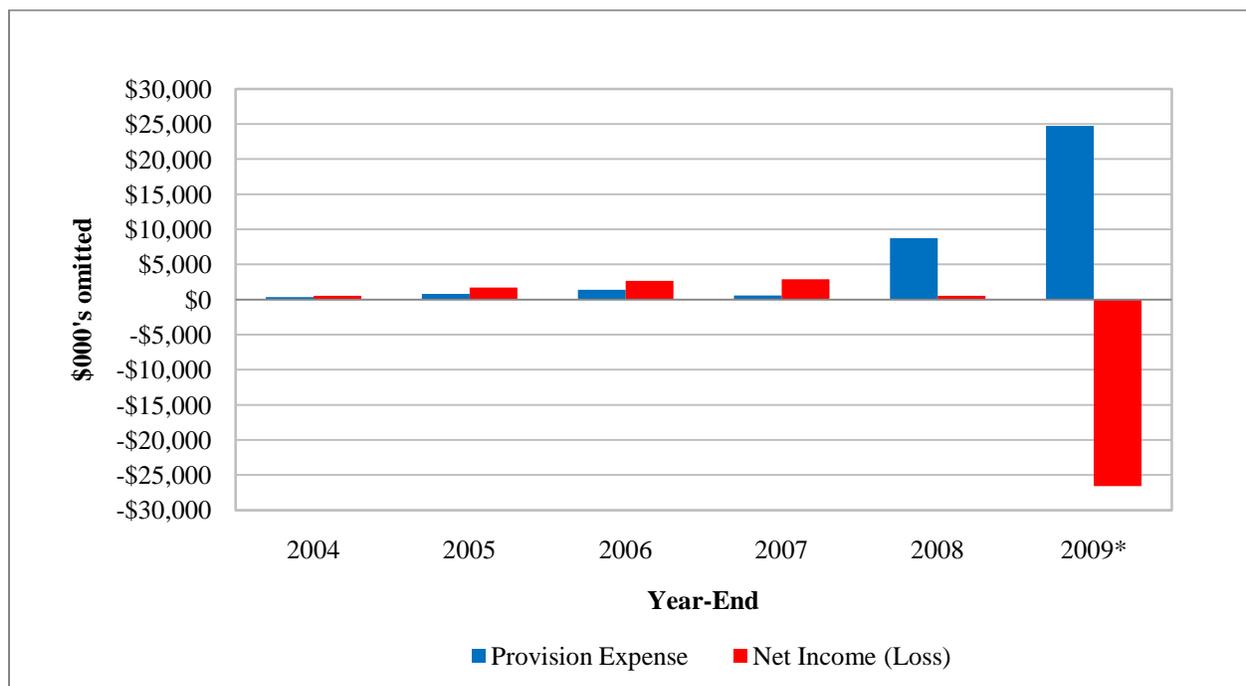
Solutions' vulnerability to real estate market declines became evident as the real estate markets it served began to deteriorate in the late 2007 to early 2008 timeframe. According to examiners, the "slumping" residential and commercial real estate markets led to classified assets increasing 474 percent from \$6.9 million in October 2007 to \$39.6 million in September 2008. In addition, examiners noted that Solutions' asset quality deterioration was exacerbated by the bank's significant CRE and CLD loan concentrations. By March 2009, classified assets totaled \$73.8 million, with approximately \$47.4 million, or 64.2 percent, of the classified assets concentrated in eight CLD real estate projects.

Solutions' Board of Directors and management failed to take timely action in response to deteriorating asset quality. In 2009, management indicated that it planned to limit CRE loan portfolio growth, but examiners concluded that management's decision was made too late to be effective. In addition, management was slow to identify problem loans, and in April 2009, examiners downgraded management's internal ratings on loans totaling \$24.3 million.

Loan Portfolio Losses Eroded Capital

The growth in classified assets prompted corresponding increases in Solutions' loan loss provision expense. As shown in Chart 4 on the next page, the bank's provision expense increased from \$0.3 million in 2004, to \$8.7 million in 2008. A continued increase in classified assets led to an additional provision expense of \$24.7 million for the nine-month period ending September 30, 2009, a 183 percent increase from the prior year. The 2009 provision expense contributed to a net loss of \$26.6 million, which significantly reduced Solutions' capital.

Chart 4: Impact of Provision Expense on Earnings



* Data as of September 30, 2009

FRB Kansas City implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies in troubled depository institutions. On April 30, 2009, Solutions was notified that it was no longer *well capitalized* and, therefore, could not accept, renew, or roll over any brokered deposits. The notice also stated that the bank was subject to limitations on the interest rates it could pay to depositors. On July 30, 2009, FRB Kansas City informed the bank's Board of Directors that Solutions was *undercapitalized* and required the bank to submit an acceptable capital restoration plan by August 19, 2009.

Solutions' capital restoration plan was deemed unacceptable, and the bank was declared *significantly undercapitalized* on September 25, 2009. The Federal Reserve Board issued a PCA Directive on October 23, 2009, that, among other things, required Solutions to restore the bank's capital position to *adequately capitalized* or merge with or be acquired by another insured depository institution.

The issuance of the PCA Directive prompted net deposit withdrawals of approximately \$10 million per week between November 2, 2009, and December 10, 2009. Because of the decline in deposits and the unavailability of additional FHLB borrowings, brokered deposits, and alternative funding sources, Solutions sought liquidity support from the Federal Reserve System's Discount Window. After obtaining sufficient collateral, FRB Kansas City granted the bank access to the Discount Window to facilitate an orderly closing. On December 11, 2009, the bank's liquidity was insufficient to meet its daily operating needs, and the State declared the bank insolvent and appointed the FDIC as receiver.

Supervision of SolutionsBank

FRB Kansas City complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. As shown in Table 1 on the next page, FRB Kansas City and the State conducted four full scope examinations, an asset quality target examination, and a supervisory assessment before Solutions failed in December 2009. The bank received CAMELS composite 2 (satisfactory) ratings for the full scope examinations conducted between November 2004 and January 2008. In November 2008, examiners began an asset quality target examination that resulted in Solutions being double downgraded to a CAMELS composite 4 (marginal) rating. Subsequently, a Written Agreement issued in March 2009 required the bank to develop improvement plans for capital, earnings, and liquidity; enhance management of CRE concentrations; and assure the allowance for loan and lease losses (ALLL) methodology was consistent with regulatory expectations.

In April 2009, FRB Kansas City and the State began a full scope examination that revealed continued asset quality deterioration and resulted in the bank receiving a CAMELS composite 5 (unsatisfactory) rating. Examiners indicated that Solutions had not complied with various provisions of the Written Agreement and had not developed an acceptable capital restoration plan. The Federal Reserve Board subsequently issued a PCA Directive on October 23, 2009, that required Solutions to become *adequately capitalized* or be acquired by or merge with another depository institution within 30 days.

In November 2009, FRB Kansas City and the State began a supervisory assessment focused on asset quality, the ALLL, and liquidity risk. Due to rapidly deteriorating liquidity, the asset quality review portion of the assessment was limited to reviewing the credit quality of loans that could be used as collateral for Discount Window borrowing. On November 9, 2009, examiners downgraded the CAMELS components for liquidity and sensitivity to market risk to 5 and indicated that Solutions would probably fail.

Our analysis of FRB Kansas City's supervision of Solutions revealed that examiners had an opportunity in early 2008 for an earlier and more forceful supervisory action in light of the bank's aggressive growth strategy.

Table 1: Supervisory Overview of Solutions

Examinations			Agency Conducting the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
11/1/2004	12/27/2004	Full	FRB Kansas City	2	2	2	2	3	2	2	
6/8/2006	8/3/2006	Full	State	2	2	2	2	2	2	2	
11/13/2007	1/22/2008	Full	FRB Kansas City	2	2	2	2	2	3	2	
11/3/2008	1/16/2009	Target	FRB Kansas City	4	4	4	4	4	4	4	Written Agreement
4/20/2009	8/19/2009	Full	Joint FRB Kansas City and State	5	5	5	5	5	4	4	PCA Directive
11/2/2009	11/9/2009	Supervisory Assessment	Joint FRB Kansas City and State	5	5	5	5	5	5	5	

Supervision History from 2004 through 2007

In November 2004, FRB Kansas City began a full scope examination that resulted in a CAMELS composite 2 (satisfactory) rating. Examiners assigned a 2 rating to all CAMELS components, except for earnings, which received a 3 (fair). The December 2004 examination report noted that Solutions’ earnings, “while improving, were weak and less than adequate to support operations and augment capital during periods of rapid asset growth.” Previously, the bank’s liquidity component was rated 1 (strong), but FRB Kansas City downgraded liquidity to a 2 because the bank increased its reliance on non-core deposit sources to fund loan growth. Examiners stated that Solutions’ aggressive growth strategy resulted in CRE and CLD loan concentrations and presented a higher than normal degree of risk. However, examiners concluded that risk management practices were acceptable because (1) management and the Board of Directors adequately monitored and controlled credit risk, (2) the bank had an adequate reporting system and independent loan review function, and (3) the loan policy contained appropriate guidance and limitations on lending activity.

In June 2006, the State conducted a full scope examination and again assigned the bank a CAMELS composite 2 rating. Examiners upgraded earnings from 3 to 2, due to improvements in Solutions’ net interest margin. Despite this upgrade, examiners concluded that the bank’s earnings would not augment capital given its significant growth. Examiners maintained the 2 rating for liquidity despite noting the “strain” caused by continued significant growth. Examiners recommended additions to the banks’ funds management policy to incorporate (1) the conditions under which the institution could borrow and (2) contingency plans for meeting large, unexpected withdrawals.

Additionally, the August 2006 examination report concluded that Solutions’ net non-core funding dependence ratio was “well above” its peer group average and violated the bank’s internal policy. Examiners concluded that credit administration practices were sufficient despite

a \$4.7 million, or 204 percent, increase in classified assets. During this examination, the State also highlighted the concentration risk posed by 10 customers with large, outstanding loans.

In November 2007, FRB Kansas City conducted a full scope examination that maintained Solutions' CAMELS composite 2 rating, although liquidity was downgraded to 3 because of the bank's increased reliance on non-core deposits. The January 2008 examination report reiterated findings from the prior State examination and noted an increase in the bank's reliance on non-core funding sources. In addition, examiners required Solutions to implement a series of actions that included (1) improving liquidity risk management monitoring and reporting to the Board of Directors, and (2) developing a contingency funding plan to include steps for managing unplanned changes in funding sources and market conditions. Examiners noted that capital ratios exhibited a declining trend and remained below the bank's peer group averages, and they required Solutions to establish a more robust capital plan in light of projections for continued aggressive loan growth.

Examiners raised concerns that the loan portfolio included a large concentration of CRE and CLD loans, and warned management that continued strong oversight was necessary because CRE loans may have a sudden negative impact on the bank's financial condition. Even though the bank's credit risk management practices were deemed acceptable, examiners required management to enhance CRE risk management processes by performing portfolio-level stress testing and establishing limits on the volume of out-of-territory loans given the "softness of the national housing markets."

November 2008 Target Examination Resulted in a Double Downgrade to a CAMELS Composite 4 Rating

In November 2008, FRB Kansas City conducted a target examination that focused on asset quality, credit risk, the ALLL, and Board of Directors' and management oversight, with a limited review of the remaining CAMELS components. The January 2009 report double downgraded the bank to a CAMELS composite 4 (marginal) rating. Capital, asset quality, management, earnings, and sensitivity were also double downgraded from 2 to 4, while liquidity was downgraded from 3 to 4.

According to supervisory guidance, institutions with a CAMELS composite 4 rating present a risk to the DIF, and failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved. Based on the examination findings and the protracted downturn in the residential and commercial real estate markets, Solutions' management, among other things, agreed to reduce loan growth, ensure stricter adherence to concentration guidelines defined by the Board of Directors, attract a higher level of core deposits, and remain proactive in identifying and resolving problem credits.

Examiners expressed concern that management's decision to execute an aggressive growth strategy without the support of an adequate capital position resulted in the bank's unsatisfactory financial condition. Examiners once again stated that Solutions' capital levels were lower than the bank's peer group averages. The examination report concluded that the bank's capital

position did not support the aggressive loan growth strategy even though Solutions received capital injections of \$8.1 million during 2008.

Examiners noted that classified assets totaled \$39.6 million, a 477 percent increase from the prior examination. According to examiners, Solutions' asset quality deterioration was due to a "slumping" residential and commercial real estate market exacerbated by the bank's CRE and CLD concentrations. The bank's declining financial condition resulted in Solutions realizing a loss of \$3.6 million as of September 30, 2008.

Solutions' troubled financial condition and other weaknesses led to a formal enforcement action in the form of a Written Agreement that was executed on March 2, 2009. The Written Agreement, among other things, required the Bank to develop plans to improve capital, asset quality, earnings, liquidity and the ALLL methodology. The Written Agreement also highlighted the need to reduce or mitigate the risk of CRE concentrations in light of current market conditions.

April 2009 Joint Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating and a PCA Directive

In April 2009, FRB Kansas City and the State conducted a full scope examination that downgraded the bank's CAMELS composite rating to 5. 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 capital, asset quality, management, and earnings components were also downgraded to 5, while liquidity and sensitivity to market risk remained unchanged.

Examiners indicated that the CRE portfolio had continued to deteriorate. As of March 31, 2009, eight CRE-related loans represented approximately 71 percent of total loan classifications. FRB Kansas City downgraded \$24.3 million in loans not previously classified by the bank. Examiners once again noted that "the aggressive growth strategy pursued by the Board of Directors and management without sufficient capital continues to hamper the bank's condition."

The August 2009 examination report noted that liquidity was inadequate and "a significant concern." According to examiners, the bank had reached its credit limit for FHLB borrowings and was left with few options to improve its liquidity position. FRB Kansas City indicated that the restrictions on deposit interest rates put into effect April 30, 2009, would further tighten liquidity as customers withdrew deposits to seek a higher return at other financial institutions.

The examination report indicated that the bank was not in compliance with the Written Agreement because the Board of Directors and management did not submit an acceptable capital restoration plan. Accordingly, the Federal Reserve Board executed a PCA Directive on October 23, 2009, that, among other things, required the bank to (1) restore its capital position to *adequately capitalized*; or (2) merge with or be acquired by another depository institution.

November 2009 Joint Supervisory Assessment

In November 2009, FRB Kansas City and the State began a joint supervisory assessment focused on asset quality, the ALLL, and liquidity risk. Due to the bank's rapidly deteriorating liquidity position, examiners anticipated that Solutions might require Discount Window access to facilitate an orderly closing. Therefore, examiners focused on assessing the credit quality of loans that could be pledged as collateral at the Discount Window. On November 9, 2009, FRB Kansas City and the State issued a letter that downgraded liquidity and sensitivity to 5 ratings. Examiners noted that liquidity had become critically deficient due to declines in deposits and indicated that the bank's failure appeared probable. As discussed earlier, on December 11, 2009, the bank's liquidity was insufficient to meet its daily operating needs, and the State declared the bank insolvent and appointed the FDIC as receiver.

Conclusion and Lessons Learned

Solutions failed because its Board of Directors and management did not control the risks associated with an aggressive growth strategy, funded by non-core deposit sources, that expanded the scope of the bank's traditional activities. This strategy resulted in the bank developing a significant loan concentration in CRE, including CLD, that made the bank particularly vulnerable to real estate market declines. As real estate markets served by the bank weakened, asset quality deterioration strained earnings and depleted capital.

In October 2009, the Federal Reserve Board executed a PCA Directive that, among other things, required Solutions to strengthen its capital position. Issuance of this formal enforcement action resulted in net deposit withdrawals. Because of the decline in deposits and the unavailability of alternative funding sources, Solutions sought liquidity support from the Federal Reserve System's Discount Window. After obtaining sufficient collateral, FRB Kansas City granted the bank access to the Discount Window to facilitate an orderly closing of the bank. On December 11, 2009, the bank's liquidity was insufficient to meet its operating needs, and the State declared Solutions insolvent and appointed the FDIC as receiver. On December 14, 2009, the next business day, the bank that assumed Solutions' liabilities as part of an acquisition fully repaid the liquidity support provided to ensure the bank's orderly closure.

With respect to supervision, FRB Kansas City complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this period, FRB Kansas City and the State conducted four full scope examinations, an asset quality target examination, and a supervisory assessment before Solutions failed in December 2009. In addition, the bank was subject to two formal enforcement actions—a Written Agreement and a PCA Directive.

Fulfilling our mandate under section 38(k) of the FDI Act provides 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 loss to the DIF. Our analysis of FRB Kansas City's supervision of Solutions revealed that examiners had an opportunity in early 2008 for an earlier and more forceful supervisory action given the bank's aggressive growth strategy. In its January 2008 examination report, FRB Kansas City commented on softness in the nationwide real estate

market and noted that the bank's loan portfolio included a large concentration of CRE and CLD loans. Examiners also observed that the bank's already below peer capital ratios had declined, and that the bank increased its reliance on non-core funding sources. In our opinion, these findings presented an opportunity to question the advisability of management's continued aggressive growth strategy. However, FRB Kansas City only required the bank to develop a more robust capital plan and to enhance its CRE risk management processes. The case for a stronger supervisory response in the early 2008 timeframe is supported by the January 2009 examination report, which concluded that management's decision to execute an aggressive growth strategy without the support of adequate capital resulted in the bank's unsatisfactory financial condition.

While we believe that FRB Kansas City had an opportunity for an earlier and more forceful supervisory action, it is not possible for us to predict the effectiveness or impact of any corrective measures. Therefore, we cannot evaluate the degree to which an earlier or more forceful supervisory response might have affected Solutions' 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 Solutions' failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. First, a community bank with large CRE and CLD loans relative to its total assets is particularly vulnerable to real estate market declines. Second, the failure underscores the risk of pursuing a new business strategy that features growth in high-risk lending outside of an institution's traditional market area. Finally, we believe the failure demonstrates that examiners should assess capital needs based on an institution's strategy and growth targets, in addition to the quantitative regulatory capital levels established by PCA.

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. His response is included as Appendix 3. The Director concurred with the conclusion and lessons learned contained in the report.

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.

Brokered Deposits

Brokered deposits are deposits that are placed in a savings institution by a broker who gathers funds from others and packages the funds in batches of \$100,000. The broker then shops for financial institutions paying the highest rates and invests in multiple \$100,000 certificates of deposit, which typically pay the highest rates of interest and are federally insured.

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.

Collateral

Collateral is the property or properties securing or being improved by the extension of credit.

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 volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets are similarly affected by adverse economic, financial, or business conditions and, in the aggregate, may pose risk to the safety and soundness of the institution.

Construction, Land Development, and Other Land (CLD) Loans

CLD loans are a subset of commercial real estate loans, secured by real estate (including vacant land), for (1) construction (or alteration) of industrial, commercial, residential, or farm buildings, and (2) land development, including pre-construction preparatory work such as laying sewer and water pipes.

Appendix 1 (continued)

Discount Window

The Discount Window functions as a safety valve in relieving pressures in reserve markets; extensions of credit can help relieve liquidity strains in a depository institution and in the banking system as a whole.

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 Prompt Corrective Action 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.

Net Interest Margin

Net interest margin is a performance metric used to evaluate a bank's profitability by measuring the difference between interest income generated in comparison to the interest paid.

Net Non-core Funding Dependence Ratio

The net non-core funding dependence ratio measures the extent to which banks fund assets with non-core funding. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Non-core Deposits

Non-core deposits include federal funds purchased, Federal Home Loan Bank advances, subordinated notes and debentures, certificates of deposit of more than \$100,000, and brokered deposits.

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 position has 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*.

Supervision and Regulation (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 Reserve Banks.

Appendix 1 (continued)

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 Federal Reserve Board's Director of the Division of Banking Supervision and Regulation and 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 the institution's financial condition and operations. These component factors 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). 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 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: June 28, 2010
To: Elizabeth A. Coleman, Inspector General
From: Patrick M. Parkinson, Director, Banking Supervision and Regulation */signed/*
Subject: Material Loss Review of SolutionsBank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft material Loss Review of SolutionsBank of Overland Park, Kansas, prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report finds that SolutionsBank failed because its Board of Directors and management did not control the risks associated with an aggressive growth strategy, funded by non-core deposit sources. The strategy resulted in the bank developing significant commercial real estate (CRE) and construction, land, and land development (CLD) lending concentrations that made the bank particularly vulnerable to real estate market declines. As real estate markets weakened, asset quality deterioration strained earnings and depleted capital. SolutionsBank was supervised by the Federal Reserve Bank of Kansas City (FRB Kansas City) under delegated authority from the Board.

Banking Supervision and Regulation staff concur with the conclusions and lessons learned in the report. FRB Kansas City complied with examination frequency guidelines for the period that was reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this time period, FRB Kansas City and the State of Kansas conducted four full scope examinations, as asset quality target examination, and a supervisory assessment. SolutionsBank was placed under a Written Agreement in 2008 and became subject to a PCA Directive in 2009. The report notes that in the January 2008 examination report, FRB Kansas City commented on “softening” in the nationwide real estate market and the bank’s large concentration of CRE and CLD loans, as well as on the bank’s declining capital levels and increased reliance on non-core funding sources. While FRB Kansas City required the bank to develop a more robust capital plan and enhance CRE risk management processes, the report concludes that, in hindsight, examiners had an opportunity in early 2008 for an earlier and more forceful supervisory action. The report also indicates that it is not possible to predict the effectiveness or impact of any corrective measures, nor to evaluate the degree to which an earlier or more forceful supervisory response might have affected SolutionsBank’s financial deterioration or the ultimate cost to the DIF.

Appendix 3 (continued)

The report identifies several important lessons. First, community banks with larger CRE and CLD loans relative to total assets are vulnerable to real estate market declines. Second, there can be risks associated with pursuing a new business strategy featuring growth in high-risk lending outside of an institution's traditional market area. And third, examiners should assess capital needs based on an institution's strategy and growth targets in addition to the quantitative capital levels established by the prompt corrective action regulation.

Appendix 4 – Principal Office of Inspector General Contributors to this Report

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