Board of Governors of the Federal Reserve System

Material Loss Review of County Bank

Office of Inspector General

September 2009

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

OFFICE OF INSPECTOR GENERAL

September 9, 2009

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 County Bank (County). 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) exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

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

County was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the California Department of Financial Institutions (State). The State closed County in February 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On March 9, 2009, the FDIC Inspector General notified us that, according to the FDIC, County's failure would result in an estimated loss to the DIF of $135.8 million, or 8 percent of the bank's $1.692 billion in total assets.

County failed because (1) a precipitous decline in the local real estate market caused significant losses concentrated in the construction and land development (CLD) loan component of the bank's commercial real estate portfolio, and (2) the Board of Directors and management failed to mitigate the bank's credit risk exposure in the face of these sharply deteriorating real estate market conditions. The State closed County after loan losses mounted, earnings and capital were impaired, liquidity was strained, and efforts to raise capital or find a buyer or merger partner failed.

With respect to supervision, FRB San Francisco complied with the frequency of safety and soundness examinations prescribed in regulatory guidance and conducted off-site monitoring commensurate with concerns and risks identified during examinations. Although County had

historically been rated a fundamentally sound financial institution, its decline was swift. The bank failed eighteen months after the State, in its 2007 examination, assigned the bank a CAMELS composite 2 rating, yet cited the first signs of asset quality deterioration and other problems. We found that FRB San Francisco was concerned about the declining local real estate market and the deficiencies cited during the 2007 State examination. In response, FRB San Francisco met with County management in July 2007 to provide statistical evidence showing that the local real estate market was declining and to stress the importance of taking action to keep ahead of emerging market conditions. FRB San Francisco examiners also accelerated County's examination interval and arranged for an asset quality target examination to begin in January 2008, five months after the State examination report was issued.

Fulfilling our mandate under section 38(k) provides an opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted additional or alternative supervisory actions. Accordingly, we believe that the magnitude and significance of County's asset quality deterioration and credit administration deficiencies that emerged in the summer of 2007, coupled with management's disagreement with regulators, warranted a more direct and forceful supervisory response by FRB San Francisco.

By August 2007, it was apparent that the real estate market decline was adversely affecting County's asset quality. County's condition had clearly deteriorated since the prior examination, and management appeared either unwilling or unable to deal with the increasing risks associated with the changing business environment. Classified assets—many of which were CLD loans—had increased 90 percent since 2006. During the 2007 examination, State examiners determined that the dollar value of classified loans initially presented by management was insufficient and, as a result, classified loans were increased by 60 percent. Credit administration deficiencies included CLD loans being renewed or extended without principal paydown or out-of-pocket funding of additional interest expense, as well as weaknesses in construction loan credit file documentation, including insufficient analysis of borrowers' financial capacity. In addition, County's management disagreed with examiners' ratings of certain CAMELS components and strongly disagreed with the amount of loss that the examiners calculated for one of the bank's larger loans.

In our view, a more aggressive supervisory response was warranted in the summer of 2007. Nevertheless, in light of the rapid deterioration in County's local real estate market, it is not possible to assess whether a more direct and forceful response by FRB San Francisco would have affected County's subsequent decline or the ensuing failure's cost to the DIF.

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that County's failure offers a lesson learned that can be applied in supervising community banks with similar characteristics and circumstances. County's rapid decline and failure indicates that community banks with a concentration in CLD loans can be highly vulnerable to changes in the real estate market that they serve. Accordingly, an early, direct, and forceful supervisory response that compels management to take immediate action to mitigate emerging risks is necessary for banks with CLD concentrations.

During the course of our review, we also found that FRB San Francisco did not follow Board procedures that required sending a brokered deposit restriction letter to County when the bank's capital position fell below *well capitalized,* as defined by the Prompt Corrective Action provisions of the FDI Act. Board procedures require Reserve Banks to send a letter to notify less than *well capitalized* institutions that they are prohibited from accepting, renewing, or rolling over brokered deposits, unless a waiver is obtained from the FDIC. Our report contains a recommendation to address this issue.

We provided our draft report for review and comment to the Acting Director of the Division of Banking Supervision and Regulation. The Acting Director concurred with our conclusions, lesson learned, and recommendation. In response to our recommendation, the Acting Director said that she will remind Reserve Banks to provide timely written notification of brokered deposit restrictions to financial institutions that are deemed less than *well capitalized.* We plan to follow up on action taken to implement our recommendation. The Acting Director's response is included as Appendix 4.

We appreciate the cooperation that we received from FRB San Francisco and Board staff during our review. The principal contributors to this report are listed in Appendix 5. 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: Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Ms. Esther George
Mr. Stephen M. Hoffman

Board of Governors of the Federal Reserve System

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Background

County Bank (County) was a state-chartered member bank of the Federal Reserve System (SMB) located in Merced, California. It had approximately $1.7 billion in assets and forty-one branches serving residents and businesses in the central valley of California. The bank was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the California Department of Financial Institutions (State).

The State closed County on February 6, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $135.8 million loss to the Deposit Insurance Fund (DIF), or 8 percent of the bank's $1.692 billion in total assets. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, 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. In a letter dated March 9, 2009, the FDIC Inspector General advised us that County's failure would result in a material loss to the DIF.

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), and

- ascertain why the institution's problems resulted in a loss to the DIF and
- make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected data from the Board in Washington, D.C.; FRB San Francisco; the California Department of Financial Institutions; the FDIC's Division of Supervision and Consumer Protection in San Francisco, California; and the FDIC's Division of Resolutions and Receiverships in Dallas, Texas. We also reviewed correspondence, surveillance reports, Reports of Examination (examination reports) issued between 2004 and 2008, and examination work papers prepared by FRB San Francisco. Appendixes at the end of this report include a glossary that defines key banking and regulatory terms, a key events timeline, and a description of the CAMELS rating system.[1] We conducted our fieldwork from March 2009 through July 2009, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

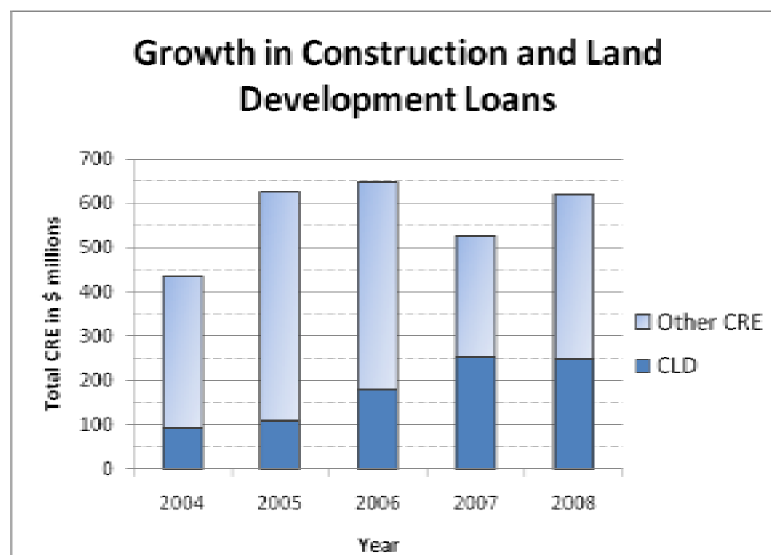
[1] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the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

Cause of the Failure

County's failure resulted from (1) a precipitous decline in the local real estate market that caused significant losses concentrated in the construction and land development (CLD) loan component of the bank's commercial real estate (CRE) portfolio, and (2) the Board of Directors' and management's failure to mitigate the bank's credit risk exposure in the face of sharply deteriorating real estate market conditions. Mounting loan losses impaired earnings, eroded capital, and affected the bank's liquidity position. Efforts to find an investor, a buyer, or a merger partner were unsuccessful, and a January 2009 letter from the State requiring County to raise $74 million of new capital was not fulfilled. Liquidity remained under severe pressure until the State closed County on February 6, 2009.

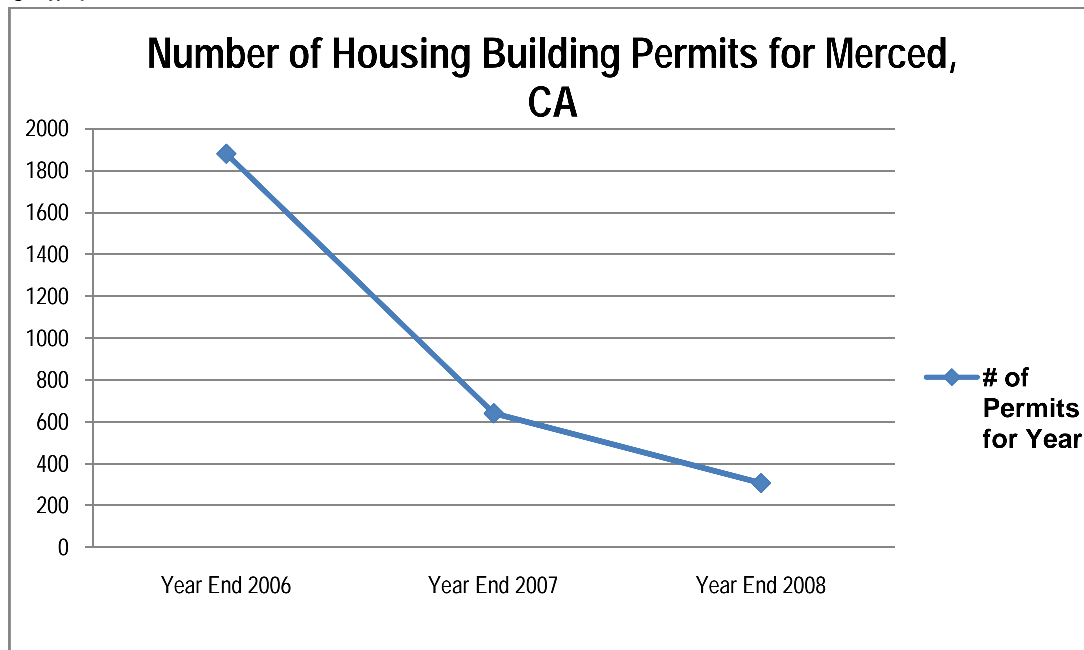
Historically, County maintained a diversified loan portfolio that included agriculture, automobile, commercial, credit card, home mortgage, personal, and real estate loans. With respect to real estate, the bank had a concentration in CRE loans. As shown in Chart 1, the CLD component of the CRE portfolio almost tripled from 2004 to 2008, when it reached approximately $248 million.

Chart 1



Our analysis of County's loan portfolio revealed that a majority of the bank's CLD loans were tied to the residential real estate market. According to examiners, County's high exposure to land and land development loans in and around Merced exacerbated the inherent risk of this class of loans. County steadily built its CLD loan portfolio when the housing market in the bank's service area was robust and growing due to what examiners cited as inexpensive land and low interest rates. In addition, a new University of California campus in Merced fueled speculation and contributed to a rapid increase in land values. However, the local real estate market was dramatically affected by the deteriorating economic conditions in California's central valley. For example, as shown in Chart 2, the number of residential housing building permits in the Merced Metropolitan Statistical Area dropped from 1,881 at the end of 2006, to 308 in 2008.

Chart 2



In addition, during the same period, the Federal Housing Finance Agency's *Housing Price Index* indicated that housing prices in the region declined approximately 50 percent.

County's Board of Directors and management did not recognize the significant risks caused by the sharply declining real estate market. For example, the bank's management and Chief Executive Officer (CEO) disagreed with a 2007 State examination, even though the bank's composite rating remained a "2," or fundamentally sound. More specifically, the CEO took issue with the State examiners' rating of asset quality and earnings as "less than satisfactory" and their calculation of a sizeable loss classification for one of the bank's larger loans. In a July 2007 meeting requested by FRB San Francisco, an examination manager provided data to County's CEO showing evidence of a declining real estate market and stressed the importance of "getting ahead" of market conditions. According to examiners, County's management did not respond to these early indicators because they expected the real estate market to recover and were continuing to focus on the bank's growth prospects.

Ultimately, the local real estate market's precipitous decline led to a rapid deterioration in asset quality, which County's Board of Directors and management were unable to mitigate. According to examiners, most of the bank's problem assets were centered in the CLD portfolio. Examination reports revealed that classified assets increased from $35 million in March 2006 to $275 million by May 2008, an increase of 686 percent. As shown in Table 1, beginning in 2007, the growth in classified assets resulted in a significant increase in the bank's loan loss provision expenses, which contributed to negative earnings.

Table 1
County's Year-end Classified Assets, Loan Loss Provision Expense, and Earnings
($000's omitted)

Date	Classified Assets	Loan Loss Provision Expense	Earnings
2006	35,442	400	23,530
2007	67,756	29,803	-2,650
2008	275,616	55,370	-96,037

During an FRB San Francisco January 2008 asset quality target examination, examiners downgraded loans tied to thirty-one borrowers and required the bank to (1) increase its classified assets by $129 million, and (2) re-file its 2007 year-end regulatory financial report to reflect additional loan loss provision expense, which also decreased the bank's capital. As a result, the bank's capital position declined from *well capitalized* to *adequately capitalized,* as defined in the PCA provisions of the FDI Act.

Reports regarding negative earnings resulted in two separate instances in 2008 when County experienced significant deposit withdrawals. Press coverage in early 2008 detailing County's 2007 losses prompted a net deposit withdrawal surge of approximately $52 million, and a November 2008 press release that disclosed third-quarter 2008 losses provoked a deposit outflow totaling $72 million. Throughout 2008, County managed its liquidity pressures by, among other things, liquidating securities and borrowing from the Federal Home Loan Bank (FHLB) and the Federal Reserve Discount Window. However, the FHLB eventually limited the amount that County could borrow, and back-up lines of credit from correspondent banks were suspended. In addition, examiners noted the "heightened liquidity risk" associated with funding the bank's high volume of uninsured deposits and time deposits that were scheduled to mature in the last five months of 2008.

Attempts to find an investor, buyer, or merger partner failed, and liquidity constraints and asset quality deterioration continued into 2009. Regulators made an on-site visit in January 2009 and characterized County's condition as "critical." The State issued a letter on January 20, 2009, requiring County to raise $74 million in new capital or find a buyer or merger partner by the end of the month. County was unable to comply with the State's requirement, and the bank was closed on February 6, 2009, after a negative earnings report caused a third incidence of deposit withdrawals.

Supervision of County Bank

FRB San Francisco and the State conducted six safety and soundness examinations and a visitation in the five-year period preceding County's failure in early 2009. As shown in Table 2, County was considered a fundamentally sound bank through 2007, receiving a CAMELS 2 composite rating. Examination frequency guidelines for CAMELS composite 2-rated banks allow a twelve- to eighteen-month examination interval. However, FRB San Francisco accelerated the schedule and began an asset quality target examination in January 2008 because of concerns over the increase in classified assets and deterioration in the bank's target real estate market. The target examination resulted in a May 2008 double downgrade to a CAMELS

composite 4 rating that reflected the bank's troubled condition and in a Written Agreement executed in July 2008. A subsequent joint FRB San Francisco-State full-scope examination began in early July 2008 and resulted in a CAMELS composite 5 rating, indicating that the bank's failure was highly probable.

Table 2 – Supervisory Overview of County

Examination		Agency Conducting the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions
Start Date	Report Issue Date			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
05/17/2004	07/29/2004	Joint FRB - State	2	2	2	3	2	2	2	Written Agreement related to Bank Secrecy Act
05/09/2005	07/14/2005	Joint FRB - State	2	2	2	2	2	2	2	
05/08/2006	07/21/2006	Joint FRB - State	2	2	2	2	2	3	2	
05/21/2007	08/10/2007	State	2	2	3	2	3	2	2	
01/28/2008	05/08/2008[a]	FRB (State Participated)	4	4	4	4	4	4	3	Written Agreement
07/07/2008	10/20/2008	Joint FRB - State	5	5	5	4	5	5	4	
01/05/2009	01/20/2009[b]	FRB, State, FDIC	n/a	n/a	n/a	n/a	n/a	n/a	n/a	

[a] Asset quality target examination
[b] Visitation

Below is a summary of County's supervision beginning with the 2007 State examination when the first signs of asset quality deterioration appeared.

2007 State Examination Resulted in a CAMELS Composite 2 Rating

The August 2007 State examination report cited a significant decrease in asset quality and a variety of credit administration deficiencies. The State reported that adversely classified assets (which included loans and Other Real Estate Owned) increased over 90 percent since the prior

examination.[2] In addition, the dollar amount of loans downgraded during the course of the examination—many of which were CLD loans—represented an increase of 60 percent over management's initial calculations. Examiners listed a number of observations covering a wide range of credit administration and underwriting issues that included: CLD loans being renewed/extended without principal paydown or out-of-pocket funding of additional interest expense, weaknesses in construction credit file documentation and the analysis of borrowers' financial capacity, and revising the bank's allowance for loan and lease losses (ALLL) methodology to better conform to accounting and regulatory guidance.

The State examination report noted that many of the credit administration and underwriting deficiencies that surfaced were "minor and should be easily correctable in the normal course of business." Although County received a CAMELS composite 2 rating, the bank's CEO disagreed with the "less than satisfactory" ratings assigned to asset quality and earnings. In addition, County management expressed strong disagreement with the amount of loss the examiners calculated for one of the bank's large loans.

FRB San Francisco Asset Quality Target Examination Resulted in a Downgrade to a CAMELS Composite 4 Rating and a Formal Enforcement Action

Concerns over the increase in classified assets and deterioration in the bank's target real estate market prompted FRB San Francisco to accelerate its examination schedule for County. An asset quality target examination was begun in January 2008, approximately five months after the State issued its 2007 examination report. The target examination, based on year-end 2007 data, disclosed that County's asset quality had deteriorated significantly since the 2007 examination. FRB San Francisco focused on CLD loans and reviewed a sample that included 130 borrowers. Examiners downgraded approximately 25 percent of the borrowers included in the sample, increasing the bank's classified assets by $129 million. Examiners noted that the loan impairment and risks associated with the downgrades seriously threatened the bank's earnings and capital. County was required to re-file its year-end regulatory financial report to reflect additional loan loss provision expenses and ended up with a loss for 2007. The examination report specifically noted that County's capital position, as defined under the PCA provisions of the FDI Act, was below *well capitalized*, and County was directed to strengthen capital planning and cease dividend and certain debt service payments.

FRB San Francisco criticized County's Board of Directors and its management for their failure to increase loan portfolio oversight in a manner that was commensurate with changes in real estate market conditions that had increased the bank's credit exposure. Examiners noted that credit risk deficiencies cited in the State's August 2007 examination report were not corrected and that, among other things, management did not monitor and enforce covenants such as loan-to-value ratios and, therefore, borrowers were not being required to pay additional principal or pledge additional collateral as original collateral values decreased. FRB San Francisco also noted that County's liquidity risk was increasing and that a number of customers with deposits over $100,000 withdrew significant portions of their accounts as a result of the press release

[2] Other Real Estate Owned is real property owned by a banking institution that is not directly related to its business. Other Real Estate Owned is often a result of foreclosure on real property because of a default by the borrower, who used the property as collateral for the loan.

disclosing the bank's 2007 losses.[3] County was told to develop a capital plan along with a contingency funding plan to address liquidity risks associated with uninsured deposits and repayment uncertainties associated with CLD loans.

On February 14, 2008, FRB San Francisco convened a meeting with members of County's management and Board of Directors to discuss the severity of ongoing examination findings and communicate the need for urgent action. In a letter sent to FRB San Francisco and the State on February 25, 2008, County's Chairman of the Board of Directors responded to the findings emerging from the target examination. The Chairman's letter acknowledged that County's Board of Directors accepted the responsibility for immediately correcting deficiencies raised by regulators and provided an action plan to address the bank's shortcomings and challenges posed by the severe economic downturn in the bank's primary market. The plan included significantly modifying the CEO's role by having him report to a newly formed Regulatory Oversight Committee and retaining a consultant to make recommendations for improving lending and loan administration.

Based on the results of the asset quality target examination, FRB San Francisco expanded the examination scope to include assessments of County's other CAMELS components and conducted an off-site inspection of County's Bank Holding Company. After downgrading County to a CAMELS composite 4 rating in the May 2008 report, FRB San Francisco requested that the Federal Reserve Board prepare a formal enforcement action in the form of a Written Agreement. The Board prepared the draft document, and FRB San Francisco and County reviewed it and then executed it in July 2008. The Written Agreement, which was posted on the Board's web page, required County to take action on a wide variety of specific items that included Board of Directors' oversight of management and bank operations, risk management, credit administration and loan review, asset improvement, and capital. Also, a capital plan was to be developed by County within 60 days.

Joint FRB San Francisco-State Examination Begun in July 2008 Resulted in a Downgrade to a CAMELS Composite 5 Rating

A joint full-scope examination begun in July 2008 resulted in County being downgraded to a CAMELS composite 5 rating. Banks in this group exhibit extremely unsafe and unsound practices or conditions and pose a significant risk to the DIF because failure is highly probable. In an examination report issued in late October 2008, examiners noted that the losses incurred in 2007 and through the second quarter of 2008 were primarily from CLD loans and that ongoing declines in collateral values for loans dependent upon real estate sales continued to adversely affect the bank. Although the PCA capital levels were within the "adequate" threshold, examiners noted that the bank's high level of classified assets presented the potential for additional loan loss provision expenses if the bank's primary market continued to show deterioration.

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[3] Before being increased to $250,000 in October 2008, FDIC deposit insurance covered $100,000 per depositor.

Examiners further noted that, despite FRB San Francisco's recommendation to the Regulatory Oversight Committee Chairman (included in the May 2008 target examination report), the Board of Directors and management did not develop a capital plan until late July 2008. According to examiners, this delay elevated the risk to the bank's viability. Examiners noted that the bank's PCA capital designation of *adequately capitalized* rather than *well capitalized* invoked restrictions on the bank's deposit pricing flexibility, thereby increasing liquidity risks. In addition, examiners highlighted the fact that County had not yet implemented a "substantive" plan to fund potential withdrawals when $283 million of time deposits matured during the last five months of 2008.

January 2009 Visitation by FRB San Francisco, State, and FDIC

A January 2009 joint visitation by FRB San Francisco, the State, and FDIC determined that County's condition had deteriorated further and was considered critical. A letter from the State communicating the visitation results noted that extreme action would be taken against the bank unless it corrected the situation on or before month end by either (1) raising $74 million of capital, (2) merging with another institution, or (3) selling its whole business to another depository institution. A potential merger partner and an investor had decided not to move forward in late 2008, and the bank's subsequent efforts to attract a merger partner or capital were likewise unsuccessful. As a result, County was not able to meet the State's January 2009 deadline, and the bank was closed on February 6, 2009, after a negative earnings report caused another incidence of unusually high deposit withdrawals.

FRB San Francisco Implemented Prompt Corrective Action

FRB San Francisco informed County's management that the bank's capital position declined from *well capitalized* to a*dequately capitalized* as defined under PCA during a March 20, 2008, meeting and in the May 2008 target examination report. PCA does not prescribe any regulatory actions or requirements for banks that are a*dequately capitalized*.[4] Regulatory reports filed at the end of January 2009 revealed that County's capital position had fallen to *undercapitalized*; however, the bank was closed less than a week later, before a PCA-related supervisory action required for *undercapitalized* banks could be prepared.

Conclusions, Lesson Learned, and Recommendation

In conclusion, the root causes of County's failure were (1) a precipitous decline in the local real estate market that caused significant losses concentrated in the construction and land development loan component of the bank's commercial real estate portfolio and (2) the Board of Directors' and management's failure to mitigate the bank's credit risk exposure in the face of sharply deteriorating real estate market conditions. County was closed after loan losses mounted, earnings and capital were impaired, liquidity was strained, and efforts to raise capital or find a buyer or merger partner failed.

[4] Although not covered in the PCA statute, section 29 of the FDI Act states that "less than well capitalized" financial institutions cannot accept, renew, or roll over brokered deposits, unless a waiver is obtained from the FDIC.

With respect to supervision, FRB San Francisco complied with the frequency of safety and soundness examinations prescribed in regulatory guidance and conducted off-site monitoring commensurate with concerns and risks identified during examinations. The State and FRB San Francisco completed six examinations from 2004 to 2009; four were conducted jointly, the State conducted one, and FRB San Francisco led an asset quality target examination that was expanded to cover all CAMELS components. Two formal enforcement actions in the form of Written Agreements were levied against County, one in 2004 related to Bank Secrecy Act violations and the other in 2008 pertaining to the bank's deteriorating financial condition. In addition, FRB San Francisco, the State, and the FDIC performed a joint visitation in January 2009.

County's decline from historically being rated a sound financial institution was swift. The bank failed eighteen months after the State's 2007 examination cited the first signs of asset quality deterioration and other problems. Our review of correspondence files and other documents revealed that FRB San Francisco was concerned about the declining local real estate market and the deficiencies cited during the 2007 State examination. As a result, an FRB San Francisco examination manager called for a meeting with County management in July 2007 to (1) present statistical evidence showing that the local real estate market was declining, and (2) stress the importance of taking action to keep ahead of emerging market conditions. FRB San Francisco examiners also accelerated the examination interval normally associated with a CAMELS 2 rated bank and arranged for an asset quality target examination to begin in January 2008, five months after the State examination report was issued.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted additional or alternative supervisory actions. Accordingly, our analysis of County's supervision indicates that the emerging problems that became apparent in the summer of 2007 provided FRB San Francisco with an opportunity for a more aggressive supervisory response.

By August 2007, it was clear that County's asset quality was being significantly affected by the real estate market decline. There were also signs that County's condition had deteriorated steeply since the 2006 examination and that management was either unwilling or unable to deal with the increasing risks associated with the changing business environment. Classified items—many of which were CLD loans—had increased 90 percent since 2006, and the dollar value of classified loans presented by management was insufficient and was increased by 60 percent during the 2007 examination. Credit administration deficiencies included CLD loans being renewed or extended without principal paydown or out-of-pocket funding of additional interest expense, and weaknesses in construction loan credit file documentation, including insufficient analysis of borrowers' financial capacity. In addition, County's management disagreed with the examiners' ratings of certain CAMELS components and strongly disagreed with examiners' calculations of the amount of loss for one of the bank's larger loans.

Overall, we believe that the magnitude and significance of asset quality deterioration and credit administration deficiencies, coupled with management's disagreement with regulators that emerged in the summer of 2007, warranted a more direct and forceful supervisory response by FRB San Francisco. Nevertheless, in light of the rapid deterioration in County's local real estate

market, it is not possible to determine the degree to which such an action would have affected County's subsequent decline or the failure's cost to the DIF.

Lesson Learned

While the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that County's failure provides a lesson learned that can be applied to supervising community banks with similar characteristics and circumstances. County's rapid decline and failure indicates that community banks with a concentration in CLD loans can be highly vulnerable to changes in the real estate market they serve. Accordingly, an early, direct, and forceful supervisory response compelling management to take immediate action to mitigate emerging risks is necessary for banks with CLD concentrations.

Recommendation

Recommendation: **We recommend that the Director of the Division of Banking Supervision and Regulation ensure that Reserve Banks provide timely notification of brokered deposit restrictions to financial institutions deemed less than *well capitalized*.**

FRB San Francisco informed County's management that the bank's capital position as defined under PCA was no longer *well capitalized* during a March 2008 meeting and in the May 2008 target examination report. Under section 29 of the FDI Act, banks deemed "less than well capitalized" cannot accept, renew, or roll over brokered deposits, unless a waiver is obtained from the FDIC. According to Board procedures, the change in County's capital position should have prompted FRB San Francisco to send a letter informing the bank of the brokered deposit restrictions. We found that FRB San Francisco was initially not aware of the Board's procedure and did not send County a brokered deposit restriction notification letter until November 2008.

Even though FRB San Francisco did not provide timely notification, our review of County's correspondence files revealed that management knew that the change in the bank's capital position invoked a restriction on brokered deposits. We also found that County officials knew they had the option of requesting a brokered deposit restriction waiver from the FDIC. Nevertheless, we believe that the Director of Banking Supervision and Regulation should ensure that Reserve Banks are sending timely brokered deposit restriction letters to supervised institutions that fall below *well capitalized*.

Analysis of Comments

We provided a copy of our report to the Acting Director of the Division of Banking Supervision and Regulation for review and comment. Her response, included as Appendix 4, indicates agreement with the report's conclusions, lesson learned, and recommendation. The Acting Director agreed that the magnitude and significance of County Bank's asset quality deterioration and credit administration deficiencies that emerged in the summer of 2007 warranted a more direct and forceful supervisory response by FRB San Francisco. She plans to implement our

recommendation by sending a reminder to ensure that Reserve Banks provide timely notification of brokered deposit restrictions to financial institutions deemed less than *well capitalized*. We will follow up on action taken to implement our recommendation.

The Acting Director welcomed the report's observations and contribution to understanding the reasons for County Bank's failure. She noted that the events described in the report are a vivid reminder to all supervisors of the critical importance of the early detection of issues and close supervision. The Acting Director also cited the dangers of concentrations in risky assets that are subject to dramatic and swift market swings that may ultimately be beyond the bank's ability to overcome.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
The ALLL is a valuation reserve established and maintained by charges against the financial institution's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.

Classified Assets
Classified assets are loans that exhibit well-defined weaknesses and a distinct possibility of loss. The term ''classified'' is divided into more specific subcategories ranging from least to most severe: ''substandard,'' ''doubtful,'' and ''loss.'' An asset classified as ''substandard" is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. An asset classified ''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. Assets classified "loss" are considered uncollectible and of such little value that their continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE)
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.

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

Concentration
A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.

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

Appendix 1 (continued)

Federal Housing Finance Agency's Housing Price Index (HPI)
The HPI is a weighted, repeat-sales index that measures the average price changes in repeat sale or refinancing on the same properties. The four-quarter percentage change in home values is simply the price change relative to the same quarter one year earlier.

Federal Reserve 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.

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.

Other Real Estate Owned (OREO)
OREO is real property owned by a banking institution that is not directly related to its business. Other Real Estate Owned is often a result of foreclosure on real property because of a default by the borrower who used the property as collateral for the loan.

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 Deposit Insurance Fund. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

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

Appendix 2 – Key Events Timeline

Date	Key Event
05/17/2004	FRB San Francisco and the State began a joint, full-scope examination. Examination report issued July 2004 assigned a CAMELS composite 2 rating.
05/09/2005	FRB San Francisco and the State began a joint, full-scope examination. Examination report issued July 2005 assigned a CAMELS composite 2 rating.
05/08/2006	FRB San Francisco and the State began a joint, full-scope examination. Examination report issued July 2006 assigned a CAMELS composite 2 rating.
05/21/2007	State began a full-scope examination. Examination report issued August 2007 assigned a CAMELS composite 2 rating, but cited a significant decrease in asset quality and a variety of credit administration deficiencies. County management disagreed with the less than satisfactory ratings assigned to asset quality and earnings and with the amount of loss that the examiners calculated for one of the bank's large loans.
07/12/2007	FRB San Francisco requested a meeting with County's CEO to discuss the declining real estate market. An examination manager stressed the importance of "getting ahead" of market conditions. Examiners believed that County's management did not respond to the early indicators because they expected the real estate market to recover and were continuing to focus on the bank's growth prospects.
01/28/2008	FRB San Francisco began an asset quality target examination (with participation from the State). The examination report, issued May 2008, resulted in a double downgrade to a CAMELS composite 4 rating reflecting County's troubled condition. In addition, examiners (1) downgraded a number of CLD loans, thus increasing County's classified assets by $129 million, and (2) required County to re-file its year-end regulatory financial report to reflect the additional loan loss provision expenses triggering a loss for 2007.
02/2008	Bank customers withdrew roughly $52 million in deposits after a press report disclosed County's year end 2007 net loss.
02/14/2008	FRB San Francisco met with County's senior management and Directors to discuss asset quality and capital concerns discovered during the recent target examination and communicate the need for urgent action.

Appendix 2 (continued)

Date	Key Event
02/25/2008	In response to the meeting with FRB San Francisco, County's Chairman of the Board sent a letter accepting responsibility for correcting deficiencies raised by regulators and provided an action plan to modify the CEO's role in managing the Bank. The action plan significantly modified the CEO's role by having him report to a newly formed Regulatory Oversight Committee.
04/2008 to 07/2008	County fell to the *adequately capitalized* PCA category. FHLB restricted County's borrowing limits, and back-up lines of credit from correspondent banks were suspended.
07/07/2008	FRB San Francisco and the State began a joint, full-scope examination. Examination report issued October 2008 downgraded County to a CAMELS composite 5 rating, indicating that County's failure was highly probable.
07/17/2008	Federal Reserve Board placed County under a Written Agreement.
11/2008	Potential leads for an investor, buyer, or merger partner fell through. Customers withdrew an additional $72 million in deposits after County's third quarter losses were disclosed.
11/25/2008	FRB San Francisco issued a brokered deposit restriction letter to County's Board of Directors.
01/20/2009	FRB San Francisco, the State, and FDIC conducted a joint visitation of County. As a result, the State issued a letter requiring County to raise $74 million of new capital by 01/31/2009.
02/2009	A negative earnings report caused another incidence of deposit withdrawals.
02/06/2009	State closed County and appointed FDIC as receiver.

Appendix 3 – CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These 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, therefore, 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 institution's size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution 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 institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Appendix 3 (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 institution's 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 institution's 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 Deposit Insurance Fund. 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 institution's 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 institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the Deposit Insurance Fund and failure is highly probable.

Appendix 4 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date:	September 3, 2009
To:	Elizabeth A. Coleman, Inspector General
From:	Esther L. George, Acting Director ***/signed/***
Subject:	Material Loss Review of County Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the Material Loss Review of County Bank, Merced, California that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that County Bank failed as a result of a (1) a precipitous decline in the local real estate market that caused significant losses concentrated in the construction and land development (CLD) loan component of the bank's commercial real estate (CRE) portfolio; and (2) the Board of Directors' and management's inability to mitigate the bank's credit risk exposure in the face of sharply deteriorating real estate market conditions.

We concur with the conclusions, lesson learned, and recommendation contained in the report. The Federal Reserve Bank of San Francisco (FRB San Francisco) complied with the frequency of safety and soundness examinations prescribed in regulatory guidance and conducted off-site monitoring commensurate with the concerns and risks identified during examinations. We note that the FRB San Francisco appropriately accelerated its 2008 examination schedule for the bank due to concerns over the increase in classified assets and deterioration in the bank's target real estate market that was evident by mid-2007. We concur, however, with the report's finding that the magnitude and significance of asset quality deterioration and credit administration deficiencies apparent in mid-2007 warranted a more direct and forceful supervisory response by the FRB San Francisco. We also agree that because of the County Bank's very high concentration in CRE loans coupled with the rapid deterioration of the bank's local real estate market, it is not possible to determine the degree to which such action would have affected the bank's subsequent decline or the DIF's cost of resolution.

Consistent with the report's recommendation, the Division will remind the districts to provide timely written notification of brokered deposit restrictions to financial institutions deemed less than well capitalized. FRB San Francisco provided such notice orally to County Bank, but this Division shortly thereafter advised them to provide such notice in writing. We believe County Bank was one of the first state member banks in the San Francisco district during this downturn to warrant such a notice, and that the district has appropriately followed written notification procedures in other cases.

Board staff very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for County Bank's failure. The events described in the report are a vivid reminder to all supervisors of the critical

Appendix 4 – Division Director's Comments (continued)

importance of the early detection of issues and close supervision, but also the dangers of high concentrations in risky assets that are subject to dramatic and swift market swings that may ultimately be beyond the bank's ability to overcome.

Appendix 5 – Principal Contributors to this Report

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