Office of Audits and Evaluations
Report No. AUD-12-007

Material Loss Review of Bank of Choice, Greeley, Colorado

February 2012

Office of Inspector General

Executive Summary

Material Loss Review of Bank of Choice, Greeley, Colorado

Report No. AUD-12-007
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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance (FDI) Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the Deposit Insurance Fund (DIF) incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) by increasing the Material Loss Review (MLR) threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

On July 22, 2011, the Colorado Division of Banking (CDB) closed Bank of Choice (BOC), and the FDIC was appointed receiver. On August 17, 2011, the FDIC notified the Office of Inspector General (OIG) that BOC's total assets at closing were $979.4 million and that the estimated loss to the DIF was $213.6 million. The FDIC OIG engaged KPMG LLP (KPMG) to conduct an MLR of BOC. The audit objectives were to (1) determine the causes of BOC's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of BOC, including implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

BOC represented the combination of three formerly separate and independent community banks that were acquired by the same parent holding company—Bank of Choice Holding Company (BOCHC), Greeley, Colorado—during the period 2004 through 2006. These three banks were:

- Weld County Bank, Evans, Colorado (Evans). Evans was acquired by BOCHC on July 1, 2004. Upon acquisition, the bank's name was changed to Bank of Choice.

- Colonial Bank, Denver, Colorado (Colonial). Colonial was acquired by BOCHC on November 1, 2005.

- The First National Bank of Arvada, Arvada, Colorado (Arvada). Arvada was acquired by BOCHC on March 17, 2006. Arvada converted to a state non-member bank when it was acquired by BOCHC, and the institution's name was changed to Bank of Choice Colorado.

Subsequent to the acquisitions, BOCHC merged Colonial into Arvada in November 2006 and Evans into Arvada in September 2008. The combined organization then adopted the name of Bank of Choice, Greeley, Colorado.

We reviewed the business operations and supervision of Evans, Colonial, and Arvada (referred to herein as BOC's predecessor banks) as part of the MLR because all three banks were under the common ownership of BOC's parent holding company, their key business strategies were generally determined on a consolidated basis, and it was the combined assets of the three banks that formed BOC in 2008. Notably, the President of Evans, who also served as the bank's chief executive officer and Chairman of the Board (COB), became the COB of BOCHC, Arvada, and Colonial. This individual, who

subsequently became the President of BOC, led the acquisitions and the banks' focus on commercial real estate (CRE) and acquisition, development, and construction (ADC) lending. BOC operated 17 branches, and the majority of the institution's deposits were within the Denver and Greeley metropolitan markets.

Audit Results

Causes of Failure and Material Loss

BOC failed primarily because the Boards of Directors (Boards) and management of BOC and its predecessor banks did not effectively manage the risks associated with heavy concentrations in CRE and ADC loans. Among other things, the Boards and management did not establish prudent CRE and ADC loan concentration limits or maintain capital at levels that were commensurate with the risk in the banks' loan portfolios. Lax lending practices also contributed to the asset quality problems that developed when economic conditions in BOC's lending markets deteriorated. BOC's risk profile was further elevated by its reliance on non-core funding sources, such as brokered deposits, large time deposits, and Federal Home Loan Bank advances, which were used by BOC's predecessor banks to support loan growth and operations. These funding sources became restricted when BOC's financial condition deteriorated, straining the institution's liquidity position.

During 2007, conditions in the Colorado real estate market began to decline. By year-end 2009, the quality of BOC's loan portfolio had deteriorated significantly, with the majority of problems centered in CRE and ADC loans. Further deterioration occurred in 2010. The associated provisions for loan losses depleted BOC's earnings, eroded its capital, and strained its liquidity. The CDB closed BOC on July 22, 2011 because the institution was unable to raise sufficient capital to support its operations.

The FDIC's Supervision of Bank of Choice

The FDIC, in coordination with the CDB, provided ongoing supervisory oversight of BOC and its predecessor banks through regular on-site examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the banks' operations and brought these risks to the attention of the institutions' Boards and management through examination and visitation reports, correspondence, and supervisory actions. Such risks included a lack of adequate risk management practices pertaining to significant concentrations in CRE and ADC loans and reliance on non-core funding sources, inadequate capital protection and liquidity levels, and adverse changes in the local Colorado economy.

Like many other institutions that failed in recent years, BOC and its predecessor banks developed a significant exposure to CRE and ADC loans at a time when the banks' financial conditions and lending markets were generally favorable. This exposure made the banks (and subsequently BOC) vulnerable to a sustained downturn in the real estate market. In retrospect, a more forward-looking supervisory approach to the risk profile and management practices at the predecessor banks during examinations conducted from 2006 to 2008 may have been prudent considering their significant exposure to CRE and ADC loans and the associated vulnerability to economic cycles, reliance on non-core finding sources to support loan growth and operations, capital levels in some periods that were just above PCA thresholds for *Well Capitalized* institutions despite an elevated risk profile, and inadequate responsiveness to repeated examiner concerns regarding the banks' risk management practices. Examiners became sharply critical of

BOC's risk management practices beginning with the November 2008 FDIC examination and issued joint supervisory and enforcement actions in 2009 and 2010, respectively. However, by that time, the bank's lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.

Based on the supervisory actions taken with respect to BOC, the FDIC properly implemented the applicable PCA provisions of section 38.

Management Response

Subsequent to the issuance of KPMG's draft report, officials in the FDIC's Division of Risk Management Supervision (RMS) provided additional information for KPMG's consideration, and KPMG revised its report to reflect this information, as appropriate. On February 16, 2012, the RMS Director provided a written response to a draft of this report. In the response, the RMS Director reiterated the causes of failure and the supervisory activities described in the report. Further, RMS stated that it has recognized the threat that institutions with high-risk profiles, such as BOC, pose to the DIF and issued to FDIC-supervised institutions a 2008 Financial Institution Letter (FIL), entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued a 2009 FIL, entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition.* According to RMS, this FIL heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits and Evaluations
Office of Inspector General

DATE: February 17, 2012

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

/Signed/

FROM: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

SUBJECT: *Material Loss Review of Bank of Choice, Greeley, Colorado*
(Report No. AUD-12-007)

The subject final report is provided for your information and use. The report does not contain recommendations, thus a response was not required. However, the Division of Risk Management Supervision provided a written response on February 16, 2012. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mark Mulholland, Assistant Inspector General for Audits, at (703) 562-6316. We appreciate the courtesies extended to the Office of Inspector General and contractor staff.

Attachment

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Part I

Report by KPMG LLP

Material Loss Review
Bank of Choice
Greeley, Colorado

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP
1676 International Drive
McLean, VA 22102

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KPMG LLP
1676 International Drive
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February 17, 2012

Executive Summary

Stephen M. Beard
Deputy Inspector General for Audits and Evaluations
Federal Deposit Insurance Corporation
3501 Fairfax Drive
Arlington, VA 22226

Material Loss Review Report for Bank of Choice, Greeley, Colorado

Dear Mr. Beard:

The FDIC Office of the Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review (MLR) of the Bank of Choice (BOC or the bank), Greeley, Colorado. This performance audit report details the results of our review. The objectives of this performance audit were to (1) determine the causes of BOC's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of BOC, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of Federal Deposit Insurance Act (FDI Act), section 38. Our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG communicates those to FDIC management for its consideration. As resources allow, the FDIC OIG conducts more comprehensive reviews of specific aspects of the FDIC's supervision program and makes recommendations as warranted. A brief summary of the results of our review follows.

BOC represented the combination of three formerly independent community banks that were acquired between 2004 and 2006 by the institution's parent holding company—Bank of Choice Holding Company (BOCHC), Greeley, Colorado. In the years following the acquisitions, BOCHC merged all three banks into BOC. We included the three banks (referred to herein as BOC's predecessor banks) in the MLR because they were under the common ownership of BOC's parent holding company, their key business strategies were generally determined on a consolidated basis, and it was the combined assets of the three banks that ultimately formed BOC in 2008.

Causes of Failure

BOC failed primarily because the Boards of Directors (Boards) and management of BOC and its predecessor banks did not effectively manage the risks associated with heavy concentrations in Commercial Real Estate (CRE) and Acquisition, Development and Construction (ADC) loans. Among other things, the Boards and management did not establish prudent CRE and ADC loan concentration limits or maintain capital at levels that

KPMG LLP is a Delaware limited liability partnership, the U.S. member firm of KPMG International Cooperative ("KPMG International"), a Swiss entity.

were commensurate with the risk in the banks' loan portfolios. Lax lending practices also contributed to the asset quality problems that developed when economic conditions in BOC's lending markets deteriorated. BOC's risk profile was further elevated by its reliance on non-core funding sources, such as brokered deposits, large time deposits, and Federal Home Loan Bank (FHLB) advances, which were used by BOC's predecessor banks to support loan growth and operations. These funding sources became restricted when BOC's financial condition deteriorated, straining the institution's liquidity position.

Evaluation of Supervision

The FDIC, in coordination with the Colorado Division of Banking (CDB), provided ongoing supervisory oversight of BOC and its predecessor banks through regular on-site examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the banks' operations and brought these risks to the attention of the institutions' Boards and management through examination and visitation reports, correspondence, and supervisory actions. Such risks included a lack of adequate risk management practices pertaining to the significant concentrations in CRE and ADC loans and reliance on non-core funding sources, inadequate capital protection and liquidity levels, as well as adverse changes in the local Colorado economy.

Like many other institutions that failed in recent years, BOC's predecessor banks developed a significant exposure to CRE and ADC loans at a time when the banks' financial conditions and lending markets were generally favorable. This exposure made the banks (and subsequently BOC) vulnerable to a sustained downturn in the real estate market. In retrospect, a more forward-looking supervisory approach to the risk profile and management practices at BOC's predecessor banks during earlier examinations may have been prudent. A stronger supervisory tenor may have resulted in BOC's predecessor banks implementing stronger risk management practices, such as prudent limits on their CRE and ADC loan concentrations and/or higher levels of capital, which could have better positioned BOC to work through the loan deterioration that developed as the Colorado real estate market deteriorated. In addition, it is our view that while earlier examination ratings reflected the financial condition of BOC's predecessor banks, the ratings did not appear to fully reflect the risks present at that time. Examiners became sharply critical of BOC's risk management practices beginning with the November 2008 FDIC examination and issued joint supervisory and enforcement actions in 2009 and 2010, respectively. However, by that time, the bank's lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC informed us that it has taken a number of actions to increase its supervisory attention to banks with risk profiles similar to BOC. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.

Prompt Corrective Action

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository institutions. Based on the supervisory actions taken, the FDIC properly implemented the applicable PCA

provisions of section 38 in a timely manner. BOC was considered *Well Capitalized* or *Adequately Capitalized* for PCA purposes until December 31, 2010, at which point the institution's financial condition had already seriously deteriorated. In this regard, capital levels were a lagging indicator of the inherent risks in the loan portfolio.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and conduct the performance audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The information included in this report was obtained during our fieldwork, which occurred during the period October 2011 through January 2012.

Very truly yours,

KPMG LLP

Why We Did the Audit

Section 38(k) of the FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the DIF incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

On July 22, 2011, the CDB closed BOC and the FDIC was appointed receiver. On August 17, 2011, the FDIC notified the OIG that BOC's total assets at closing were $979.4 million and that the estimated loss to the DIF was $213.6 million. The FDIC OIG engaged KPMG to conduct an MLR of BOC. The performance audit objectives were to (1) determine the causes of BOC's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of BOC, including the FDIC's implementation of the PCA provisions of section 38. Appendix 1, Objectives, Scope, and Methodology, describes the procedures used by KPMG to conduct this performance audit.[1] In addition, Appendix 2 provides a glossary of terms, and Appendix 3 contains a list of acronyms used in this report.

Background

BOC represented the combination of three formerly separate and independent community banks that were acquired by the institution's parent holding company, BOCHC, which was formed in March 2004.[2] These three banks were:

- Weld County Bank, Evans, Colorado (Evans). Evans was chartered in October 1997 and acquired by BOCHC on July 1, 2004. Upon acquisition, the bank's name was changed to Bank of Choice.
- Colonial Bank, Denver, Colorado (Colonial). Colonial was chartered in September 1982 and acquired by BOCHC on November 1, 2005.
- The First National Bank of Arvada, Arvada, Colorado (Arvada). Arvada was chartered in January 1896 and acquired by BOCHC on March 17, 2006. Arvada converted to a state non-member bank when it was acquired by BOCHC, and the institution's name was changed to Bank of Choice Colorado.

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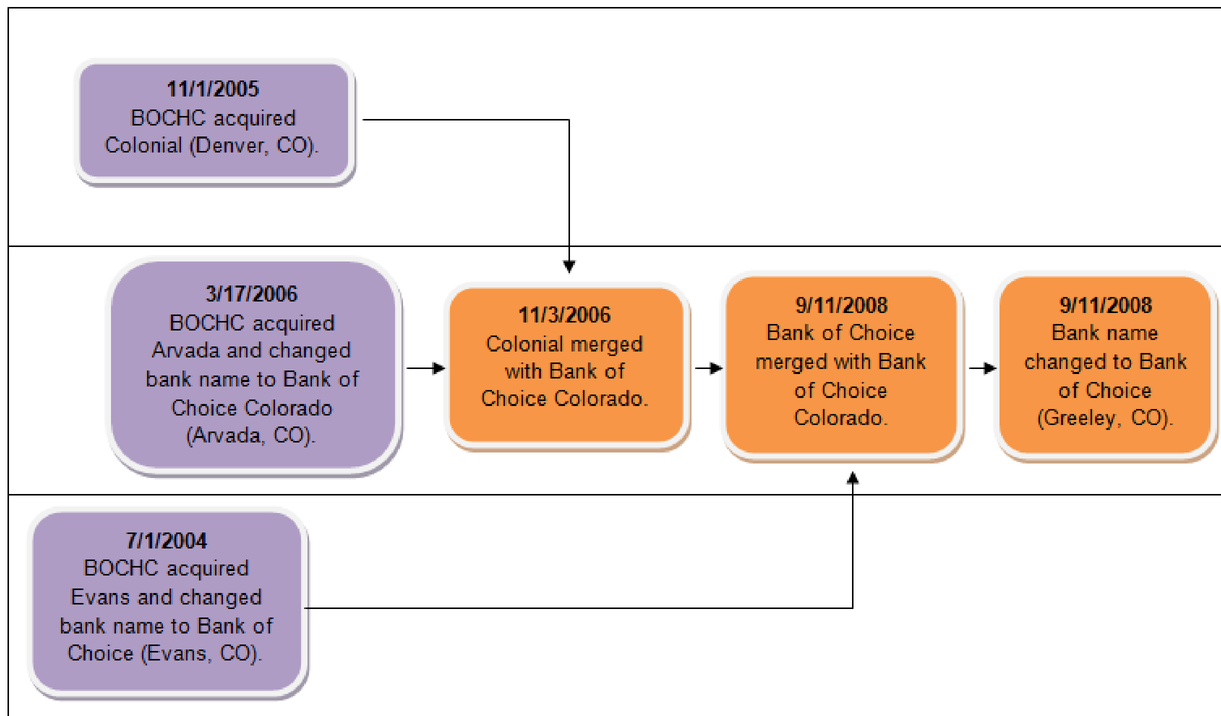
[1] In conducting this performance audit and preparing the report, KPMG relied primarily on information provided by the OIG and the FDIC's Division of Risk Management Supervision (RMS).

[2] BOCHC acquired a fourth institution—Palisades National Bank, Palisade, Colorado—in January 2005. However, BOCHC sold the institution in January 2011. At the time of its sale, Palisades National Bank had approximately $53 million in total assets. We did not include this institution in the scope of this MLR as it was not merged into BOC.

In the years following the acquisitions, BOCHC merged all three banks into BOC. Figure 1 illustrates the mergers and acquisitions that ultimately formed BOC.[3]

Figure 1: BOCHC Acquisitions and Mergers, 2004 – 2008



Source: KPMG analysis of BOC's Supervisory History prepared by RMS.

We reviewed the supervisory activities of Colonial, Arvada, and Evans as part of the MLR because all three banks were under the common ownership of BOC's parent holding company, their key business strategies were generally determined on a consolidated basis, and it was the combined assets of these three banks that ultimately formed BOC in 2008. Notably, the President of Evans, who also served as the bank's chief executive officer (CEO) and Chairman of the Board (COB), subsequently became the COB of BOCHC, Arvada, and Colonial, and the President of BOC. This individual led the organizations' acquisitions and aggressive CRE growth strategy. Formal business plans and strategic plans were established on a consolidated basis at the BOCHC level that set forth the goals and visions of the holding company and its subsidiaries.

The FDIC received a corporate reorganization merger application for Arvada and Colonial on August 25, 2006 and subsequently approved the application on October 16, 2006. As of September 30, 2006, Arvada and Colonial had total assets of $227.7 million and $236.7 million, respectively. The FDIC received a corporate reorganization merger

[3] For the purposes of this report, BOC, formerly named Bank of Choice Colorado, which was formerly named First National Bank of Arvada, will be referred to as "Arvada" for the time period prior to September 11, 2008. Similarly, the Bank of Choice, Evans, Colorado, formerly named Weld County Bank, Evans, Colorado, will be referred to as "Evans" for the time period prior to September 11, 2008. We use the acronym "BOC" when referring to the merged institutions, which reflects the time period subsequent to the merger of Evans into Arvada on September 11, 2008.

application for Arvada and Evans on June 11, 2008 and subsequently approved the application on July 14, 2008. As of June 30, 2008, Arvada and Evans had total assets of $623.8 million and $562.6 million, respectively. When reviewing the merger applications, the FDIC considered various factors as required by the FDI Act and outlined in the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual). Such factors included the financial condition of the banks, the capital structure of the resulting institution, and the general character of bank management. According to approval documentation for the merger applications, such factors were favorably resolved by the FDIC.

BOC operated 17 branches and the majority of the institution's deposits were within the Denver and Greeley metropolitan markets. BOC, Colonial, Arvada, and Evans emphasized CRE and ADC lending, the majority of which was in the state of Colorado. Table 1 illustrates the financial condition of BOC and two of its predecessor banks (Arvada and Evans) as of December 31, 2010 and for the 4 preceding calendar years.

Table 1: Selected Bank Financial Information, 2006 - 2010

Financial Data (millions)	12/10	12/09	12/08	12/07		12/06	
	BOC	BOC	BOC	Evans	Arvada	Evans	Arvada
Total Assets	$1,155	$1,225	$1,180	$547	$570	$445	$477
Total Loans	$692	$853	$921	$424	$455	$371	$322
Total Deposits	$996	$934**	$854*	$424	$465	$344	$399
Brokered Deposits/Total Liabilities	4.37%	5.64%**	24.85%	9.51%	11.02%	12.87%	7.36%
FHLB Advances/Total Liabilities	9.65%	13.67%	14.75%	10.91%	1.24%	11.55%	0%
ADC Loans/Total Capital	390%	239%	332%	288%	415%	253%	303%
CRE Loans/Total Capital***	1158%	545%	616%	613%	690%	613%	590%
Noncurrent Loans/Gross Loans	14.13%	7.46%	3.66%	2.18%	1.93%	1.52%	1.03%
Return on Average Assets	(4.74%)	(4.27%)	0.11%	0.46%	0.79%	0.64%	1.19%
Tier 1 Leverage Capital	2.32%	7.42%	8.84%	7.97%	8.41%	8.77%	8.53%
Total Risk Based Capital	5.16%	10.76%	10.40%	10.01%	10.11%	10.01%	11.04%

Source: Uniform Bank Performance Reports (UBPR) for BOC, Arvada, and Evans.
*Decrease in total deposits from 2007 to 2008 appears attributable to the expiration of a $200 million Certificate of Deposit (CD) program and attrition of core time deposits, coupled with an increased reliance on wholesale funding, including brokered deposits and FHLB advances.
**The decrease in the brokered deposits to total liabilities ratio and the increase in total deposits appears attributable to a large increase in core deposits that offset a runoff of approximately $100 million in brokered CDs. The increase in deposits is partially attributed to the closing of a competitor bank.
***CRE concentrations include owner-occupied CRE. This also applies to Table 2, Figure 2, and Figure 3 within this report.

Causes of Failure and Material Loss

BOC failed primarily because the Boards and management of BOC and its predecessor banks did not effectively manage the risks associated with heavy concentrations in CRE and ADC loans. Among other things, the Boards and management of BOC and its predecessor banks did not establish prudent CRE and ADC loan concentration limits or maintain capital at levels that were commensurate with the risk in the banks' loan portfolios. Lax lending practices also contributed to the asset quality problems that developed when economic conditions in BOC's lending markets deteriorated. BOC's risk profile was further elevated by its reliance on non-core funding sources, such as brokered deposits, large time deposits, and FHLB advances, which were used by BOC's predecessor banks to support loan growth and operations. These funding sources became restricted when BOC's financial condition deteriorated, straining the institution's liquidity position.

During 2007, conditions in the Colorado real estate market began to decline. By year-end 2009, the quality of BOC's loan portfolio had deteriorated significantly, with the majority of problems centered in CRE and ADC loans. Further deterioration occurred in 2010. The associated provisions for loan losses depleted BOC's earnings, eroded its capital, and strained its liquidity. The CDB closed BOC on July 22, 2011 because the institution was unable to raise sufficient capital to support its operations.

Board and Management Oversight

According to the Examination Manual, an institution's Board has overall responsibility and authority for formulating sound policies and objectives for the institution and for effectively supervising the institution's affairs. Executive officers, such as the President and CEO, have primary responsibility for managing the day-to-day operations and affairs of the institution. Further, ensuring appropriate corrective actions to regulatory concerns is a key responsibility of the Board.

As discussed in subsequent sections of this report, the Boards and management of BOC and its predecessor banks did not establish and implement adequate risk management controls pertaining to their CRE and ADC lending and reliance on wholesale funding sources. Examiners identified weaknesses pertaining to the institutions' risk management practices in these areas during the years preceding BOC's failure and made suggestions for improvement. Specifically, examination reports issued from 2004 to 2007 for Arvada, Evans, and Colonial noted a lack of formal CRE concentration exposure limits and inadequate liquidity and wholesale funding policies. However, the actions taken by the Boards and management of these three banks to address examiner concerns were generally not timely or adequate. Examiners subsequently determined that the limits ultimately established by BOC for both CRE loans and wholesale funding sources were excessive.

Lax lending practices also contributed to the asset quality problems that developed when economic conditions in BOC's lending markets deteriorated. For example, during the February 2008 CDB examination of Arvada, examiners cited the need for credit administration enhancements, including:

- improved documentation of borrower cash flows, including global cash flow analyses;
- better documentation and a clear presentation of borrower repayment capacity;
- inclusion of debt service coverage ratios in loan files;
- better documentation and support for appraisal evaluations; and
- implementation of a monitoring process for loans with interest reserves that were running out or totally exhausted, particularly for borrowers whose construction projects had slowed or were experiencing stale sales.

As the real estate market declined and the level of problem assets at BOC became more apparent, examiners noted that bank management's recognition of emerging problems was not always timely. For example, during the August 2009 visitation of BOC, examiners noted a material flaw in the Allowance for Loan and Lease Losses (ALLL) methodology that resulted in the need for an additional provision of about $4 million. During the June 2011 visitation, examiners identified the need for an additional provision to the ALLL of at least $21 million.

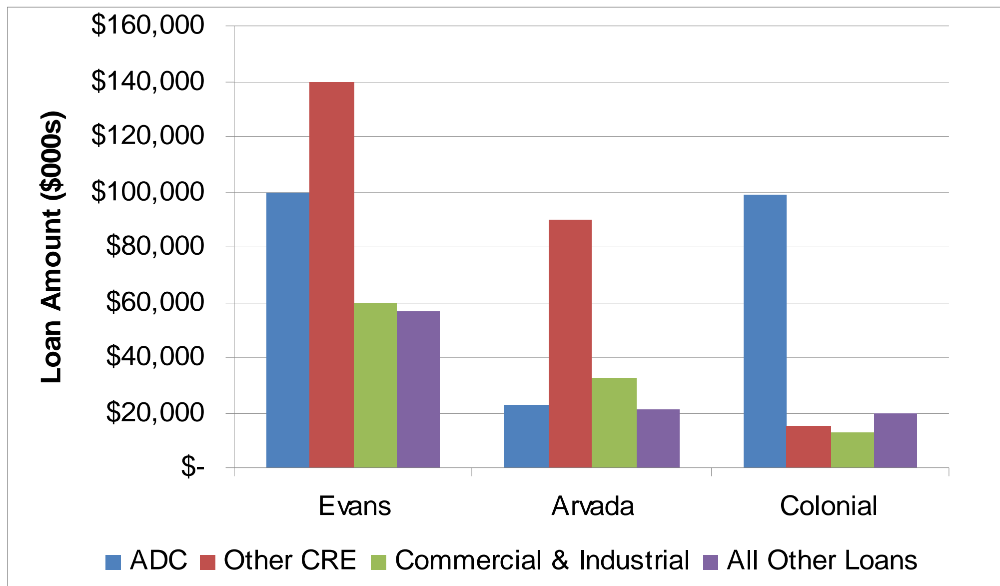
Although earlier examinations noted weaknesses in credit administration practices, examiners considered risk management practices related to the credit function at Colonial, Evans, and Arvada to be satisfactory, as evidenced by the "1" or "2" ratings assigned to Asset Quality. Examiners assigned Asset Quality a "3" rating at the November 2008 examination of BOC, and further downgraded the rating to a "4" and then a "5" at the August 2009 visitation and November 2009 examination, respectively. Examiners at the January 2011 joint examination attributed BOC's high level of adversely classified assets to weak credit underwriting, poor risk management practices, poor loan administration, and the bank's concentration in CRE lending.

Growth Concentrated in CRE and ADC Lending

BOC had a significant exposure to CRE and ADC loans, which was in large measure the result of the lending practices of the banks that merged into BOC. Together with weak concentration risk management practices, this exposure made BOC vulnerable to a sustained downturn in the Colorado real estate market. Further, the capital levels of BOC and its predecessor banks remained relatively constant between 2006 and 2009, and, at certain times during that period, were just above PCA thresholds for a *Well Capitalized* institution. At the same time, risk in the banks' loan portfolios increased due to the growing CRE and ADC loan exposures. Had the banks maintained higher capital ratios, loan growth may have been constrained, and losses to the DIF may have been mitigated to some extent.

Figure 2 illustrates the composition of the loan portfolios for Evans, Arvada, and Colonial as of September 30, 2006, which was the last quarter in which all three banks filed separate Reports of Condition and Income (Call Report).

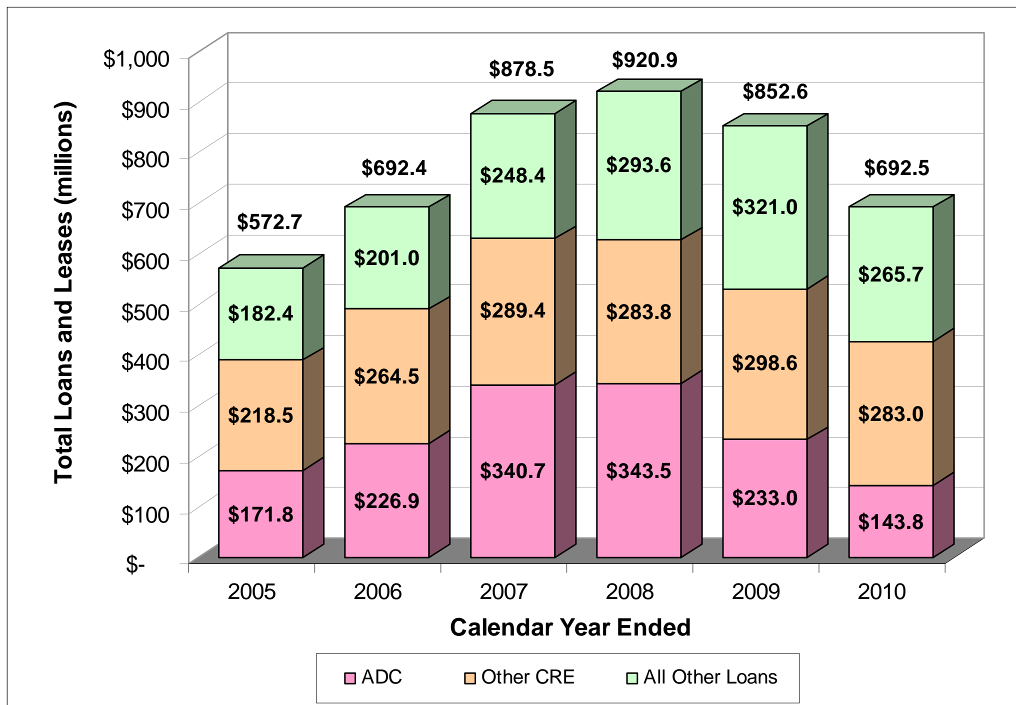
Figure 2: Loan Composition of BOCHC's Subsidiary Banks, September 30, 2006



Source: KPMG analysis of Call Reports for Evans, Arvada, and Colonial.

Figure 3 illustrates the general composition and growth of the combined loan portfolios for BOC, Evans, Arvada, and Colonial in the years preceding BOC's failure.

Figure 3: Composition and Growth of Combined Loan Portfolios, 2005 - 2010



Source: KPMG analysis of Call Reports for BOC, Evans, Arvada, and Colonial. Data for 2005 reflects the combined total loan portfolios for Colonial, Arvada, and Evans. Data for 2006 and 2007 reflects the combined total loan portfolios for Arvada and Evans, as Colonial was merged into Arvada in 2006. Data from 2008 to 2010 reflects the total loan portfolio for BOC after the 2008 merger of Arvada and Evans.

Regulatory concerns pertaining to risks associated with excessive ADC lending date back many years. In October 1998, the FDIC issued a Financial Institution Letter (FIL), *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending* (FIL-110-98), which states that ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that this activity remains profitable.

ADC lending generally involves a greater degree of risk than permanent financing for finished residences or commercial buildings. Associated risks include adverse changes in market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans.

Regulatory concerns pertaining to CRE and ADC lending were reinforced in December 2006 when the FDIC, the Office of the Comptroller of the Currency (OCC), and Board of Governors of the Federal Reserve System issued joint guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The Joint Guidance defines criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk, but it does not establish specific CRE lending limits. According to the Joint Guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

- total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

In addition, in March 2008, the FDIC issued FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risks associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices.

As shown in Table 2, BOC and its predecessor banks Evans and Arvada had CRE and ADC loan concentrations as a percentage of total capital that significantly exceeded the levels defined in the Joint Guidance as warranting additional supervisory analysis. Further, the banks' CRE and ADC loan concentrations as a percentage of total capital substantially exceeded their peer group averages.[4]

[4] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. BOC's peer group consisted of insured commercial banks having assets between $1 billion and $3 billion. Arvada's and Evans' peer group consisted of insured commercial banks having assets between $300 million and $1 billion.

Table 2: CRE and ADC Concentrations Compared to Peer Groups

Bank	Period Ended	CRE Loans as a Percent of Total Capital			ADC Loans as a Percent of Total Capital		
		Bank CRE	Peer Group CRE	Bank Percentile	Bank ADC	Peer Group ADC	Bank Percentile
Arvada	Dec-06	590	372	89	303	117	91
Evans		613		91	253		87
Arvada	Dec-07	690	377	96	415	124	97
Evans		613		90	288		89
BOC	Dec-08	616	421	86	332	139	91
BOC	Dec-09	545	386	83	239	98	91
BOC	Dec-10	1158	336	98	390	65	98

Source: UBPRs for Evans, Arvada, and BOC.
Note: Increases in 2010 are due primarily to a decline in capital and not increases in loan volume. Data under the percentile column represents the percentile ranking or percentage position of each bank relative to other banks in its peer group.

Although BOC and its predecessor banks had implemented certain controls for managing CRE and ADC loan concentrations, their concentration risk management practices were not adequate. For example, the May 2006 and November 2006 examination reports for Evans and Arvada, respectively, noted that the banks' loan policies did not include asset concentration parameters in relation to Tier 1 Capital, nor did the loan policies establish limits on speculative construction loans to builders. The July 2006 CDB examination report for Colonial also noted a lack of tolerance limits for credit concentrations. In addition, the October 2007 CDB examination report for Evans noted that CRE risk tolerances needed to be established, and the November 2008 FDIC examination report for BOC stated that the Board and management had failed to establish risk exposure limits and sub-limits for CRE loans. Further, the November 2009 joint examination report noted that BOC had established an ADC loan concentration limit of up to 375 percent of total risk-based capital, exposing the bank to potential adverse market conditions.

Further, examiners noted at the November 2008 examination that BOC had not stress-tested its CRE and ADC loan portfolios to assess the impact that various economic scenarios might have on the institution's asset quality, capital, and earnings as described in the Joint Guidance.

CRE and ADC Loan Losses

At the November 2008 examination, BOC's adversely classified assets totaled $63 million, or 59 percent of Tier 1 Capital plus the ALLL. Almost all of these classifications consisted of CRE loans, including ADC loans. The level of adversely classified CRE assets increased dramatically at the November 2009 joint examination, totaling approximately $140 million, or 88 percent of total adversely classified assets. Of the $198 million in adversely classified assets at the January 2011 joint examination, approximately $123 million (or 64 percent) pertained to CRE. In its final Call Report for the quarter ended June 30, 2011, BOC reported

that 16 percent of its total loan portfolio was in non-accrual status. Further, about 31 percent of the bank's CRE loan portfolio and 46 percent of the ADC loan portfolio was greater than 30 days past due or in non-accrual status at that time.

Capital Levels Relative to CRE and ADC Loan Growth

The Joint Guidance states that institutions with CRE concentrations should hold capital exceeding regulatory minimums and commensurate with the level of risk in their CRE lending portfolios. In addition, the Examination Manual states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed. Further, the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for purposes of PCA.

BOC and its predecessor banks (Arvada and Evans) relied on BOCHC for capital injections to support loan growth and to maintain a *Well Capitalized* PCA status. As reflected in Table 3, the Total Risk-based Capital ratios for BOC and its predecessor banks Arvada and Evans remained relatively constant, while risk associated with the institutions' CRE and ADC loan concentrations increased. Notably, Evans' and Arvada's Total Risk-based Capital ratios were less than one-tenth of 1 percent above the minimum threshold for *Well Capitalized* institutions at the October 2007 and February 2008 CDB examinations, respectively. Such capital levels do not appear to have been commensurate with the level of risk in the banks' loan portfolios. In addition, the capital ratios of BOC and its predecessor banks were consistently below peer group averages despite CRE and ADC loan exposures that were much higher than peer group averages. Had the banks maintained higher capital ratios, loan growth may have been constrained and losses to the DIF may have been mitigated to some extent.

Table 3: Total Risk-Based Capital Ratios Compared to Peer Group

Bank	Period Ended	Bank Ratio	Peer Group Ratio	Bank Percentile
Arvada	Dec-06	11.04	12.89	25
Evans		10.01		0
Arvada	Dec-07	10.11	12.73	3
Evans		10.01		1
BOC	Dec-08	10.40	11.69	19
BOC	Dec-09	10.76	12.52	18
BOC	Dec-10	5.16	14.01	1

Source: UBPRs for Evans, Arvada, and BOC.

Reliance on Non-core Funding Sources

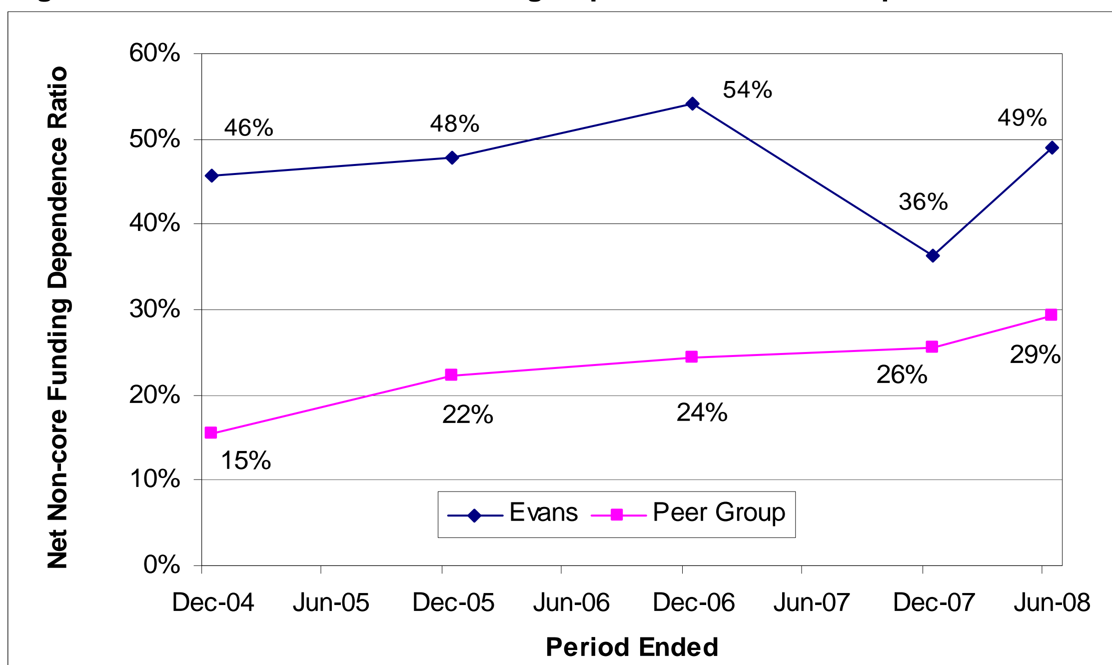
Evans, Colonial, Arvada, and BOC relied heavily on non-core funding sources to support loan growth and maintain liquidity without implementing adequate risk management practices, such as appropriate measurement, monitoring, and reporting systems. Examination reports for Evans, Colonial, and Arvada issued in 2006 noted weaknesses pertaining to the

bank's liquidity risk management practices, such as a lack of risk limits and effective monitoring.

The Examination Manual states that the non-core funding dependence ratio is a measure of the degree to which a bank relies on potentially volatile liabilities, such as, but not limited to, CDs over $100,000 and brokered deposits to fund long-term earning assets (e.g., loans with a term of 1 year or more). Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher ratios reflect reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. In March 2009, the FDIC issued FIL-13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*, which indicated that institutions with aggressive growth strategies or excessive reliance on volatile funding sources are subject to heightened supervisory monitoring and examination.

Evans' reliance on non-core funding was particularly high. Figure 4 illustrates the trend in Evans' non-core funding dependence ratio between December 2004 and June 2008.

Figure 4: Evans Net Non-core Funding Dependence Ratio Compared to Peer Group



Source: KPMG analysis of UBPRs for Evans.

The November 2008 examination report noted that although Arvada had been less reliant on non-core funding sources than Evans, significant loan growth at Arvada in 2007 was mainly funded using FHLB advances and large time deposits. As a result, Arvada's net non-core funding dependence ratio increased from 22 percent as of December 31, 2006, to 46 percent as of June 30, 2008, which was the final reporting quarter prior to the formation of BOC. Following the formation of BOC in 2008, management had been unsuccessful in attracting more stable core deposits. To lower its cost of deposits, BOC's management initiated a program to use FHLB advances and brokered deposits to a greater extent to replace some of

the $200 million in high-cost time deposits that were generated from a promotional CD program implemented in the summer of 2007.

As of December 31, 2008, BOC's net non-core funding dependence ratio peaked a 56 percent. At this time, BOC had $261.1 million in brokered deposits, which represented 31 percent of total deposits, and was more than a 200 percent increase from the $82.1 million in brokered deposits that Evans and Arvada collectively held as of December 31, 2006. Further, the November 2008 examination report for BOC noted that the Board had increased its brokered deposit limitation from 25 to 40 percent of total deposits. In view of the bank's asset quality weaknesses and the institution's elevated risk profile, examiners considered this limitation to be excessive. Table 4 summarizes funding sources from 2006 through 2010.

Table 4: Summary of Funding Sources

Bank	Period Ended	Core Deposits ($000s)	Brokered Deposits ($000s)	Time Deposits above insurance limit ($000s)	FHLB Advances ($000s)
Evans and Arvada	12/31/06	$426,433	$82,139	$234,683	$47,100
Evans and Arvada	12/31/07	$544,680	$101,932	$242,236	$61,050
BOC	12/31/08	$457,828	$261,136	$135,109	$154,990
BOC	12/31/09	$703,278	$54,892	$176,157	$154,930
BOC	12/31/10	$845,292	$49,256	$101,167	$108,870

Source: KPMG analysis of UBPRs for Evans, Arvada, and BOC. Data for 2006 and 2007 reflects combined figures for Evans and Arvada.

BOC reduced its level of non-core deposits and bolstered core deposits starting in 2009. However, Evans' and Arvada's dependence on large time deposits, brokered deposits, and FHLB advances facilitated the loan growth strategy, which ultimately contributed to the financial problems experienced by BOC when its lending markets deteriorated. BOC's non-core funding sources became restricted when BOC's financial condition deteriorated, straining the institution's liquidity position.

The FDIC's Supervision of Bank of Choice

The FDIC, in coordination with the CDB, provided ongoing supervisory oversight of BOC and its predecessor banks through regular on-site examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the banks' operations and brought these risks to the attention of the institutions' Boards and management through examination and visitation reports, correspondence, and supervisory actions. Such risks included a lack of adequate risk management practices pertaining to significant concentrations in CRE and ADC loans and reliance on non-core funding sources,

inadequate capital protection and liquidity levels, as well as adverse changes in the local Colorado economy.

The following sections detail our analysis of the supervisory history, supervisory and enforcement actions, offsite monitoring, PCA activities, and supervisory lessons learned pertaining to BOC and its predecessor banks.

Supervisory History

The FDIC, OCC, and CDB conducted 13 examinations and 3 visitations of BOC and its predecessor banks between 2004 and July 2011. The banks' composite ratings resulting from these examinations were a "1" or "2" from 2004 through February 2008, with the exception of the February 2004 examination of Arvada. The first examination of BOC as a combined entity in November 2008 resulted in a composite rating of "3" and led to an MOU in February 2009. BOC's composite rating was further downgraded to a "5" at the November 2009 joint examination, with the examination results leading to a Consent Order (Order) effective May 6, 2010. The institution remained a composite "5" until it was closed in July 2011. The frequency of this on-site examination activity was consistent with relevant statutory and regulatory requirements.[5] Table 5 summarizes key supervisory information pertaining to Colonial, Evans, Arvada, and BOC from 2004 through 2011.

[5] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, on-site examinations of every state non-member bank at least once every12-month period and allows for 18-month intervals for certain small institutions (i.e., total assets of less than $500 million, effective April 2007; previously $250 million) if certain conditions are satisfied.

Table 5: On-site Examinations and Visitations

Bank Name	Examination Start Date	Examination or Visitation	Regulators	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken
Colonial	6/27/2005	Examination	FDIC	211112/1	N/A
Colonial	7/24/2006	Examination	CDB	211122/1	N/A
Evans	6/14/2004	Examination	FDIC	212222/2	N/A
Evans	6/6/2005	Examination	CDB	212333/2	N/A
Evans	5/30/2006	Examination	FDIC	222222/2	N/A
Evans	10/1/2007	Examination	CDB	222322/2	N/A
Arvada	2/16/2004	Examination	OCC	233212/3	Cease and Desist Order (C&D) and Civil Money Penalties (CMP)*
Arvada	6/20/2005	Examination	OCC	222111/2	N/A
Arvada	11/27/2006	Examination	FDIC	222222/2	N/A
Arvada	2/19/2008	Examination	CDB**	222222/2	N/A
BOC	11/10/2008	Examination	FDIC	333343/3	MOU - February 19, 2009
BOC	8/11/2009	Visitation	FDIC	343443/3	MOU remained in effect
BOC	11/23/2009	Examination	FDIC/CDB	555555/5	Order – May 6, 2010
BOC	7/26/2010	Visitation	FDIC	No rating changes	Order remained in effect
BOC	1/18/2011	Examination	FDIC/CDB	555555/5	Order remained in effect
BOC	6/6/2011	Visitation	FDIC/CDB	No rating changes	Order remained in effect

Source: KPMG analysis of examination and visitation reports for Colonial, Evans, Arvada, and BOC.
* Arvada was issued a C&D and CMP at the February 16, 2004 OCC examination due to previously purchased participations in mostly subprime mortgages coupled with inadequate policies and procedures for subprime credits. With the assistance of a third-party investor, the originator of the subprime loans repurchased all of the subprime loans. Arvada paid $50,000 in CMP and received a composite "2" rating at the subsequent 2005 OCC examination.
** The FDIC provided assistance to the CDB during this examination.

Supervisory and Enforcement Actions

Based on the results of the November 2008 FDIC examination, the FDIC and CDB signed an MOU with BOC, effective February 19, 2009. Among other things, the MOU required BOC to:

- submit a written capital plan to increase capital levels;
- submit a written classified asset reduction plan;
- revise the Loan Policy to address concentrations and establish risk limitations for CRE lending as a percent of total capital;
- submit a written profit plan that establishes strategies and measures to improve the profitability of the bank;

- revise the Asset/Liability Management (ALM) Policy to incorporate a strategy to achieve an acceptable interest rate sensitivity balance; and

- revise the Liquidity Policy to establish objectives and funding strategies aimed at improving liquidity and reducing reliance on non-core/volatile funding sources.

The FDIC performed an on-site visitation in August 2009 to assess BOC's progress in addressing the provisions of the MOU. Examiners noted management had made reasonable, good faith efforts to address the provisions of the MOU, but much remained to be accomplished. For example, examiners noted that the capital plan submitted on April 27, 2009 did not include a "specific expressed determination by the Board of the minimum level of capital to be maintained by the bank." Based on the findings of the visitation, the FDIC notified BOC's Board that the bank was deemed to be in a "troubled condition" in a letter dated September 21, 2009. Section 303 of the FDIC Rules and Regulations defines the restrictions pertaining to institutions in a "troubled condition." Such restrictions include, but are not limited to, notifying the FDIC in advance of any additions to the Board or the senior management team.

Based on the results of the November 2009 joint examination, the FDIC and CDB issued an Order effective May 6, 2010. Among other things, the Order required BOC to:

- increase the Board's participation in the affairs of the bank;

- submit a written capital plan to achieve a Tier 1 Capital ratio of 9 percent or more and a Total Risk Based Capital Ratio of 13 percent or more;

- restrict any declaration of dividends;

- adopt a strategic plan addressing ALM and the need to reduce problem loans and restrict asset growth;

- submit a written profit plan and a realistic comprehensive budget;

- submit a written plan addressing liquidity, the bank's reliance on volatile liabilities (including brokered deposits), and asset/liability management;

- submit a written plan to reduce all loan concentrations, including concentrations in construction and land development and non-owner-occupied commercial real estate;

- submit an interest rate policy; and

- revise the Loan Policy to address troubled debt restructuring.

The FDIC performed an on-site visitation in July 2010 to review compliance with the provisions of the Order. While BOC had taken some action to address most of the Order's

provisions, examiners noted that many critical elements of the Order remained largely in the planning stage, and implementation had either not been initiated or had not succeeded.

Offsite Monitoring

The FDIC has established an offsite review program that is designed to identify emerging supervisory concerns and potential problems so that bank supervisory strategies can be adjusted appropriately. Under the program, offsite reviews are performed quarterly for each bank that appears on the Offsite Review List (ORL).[6] Regional RMS management is responsible for implementing procedures to ensure that offsite review findings are considered when establishing examination schedules and other supervisory activities. Offsite reviews must be completed 3½ months after each quarterly Call Report date. This schedule generally provides 45 days to complete the offsite reviews once the Call Report is finalized.

The FDIC uses various offsite monitoring tools to help assess the financial condition of banks. These tools use statistical techniques, Call Report data, and other information to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources. Table 6 identifies the key offsite monitoring tools that identified risk flags for Evans, Arvada, and BOC.

[6] The ORL identifies institutions warranting heightened supervisory oversight. Since the offsite review program is intended to identify potential emerging problems, the ORL includes only those institutions with a composite rating of a "1" or "2."

Table 6: Offsite Review History

Bank	Offsite Review Date	Statistical CAMELS Offsite Rating System (SCOR)[A]	SCOR-Lag[B]	Real Estate Stress Test (REST)[C]	Growth Monitoring System (GMS)[D]	Consistent Grower[E]	Young Institutions[F]	Multiflag[G]
Evans	6/30/05		✓	✓	✓	✓	✓	✓
Evans	3/31/08	✓	✓	✓				
Evans	6/30/08	✓	✓	✓		✓		
Arvada	3/31/08		✓	✓				
Arvada	6/30/08	✓	✓	✓				
BOC	9/30/08	✓	✓	✓	✓			
BOC	12/31/08	✓	✓	✓	✓			

Source: KPMG analysis of the results of offsite reviews for Evans, Arvada, and BOC.
[A] SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
[B] SCOR-lag is a derivation of SCOR that assesses the financial condition of rapidly growing banks. SCOR ratios used to measure asset quality are likely to be understated at a rapidly growing bank since few loans are non-performing at origination. A common technique to avoid such an understatement is the use of a lag-ratio. SCOR-lag uses current period SCOR data and then adjusts the asset quality ratios on a 1-year lag basis.
[C] REST measures exposures to real estate lending.
[D] GMS identifies institutions experiencing rapid growth and/or with a funding structure highly dependent on non-core funding sources.
[E] Consistent Grower is a cumulative growth score for an institution using up to 20 quarters of GMS scores.
[F] Young Institutions identifies institutions that are less than 8 years old.
[G] Multiflag is determined by combining the multiple risk measures from the various offsite review models.

As reflected in Table 6, Evans was flagged for offsite review once in 2005 and twice in 2008. Arvada was first flagged for offsite review in the first two quarters of 2008, and BOC was flagged for review in the final two quarters of 2008. Relevant examiner comments documented during the offsite reviews include the following:

- June 2005 (Evans): Loan growth was the primary flag. The bank's use of non-core deposits had increased and had been utilized without adequate policies, measuring tools, or monitoring.
- March 2008 (Evans and Arvada): The level of risk was high with an increasing trend. Financial data indicated material stress on the banks' financial condition. The Chairman and CEO for both banks acknowledged that the banks were experiencing problems, and RMS scheduled an examination with a November 2008 start date.
- June 2008 (Evans and Arvada): The level of risk was high with an increasing trend. Financial data indicated material stress on the banks' financial condition, and RMS expected to downgrade the banks at the November 2008 examination.
- September 2008 (BOC): The onsite examination confirmed deterioration, and an MOU to address the weaknesses was in process.
- December 2008 (BOC): The onsite examination confirmed deterioration, and a UFIRS of 333343/3 was assigned. An MOU to address the weaknesses identified was put in place effective February 19, 2009.

The offsite reviews were conducted in accordance with FDIC policy and, as such, focused on numerical measures of risk with less emphasis on unsafe or unsound practices, such as risk

management practices. The offsite monitoring did not appear to have significantly changed the FDIC's approach to supervising the institutions because: (1) offsite reviews were not triggered in 2006 or 2007, a period in which the institutions were assuming increased risk during favorable economic conditions, and (2) when offsite reviews were triggered in 2008, on-site examinations were either recently completed or scheduled to begin relatively soon thereafter at BOC.

Supervisory Response Related to Board and Management Oversight

According to the Examination Manual, an institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk. The Examination Manual further notes that the quality of management is often the single most important element in the successful operation of an insured institution and is usually the factor that is most indicative of how well risk is identified, measured, monitored, and controlled. Further, ensuring appropriate corrective actions to regulatory concerns is a key responsibility of the Board.

BOC's Board and management exhibited a high tolerance for risk that included significant concentrations in CRE and ADC loans and a reliance on non-core funding deposits without appropriate risk management practices to mitigate the corresponding risk. Examiners generally considered Board oversight and management performance at Colonial, Evans, and Arvada to be satisfactory, as evidenced by the "1" or "2" ratings assigned to Management. For example, CDB examiners noted in the 2006 Colonial examination report that management's overall ability to identify, monitor, and manage the risks inherent in its operations and general effectiveness in operating the institution in a safe and sound manner was evident in the bank's performance. Notwithstanding these determinations, FDIC and CDB examiners expressed repeated concern about the risk management practices of BOC's predecessor banks and made recommendations for improvement. FDIC and CDB examiners expressed significant concerns about BOC's risk management practices beginning with the November 2008 examination. However, the actions taken by the Boards and management of BOC and its predecessor banks to address examiner concerns and recommendations were generally not timely or adequate.

Table 7 summarizes examiner comments in examination reports issued between 2004 and BOC's failure that pertain to issues for which the Boards and management of the banks had a responsibility to effectively address.

Table 7: Examiner Comments on Key Risks

Bank	Examination Date	Examiner Comments
Evans	6/14/2004	• A better system for tracking CRE industry concentrations was needed. • As noted in the previous two examinations, examiners strongly encouraged management to establish funding limits, and measure and monitor the bank's dependence ratio, as required by the bank's ALM Policy.
Evans	6/6/2005	• The ALM Policy continued to require the Board and management's attention. Specifically, the policy did not establish appropriate risk limits and improved internal monitoring and Board reporting was needed. The lack of appropriate limits regarding the use of alternate funding sources was a noted weakness and a repeat criticism.

Bank	Examination Date	Examiner Comments
Evans	5/30/2006	• The Loan Policy did not include asset concentration parameters in relation to Tier 1 Capital nor provide general limits on speculative construction loans to builders. • The ALM Policy provided no formal risk limitations for wholesale funding resources or liquidity.
Colonial	7/24/2006	• Tolerance limits for concentrations of credit had not been established. • Minimal liquidity monitoring was provided to the Board, and the limited information that was provided did not accurately depict the liquidity position of the bank. This was a repeat criticism from a 2003 examination.
Arvada	11/27/2006	• The Loan Policy did not include asset concentration parameters in relation to Tier 1 Capital nor provide general limits on speculative construction loans to builders. • Enhanced funds management processes, contingency planning, and capital maintenance were necessary when utilizing brokered deposits. • Net non-core funding dependency and reliance on wholesale funding ratios were not being calculated or reported to the Board, and examiners recommended that the ALM Policy be revised to include a maximum limitation on brokered deposits. • Several loan policy recommendations were made, including, but not limited to, specifying lending authority, defining Board responsibility for loan approval, establishing guidelines for obtaining and reviewing real estate appraisals, and applying appropriate financial accounting standards to the ALLL methodology.
Evans	10/1/2007	• CRE risk tolerance limits should be established by the Board, and the principles of the Joint Guidance should be incorporated into the loan policy. • Policies continued to lack formal risk limits relative to wholesale funding sources.
Arvada	2/19/2008	• Examiners cited the need for several credit administration enhancements to loan presentations, including the need for: o improved documentation of borrower cash flows, including global cash flows; o better documentation and a clear presentation of borrower repayment capacity; o inclusion of debt service coverage ratios in the loan files; o better documentation and support for evaluations conducted for appraisals; and o implementation of a monitoring process for loans with interest reserves that were running out or totally exhausted, particularly for borrowers whose construction projects had slowed or were experiencing stale sales.
BOC	11/10/2008	• Although recommended at previous examinations, the Board and management failed to establish risk exposure limits and sub-limits for CRE loans. • Examiners considered the Board's decision to increase brokered deposit limits from 25 to 40 percent of total deposits excessive in view of the bank's asset quality weaknesses and elevated risk profile. • Risk management policies and practices for ALM and the investment function were not considered adequate, and several recommendations were made to revise the Interest Rate Risk and Liquidity policies. • Reliance on non-core funding was excessive and on-balance sheet liquidity was minimal.

Bank	Examination Date	Examiner Comments
		• The bank had become increasingly reliant on non-core funding sources and had not established appropriate limits on non-core funding sources, as recommended by examiners. • The level of reliance on non-core funding sources magnified the potential for a liquidity shortfall given the bank's deteriorating financial condition, and in particular the declining asset quality. • The increase in non-core fund usage occurred without development of a Contingency Funding Plan to address material liquidity shortfalls.
BOC	11/23/2009	• The CRE concentration limits established in March 2009 exceeded the Joint Guidance. In particular, bank policy limits for ADC lending were set at 375 percent, while the supervisory guidance for ADC lending was 100 percent. • A more proactive approach to loan review and regular monitoring of customers' activities would alert management to borrower difficulties, such as slowing sales, depletion of liquidity, reduced cash flow, and increasing debt, which would allow for early intervention and mitigation of losses. • Internal audit procedures were considered to be limited and omitted a comprehensive evaluation of risk.
BOC	1/18/2011	• Management should conduct a portfolio-level stress test or sensitivity analysis on the CRE concentration to quantify the impact of changing economic conditions on asset quality, earnings, and capital.

Source: KPMG analysis of examination reports for Colonial, Evans, Arvada, and BOC.

The November 2009 joint examination report stated that BOC's Board and management had failed to stem the deterioration of the bank and that the condition of the bank indicated that the Board had not provided effective direction and administrative oversight, or correctly evaluated the primary risk areas of the institution. The January 2011 joint examination report noted that management had failed to implement effective risk management practices and controls as the bank nearly doubled in size from year-end 2007 to year-end 2008 through mergers and acquisitions. By 2011, it was apparent to examiners that the Board and management had failed to establish policies and risk tolerance levels to adequately protect the bank from a lack of sales and the real estate market collapse.

According to the Examination Manual, the following evaluation factors should be considered when determining the Management component rating:

- the level and quality of oversight and support of all institution activities by the Board and management;
- the ability of the Board and management, in their respective roles, to plan for and respond to the risks that may arise from changing business conditions or the initiation of new activities or products;
- the adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities; and
- the responsiveness to recommendations from auditors and supervisory authorities.

As noted in Table 5, examiners assigned Colonial, Evans, and Arvada Management component ratings of "1" or "2." At the November 2008 examination, examiners assigned BOC a Management component rating of "3," and subsequently downgraded this rating to a "5" at the November 2009 examination.

Supervisory Response Related to Growth Concentrated in CRE and ADC Lending

Examiners generally considered Colonial's, Evans', and Arvada's risk management practices pertaining to asset quality to be satisfactory, as evidenced by the "1" or "2" ratings assigned to Asset Quality. Notwithstanding these determinations, examination reports issued between 2006 and 2011 expressed concern regarding the risks associated with the banks' CRE and ADC loan concentrations. In addition to the many comments and recommendations on the banks' concentration risk management controls contained in Table 7, Table 8 identifies additional comments in examination reports specifically pertaining to CRE and ADC concentrations.

Table 8: Examiner Comments Related to CRE and Concentrations, 2006 - 2011

Bank	Examination Start Date	CRE / ADC as a Percentage of Total Capital	Examiner Comments
Colonial	7/24/2006	522% / 444% as of 3/31/2006	Examiners noted that nearly all the classified loans at the examination were construction loans.
Evans	5/30/2006	587% / 244% as of 3/31/2006	Examiners noted that the continued large concentration in construction loans, particularly speculative construction loans and land/lot development loans, increased the need for the Board and management to ensure appropriate loan underwriting and administration remained in place. Examiners noted a high risk exposure to potential fluctuations in the real estate market.
Evans	10/1/2007	624% / 300% as of 6/30/2007	Examiners recognized a CRE concentration, noting that analysis was needed on the types of properties financed, the adequacy of their collateral coverage and cash flow, and the market effects on the repayment abilities of customers.
Arvada	11/27/2006	602% / 120% as of 9/30/2006	Examiners noted that the loan portfolio contained an industry concentration in real estate construction/land development loans.
Arvada	2/19/2008	689% / 415% as of 12/31/2007	While CRE concentration levels were documented in the examination report, there were no further comments on the CRE concentration level or practices at this examination.
BOC	11/10/2008	586% / 320% as of 9/30/2008	Examiners noted that a portfolio-level stress test or sensitivity analysis on CRE loans needed to be implemented to quantify the impact of changing economic conditions on asset quality, earnings, and capital. The bulk of the CRE concentrations were comprised of higher-risk ADC loans.
BOC	11/23/2009	569% / 276% as of 9/30/2009	Examiners noted that CRE loans, particularly ADC loans, had been adversely affected by the weak real estate market, contributing to the increased level of adverse classifications. Approximately $140 million (or 88 percent) of adversely classified loans were CRE.

Bank	Examination Start Date	CRE / ADC as a Percentage of Total Capital	Examiner Comments
BOC	1/18/2011	1158% / 390% as of 12/31/2010	Examiners noted that the alarming increase in problem assets and credit losses was attributed to the excessive concentration of collateral dependent, high-risk ADC and CRE loans. Approximately $123 million (or 64 percent) of adversely classified loans were CRE.

Source: KPMG analysis of examination reports for Colonial, Evans, Arvada, and BOC. ADC and CRE percentages were obtained from UBPRs for the institutions.

The Examination Manual notes that examiners should consider the existence of asset concentrations, as well as the level and trend of classified, nonaccrual, and delinquent assets, when assessing the Asset Quality component. The Examination Manual further states that management's ability to identify, measure, monitor, and control credit risk should be reflected in the Asset Quality component rating.

The Asset Quality component for Colonial, Evans, and Arvada was rated either a "1" or "2" from 2006 to February 2008. At the November 2008 examination, BOC was assigned an Asset Quality rating of "3." Examiners downgraded this rating to a "4" at the August 2009 visitation, and to a "5" at the November 2009 examination.

Supervisory Response Related to Reliance on Non-core Funding Sources

BOC and its predecessor banks relied on non-core funding sources, such as large time deposits, brokered deposits, and FHLB advances, to fund operations and loan growth. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. According to the Examination Manual, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs. According to the Examination Manual, potential red flags that may indicate the need for examiners to take action to ensure that the risks associated with brokered or other rate sensitive funding sources are managed appropriately include, but are not limited to, significant funding shifts from traditional funding sources and the absence of adequate policy limitations on these kinds of funding sources.

With the exception of the June 2005 Evans examination, examiners considered Colonial's, Evans', and Arvada's liquidity position to be satisfactory or better, as evidenced by the "1" or "2" ratings assigned to Liquidity. Table 7 references concerns raised by examiners in examination reports issued between 2004 and 2011 regarding the institutions' liquidity risk management practices, including their use of non-core funding. BOC was assigned a Liquidity rating of "4" at the November 2008 examination, and examiners further downgraded Liquidity to a "5" rating at the November 2009 examination.

Implementation of PCA

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve the problems of insured depository institutions at the least possible cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan (CRP), mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to BOC, the FDIC properly implemented the applicable PCA provisions of section 38. BOC was considered *Well Capitalized* or *Adequately Capitalized* for PCA purposes until December 31, 2010, at which point the institution's condition had already seriously deteriorated. In that regard, capital levels were a lagging indicator of the inherent risks in the loan portfolio. Table 9 illustrates the capital ratios of BOC and its predecessor banks relative to the PCA thresholds for *Well Capitalized* institutions during examinations and at other key points in time. A chronological description of the changes in the banks' capital categories and the FDIC's implementation of PCA follow the table.

Table 9: Summary of Capital Level Categories for Colonial, Evans, Arvada, and BOC

Bank	Examination or Event Date	As of Date	Total Risk-Based	Tier 1 Risk-Based	Leverage	PCA Capital Category
Well Capitalized **Threshold**			**≥10%**	**≥6%**	**≥5%**	
Colonial	7/24/2006 Examination	3/31/2006	13.03	12.11	8.88	*Well Capitalized*
Evans	5/30/2006 Examination	3/31/2006	10.4	9.46	8.34	*Well Capitalized*
Evans	10/1/2007 Examination	6/30/2007	10.0	9.16	8.45	*Well Capitalized*
Arvada	11/27/2006 Examination	9/30/2006	10.5	9.39	8.70	*Well Capitalized*
Arvada	2/19/2008 Examination	12/31/2007	10.08	9.25	8.41	*Well Capitalized*
BOC	11/10/2008 Examination	9/30/2008	10.5	9.94	8.94	*Well Capitalized*
BOC	11/23/2009 Examination	9/30/2009	9.54	8.27	6.66	*Adequately Capitalized*
BOC	1/25/2011 PCA Notification	12/31/2010	N/A	N/A	2.31*	*Significantly Undercapitalized*
BOC	3/14/2011 PCA Directive					
BOC	4/28/2011 PCA Notification	12/31/2010**	4.56	3.28	1.96	*Critically Undercapitalized*

Source: KPMG analysis of examination reports for Colonial, Evans, Arvada, and BOC.
* Data source is the capital plan submitted by the bank on January 20, 2011. Once the leverage ratio fell below 3 percent, BOC became *Significantly Undercapitalized*.
** Capital ratios as of 12/31/10 were recalculated by examiners based on the results of the 1/18/2011 joint examination. BOC became *Critically Undercapitalized* when its tangible equity to total assets ratio went below 2 percent.

BOC was considered *Well Capitalized* for PCA purposes until the November 2009 joint examination, at which time the bank fell to *Adequately Capitalized* based on the results of the examination. Before falling to *Adequately Capitalized*, BOC entered into an MOU with the FDIC and CDB, effective February 19, 2009, requiring the bank to submit a capital plan to increase capital. Although BOC submitted a capital plan to the FDIC on April 27, 2009, examiners subsequently determined that the plan did not include an expressed determination by the Board of the minimum level of capital to be maintained by the bank.

According to the bank's Call Report data, BOC returned to a *Well Capitalized* position for PCA purposes as of December 31, 2009; however, the bank fell back to *Adequately Capitalized* as a result of the May 2010 Order. Based on the results of the November 2009 joint examination, the FDIC issued an Order effective May 6, 2010, requiring BOC to submit a written capital plan within 60 days to achieve a Tier 1 Capital ratio of 9 percent or more and a Total Risk Based Capital ratio of 13 percent or more. The bank submitted a capital plan on July 2, 2010. In a letter dated July 28, 2010, the FDIC and CDB notified BOC that the plan

was not acceptable because it did not achieve the minimum capital ratios contained in the Order, nor did it include the required detailed contingency plan for selling the bank. The FDIC requested a revised capital plan by August 30, 2010. BOC submitted a revised capital plan on August 27, 2010. In a letter dated September 10, 2010, the FDIC notified the bank that the revised capital plan was not acceptable because it failed to obtain the Order's capital ratios in a reasonable time period. The letter requested another revised capital plan by October 15, 2010.

BOC requested, and was granted, an extension for a revised capital plan until November 1, 2010. Although the bank submitted a revised capital plan by that date, the FDIC determined that it was not acceptable because it failed to provide for a timely capital injection in order for the bank to achieve and maintain the Order's capital ratios. The FDIC requested that the bank provide a revised capital plan by December 6, 2010. The bank submitted a revised capital plan on December 6, 2010. The FDIC found this plan to be acceptable contingent upon management submitting an addendum that quantified the amount of expected losses and the total capital necessary to restore the bank to a satisfactory condition by March 31, 2011. Although the bank submitted the requested addendum on December 23, 2010, the FDIC and CDB determined that the addendum did not include all of the previously requested information. In a letter dated January 13, 2011, the FDIC requested that the bank provide a more comprehensive capital plan by February 15, 2011.

The bank submitted a *Revised Bank of Choice Combined Strategic and Capital Plan* on January 20, 2011. In a letter dated January 25, 2011, the FDIC notified BOC's Board that it was *Significantly Undercapitalized* based on the December 31, 2010 Tier 1 Capital ratio of 2.31 percent submitted in the *Revised Bank of Choice Combined Strategic and Capital Plan*. The letter notified management that the bank was subject to the relevant mandatory requirements of section 38 of the FDI Act, including the submission of a CRP by March 11, 2011 and restrictions on asset growth, acquisitions, new activities, new branches, payment of dividends or making any other capital distribution, or management fees. The FDIC notified the bank on February 23, 2011 that the *Revised Bank of Choice Combined Strategic and Capital Plan* was not acceptable as it did not demonstrate that the bank would either be recapitalized or sold within a reasonable period of time.

BOC submitted a CRP on March 11, 2011. In a letter dated March 14, 2011, the FDIC notified the bank that the plan was unacceptable because it lacked a holding company guarantee, did not provide a plan to recapitalize the bank absent selling the bank to an undisclosed buyer, and lacked substantive information to determine if it complied with the requirements of section 38(e)(2)(B) of the FDI Act.[7] Due to BOC's *Significantly Undercapitalized* status and failure to submit an acceptable CRP, the bank was subject to additional mandatory restrictions and actions embodied in section 38(f) of the FDI Act. Consequently, the FDIC issued a PCA Directive on March 14, 2011, which included provisions that required the bank to take certain actions including, but not limited to:

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[7] Section 38(e)(2)(B) of the FDI Act specifies that the CRP shall specify the steps the insured depository institution will take to become adequately capitalized, the levels of capital to be attained during each year the plan will be in effect, how the institution will comply with the restrictions or requirements then in effect, and the types and levels of activities in which the institution will engage.

- recapitalizing the bank within 30 days;
- submitting an acceptable capital restoration plan by March 28, 2011;
- restricting interest rates paid on deposits;
- refraining from accepting, renewing, or rolling over any brokered deposits; and
- refraining from making any capital distributions or dividend payments to its parent or any affiliate.

The bank submitted a CRP on April 8, 2011, and, in a letter dated April 21, 2011, the FDIC informed BOC that the plan was not acceptable because it did not contain all required information, including a signed guarantee from BOCHC. Although this CRP was received 11 days after the March 28, 2011 due date, the bank was already subject to section 38(f) of the FDI Act, which applies to both *Significantly Undercapitalized* and *Undercapitalized* institutions that fail to submit a timely CRP. The FDIC requested a revised CRP by May 15, 2011. We did not find any evidence that BOC submitted a revised CRP.

In the transmittal letter for the January 2011 joint examination report, dated April 28, 2011, the FDIC notified the bank that it was *Critically Undercapitalized*. Bank management pursued a number of avenues to raise equity capital, including the retention of a third-party investment advisor. Several private equity groups and banks were identified for potential investments or mergers. However, given the bank's distressed financial condition, timely access to substantial capital funds appeared unlikely. Efforts to raise equity capital were ultimately unsuccessful, and the bank was closed on July 22, 2011.

Supervisory Lessons Learned

The perspectives gained from the failure of BOC are not unique. Like many other institutions that failed in recent years, BOC's predecessor banks developed a significant exposure to CRE and ADC loans at a time when the banks' financial conditions and lending markets were generally favorable. This exposure made the banks (and subsequently BOC) vulnerable to a sustained downturn in the real estate market. In retrospect, a more forward-looking supervisory approach to the risk profile and management practices at Colonial, Evans, and Arvada during examinations conducted from 2006 to 2008 may have been prudent considering their:

- significant exposure to CRE and ADC loans and the associated vulnerability to economic cycles;
- reliance on non-core funding sources to support loan growth and operations;
- capital levels in some periods that were just above the PCA threshold for a *Well Capitalized* institution despite an elevated risk profile; and

- inadequate responsiveness to repeated examiner concerns regarding the banks' risk management practices.

A stronger supervisory tenor during earlier examinations may have influenced BOC's predecessor banks to implement stronger risk management practices, such as prudent limits on their CRE and ADC loan concentrations and/or higher levels of capital, which could have better positioned BOC to work through the loan deterioration that developed as the Colorado real estate market deteriorated. In addition, it is our view that while earlier composite and component ratings in the areas of Management, Asset Quality, Liquidity, and Capital reflected the financial condition of BOC's predecessor banks, the ratings did not appear to fully reflect the risks present in the banks at that time. Examiners became sharply critical of BOC's risk management practices beginning with the November 2008 FDIC examination and issued joint supervisory and enforcement actions in 2009 and 2010, respectively. However, by that time, the bank's lending markets were rapidly deteriorating, making remedial efforts difficult.

In December 2010, the OIG issued an audit report, entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* for the purpose of identifying trends in recent bank failures and determining the FDIC's actions to enhance its supervision program. The audit report notes that CAMELS ratings assigned to failed institutions placed greater emphasis on a bank's financial condition at the time of the examination and levels of capital and earnings, rather than the bank's ability to successfully mitigate identified risks.[8] The audit report further states that risky behaviors that did not seem to have had a sufficient impact on CAMELS ratings included, but were not limited to: (1) the pursuit of aggressive growth in CRE and ADC loans, (2) excessive levels of asset concentration with little risk mitigation, and (3) reliance on wholesale funding to support asset growth. Such findings are consistent with the results of our assessment of the supervisory approach for BOC's predecessor banks.

The FDIC informed us that it has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, issued FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices. The FDIC has also issued FIL-84-2008, entitled, *Liquidity Risk Management*, which highlights the importance of (among other things) contingency funding plans in addressing relevant stress events. Further, as noted earlier in the report, the FDIC issued FIL-13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*, which indicated that institutions with aggressive growth strategies or excessive reliance on volatile funding sources are subject to heightened supervisory monitoring.

Additionally, the FDIC completed a training initiative in 2010 for its entire supervisory workforce that emphasized the need to assess a bank's risk profile using forward-looking

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[8] Report No. MLR-11-010. The objectives of the December 2010 Audit Report are discussed in Appendix 1 of this report.

supervision. The training addressed the importance of considering management practices as well as current financial performance or trends when assigning ratings, consistent with existing examination guidance. Further, on January 26, 2010, the FDIC issued guidance to its examiners that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed.[9]

[9] RMS Regional Directors Memorandum entitled, *Matters Requiring Board Attention* (Transmittal No. 2010-003).

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the DIF incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate Federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within six months after it becomes apparent that a material loss has been incurred.

Consistent with the Financial Reform and FDI Act provisions described above, the objectives of this MLR were to (1) determine the causes of BOC's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of BOC, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from October 2011 to January 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of BOC and its predecessor banks from 2004 until BOC's failure on July 22, 2011. Our review also entailed an evaluation of the regulatory supervision of the institutions over the same period.

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

- Analyzed examination and visitation reports prepared by FDIC and CDB examiners from 2004 to 2011.

- Reviewed the following documentation:

  - Financial institution data and correspondence maintained at the RMS Dallas Regional Office and Denver Field Office, as provided to KPMG by RMS.

  - Reports prepared by the Division of Resolutions and Receiverships and RMS relating to BOC's closure.

  - Pertinent RMS policies and procedures.

- Interviewed relevant FDIC officials who had supervisory responsibilities pertaining to BOC and its predecessor banks, which included RMS regional officials from the Dallas Regional Office and examination staff at the Denver Field Office.

- Interviewed appropriate officials from the CDB to discuss the historical perspectives of the institutions, applicable examinations, and other activities regarding the CDB's supervision of the banks.

- Researched various banking laws and regulations.

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

> (1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.
>
> (2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

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

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations

Consistent with the audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in the FDIC's systems, reports, and interviews of examiners to understand the banks' management controls pertaining to the causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the

effectiveness of information system controls. We relied on our analysis of information from various sources, including examination and visitation reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this MLR, we did not assess the strengths and weaknesses of RMS's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. RMS compliance with the Results Act is reviewed in OIG's program audits of RMS operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with relevant provisions of section 38 of the FDI Act and limited tests to determine compliance with certain other aspects of the FDI Act and the FDIC's Rules and Regulations. The results of our tests are discussed, where appropriate, in this report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

The FDIC provided us with a memorandum issued by the OIG on May 1, 2009. The memorandum outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. In addition, as mentioned earlier in the report, the OIG issued an audit report, entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

Further, with respect to more in-depth coverage of specific issues, the OIGs of the FDIC, the Department of the Treasury, and the Board of Governors of the Federal Reserve System issued an evaluation report in September 2011, entitled, *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which assessed the role and Federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA*, and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Additionally, the FDIC OIG has informed us that it began an evaluation in July 2011 to study the characteristics and related supervisory approaches that may have prevented

FDIC-supervised institutions with significant ADC loan concentrations from being designated as problem banks or failing during the recent financial crisis. Most recently, in January 2012, the President signed Public Law 112-88 (H.R. 2056, as amended), which requires the Inspector General of the FDIC to conduct a comprehensive study on the impact of the failure of insured depository institutions. Among the reviews initiated in response to this law, the FDIC OIG has initiated reviews in the following areas of bank supervision:

- evaluation and use of appraisals,
- implementation of FDIC policy statement on CRE loan workouts,
- risk management enforcement actions, and
- examiner assessment of capital.

The Inspector General is required to submit a report on the results of the study and any related recommendations to Congress by January 3, 2013.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction, and that provide interim financing for constructing residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Call Report	Consolidated Reports of Condition and Income (also known as Call Reports) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the FDI Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Capital Restoration Plan (CRP)	Section 325.104(a)(1) of the FDIC Rules and Regulations requires a bank to file a written CRP with the appropriate FDIC regional director within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is *Undercapitalized*, *Significantly Undercapitalized,* or *Critically Undercapitalized*, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.
Commercial Real Estate (CRE) Loans	CRE loans 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. CRE loans also include land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans.

Term	Definition
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.
Consent Order	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A Consent Order may be terminated by the regulators when they have determined that the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Federal Home Loan Bank (FHLB) Advances	The FHLB System provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to its members. Advances are funds that are available to members with a wide variety of terms to maturity, from overnight to long term, and are collateralized. Advances are designed to prevent any possible loss to FHLBs, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow analysis must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, current and complete operating statements of all related entities, and future economic conditions. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss to the DIF in excess of $200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Banking Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.

Term	Definition
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify a bank's emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the ORL. Regional management is responsible for implementing procedures to ensure that offsite review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code Section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Risk-Based Capital Rules	Appendix A to Part 325—*Statement of Policy on Risk-Based Capital*—defines the FDIC's risk-based capital rules. Appendix A states that an institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together, and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution's qualifying total capital base is the numerator of the ratio.

Term	Definition
Tier 1 Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Trust Preferred Securities	Hybrid instruments possessing characteristics typically associated with debt obligations. Under the basic structure of trust preferred securities, a corporate issuer, such as a bank holding company, first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the corporate issuer, and trust preferred securities, which are sold to investors. The business trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The corporate issuer makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. The subordinated debentures have a stated maturity and may also be redeemed under other circumstances. Most trust preferred securities are subject to a mandatory redemption upon the repayment of the debentures.
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component, and an overall composite, is assigned a rating of "1" through "5", with "1" having the least regulatory concern and "5" having the greatest concern.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ALM	Asset Liability Management
BOC	Bank of Choice
BOCHC	Bank of Choice Holding Company
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
CFP	Contingency Funding Plan
CMP	Civil Money Penalty
CDB	Colorado Division of Banking
CEO	Chief Executive Officer
COB	Chairman of the Board
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GAGAS	Generally Accepted Government Auditing Standards
GMS	Growth Monitoring System
MLR	Material Loss Review
MOU	Memorandum of Understanding
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
ORL	Offsite Review List
PCA	Prompt Corrective Action
REST	Real Estate Stress Test
RMS	Division of Risk Management Supervision
SCOR	Statistical CAMELS Offsite Rating
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

OIG Evaluation of Management Response

OIG Evaluation of Management Response

Subsequent to the issuance of KPMG's draft report, RMS officials provided additional information for KPMG's consideration, and KPMG revised its report to reflect this information, as appropriate. On February 16, 2012, the RMS Director provided a written response to a draft of this report. That response is provided in its entirety on page II-2 of this report.

In the response, the RMS Director reiterated the causes of BOC's failure and the supervisory activities described in the report. Further, RMS stated that it has recognized the threat that institutions with high-risk profiles, such as BOC, pose to the DIF and issued to FDIC-supervised institutions a 2008 FIL, entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued a 2009 FIL, entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition.* According to RMS, this FIL heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Risk Management Supervision

February 16, 2012

TO: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Bank of Choice, Greeley, Colorado (Assignment No. 2011-097)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of Bank of Choice (BOC), which failed on July 22, 2011. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on January 13, 2012.

BOC failed due to the inability of the Boards and management of BOC and its predecessor institutions to manage the risks associated with a strategy centered on concentrations of commercial real estate (CRE) and acquisition, development, and construction (ADC) loans. The Boards and management did not establish risk exposure limits. BOC's lax oversight of the lending function, coupled with weak CRE markets in Colorado, also contributed to the deterioration in the quality of its loan portfolio, resulting in substantial losses. Dependence on noncore funding further elevated BOC's risk profile. The associated provisions for loan losses depleted BOC's earnings, eroded its capital and strained its liquidity. BOC was unable to raise additional capital to maintain safe and sound operations.

From 2006 through June 2011, the FDIC and the Colorado Division of Banking (CDB) conducted eight risk management examinations, three visitations and ongoing offsite monitoring. Examiners identified risks in the banks' operations and brought these risks to the attention of the institutions' Boards and management. At the November 2008 FDIC examination, examiners strongly criticized BOC's deficient risk management practices noting deterioration in all component ratings, and BOC was downgraded. A Memorandum of Understanding was issued in 2009 to address examination weaknesses; however, BOC management failed to implement appropriate corrective actions. As BOC continued to deteriorate further, examiners downgraded BOC and issued a Consent Order on May 6, 2010.

RMS has recognized the threat that institutions with high risk profiles, such as BOC, pose to the Deposit Insurance Fund and issued to FDIC-supervised institutions a 2008 Financial Institution Letter (FIL) entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued a 2009 FIL entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition.* This FIL heightened our supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

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