Audit Report

OIG-11-105

SAFETY AND SOUNDNESS: Material Loss Review of First National Bank of Anthony

September 20, 2011

Office of Inspector General

DEPARTMENT OF THE TREASURY

Contents

Audit Report

Causes of FNB Anthony's Failure 2
Aggressive Growth With High-Risk CRE Concentration 2
Ineffective Credit Risk Management Processes 4

OCC's Supervision of FNB Anthony 5
OCC's Supervision of FNB Anthony Was Appropriate 5
OCC's Use of PCA and Enforcement Actions 7

Conclusion 9

Appendices

Appendix 1: Objectives, Scope, and Methodology 10
Appendix 2: Background 13
Appendix 3: Management Response 15
Appendix 4: Major Contributors to This Report 16
Appendix 5: Report Distribution 17

Abbreviations

CRE	commercial real estate
FDIC	Federal Deposit Insurance Corporation
FNB Anthony	First National Bank of Anthony
MOU	memorandum of understanding
MRA	matter requiring attention
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
PCA	prompt corrective action
ROE	report of examination

This Page Intentionally Left Blank

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

September 20, 2011

John G. Walsh
Acting Comptroller of the Currency

This report presents the results of our material loss review of the failure of First National Bank of Anthony (FNB Anthony), of Anthony, Kansas, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed FNB Anthony and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on June 19, 2009. This review is mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of FNB Anthony's estimated loss to the Deposit Insurance Fund[1] at the time of its failure.[2] As of June 30, 2011, FDIC estimated a loss of $38.3 million. FDIC also estimated that FNB Anthony's failure resulted in a loss of $2.1 million to the Transaction Account Guarantee Program.

Our objectives were to determine the causes of FNB Anthony's failure; assess OCC's supervision of FNB Anthony, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed OCC and FDIC officials. We conducted our fieldwork from October 2009 through December 2009. Appendix 1 contains a more detailed description of our review objectives, scope, and methodology. Appendix 2 contains

[1] Certain terms that are underlined when first used in this report, are defined in, *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (April 11, 2011). That document is available on the Treasury Office of Inspector General's (OIG) website at http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx.
[2] At the time of FNB Anthony's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

background information on FNB Anthony's history and OCC's assessment fees and examination hours.

In brief, the primary causes of FNB Anthony's failure were an aggressive growth strategy with a high-risk concentration in commercial real estate (CRE) loans and ineffective credit risk management processes. These factors, combined with the rapid decline in the real estate market, resulted in the deterioration of the bank's asset quality, a substantial volume of problem loans, and significant loan losses. In turn, these loan losses diminished earnings and capital and, ultimately, led to FNB Anthony's failure.

OCC's supervision of FNB Anthony did not prevent a material loss to the Deposit Insurance Fund. However, we concluded that OCC's supervision of FNB Anthony was appropriate. OCC identified credit administration issues in a timely manner, issued enforcement actions, and used its authority under PCA.

We are not making any recommendations to OCC as a result of our material loss review of FNB Anthony. We provided a draft of this report to OCC for its review. In a written response, which is included as appendix 3, OCC stated that it agreed with our conclusions as to the causes of FNB Anthony and OCC's supervision over the bank.

Causes of FNB Anthony's Failure

Aggressive Growth With High-Risk CRE Concentration

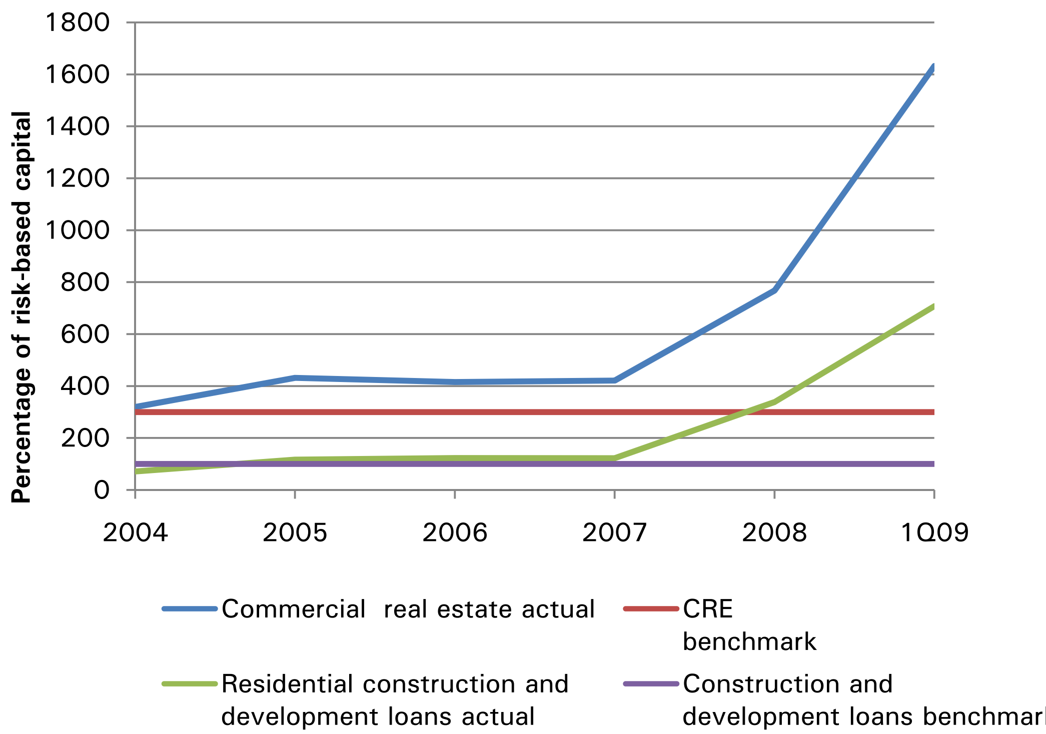
FNB Anthony had an aggressive growth strategy, which included a high-risk concentration in CRE loans, with an emphasis on residential construction and development loans. From December 31, 2004 to December 31, 2008, total assets increased $62 million, or 61 percent, and net loans increased $46 million, or 57 percent.

OCC guidance to examiners specifies the following levels at which an institution's CRE loans represent a concentration risk requiring further analysis:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total risk-based capital; or
- total CRE loans represent 300 percent or more of the institution's total risk-based capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.[3]

As shown in Figure 1, FNB Anthony's CRE loans as a percentage of total risk-based capital significantly exceeded these supervisory benchmarks beginning in 2004.

Figure 1. FNB Anthony's CRE Loan Exposure as a Percentage of Total Risk-Based Capital



Source: OIG analysis of FNB Anthony's Uniform Bank Performance Reports.

FNB Anthony continued to increase its CRE concentrations by originating CRE loans at or near the real estate market peak in 2006. When the real estate market began to deteriorate in 2007,

[3] OCC Bulletin 2006-46, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Dec. 6, 2006).

FNB Anthony's CRE loan portfolio, especially the loans originated at or near the peak of the market, suffered significant credit deterioration. An OCC June 2008 examination of FNB First Anthony found that this deterioration resulted in losses, which depleted earnings and capital and caused a severe strain on liquidity. The bank's CRE concentrations as a percentage of total risk-based capital thus further increased as the bank's capital began to significantly erode, leading to FNB Anthony's failure.

Ineffective Credit Risk Management Processes

Although OCC guidance does not specify limits on banks' CRE lending, it does describe risk management practices an institution is expected to have in place to pursue CRE lending in a safe and sound manner. According to the guidance, institutions should address the following key elements in establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

- board and management oversight
- portfolio management
- management information systems
- market analysis
- credit underwriting standards
- portfolio stress testing and sensitivity analysis
- credit risk review function

FNB Anthony did not adequately meet these key elements because the bank's board of directors failed to ensure that a competent and effective executive management team was in place. In turn, ineffective board and management oversight resulted in substantial deficiencies in the bank's credit administration practices. From 2004 through FNB Anthony's closure, OCC examiners repeatedly found significant credit administration deficiencies. These deficiencies included deficient and inconsistent credit administration and policies; overly liberal underwriting, loan structures, and repayment terms; excessive collateral, credit, and documentation exceptions; failure to ensure that concentration risk management processes kept pace with the CRE concentration; lack of accountability of loan officers; and insufficient credit analysis, credit information, and stress testing, which was detrimental to effective credit risk management.

OCC's Supervision of FNB Anthony

OCC's Supervision of FNB Anthony Was Appropriate

OCC's supervision of FNB Anthony did not prevent a material loss to the Deposit Insurance Fund. However, based on our audit work, we concluded that OCC's supervision of FNB Anthony was appropriate. OCC identified credit administration issues in a timely manner, issued enforcement actions, and used its authority under PCA.

The following table summarizes OCC's examinations of FNB Anthony and related enforcement actions from 2004 to 2009.[4] Generally, matters requiring attention (MRAs) represent the most significant items reported in reports of examinations (ROEs) requiring corrective action.

[4] OCC followed its internal requirements with respect to the timeliness of annual examinations of FNB Anthony and quarterly monitoring of the bank.

Table 1. Summary of OCC's FNB Anthony Examinations and Enforcement Actions

Date started/date completed	Assets (millions)	CAMELS rating	No. of MRAs	Number of recommendations	Enforcement actions
		Examination Results			
5/11/2004 8/20/2004 Full-scope examination	$93	2/222222	2	13	None
12/5/2005 2/23/2006 Full-scope examination	$127	2/223222	11	0	Memorandum of Understanding (MOU) signed 3/23/2006
12/21/2006 3/1/2007 Full-scope examination	$143	2/222322	0	0	MOU remained in place until 3/1/2007
6/16/2008 9/16/2008 Full-scope examination	$169	4/445442	16	0	Consent order issued 11/20/2008; PCA notice of undercapitalized status issued 2/11/2009

Sources: OCC ROEs, enforcement action documents, Western District Supervisory Review Committee[5] memorandum, and FNB Anthony's call reports.

From 2004 through 2005, OCC examiners found, among other things, significant credit risk management deficiencies. As Table 1 shows, OCC issued numerous MRAs. The Table also shows that OCC required FNB Anthony to enter into a MOU on March 23, 2006. That MOU set forth articles addressing loan portfolio management, loan review, and consumer compliance.[6]

Subsequently, in its 2006 ROE, OCC noted that the overall condition of the bank remained satisfactory and that the board and management had achieved significant improvement in credit administration. OCC also concluded that the board was in compliance with all the articles of the MOU, and, therefore

[5] Established in each OCC region, the purpose of the District Supervisory Review Committee is to ensure consistent, fair, timely, and appropriate implementation and resolution of enforcement actions.
[6] The MOU required FNB Anthony to (1) develop and implement a written program to improve the bank's loan portfolio management; (2) establish an independent and ongoing loan review system; and (3) implement and adhere to a consumer compliance program to ensure that the bank was operating in compliance with consumer protection laws, rules, and regulations. These articles in the MOU contained specific requirements to address the MRAs and deficiencies included in the 2005 ROE.

terminated the MOU on March 1, 2007. In addition, OCC concluded that the prior MRAs had been adequately addressed and did not include any MRAs or recommendations in its 2006 ROE. We found that OCC's examination documentation supported these findings and conclusions.

During the 2008 examination, OCC examiners found that the bank had deteriorated. They noted that deficiencies reported in 2004 and 2005 had resurfaced, along with new deficiencies. The 2008 ROE contained 16 MRAs, the majority relating to concentration and credit risk management practices.

On September 5, 2008, supervision of the bank was transferred to OCC's Special Supervision Division. In addition, the OCC District Supervisory Review Committee recommended and the district deputy comptroller approved entering into a consent order, a formal enforcement action, with FNB Anthony on August 27, 2008. OCC sent a draft consent order to the bank on October 10, 2008. On October 20, 2008, the bank's board executed the order. The final consent order, issued November 20, 2008, consisted of 16 articles and ordered the board and management to address the deficiencies cited in the 2008 full scope examination with respect to management, credit administration, asset quality, capital and strategic planning, and liquidity.

OCC's Use of PCA and Enforcement Actions

The purpose of PCA is to resolve problems of insured depository institutions with the least possible long-term loss to the Deposit Insurance Fund. PCA requires federal banking agencies to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility to discipline institutions based on criteria other than capital levels to help reduce deposit insurance losses caused by unsafe and unsound practices.

As FNB Anthony's capital levels deteriorated, OCC imposed PCA restrictions on the bank and took enforcement action. Specifically, OCC took the following key actions:

- On June 27, 2008, OCC notified FNB Anthony's board that the bank was in troubled condition.

- On July 30, 2008, OCC notified the board that FNB Anthony was deemed adequately capitalized based on its June 30, 2008 call report.

- On November 20, 2008, as discussed above, OCC issued a consent order as a result of the safety and soundness concerns identified in its March 2008 ROE. The consent order, among other things, required that the board, within 120 days, achieve and thereafter maintain minimum capital levels for its Tier 1 capital of at least 11 percent of risk-weighted assets, and 8 percent of adjusted total assets.[7]

- On February 11, 2009, OCC notified the board that FNB Anthony was deemed undercapitalized based on the December 31, 2008 call report. Concurrently, OCC required the bank to submit an acceptable capital restoration plan (CRP) no later than March 16, 2009.

- On March 16, 2009, instead of submitting a CRP, the board submitted a document it called a disposition plan as the board concluded that it could not raise the capital necessary to rehabilitate FNB Anthony's condition.

- In a March 19, 2009, letter, OCC notified the board that the disposition plan did not meet the requirements of an acceptable CRP. Also, OCC deemed FNB Anthony critically undercapitalized based on the bank's balance sheet as of February 28, 2009, and identified losses and a required provision of $3.4 million for loan and lease loss expense that would reduce the bank's tangible equity capital ratio to approximately 1.91 percent.

On June 19, 2009, OCC exercised its authority to close the bank and appointed FDIC as receiver. The action was 92 days after FNB Anthony was first deemed critically undercapitalized.

[7] Adjusted total assets are defined as the average total asset figure used for call report purposes minus end-of-quarter intangible assets.

Conclusion

We are not making any new recommendations to OCC as a result of our material loss review of the FNB Anthony failure.

It is important to note that we have reported in prior MLRs that high concentrations in CRE loans were a significant factor in the failure of other banks. For example, in our May 2010 MLR report on Union Bank,[8] we recommended that OCC work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner responses to high-risk concentrations. The failure of FNB Anthony was another case in which a bank failed primarily because it had a high concentration in CRE loans.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-5776. Major contributors to this report are listed in appendix 4.

/s/
Susan Barron
Audit Director

[8] *Safety and Soundness: Material Loss Review of Union Bank, National Association*, OIG-CA-10-009 (May 11, 2010).

We conducted this material loss review of First National Bank of Anthony (FNB Anthony), of Anthony, Kansas, in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[9] This section provides that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that

- ascertains why the institution's problems resulted in a material loss to the insurance fund;
- reviews the agency's supervision of the institution, including its implementation of the prompt corrective action (PCA) provisions of section 38; and
- makes recommendations for preventing any such loss in the future.

At the time of FNB Anthony's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

We initiated a material loss review of FNB Anthony based on the loss estimate to the Deposit Insurance Fund by the Federal Deposit Insurance Corporation (FDIC), which was $30.5 million when the Office of the Comptroller of the Currency (OCC) closed the bank on June 19, 2009. As of June 30, 2011, FDIC's loss estimate was $38.3 million.

Our objectives were to determine the causes of FNB Anthony's failure; assess OCC's supervision of FNB Anthony, including implementation of the PCA provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish our objectives, we conducted fieldwork at OCC's headquarters in Washington, DC, its field office in Wichita, Kansas, and FNB Anthony's former branch office located in Wichita, Kansas. We also conducted interviews with OCC and FDIC officials. We conducted our fieldwork from October 2009 through December 2009.

[9] 12 U.S.C. § 1831o(k).

To assess the adequacy of OCC's supervision of FNB Anthony, we determined (1) when OCC first identified FNB Anthony's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OCC took to get the bank to correct the problems. We also assessed whether OCC (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following work:

- We determined that the time period relating to OCC's supervision of FNB Anthony covered by our audit would be from May 2004 through FNB Anthony's failure on June 19, 2009. This period included four full scope safety and soundness examinations.

- We reviewed OCC's supervisory files and records for FNB Anthony from 2004 through 2008. We analyzed examination reports, supporting workpapers, and related supervisory correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the regulatory action OCC used to compel bank management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.

- We interviewed and discussed various aspects of FNB Anthony's supervision with OCC officials and examiners to obtain their perspectives on the bank's condition and the scope of the examinations.

- We interviewed FDIC officials responsible for monitoring FNB Anthony for federal deposit insurance purposes.

- We interviewed an official with FDIC's Division of Resolutions and Receiverships who was involved in the supervision and closing of FNB Anthony.

- We assessed OCC's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[10]

We conducted this performance audit 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.

[10] 12 U.S.C. § 1811 et seq.

History of FNB Anthony Bank

First National Bank of Anthony (FNB Anthony), located in Anthony, Kansas, was chartered on September 21, 1885. FNB Anthony was a community bank with trust powers. In addition to its main office, FNB Anthony had (1) five branches, which were located in Harper, Mayfield, Olathe, Overland Park, and Wichita, Kansas; and (2) one loan production office, which was located in Wichita, Kansas. First SCK Financial Company of Anthony Kansas, a one-bank holding company, wholly owned FNB Anthony. Ninety-two (92) percent of First SCK Financial Company's stock was held by two individuals.

Historically, the economy of Anthony, Kansas, and the surrounding area was heavily dependent on the agricultural sector. In an effort to improve its business, FNB Anthony transitioned from agricultural lending in its local market to commercial real estate lending in larger markets. FNB Anthony's commercial real estate portfolio consisted of residential construction and development lending.

OCC Assessments Paid by FNB Anthony

OCC funds its operations in part through semiannual assessments on national banks. OCC publishes annual fee schedules, which include general assessments to be paid by each institution based on the institution's total assets. If the institution is a problem bank (i.e., it has a CAMELS composite rating of 3, 4, or 5), OCC also applies a surcharge to the institution's assessment to cover additional supervisory costs. These surcharges are calculated by multiplying the sum of the general assessment by 50 percent for 3-rated institutions or by 100 percent for 4- and 5-rated institutions. Table 2 shows the assessments that FNB Anthony paid to OCC from 2004 through 2008 and their share of the total assessments paid by OCC-regulated banks.

Table 2: Assessments Paid by FNB Anthony to OCC, 2004–2008

Billing Period	Exam Rating	Amount Paid	Percent of Total Collections
1/1/2004–6/30/2004	2	$21,713	0.009%
7/1/2004–12/31/2004	2	23,031	0.008%
1/1/2005–6/30/2005	2	25,069	0.009%
7/1/2005–12/31/2005	2	27,535	0.009%
1/1/2006–6/30/2006	2	28,250	0.009%
7/1/2006–12/31/2006	2	29,013	0.009%
1/1/2007-6/30/2007	2	30,271	0.009%
7/1/2007–12/31/2007	4	30,619	0.009%
1/1/2008–6/30/2008	4	31,848	0.009%
7/1/2008-12/31/2008	4	61,850	0.161%

Source: OCC $MART database.

Number of OCC Staff Hours Spent Examining FNB Anthony

Table 3 shows the number of OCC staff hours spent examining FNB Anthony from 2004 to 2008.

Table 3: Number of OCC Hours Spent on Examining FNB Anthony, 2004–2008

Examination Start Date	Number of Examination Hours
5/11/2004	362
12/5/2005	450
12/21/2006	475
6/16/2008	613
Total	1,900

Source: OCC Examiner View.
Note: Examination hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations. They do not include time spent performing off-site monitoring.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Susan Barron, Audit Director

From: John Walsh, Acting Comptroller of the Currency /s/

Date: September 12, 2011

Subject: Response to Material Loss Review of First National Bank of Anthony

We have received and reviewed your draft report titled "Material Loss Review of First National Bank of Anthony (FNB Anthony)." This review is mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of the bank's estimated loss to the Deposit Insurance Fund at the time of its failure. Your objectives were to determine the causes of FNB Anthony's failure; assess OCC's supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, you reviewed the supervisory files and interviewed OCC and FDIC officials.

You concluded that the primary causes of FNB Anthony's failure were aggressive growth with high-risk CRE concentration and ineffective credit risk management processes. We agree.

You also concluded that the OCC's supervision of FNB Anthony was appropriate and OCC imposed PCA restrictions on the bank and took enforcement actions. We agree.

Your report did not contain any recommendations.

Thank you for the opportunity to review and comment on your draft report. If you need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-874-5020.

Lisa DeAngelis, Audit Manager
Fawntrella Thompson, Auditor-in-Charge
Angelo Arpaia, Auditor
Alicia Bruce, Auditor
Kevin Guishard, Auditor
Robert Hong, Auditor
Dana Duvall, Referencer

Department of the Treasury

Deputy Secretary
Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control

Office of the Comptroller of the Currency

Acting Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

Federal Deposit Insurance Corporation

Acting Chairman
Inspector General

United States Senate

Chairman and Ranking Member
Committee on Banking, Housing, and Urban Affairs

Chairman and Ranking Member
Committee on Finance

United States House of Representatives

Chairman and Ranking Member
Committee on Financial Services

Government Accountability Office

Comptroller General of the United States