Audit Report

OIG-CA-10-009

SAFETY AND SOUNDNESS: Material Loss Review of Union Bank, National Association

May 11, 2010

Office of Inspector General

Department of the Treasury

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

May 11, 2010

**MEMORANDUM FOR JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY**

FROM: Jeffrey Dye
Director, Banking Audits

SUBJECT: Material Loss Review of Union Bank, National Association

INTRODUCTION

The Office of the Comptroller of the Currency (OCC) closed Union Bank, National Association (Union Bank), Gilbert, Arizona, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on August 14, 2009. As of January 26, 2010, FDIC estimated that Union Bank's loss to the Deposit Insurance Fund was $54.5 million.

Under section 38(k) of the Federal Deposit Insurance Act, we are responsible for conducting a material loss review of the failure of Union Bank. To help fulfill this responsibility, we contracted with Mayer Hoffman McCann P.C. (MHM), an independent certified public accounting firm. MHM's report dated April 20, 2010, is provided as Section I.

RESULTS OF MATERIAL LOSS REVIEW

We concur with MHM's report that indicated:

- Union Bank failed primarily because of high commercial real estate concentrations with a particular focus on construction and land development loans in Arizona. Once the real estate market began declining, Union Bank was exposed to rapid asset quality deterioration and the losses ultimately led to its demise.

- A stronger supervisory response by OCC was warranted to address the high commercial real estate concentrations.

Details of their conclusions are in their report.

We also concur with MHM's recommendation in the report 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.

Please be advised that in accordance with Treasury Directive 40-03, "Treasury Audit Resolution, Follow-up, and Closure," OCC is responsible for taking corrective action on this recommendation. OCC should also record the recommendation and related actions in the Department of the Treasury's Joint Audit Management Enterprise System (JAMES).

We are providing, as Section II, a listing of recommendations made as a result of completed material loss reviews of OCC-regulated institutions during the current economic crisis. Section III identifies the recipients of this report.

OBJECTIVES, SCOPE, AND METHODOLOGY

Under section 38 (k), we are responsible to prepare a report to OCC that (1) ascertains why Union Bank's problems resulted in a material loss to the Deposit Insurance Fund; (2) reviews OCC's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38(k); and makes recommendations for preventing any such loss in the future. Section 38(k) defines a loss as material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

To help fulfill these responsibilities, we contracted with MHM to perform a material loss review in accordance with generally accepted government auditing standards. We evaluated the nature, extent, and timing of the work; monitored progress throughout the audit; reviewed the documentation of MHM; met with partners and staff members; evaluated the key judgments; met with OCC officials; performed independent tests of OCC supervisory records; and performed other procedures we deemed appropriate in the circumstances. We conducted our work in accordance with generally accepted government auditing standards.

Should you wish to discuss the report, you may contact me at (202) 927-0384 or Jaideep Mathai, Audit Manager, at (202) 927-0356.

Section I

Mayer Hoffman McCann P.C.'s Report on Material Loss Review of Union Bank, National Association

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Inspector General
Department of the Treasury
Material Loss Review of
Union Bank, National Association
April 20, 2010

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Acronyms in the Report

ADC	Acquisition and Development Construction
ALLL	Allowance for Loan and Lease Losses
CEO	Chief Executive Officer
CRE	Commercial Real Estate
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
IT	Information Technology
MRA	Matters Requiring Attention
OIG	Department of the Treasury, Office of Inspector General
OCC	Office of the Comptroller of the Currency
PCA	Prompt Corrective Action
ROE	Report of Examination

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Inspector General
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RE: Transmittal of Results for the Material Loss Review Report for Union Bank, Gilbert, Arizona

This letter is to acknowledge delivery of our performance audit report of the Material Loss Review for Union Bank in accordance with Contract No. GS-23F-0288N, Order No. TPD-OIG-09-K-00043. The objectives of this performance audit were to: (1) determine the causes of Union Bank's failure and resulting material loss to the Deposit Insurance Fund and (2) evaluate the Office of the Comptroller of the Currency's supervision of Union Bank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

The performance audit results are in the accompanying performance audit report. The information included in this report was obtained during our fieldwork, which occurred during the period from October 22, 2009 through December 23, 2009.

We conducted our 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Leawood, Kansas
April 20, 2010

Mayer Hoffman McCann P.C.

Results in Brief

Union Bank failed primarily because of high commercial real estate concentrations with a particular focus on construction and land development loans in Arizona. The bank embarked on a growth strategy that emphasized commercial lending starting in 2004 when it hired a new president. While growing its loan portfolio, Union Bank's board and management did not establish adequate risk management systems to properly monitor and control the risks inherent in a commercial real estate portfolio. In addition, the bank funded its growth through high cost Internet certificates of deposit (CDs). Once the real estate market began declining, Union Bank was exposed to rapid asset quality deterioration and the losses ultimately led to its demise.

A stronger supervisory response by the Office of the Comptroller of the Currency (OCC) was warranted to address the high commercial real estate (CRE) concentrations. OCC recognized the bank's CRE concentrations in its 2006 examination. However, this issue was not elevated to a matter requiring attention (MRA) until the 2007 examination. In its 2007 full-scope examination, OCC required certain corrective actions through MRAs to address general concerns with the bank's credit administration and CRE concentrations. On April 21, 2008, OCC began a limited scope examination of Union Bank's CRE portfolio targeting asset quality. At the conclusion of the examination, OCC downgraded the composite CAMELS rating of the bank from 2 to 4.

We concluded that the corrective actions in the 2007 full-scope examination were too general and not critical enough of Union Bank's high concentrations in CRE loans. The CAMELS rating of 2 assigned to both asset quality and capital adequacy was inconsistent with the nature and significance of examination comments as well as the guidance in the Interagency Policy Statement on CRE Concentrations.

OCC conducted timely and regular examinations of Union Bank and provided oversight through its off-site monitoring. In addition, OCC appropriately used its authority under prompt corrective action (PCA) when it issued a cease and desist (C&D) order on August 18, 2008 and reclassified Union Bank's capital level to adequately capitalized as well as imposing restrictions on deposit pricing and brokered deposits.

OCC has not yet completed an internal failed bank review of Union Bank.

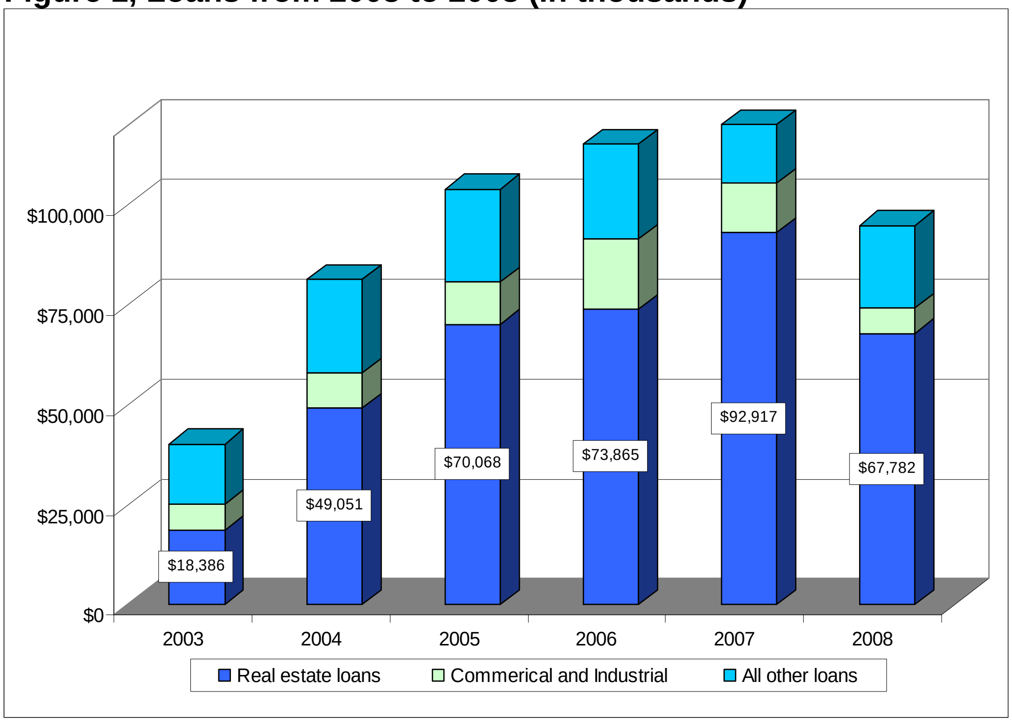
We recommend that OCC work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations.

Causes of Union Bank's Failure

Heavy Concentration in Commercial Real Estate

From January 1, 2004 through December 31, 2007, the bank grew assets by more than 1.5 times – from $53 million to $137 million. The growth was an intentional business strategy initiated by the bank's board of directors in 2004 when it hired a new president. As illustrated in Figure 1, the growth was primarily achieved through the origination of real estate loans.

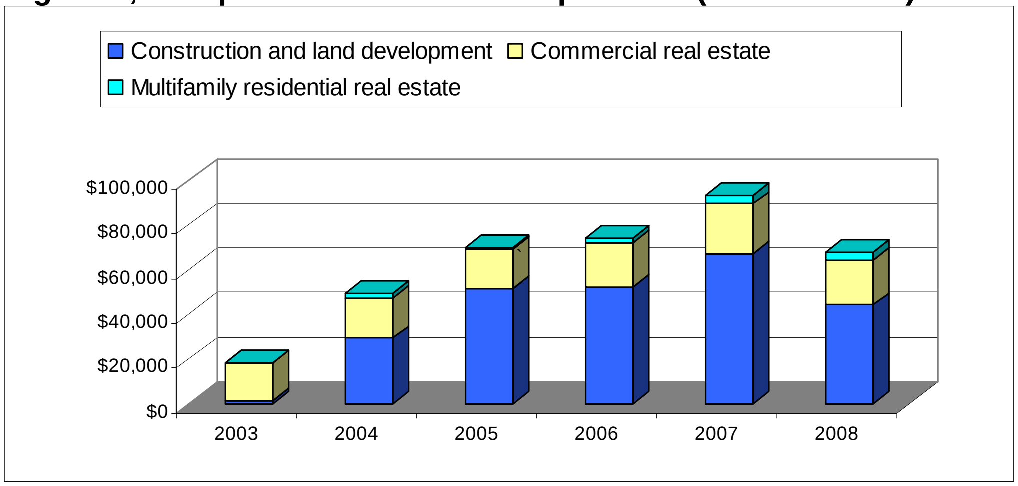
Figure 1, Loans from 2003 to 2008 (in thousands)



Source: Analysis from FDIC Statistics on Depository Institutions

Of the real estate loans, the bank concentrated on construction and development loans that had original maturities between 12 and 18 months and were generally underwritten with interest reserves that serviced interest payments until maturity. Because of the short-term nature of these loans, the bank's portfolio turned over frequently and showed few delinquencies until the real estate market slump. Figure 2 illustrates Union Bank's growth in its construction and development loan portfolio.

Figure 2, Composition of real estate portfolio (in thousands)



Source: Analysis from FDIC Statistics on Depository Institutions

In the Concentration in Commercial Real Estate Lending, Sound Risk Management Practices, issued December 2006 (Joint Agency Guidance), a bank is potentially exposed to commercial credit risk if either (1) loans for construction, land development and other land exceed 100 percent of total capital, or (2) total commercial real estate loans represent over 300 percent of total capital and the balance of the portfolio increases more than 50 percent in the prior 36 months.[1] Union Bank was continuously exposed to commercial real estate concentration risk. Figure 3 depicts the bank's construction, land and development loans as a percent of capital for the years ending December 31:

Figure 3, Commercial Real Estate Concentrations

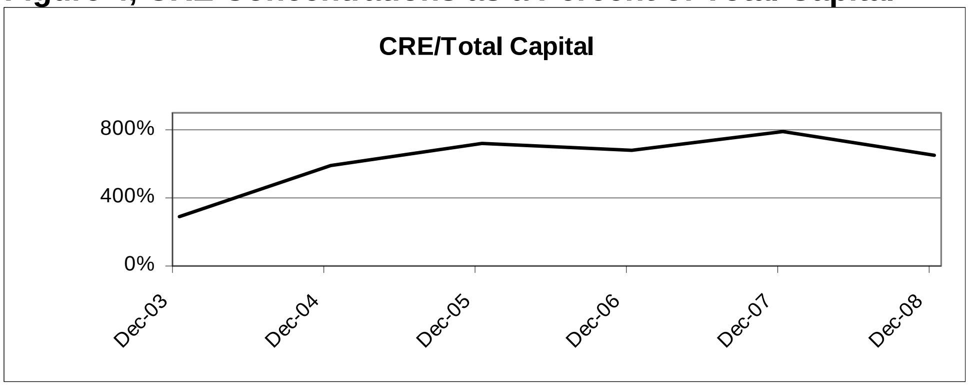
December 31,	Construction and Land Development Loans as a Percent of Capital
2005	530%
2006	479%
2007	568%
2008	420%

Source: Analysis from FDIC Statistics on Depository Institutions

[1] Under OCC's guidance, a concentration of credit consisted of direct, indirect, or contingent obligations exceeding 25 percent of the bank's capital structure, which is composed of Tier 1 Capital plus the allowance for loan loss. The Joint Agency Guidance established heightened risk management expectations for institutions with significant CRE concentrations.

Even though Union Bank's considerable construction and land development loan concentration made it highly susceptible to negative market fluctuations, the board did not increase the bank's capital position to cushion the bank against any down turn in the real estate economy. As Figure 4 illustrates, CRE concentrations as a percent of total capital continued to increase.

Figure 4, CRE Concentrations as a Percent of Total Capital



Source: Analysis from FDIC Statistics on Depository Institutions

The Joint Agency Guidance reminded institutions that they should hold capital commensurate with the level and nature of the risks to which they are exposed. Institutions exposed to significant risks through commercial real estate concentrations were urged to consider holding capital in excess of regulatory capital requirements.

As early as the September 30, 2005 examination, OCC examiners recommended the establishment of a formal capital plan as CRE concentrations exceeded 400 percent of capital. The recommendation for a capital plan was communicated in a MRA as a result of the examination. The CRE concentration level was again noted by examiners during the December 31, 2007 examination and communicated as an MRA.

As discussed later in this report, Union Bank's capital was eroded by several factors including the board's approval to pay excessive discretionary expenses, continual funding of a planned branch and headquarters building in Chandler, Arizona, its willingness to continue holding CRE concentrations, and its ineffectiveness at ensuring adequate controls were in place to manage lending risks.

Despite the CRE concentrations, the bank's financial results showed few signs of stress through 2006. There were no charge offs for the years ended December 31, 2005 or 2006 in the bank's real estate portfolio nor were there any non-accrual CRE loans at either December 31, 2005 or 2006. However, beginning in 2007, as the Arizona real estate market began to deteriorate, the bank's exposure became evident. The figure below illustrates increases in other real estate owned (OREO) and non-accrual loans as of December 31, 2006, 2007 and 2008.

Figure 5, OREO and Non-accrual loans

	2006	2007	2008
OREO	$ -	$1,594,000	$11,459,000
Non-accrual loans	-	647,000	6,593,000
Total	**$ -**	**$2,241,000**	**$18,052,000**

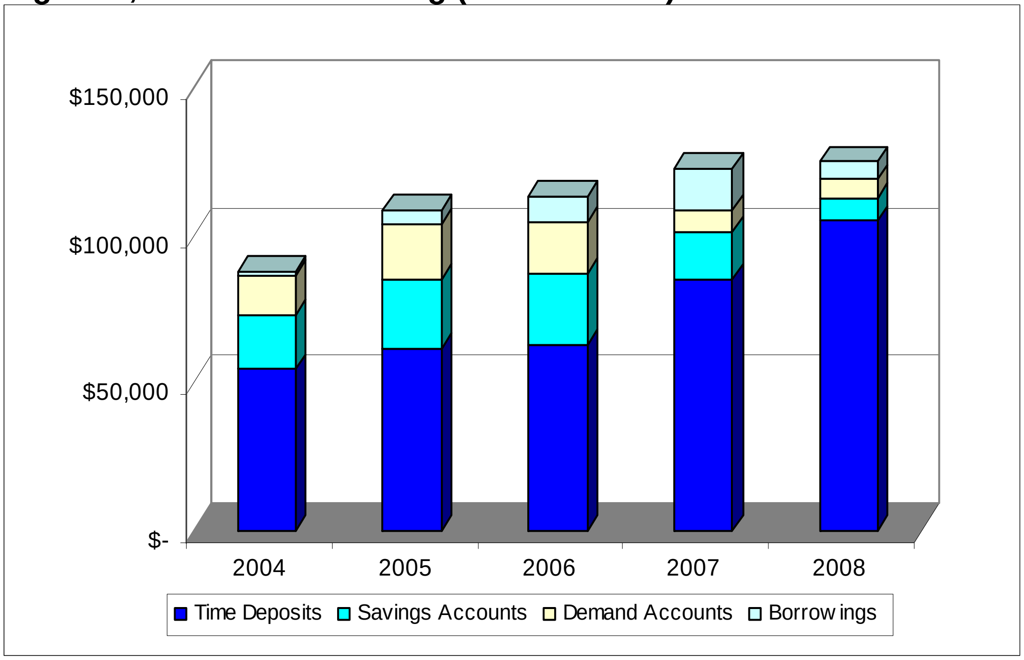
Source: Analysis from FDIC Statistics on Depository Institutions

Union Bank's lack of charge offs or non-accrual loans during 2005 and 2006 is typical of CRE loans. Because CRE loans – especially construction and land development loans – generally mature every 12 to 18 months and require no payment until maturity, usual stress indicators, such as increased delinquency rates, generally lag the portfolio's underlying weaknesses. When the underlying collateral values dropped, Union Bank's customers were unable to sell or refinance their projects, exposing the bank to significant losses from its CRE loans for which it lacked adequate capital to absorb. The lack of adequate capital to absorb the collateral loss was a contributing factor to Union Bank's failure.

Reliance on Internet Certificates of Deposits

The competitive Phoenix banking environment and Union Bank's small branch system caused management to rely extensively on CDs gathered through Internet listing services (Internet CDs) to fund its loan growth. Figure 6 illustrates Union Bank's use of interest-bearing deposits compared to other funding sources.

Figure 6, Sources of Funding (in thousands)



Source: Analysis from FDIC Statistics on Depository Institutions

In addition, Union Bank was heavily concentrated in time deposits compared to its peers as illustrated in Figure 7.

Figure 7, Time Deposits as a Percent of Assets – A Peer Comparison

Time Deposits/Assets	Dec. 31, 2004	Dec. 31, 2005	Dec. 31, 2006	Dec. 31, 2007	Dec. 31, 2008
Union Bank, N.A.	57%	52%	50%	62%	77%
Peer	28%	30%	34%	36%	40%
Variance	28%	22%	16%	26%	37%

Source: Analysis from FDIC Statistics on Depository Institutions

As of March 2005, Union Bank held $31 million of Internet CDs, which comprised 30 percent of all deposits. By December 31, 2007, Internet CDs grew to $66 million, which amounted to 61 percent of all deposits. Management favored higher cost Internet CDs over growing local deposits because of the costs involved in marketing and retaining customers after initial teaser rates.

As a result of the heavy reliance on time deposits, Union Bank's cost of funds was higher than its peers. However, because most of the deposits were deployed funding high yielding CRE loans, Union Bank's net interest margins compared favorably to its peers until the bank accumulated significant amounts of non-earning assets due to non-accrual loans and OREO. Figure 8 compares Union Bank's performance ratios to its peers.

Figure 8, Performance Ratios, 2004 through 2009

Performance Ratios	Dec. 31, 2004	Dec. 31, 2005	Dec. 31, 2006	Dec. 31, 2007	Dec. 31, 2008	June 30, 2009
Cost of Funds *						
Union Bank, N.A.	1.40%	2.31%	3.23%	4.23%	4.41%	4.66%
Peer	1.12%	1.65%	2.58%	2.99%	2.40%	1.82%
Variance	0.28%	0.66%	0.65%	1.24%	2.01%	2.84%
Net Interest Margin **						
Union Bank, N.A.	5.94%	6.13%	6.07%	5.31%	3.44%	0.86%
Peer	4.86%	5.12%	5.51%	5.08%	4.27%	3.62%
Variance	1.08%	1.01%	0.56%	0.23%	-0.83%	-2.76%

Source: Analysis from FDIC Statistics on Depository Institutions[2]
* Cost of Funds equals year-to-date interest expense divided by average earning assets
** Net Interest Margin equals (interest revenue less interest expense) / average earning assets

As highlighted in Figure 8 above, management's decision to rely on volatile Internet CDs contributed to the bank's failure. During the 2004 examination, OCC examiners noted that Internet CDs were considered unstable because of their rate and credit sensitivity. However, Union Bank's Internet deposits had been historically stable through 2005. That experience changed when the bank began experiencing financial problems. First, as it was shrinking its asset base, it simultaneously decreased its borrowing base with the Federal Home Loan Bank, making it more reliant on high-cost Internet CDs. Secondly, in late 2007, when Union Bank sold its Iowa branches, it also sold a significant portion of its core deposits. Management was forced to replace the core deposits with Internet CDs and some Federal Home Loan Bank advances at much higher rates.

[2] Peer group was obtained through FDIC SDI application. Peers consisted of banks with assets between $50 million and $2 billion in the FDIC San Francisco region.

Inadequate Management and Governance

Union Bank's board and management were heavily influenced by the majority shareholder and, beginning in 2004, a new president who was hired to grow the bank. The board and management repeatedly failed to ensure that adequate policies and procedures were in place to ensure the safety of the bank. OCC began to criticize the board with its March 2007 examination when it noted that the board met only five times during 2006. The criticism continued in future examinations when OCC commented that the board and management failed to fulfill its promise to hire a senior credit officer, failed to implement effective risk management systems, and continued to pay substantial management fees and other discretionary expenses.

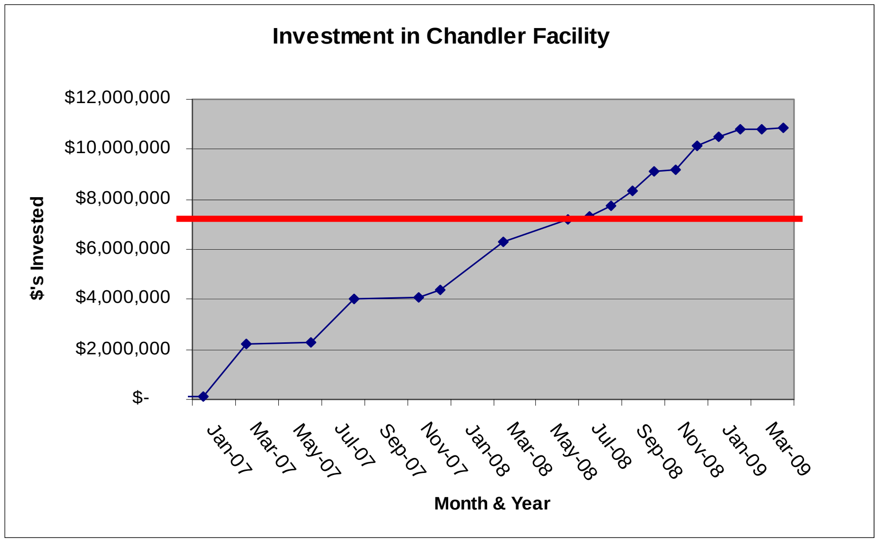
The following examples demonstrate the fundamental weaknesses in the bank's governance and management functions.

Chandler Facility

In 2005, Union Bank's management decided to purchase land in Chandler, Arizona, to construct a new branch and corporate offices. The bank purchased the land in March 2007 and began construction in August 2007. In July 2008, the bank's CAMELS composite rating was downgraded to a 4, and in August 2008, the bank was notified that it was in troubled condition and entered into a C&D order with OCC. Despite the bank's failing financial health, management and the board continued to fund the building's construction, diverting needed liquidity to a non-earning asset.

Figure 9, plots the bank's expenditures on the branch. All amounts invested above the horizontal line represent investments after the bank was downgraded to a composite 4.

Figure 9, Investment in Facility



Source: Obtained from bank records

In 2009, Union Bank recorded a $2.7 million other-than-temporary impairment charge related to the Chandler facility, which was a significant contributor to the deterioration of the bank's capital.[3]

In an April 20, 2009 letter, OCC criticized the board for its investment of $4.4 million in the Chandler facility subsequent to the bank being downgraded to a CAMELS composite rating of 4.

Business Manager Portfolio

Union Bank operated this program, which was essentially an accounts receivable factoring program, profitably until 2005 when it hired the nephew of the chairman of the board to manage the portfolio. The nephew was a recent college graduate with a degree in geography and no previous banking experience. Bank management failed to monitor or supervise his performance. He resigned in 2006 after the bank incurred a $1.4 million loss in the factoring program as a result of not following established controls.

Lack of Credit Controls

The board failed to establish effective underwriting, approval, or monitoring processes commensurate with the risk inherent in a high CRE concentration. For example, Union Bank lacked effective systems to identify and monitor credit concentrations. In its 2007 examination, OCC issued an MRA requiring the bank to enhance its

[3] OCC examiners concluded that management violated 12 U.S.C § 371d and 12 CFR §5.37 because it failed to obtain prior approval for its investments in the branch. As such, OCC required the board to promptly divest of the asset. An appraisal of the property indicated that its fair value was $2.7 million lower than its carrying cost. As such, the bank recorded an other-than-temporary impairment.

loan segmentation methods in order to better identify concentrations. The MRA was not addressed in a manner satisfactory to the examiners and a second MRA was issued in the 2008 targeted examination.

The board also relaxed controls in 2004 related to underwriting quality when it approved raising two senior loan officers' lending authority to a combined $1,000,000. The board noted the increase was necessary because the loan committee members lacked the expertise to properly evaluate the loans, and that the volume of loans made it difficult for outside loan committee members to approve the loans in a timely manner. In 2007, senior loan officers' lending authority was again raised, to $1,750,000, at a time when the legal lending authority of the bank was $1,780,000.

The board also relaxed controls in 2005 related to the bank's concentration policies. In 2005, the board identified noncompliance with its loan concentration policies related to residential and commercial real estate. The board concluded that this type of lending was Union Bank's core business, and concentration limits were raised.

Failure to Properly Staff Key Positions
In addition to his responsibilities as Union Bank president, the chief executive officer also served as chief financial officer, senior lending officer, and credit administrator from 2004 through 2006. As the bank's loan portfolio grew with higher risk CRE loans, it required additional staffing in order to manage its activities. OCC instructed the board to hire additional executives through an MRA in its July 2007 ROE. The bank hired a chief financial officer; however, the MRA was repeated during its April 2008 examination because the bank had failed to retain a senior credit officer.

Discretionary Expenses
The majority shareholder's influence over the board is illustrated by the board's continued approval of discretionary expenses after being cautioned by OCC. In the 2005 ROE, OCC examiners pointed out that the bank expensed $317,000[4] in give-aways, charitable contributions, meals and travel during the year and urged the board to improve controls to ensure the expenses were for legitimate business expenses. OCC repeated the comment in its 2008 targeted exam when it noted that the bank historically had paid substantial management fees, charitable contributions, and expense reimbursements on behalf of the principal shareholders.

[4] The 2005 report of examination noted that the $317,000 was made up of: 1) $165,000 in promotions, 2) $76,000 in charitable contributions, 3) $50,000 in meals, and 4) $26,000 in travel.

OCC's Supervision of Union Bank

We believe that the OCC should have provided a stronger supervisory response to Union Bank's real estate concentration levels and other issues communicated in the Reports of Examination (ROE).

Figure 10 summarizes the results of OCC's safety and soundness examinations from ROEs starting with the 2004 examination cycle. Appendix 5 provides the details of matters requiring attention.

Figure 10, Summary of OCC Examinations

Date Started	CAMELS Ratings	Number of MRA	Number of other recommendations	Formal Enforcement Actions
7/16/04	2/222322	1	8	None
1/11/06	2/222222	1	0	None
7/9/07	2/222322	7	0	None
4/21/08	4/444442	10	0	Consent Order 8/14/08
9/30/08*	5/455543	0	0	Troubled Condition Letter 12/1/2008

Source: OCC ROEs and call reports
* Targeted exam

A Stronger Supervisory Response to Union Bank's Heavy Concentration in Commercial Real Estate was Warranted

We concluded that a stronger and timelier OCC supervisory response was warranted to address the high CRE concentrations that were recognized by examiners as early as 2006. In the 2006 examination, OCC reminded the board and management that there were inherent risks with concentrations and that diversification was a fundamental risk management principle. However, this issue was not elevated to an MRA until the 2007 examination and asset quality was not downgraded until the 2008 exam. The following table summarizes the nature of the OCC MRAs from 2004 through 2008.

Figure 11, OCC MRAs from 2004 to 2008

		Year			
Type of MRA		**2004**	**2006**	**2007**	**2008**
Liquidity					
Interest rate management		1			
Liquidity management					1
Capital & Management					
Capital plan			1		1
Discretionary expenses					1
Asset Quality					
Business Manager Portfolio				1	
CRE concentrations				1	1*
LTV exceptions				1	
Loan grading				1	1*
Credit analysis				1	1*
Staffing				1	1*
Board supervision				1	
Loan covenants					1
Allowance for loan losses					1
Loan stress testing					1

Source: OCC ROEs and call reports

* Repeated MRA

During the 2007 exam, OCC issued an MRA related to asset quality in an attempt to highlight the bank's risk exposure due to concentrations. However, OCC did not encourage the bank to reduce its CRE concentrations or adequately indicate that it was concerned with the high levels of CRE concentrations carried by the bank. In our discussions with OCC examiners, the examiners said that although the bank exhibited heavy concentrations in CRE lending, they felt that there was no clear guidance on what levels of concentration were excessive and posed a safety and soundness issue. It was not until after the real estate market collapsed that the problems associated with the excessive levels of concentrations became evident. OCC examiners indicated that early 2008 was when the real estate slowdown in Arizona became evident.

MHM discussed the 2007 findings with OCC examiners and whether a stronger response was warranted including downgrades in CAMELS ratings. The examiners indicated that the levels of concentrations were not enough of a factor to warrant a downgrade in the CAMELS Composite rating to a 3. The examiners indicated that a 3-rated bank is considered to have significant problems and there should be fairly tangible criteria available to warrant such a downgrade. The most compelling factor would be increases in classified assets. Those levels were relatively low during the 2007 examination.

We conclude that the levels of concentrations carried by the bank were high risk and appropriately noted as such in the ROE comments. However, in hindsight, the 2007 ROE could have been more critical of asset quality given the high concentrations in CRE. While the downturn in the real estate market may not have been evident during the 2007 examination, the CAMELS ratings are to reflect the quantity of existing and potential credit risk associated with the loan portfolio, including levels of asset concentrations[5]. Due to the nature of CRE loans, particularly construction and land development, the usual stress indicators, such as increased delinquency rates, generally lag the portfolio's underlying weaknesses. Therefore, additional emphasis on concentrations would have been warranted in the CAMELS ratings assigned.

On April 21, 2008, OCC examiners began a limited scope CRE targeted examination of Union Bank. The scope of the examination was a targeted review of asset quality, specifically related to CRE. During the examination, loans totaling approximately $27 million, or approximately 50 percent of the CRE portfolio, were reviewed, and the financial condition and risk profile of Union Bank were assessed. At the conclusion of the examination, OCC downgraded the composite CAMELS rating of the bank from 2 to 4.

Prompt Corrective Action Used Appropriately

We believe OCC appropriately and timely used its authority under PCA.

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund (12 U.S.C. §1831o and 12 C.F.R. §6). PCA provides federal banking agencies with the authority 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 to help reduce deposit insurance losses caused by unsafe and unsound

[5] Uniform Financial Institutions Rating System, December 19, 1996 – *Asset Quality*

practices. For example, OCC's Enforcement Action Policy[6] allows for the imposing of more severe limitations than a bank's PCA capital category would otherwise permit or require if it is determined that the bank is in an unsafe or unsound condition, or engaging in unsafe or unsound practices.

- On August 14, 2008, OCC took enforcement action in the form of a Cease and Desist Order (C&D) based on results of its April 21, 2008 targeted review of asset quality, which revealed continued asset quality erosion, persistent real estate concentrations and large loan losses. At March 31, 2008, the bank was considered well capitalized at its tier 1 risk based capital of 9.31 percent and total risk based capital ratios of 10.44 percent.

- On December 1, 2008, OCC transferred supervision of the bank to OCC's Special Supervision Division based on results reported in the bank's September 30, 2008 call report that indicated continued erosion in asset quality and deteriorating capital levels.

- On May 1, 2009, OCC notified the board that based on bank's March 31, 2009 call report, the bank was deemed undercapitalized for PCA purposes and that it was required to submit an acceptable Capital Restoration Plan (CRP) by May 18, 2009.

- On June 18, 2009, OCC informed the board that the bank's CRP was unacceptable primarily because it relied on raising sufficient capital through a proposed future Private Placement Offering, in which there was questionable probability of success. Due to the board's failure to submit an acceptable CRP, the bank was deemed significantly undercapitalized.

- On July 6, 2009, OCC informed the board that that bank was deemed to be critically undercapitalized based on its June 30, 2009 operating results.

[6] OCC Enforcement Action Policy

Lessons Learned Review by the OCC

According to OCC headquarters officials, an internal lessons learned review of the failure of Union Bank was in process but had not been completed at the time of our review. The purpose of the review is to asses both the causes of the failure and OCC's supervision of the bank.

Recommendation

As a result of our material loss review of Union Bank, we recommend 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 determining an appropriate range of examiner response to high risk concentrations.

<u>Management Response</u>
OCC responded that it works with other regulators to develop guidance on a variety of subjects where common issues or concerns exist. Also, federal banking agencies are in the process of evaluating a number of factors that contributed to current problems in the banking industry and will consider what regulatory changes are needed. OCC also responded that although it was too early to determine whether the final outcome of the agencies' deliberations will includes changes in concentration limits or risk management expectations, it offered assurances that OCC will continue to study the situation and interface with other regulatory partners.

<u>Mayer Hoffman McCann P.C. Comment</u>
The implementation of the recommendation is the responsibility of OCC management.

* * * * * * * * * * * * * * * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit.

Our objectives were to determine the causes of Union Bank's failure and assess the bank's supervision by the Office of the Comptroller of the Currency (OCC). We conducted this material loss review of Union Bank under contract with Department of the Treasury Office of Inspector General (OIG) in response to its mandate under section 38(k) of the Federal Deposit Insurance Act.[7] 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 (k); and
- makes recommendations for preventing any such loss in the future.

Section 38(k) defines a loss as material if it exceeds 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.

The Treasury OIG contracted with our firm to conduct this material loss review of Union Bank based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of January 26, 2010, the FDIC estimated that the loss to the Deposit Insurance Fund from Union Bank's failure would be $54.5 million which was about 48 percent of Union Bank's $113.2 million in total assets.

Our objectives were to determine the causes of Union Bank's failure; assess OCC's supervision of Union Bank, 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 Phoenix, Arizona, and it's Western District Office in Denver, Colorado. We also interviewed FDIC personnel in their Irvine, California and San Francisco, California offices. We conducted our fieldwork from November 2009 through January 2010.

To assess the adequacy of OCC's supervision of Union Bank, we determined (1) when OCC first identified Union Bank's safety and soundness problems, (2) the gravity of the problems, and (3) the

[7] 12 U.S.C. § 1831o(k).

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 Union Bank covered by our audit would be from January 1, 2003 through Union Bank's failure on August 14, 2009. This period included four full scope exams, 14 quarterly off-site reviews, and one targeted exam.

- We reviewed OCC's supervisory files and records for Union Bank from January 2003 through August 2009. We analyzed examination reports, supporting work papers, 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 any work performed by third party accounting firms.

- We interviewed and discussed various aspects of Union Bank's supervision with OCC officials, examiners, and an attorney to obtain their perspectives on the bank's condition and the scope of the examinations.

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

- We interviewed officials from FDIC's Division of Resolutions and Receiverships who were involved in the supervision and closing of Union Bank.

- We assessed OCC's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[8]

[8] 12 U.S.C. § 1811 et seq.

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.

History of Union Bank, N.A.

Union Bank was chartered in May 1998 as a de novo national bank in Gilbert, Arizona. The bank was wholly owned by a one bank holding company, Heartland Bancshares, Inc. (“Heartland” or “Holding Company”). Heartland was primarily owned and controlled by one family, which owned approximately 90 percent of the common stock and 100 percent of the preferred stock. Heartland was at one time a two bank holding company consisting of Union Bank and a bank in Iowa. The Iowa bank was merged into Union Bank in 2002, which resulted in Union Bank having two branches in Iowa. The Iowa branches of the bank, however, were sold at the end of 2007, leaving one branch in Gilbert, Arizona.

Appendix 4 contains a chronology of significant events regarding Union Bank.

Types of Examinations Conducted by OCC

OCC conducts various types of examinations, including full-scope onsite examinations. A full-scope examination is a combined examination of the institution’s safety and soundness, compliance with various laws and regulations, and information technology (IT) systems.

The safety and soundness portion of the examination includes a review and evaluation of the six CAMELS components: capital adequacy, asset quality, management administration, earnings, liquidity, and sensitivity to market risk. OCC assigns the bank a rating for each component and a composite rating based on its assessment of the overall condition of the bank and its level of supervisory concern. The IT portion of the examination evaluates the overall performance of IT within the institution and the institution’s ability to identify, measure, monitor, and control technology-related risks. The compliance portion of the examination includes an assessment of how well the bank manages compliance with various consumer protection laws and related regulations, such as the Truth in Lending Act, Truth in Savings Act, and Bank Secrecy Act. A targeted examination is any examination that does not fulfill all the statutory requirements of a full-scope examination.

OCC must schedule full-scope, onsite examinations of insured banks once during either a 12-month or 18-month cycle. OCC is to conduct examinations on a 12-month cycle until a bank’s management has demonstrated its ability to operate the institution in a safe and sound manner and satisfied all conditions imposed at the time of approval of its charter. Once a bank meets these criteria, OCC may use an 18-month examination cycle if the bank:

- has total assets of less than $500 million;
- is well-capitalized;
- at its most recent examination received a Management component rating of 1 or 2;
- is not currently subject to a formal enforcement proceeding or order by FDIC, OCC, or the Federal Reserve System; and
- has not undergone a change in control during the 12-month period since completion of the last full-scope, onsite examination.

Enforcement Actions Available to OCC

OCC examinations of banks result in the issuance of reports of examinations (ROE) that identify any areas of concern. OCC uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

Informal Enforcement Actions

OCC may use informal enforcement actions when a bank's overall condition is sound, but it is necessary to obtain written commitments from a bank's board of directors or management to ensure that it will correct problems and weaknesses. Informal enforcement actions provide a bank with more explicit guidance and direction than a ROE normally contains but are generally not legally binding. Informal enforcement actions include commitment letters and memoranda of understanding.

Formal Enforcement Actions

Formal enforcement actions are authorized by statute, generally more severe than informal actions, and disclosed to the public. Formal enforcement actions are enforceable under the Federal Deposit Insurance Act. They are appropriate when a bank has significant problems, especially when there is a threat of harm to the bank, depositors, or the public. OCC is to use formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to influence bank management and board members to correct identified problems and concerns in the bank's operations. Because formal actions are enforceable, OCC can assess civil money penalties against banks and individuals for noncompliance with a formal agreement or final order. OCC can also request a federal court to require the bank to comply with an order. Formal enforcement actions include consent orders, cease and desist orders, formal written agreements, safety and soundness, and prompt corrective action directives.

OCC Enforcement Guidelines

Factors used in determining whether to use informal action or formal actions include the following:

- the overall condition of the bank;
- the nature, extent, and severity of the bank's problems and weaknesses;
- the commitment and ability of bank management to correct the identified deficiencies; and
- the existence of previously identified but unaddressed problems or weaknesses.[9]

[9] OCC Policies and Procedures Manual 5310-3 (Rev).

Allowance for loan and lease losses (ALLL)	An estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid.
Brokered deposit	Any deposit that is obtained, directly or indirectly, from a deposit broker. The bank solicits deposits by offering rates of interest that are significantly higher than the rates offered by other insured depository institutions in its normal market area. Use of brokered deposits is limited to well-capitalized insured depository institutions and, with a waiver from the Federal Deposit Insurance Corporation (FDIC), to adequately capitalized institutions. Undercapitalized institutions are not permitted to accept brokered deposits. (See 12 U.S.C. § 1831(f) and 12 C.F.R. 337.6.)
Call report	A quarterly report of income and financial condition that banks file with their regulatory agency. The contents of a call report include consolidated detailed financial information on assets, liabilities, capital, and loans to executive officers, as well as income, expenses, and changes in capital accounts.
CAMELS	An acronym for performance rating components for financial institutions: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst.
Capital Restoration Plan (CRP)	A plan submitted to the appropriate federal banking agency by an undercapitalized insured depository institution. A capital restoration plan specifies the steps the insured depository institution is to take to become adequately capitalized, the levels of capital to be attained during each year in which the plan is in effect, how the institution is to comply with the restrictions or requirements then in effect, the types and levels of activities in which the institution is to engage, and any other information that the federal banking agency may require.

Cease and Desist Order	A formal action in which provisions are set out in article-by-article form and prescribes restrictions and remedial measures necessary to correct deficiencies or violations in the bank in order to return it to a safe and sound condition. The form and legal effect is identical to a consent order; however, a cease and desist order is imposed on an involuntary basis after issuance of a Notice of Charges, hearing before an administrative law judge, and final decision and order issued by the Comptroller.
Classified Asset	A loan or other asset that, in the opinion of examiners, is at risk to some degree. Such assets fail to meet acceptable credit standards. Examiners have adopted the following uniform guidelines for listing poorly performing assets: (1) loss, or complete write-off; (2) doubtful, where repayment in full is questionable; (3) substandard, where some loss is probable unless corrective actions are taken; and (4) special mention, indicating potential problems such as missing documentation or insufficient collateral.
Commercial real estate loans	Loans for real property where the primary or significant source of repayment is from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property. Commercial real estate loans include construction and real estate development, land development, and commercial properties such as office buildings and shopping centers.
Concentration (of credit)	A situation where direct, indirect, or contingent obligations exceed 25 percent of a bank's capital structure.
Concentration risk	Risk in a loan portfolio that arises when a disproportionate number of an institution's loans are concentrated in one or a small number of financial sectors, geographical areas, or borrowers.

Consent order	The title given by the Office of the Comptroller of the Currency (OCC) to a cease and desist order that is entered into and becomes final through the board of directors' execution, on behalf of the bank, of a stipulation and consent document. Its provisions are set out in article-by-article form and prescribes restrictions and remedial measures necessary to correct deficiencies or violations in the bank in order to return it to a safe and sound condition.
De novo bank	A newly chartered bank that has been open for less than 3 years.
Division of Resolutions and Receiverships (DRR)	A division within FDIC that is charged with resolving failing and failed financial institutions, including ensuring that depositors have prompt access to their insured funds.
Federal Home Loan Bank	The Federal Home Loan Bank (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 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. To protect their position, FHLBs have a claim on any of the additional eligible collateral in the failed bank. In addition, FDIC has a regulation that reaffirms FHLB priority, and FHLBs can demand prepayment of advances when institutions fail.
Formal agreement	A type of formal enforcement action authorized by statute. Formal agreements are generally more severe than informal actions and are disclosed to the public. Formal actions are also enforceable through the assessment of civil money penalties.

Full-scope examination	Examination activities performed during the supervisory cycle that (1) are sufficient in scope to assign or confirm a bank's CAMELS composite and component ratings; (2) satisfy core assessment requirements; (3) result in conclusions about a bank's risk profile; (4) include onsite supervisory activities; and (5) generally conclude with the issuance of a report of examination.
Generally accepted accounting principles	A widely accepted set of rules, standards, and procedures for reporting financial information, established by the Financial Accounting Standards Board.
Impairment	Decline in fair value of a loan below the amortized cost basis.
Interest reserve	An account established by the lender to periodically advance funding to pay interest charges on the outstanding balance of a loan.
Matter Requiring Attention	A bank practice noted during an examination that deviates from sound governance, internal control, and risk management principles, which may adversely affect the bank's earnings or capital, risk profile, or reputation if not addressed. It may also result in substantive noncompliance with laws and regulations, internal policies or processes, OCC supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by a bank. Matters requiring attention are not enforcement actions, but failure by a bank's board and management to address a matter requiring attention could lead to an enforcement action.
Other Real Estate Owned	Real properties that a bank has acquired that do not constitute its banking facilities. Such properties include real estate acquired in full or partial satisfaction of a debt previously contracted and are subject to specific holding periods, disposition requirements, and appraisal requirements.
Other-than-temporary impairment charge	A loss that must be recognized when it is determined that an impairment is other than temporary. The amount recognized equals the difference between the cost of an investment and its fair value.

Prompt corrective action	A framework of supervisory actions for insured banks that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as a bank falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. (See 12 U.S.C. § 1831o) The prompt corrective action minimum requirements are as follows:

Capital Category	Total Risk-Based		Tier 1/ Risk-Based		Tier 1/ Leverage
Well-capitalized[a]	10% or greater	and	6% or greater	and	5% or greater
Adequately capitalized	8% or greater	and	4% or greater	and	4% or greater (3% for 1-rated)
Undercapitalized	Less than 8%	or	Less than 4%	or	Less than 4% (except for 1-rated)
Significantly undercapitalized	Less than 6%	or	Less than 3%	or	Less than 3%
Critically undercapitalized	Has a ratio of tangible equity to total assets that is equal to or less than 2 percent. Tangible equity is defined in 12 C.F.R. § 565.2(f).				

[a] To be well-capitalized, a bank also cannot be subject to a higher capital requirement imposed by OCC.

Risk-based capital	The sum of Tier1 plus Tier 2 capital.
Targeted examination	A bank examination that does not fulfill all of the requirements of a statutory full-scope examination. Targeted examinations may focus on one particular product, function, or risk, or they may cover specialty areas.
Tier 1 capital	Common shareholder's equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.
Tier 2 capital	Subordinated debt, intermediate-term preferred stock, cumulative and long-term preferred stock, and a portion of the allowance for loan and lease losses.

The following chronology describes significant events in the history of Union Bank, including examinations conducted and enforcement actions taken by the OCC.

- Bank Chartered (5/1/98)
  - Union Bank, a community bank with no trust powers, was chartered as a de novo bank named Union Bank of Arizona, National Association in Gilbert, Arizona. Union Bank was wholly owned by one holding company, Heartland Bancshares, Inc. (Heartland).
- Consent Order (7/31/02)
  - Consent Order issued to Union Bank board by the OCC as a result of the findings of the examination that commenced on April 29, 2002. Order's provision required the board to: a) ensure competent management was in place by hiring senior loan officer and president who would manage the bank's daily affairs, b) achieve and maintain higher capital levels, c) develop a liquidity program that reduced the bank's dependence on volatile liabilities and limit internet funding, d) establish a written credit administration program, e) establish an internal loan review program, f) review ALLL adequacy and establish a program for maintenance of adequate allowance, g) prepare a budget/business plan, and h) implement an internal audit program.
- Bank Merger (12/24/02)
  - First Community National Bank in Corning, Iowa was merged into Union Bank.
- Safety and Soundness Exam (6/3/03)
  - OCC performs a safety and soundness exam. The exam resulted in a composite and CAMELS ratings 3/333423.
- Exam Findings (7/18/03)
  - OCC and FDIC representatives attended the 7/18/03 board meeting to present the recent exam findings. They noted that the bank's condition was slowly improving and provided recommendations to improve credit administration.
- SRC Meeting (8/13/03)
  - The OCC decided to maintain the Consent Order as the bank was still unable to demonstrate the ability to generate and support sound commercial loan underwriting and management.
  - CAMELS Rating upgraded to 3/333423

- Board proposes to OCC to hire experienced banker as president and director (1/5/04)
    - In January of 2004, new president was proposed to serve as president of Union Bank. In April, the no objection letter was sent to the bank by the OCC.
- District SRC Meeting: Upgrade and Terminate Consent Order (2/20/04)
    - Based on the considerations that the bank's condition was improved and stable, that asset quality was satisfactory with moderate and stable credit risk, and that the bank was in full compliance with all articles of the Order, the Consent Order was recommended to be lifted.
    - CAMELS rating upgraded to 2/222322
- Upgrade & Terminate C&D (2/24/04)
    - The OCC presented Consent Order termination letter to the board.
- Safety and Soundness Exam (7/16/04)
    - OCC performs a safety and soundness exam. The exam resulted in a composite and CAMELS ratings 2/222322.
- FDIC Rating Discussion (9/30/04)
    - FDIC indicated its desire to rate the bank a composite 2, but to leave management and sensitivity ratings at a 3. It was also noted that the FDIC would most likely not ask to participate in future examinations.
- Safety and Soundness Exam (1/11/06)
    - OCC performs safety and soundness exam. The exam resulted in a composite and CAMELS ratings 2/222222
- Board Meeting (4/11/06)
    - Two members of the OCC met with the board to discuss the latest exam and CRA Public Evaluation. President offered that a capital plan is being developed and will be forwarded to the OCC upon completion and that the bank has increased ALLL provisions.
- Safety and Soundness Exam (7/9/07)
    - OCC performs a safety and soundness exam. OCC examiners again concluded that the overall condition of Union Bank was satisfactory. Union Bank received a composite CAMELS rating of 2, with all components remaining at 2, except earnings, which was downgraded to 3.
- Sale of Iowa Branches (12/31/07)
    - Iowa branches of Union Bank were sold leaving just one branch in Gilbert, Arizona. The gain from this transaction is approximately $2.5 million.
- MRA Follow-up Letter (2/20/08)
    - A letter was sent to the bank to discuss the MRAs which were outlined during the 7/9/07 ROE. The OCC scheduled a visit to the bank on 2/25/08 to discuss the MRAs and review CRE loan exposure.

- Safety and Soundness Exam (4/21/08)
    - OCC performs a safety and soundness exam. The scope was a targeted review of asset quality, specifically related to CRE. Examiners downgraded the composite CAMELS rating of Union Bank from 2 to 4. The component rating for earnings was reduced from 3 to 4, and component ratings for capital, asset quality, management, and liquidity were reduced from 2 to 4.
- Licensing Branch Application (7/1/08)
    - The OCC advised the bank that due to the deteriorating financial condition of the bank, it was removing the bank's applications for relocation of the main office and establishment of a branch from expedited review. The OCC informed the bank that it was to perform additional evaluations on how the new main location and addition of a branch would benefit the bank and fit into the bank's strategic plan.
- District SRC Meeting (7/1/08)
    - The OCC noted a CAMELS downgrade due to deteriorating condition caused by lax board oversight of the bank's lending activities, specifically the board's failure to appropriately implement sound and effective risk management of the bank's high concentration in CRE.
    - CAMELS rating: 4/344442
- Branch Withdrawal (7/29/08)
    - The bank notified the OCC that it wished to withdraw the applications for the relocation of the main offices and the establishment of a new branch.
- Enforcement Action Signed (8/14/08)
    - The OCC held a meeting with the bank's board of directors, at which time all members of the board signed the Consent Order, which required the board to: a) establish an asset diversification program, b) hire a senior credit officer, c) approve a plan to reduce the level of credit risk, d) implement a plan to reduce criticized assets, e) develop a program to insure assets are appropriately and timely risk rated, f) hire a qualified external loan review consultant, g) adopt policies for maintaining adequate ALLL, h) reduce the bank's reliance on wholesale and credit-sensitive liabilities, i) adopt a capital plan that includes higher-than-minimum regulatory capital levels, and j) receive prior approval for any management fees paid to individuals. The bank's board was also notified that the bank was considered in Troubled Condition in August 2008.
- Capital Injection (9/1/08)
    - Chairman of the board injected $1 million into Union Bank from the sale of Heartland stock to his father.
- Branch Purchase and Assumption Agreement (9/18/08)
    - On 9/12/08, Union Bank entered into a Branch Purchase and Assumption Agreement with Unison Bank for the branch office located in Queen Creek, AZ. This sale was to take place on or before 11/30/08 and was expected to net the bank $850,000 in capital.

- Safety and Soundness Exam (9/30/08)
    - OCC performs safety and soundness exam. The exam resulted in a composite and CAMELS ratings 5/455543
- Transfer to Special Supervision Division (12/1/08)
    - Based on the bank's deteriorating financial condition, its supervision was transferred to OCC's Special Supervision Division in Washington D.C.
- Targeted Exam (12/8/08)
    - OCC conducted an interim targeted examination of Union Bank based upon financial information as of September 30, 2008 and other available information up to the time the report was finalized on February 4, 2009. Examiners found the overall condition of Union Bank was critically deficient and downgraded Union Bank's composite CAMELS rating from 4 to 5. The component ratings for earnings, asset quality, and management were downgraded from 4 to 5, while the component rating for capital remained at 4. The bank reported Tier 1 Leverage Ratio of 7.92 percent as of December 31, 2008, which was below the minimum required by the Consent Order. Also the ratio was overstated because of erroneous accounting entries that inadvertently increased the ratio.
- Board Exit Meeting (1/6/09)
    - Subsequent to the first Consent Order Follow-Up, the OCC met with the board to communicate an additional CAMELS downgrade to a composite '5'.
- Sale of Queen Creek Branch (1/30/09)
    - Union Bank sold its Queen Creek, Arizona branch and booked a gain on the sale of $732,830.
- OREO Letter (1/30/09)
    - OCC's informed management and the board that the recognition of $2.4 million in non-interest income attributed to the write up of OREO properties were an error in accounting and must be reversed.
- Management Fees Letter (2/25/09)
    - The Federal Reserve informed the OCC that the bank was paying $22,000 per month to Heartland in order to service holding company debt. Upon notification, the OCC immediately informed the bank that this, as well as paying the holding company dividends to service the holding company's debt, was strictly prohibited and in violation with Article X (relating to capital ratios) of the C&D order.
- Undercapitalized Notification (4/30/09)
    - The OCC informed the bank that it was undercapitalized based on its March 31, 2009 reported financial results. As a result, bank is required to provide the OCC with an acceptable Capital Restoration Plan (CRP) no later than May 18, 2009.

- Capital Call Meeting (5/27/09)
    - The OCC, FDIC Division of Supervision and Compliance and FDIC Division of Receivership and Resolution met with the board of directors and informed it that the FDIC would prepare to close the bank while it continued to look for capital.
- Non-approval of CRP Letter (6/18/09)
    - OCC rejected board's CRP because it was based on future events that were questionable in terms of succeeding. As the CRP was not acceptable, the bank was treated as if it were significantly undercapitalized.
- Safety and Soundness Exam (7/6/09)
    - OCC performs safety and soundness exam. The exam resulted in a composite and CAMELS ratings 5/555543.
- Critically Undercapitalized Letter (7/9/09)
    - Based on the financial information provided to the OCC as of 6/30/09, the OCC informed the bank through a PCA that the bank was deemed to be critically undercapitalized.
- Bank Failed (8/14/09)
    - Union Bank was closed by OCC. The FDIC was appointed receiver. Select deposits were acquired by MidFirst Bank, which is headquartered in Oklahoma.

Date examination started	CAMELS rating	Significant safety and soundness matters requiring attention and other recommendations cited in Reports of Examination 2003-2009	Enforcement actions
6/3/2003	3/333423	**Matters requiring attention** • The board and management need to ensure sound underwriting and credit administration principles are enforced. • Management and the board have not achieved full compliance with the Interagency Guidelines Establishing Standards for Safeguarding Customer Information. **Other Recommendations** • None identified.	Formal agreement issued 7/31/2002
7/16/2004	2/222322	**Matters requiring attention** • Management of the risk to the bank's earnings and capital posed by changes in interest rates is not adequate. **Other Recommendations** • 8 identified – Capital 1, Assets Quality 6, Liquidity 1	None
1/11/2006	2/222222	**Matters requiring attention** • A capital plan should be formulated based upon budgeted projections, dividends and earnings retention, projected asset growth and mix for risk based capital ratios, and resulting leverage and risk based capital projections and ratios. **Other Recommendations** • None identified.	None
7/9/2007	2/222322	**Matters requiring attention** • The board must ensure that appropriate credit management staff is attained to ensure all loan portfolio supervision responsibilities are adequately addressed. • The board of directors needs to meet on a frequent and consistent basis to ensure effective planning, policy making, personnel administration, control systems, and management of information systems. • Management and loan officers should review loan grade definitions and assess the accuracy of loan grades assigned to their credits. • Covenants requiring updated financial information should be established at origination. The analysis of the principal's outside financial support and sustained cash flow ability should be better documented in credit presentations. • Management needs to refine reporting of policy exceptions. Supervisory LTV exceptions should be reported separately,	

Date examination started	CAMELS rating	Significant safety and soundness matters requiring attention and other recommendations cited in Reports of Examination 2003-2009	Enforcement actions
		aggregated and compared to capital. • The board needs to establish internal CRE credit concentration limits and should set limits for overall CRE concentrations and for the higher risk segments. Policies should be enhanced to ensure guidance on sound risk management practices is outlined. The board needs to ensure this guidance is implemented, and that they appropriately identify and monitor the risk. • Management needs to develop specific action plans for each of the credits in the program, the board needs to assess the program as a continued product line for the bank, and management needs to pursue the filing of a Suspicious Activity Report outlining actions that resulted in loss of the bank related to the AR Factoring Program. **Other Recommendations** • None identified.	
4/21/2008	4/444442	**Matters requiring attention** • Management and loan officers are not identifying problem assets in a timely manner, which has resulted in criticized and classified assets being understated and efforts to mitigate risk have been delayed. Independent loan review is inadequate in scope and coverage and does not provide management with a quality independent assessment of the loan portfolio. • The board needs to develop and implement strategies to reduce credit and rate sensitive funds sources and maintain liquid assets. • Management needs to set concentration limits for loans by type, purpose, geography, and other meaningful factors as well as the development of contingency plans to mitigate excessive exposures and respond to changing market conditions. • Loan covenants should be consistently used to govern credit agreements. Additionally, the absence of or failure to meet these requirements should be tracked as exceptions. • Management must obtain complete and updated financial information and perform a thorough analysis, including borrower/guarantor capacity to liquidate the debt in a reasonable period. • Management needs to update its ALLL methodology to include FAS 5 pools and FAS 114 impairment calculations consistent with GAAP and regulatory guidance. [10]	Consent Order issued 8/14/2008

[10] Generally accepted accounting principles and Interagency Policy Statement on the Allowance for Loan Losses dated December 13, 2006 note that loan loss allowances must consider inherent risks in homogeneous loan pools as well as identified or specific risks identified on an individual loan basis.

Date examination started	CAMELS rating	Significant safety and soundness matters requiring attention and other recommendations cited in Reports of Examination 2003-2009	Enforcement actions
		• Management should adopt policies and guidelines that require periodic stress testing of different property types and stress testing of multiple variables. • The board and management must develop a plan to maintain capital levels that are sufficient for the volume and type of business operation and the associated risk. **Other Recommendations** • None identified.	

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Brian Deak, CPA, Audit Partner, Mayer Hoffman McCann P.C.

From: John C. Dugan, Comptroller of the Currency /s/

Date: April 9, 2010

Subject: Response to Material Loss Review of Union Bank, N.A.

We have received and reviewed your draft report titled "Material Loss Review of Union Bank, National Association." Your overall objectives were to determine the cause of the failure of Union Bank, National Association (Union); assess the OCC's supervision of the bank, including implementation of the Prompt Corrective Action (PCA) provisions of section 38(k); and make recommendations for preventing such a loss in the future.

You concluded that Union failed primarily because of high commercial real estate concentrations with a particular focus on construction and land development loans in Arizona. Once the real estate market began declining, Union Bank was exposed to rapid asset quality deterioration and the losses ultimately led to its demise. You also concluded that Union Bank's board and management did not establish adequate risk management systems to properly monitor and control the risk inherent in a commercial real estate portfolio and funded its growth through high cost internet certificates of deposit.

Your report states that a stronger supervisory response by the OCC was warranted to address the high commercial real estate (CRE) concentrations. You also determined that the OCC appropriately used its authority under PCA. We agree with these conclusions. Our response to your specific recommendation is presented below.

Work with Regulatory Partners to Determine Whether to Propose Legislation and/or change Regulatory Guidance for Concentrations or Other Controls

The OCC works with other regulators to develop guidance on a variety of subjects where common issues or concerns exist. The federal banking agencies are evaluating a number of factors that contributed to the current problems in the banking industry and will consider what regulatory changes are needed. At this point, it is too early to say whether the final outcome of those deliberations will include changes in concentration limits or risk management expectations, but I can assure you that we will continue to study the situation and interface with our regulatory partners when appropriate.

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

Section II

Prior Office of Inspector General Material Loss Review Recommendations

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The Treasury Office of Inspector General has completed eight mandated material loss reviews of failed banks regulated by the Office of the Comptroller of the Currency (OCC) since November 2008. This section provides our recommendations to OCC resulting from these reviews. With one exception as footnoted in this appendix, OCC management concurred with the recommendations and has taken or planned corrective actions that are responsive to the recommendations. In certain instances, the recommendations address matters that require ongoing OCC management and examiner attention.

Report Title	Recommendations to the Comptroller
Safety and Soundness: Material Loss Review of ANB Financial, National Association, OIG-09-013 (Nov. 25, 2008) OCC closed ANB Financial and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on May 9, 2008. At that time, FDIC estimated a loss to the Deposit Insurance Fund of $214 million.	Re-emphasize to examiners that examiners must closely investigate an institution's circumstances and alter its supervisory plan if certain conditions exist as specified in OCC's Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution. Re-emphasize to examiners that formal action is presumed warranted when certain circumstances specified in OCC's Enforcement Action Policy (PPM 5310-3) exist. Examiners should also be directed to document in the examination files the reasons for not taking formal enforcement action if those circumstances do exist. Reassess guidance and examination procedures in the Comptroller's Handbook related to bank use of wholesale funding with focus on heavy reliance on brokered deposits and other nonretail deposit funding sources for growth. Establish in policy a "lessons-learned" process to assess the causes of bank failures and the supervision exercised over the institution and to take appropriate action to address any significant weaknesses or concerns identified.
Safety and Soundness: Material Loss Review of First National Bank of Nevada and First Heritage Bank, National Association, OIG-09-033 (Feb. 27, 2009) OCC closed First National Bank of Nevada and First Heritage Bank and appointed FDIC as receiver on July 25, 2008. As of December 31, 2008, FDIC estimated losses to the Deposit Insurance Fund of $706 million for First National Bank of Nevada and $33 million for First Heritage Bank.	Re-emphasize to examiners the need to ensure that banks take swift corrective actions in response to examination findings. Re-emphasize to examiners OCC's policy on the preparation of supervision workpapers (i.e., workpapers are to be clear, concise, and readily understood by other examiners and reviewers).

Report Title	Recommendations to the Comptroller
Safety and Soundness: Material Loss Review of the National Bank of Commerce, OIG-09-042 (Aug. 6, 2009) OCC closed National Bank of Commerce and appointed FDIC as receiver on January 16, 2009. As of June 30, 2009, FDIC estimated a loss to the Deposit Insurance Fund of $92.5 million from this failure.	Conduct a review of investments by national banks for any potential high-risk concentrations and take appropriate supervisory action. Reassess examination guidance regarding investment securities, including government-sponsored enterprise securities.
Safety and Soundness: Material Loss Review of Ocala National Bank, OIG-09-043 (Aug. 26, 2009) OCC closed Ocala National Bank and appointed FDIC as receiver on January 30, 2009. As of August 7, 2009, FDIC estimated a loss to the Deposit Insurance Fund of $99.6 million.	Caution examiners and their supervisors that when a bank's condition has deteriorated, it is incumbent on examiners to properly support and document in examination work papers the CAMELS component and composite ratings assigned, including those that may not have changed from prior examinations, as well as support a decision not to take an enforcement action. Remind examiners that it is prudent to expand examination procedures for troubled or high-risk banks to review the appropriateness of (a) dividends and (b) payments to related organizations, particularly when the dividends or payments may benefit bank management and board members. In this regard, OCC should reassess, and revise as appropriate, its examination guidance for when expanded reviews of dividends and related organizations should be performed.
Safety and Soundness: Material Loss Review of TeamBank, National Association, OIG-10-01 (Oct. 7, 2009) OCC closed TeamBank National Association and appointed FDIC as receiver on March 20, 2009. As of September 18, 2009, FDIC estimated a loss to the Deposit Insurance Fund of $98.4 million.	Emphasize to examiners that matters requiring attention are to be issued in reports of examination in accordance with the criteria regarding deviations from sound management and noncompliance with laws or policies listed in the Comptroller's Handbook. Emphasize to examiners the need to a. adequately assess the responsibilities of a controlling official (chief executive officer/president, for example) managing the bank to ensure that the official's duties are commensurate with the risk profile and growth strategy of the institution; b. review incentive compensation and bonus plans for executives and loan officers; and c. ensure that banks conduct transactional and portfolio stress testing when appropriate.

Report Title	Recommendations to the Comptroller
Safety and Soundness: Material Loss Review of Omni, National Bank, OIG-10-017 (Dec. 9, 2009) OCC closed Omni, National Bank and appointed FDIC as receiver on March 27, 2009. As of October 31, 2009, FDIC estimated a loss to the Deposit Insurance Fund of $288.2 million.	Review OCC processes to ensure that more timely enforcement action is taken once the need for such action is identified.[1] Impress upon examiner staff the importance of completing all activities in annual supervisory cycles, including quarterly monitoring. In this regard, supervisors should ensure that quarterly monitoring activities are scheduled and carried out. Implement a policy for EIC rotation for midsize and community.
Safety and Soundness: Material Loss Review of Silverton Bank N. A., OIG-10-033 (Jan. 22, 2010) OCC closed Silverton Bank N.A. and appointed FDIC as receiver on May 1, 2009. As of October 31, 2009, FDIC estimated a loss to the Deposit Insurance Fund of $1.26 billion.	Ensure that after a charter conversion an EIC is promptly assigned and supervisory coverage of the institution is continuous, to include the timely initiation (within no more than 12 months of the full-scope examination by the prior regulator) of the first full-scope examination after conversion. Ensure that appropriate actions are taken to amend or reinforce OCC guidance in response to the lessons learned review of the Silverton failure. Ensure that banks seeking conversion to a national charter address all significant deficiencies identified by OCC or prior regulators before approval. Formalize the process for second level reviews of charter conversions.
Safety and Soundness: Material Loss Review of Citizens Bank, OIG-10-038 (Mar. 22, 2010) OCC closed Citizens National Bank N.A. and appointed FDIC as receiver on May 22, 2009. As of January 29, 2010, FDIC estimated a loss to the Deposit Insurance Fund of $26 million.	Due to the complexity of the risk-based capital treatment of structured investment securities, assess the adequacy of OCC Bulletin 2009-15, Investment Securities, after it has been in use for a reasonable time. Work with OCC's regulatory partners to determine whether to propose appropriate legislation and/or change regulatory guidance to establish limits or other controls for bank investments.

[1] OCC did not agree with this recommendation. In its response to our report, OCC asserted that current policies are sufficient to ensure that timely enforcement action is taken. We accepted its position with respect to its current processes and consider the recommendation closed.

Section III

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