Audit Report

OIG-11-085

SAFETY AND SOUNDNESS: In-Depth Review of Waterfield Bank

July 14, 2011

Office of Inspector General

Department of the Treasury

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

July 14, 2011

MEMORANDUM FOR JOHN E. BOWMAN
ACTING DIRECTOR

FROM: Michael Maloney /s/
Director, Fiscal Service

SUBJECT: In-Depth Review of Waterfield Bank

INTRODUCTION

The Office of Thrift Supervision (OTS) closed Waterfield Bank (Waterfield), Germantown, Maryland, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on March 5, 2009. As of May 31st, 2011, FDIC estimated that Waterfield's loss to the Deposit Insurance Fund was $42.5 million.

Pursuant to section 38(k) of the Federal Deposit Insurance Act, we contracted with Moss Adams LLP (Moss Adams), an independent certified public accounting firm, to perform an in-depth review of the failure of Waterfield. Moss Adams's report dated July 5, 2011, is provided as Section I.

It should be noted that Moss Adams initiated its work under the material loss review provision of section 38(k) which at the time of Waterfield's failure defined a loss to the Deposit Insurance Fund as material if the loss exceeded the greater of $25 million or 2 percent of the institution's total assets. That provision also required that our office conduct a review into the causes of the failure and the supervision exercised over the institution. Effective July 21, 2010, section 38(k) was amended by P.L. 111-203, also known as the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a result, among other things, the loss threshold to the Deposit Insurance Fund triggering a required material loss review was reset as follows: losses that exceed $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar year 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met). As amended, section 38(k) provides that the cognizant Inspector General is to perform an in-depth review of failures under the material loss threshold if the Inspector General determines that unusual circumstances exist with respect to the failure. Because Moss Adams's fieldwork was substantially finished when section 38(k) was amended, we determined that this was an unusual circumstance and therefore we directed Moss Adams to complete its review of Waterfield as an in-depth review.

RESULTS OF IN-DEPTH REVIEW

We concur with Moss Adams's report that indicated:

- Waterfield failed primarily because of (1) a significant decline in value and liquidity of their non-agency collateralized mortgage obligation securities (CMOs) and (2) the write-down of assets resulting from purchase accounting adjustments. Secondary causes of failure included (1) significant loan delinquencies and losses incurred on loans and (2) inadequate capital relative to the risk level of its CMOs, poor loan quality, and high overhead structure. Waterfield Bank became reliant on brokered deposits upon its purchase by Affinity Financial Corporation, Incorporated. Starting in January 2008, Waterfield Bank's business plan was to rely almost exclusively on a related party to provide deposits. As the condition of the institution deteriorated, Waterfield Bank faced restrictions on its acceptance of brokered deposits and its access to federal borrowings became limited. These conditions collectively created a capital deficit and liquidity issue that prompted OTS to close the institution.

- OTS's supervision of Waterfield Bank did not prevent a significant loss to the Deposit Insurance Fund. OTS identified concentrations in non-agency CMOs, valuation issues with their purchase accounting, and poor loan quality early on, but did not adequately address the associated risk.

Details of Moss Adams's conclusions are in their report.

Moss Adams recommended in the report that OTS:

- appropriately curtails high-risk business strategies employed by insured institutions through appropriate formal supervisory enforcement actions.

- performs a more thorough evaluation of the financial condition and business plan of prospective acquirers, including following protocol for monitoring the execution of the business plan.

- ensures that thrifts comply with conditions stated in approval documents on an ongoing basis, including prompt follow-up if required submissions are not timely received. Additionally, OTS staff should be directed to review such submissions in a timely manner and take appropriate supervisory action when deviations or other problems are identified.

- ensures that supervision of thrifts is not adversely impacted by the assignment of personnel to internal failed bank reviews.

While we believe these recommendations are appropriate based on the findings and conclusions by Moss Adams, it should be noted that pursuant to P.L. 111-203, the functions of OTS will transfer to other federal banking agencies on July 21, 2011. Additionally, OTS is to be abolished effective 90 days after the transfer date.

OBJECTIVES, SCOPE, AND METHODOLOGY

We contracted with Moss Adams to perform an in-depth review of Waterfield 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 Moss Adams; met with partners and staff members; evaluated the key judgments; met with OTS officials; reviewed OTS supervisory records; and performed other procedures we deemed appropriate in the circumstances. We conducted our work in accordance with generally accepted government auditing standards.

Section II identifies the recipients of this report. Should you wish to discuss the report, you may contact me at (202) 927-6512.

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Section I

Moss Adams LLP’s Report on the In-Depth Review of Waterfield Bank

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Abbreviations

ALLL	allowance for loan and lease losses
ASC	Accounting Standards Codification
CCR	Consolidated Capital Requirement
C&D	cease and desist order
C.F.R.	Code of Federal Regulations
CMOs	collateralized mortgage obligation securities
DRR	Division of Resolutions and Receiverships
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FRB	Federal Reserve Board
GAAP	generally accepted accounting principles
MRBA	matters requiring board attention
OTS	Office of Thrift Supervision
OTTI	other-than-temporary impairment
PCA	prompt corrective action
ROE	report of examination
SNL	SNL Financial LC
U.S.C.	United States Code
TFR	Thrift Financial Report

MOSS-ADAMS LLP
Certified Public Accountants | Business Consultants

Inspector General
Department of the Treasury

RE: Transmittal of Results for the In-Depth Review Report for
Waterfield Bank, Germantown, Maryland

This letter is to acknowledge delivery of our performance audit report on the in-depth review for Waterfield Bank. The objectives of this performance audit were to (1) determine the causes of Waterfield Bank's failure and resulting loss to the Deposit Insurance Fund and (2) assess the Office of Thrift Supervision's (OTS) supervision of Waterfield Bank, including implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the Federal Deposit Insurance Act.

The information included in this report was obtained during our fieldwork, which occurred during the period from June 1, 2010, through June 18, 2010.

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.

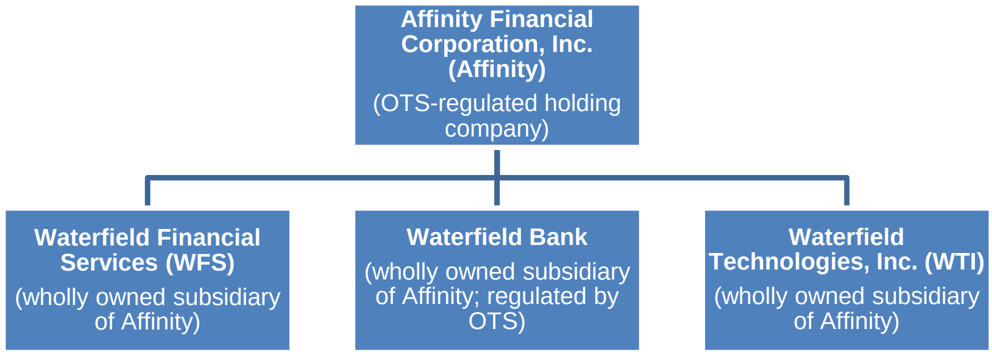
We also included several appendices to this report. Appendix 1 contains a more detailed description of our in-depth review objectives, scope, and methodology. Appendix 2 contains background information on Waterfield Bank's history and OTS's supervision process. Appendix 3 provides a glossary of terms used in the report. The terms defined in the glossary are underlined the first time they are used in the report. Appendix 4 provides OTS's comments regarding the report's recommendations.

Moss Adams LLP

Everett, Washington
July 5, 2011

Results in Brief

At March 5, 2010, the organization of related entities of Waterfield Bank was as follows:



Waterfield Bank was originally capitalized with $11 million in June 2000 and was named Assurance Partners Bank. Assurance Partners Bank was unable to reach profitability and in April 2005, Federal City Bancorp, Inc., infused $8 million in capital into Assurance Partners Bank and changed the name to American Partners Bank. American Partners Bank was unable to achieve profitability and on January 16, 2008, Affinity infused $20 million in capital and changed the name to Waterfield Bank, which later failed on March 5, 2010. The Federal Deposit Insurance Corporation (FDIC) estimated that the loss to the Deposit Insurance Fund from Waterfield Bank's failure was $42.5 million.

Waterfield Bank failed primarily because of (1) a significant decline in value and liquidity of their non-agency collateralized mortgage obligation securities (CMOs) and (2) the write-down of assets resulting from purchase accounting adjustments. Secondary causes of failure included (1) significant loan delinquencies and losses incurred on loans and (2) inadequate capital relative to the risk level of its CMOs, poor loan quality, and high overhead structure. Waterfield Bank became reliant on brokered deposits upon its purchase by Affinity. Starting in January 2008, Waterfield Bank's business plan was to rely almost exclusively on Waterfield Financial Services (WFS and a related party) to provide deposits. As the condition of the institution deteriorated, Waterfield Bank faced restrictions on its acceptance of brokered deposits and its access to federal borrowings became limited. The other-than-temporary impairment (OTTI) on non-agency CMOs, write-down of assets from purchase accounting adjustments, increase in nonperforming loans, and continued losses from a high overhead structure, combined with the institution's inability to obtain reliable funding, created a capital deficit and liquidity issue that prompted OTS to close the institution.

OTS's supervision of Waterfield Bank did not prevent a significant loss to the Deposit Insurance Fund. OTS identified concentrations in non-agency CMOs, valuation issues with their purchase accounting, and poor loan quality early on, but did not adequately address the associated risk. OTS took enforcement action against the institution only after the non-agency CMO concentrations became problematic. The purchase accounting adjustments, which had a material impact on regulatory capital, were not finalized and recorded until approximately two years after the acquisition by Affinity. In addition, OTS reached a supervisory judgment on a matter in 2008 that was inconsistent with Waterfield Bank's risk profile. Specifically, OTS upgraded Waterfield Bank's CAMELS composite rating from 4 to 3 based on the $20 million capital infusion by Affinity and the new management team brought on to run the institution. However, there were no underlying changes in Waterfield Bank's condition that warranted the upgraded composite rating. Finally, OTS's 2008 full scope examination of Waterfield Bank took significantly longer than the typical examination of a similar-sized institution. At the time of the 2008 examination, certain OTS field personnel were assigned to internal failed bank reviews. This was in addition to their normal workload, which contributed to their untimely completion of the examination.

In accordance with its policy, OTS conducted an internal failed bank review of Waterfield Bank and determined that the thrift's failure was primarily caused by a significant concentration of non-agency CMOs that incurred considerable deterioration in value, which directly contributed to Waterfield Bank's negative capital position and failure. In its review, OTS also concluded that the heavy general and administrative expenses Waterfield Bank incurred building an infrastructure to support projected growth, as well as the reduction in value associated with the acquired held-to-maturity loan portfolio, which necessitated a decrease in equity capital, contributed to Waterfield Bank's failure. The review identified areas of weakness in OTS's supervision of Waterfield Bank related to eligibility examinations and approval applications for potential savings and loan holding companies. Our in-depth review affirmed OTS's internal findings and the need for corrective action.

We are recommending that OTS (1) appropriately curtails high-risk business strategies employed by insured institutions through appropriate formal supervisory enforcement actions; (2) performs a more thorough evaluation of the financial condition and business plan of prospective acquirers, including following protocol for monitoring the execution of the business plan; (3) ensures that thrifts comply with conditions stated in approval documents on an ongoing basis, including prompt follow-up if required submissions are not timely received. Additionally, OTS staff should be directed to review such submissions in a timely manner and take appropriate supervisory action when deviations or other problems are identified; and (4) ensures that supervision of thrifts is not adversely impacted by the assignment of personnel to internal failed bank reviews.

Causes of Waterfield Bank's Failure

Waterfield Bank failed because of a significant decline in value and liquidity of its non-agency CMOs that resulted in a $7.9 million OTTI charge to income in December 2009 and a write-down of $7.7 million in assets in December 2009, resulting from purchase accounting adjustments recorded after its acquisition by Affinity. Secondary causes of Waterfield Bank's failure were poor asset quality and high overhead costs, which resulted in operating losses. These factors, combined with Waterfield Bank's inability to obtain reliable funding sources, created a capital deficit and liquidity issue that prompted OTS to close the institution on March 5, 2010.

High Concentration in Non-Agency Collateralized Mortgage Obligation Securities

OTS defines a concentration as a group of similar types of assets or liabilities that, when aggregated, exceeds 25 percent of an institution's core capital plus allowance for loan and lease losses (ALLL). Concentrations pose risk to an institution because negative events affecting overly concentrated groups of assets can have a highly detrimental impact on the institution. Waterfield Bank maintained high concentrations of non-agency CMOs in its investment portfolio.

Waterfield Bank was recapitalized on January 16, 2008, with a $20 million capital infusion by Affinity, and had total assets at the time of $160 million. Shortly thereafter, management leveraged Waterfield Bank's balance sheet by investing in AAA-rated non-agency CMOs, building the portfolio to more than $121.1 million by June 30, 2008. The AAA non-agency CMOs portfolio peaked at September 30, 2008, at $125 million, or 800 percent of total capital. The AAA non-agency CMO portfolio was funded by what was later determined to be brokered deposits from WFS, a related party. In the latter half of 2008, the non-agency CMO market declined, resulting in an illiquid market and significant unrealized losses.

By December 31, 2008, the unrealized loss on non-agency CMOs, net of tax, was approximately $16.7 million. This unrealized loss represented 84 percent of the $20 million of initial capital infused into Waterfield Bank. Management was unable to liquidate the investments due to both the illiquid market for non-agency CMOs and the accounting and regulatory capital implications. Ultimately, in the fourth quarter of 2009, Waterfield Bank concluded that it could no longer continue to carry the value of the non-agency CMOs at amortized cost, and, therefore, had to record an OTTI write-down of $7.9 million. This charge in the fourth quarter of 2009 contributed to the significant decline in capital, resulting in Waterfield Bank being critically undercapitalized.

Late Recording of Purchase Accounting Adjustments

The acquisition of American Partners Bank by Affinity and the subsequent name change to Waterfield Bank occurred on January 16, 2008. The final purchase accounting adjustments[1] resulting from the acquisition were not recorded by Waterfield Bank until December 2009. Recording the final purchase accounting adjustments reduced income by $7.7 million and had a material impact on Waterfield Bank's equity and regulatory capital.

Waterfield Bank's tier 1 leverage ratio was 10 percent at March 31, 2008, shortly after the acquisition on January 16, 2008, and later fell to negative 5.16 percent at December 31, 2009. The significant decline in Waterfield Bank's ratio in the fourth quarter of 2009 reflects the impact of the OTTI on the non-agency CMOs, recording of the purchase accounting adjustments, provision for loan losses, and high operating expenses.

Had the $7.7 million of purchase accounting adjustments been recorded timely, Waterfield Bank would have fallen below well capitalized for the quarters ended June 30, 2008 (adequately capitalized), September 30, 2008 (adequately capitalized), and December 31, 2008 (undercapitalized).

Poor Credit Quality and Contingent Liability from Mortgage Banking Operations

At December 31, 2009, 10.45 percent of Waterfield Bank's loans were classified as nonperforming, an increase from 1.66 percent at December 31, 2007. The provision for loan losses for the year ended December 31, 2009, was $2.9 million, compared to $1.3 million for 2008 and $427,000 for 2007. The credit quality problems were primarily caused from mortgage banking operations. American Partners Bank—and, subsequently, Waterfield Bank—originated and sold into the secondary market prime and subprime mortgage loans. During 2008, over $1 billion of loans were originated and sold into the secondary market. A number of loans originated and placed into Waterfield Bank's single-family portfolio did not meet the underwriting guidelines established by board-approved policies, including mortgage banking originations rejected by investors. These underwriting problems resulted in a material amount of un-saleable loans, and many of those sold were required by investors to be repurchased by Waterfield Bank. The mortgage banking loan problems contributed significantly to the elevated nonperforming loan to total loan ratios throughout 2008 and 2009.

Waterfield Bank's capital was also at risk for an ongoing contingency related to earlier sales to the secondary market due to asserted fraudulent underwriting or misrepresentation for loans originated in 2006, 2007, and 2008. Secondary market sales were significant through 2009. In 2009, due

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[1] Under purchase accounting (Accounting Standards Codification topic 805 (ASC 805), *Business Combinations*), when an entity is purchased, its assets and liabilities are marked to fair value and recorded as such on the purchaser's financial statements. The excess of the total acquisition cost over the sum of the fair values of the assets acquired, less liabilities assumed, is recorded as goodwill. Any resulting goodwill is deducted from equity capital to arrive at regulatory capital.

to ongoing repurchases of mortgage loans sold to Countrywide Home Loan, Inc. and its successor, Bank of America, management entered into an indemnification agreement whereby Bank of America would discontinue requesting that Waterfield Bank repurchase loans previously sold. The net cost to Waterfield Bank for the indemnification was $1 million.

High Overhead Costs and Significant Losses

Waterfield Bank was structurally unprofitable and posted only one quarter of profitability during the five-year period ended December 31, 2009. Management was slow to recognize and respond to the economic downturn and its impact on Waterfield Bank's mortgage banking operations. As of December 31, 2008, Waterfield Bank continued to have operations spread over the United States, with its main office in California; an operations center in Indiana; mortgage banking loan production offices in Washington, DC, and Virginia; and bank offices in New Jersey, Florida, and Maryland. For the years ended December 31, 2009 and 2008, noninterest expense totaled $18.9 million and $14.5 million, respectively. The majority of these expenses consisted of compensation and benefits for employees and directors, as well as occupancy expense. These high overhead costs (for the year ended December 31, 2009, noninterest expense to average total assets was 4 percent), combined with limited earning assets and a decline in its mortgage banking business, resulted in Waterfield Bank posting a net loss of $5.7 million for the year ended December 31, 2008, compared to projected net income of $4.1 million based on its business plan, and a net loss of $18.5 million for 2009. Included in 2009's $18.5 million net loss were charges of $7.9 million related to OTTI on non-agency CMOs, $7.7 million related to purchase accounting adjustments, and the $1 million indemnification expense paid to Bank of America.

The continued operating losses caused Waterfield Bank's PCA category to fall below adequately capitalized, with a total risk-based capital of 7.64 percent at September 30, 2009.

Poor Financial Condition of Affinity and its Wholly Owned Subsidiaries, WFS and WTI

Affinity, WFS, and WTI provided no financial support to Waterfield Bank, nor were they a source of strength. Figure 1 shows the losses from operations of the entities for 2009 and 2008.

Figure 1. Net losses of Affinity, WFS, and WTI for the years ended 2009 and 2008.

	2009 Net Loss	2008 Net Loss
Affinity Financial Corporation, Inc.	$ (2,669,578)	$ (1,980,309)
Waterfield Financial Servcies, Inc.	$ (1,558,211)	$ (4,722,488)
Waterfield Technologies, Inc.	$ (9,955)	$ (868,745)

Source: Respective entities' internal financial statements

At December 31, 2007, immediately prior to Affinity's acquisition of the institution, Affinity's audited consolidated financial statements reflected a stockholders' deficit of $1 million and total assets of $4.8 million. The financial condition of Affinity, WFS, and WTI contributed to a 2009 dispute over intercompany receivables and payables. At the conclusion of the dispute in 2009, Waterfield Bank wrote off approximately $1 million of receivables due from Affinity, WFS, and WTI as a result of the poor financial condition of the entities and disagreements over charges.

High-Risk Business Plan and Unstable Funding Structure

Waterfield Bank's original business plan, dated February 2007, called for rapid asset growth, with projected assets growing from $155 million at acquisition (January 2008) to $2.2 billion by the end of year three. The growth was to be supported by an initial capital infusion of $75 million from Affinity; ongoing capital infusions from Affinity by reinvesting earnings from its wholly owned subsidiaries, WFS and WTI; and WFS providing deposits as the primary funding source. Affinity submitted a revised business plan dated November 2007 to OTS but still focused on rapid asset growth, with assets projected to grow from $172 million at acquisition to $1.2 billion by the end of year three. The capital infusion was $20 million, with $8.5 million borrowed by Affinity through a bridge loan. Payment of the bridge loan was to be from the sale of additional stock, which ultimately never occurred, nor did the additional capital infusions from Affinity.

Waterfield Bank did not adjust its cost structure to reflect the $55 million reduction in the actual capital infusion (from the $75 million planned to $20 million actually infused) and Affinity's inability to infuse additional capital. Rather, management continued to run operations spread across the nation and added loan production offices on the East Coast. This expensive infrastructure resulted in excessive overhead costs well in excess of income levels.

The business plan also called for a substantial reliance on deposits from WFS as its primary funding source for growth. The deposit-gathering agreement with WFS allowed Waterfield Bank to rapidly grow deposits from $104 million at December 31, 2007, before the acquisition, to $215 million by

June 30, 2008. During this time, management used the deposits to purchase approximately $121.1 million of non-agency CMOs, which shortly thereafter became illiquid and impaired, as noted earlier.

Inadequate Capital Levels

Although Waterfield Bank was considered well capitalized under PCA requirements until June 30, 2009, when the institution fell to adequately-capitalized, its capital levels were nevertheless inadequate because of its exposure to non-agency CMOs and loans with higher levels of credit risk, as well as the institution's high-cost overhead structure. According to Section 120 of the OTS *Examination Handbook*, institutions that engage in higher-risk activities require more capital, especially if the activities are conducted at significant concentration levels.

Following the filing of the June 30, 2009, thrift financial report (TFR), Waterfield Bank's PCA status fell to adequately capitalized. OTS issued a troubled condition letter that restricted the institution from accepting, renewing, or rolling over any brokered deposits without prior written approval from the FDIC. Waterfield Bank was unable to obtain stable funding sources without the use of brokered deposits through WFS. Waterfield Bank's high concentrations in non-agency CMOs became illiquid and impaired; this, combined with a write-down of assets resulting from purchase accounting adjustments, poor asset quality, high overhead structure, and significant operating losses, created a capital deficit and liquidity issue. Waterfield Bank dropped to critically undercapitalized at December 31, 2009, and was closed by OTS on March 5, 2010.

OTS's Supervision of Waterfield Bank

OTS's supervision of Waterfield Bank did not prevent a significant loss to the Deposit Insurance Fund. OTS identified concentrations in non-agency CMOs at the institution but did not adequately address the risk associated with them. OTS prescribed corrective action to address Waterfield Bank's high concentrations in non-agency CMOs in December 2008, but only after those non-agency CMOs became illiquid. In addition, OTS reached a supervisory judgment on a matter in 2008 that was inconsistent with Waterfield Bank's rising risk profile. Specifically, OTS upgraded Waterfield Bank's CAMELS composite and component ratings from 4/445533 as of September 28, 2007, to 3/232332 at January 30, 2008. The upgrade was based on a limited examination mailed on January 30, 2008, after the infusion of $20 million in capital from Affinity, which was raised, in part, by borrowing $8.5 million, and by the new management team brought in to run the institution.

Figure 2 lists OTS's full-scope safety and soundness and limited examinations of Waterfield Bank from 2005 until the thrift's failure and provides information on the significant results of those examinations. Generally, matters requiring board attention (MRBA) represent the most significant items requiring corrective action found by examiners. Figure 2 also lists the informal and formal enforcement actions taken against Waterfield Bank by OTS.[2]

[2] OTS conducted its examinations and performed offsite monitoring of Waterfield Bank in accordance with the timeframes prescribed in the OTS *Examination Handbook*, except as noted in this report.

Figure 2. Summary of OTS's Examinations and Enforcement Actions for Waterfield Bank.

		Examination Results[3]			
Date started/ completed/ mailed	Assets (in millions)	CAMELS Rating	Number of MRBAs	Number of corrective actions	Enforcement actions
3/29/2005 5/13/2005 6/22/2005	$38	3/212421	3	-	None
3/20/2006 4/21/2006 5/18/2006	$78	2/222321	4	5	None
5/29/2007 10/10/2007 11/09/2007	$147	4/445543	6	27	OTS issues a troubled condition letter on 8/24/07.
9/28/2007 9/28/2007 9/28/2007 (Limited exam)	$138	4/445533	-	-	None
1/30/2008 1/30/2008 1/30/2008 (Limited exam)	$127	3/232332	-	-	None
6/9/2008 7/14/2008 8/13/2008 (Limited exam)	$185	N/A	-	-	None
12/8/2008 6/30/2009 7/30/2009	$282	4/433444	4	22	OTS issues a troubled condition letter on 7/30/09. OTS issues a cease and desist order on 10/1/09.
11/23/2009 1/8/2010 1/22/2010 (Limited exam)	$197	5/55455-	-	2	None
2/1/2010 (Not completed) (Limited exam)	$197	N/A	-	-	None
2/22/2010 (Not completed)	$156	N/A	-	-	None

[3] Source: OTS Report of Examinations

OTS Did Not Take Forceful and Timely Actions to Address Unsafe Concentrations in Non-Agency CMOs

During the second quarter of 2008, Waterfield Bank purchased $110 million of non-agency CMOs, bringing the total to $121.1 million at June 30, 2008, representing 651 percent of total equity capital. In the OTS limited examination report[4] started on June 9, 2008, and mailed August 13, 2008, OTS did not identify the significant concentration in non-agency CMOs, nor did it identify the concentration from the June 30, 2008, TFR. As stated earlier, OTS defines a concentration as a group of similar assets or liabilities that, when aggregated, exceeds 25 percent of an institution's risk-based capital (core capital plus ALLL). As a result, there was no action to address the concentration in non-agency CMOs until the market had deteriorated significantly. OTS identified the non-agency CMO security concentrations in its full-scope examination that commenced on December 8, 2008, and mailed July 30, 2009. At December 31, 2008, the unrealized loss on the non-agency CMOs, net of tax, was $16.7 million. Had OTS identified the excessive concentration risk earlier, additional restrictions could have been imposed. Based on discussions with OTS personnel, Affinity's business plan contemplated an investment mix that was more diversified than what was actually purchased. In addition, had the quarterly variance reports been provided by management to OTS as required by Condition 5 of the OTS merger approval letter, the concentrations may have been identified and remediated sooner. There was no indication that quarterly business plan variance reports were requested by OTS between safety and soundness examinations.

Waterfield Bank's investment policy limited the purchase of individual securities to less than 25 percent of tangible capital. Eight non-agency CMOs purchased in 2008 exceeded this threshold, seven of which were purchased prior to the August 13, 2008, mail date of the OTS limited examination report.

The December 2008 report of examination (ROE) included OTS's first corrective action to address Waterfield Bank's non-agency CMO concentration levels.[5] OTS stated that management should prepare an updated analysis each quarter assessing whether all or a portion of the indicated impairment associated with the non-agency CMOs should be treated as OTTI, and implement internal controls to ensure agency rating changes were carried through to proper reporting of CMOs on the Schedule Consolidated Capital Requirement (SCCR). However, OTS's corrective action did not require the institution to lower concentration levels; the corrective action only required the institution to improve its monitoring of its concentration and reporting of rating changes.

[4] The purpose of the limited examination was for OTS to assess compliance with Waterfield Bank's new business plan approved in connection with the acquisition and management's progress in addressing concerns from the last full-scope examination mailed November 9, 2007.
[5] Corrective actions are included in ROEs to address deficiencies and violations found during the examination. They are communicated to the institution with the expectation that the problems they address will be corrected by the next examination.

Greater supervisory action prior to the ROE mailed July 30, 2009, was warranted to address the institution's concentrations in non-agency CMOs, including requiring Waterfield Bank to lower its concentrations in non-agency CMOs through an increase in capital levels.

During our interviews, various OTS examination staff acknowledged that earlier supervisory action should have been taken to address the institution's concentrations in non-agency CMOs. They indicated that no action was taken at the time of purchase because all the non-agency CMOs were investment grade.

OTS Actions Were Not Consistent With Waterfield Bank's Risk Profile

In the OTS limited examination mailed on January 30, 2008, OTS upgraded Waterfield Bank's CAMELS composite rating to 3 from 4, which was inconsistent with the institution's risk profile and unproven high-risk business plan. As discussed earlier, Waterfield Bank had a high-cost operating structure, poor asset quality, and a high-risk business plan implemented by a new management team. When we asked OTS personnel about the basis for their CAMELS upgrade, they cited the equity infusion of $20 million by Affinity and the new management team.

OTS upgraded the CAMELS composite and component ratings from 4/445543 to 3/232332. The basis for OTS's upgrade was the equity infusion of $20 million, $8.5 million of which was borrowed by Affinity, which resulted in Waterfield Bank becoming well capitalized with a core capital ratio of 15.35 percent and a total risk-based capital ratio of 26.95 percent; the reduction in the percent of problem assets to equity as a result of the equity infusion of $20 million; the new business plan; and OTS's knowledge of the experience and capabilities of the new management team.

Waterfield Bank's first quarter net income was not consistent with the business plan. The institution posted a net loss of $1.8 million for the first quarter of 2008, compared to the business plan's projection of net income of $300,000. In addition, nonperforming loans to total loans increased from 1.66 percent at December 31, 2007, to 2.49 percent at March 31, 2008.

This rating change was inconsistent with Waterfield Bank's unproven, high-risk business plan, continued losses, and poor asset quality.

OTS Did Not Timely Address Waterfield Bank's Purchase Accounting Issues

During the December 2008 examination, OTS identified that the purchase accounting adjustments had not been recorded in accordance with generally accepted accounting principles (GAAP). At December 31, 2008, Waterfield Bank's tier 1 capital was only $370,000 above the well capitalized minimum. To the extent that even small portions of the fair value purchase accounting adjustments were disallowed, a restated December 31, 2008, TFR would have likely indicated that the institution was not well capitalized, as reported.

The ROE for the December 2008 examination, mailed July 30, 2009, included OTS's first corrective action to address Waterfield Bank's late recording of the purchase accounting adjustments. OTS stated in the ROE that management should work with the institution's independent auditors to ensure that upon completion of their audit, the audit work papers related to the review of purchase accounting entries were submitted to OTS's regional accountant for review. However, OTS's corrective actions were not issued timely, nor were they complied with by Waterfield Bank. It was more than 18 months from the acquisition's completion on January 16, 2008, until the first OTS corrective action was issued in the ROE mailed July 30, 2009, and it was not until December 2009 that the final purchase accounting entries were recorded.

We believe that more timely and greater supervisory action prior to the ROE mailed July 30, 2009, was warranted to address the institution's failure to properly record the purchase accounting adjustments, including requiring Waterfield Bank to take the necessary steps to determine the purchase accounting entries and record them within the 12-month required timeframe under GAAP.

OTS Did Not Take Supervisory Action Against Waterfield Bank in a Timely Manner

OTS did not complete all of its examinations of Waterfield Bank and take regulatory action in a timely manner.

OTS's 2007 and 2008 full-scope examinations took significantly longer than the typical examination of a similar-sized institution. The 2007 examination spanned 160 days until transmitted, and the 2008 examination spanned 234 days until transmitted. Based on discussions with OTS personnel, during the 2008 examination OTS field personnel were assigned to internal failed bank reviews for other OTS regions. Based on discussions with OTS personnel, this practice is no longer followed because the OTS Quality Control department is sufficiently staffed to perform internal failed bank reviews. OTS examiners stated that enforcement action was taken within an appropriate amount of time after mailing of the December 2008 ROE; however, OTS personnel acknowledged that the time between commencement of the examination and the mailing of the ROE was longer than normal. Assigning field personnel to internal failed bank reviews contributed to the untimely completion of the examination.

During 2007, while Waterfield Bank was operating under the name of American Partners Bank, it was classified as undercapitalized for the first three quarters of 2007 and was classified as significantly undercapitalized at December 31, 2007. However, the institution only received a PCA directive dated August 24, 2007. Based on OTS's May 2007 examination, the institution was to receive a cease and desist order;[6] however, the order was

[6] Section 080 of the OTS examination handbook states that "a cease and desist order normally requires the association to correct any violation of law, regulation, or an unsafe or unsound practice. OTS may issue a cease and desist order in

never issued. OTS did not issue the cease and desist order due to the expected capital infusion by Affinity and its potential impact on the completion of the transaction. Based on discussions with OTS personnel, they were concerned that a cease and desist order could jeopardize the pending acquisition. The OTS Regional Enforcement Counsel indicated their practice has changed to no longer hold a cease and desist order due to a pending transaction.

OTS Did Not Perform a Thorough Evaluation of the Acquisition by Affinity

Waterfield Bank's original business plan dated February 2007 called for rapid asset growth, with projected assets growing from $155 million at acquisition (January 2008) to $2.2 billion by the end of year three. The growth was to be supported by a capital infusion of $75 million; ongoing capital infusions from Affinity by reinvesting earnings from its wholly owned subsidiaries, WFS and WTI; and WFS providing deposits as the primary funding source. Affinity submitted a revised business plan in November 2007 but still focused on rapid asset growth, with projected assets growing from $172 million at acquisition to $1.2 billion by the end of year three. The capital infusion was $20 million, with $8.5 million borrowed by Affinity through a bridge loan. Payment of the bridge loan was to come from the sale of additional stock, which ultimately never occurred, nor did the additional capital infusions from Affinity. The approved business plan also projected net income of $300,000 for the first quarter after acquisition and $4.1 million for the first year, increasing to $15.3 million for year three. OTS approved the acquisition and business plan on January 7, 2008.

We believe that OTS did not perform an adequate review of Affinity's financial condition prior to acquiring American Partners Bank. At the time of acquisition, Affinity had an accumulated deficit of more than $1 million and total assets of $4.8 million. For the years ended December 31, 2007, 2006, and 2005, Affinity recorded net losses of $4 million, $10.7 million, and $1.7 million, respectively. In our opinion, OTS should have made further inquiries regarding Affinity's ability to service the $8.5 million debt and infuse additional capital, given its financial condition and history. Based on discussions with OTS personnel, a $20 million capital infusion was determined a better solution than imminent failure of American Partners Bank, even with a portion financed.

Waterfield Bank's business plan also included a high reliance on brokered deposits as the main funding source for growth and liquidity. WFS gathered deposits through affinity group websites; by mail, wire, ATM, and UPS stores; or direct transfer from a partner bank. Once received, Affinity would place the deposits at a partner bank for a negotiated spread plus processing

response to violations of federal banking, securities, or other laws by associations or individuals, or if it believes that an unsafe and unsound practice or violation is about to occur. OTS authority for issuing cease and desist orders is the Federal Deposit Insurance Act. OTS may issue a cease and desist order if one of the following factors is present: (1) an unsafe or unsound practice; (2) a violation of law, rule, or regulation; or (3) a violation of any condition imposed in writing in connection with the granting of an application, or any written agreement with OTS."

fees. Through intra-agency communications, OTS first acknowledged in December 2006 that the FDIC considers the type of deposit arrangements that were proposed in the Affinity business plan to be brokered deposits. The initial business plan called for the transfer of approximately $650 million of these affinity deposits into Waterfield Bank, and there was no acknowledgement that the deposits were considered to be brokered deposits. OTS did not rule on the brokered deposit issue until brokered deposit restrictions were placed on Waterfield Bank on July 2, 2009, after which the FDIC ultimately concluded on October 30, 2009, that the deposits were brokered deposits. Based on discussions with OTS personnel, they acknowledged the brokered deposits issue should have been addressed sooner. Although an institution is allowed to have brokered deposits when it is well capitalized, OTS personnel noted that the economic conditions in January 2008 (date of acquisition) were symptomatic of issues that could lead to brokered deposit restrictions.

The reliance on this type of funding source was a significant change in business operations for American Partners Bank. Historically, American Partners Bank never used brokered deposits as a primary funding source prior to the merger. Rather, it used short-term borrowings to fund a wholesale mortgage banking operation with limited core deposits. The deposit-gathering portion of the Affinity business plan was a significant change in operations for the institution, which was not structured to sustain the high overhead costs associated with this operational change.[7] Given the significant change in both management control and operations of the institution, we believe OTS should have conducted an eligibility examination to properly assess the inherent risks of the brokered deposits, coupled with the mortgage banking operations. Based on discussions with OTS personnel, the determination of whether an eligibility examination is required is a matter of judgment. OTS personnel identified that there were certain matters in the business plan and in the financial condition of Affinity that would support an eligibility examination.

Subsequent to the merger, OTS did not monitor the operations of Waterfield Bank as compared to the approved business plan. Condition 5 of the OTS approval letter dated January 7, 2008, required during the term of the business plan that Waterfield Bank submit to OTS, within 45 calendar days after the end of each calendar quarter, a business plan variance report detailing the institution's compliance with the business plan and an explanation of any deviations. OTS noted in its ROE for the December 2008 examination (issued in July 2009) that Waterfield Bank had not been submitting quarterly business plan variance reports to OTS. During this time, Waterfield Bank's actual results were vastly different from the approved business plan. As stated above, the business plan called for an increase in assets from $172 million at acquisition to $520 million after year one (December 31, 2008), while the institution's actual assets were $287 million

[7] Section 060 of the OTS *Examination Handbook* states that "OTS will perform an eligibility examination in cases where the application involves an existing company or line of business that is to be converted to, to be combined with, or will otherwise materially alter or affect the operations of a savings association."

at December 31, 2008. The business plan also called for net income of $300,000 for the first quarter after acquisition and $4.1 million for the year. For 2008, the institution posted quarterly losses of $1.8 million for the first quarter, $1.3 million for the second quarter, $1.2 million for the third quarter, and $1.3 million for the fourth quarter, for a combined loss for the year of $5.6 million. Had OTS received and reviewed the required quarterly business plan variance reports, it may have been able to identify Waterfield Bank's problems sooner. There was no indication that quarterly business plan variance reports were requested by OTS between safety and soundness examinations.

OTS Implemented Prompt Corrective Action In Accordance With Requirements

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. According to PCA requirements, federal banking agencies are to take certain actions when an institution's capital drops to certain levels. Under PCA, regulators also have flexibility to require corrective action by institutions based on criteria other than capital levels to help reduce deposit insurance losses caused by unsafe and unsound practices.

We concluded that OTS used its authority under PCA in accordance with PCA requirements. At December 31, 2006, American Partners Bank dropped from well capitalized to adequately capitalized. On August 7, 2007, American Partners Bank filed an amended March 31, 2007, TFR, which dropped the institution from adequately capitalized to undercapitalized. OTS notified American Partners Bank of its undercapitalized status and that it was considered to be in troubled condition through a troubled condition letter dated August 24, 2007.

At December 31, 2007, American Partners Bank dropped from undercapitalized to significantly undercapitalized. OTS notified American Partners Bank of its lower capital status in a Notice of Intent to Issue Prompt Corrective Action Directive with Notice of Conditional Approval of <u>Capital Restoration Plan</u> letter dated January 8, 2008. The acquisition of American Partners Bank by Affinity was consummated on January 16, 2008, and the name American Partners Bank was changed to Waterfield Bank.

At June 30, 2009, Waterfield Bank dropped from well capitalized to adequately capitalized. Additionally, OTS downgraded the institution's CAMELS composite rating from a 3 to 4 in its July 30, 2009, ROE for the December 2008 examination. OTS also notified Waterfield Bank of its troubled condition in a letter dated July 30, 2009.

The troubled condition letter informed Waterfield Bank of the restrictions associated with its capital level decline and troubled condition status, which included (1) a growth restriction; (2) a requirement for notice of a change of director or senior executive officer; (3) restrictions on golden parachute payments; (4) restrictions on contracts, compensation, or benefits;

(5) restrictions on certain third-party contracts; (6) restrictions on dividends; (7) no expedited treatment for applications and notices filed with OTS; and (8) a brokered deposits restriction and a requirement to develop a written plan to reduce reliance on brokered deposits. The troubled condition restrictions were consistent with PCA and OTS guidance, given the PCA status and conditions of the thrift.

OTS issued a cease and desist order on October 1, 2009. The cease and desist order provided for restrictions and requirements related to capital liquidity, brokered deposits, credit administrations, interest rate risk, business plans, asset quality, financial reporting, policies and procedures, compliance, investment management, compensation arrangements, transactions with affiliates, and management changes.

At December 31, 2009, Waterfield Bank dropped from significantly undercapitalized to critically undercapitalized. OTS notified Waterfield Bank of its lower capital status in a Notification of Critically Undercapitalized Status and Notice of Intent to Issue Prompt Corrective Action Directive With Notice of Disapproval of Capital Restoration Plan letter dated January 26, 2010. On February 4, 2010, Waterfield Bank consented to the appointment of a conservator or receiver by OTS. On May 5, 2010, OTS closed Waterfield Bank and appointed the FDIC as receiver.

OTS Failed Thrift Institutions Review

OTS policy requires that an internal assessment be conducted when a thrift fails. That assessment, referred to as a failed thrift institutions review, is performed by staff independent of the region responsible for supervisory oversight of the failed thrift. The report is reviewed and signed by OTS's deputy director of examinations, supervision, and consumer protection. Staff from OTS's Western Region performed an internal review of Waterfield Bank following its failure in March 2010. The scope of the review focused primarily on OTS's supervision from Affinity's application to acquire Waterfield Bank in 2007 through the failure in March 2010.

OTS's review determined that Waterfield Bank's failure was caused by significant concentrations of non-agency collateralized mortgage obligations that incurred considerable deterioration in value, which directly contributed to Waterfield Bank's negative capital position. The internal failed bank review also concluded that Waterfield Bank incurred heavy general and administrative expenses building an infrastructure to support projected growth, and that Waterfield Bank's capital position deteriorated due to quarterly net losses. Furthermore, the internal failed bank review determined that purchase accounting adjustments from Affinity's acquisition of Waterfield Bank initially overvalued the acquired loans by approximately $5 million, necessitating a decrease in equity capital.

The OTS internal failed bank review identified weaknesses in supervision. The internal failed bank review found that OTS should have completed an eligibility examination, which would have disclosed information that OTS could have benefited from to more effectively regulate Affinity and Waterfield Bank. The internal failed bank review also found that, due to the unique nature of Affinity's activities and the affiliated transactions, the supervisory process should have included documented analysis and evaluation of the deposit-gathering process prior to or shortly after the change in control. The internal failed bank review also noted that there was no evidence that OTS monitored or tracked compliance with the condition for acquisition approval related to the business plan variance reports until such compliance was reviewed in conjunction with the December 8, 2008, examination.

The OTS report made the following recommendations:

- OTS should require that eligibility examinations be conducted for all potential savings and loan holding companies when an active organization proposes to charter a new thrift institution or acquire control of an existing one.

- Unique material strategies, including material transactions with affiliate activities that could affect an institution, need to be analyzed and documented prior to the approval of an application to charter or acquire control of a savings institution. In those situations, the application approval digest should document any material risks foreseen in the proposed transaction and set forth supervisory strategies to monitor and control material and/or unique risks following consummation of the proposed transaction.

- Formal recommendations to address concentration deficiencies were not provided, as the deficiencies were substantially the same issues noted in recent 2009 and 2010 failed bank reviews and OIG audit reports.

Our in-depth review affirms the findings and recommendations of OTS's internal review.

Recommendations

As a result of our in-depth review of Waterfield Bank, we recommend that the Director of OTS do the following:

1. Appropriately curtail high-risk business strategies employed by insured institutions through appropriate formal supervisory enforcement actions.

2. Perform a more thorough evaluation of the financial condition and business plans of prospective acquirers and follow all protocol for monitoring of the execution of the business plans.

3. Ensure that thrifts comply with conditions stated in approval documents on an ongoing basis and ensure that a prompt follow-up is performed if required submissions, such as business plan variance reports, are not timely received. Additionally, OTS staff should be directed to review such submissions in a timely manner and take appropriate supervisory action when deviations or other problems are identified.

4. Ensure that supervision of thrifts is not adversely impacted by the assignment of personnel to internal failed bank reviews.

Management Response

OTS responded that they acknowledge and concur with conclusions and recommendations.

Moss Adams LLP Comment

The implementation of the recommendations is the responsibility of OTS management.

We performed an in-depth review of the failure of Waterfield Bank under a contract with the Department of the Treasury Office of Inspector General (OIG). Our objectives were to determine the causes of Waterfield Bank's failure and assess its supervision by OTS.

We conducted this in-depth review of Waterfield Bank in response to Section 38(k) of the Federal Deposit Insurance Act. This section provides that if the inspector general for the appropriate federal banking agency determines an in-depth review of a nonmaterial loss to the Deposit Insurance Fund is warranted, the inspector general is to prepare a report to the agency that

- ascertains why the institution's problems resulted in a loss to the Deposit Insurance Fund;
- reviews the agency's supervision of the institution, including its implementation of the PCA provisions of Section 38; and
- makes recommendations for preventing any such loss in the future.[8]

To accomplish our review, we conducted fieldwork at OTS's regional office in Atlanta, Georgia, and at the FDIC's Division of Resolutions and Receiverships (DRR) office located in Irvine, California. We also interviewed officials of OTS and the FDIC's Division of Supervision and Consumer Protection. As part of this in-depth review, the OIG conducted the interview of FDIC DRR personnel and provided us summary information regarding their review. We conducted our fieldwork during June 2010.

To assess the adequacy of OTS's supervision of Waterfield Bank, we determined (1) when OTS first identified the institution's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the institution to correct the problems. We also assessed whether OTS (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:

- Based on our reviews of the ROE and discussions with OTS, we determined that the period covered by our audit would be from January 1, 2005, through 2009. This period included four full-scope safety and soundness examinations and four limited-scope

[8] When Waterfield Bank failed, Section 38(k) defined a loss to the Deposit Insurance Fund as material if it exceeds the greater of $25 million or 2 percent of the institution's total assets. Amended by the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, effective July 21, 2010, Section 38(k) defines a material loss as any loss in excess of $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). The FDIC's estimated loss for Waterfield Bank at the time of its failure on March 5, 2010, was $51 million, and the Treasury OIG contracted with our firm to perform a material loss review. Although a material loss review of Waterfield Bank was no longer required under the Dodd-Frank amendment to Section 38(k), the Treasury OIG determined that our performance audit should continue as an in-depth review.

examinations.

- We reviewed OTS's supervisory files and records for Waterfield Bank from 2005 through February 2010. We analyzed examination reports, supporting work papers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OTS used to assess the institution's condition, and the regulatory action used by OTS to compel the institution's management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated work papers.

- We interviewed and discussed various aspects of the supervision of the institution with OTS officials and examiners to obtain their perspectives on the institution's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring Waterfield Bank for federal deposit insurance purposes. The OIG auditor interviewed FDIC DRR officials and reviewed their investigative report, and then informed us of any information obtained from the interview that was considered pertinent to the review.

- We selectively reviewed Waterfield Bank's documents that had been taken by the FDIC and inventoried by FDIC DRR personnel. We identified from the FDIC's inventory list those documents for our review that were most likely to shed light on the reasons for the institution's failure and OTS's supervision of the institution.

- We assessed OTS's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act, as amended by 12 U.S.C. Section 1820(d).

- In accordance with its policy, OTS conducted an internal failed bank review of Waterfield Bank. Our in-depth review affirmed OTS's internal findings and the need for corrective action.

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.

Waterfield Bank's History

Since the institution's inception in 2000, Waterfield Bank has changed ownership three times. Initially, it opened on June 12, 2000, as Assurance Partners Bank, a federally chartered de novo thrift in Carmel, Indiana. The institution was organized by the National Association of Mutual Insurance Companies (NAMIC), a national trade association of property and casualty insurance companies, headquartered in Indianapolis, Indiana, that controlled the institution as its top-tier holding company. The original business strategy of marketing loan and deposit products through insurance agencies proved unsuccessful, as the NAMIC group of companies never supported the institution as anticipated. As a result, the institution was unable to achieve its growth projections and operate profitably.

On April 8, 2005, Federal City Bancorp, Inc. acquired a controlling interest in the institution via a private placement. The headquarters were relocated to Bethesda, Maryland, and the name was changed to American Partners Bank. Federal City Bancorp, Inc. was a shell corporation with American Partners Bank as its sole wholly owned subsidiary; no entity or individual owned more than 10% of the holding company's common stock. While the revised business plan of the institution retained some elements of the predecessor's business plan (maintaining loan and deposit relationships with NAMIC-related entities and the branch in Carmel), it focused on building a diversified lending and retail banking presence in the Washington, DC, metropolitan area to be supplemented with a retail mortgage banking operation. The revised business plan projected rapid balance sheet growth and large operating losses to be supported by a subsequent capital infusion of $10 million. However, management abandoned the business strategy in mid-2006, once the capital infusion did not materialize, and turned the institution into a wholesale mortgage banking company with loans originated primarily from new offices in New Jersey and Florida. Management used short-term lines of credit to fund the growth, given the lack of a retail branching network (there was only one branch office) and the inability to borrow funds from the Federal Home Loan Bank (FHLB).

There was significant turnover in executive management: the former managing officer resigned in mid-2006 and his replacement resigned soon after. Two senior officers were elevated to co-chief executive officers (CEO) under the direction of the chairman, who did not reside in the area. Many of the directors did not live in the area; consequently, board meetings were often held by conference call. The establishment of the wholesale lending operation was a major deviation from the OTS-approved business plan. In December 2006, the institution entered into an Early Purchase Program (EPP)[9] warehouse funding arrangement with Countrywide. Management

[9]The EPP functions as a warehouse line of credit, but an attempt was made to structure the relationship in a way that would allow Waterfield Bank to treat the loans being funded by the EPP as being sold to Countrywide at the time of initial funding, as opposed to being financed by Countrywide. Initial funding for each loan takes place within a few days of the loan closing, but long before Countrywide has reviewed and accepted the loan for purchase.

improperly accounted for these EPP loans as sales, rather than placing them on the balance sheet for the period they were funded under the EPP. While credit quality was generally satisfactory, approximately 37 percent of the production was in nontraditional mortgage products that did not comply with the Interagency Guidance on Nontraditional Mortgage Product Risks (September 26, 2006)[10]. In January 2007, faced with a significant capital and liquidity crisis in trying to manage the mortgage banking business, the institution signed a merger agreement with Affinity.

Affinity was formed in 1997 and controlled by the Waterfield family. Since 1999, Affinity has provided private label financial products and services to affinity groups, employers, and financial institutions. Products and services offered by Affinity focused on raising bank deposits through WFS, a wholly owned subsidiary of Affinity. Most of the affinity relationships were based on exclusive, multi-year contracts. WFS also operated two proprietary websites that gathered deposits nationally and then placed them at client banks. WFS acted as agent and servicer of the accounts (Waterfield Bank performed deposit servicing) pursuant to agreements with each bank, which allowed WFS to decide where the deposits were placed and to negotiate the rate. The primary deposit products offered by WFS were savings, money market, certificate of deposit, and checking accounts.

On January 16, 2008, Affinity acquired Federal City Bancorp, Inc. and infused $20 million in American Partners Bank. The institution's name was changed to Waterfield Bank and a new board of directors and management team were installed. In addition to the headquarters in Maryland; the branch office in Maryland; the back office operations in Indiana; and remote loan production offices in Maryland, New Jersey, and Florida, Waterfield Bank also moved its primary administrative offices to California. On May 30, 2008, OTS approved an application to establish a retail branch office in California, which never opened. Attempting to maintain a nationwide footprint continued to strain financial and management resources.

The initial acquisition strategy proposed a capital infusion of $75 million and an aggressive growth strategy. However, Affinity could only raise $20 million in capital, of which $8.5 million was borrowed. Although the lower capital infusion caused the business plan to be revised, expansion plans continued escalating costs beyond levels supportable by income. Asset growth was funded mainly through the use of WFS's managed deposits, which supported the mortgage banking operations and funded investments in AAA-rated non-agency CMOs. After one year of operations, Waterfield Bank remained unprofitable, with capital minimally above the well capitalized threshold. Management's ability to restructure operations was limited, given

[10] The interagency guidance provides information related to managing the risks associated with nontraditional mortgage loans. Nontraditional mortgage loans are closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest, and include such products as "interest-only" mortgages for which a borrower pays no loan principal for the first few years of the loan, and "payment option" adjustable-rate mortgages (ARMs) for which a borrower has flexible payment options with the potential for negative amortization.

the significant amount of non-agency CMOs purchased subsequent to the acquisition that were illiquid and impaired. Classified assets were primarily secured by residential properties and included a high level of mortgage banking originations rejected by investors and, to a lesser extent, loans to insurance company agents. While continuing to pursue a capital infusion from outside sources, management adjusted its focus toward shrinking the balance sheet of Waterfield Bank and reducing expenses.

Management tried to reduce expenses in 2009 with the closure of the operations center in Carmel, Indiana, and termination of the wholesale mortgage operation, but to no avail. Waterfield Bank failed on March 5, 2010, with essentially no active operating lines of business and no funding source.

Types of Examinations Conducted by OTS

OTS conducts various types of examinations, including safety and soundness, compliance, and information technology.

OTS conducts full-scope examinations of insured institutions once every 12 or 18 months. During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns the institution a CAMELS composite rating based on its assessment of the overall condition and level of supervisory concern.

OTS uses the 12-month cycle until the institution's management has demonstrated its ability to operate the institution in a safe and sound manner and has satisfied all conditions imposed at the time of its charter approval. The 18-month examination interval applies to insured institutions that have total assets of $500 million or less and

- received a CAMELS composite rating of 1 or 2 and a compliance rating of 1 or 2 for their most recent examination;
- received a CAMELS management component rating of 1 or 2 for their most recent examination;
- are well capitalized;
- are not currently subject to a formal enforcement proceeding or order by OTS or the FDIC; and
- have not undergone a change in control during the 12-month period since completion of the last full-scope examination.

Enforcement Actions Available to OTS

OTS performs various examinations of institutions that result in the issuance of ROEs identifying areas of concern. OTS uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

Informal Enforcement Actions

When an institution's overall condition is sound, but it is necessary to obtain written commitments from an institution's board of directors or management to ensure that it will correct identified problems and weaknesses, OTS may use informal enforcement actions. OTS commonly uses informal actions for problems in well or adequately capitalized institutions and institutions with a composite rating of 1, 2, or 3.

Informal actions notify an institution's board and management that OTS has identified problems that warrant attention. A record of informal action is beneficial in case formal action is necessary later.

If an institution violates or refuses to comply with an informal action, OTS cannot enforce compliance in federal court or assess civil money penalties for noncompliance. However, OTS may initiate more severe enforcement action against a noncompliant institution. The effectiveness of informal action depends, in part, on the willingness and ability of an institution to correct deficiencies that OTS notes.

Informal enforcement actions include supervisory directives, memoranda of understanding, and board resolutions.

Formal Enforcement Actions

If informal tools do not resolve a problem that has been identified, OTS is to use formal enforcement tools.

Formal enforcement actions are enforceable under the Federal Deposit Insurance Act. They are appropriate when an institution has significant problems, especially when there is a threat of harm to the institution, depositors, or the public. OTS is to use formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems.

OTS can assess civil money penalties against institutions and individuals for noncompliance with a formal agreement or final orders. OTS can also request a federal court to require the institution to comply with an order. Unlike informal actions, formal enforcement actions are public.

Formal enforcement actions include cease and desist orders, civil money penalties, and PCA directives.

OTS Enforcement Guidelines

Considerations for determining whether to use informal action or formal action include:

- the extent of actual or potential damage, harm, or loss to the institution because of the action or inaction;
- whether the institution has repeated the illegal action or unsafe or unsound practice;
- the likelihood that the conduct may occur again;
- the institution's record for taking corrective action in the past;
- the capability, cooperation, integrity, and commitment of the institution's management, board of directors, and ownership to correct identified problems;
- the effect of the illegal, unsafe, or unsound conduct on other financial institutions, depositors, or the public;
- the examination rating of the institution;
- whether the institution's condition is improving or deteriorating; and
- the presence of unique circumstances.

OTS Assessments Paid by Waterfield Bank

OTS funds its operations, in part, through semiannual assessments on savings associations. OTS determines each institution's assessment by adding together three components reflecting the size, condition, and complexity of an institution. OTS computes the size component by multiplying an institution's total assets, as reported on its TFR, by the applicable assessment rate. The condition component is a percentage of the size component and is imposed on institutions that have a 3, 4, or 5 CAMELS composite rating. OTS imposes a complexity component if (1) a thrift administers more than $1 billion in trust assets; (2) the outstanding balance of assets fully or partially covered by recourse obligations or direct credit substitutes exceeds $1 billion; or (3) the thrift services more than $1 billion in loans for others. OTS calculates the complexity component by multiplying set rates by the amounts by which an association exceeds each threshold. Figure 3 shows the assessments that Waterfield Bank paid to OTS from 2005 through 2010.

Figure 3. Assessments paid by Waterfield Bank to OTS, 2005–2010.

Billing Period	Exam Rating	Amount Paid
1/1/2005 - 6/30/2005	3	$ 13,502
7/1/2005 - 12/31/2005	3	12,903
1/1/2006 - 6/30/2006	3	17,324
7/1/2006 - 12/31/2006	2	15,900
1/1/2007 - 6/30/2007	2	22,966
7/1/2007 - 12/31/2007	2	23,979
1/1/2008 - 6/30/2008	3	33,206
7/1/2008 - 12/31/2008	3	43,902
1/1/2009 - 6/30/2009	3	60,678
7/1/2009 - 12/31/2009	4	72,238
1/1/2010 - 6/30/2010	4	63,632
Total		$ 380,230

Number of OTS Staff Hours Spent Examining Waterfield Bank

Figure 4 shows the number of OTS staff hours spent examining Waterfield Bank from 2005 to 2009.

Figure 4: Number of OTS Hours Spent on Examining Waterfield Bank, 2005–2009.

Examination Start Date	Number of Examination Hours
3/29/2005	396
3/20/2006	514
5/31/2007	1,445
5/31/2007	45
1/30/2008	0
6/9/2008	100
12/8/2008	1,536.5
11/23/2009	279.5
Total	4,316

Source: OTS
Hours are totaled for safety and soundness examinations, limited examinations, and compliance examinations.

Affinity deposits	Affinity deposits are banking products offered by affinity groups under their own names. The deposits are then placed with financial institutions.
Affinity group	An affinity group is a club, organization, or group with a common bond, such as an alumni association, a fraternal order, or a professional organization. Affinity groups can be based on a common ideology, a shared concern for a given issue, or a common activity, role, or skill. Affinity groups may have either open or closed membership.
Allowance for loan and lease losses	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.
Board resolution	A document designed to address one or more specific concerns identified by OTS and adopted by a thrift's board of directors.
Brokered deposit	Any deposit that is obtained, directly or indirectly, from a deposit broker. The bank or thrift 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 FDIC, to adequately capitalized institutions. Undercapitalized institutions are not permitted to accept brokered deposits. (See 12 U.S.C. Section 1831(f) and 12 C.F.R. Section 337.6.)
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	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 type of formal enforcement action. A cease and desist order issued by OTS normally requires a thrift to correct a violation of a law or regulation, or an unsafe or unsound practice. OTS may issue a cease and desist order in response to violations of federal banking, securities, or other laws by institutions or individuals or if it believes that an unsafe and unsound practice or violation is about to occur.
Compliance	The part of a financial institution examination that includes an assessment of how well the institution manages compliance with consumer protection and public interest laws and regulations, including the Bank Secrecy Act.
Concentration	As defined by the OTS, a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of a thrift's core capital plus allowance for loan and lease losses. Concentrations may include direct, indirect, and contingent obligations or large purchases of loans from a single counterparty.
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.
Core capital	Tier 1 capital consisting primarily of stockholder's equity.
Critically undercapitalized	An insured depository institution is critically undercapitalized if it 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. Section 565.2(f).
Division of Resolutions and Receiverships	A division within the 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 System	A system of 12 regional cooperative banks created by Congress from which member institutions borrow funds to finance housing, economic development, infrastructure, and jobs. The 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 members. Advances with a wide variety of terms to maturity, from overnight to long-term, are available to members and are collateralized. Advances are designed to prevent any possible loss to Federal Home Loan Banks, 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, Federal Home Loan Banks have a claim on any of the additional eligible collateral in a failed institution. In addition, the FDIC has a regulation that reaffirms the priority of Federal Home Loan Banks, which 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 an institution's CAMELS composite and component ratings; (2) satisfy core assessment requirements; (3) result in conclusions about an institution'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.
Information technology examination	An examination that includes review and evaluation of the overall management of information systems used by a thrift and of the effectiveness of the internal audit and security functions for those systems.
Non-agency collateralized mortgage obligation	A type of financial debt vehicle that is subject to both credit risk and interest rate risk because it is not sponsored by a Government-Sponsored Enterprise. Legally, a CMO is a special purpose entity that is wholly separate from the institution(s) that create it. The entity is the legal owner of a set of mortgages, called a pool. Investors in a CMO buy bonds issued by the CMO, and they receive payments according to a defined set of rules. With regard to terminology, the mortgages themselves are termed collateral and the bonds are tranches (also called classes), while the structure is the set of rules that dictates how money received from the collateral will be distributed. The legal entity, collateral, and structure are collectively referred to as the

deal.

Nonperforming loans

Loans that are not earning income and for which (1) payment of principal and interest is no longer anticipated, (2) principal or interest is 90 days or more delinquent, or (3) the maturity date has passed and payment in full has not been made.

Prompt corrective action

A framework of supervisory actions for insured institutions that are not adequately capitalized. The framework 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 an institution falls into lower capital categories. The capital categories are well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized (See 12 U.S.C. Section 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. Section 565.2(f).				

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

Risk-based capital

The sum of Tier 1 plus Tier 2 capital.

Safety and soundness

The part of an examination that includes a review and evaluation of each of the component CAMELS ratings (see explanation of CAMELS, above).

Tangible equity

Total assets, minus intangible assets and total liabilities.

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.
Thrift financial report	A financial report that institutions are required to file quarterly with OTS. The report includes detailed information about the institution's operations and financial condition and must be prepared in accordance with generally accepted accounting principles. The thrift's financial report is similar to the call report required of commercial banks.
Troubled condition	A condition in which a thrift meets any of the following criteria: (1) OTS notifies it in writing that it has been assigned a composite CAMELS rating of 4 or 5; (2) it is subject to a capital directive, a cease and desist order, a consent order, a formal written agreement, or a prompt corrective action directive relating to its safety and soundness or financial viability; or (3) OTS informs it in writing of its troubled condition based on information available to OTS. Such information may include current financial statements and reports of examination.

Management Response

Office of Thrift Supervision
Department of the Treasury

Thomas A. Barnes
Deputy Director, Examinations, Supervision, and Consumer Protection

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June 30, 2011

MEMORANDUM FOR: Moss Adams LLP
Contractor to Treasury Office of Inspector General

FROM: Thomas A. Barnes /s/
Deputy Director

SUBJECT: Draft Audit Report on the Material Loss Review (MLR) of Waterfield Bank

Thank you for the opportunity to comment on the draft Material Loss Review Report (Report) for Waterfield Bank prepared by Moss Adams LLP for the Department of the Treasury Office of Inspector General (OIG). The stated objectives of the Report were to determine the causes of Waterfield Bank's failure and resulting loss to the Deposit Insurance Fund and assess the Office of Thrift Supervision's (OTS) supervision of Waterfield Bank, including implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the Federal Deposit Insurance Act. The Report concluded that Waterfield Bank failed primarily because of a significant decline in value and liquidity of the bank's non-agency collateralized mortgage obligation securities (CMOs) and the write-down of assets resulting from purchase accounting adjustments. Secondary causes of failure included significant loan delinquencies and losses incurred on loans and inadequate capital relative to the risk level of its CMOs, poor loan quality, and high overhead structure.

The Report contained the following recommendations:

1. Appropriately curtail high-risk business strategies employed by insured institutions through appropriate formal supervisory enforcement actions.

2. Perform a more thorough evaluation of the financial condition and business plans of prospective acquirers and follow all protocol for monitoring of the execution of the business plans.

3. Ensure that thrifts comply with conditions stated in approval documents on an ongoing basis and ensure that a prompt follow-up is performed if required submissions, such as business plan variance reports, are not timely received. Additionally, OTS staff should be directed to review such submissions in a timely manner and take appropriate supervisory action when deviations or other problems are identified.

4. Ensure that supervision of thrifts is not adversely impacted by the assignment of personnel to internal failed bank reviews.

We acknowledge and concur with the conclusions and the recommendations in the Report.
Thank you again for the opportunity to review and respond to the draft Report. OTS appreciates the professionalism and courtesies provided by your staff on behalf of the Office of Inspector General.

Section II

Report Distribution

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