Board of Governors of the Federal Reserve System

Material Loss Review of Community Bank of Nevada

Office of Inspector General

March 2010

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

OFFICE OF INSPECTOR GENERAL

March 15, 2010

The Honorable Daniel K. Tarullo
Chairman
Committee on Supervisory and Regulatory Affairs
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of the Community Bank of Nevada (CBON). The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) is material—that is, it exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

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

CBON was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Nevada Financial Institutions Division (State). The State closed CBON in August 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On September 15, 2009, the FDIC Inspector General notified us that CBON's failure would result in an estimated loss to the DIF of $766.5 million, or 51.1 percent of the bank's $1.5 billion in total assets.

CBON failed because its Board of Directors and management did not adequately control the risks resulting from its strategy of aggressive growth concentrated in construction, land, and land development (CLD) loans within the local real estate market. A precipitous and unprecedented deterioration of economic conditions within Las Vegas affected the local real estate market, and the bank's CLD portfolio experienced significant losses. Bank management was optimistic that conditions would improve and, therefore, failed to identify and quantify the magnitude of risk within its heavily concentrated portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately led the State to close CBON and appoint the FDIC as receiver on August 14, 2009.

With respect to supervision, FRB San Francisco complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring commensurate with concerns and risks identified during examinations. FRB San Francisco and the State conducted six full scope safety and soundness examinations, two off-site supervisory assessments, and one target examination in the five and one-half years preceding CBON's closure. Additionally, the bank was placed under a formal enforcement action, in the form of a Written Agreement, to address weaknesses identified during the October 2008 target examination.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted an earlier or alternative supervisory action. Accordingly, in our opinion, the breadth and significance of issues that examiners encountered leading up to and during the summer of 2008—when an off-site assessment downgraded CBON's CAMELS composite rating to a 3—offered an early opportunity for an immediate supervisory response, such as an appropriate enforcement action compelling the bank's Board of Directors and management to mitigate the increasing risks associated with (1) the declining real estate market and (2) previously identified weaknesses in asset quality, earnings, credit risk management, and liquidity.

The examination report issued in May 2008 noted that CBON's overall risk profile was increasing significantly due to what examiners referred to as "rapidly changing market dynamics." In addition, the May 2008 examination (1) identified gaps in CBON's risk management processes for loan review, appraisals, credit underwriting and administrative practices, and liquidity; and (2) noted that the Board of Directors and management should be proactive to address the bank's escalating risks. During a July 2008 meeting with CBON's Board of Directors, examiners noted that the bank's CAMELS composite 2 rating was supported by the bank's financial results, but that it did not reflect the high level of risk inherent in management's high-concentration strategy. At that meeting, examiners cited the potential for rapid and severe negative shifts in the bank's condition due to its concentration in construction lending and the reliance on wholesale funding.

The August 2008 supervisory assessment revealed that the risks and potential for negative changes to the bank's financial condition previously cited by examiners were actually occurring. Asset quality was downgraded to less than satisfactory due to a substantial increase in classified loans and nonperforming assets. Earnings dropped significantly, and examiners noted that, at current levels, earnings might not fully support operations and be sufficient to replenish capital and the allowance for loan and lease losses given the institution's overall risk profile.

While we believe that an early and forceful supervisory response was warranted as a result of the issues encountered leading up to and during the August 2008 supervisory assessment, in light of the subsequent steep and rapid deterioration of the local real estate market, it is not possible to determine if an earlier enforcement action would have affected CBON's subsequent decline or the failure's cost to the DIF.

Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, the CBON failure offers valuable lessons learned that can be applied when supervising community banks with similar characteristics. CBON's failure illustrates that a bank with a strategy that features a high concentration of CLD loans is extremely vulnerable to changes in the real estate market it serves. In our opinion, CBON's failure also demonstrates that extremely high CLD concentrations can surpass a bank's capability to withstand a sharply deteriorating market and, therefore, poses a substantial risk to the safety and soundness of a financial institution.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. Overall, the Director agreed with our conclusion and concurred with the lessons learned. His response is included as Appendix 3.

We appreciate the cooperation that we received from FRB San Francisco and Board staff during our review. The principal contributors to this report are listed in Appendix 4. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

Elizabeth A. Coleman

Elizabeth A. Coleman
Inspector General

cc: Chairman Ben S. Bernanke
Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Governor Kevin M. Warsh
Mr. Stephen R. Malphrus
Mr. Patrick M. Parkinson
Mr. Stephen M. Hoffman

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Background

Community Bank of Nevada (CBON)—a community bank located in Las Vegas, Nevada—opened in July 1995 as a state member bank (SMB) of the Federal Reserve System. CBON served the Las Vegas metropolitan area (Las Vegas) and had as many as thirteen branch offices. CBON was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Nevada Financial Institutions Division (State).

The State closed CBON on August 14, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $766.5 million loss to the Deposit Insurance Fund (DIF), or 51.1 percent of the bank's $1.5 billion in total assets. In a letter dated September 15, 2009, the FDIC Inspector General advised us that the FDIC had determined that CBON's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

When a loss to the DIF is considered material, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency

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

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed FRB San Francisco, State, and Board staff. We also reviewed correspondence, regulatory reports filed by CBON, surveillance reports, Reports of Examination (examination reports) issued between 2004 and 2009, and examination work papers prepared by FRB San Francisco. Appendixes at the end of this report include a glossary of key banking and regulatory terms and a description of the CAMELS rating system.[1] We conducted our fieldwork from October 2009 through December 2009 in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

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

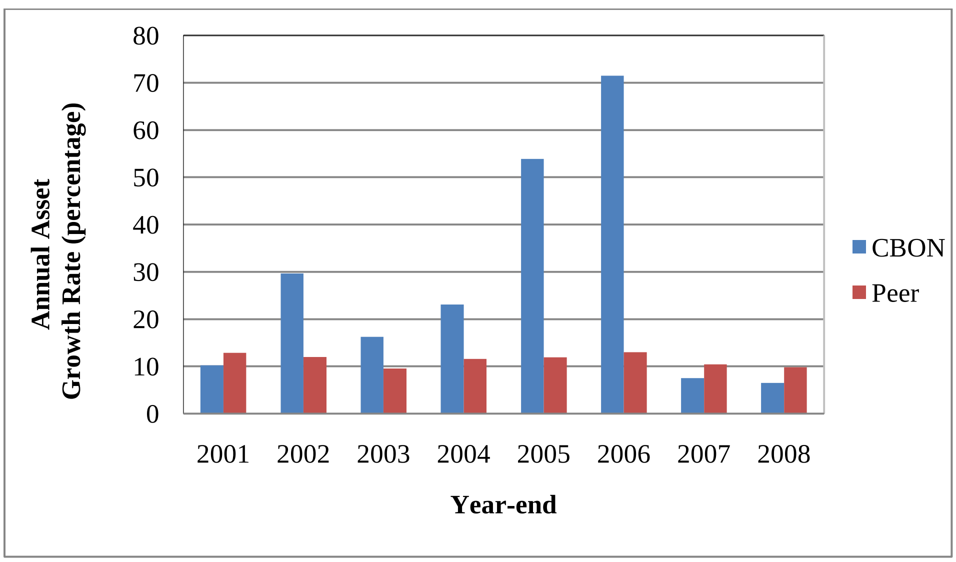
Cause of the Failure

CBON failed because its Board of Directors and management did not adequately control the risks resulting from its strategy of aggressive growth concentrated in construction, land, and land development (CLD) loans within the local real estate market. A precipitous and unprecedented deterioration of economic conditions within Las Vegas affected the local real estate market, and the bank's CLD portfolio experienced significant losses. Bank management was optimistic that conditions would improve and, therefore, failed to identify and quantify the magnitude of risk within its heavily concentrated portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately led the State to close CBON and appoint the FDIC as receiver on August 14, 2009.

CBON Pursued Aggressive Growth

From its inception, CBON grew aggressively. As shown in Chart 1, CBON's annual asset growth rate was significantly higher than its peers until 2007. From 2001 through 2008, CBON's average annual asset growth rate was approximately 27 percent, compared to its peers' average of 11 percent.[2] CBON's most significant growth period was between 2005 and 2006, when it acquired two Nevada-based banks with similar business models.

Chart 1: CBON's Annual Asset Growth Rate



CBON's asset growth was commensurate with the growth of its target market, Las Vegas, which was the most populous area within Nevada, the fastest growing state for four consecutive decades (1960 through 1999). The population growth of Las Vegas outpaced that of the state, primarily due to the migration of residents from other states who were drawn by high employment rates, affordable housing, and favorable personal income tax treatment. These factors, combined with other market influences, fueled a robust real estate economy.

[2] CBON's peer group refers to its national peer group, as defined by the Uniform Bank Performance Reports.

One such market influence was the prevalence of federally-owned lands surrounding Las Vegas, which limited development activities. Legislation enacted in 1998 allowed for the expeditious sale of some of these federal lands through public auctions, in part to accommodate the rapid population growth and facilitate the area's orderly development.[3] These land sales further stimulated construction and development activities and may have contributed to overbuilding within Las Vegas.

CBON's Board of Directors and management adopted an aggressive strategy that capitalized on these growth factors and, in so doing, developed a high concentration of commercial real estate (CRE) loans. Within the CRE portfolio, CBON also developed a concentration in CLD loans for retail projects. The demand for retail development was created by the robust growth of the residential housing market; thus, management's strategy relied heavily on continued growth in Las Vegas.

Management Developed a Highly Concentrated Loan Portfolio

As shown in Chart 2, CBON's CRE loan concentration grew to 699 percent of total capital by 2001, and it subsequently remained close to 600 percent through June 2008.[4] In 2002, the Board of Directors authorized a CRE loan limit of 900 percent of capital, pursuant to the bank's aggressive growth strategy, and by September of that year, CBON's concentration ranked third highest among SMBs in its Federal Reserve System district.[5] Despite a subsequent decrease of the CRE loan limit to 700 percent, management was committed to its strategy of developing a highly concentrated CRE loan portfolio. Within its CRE loan portfolio, CBON's concentration of CLD loans rose from 270 percent of total capital in 2001, to approximately 400 percent by year-end 2006, where it remained through June 30, 2008.

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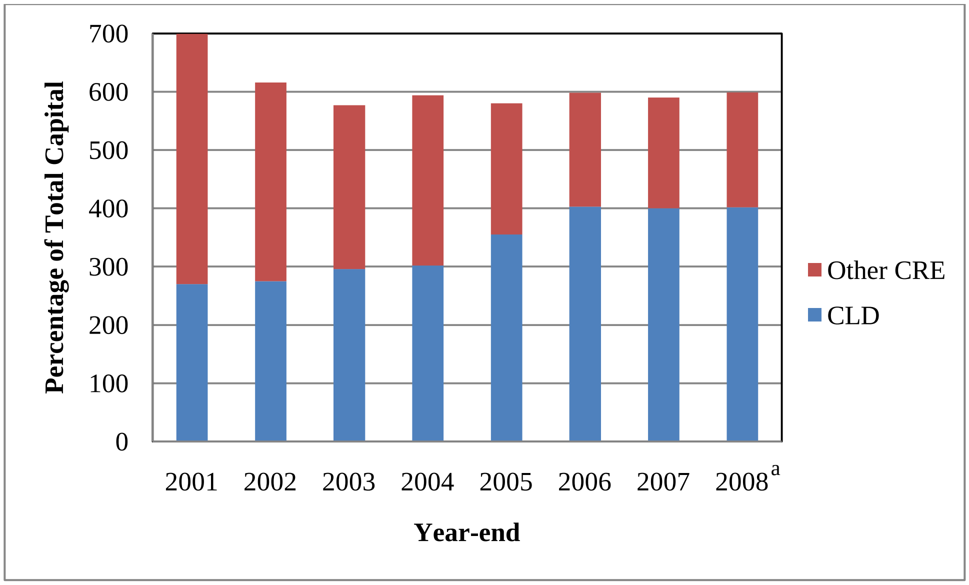
[3] Southern Nevada Public Land Management Act (Public Law No. 105-263, codified at 31 U.S.C. 6901).

[4] According to Supervision and Regulation Letter 07-1, an institution that meets the following criteria presents potential CRE concentration risk: (1) total CRE loans represent 300 percent or more of the institution's total capital and (2) the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior thirty-six months.

[5] FRB San Francisco oversees the twelfth district of the Federal Reserve System, which includes nine western states and some U.S. territories. It is the largest district in terms of demographic, geographic, and economic size.

Chart 2: CBON's CRE and CLD Loan Concentrations



[a] Data as of 6/30/2008

Rapid Deterioration of Local Economic Conditions Led to Mounting Loan Losses

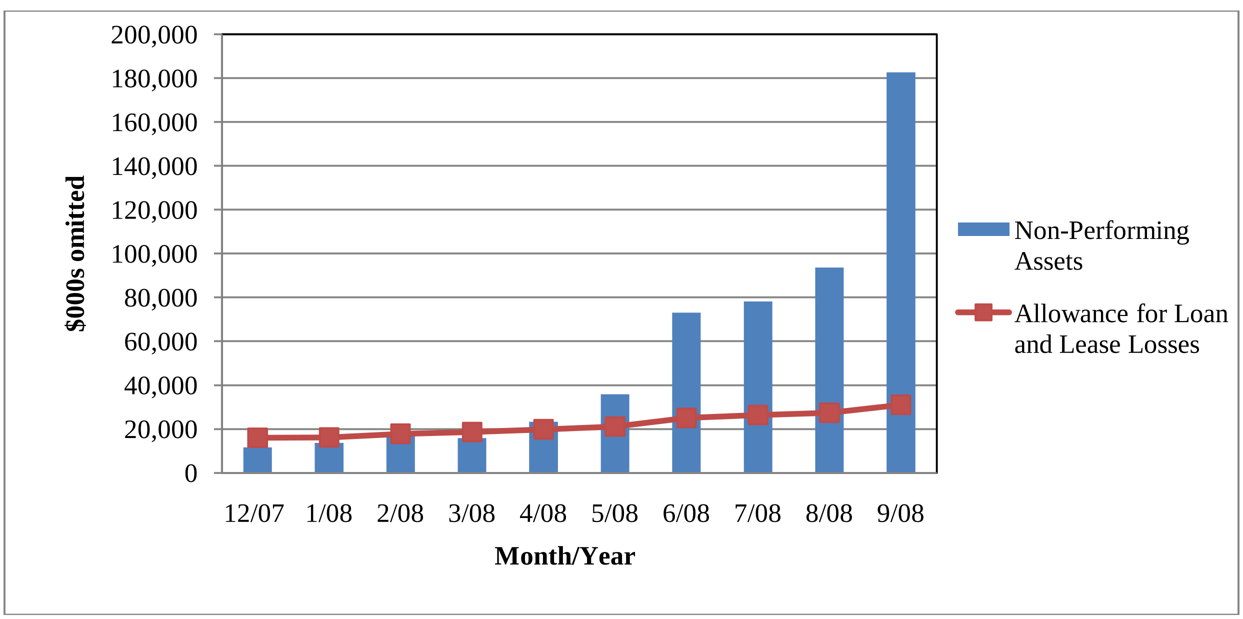
The historically aggressive growth of Las Vegas resulted in overbuilding in both residential and CRE markets. By the second quarter 2008, the confluence of rising homebuilder inventories, office and retail vacancies, and unemployment caused a rapid deterioration of local economic conditions. As shown in Chart 3, the Las Vegas market was historically able to absorb available retail space; however, in 2008 there was a precipitous decline in the leasing of such space. The sharp increase of retail vacancies and a related decline in retail rental rates adversely impacted the Las Vegas retail CLD market, leading to a significant deterioration of CBON's loan portfolio.

Chart 3: Trend of Retail Completions vs. Net Absorption in Las Vegas[a]

[a] Net absorption refers to the amount of square footage leased for new and existing vacant retail space, less any amount of space vacated, during a period.

As shown in Chart 4, the bank's financial condition deteriorated rapidly as nonperforming assets grew monthly. Similarly, classified assets rapidly increased over the same period, from 31 percent of tier 1 capital plus the allowance for loan and leases losses (ALLL) (or $58 million) as of December 2007, to 195 percent (or $387 million) by September 2008.

Chart 4: Trend of CBON's Nonperforming Assets



CBON's management maintained what examiners described as a "lethal sense of optimism" regarding the resilience of the Las Vegas market. According to examiners, the bank's Board of

Directors and management were also confident that the bank's underwriting practices, risk management efforts, and historically low loss history would sustain its sound financial position. Accordingly, as shown in Chart 4, management did not increase the level of the ALLL commensurate with the increases of classified assets.

As a result of a target examination that began in October 2008, examiners determined that CBON's ALLL was insufficient due to the exponential growth of the bank's classified assets. FRB San Francisco required CBON to increase its provision expense by more than 4,000 percent from $2.6 million as of year-end 2007, to $118.5 million for year-end 2008.[6] The additional provision expense resulted in a net loss of approximately $189 million for year-end 2008 compared to net income of approximately $26 million for the prior year. In addition to completely eliminating earnings, the provision expense also significantly reduced the bank's capital.

Loan Portfolio Losses Eroded Capital

CBON's deteriorating capital position invoked the PCA provisions of the FDI Act. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled depository institutions. FRB San Francisco implemented PCA and made timely notifications when the bank reached various PCA capital categories. The bank's capital category dropped from the *well capitalized* threshold to *adequately capitalized* in May 2009. CBON's financial condition continued to decline precipitously, and its capital position fell to the *significantly undercapitalized* designation in July 2009 as a result of examination findings. Finally, the bank fell to the *critically undercapitalized* designation in August 2009. CBON was closed by the State on August 14, 2009, and the FDIC was named receiver.

Supervision of Community Bank of Nevada

FRB San Francisco complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring commensurate with concerns and risks identified during examinations. FRB San Francisco and the State conducted six full scope safety and soundness examinations, two off-site supervisory assessments, and one target examination in the five and one-half years preceding CBON's closure.[7] Additionally, the bank was placed under a formal enforcement action, in the form of a Written Agreement, to address weaknesses identified during a 2008 target examination.

As shown in Table 1, the bank's condition was rated a CAMELS composite 2 rating (satisfactory) through the second quarter of 2008. The satisfactory ratings were supported by the bank's historically strong financial performance and a management team that examiners concluded was generally competent and responsive to regulatory recommendations. Although CBON had maintained a high CRE concentration, FRB San Francisco concluded that—under

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[6] The December 2008 provision expense of $118.5 million was a revised and restated figure, as a result of examination findings.

[7] All supervisory events related to CBON were conducted jointly by FRB San Francisco and the State. FRB San Francisco served as the lead agency for all examinations and actions as the State was not accredited by the Conference of State Banking Supervisors.

normal market conditions—the bank's risk management framework was generally adequate to mitigate the risks inherent in its strategy. However, a June 30, 2008, regulatory filing by CBON indicated significant deterioration within the bank's loan portfolio. As a result, FRB San Francisco initiated a series of supervisory reviews that resulted in CAMELS ratings downgrades and a formal enforcement action. By June 2009, the bank was rated a CAMELS composite 5 (critically deficient), and its failure was deemed highly probable.

Table 1: Supervisory Overview of CBON

Examination			CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope		Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
01/12/2004	03/11/2004	Full Scope	2	2	2	2	2	2	2	
02/14/2005	05/05/2005	Full Scope	2	2	2	2	2	2	2	
02/13/2006	04/19/2006	Full Scope	2	2	2	2	2	2	2	
03/12/2007	05/30/2007	Full Scope	2	2	2	2	2	2	2	
03/03/2008	05/22/2008	Full Scope	2	2	2	2	2	3	2	
08/18/2008	09/19/2008	Off-site Assessment	3	2	3	2*	3	3	2	
10/27/2008	03/13/2009	Target	4	4	5	4	5	4	3	Written Agreement
05/19/2009**	06/01/2009	Interim Supervisory Assessment	5	5	5	4*	5	5	5	
04/27/2009	08/13/2009	Full Scope	5	5	5	5	5	5	5	

* The rating for management was carried forward from the prior examination.

** The initial findings from the full scope examination that began on April 27, 2009, prompted examiners to initiate an off-site assessment on May 19, 2009, that was finished before the examination was completed.

Supervision History through 2007

As early as 2000, FRB San Francisco noted CBON's high CRE concentrations and included the bank in a district-wide CRE review performed in multiple phases between 2000 and 2004.[8]

[8] The review assessed the level of risk in CRE exposures and evaluated underlying risk management systems at thirty selected institutions having the highest CRE concentrations.

FRB San Francisco conducted four routine, full scope examinations from 2004 through 2007, with each examination resulting in a composite rating of 2 and each CAMELS component receiving a 2 rating. Examiners determined that management was capable of mitigating the bank's high level of credit risk, while maintaining its satisfactory financial condition through periods of aggressive growth. CBON's capital, asset quality, earnings, and liquidity were comparatively stronger than its peer group; however, FRB San Francisco did not rate these components higher than satisfactory due to concerns regarding the bank's inherently risky strategy featuring high CRE concentrations.

During this 2004 to 2007 period, examiners also concluded that CBON's credit risk management and administration were generally adequate. Specifically, examiners noted sound underwriting standards, detailed policies and procedures, appropriate management information systems, an effective loan grading system and review function, and early adoption of a portfolio-wide capital stress test model. Examiners did make minor recommendations to improve the bank's credit risk function; however, they noted that bank management generally addressed these issues by the subsequent examination.

March 2008 Examination Resulted in a CAMELS Composite 2 Rating, but an Increased Risk Profile Prompted Heightened Supervision

In March 2008, FRB San Francisco commenced a regularly scheduled full scope examination based on year-end 2007 financial statements. The May 2008 examination report resulted in a CAMELS composite 2 rating. All components remained at 2 ratings based on continued positive financial performance, with the exception of liquidity, which was downgraded to a 3 rating. Examiners noted that liquidity risk was high and increasing because of the elevated risks associated with a shift in the bank's funding strategy that increased the bank's reliance on wholesale funding to support loan growth.[9]

Although the bank was considered satisfactory based on its financial performance at year-end 2007, examiners noted that the bank's overall risk profile was "increasing significantly due to rapidly-changing market dynamics." Examiners specifically noted that CBON's high concentration in CRE and construction lending secured by land exposed the bank to significant risks because land exhibits more price volatility and stagnation of sales than properties with existing or potential cash flow. Examiners stated that continued declines in market conditions could have a "significantly detrimental" impact on the bank's ongoing "sound financial condition."

The examination report noted "gaps" in certain risk management processes and stated that the Board of Directors and management needed to ensure that they were more proactive in establishing strong risk management processes and practices to address the bank's "escalating" inherent risks. Examiners stated that management's efforts in identifying and monitoring higher risk loans were "not fully effective and must be strengthened due to the rapidly deteriorating real estate market." According to examiners, "loan review and loan grading has not kept pace with a rapidly changing market," and CBON "should improve its loan review procedures to facilitate a

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[9] Wholesale funding sources include Federal Home Loan Bank advances, brokered deposits, and deposits obtained through the internet or certificate of deposit listing services.

more timely recognition of credit deterioration." The examination report cited deficiencies in CBON's appraisal practices, and examiners cautioned that it was "imprudent to allow such exceptions in a highly volatile market."

The examination noted $98.7 million in loans secured by raw or vacant land that were originated with interest reserves to cover interest payments, but CBON's loan policy did not address the issue.[10] Examiners stated that it did not appear that interest reserves were being used to mask a borrower's or guarantor's inability to service debt. Nonetheless, examiners noted that the use of interest reserves created additional inherent risk.

The examination report required CBON's Board of Directors and management to immediately strengthen loan review procedures, appraisal practices, liquidity risk management, and credit underwriting and administrative practices related to loans secured by land. In addition, FRB San Francisco added CBON to the Federal Reserve System's watch list and informed the bank that a credit target examination would begin in October 2008.[11]

FRB San Francisco Attended a July 2008 Meeting with CBON's Board of Directors

FRB San Francisco examiners attended a July 2008 meeting with CBON's Board of Directors. Examiners emphasized that the Board of Directors was responsible for identifying, monitoring, and mitigating the bank's risk. Examiners told the Board of Directors that the CAMELS composite 2 rating included in the May 2008 examination report was supported by the bank's financial results, but that it did not reflect the high level of risk inherent in management's high-concentration strategy. Specifically, examiners noted the potential for rapid and severe negative shifts in the bank's condition due to CBON's concentration in construction lending and the bank's reliance on wholesale funding. CBON's Board of Directors was told that although deterioration had not yet been seen, plans should be in place because CRE markets tend to follow, but lag, trends in residential real estate.

August 2008 Supervisory Assessment Resulted in a Downgrade

In August 2008, FRB San Francisco initiated an off-site supervisory assessment based on the notable deterioration revealed in CBON's second quarter financial data. In a September 2008 letter to CBON's Board of Directors, examiners stated that the bank's earnings had severely weakened as deteriorating credit quality prompted management to make a substantial provision to the ALLL. Examiners downgraded CBON to a CAMELS composite 3 rating. The asset quality and earnings CAMELS components were each downgraded from a 2 to a 3, while liquidity remained a 3.

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[10] Interest reserves are accounts set up and funded by lenders to periodically advance loan funds to pay interest charges on the outstanding balance of a CLD loan. The interest is capitalized and added to the loan balance. This practice can mask loans that would otherwise be reported as delinquent and erode collateral protection, increasing a lender's exposure to credit losses.

[11] The watch list is a listing of SMBs that warrant increased supervisory attention. The list is maintained by the Board, and supervisory guidance requires that routine surveillance activities be performed for each institution on at least a quarterly basis.

Examiners stated that loan classifications had risen from the $58 million noted in the prior examination to $154 million by June 30, 2008. In addition, nonperforming assets increased 531 percent from $11.5 million at year-end 2007 to $72.6 million by mid-year 2008. Examiners noted that the bank's current level of earnings might not fully support operations or provide a basis for supporting capital and the ALLL, given the bank's overall risk profile. With respect to liquidity, examiners noted an increased reliance on "traditionally volatile sources such as wholesale funding."

October 2008 Target Examination Resulted in a CAMELS Composite 4 Rating and a Formal Enforcement Action

In October 2008, FRB San Francisco began a target examination that resulted in several CAMELS component downgrades and double-downgrades. The bank received a CAMELS composite 4 rating (marginal) and was deemed to be in "troubled condition." Additionally, FRB San Francisco downgraded liquidity to a 4 and sensitivity to a 3, and double-downgraded capital, asset quality, management, and earnings.

The target examination revealed rapid and systemic asset quality deterioration and a severely underfunded ALLL; examiners concluded that the bank exhibited generally unsafe and unsound banking practices. Specifically, adversely-classified assets reached a level that was approximately twice the bank's capital and ALLL, and more than 10 percent of the total loan portfolio was nonperforming. Examiners determined that the bank's financial deterioration was driven by problem loans, primarily in the CLD portfolio. Examiners concluded that one of the bank's most significant issues was management's inability or unwillingness to identify and quantify the full risk within its portfolio.

FRB San Francisco initiated a Written Agreement in January 2009 as a result of this examination. FRB San Francisco instructed the bank to restate its September 30, 2008, regulatory financial report to reflect an appropriate ALLL level. Examiners concluded that CBON's methodology for assessing the adequacy of its ALLL was significantly flawed, and that the ALLL should have been between $85 million to $100 million, not the $31 million originally stated. Therefore, the required additional provision of at least $54 million warranted a restatement of the bank's regulatory filing, and completely depleted the bank's year-end 2008 earnings.

CBON's management was confident that the bank's loan portfolio was fundamentally sound and optimistic that market conditions would improve. As a result, management strongly disagreed with FRB San Francisco's ALLL calculation and informed regulators of its intent to appeal the examination results. The examination report was issued on March 13, 2009, and the Written Agreement was formally executed on May 21, 2009. The examination and Written Agreement emphasized the urgency for management to address critical financial issues, including (1) improving the ALLL assessment and funding, (2) planning for potential cash and liquidity crises, (3) "bolstering capital by any means possible," and (4) continuing the workouts of problem assets.

April 2009 Full Scope Examination and Interim Supervisory Assessment Resulted in CAMELS Composite 5 Ratings

Examiners began a full scope examination on April 27, 2009, and soon noted that the bank's financial condition had worsened significantly from the prior examination. FRB San Francisco decided that the bank's severe deterioration warranted immediate action. While examination work continued, examiners initiated an interim supervisory assessment on May 19, 2009, and issued a supervisory letter less than two weeks later. The letter cited CBON's critically deficient condition and downgraded the bank's composite rating to a 5, along with corresponding downgrades in the capital, liquidity, and sensitivity components. The full scope examination that began in April 2009 was finalized in an examination report dated August 13, 2009. CBON received a composite rating of 5, and each component also was rated 5.

Many of the serious issues identified in the October 2008 target examination were repeated in the April 2009 examination. Examiners concluded that the bank's deteriorating financial condition was caused by problem loans, primarily in the CLD portfolio, and that CBON's critically deficient asset quality elevated systemic risk within every CAMELS component. Examiners noted that the bank's ALLL remained significantly underfunded and that the ALLL methodology was "materially flawed." The likelihood of management remediating the critical financial issues cited in the prior examination and the Written Agreement had diminished in the face of deepening local and national recessions. Examiners concluded that without immediate outside financial assistance, the bank's failure was a distinct possibility and posed a threat to the DIF. CBON declined to *critically undercapitalized* on August 6, 2009. The State closed the bank on August 14, 2009, and appointed the FDIC as receiver.

Conclusions and Lessons Learned

CBON failed because its Board of Directors and management did not adequately control the risks resulting from its strategy of aggressive growth concentrated in CLD loans within the local real estate market. A precipitous and unprecedented deterioration of economic conditions within Las Vegas affected the local real estate market, and the bank's CLD portfolio experienced significant losses. Bank management was optimistic that conditions would improve and, therefore, failed to identify and quantify the magnitude of risk within its heavily concentrated portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately led the State to close CBON and appoint the FDIC as receiver on August 14, 2009.

With respect to supervision, FRB San Francisco complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring commensurate with concerns and risks identified during examinations. FRB San Francisco and the State conducted six full scope safety and soundness examinations, two off-site supervisory assessments, and one target examination in the five and one-half years preceding CBON's closure. Additionally, the bank was placed under a formal enforcement action, in the form of a Written Agreement, to address weaknesses identified during the October 2008 target examination.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted an earlier or alternative supervisory action. Accordingly, in our opinion, the breadth and significance of issues that examiners encountered leading up to and during the summer of 2008—when the off-site assessment downgraded CBON's CAMELS composite rating to a 3—offered an early opportunity for an immediate supervisory response, such as an appropriate enforcement action compelling the bank's Board of Directors and management to mitigate the increasing risks associated with (1) the declining real estate market and (2) previously identified weaknesses in asset quality, earnings, credit risk management, and liquidity.

The examination report issued in May 2008 noted that CBON's overall risk profile was increasing significantly due to what examiners referred to as "rapidly changing market dynamics." In addition, the May 2008 examination (1) identified gaps in CBON's risk management processes for loan review, appraisals, credit underwriting and administrative practices, and liquidity; and (2) noted that the Board of Directors and management should be proactive to address the bank's escalating risks. During a July 2008 meeting with CBON's Board of Directors, examiners noted that the bank's CAMELS composite 2 rating was supported by the bank's financial results, but that it did not reflect the high level of risk inherent in management's high-concentration strategy. At that meeting, examiners cited the potential for rapid and severe negative shifts in the bank's condition due to its concentration in construction lending and the reliance on wholesale funding.

The August 2008 supervisory assessment revealed that the risks and potential for negative changes to the bank's financial condition previously cited by examiners were actually occurring. Asset quality was downgraded to less than satisfactory due to a significant increase in classified loans and nonperforming assets. Earnings dropped significantly; and examiners noted that, at current levels, given the institution's overall risk profile, earnings might not fully support operations and/or be sufficient to replenish capital and the ALLL.

While we believe that an early and forceful supervisory response was warranted as a result of the issues encountered leading up to and during the August 2008 supervisory assessment, in light of the subsequent steep and rapid deterioration of the local real estate market, it is not possible to determine if an earlier enforcement action would have affected CBON's subsequent decline or the failure's cost to the DIF.

Lessons Learned

Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, the CBON failure offers valuable lessons learned that can be applied when supervising community banks with similar characteristics. CBON's failure illustrates that a bank with a strategy that features a high concentration of CLD loans is extremely vulnerable to changes in the real estate market it serves. In our opinion, CBON's failure also demonstrates that extremely high CLD concentrations can surpass a bank's capability to withstand a sharply deteriorating market and, therefore, poses a substantial risk to the safety and soundness of a financial institution.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response is included as Appendix 3. The Director concurred with our conclusions and lessons learned, and welcomed the report's observations and contribution to understanding the reasons for CBON's failure. He noted that a more forceful supervisory response was warranted when CBON's rating was downgraded in August 2008. The Director also indicated that, as highlighted in our report, a lesson learned from CBON's failure is that extremely high CLD concentrations can result in risks beyond a bank's ability to control and, therefore, pose a substantial risk to the safety and soundness of the institution.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

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

Brokered Deposits
Brokered deposits are deposits that are placed in a savings institution by a broker who gathers funds from others and packages the funds in batches of $100,000. The broker then shops for financial institutions paying the highest rates and invests in multiple $100,000 certificates of deposit, which typically pay the highest rates of interest and are federally insured.

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

Commercial Real Estate (CRE) Loans
CRE loans are land development and construction loans (including one-to-four family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm, nonresidential property where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Concentration
A concentration is a significantly large amount of credit, assets, or other obligations, with similar risk characteristics that a financial institution has committed to a particular area, industry, person, or group. These assets are similarly affected by adverse economic, financial, or business conditions, and in the aggregate, may pose a risk to the institution.

Construction, Land, and Land Development (CLD) Loans
CLD loans are the subset of commercial real estate loans that provide funding for acquiring and developing land for future development and/or construction and provide interim financing for residential or commercial structures. These loans can be secured by real estate or vacant land.

Appendix 1 (continued)

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

Liquidity
Liquidity is the ability to accommodate decreases in liabilities to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

Nonperforming Assets
Nonperforming assets are the sum of (1) the total of loans and lease financing receivables past due ninety or more days and still accruing interest, (2) the total of nonaccrual loans and lease financing receivables, and (3) the total of other real estate owned.

Prompt Corrective Action (PCA)
PCA is a framework of supervisory actions, set forth in 12 U.S.C. 1831o, for insured depository institutions whose capital positions have declined below certain threshold levels. It was intended to ensure that action is taken when an institution becomes financially troubled, in order to resolve the problems of the institution at the least possible long-term loss to the DIF. The capital categories are *well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.*

Tier 1 Capital
Tier 1 capital is a regulatory capital measure that may include common shareholder's equity (common stock, surplus, and retained earnings), non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

Underwriting
Underwriting is a part of a bank's lending policies and procedures that enable the bank's lending staff to evaluate all relevant credit factors. These factors include the capacity of the borrower or income from the underlying property to adequately service the debt; the market value of the underlying real estate collateral; the overall creditworthiness of the borrower; the level of the borrower's equity invested in the property; any secondary sources of repayment; and any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

Uniform Bank Performance Report (UBPR)
The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council based on quarterly data provided by banks and is for the use of banking supervisors, bankers, and the general public.

Appendix 1 (continued)

Wholesale Funding
Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the internet or certificate of deposit listing services.

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

Appendix 2 – CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of the institution's financial condition and operations. These component factors address the adequacy of *capital*, the quality of *assets*, the capability of *management*, the quality and level of *earnings*, the adequacy of *liquidity*, and the *sensitivity* to market risk (CAMELS). Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definition

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the Board of Directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institutions' size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For financial institutions to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the Board of Directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institutions' size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Appendix 2 (continued)

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institutions' size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the Board of Directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the DIF. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institutions' size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institutions to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the DIF and failure is highly probable.

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: March 15, 2010

To: Elizabeth A. Coleman, Inspector General

From: Patrick M. Parkinson, Director **/signed/**

Subject: Draft "Material Loss Review of Community Bank of Nevada"

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Community Bank of Nevada ("CBON"), Las Vegas, Nevada, that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that CBON failed because its Board of Directors and management did not adequately control the risks resulting from its strategy of aggressive growth concentrated in construction and land development ("CLD") loans. A steep and unprecedented deterioration of economic conditions within Las Vegas in combination with substantial overbuilding in both residential and commercial real estate in that market had a swift and significantly adverse effect on CBON's CLD portfolio. Additionally, bank management was optimistic that conditions would improve and, as a result, failed to identify and quantify the magnitude of risk within its heavily concentrated portfolio. CBON was supervised by the Federal Reserve Bank of San Francisco (FRB-San Francisco).

We concur with the conclusions and lesson learned contained in the report. FRB-San Francisco was focused as early as 2000 on CBON's high CRE concentrations and included the bank in a district-wide CRE review performed in multiple phases between 2000 and 2004. In the five and one-half years preceding CBON's closure, FRB-San Francisco and the State of Nevada conducted six full scope safety and soundness examinations, two off-site supervisory assessments, and one target examination. Credit risk management deficiencies were noted in a May 2008 examination, followed by the emergence of financial deterioration in June 30, 2008 financial reports. Based on the foregoing, FRB-San Francisco assigned a rating of CAMELS composite "3" in August 2008, and then subsequently downgraded the bank to 'a CAMELS composite "4" at an October 2008 target. The bank was assigned a CAMELS composite "5" rating in May 2009. We agree with the report's conclusion that the August 2008 downgrade warranted more a more forceful supervisory response, but also concur that it is unclear that more aggressive supervisory action at this stage would have affected the bank's subsequent decline or the ultimate cost of resolution to the DIF.

The report highlights that a lesson learned from CBON's failure is that extremely high CLD concentrations can result in risks beyond a bank's ability to control, and therefore pose a substantial risk to the safety and soundness of the institution.

This Division very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for CBON's failure.

Appendix 4 – Principal Contributors to this Report

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