OFFICE OF INSPECTOR GENERAL

Evaluation Report 2013-IE-B-002

Review of the Failure of Bank of Whitman

March 22, 2013

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
CONSUMER FINANCIAL PROTECTION BUREAU

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Abbreviations

ALLL	Allowance for Loan and Lease Losses
CBEM	*Commercial Bank Examination Manual*
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CLO	Chief Lending Officer
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
Federal Reserve Board	Board of Governors of the Federal Reserve System
FRB San Francisco	Federal Reserve Bank of San Francisco
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
SR	Supervision and Regulation
State	Washington State Department of Financial Institutions
Whitman	Bank of Whitman

Executive Summary:

Review of the Failure of Bank of Whitman

2013-IE-B-002 **March 22, 2013**

Purpose

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act, 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Office of Inspector General conducted an in-depth review of the failure of Bank of Whitman (Whitman) because the loss to the Deposit Insurance Fund presented unusual circumstances due to various questionable transactions and business practices involving senior management.

Background

Whitman began operations on September 29, 1977, as a state nonmember bank headquartered in Colfax, Washington, and converted to state member bank status in 2004. Whitman 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, and by the Washington State Department of Financial Institutions (State). On August 5, 2011, the State closed Whitman and appointed the Federal Deposit Insurance Corporation as receiver.

Findings

Whitman failed because of the convergence of several factors. The bank altered its traditional agricultural lending strategy and expanded into new market areas, which resulted in rapid growth and high commercial real estate concentrations as well as credit concentrations to individual borrowers. Whitman's corporate governance weaknesses allowed the bank's senior management to dominate the institution's affairs and undermine the effectiveness of key control functions. Whitman's credit concentrations and poor credit risk management practices, along with a decline in the local real estate market, resulted in asset quality deterioration, significant losses, and eroded capital. At that point, management engaged in a series of practices to mask the bank's true condition. The escalating losses depleted earnings and left the bank in a *critically undercapitalized* condition.

With respect to supervision, FRB San Francisco complied with the premembership requirements and examination frequency guidelines for the time frame we reviewed, 2005 through 2011, and conducted regular offsite monitoring. However, our analysis of FRB San Francisco's supervision of Whitman revealed that FRB San Francisco identified the bank's fundamental weaknesses during its first examination in 2005 but did not take decisive action to resolve those weaknesses until September 2009. In our opinion, FRB San Francisco had multiple opportunities from 2005 to 2009 to take stronger supervisory action to address the bank's persistent deficiencies.

Recommendation

We recommend that the Director of the Division of Banking Supervision and Regulation review the supervisory approach for premembership examinations and determine whether enhancements to the current approach outlined in Supervision and Regulation Letter 11-2, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*, are appropriate.

Management's Response

Banking Supervision and Regulation staff acknowledged the conclusions and lessons learned in the report and will follow up on the report's recommendation.

Summary of Recommendations, Report No. 2013-IE-B-002

Rec. no.	Report page no.	Recommendation	Responsible office
1	29	Review the supervisory approach for premembership examinations and determine whether enhancements to the current approach outlined in Supervision and Regulation Letter 11-2 are appropriate	Division of Banking Supervision and Regulation

OFFICE OF INSPECTOR GENERAL

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CONSUMER FINANCIAL PROTECTION BUREAU

March 22, 2013

MEMORANDUM

TO: Michael S. Gibson
Director, Division of Banking Supervision and Regulation

FROM: Michael P. VanHuysen
Acting Associate Inspector General for Inspections and Evaluations and
Senior OIG Manager

SUBJECT: OIG Report No. 2013-IE-B-002: *Review of the Failure of Bank of Whitman*

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act, 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Office of Inspector General conducted an in-depth review of the failure of Bank of Whitman.

We provided the Division of Banking Supervision and Regulation with a draft of our report for review and comment. In your response, you indicated that your staff acknowledged the conclusions and lessons learned in the report and will follow up on the report's recommendation. The response is included as appendix C.

We appreciate the cooperation that we received from Federal Reserve Bank of San Francisco and Board of Governors of the Federal Reserve System staff during our review. This report will be added to our public website 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.

cc: Chairman Ben S. Bernanke
Vice Chair Janet L. Yellen
Governor Elizabeth A. Duke
Governor Daniel K. Tarullo
Governor Sarah Bloom Raskin
Governor Jeremy C. Stein
Governor Jerome H. Powell
Ms. Teresa Curran

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Introduction

Background

Bank of Whitman (Whitman) began operations in September 1977 in Colfax, Washington, as a state nonmember bank and converted to state member bank status in 2004. By 2011, Whitman operated 20 branches in eastern Washington. Whitman was wholly owned by Whitman Bancorporation, Inc., a single bank holding company. The bank's traditional business activities focused on agricultural lending. Prior to becoming a state member bank, Whitman expanded its strategic focus to include commercial real estate (CRE) lending. The bank 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 (Federal Reserve Board), and by the Washington State Department of Financial Institutions (State).

On August 5, 2011, the State closed Whitman and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that Whitman's failure would result in a $134.8 million loss to the Deposit Insurance Fund (DIF), or 24.6 percent of the bank's $548.6 million in total assets at closing. Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), defines a material loss to the DIF as an estimated loss in excess of $200 million.[1] The Dodd-Frank Act requires an in-depth review of any bank failure beneath the material loss threshold when the Inspector General of the appropriate federal banking agency determines that the loss exhibits "unusual circumstances." As a result of our initial review, we concluded that Whitman's failure presented unusual circumstances because of various questionable transactions and business practices involving senior management.

Objectives, Scope, and Methodology

When a loss to the DIF presents unusual circumstances, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal banking agency undertake the following:

- 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
- make recommendations for preventing any such loss in the future[2]

1. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011.

2. This review fulfills a statutory mandate and does not serve any investigative purpose.

To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB San Francisco, the State, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by Whitman, examination reports issued from 2005 through 2011, examination work papers prepared by FRB San Francisco, relevant FDIC documents, and reports prepared by external firms.

We conducted our fieldwork from October 2011 through November 2012 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency. Appendixes at the end of this report include a glossary of key banking and regulatory terms and a description of the CAMELS rating system.[3]

3. 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. For full-scope examinations, examiners assign a rating of 1 through 5 for each component and the overall composite score, with 1 indicating the least regulatory concern and 5 indicating the greatest concern.

Causes of the Failure

Whitman failed because of the convergence of several factors. The bank altered its traditional agricultural lending strategy and expanded into new market areas, which resulted in rapid growth and high CRE concentrations as well as credit concentrations to individual borrowers. Whitman's corporate governance weaknesses allowed the bank's senior management to dominate the institution's affairs and undermine the effectiveness of key control functions. Whitman's credit concentrations and poor credit risk management practices, along with a decline in the local real estate market, resulted in asset quality deterioration and significant losses. At that point, management engaged in a series of questionable practices to mask the bank's true condition. The escalating losses depleted earnings, eroded capital, and left the bank in a PCA *critically undercapitalized* condition, which prompted the State to close Whitman and appoint the FDIC as receiver on August 5, 2011.

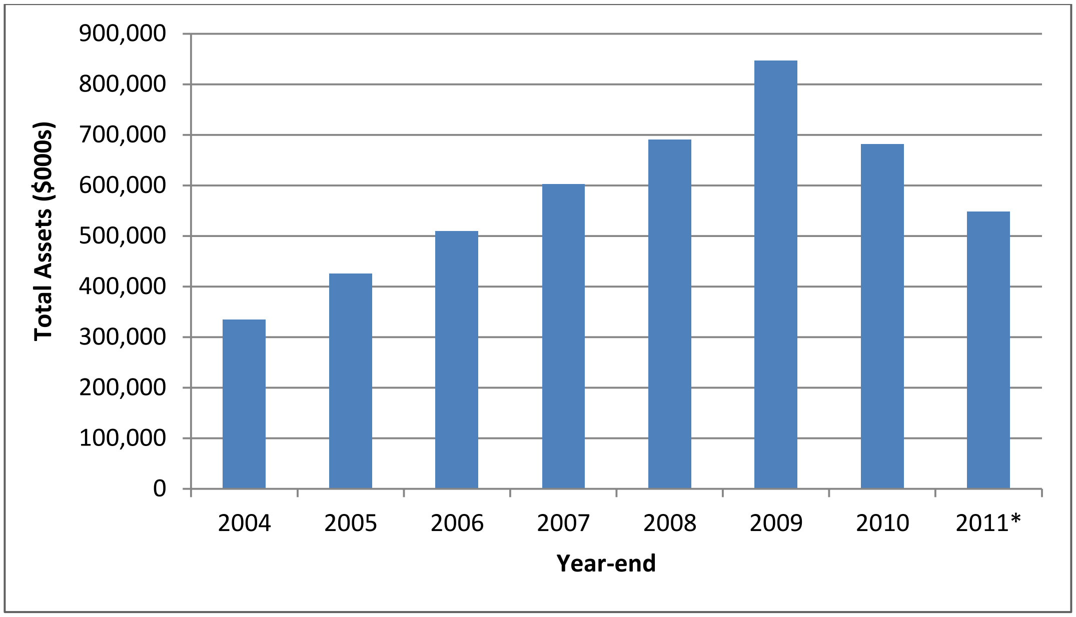
Loan Concentrations

For nearly 30 years, Whitman's traditional business activities focused on agricultural lending, its management team's area of expertise. Prior to converting to state member bank status, Whitman altered its strategy to focus on CRE lending as part of its growth efforts. However, according to an FRB San Francisco interviewee, the board of directors and management lacked adequate commercial lending experience. Whitman's outside directors included farmers, an attorney, a retired banker, and a physician. The retired banker was the only outside director with prior banking experience.

As shown in chart 1, the bank's pursuit of a rapid growth strategy resulted in its total assets increasing more than 150 percent, from approximately $335 million in 2004 to approximately $847 million in 2009. As part of its growth strategy, Whitman expanded into new geographic areas and diversified its lending activities. Whitman expanded into Spokane, Washington, which FRB San Francisco examiners described as a saturated and highly competitive market. Whitman also experienced significant growth in its CRE lending activities, eventually resulting in high CRE concentrations. As highlighted in our September 2011 *Summary Analysis of Failed Bank Reviews*,[4] asset concentrations tied to CRE or construction, land, and land development loans increase banks' vulnerability to changes in the marketplace and compound the risks inherent in individual loans.

4. This report can be found at http://federalreserve.gov/oig/files/Cross_Cutting_Final_Report_9.30.11.pdf.

Chart 1: Whitman's Total Assets

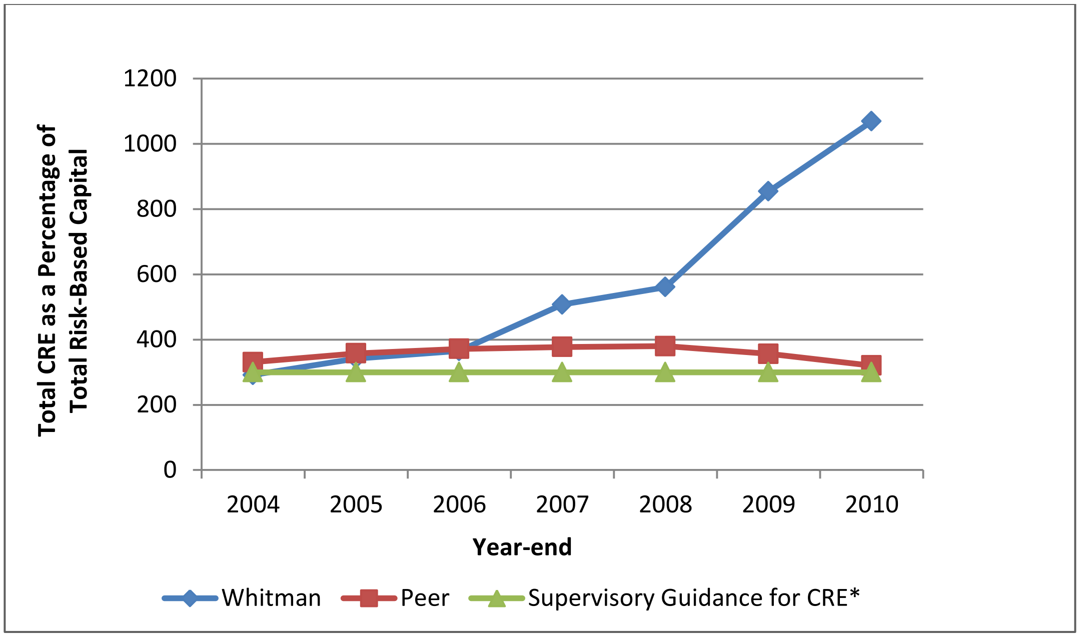


* As of June 30, 2011.

As illustrated in chart 2, Whitman's CRE concentration increased from approximately 292 percent of total risk-based capital in December 2004 to approximately 854 percent in December 2009. Whitman's CRE loans as a percentage of total risk-based capital significantly exceeded both the supervisory criteria for concentration risk noted in the Federal Reserve Board's Supervision and Regulation (SR) Letter 07-1, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, and the levels of its peers.[5]

5. According to the Federal Reserve Board's SR Letter 07-1, an institution presents potential significant CRE concentration risk if it meets the following criteria: (1) total reported construction, land, and development loans represent 100 percent or more of an institution's total capital or (2) total CRE loans represent 300 percent or more of the institution's total capital and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Chart 2: Whitman's Total CRE Concentrations



* SR Letter 07-1 became effective in 2007; depiction of the CRE concentration guidelines prior to 2007 is for illustrative purposes only.

In addition to significant CRE concentrations, in 2007 FRB San Francisco identified that Whitman had high loan concentrations to individual borrowers. These concentrations increased the risk that a single borrower experiencing financial difficulties could substantially diminish the bank's capital position. In 2008, the violations of laws and regulations section of the State's examination report noted the bank's legal lending limit violations related to eight individual borrowers.[6] During the 2008 examination, Whitman's legal lending limit to an individual borrower was approximately $10.2 million. The loans for these eight borrowers totaled approximately $277 million and exceeded the aggregate lending limit for these borrowers by $196 million (chart 3). Loans to one of the eight borrowers, an individual ultimately subject to Securities and Exchange Commission charges for engaging in securities fraud and operating a Ponzi scheme,[7] totaled approximately $60 million and accounted for 118 percent of the bank's capital.[8] In 2009, FRB San Francisco stated that the concentrated lending to this one borrower was the root cause for 38 percent of the bank's classified loans. This relationship ultimately resulted in significant losses. As of 2011, Whitman's management had done little to correct these violations or to mitigate the risks associated with these concentrations of credit.

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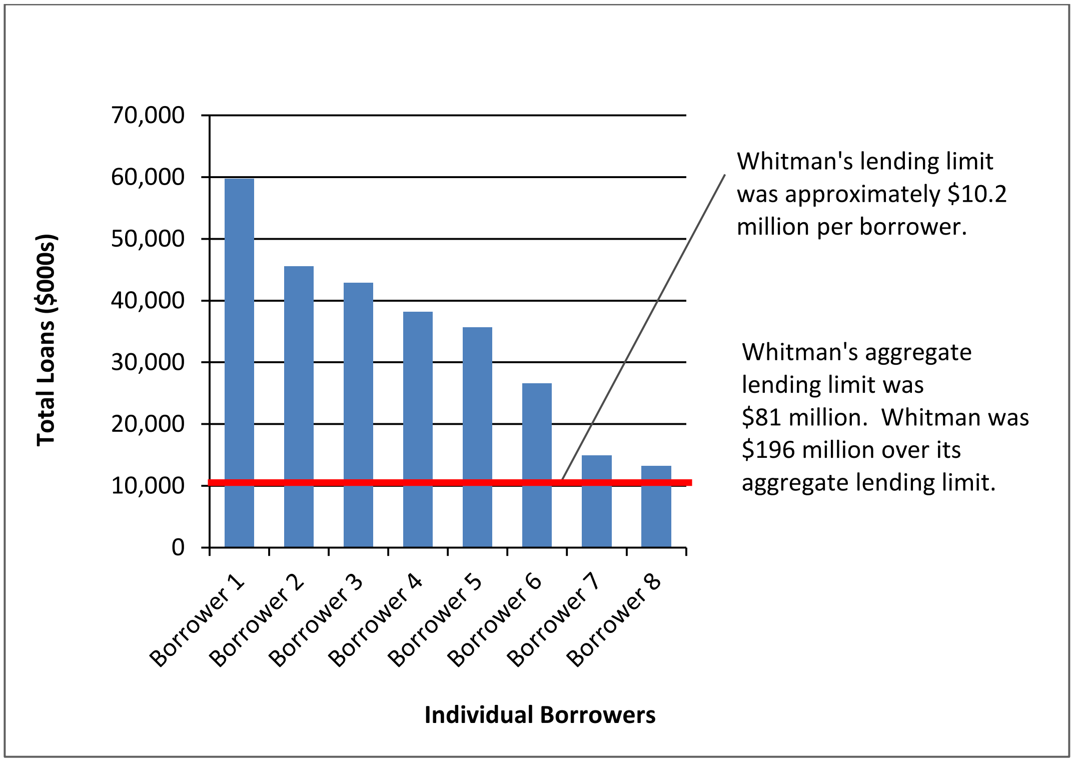
6. With certain exceptions, section 30.04.111 of the Revised Code of Washington limits the total loans and extensions of credit to a borrower at any one time to 20 percent of the bank's capital and surplus.

7. A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors.

8. On March 2, 2009, the Securities and Exchange Commission filed a complaint alleging that this individual engaged in a massive fraud that led to losses of hundreds of millions of dollars for investors. This complaint can be found at http://www.sec.gov/litigation/complaints/2009/comp20920.pdf.

Chart 3: Concentrations to Single Borrowers as of March 2008



In our opinion, Whitman's pursuit of a rapid growth strategy coupled with the lack of adequate CRE lending experience of its board of directors and management resulted in CRE and individual borrower concentrations that presented heightened risk to the institution.

Corporate Governance Weaknesses

FRB San Francisco and State examiners identified a number of corporate governance weaknesses at Whitman. These weaknesses included dominant management,[9] conflicts of interest and nepotism that undermined the effectiveness of key control functions, a deficient board of directors and senior management team, and a weak internal audit function.

Dominant Management

Whitman's president, chief executive officer (CEO), and chairman of the board (hereafter referred to as the CEO) controlled the institution's strategy. In every full-scope examination report from 2005 to 2011, FRB San Francisco examiners noted the CEO's dominance. Furthermore, during interviews, several FRB San Francisco and State examination staff members commented that Whitman's management team did not embrace constructive criticism during the examination process. FRB San Francisco examiners also mentioned that several outside directors appeared to have a prior personal or professional relationship with the

9. According to the CBEM, examiners should be alert for situations in which top management dominates the board of directors or where top management acts solely at the direction of either the board of directors or a dominant influence on the board of directors.

CEO. We believe that these apparent connections allowed the CEO to maintain his dominance. In 2010, the State issued a Consent Order that required Whitman's board of directors to engage an independent assessment of the bank's management. Whitman's independent directors retained an external firm to conduct the assessment, which included employee interviews and questionnaires. Many employees interviewed by the external firm noted their unwillingness to communicate concerns to the CEO regarding issues impacting the bank because they feared retaliation.

Whitman's chief lending officer (CLO) and chief financial officer (CFO), who were members of the board of directors, also exerted dominance over Whitman throughout much of the bank's history. In its management assessment, the external firm concluded that the CEO, CLO, and CFO were involved in virtually all of the institution's decisions.

Conflicts of Interest and Nepotism

During the five years prior to Whitman's closure, senior management hired relatives as potential successors to management in a manner that compromised the independence of key control functions and created conflicts of interest. An external firm's management assessment revealed several family relationships tied to the CEO, CLO, and CFO. This assessment noted that the nepotism at Whitman added strain to an already weak management system.

According to an FRB San Francisco interviewee, it is common for small community banks to employ family members. While federal banking statutes and regulations do not explicitly prohibit nepotism in small community banks' employment practices, the CBEM states that offices staffed by members of the same family require special alertness on the part of the examiner. In our opinion, the extensive nepotism at Whitman created conflicts of interest and compromised several key control functions. For example, the CEO's daughter held conflicting positions at Whitman. She served as the compliance officer while also serving as a loan officer with her own loan portfolio. In our opinion, serving as a loan officer impaired her ability to objectively review her loan portfolio for potential compliance violations in her role as the compliance officer. We believe that her conflicting responsibilities evidenced multiple internal control weaknesses, including a failure to appropriately segregate duties. FRB San Francisco raised concerns about this arrangement with Whitman management, noting that it presented a conflict of interest and independence issues. Also, we believe that the familial relationship between the CEO and his daughter compromised the independence of the compliance function.

As another example, the CLO's son served as the chief internal auditor. According to SR Letter 03-05, *Interagency Policy Statement on the Internal Audit Function and its Outsourcing*, the internal audit function's role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk management, control, and governance processes. The relationship between the CLO and the chief internal auditor presented a conflict of interest that impaired the independence of Whitman's internal audit function.

Deficient Board of Directors and Senior Management

Whitman's board of directors and senior management established the institution's strategic focus on CRE and developing large lending relationships with individual borrowers. The board of directors and senior management failed to develop a risk management system commensurate with the risk associated with these activities.[10] In addition, the board of directors failed to take action when presented with information detailing questionable practices and improper conduct involving senior management.

FRB San Francisco and State examiners consistently noted deficiencies in the bank's risk management practices and in the board of directors' and management's oversight. As a result of a 2005 examination, FRB San Francisco issued a commitment letter to address Whitman's risk management weaknesses. In 2007, FRB San Francisco found Whitman to be in compliance with the commitment letter and terminated the action, but noted that the recently implemented risk management processes required validation to ensure their effectiveness. While the board of directors and management took some steps to address the deficiencies, they did not maintain effective risk management practices or improve their oversight. In subsequent examinations, FRB San Francisco and State examiners continued to identify risk management weaknesses, including unsecured lending and the need to strengthen credit administration and underwriting practices. Despite these recurring issues, examiners did not downgrade Whitman's management component rating until September 2009. In July 2010, examiners implemented a formal enforcement action, which required the board of directors to strengthen its oversight of Whitman's management and operations. However, the weaknesses remained unresolved.

Dominant members of management often ignored internal controls and did not always report deviations from policy to the board of directors. The board of directors failed to take action when presented with forensic accounting reports and employee letters detailing questionable practices and improper conduct involving senior management. One forensic accounting report, issued in December 2010, notified the board of directors of a transaction involving material departures from prudent banking practices and the bank's own written policies. This forensic accounting report detailed inappropriate conduct by senior officers to conceal two long-standing delinquent loans. Another forensic accounting report, also issued in December 2010, notified the board of directors of a transaction involving inappropriate conduct by senior bank officers in relation to the sale of other real estate owned (OREO); the report concluded that the transaction was "ill-conceived." In addition, in a March 2011 letter, several employees notified the board of directors that Whitman's senior management allegedly coerced Whitman employees into obtaining personal loans to purchase Whitman stock. The board of directors failed to take action to address these issues and failed to notify the appropriate authorities.

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10. SR Letter 95-51, *Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies*, states that "boards of directors have the ultimate responsibility for the level of risk taken by their institution. Accordingly, they should approve the overall business strategies and significant policies of their organization, including those related to managing and taking risks, and should also ensure that senior management is fully capable of managing the activities that their institutions conduct." SR Letter 95-51 also states that senior management is responsible for implementing strategies in a manner that limits risks associated with each strategy.

Weak Internal Audit

Deficiencies in Whitman's internal audit program further contributed to the overall corporate governance weaknesses. As early as 2005, FRB San Francisco examiners criticized Whitman's internal audit program and noted that the board of directors should improve the internal audit program to reflect the risk and complexity of the bank's size, structure, and processes. SR Letter 03-05 notes that the internal audit manager should ideally report directly and solely to the audit committee regarding both audit issues and administrative matters.[11] In 2006, State examiners raised concerns about the independence of the internal audit function because the CLO's son served as the chief internal auditor. Furthermore, the State expressed concerns regarding the "involvement of the Chief Operating Officer in overseeing some of the internal audit activities." As a result of this examination, the State informed the board of directors that it must correct the structure of the internal audit program, as it lacked independence. Whitman responded to the criticism by outsourcing internal audit in mid-2006. During a 2008 examination, the State noted that Whitman had added a new internal auditor and adequately addressed criticisms from the previous examination.

In 2009, the audit committee's three outside directors expressed concerns regarding the number of inside directors and the difficulties of implementing change at the bank. Throughout various examinations, examiners noted other weaknesses in Whitman's internal audit program. In 2010, FRB San Francisco and State examiners noted that management should improve the audit program by including a loan operations audit and increasing the frequency of key audits. In 2011, FRB San Francisco and State examiners determined that management suspended the bank's audit program, canceling various internal and external reviews, and noted that Whitman lacked an internal auditor and did not have plans to hire one in the foreseeable future.

Inadequate Credit Risk Management

Whitman's board of directors and management failed to establish a credit risk management framework and infrastructure commensurate with the risks in the bank's loan portfolio. According to the CBEM, the bank's board of directors and senior management have an important role in ensuring the adequate development, execution, maintenance, and compliance monitoring of the bank's internal controls. The CBEM notes that a component of internal control is risk assessment, which is the identification, analysis, and management of risks. FRB San Francisco noted Whitman's inadequate credit risk management during its initial examination of Whitman in 2005. During this examination, FRB San Francisco examiners identified deficiencies in credit administration and internal controls, specifically deficient underwriting; weak problem loan identification; inadequate credit risk identification; lack of an independent credit review process; and several weaknesses in the appraisal process, including dated or inadequately supported appraisals and the failure to obtain appraisals. As noted previously, upon conclusion of this examination, FRB San Francisco and Whitman entered into a commitment letter to address the bank's risk management weaknesses. FRB San Francisco terminated the action in 2007 but noted that the recently implemented risk management processes had not yet been tested or validated.

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11. SR Letter 03-05 also acknowledges that an institution may place the manager of internal audit under a dual reporting arrangement and states that in such cases, the internal audit manager should report administratively to the CEO and be functionally accountable to the audit committee on issues discovered by the internal audit function.

In subsequent years, the bank made little progress toward developing credit administration practices consistent with the heightened risk in the loan portfolio. During this period, examiners identified a number of weaknesses in Whitman's credit risk management practices, including the following:

- liberal and lax underwriting, including failure to cite exceptions to policy, inadequate cash flow or global debt analysis for significant relationships, and poor guidance for underwriting CRE loans
- inadequate monitoring related to credit concentrations
- unreliable and deficient problem loan recognition, including inaccuracies in loan grading and delays in downgrading loan risk grading based on deteriorating loan performance
- deficiencies in the Allowance for Loan and Lease Losses (ALLL) methodology
- widespread repeat federal regulatory and state legal lending limit violations, such as violations of subpart G of Regulation Y, *Bank Holding Companies and Change in Bank Control,* for various deficiencies in appraisal practices[12]

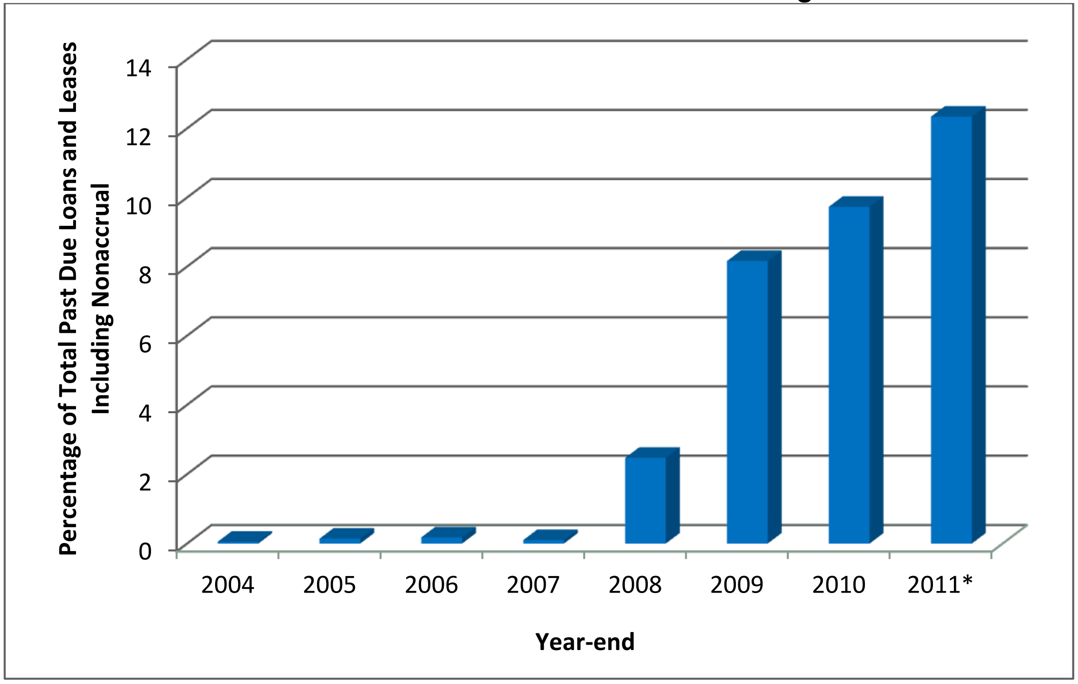
Whitman's credit risk management weaknesses continued and remained unresolved through the bank's failure.

Deterioration in Asset Quality

As a result of Whitman's concentrated lending, Whitman's inadequate credit risk management framework, and a declining local real estate market, the bank's classified assets steadily increased and asset quality deteriorated. As illustrated in chart 4, Whitman's past-due loans and leases began to increase dramatically in 2008. In addition, adversely classified assets grew by more than $90 million from a 2009 full-scope examination to a 2010 full-scope examination and represented approximately 339 percent of tier 1 capital and the ALLL by 2011.

12. Regulation Y generally regulates the acquisition of control of banks and bank holding companies by companies and individuals, with subpart G applying to appraisal standards.

Chart 4: Whitman's Past-due Loans and Leases Including Nonaccrual



* As of June 30, 2011.

FRB San Francisco and State examiners noted that many factors contributed to the deterioration of Whitman's asset quality. These factors included liberal underwriting, borrower and CRE concentrations, poor selection of risk, and the untimely identification of credit risk. As a result of these weaknesses, Whitman was extremely vulnerable to a softening real estate market. An FRB San Francisco examiner stated that the economic downturn did affect Washington State. As the real estate market began to deteriorate, Whitman became overwhelmed as its customers struggled to make loan payments, which adversely impacted asset quality. In a September 2009 examination, FRB San Francisco identified the economic downturn as a significant factor in Whitman's decline in asset quality. Furthermore, FRB San Francisco examiners noted that management's attempt to aggressively resolve problem loans resulted in an increase in liberal underwriting through unsecured lending, which contributed to the deterioration of Whitman's asset quality.

Questionable Transactions and Business Practices

As Whitman's asset quality deteriorated, its senior management used various measures to conceal the extent of problem loans and mask the bank's true condition. These measures included questionable transactions involving a bank-approved appraiser as well as a strategy of replacing secured problem loans with new unsecured loans that had questionable structures and liberal underwriting. These actions caused the bank to suffer further losses. In addition, a letter from several Whitman employees alleged that senior management coerced them into obtaining personal loans to purchase Whitman stock in an attempt to bolster the bank's capital.

Questionable Transactions Involving a Bank-approved Appraiser

In 2010, FRB San Francisco noted that a bank-approved appraiser's son obtained a loan from Whitman for "business purposes or business investments." FRB San Francisco and State examiners identified that the appraiser's son instead used the proceeds to make outstanding interest payments on a loan that his father had obtained from the bank. Examiners described this arrangement as a diversion of loan funds involving a "straw borrower" and directed management to notify the appropriate authorities regarding this transaction. Management filed notification forms regarding this transaction and FRB San Francisco subsequently filed its own notification forms related to the same transaction.

FRB San Francisco, the State, and an external firm criticized another transaction involving the same appraiser. Whitman extended a loan to a limited liability company to facilitate the sale of OREO property. The appraiser had an ownership interest in the limited liability company and served as guarantor for the loan. The bank initially used a 2008 appraisal that this guarantor performed on the property. Examiners noted that this arrangement had the appearance of self-dealing and posed a potential conflict of interest. An external firm concluded that the purpose of the transaction was to eliminate the negative effects of a bad commercial loan on Whitman's books. The firm concluded that the transaction was "ill-conceived" and "not at arms-length." FRB San Francisco filed the appropriate notification forms regarding this transaction.

Unsecured Lending

In addition, Whitman's management increasingly engaged in unsecured lending by replacing secured problem loans with new unsecured loans to conceal the bank's true condition. FRB San Francisco and State examiners identified that this strategy frequently involved selling a troubled note or a 100 percent participation in the troubled note to a new borrower. Whitman would finance this arrangement by extending an unsecured loan to the new borrower and only requiring interest or principal payments at maturity, often at a concessionary low rate. The CBEM states that an unsecured loan portfolio can represent a bank's most significant risk and that if a borrower's financial condition deteriorates, the lender's options to resolve the lending relationship deteriorate as well.

As early as 2006, Whitman engaged in unsecured lending. In 2008, State examiners identified that the bank had several large borrowers with unsecured lines of credit and instructed Whitman to enhance its unsecured lending guidelines. During full-scope and target examinations in 2009, FRB San Francisco examiners issued a Matter Requiring Immediate Attention instructing the board of directors to improve its monitoring of unsecured lines of credit.[13] Whitman's management did not establish a limit on the amount of unsecured loans in the portfolio. As of year-end 2009, outstanding unsecured loans totaled $106 million, or 17 percent of the loan portfolio. FRB San Francisco and State examiners noted that this amount of unsecured loans elevated the risk of loss to the institution.

In 2010, FRB San Francisco and State examiners noted that (1) the risks associated with Whitman's large unsecured loan portfolio were not commensurate with the current capital

13. The CBEM defines Matters Requiring Immediate Attention as matters arising from an examination that the Federal Reserve is requiring a banking organization to address immediately.

levels and (2) management had been instructed to develop underwriting guidelines for unsecured lending since the March 2008 State examination. Whitman, however, failed to establish underwriting guidelines for unsecured lending, which reflected unsafe and unsound credit underwriting. In 2010, examiners notified Whitman management that its strategy to minimize problem loans by liberally underwriting unsecured loans exposed the bank to additional risk. Also in 2010, an external firm reviewed a transaction involving unsecured lending and noted that its purpose was to "remove from the bank's books or camouflage" two long-standing delinquent loans. The firm concluded that this transaction involved material departures from prudent banking practices and Whitman's policies. FRB San Francisco filed the appropriate notification forms regarding this transaction.

Alleged Coercion behind Employee Stock Purchases

Whitman's senior management allegedly coerced Whitman employees into obtaining personal loans to purchase Whitman stock in an attempt to bolster the bank's capital. In March 2011, several Whitman employees claimed that they were instructed to purchase Whitman stock as a condition of their employment. They alleged that senior management informed them that loan arrangements were being made with another bank to accomplish the stock purchases. During an interview, an FRB San Francisco examiner noted that senior management provided employees with completed loan applications to sign to request these loans. The May 2011 examination report noted that directors and bank officers received Whitman lines of credit to facilitate the stock purchases. FRB San Francisco and State examiners noted that this appeared to be a violation of 12 U.S.C. 324, which prohibits banks from lending on or purchasing their own stock. FRB San Francisco filed the appropriate notification forms regarding this transaction.

Deficient ALLL Level and Methodology

From 2005 to 2011, examiners repeatedly criticized Whitman's ALLL methodology. In 2005, FRB San Francisco examiners noted that Whitman's ALLL methodology was outdated. During a January 2007 examination, FRB San Francisco examiners noted that the ALLL methodology was inconsistent with regulatory guidance and generally accepted accounting principles.[14] From 2009 to 2011, examiners described the ALLL methodology as materially flawed, in contravention of interagency guidance, unacceptable, and needing improvement.

Additionally, as early as 2007, examiners noted deficiencies in Whitman's ALLL levels. In 2009, FRB San Francisco examiners notified Whitman that it needed an additional provision of $7 million to raise the ALLL to a minimally acceptable level. In 2010, management underfunded the ALLL by $10 million due to ineffective loan grading and a large volume of examiner downgrades. After a provision of approximately $10.6 million to bring the ALLL to $30 million at June 30, 2011, the bank fell to the PCA *critically undercapitalized* category.

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14. According to SR Letter 06-17, *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)*, "each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses."

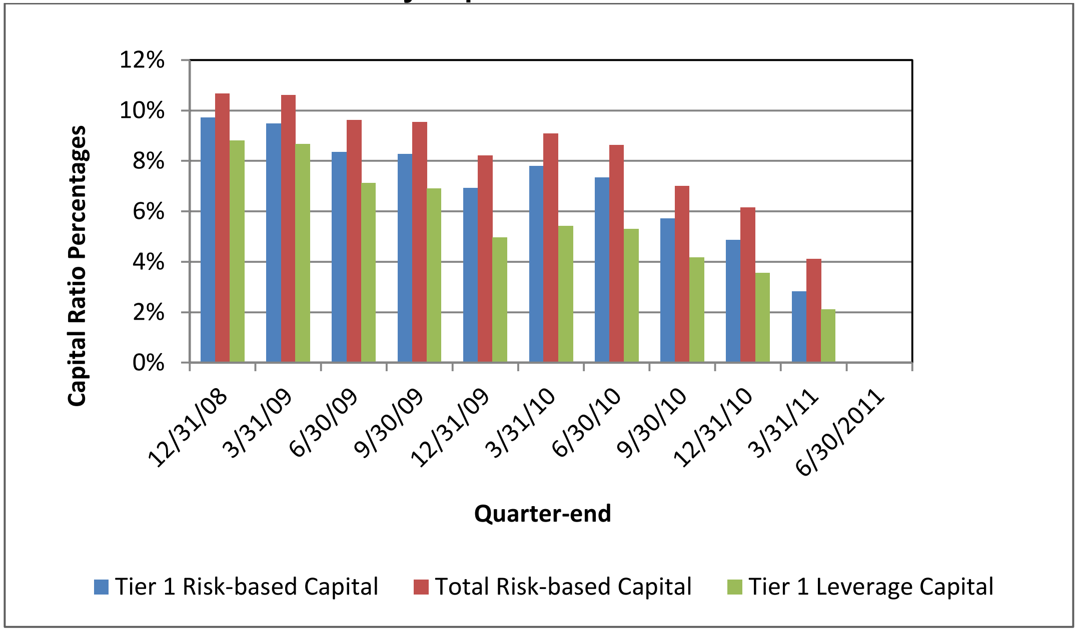
Depleted Earnings

The deterioration of Whitman's asset quality coupled with high ALLL provisions eventually resulted in depleted earnings. In 2007, Whitman's earnings performance declined primarily due to a large loan loss in the fourth quarter of 2006; however, FRB San Francisco examiners concluded that earnings still augmented capital. Examiners labeled earnings satisfactory and sufficient in 2008 and February 2009, respectively. In September 2009, however, FRB San Francisco examiners noted that earnings were critically deficient due to high ALLL provisions and a contracting net interest margin. FRB San Francisco concluded that Whitman's earnings did not support the bank's operations, augment capital, and fund the ALLL. FRB San Francisco examiners noted that poor asset quality and weak credit risk management elevated the risk to the bank's earnings. Whitman's earnings remained critically deficient and unable to support capital through the bank's closure. In 2011, FRB San Francisco and State examiners noted that additional provision expenses, further compression of the net interest margin, and high overhead costs had negatively impacted earnings.

Erosion of Capital

Chart 5 illustrates Whitman's quarterly capital ratios from the fourth quarter of 2008 through the second quarter of 2011. As of December 31, 2008, Whitman's tier 1 risk-based capital, total risk-based capital, and tier 1 leverage capital ratios were 9.71 percent, 10.69 percent, and 8.82 percent, respectively. FRB San Francisco examiners warned Whitman that although these capital ratios appeared adequate and met the PCA *well capitalized* guidelines, continued deterioration in its loan portfolio could seriously affect the bank's capital position.

Chart 5: Whitman's Quarterly Capital Ratios



During a September 2009 target examination, FRB San Francisco examiners deemed Whitman's capital inadequate for its risk profile and urged management to develop a formal capital plan to preserve and augment capital. Furthermore, Whitman could no longer rely on its holding company for capital support because the holding company was also experiencing financial strain. As of a September 2010 target examination, Whitman still had not submitted an acceptable capital plan. FRB San Francisco and State examiners noted that they had repeatedly raised this issue to the board of directors throughout the year, yet the board of directors did not exhibit any sense of urgency to aggressively raise capital. Whitman's severe asset quality deterioration continued to result in net losses and capital depletion, which caused the bank to fall to *undercapitalized* in the quarter ending September 30, 2010.

FRB San Francisco required Whitman to submit an acceptable capital restoration plan by November 24, 2010. Whitman failed to do so, and as a result, the Federal Reserve Board issued a PCA directive effective February 9, 2011. Whitman fell to PCA *significantly undercapitalized* status in March 2011 and to *critically undercapitalized* upon conclusion of the May 2011 examination when FRB San Francisco and State examiners required a provision of approximately $10.6 million to the ALLL. On August 5, 2011, the State closed Whitman and appointed the FDIC as receiver.

Supervision of Whitman

FRB San Francisco complied with examination frequency guidelines for the time frame we reviewed, 2005 through 2011, and conducted regular offsite monitoring. During the period covered by our review, FRB San Francisco and the State conducted seven full-scope examinations and three target examinations; executed three enforcement actions, specifically a commitment letter, a written agreement, and a consent order; and implemented applicable PCA provisions. FRB San Francisco responded to situations involving suspicious activity in accordance with the expectations outlined in CBEM 5020.1 and filed the appropriate notification forms.

Our analysis of FRB San Francisco's supervision of Whitman from 2005 through 2011 revealed that FRB San Francisco identified corporate governance weaknesses and other significant deficiencies during its first examination in 2005 but did not take sufficient supervisory action to address these weaknesses until September 2009. In our opinion, Whitman's inability to resolve internal control weaknesses, risk management issues, and federal regulatory and state legal lending limit violations constituted early warning signs regarding the effectiveness of management, the board of directors, and the internal audit function. We acknowledge that the CBEM notes the need for subjective judgment in examinations. However, we believe that FRB San Francisco had multiple opportunities from 2005 through 2009 to take alternative supervisory action by (1) implementing more aggressive enforcement actions, (2) validating the effectiveness of recent control enhancements before upgrading the management component rating in January 2007, and (3) downgrading Whitman's CAMELS composite or component ratings to address the bank's persistent deficiencies prior to the September 2009 examination. The bank's supervisory history is outlined in table 1.

FRB San Francisco complied with premembership supervisory requirements outlined in SR Letter 98-28, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*, by verifying that Whitman satisfied the eligible bank criteria detailed in section 208.2(e) of Regulation H, *Membership of State Banking Institutions in the Federal Reserve System*, before being allowed to become a state member bank.[15] These criteria are used to evaluate whether an institution seeking to convert to state member status should be examined before being allowed to convert. To meet these criteria, an institution must (1) be well capitalized under subpart D of Regulation H, (2) have a composite CAMELS rating of 1 or 2, (3) have a Community Reinvestment Act rating of outstanding or satisfactory, (4) have a compliance rating of 1 or 2, and (5) have no major unresolved supervisory issues outstanding as determined by the Federal Reserve Board or the applicable Federal Reserve Bank. In 2004, FRB San Francisco appropriately confirmed that Whitman satisfied these criteria and therefore did not require a premembership examination. SR Letter 98-28 has since been superseded by SR Letter 11-2, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*. SR Letter 11-2 contains technical

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15. Regulation H defines the requirements for membership of state-chartered banks in the Federal Reserve System.

clarifications to SR Letter 98-28 but maintains the eligible bank criteria found in SR Letter 98-28.

Table 1: Whitman Supervisory Overview

Examination				CAMELS Composite Rating	CAMELS Component and Risk Management Ratings							Supervisory Actions
Start Date	Report Issue Date	Scope	Agency Conducting Examination		Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	Risk Management	
01/24/2005	05/02/2005	Full	FRB San Francisco	2	2	2	3	2	3	2	3	Commitment letter issued 05/05/2005
03/20/2006	06/01/2006	Full	State	2	2	2	3	2	2	2	-	
01/22/2007	04/19/2007	Full	FRB San Francisco	2	2	2	2	3	2	2	3	Commitment letter released 04/19/2007
11/05/2007	12/17/2007	Target	FRB San Francisco	-	-	-	-	-	-	-	-	
03/24/2008	05/02/2008	Full	State	2	2	2	2	2	2	2	-	
02/17/2009	05/01/2009	Full	FRB San Francisco	2	2	3	2	2	3	2	2	
09/14/2009	11/24/2009	Target	FRB San Francisco	4	4	4	4	5	4	3	4	Written agreement executed 07/08/2010
03/29/2010	06/29/2010	Full	FRB San Francisco & State (Joint)	5	5	5	5	5	4	3	-	Consent order issued 10/22/2010[a]
09/27/2010	12/09/2010	Target	FRB San Francisco & State (Joint)	5	5	5	5	5	5	5	5	PCA directive issued 02/09/2011
05/23/2011	07/25/2011	Full	FRB San Francisco & State (Joint)	5	5	5	5	5	5	5	5	

[a] The consent order was issued by the State.

January 2005 Full-scope Examination Resulted in a Commitment Letter

In January 2005, FRB San Francisco began its first full-scope examination of Whitman. FRB San Francisco's examination resulted in a CAMELS composite 2 (satisfactory) rating. Whitman received 3 (fair) ratings for the liquidity and management CAMELS components and received 2 ratings for capital, asset quality, earnings, and sensitivity to market risk. The bank's asset quality component rating declined from 1 (strong) to 2 due to an increase in classified assets from $321,000 during the prior examination to $8.9 million.
FRB San Francisco noted that the increased volume of classifications was largely the result of one relationship in the commercial and industrial portfolio. In our opinion, this was an early indicator of Whitman's propensity to develop large lending relationships. The May 2005 examination report stated that Whitman's overall financial condition was satisfactory but

noted that management and risk management needed improvement. Whitman's management component rating declined from 2 to 3.

FRB San Francisco commented on the dominance of the CEO, CFO, and CLO over the direction of the institution. Additionally, FRB San Francisco noted the CEO's plans to hire relatives of senior management to serve as department heads. According to FRB San Francisco examiners, the CFO admitted that "it was always the hope of senior management that their children would come to work for the bank to provide continuity of management." In our opinion, senior management's dominance and plans to hire relatives for key functions were an early indicator of management weaknesses.

FRB San Francisco's criticisms of Whitman included deficient credit administration practices, weak internal audit function, inappropriate and outdated ALLL methodology, noncompliance with federal regulations, and weak internal controls. In particular, examiners noted credit administration weaknesses relating to (1) controls for construction lending that were inconsistent with safe and sound banking practices, (2) inadequacies in appraisal policies, (3) the lack of an independent credit review, and (4) underwriting deficiencies. FRB San Francisco commented that several of the deficiencies noted during this examination had been identified in prior examination reports. In the examination report, FRB San Francisco examiners urged Whitman to strengthen credit risk management given the bank's portfolio size, strategic plans for loan growth, and classified assets. Additionally, examiners warned Whitman that its risk management practices could adversely affect long-term capital preservation if not adequately addressed.

FRB San Francisco noted that Whitman's legal risk was increasing due to lax credit administration practices. Examiners also noted several regulatory violations,[16] including

- a violation of Regulation H, as the bank's customer information security program failed to meet the requirements of section 501(b) of the Gramm-Leach-Bliley Act
- a violation of Regulation W, *Transactions between Member Banks and Their Affiliates*, for an inappropriate allocation of expenses between Whitman and its holding company[17]
- several violations of Regulation Y for failure to obtain appraisals, perform real estate evaluations, and adequately document appraisal reviews

In our opinion, the fact that these violations occurred within multiple divisions of the institution were also an early indication of the ineffectiveness of management's oversight.[18]

As a result of the examination, FRB San Francisco and Whitman entered into a commitment letter to address the bank's audit and risk management weaknesses. According to CBEM section 5040.1, commitment letters are informal supervisory actions that (1) are generally used to correct minor problems or to request periodic reports addressing certain

16. According to the CBEM, every Federal Reserve examination report should include a Violations of Laws and Regulations page or section, detailing the requirements of the regulation or statute and a discussion of how or why the violation occurred. The examiner should describe any plans or recommendations for corrective action.

17. Regulation W implements sections 23A and 23B of the Federal Reserve Act, which establish certain restrictions on and requirements for transactions between a member bank and its affiliates.

18. SR Letter 95-51 states that senior management is responsible for implementing strategies in a manner that ensures compliance with laws and regulations on both a long-term and day-to-day basis.

aspects of a bank's operations and (2) may be used when there are no significant violations of law or unsafe or unsound practices and when the bank and its officers are expected to cooperate and comply. As noted above, FRB San Francisco's 2005 examination of Whitman identified controls that were inconsistent with safe and sound banking practices, several regulatory violations, and several recurring deficiencies from prior regulatory examination reports. In our opinion, Whitman's extensive deficiencies and regulatory violations warranted a supervisory response stronger than a commitment letter, such as a memorandum of understanding, to better convey the severity of the issues and the urgent need to resolve them, especially since this examination was FRB San Francisco's initial review of the bank. According to CBEM section 5040.1, a memorandum of understanding is generally used when a bank has multiple deficiencies and must be signed by the bank's board of directors.

We believe that the deficiencies identified during this examination remained at Whitman as its risk profile increased and contributed to Whitman's failure. In our opinion, the deficiencies identified during this examination, several of which existed prior to Whitman's conversion to state member bank status, also evidenced the ineffectiveness of the eligible bank criteria for determining when to conduct a premembership examination.

March 2006 Full-scope State Examination Resulted in Liquidity Component Rating Upgrade

As a result of a March 2006 examination, the State maintained Whitman's 2 CAMELS composite rating and upgraded the bank's liquidity component rating from 3 to 2. FRB San Francisco participated in this State examination to review management's compliance with the commitment letter. The State concluded that Whitman's overall condition was satisfactory but that the bank's risk management practices needed improvement. Examiners labeled Whitman's earnings and capital satisfactory but noted that the bank's capital ratios had declined since the prior examination due to strong asset growth outpacing earnings retention.

State examiners expressed concerns about the independence of the internal audit function because the CLO's son served as the chief internal auditor. Examiners also noted the chief operating officer's involvement in overseeing some of the internal audit activities. Accordingly, the State instructed the board of directors to address the lack of independence in the internal audit function and to enhance the audit tracking process, among other areas.

State examiners also noted the need for policy and procedure enhancements, responsiveness to recommendations from auditors and supervisory authorities, and compliance with laws and regulations. Among other items, examiners recommended that Whitman (1) strengthen lending policies and credit administration procedures, (2) establish an insider loan policy and improve documentation for insider loans, and (3) establish loan portfolio concentration limits. The State determined that Whitman's response to the independent credit review criticisms from the previous examination was less than satisfactory. Additionally, examiners notified Whitman of new violations of Regulation O, *Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*,[19] and Regulation Y, as well as noncompliance with

19. Regulation O restricts credit that a member bank may extend to its executive officers, directors, and principal shareholders and their related interests.

the *Interagency Guidelines for Real Estate Lending Policies*.[20] The commitment letter remained in effect as a result of the examination.

January 2007 Full-scope Examination Maintained the Satisfactory Composite Rating and Terminated the Commitment Letter

In January 2007, FRB San Francisco conducted a full-scope examination that maintained the CAMELS composite 2 rating and terminated the 2005 commitment letter. Examiners upgraded the management component rating from 3 to 2. Examiners also downgraded the earnings component rating from 2 to 3 primarily due to a large loan loss in the fourth quarter of 2006.

The Matters Requiring Board Attention section of the examination report noted issues with credit underwriting, ALLL methodology and levels, and measurement and monitoring of credit risk. In addition, FRB San Francisco examiners identified concentrations of credit to borrowers that either individually, or through related entities, exceeded 25 percent of tier 1 capital and reserves. FRB San Francisco again commented on the CEO's dominance over Whitman's affairs.

FRB San Francisco upgraded the bank's management component rating due to its sound financial performance and the responsiveness of management to examination feedback. Additionally, examiners concluded that Whitman was in full compliance with the commitment letter and terminated the action. Examiners noted that Whitman's management had (1) strengthened construction lending policies and procedures, (2) improved the appraisal process and implemented an effective appraisal policy, (3) improved the independent credit review process, and (4) taken actions indicating a stronger internal audit function. However, FRB San Francisco stated that the recently implemented risk management processes related to audit, credit, liquidity, the Bank Secrecy Act, and information technology required validation by management and auditors to ensure their overall effectiveness. Furthermore, FRB San Francisco examiners noted that the overall risk management remained fair and needed further enhancement. In our opinion, FRB San Francisco should not have upgraded the management rating without having the opportunity to validate the effectiveness of recent control enhancements.

November 2007 Target Examination Focused on Risk Management

In November 2007, FRB San Francisco conducted a target examination to assess Whitman's progress toward strengthening its risk management. Examiners concluded that Whitman had made measurable progress toward strengthening its overall risk management and addressing concerns from the prior examination; however, FRB San Francisco encouraged management and the board of directors to continue strengthening underwriting and credit monitoring.

20. The *Interagency Guidelines for Real Estate Lending Policies* describes the criteria and specific factors that insured institutions are expected to consider in establishing their real estate lending practices. In general, the guidelines identify the loan portfolio management and underwriting considerations that should be addressed in a sound real estate lending policy.

FRB San Francisco noted that Whitman's management and board of directors had not addressed several risk management concerns identified in prior examinations. FRB San Francisco noted that (1) internal loan grade definitions did not match regulatory definitions, (2) the Regulation O policy and procedures needed further enhancement, and (3) the ALLL policy needed refinement.

March 2008 Full-scope State Examination Maintained a Satisfactory CAMELS Composite Rating

As a result of a March 2008 examination, the State maintained Whitman's CAMELS composite 2 rating. Examiners upgraded the earnings component rating from 3 to 2 and maintained 2 ratings for all other components. The State deemed Whitman's overall condition satisfactory and its risk management practices appropriate for the size and complexity of the institution.

State examiners noted that credit administration had improved and underwriting was adequate. The State concluded that Whitman's ALLL methodology was generally adequate and that the allowance level was appropriate. Examiners noted several areas of concern, however, including (1) high CRE concentrations, (2) high noncore funding, and (3) federal regulatory and state legal lending limit violations. In particular, the State notified Whitman of several violations, including violations of Regulation Y and Revised Code of Washington 30.04.111, *Limit on Loans and Extensions of Credit to One Person*. Examiners also notified Whitman of a contravention of *Interagency Guidelines for Real Estate Lending Policies* for a loan that exceeded supervisory loan-to-value guidelines.

State examiners noted that Whitman's concentration risk was elevated due to a high volume of loans made to a relatively small group of borrowers. According to the State, Whitman's management exceeded limitations on loans to a single borrower with eight separate individuals. Loans to one borrower totaled approximately $60 million and accounted for 118 percent of the bank's capital. In aggregate, Whitman exceeded the lending limit for the eight borrowers by $196 million as of March 2008. The concentrated lending to individual borrowers increased the risk that a single borrower experiencing financial difficulties could significantly affect the bank's capital position, which ultimately contributed to Whitman's failure.

February 2009 Full-scope Examination Resulted in Asset Quality and Liquidity Component Rating Downgrades

FRB San Francisco began a full-scope examination of Whitman in February 2009. The previous examination noted significant findings regarding legal lending limit violations. FRB San Francisco examiners determined that Whitman remained in satisfactory condition but noted that its overall risk profile was moderate with an increasing trend even though the bank's legal lending limit violations remained unresolved. The bank's CAMELS composite rating remained a 2, but examiners downgraded the bank's asset quality and liquidity component ratings from 2 to 3.

FRB San Francisco examiners noted an increase in Whitman's classified assets and the need for improved credit risk management practices. Furthermore, FRB San Francisco identified management's lack of oversight on large unsecured lines of credit and urged management to improve its monitoring of them. Examiners did not find any new legal violations during this examination and deemed the internal audit program and internal controls adequate for Whitman's size and complexity.

Examiners noted that Whitman's credit risk was increasing due to its high CRE concentrations and a softening real estate market. FRB San Francisco concluded, however, that the CRE levels remained manageable. The volume of CRE loans had increased by $41.2 million since the prior year. Examiners concluded that Whitman's CRE concentration risk management was adequate but noted the need for enhanced underwriting of CRE loans.

During this examination, FRB San Francisco again commented on the CEO's dominance in controlling the institution. Additionally, examiners noted that three outside directors expressed concerns regarding the number of inside directors and the difficulties of implementing change. FRB San Francisco stated that the inside directors were part of the executive management team and that strong bonds appeared to exist.

FRB San Francisco examiners notified Whitman that asset quality problems were evident, economic conditions were weakening, and continued deterioration in the loan portfolio could seriously impact Whitman's capital position. An FRB San Francisco interviewee noted that he did not feel comfortable with the combination of the management team, the deteriorating economy, and the composition of the bank's portfolio. Nevertheless, Whitman's composite rating remained a 2. In our opinion, the bank's increasing risk profile and weak credit risk management practices warranted a stronger supervisory response, such as downgrades to the composite and component ratings.

September 2009 Target Examination Resulted in a Double Downgrade to the CAMELS Composite Rating and Multiple CAMELS Component Rating Downgrades

FRB San Francisco recognized several significant issues in the February 2009 examination and appropriately accelerated the next examination to September 2009. In September 2009, FRB San Francisco began a target examination to review the accuracy of Whitman's internal loan rating system and the overall effectiveness of its credit risk management. The target examination revealed that the bank had serious financial and ongoing managerial deficiencies and exhibited unsafe and unsound conditions or practices. FRB San Francisco examiners noted deficient board oversight and risk management activities as well as an increased level and severity of problem assets and critically deficient earnings. Based on the results of the target examination, FRB San Francisco expanded the examination scope to include all of Whitman's CAMELS components. The examination resulted in a double downgrade to the CAMELS composite rating from 2 to 4 (deficient). Additionally, the examination resulted in a triple downgrade to the earnings component rating from 2 to 5 (critically deficient) and double downgrades to the risk management rating and the capital and management component ratings from 2 to 4. FRB San Francisco examiners also downgraded the asset quality and liquidity component ratings from 3 to 4 and the sensitivity to market risk component rating from 2 to 3.

FRB San Francisco noted deficient board of directors' oversight and risk management and inadequate capital for Whitman's heightened risk profile. Examiners criticized the board of directors and management for implementing a strategy that allowed high borrower and CRE concentrations and questionable underwriting practices. FRB San Francisco also notified Whitman of its need to improve credit risk management after identifying weaknesses in risk identification, underwriting standards, appraisal practices, and concentrations of credit. In addition, examiners informed Whitman that its ALLL methodology was unacceptable.

Whitman's classified assets increased by approximately 228 percent since the February 2009 examination. FRB San Francisco examiners noted that OREO had increased from approximately $270,000 at the prior examination to nearly $8 million at the target examination. Examiners attributed the bank's asset quality deterioration to the economic downturn, liberal underwriting, borrower concentrations, and poor risk selection. FRB San Francisco issued Matters Requiring Immediate Attention directing the board of directors to, among other things, (1) establish a plan to reduce classified assets, (2) improve the monitoring of unsecured lines of credit, (3) establish portfolio limits for unsecured lending, (4) reduce CRE concentrations, and (5) strengthen credit administration and underwriting.

As previously noted, FRB San Francisco downgraded the earnings component rating from 2 to 5. Examiners noted that the distressed asset quality coupled with weak credit risk management, high ALLL provisions, and a contracting net interest margin elevated the risk to the bank's earnings. Furthermore, examiners concluded that Whitman's capital levels were deficient given the bank's risk profile. In our opinion, this significant downgrade further evidences that stronger supervisory action should have been taken during the prior examination, especially given the short time frame between these examinations.

As a result of this examination, FRB San Francisco directed management to develop a comprehensive capital plan and warned that the bank's capital position was under pressure. FRB San Francisco also deemed Whitman to be in "troubled condition."[21] Furthermore, as a result of this examination, examiners initiated a formal enforcement action and implemented the action, a written agreement, in July 2010. We acknowledge that this was the appropriate supervisory response. However, by the time examiners initiated the action, the severity of Whitman's asset quality deterioration had already negatively impacted the bank's capital and earnings.

March 2010 Joint Full-scope Examination Resulted in a Downgrade to the CAMELS Composite Rating and Downgrades to CAMELS Component Ratings

As a result of a March 2010 full-scope examination of Whitman, FRB San Francisco and State examiners downgraded the CAMELS composite rating to 5, noting that the bank's overall condition continued to deteriorate and threaten its viability. In addition, examiners

21. Section 225.71 of Regulation Y defines a "troubled condition" for a state member bank as an institution that (1) has a composite rating of 4 or 5; (2) is subject to a cease-and-desist order or a formal written agreement that requires action to improve the institution's financial condition, unless otherwise informed in writing by the Federal Reserve Board or applicable Federal Reserve Bank; or (3) is informed in writing by the Federal Reserve Board or applicable Federal Reserve Bank that it is in a troubled condition.

downgraded the capital, asset quality, and management component ratings to 5. The earnings, liquidity, and sensitivity to market risk ratings remained unchanged.

In the Matters Requiring Board Attention section of the examination report, FRB San Francisco and State examiners instructed the board of directors to, among other things, (1) reduce the level of adversely classified items, (2) develop a formal capital plan that will increase capital ratios to a level commensurate with the bank's risk profile, (3) strengthen board of directors and management oversight, (4) establish specific underwriting criteria for all unsecured lending, and (5) correct apparent violations of law and contraventions of regulatory guidance and ensure future compliance.

FRB San Francisco and State examiners labeled asset quality critically deficient and noted an increase of more than $90 million in adversely classified items since the February 2009 examination and appropriately downgraded Whitman's asset quality component rating to 5. Additionally, examiners determined that concentrations of CRE and credit to individual borrowers remained excessive and instructed Whitman to reduce the concentrations. Examiners noted that Whitman's historically liberal underwriting practices and concentrations of credit to single borrowers had resulted in the high volume of problem loans. Furthermore, FRB San Francisco and State examiners noted numerous credit administration weaknesses and an unreliable credit grading process. Examiners also noted management's strategy to replace secured problem loans with unsecured loans to new borrowers and concluded that the strategy demonstrated imprudent credit underwriting and appropriately downgraded Whitman's management component rating to 5.

FRB San Francisco and the State notified management that this strategy of liberally underwriting unsecured loans to work through problem loans exposed the bank to additional risk. Furthermore, during the examination, a whistleblower alleged to FRB San Francisco that Whitman was intentionally misrepresenting nonperforming assets. The whistleblower also alleged that a bank-approved appraiser's son obtained a loan from Whitman for "business purposes or business investments," but instead used the proceeds to make outstanding interest payments on a loan that his father had obtained from the bank. Examiners directed management to notify the appropriate authorities regarding this transaction. Examiners also criticized another transaction involving the same appraiser, noting that the transaction had the appearance of self-dealing and a potential conflict of interest. FRB San Francisco filed the appropriate notification forms regarding this transaction.

FRB San Francisco and State examiners also noted that Whitman's severe asset quality deterioration continued to result in net losses and capital depletion. According to examiners, Whitman's ALLL methodology continued to be inappropriate, and the ALLL remained underfunded. Whitman's asset quality deterioration resulted in significant provision expenses. Examiners concluded that capital was critically deficient and that immediate financial support was required. According to examiners, Whitman's holding company was not able to provide capital support at that time due to its own financial strain. In March 2010, a member of senior management in credit administration resigned, claiming he was expected to engage in schemes to deflect regulators' attention from Whitman's capital issues and that he was terminated for choosing not to assist in the efforts.

FRB San Francisco and State examiners concluded that management's and the board of director's oversight was critically deficient and noted that management had not appropriately identified risks. Examiners also noted that management had not addressed key recommendations and criticisms from prior examinations. Additionally, examiners noted several violations and contraventions of federal regulatory guidance, including violations of Regulation Y and contraventions of Regulation H. Furthermore, examiners recommended that Whitman strengthen its management by adding qualified individuals from outside the bank to change the credit culture because of the dominating influence of the senior executive team. As a result of the September 2009 and March 2010 examinations, FRB San Francisco executed a written agreement in July 2010, and the State issued a consent order in October 2010.

September 2010 Joint Target Examination Resulted in Critically Deficient CAMELS Composite and Component Ratings

FRB San Francisco and the State conducted a joint target examination and maintained the bank's CAMELS composite 5 rating, as the overall condition of the bank continued to deteriorate. Examiners downgraded the liquidity and sensitivity to market risk component ratings to 5 and maintained 5 ratings for all other components.

The joint examination report noted that liberal underwriting, concentrations of credit to single borrowers, large unsecured loans, and a high volume of problem loans posed a distinct threat to Whitman's viability. FRB San Francisco and State examiners stated that, since the prior examination, adversely classified assets had increased by more than $23 million and represented approximately 253 percent of tier 1 capital plus ALLL. Furthermore, examiners identified weaknesses in the bank's management of problem loans, credit concentrations, and the ALLL methodology. Examiners expressed doubt regarding the integrity of Whitman's loan workout program and noted management's propensity to manipulate problem loans.

Additionally, FRB San Francisco and State examiners concluded that Whitman had not complied with the written agreement and had not adequately addressed eight of the provisions relating to, among other things, board of directors' oversight of the institution, enhancements to the ALLL methodology, and the capital plan. The examination report deemed Whitman's ALLL methodology to be unacceptable and inappropriate and the ALLL to be underfunded. Furthermore, examiners noted that Whitman still had not submitted an acceptable capital plan; subsequently, the Federal Reserve Board issued a PCA directive to Whitman on February 9, 2011.

May 2011 Joint Full-scope Examination Resulted in a PCA *Critically Undercapitalized* Status

As a result of a May 2011 joint examination, FRB San Francisco and State examiners determined that Whitman exhibited extremely unsafe and unsound practices and conditions and that its financial performance was critically deficient. Examiners maintained Whitman's CAMELS composite and component ratings at 5. According to examiners, Whitman's ineffective board of directors and senior management oversight and deficient risk management practices were the catalyst to the bank's declining and unsatisfactory condition.

The joint examination report noted that Whitman's risk management practices were inadequate and noted that the ALLL methodology was materially flawed and that the ALLL was significantly underfunded. FRB San Francisco and State examiners noted that this was the fourth consecutive examination with criticisms to management's oversight of the ALLL methodology. Examiners required a provision of approximately $10.6 million to the ALLL, which resulted in Whitman falling to *critically undercapitalized* upon conclusion of the May 2011 examination.

Furthermore, FRB San Francisco and State examiners noted that Whitman had not complied with the written agreement and still had not adequately addressed eight provisions relating to, among other things, the board of directors' oversight of the institution, credit risk management, lending and credit administration, the ALLL, and the capital plan. In addition, examiners concluded that an immediate capital injection was necessary for Whitman to avoid failure and noted that Whitman still had not submitted an acceptable capital plan at the time of the examination.

FRB San Francisco and the State expressed concern regarding Whitman's CRE exposure due to high levels of classified loans and management's inability to identify asset quality problems in a timely manner. At the time of this examination, adversely classified loans accounted for approximately 22 percent of total assets and approximately 340 percent of tier 1 capital and ALLL. In addition, examiners criticized Whitman's credit risk practices and noted the need to improve areas such as management of concentrations and the lack of an ongoing loan review function.

The examination report noted that Whitman had circumvented or disabled its risk management processes altogether, which led to an environment in which questionable accounting practices and unethical business practices went unchallenged. During the examination, FRB San Francisco and the State also noted that the board of directors chose to ignore or neglected to act on information regarding suspicious activities. According to the report, senior management allegedly coerced several employees to obtain loans in an effort to increase the bank's capital. For example, a member of management alleged that he was coerced into purchasing Whitman stock as a condition of his employment. Examiners noted that the board of directors failed to follow established policies and procedures for notifying appropriate authorities in this and other instances. FRB San Francisco responded to these situations in accordance with the expectations outlined in CBEM 5020.1 and filed the appropriate notification forms.

As a result of the examination, FRB San Francisco and State examiners concluded that Whitman's high level of problem loans, failure to raise additional capital, and overall lack of compliance with the written agreement and the consent order demonstrated management's inability to return Whitman to a satisfactory condition. Whitman fell to *critically undercapitalized* upon conclusion of the May 2011 examination. The State closed Whitman and appointed the FDIC as receiver on August 5, 2011.

Conclusions, Lessons Learned, and Recommendation

Conclusions

Whitman failed because of the convergence of several factors. The bank altered its traditional agricultural lending strategy and expanded into new market areas, which resulted in rapid growth and high CRE concentrations as well as credit concentrations to individual borrowers. Whitman's corporate governance weaknesses allowed the bank's senior management to dominate the institution's affairs and undermine the effectiveness of key control functions. Whitman's credit concentrations and poor credit risk management practices, along with a decline in the local real estate market, resulted in asset quality deterioration and significant losses. At that point, management engaged in a series of questionable practices to mask the bank's true condition. The escalating losses depleted earnings, eroded capital, and left the bank in a PCA *critically undercapitalized* condition, which prompted the State to close Whitman and appoint the FDIC as receiver on August 5, 2011.

With respect to supervision, FRB San Francisco complied with premembership requirements and examination frequency guidelines for the time frame we reviewed, 2005 to 2011. FRB San Francisco also responded to situations involving suspicious activity in accordance with the expectations outlined in CBEM 5020.1 and filed the appropriate notification forms.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. Our analysis of FRB San Francisco's supervision of Whitman revealed that FRB San Francisco identified the bank's fundamental weaknesses during its first examination in 2005 but did not take decisive action to resolve those weaknesses until September 2009. Whitman exhibited a number of recurring and pervasive corporate governance weaknesses, such as dominant management, conflicts of interest and nepotism, a deficient board of directors, weak credit risk management and internal controls, and an ineffective internal audit function. Further, we believe that Whitman's inability to resolve internal control weaknesses, risk management issues, and federal regulatory and state legal lending limit violations constituted an early warning sign regarding the effectiveness of management, the board of directors, and the internal audit function.

In our opinion, FRB San Francisco had multiple opportunities from 2005 to 2009 to take stronger supervisory action by implementing more aggressive enforcement actions. For example, FRB San Francisco and Whitman entered into a commitment letter based on the results of the 2005 examination, which identified regulatory violations and multiple deficiencies, including unsafe and unsound practices related to construction lending. In our opinion and based on the criteria outlined in the CBEM, Whitman's violations and deficiencies warranted a stronger supervisory response than a commitment letter, such as a memorandum of understanding, to better convey the severity of the issues and the urgent need to resolve them. We also believe FRB San Francisco should not have upgraded the management rating in January 2007 without having the opportunity to validate the effectiveness of recent control enhancements. In our opinion, FRB San Francisco also had opportunities to downgrade Whitman's CAMELS composite or component ratings to address the bank's persistent deficiencies prior to the September 2009 examination. While we believe that FRB San Francisco had opportunities for earlier supervisory responses, it is not possible for us to predict the effectiveness or outcome of any measures that might have been taken. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected Whitman's financial deterioration or the ultimate cost to the DIF.

The need for stronger supervisory action sooner has been a consistent theme in our prior failed bank reviews, as highlighted in our September 2011 *Summary Analysis of Failed Bank Reviews*. A recommendation in that report noted the need for examiner training sessions to reinforce the importance of, among other areas, escalating supervisory actions based on management's failure to resolve examination comments. In the case of Whitman, management's failure to resolve recurring weaknesses demonstrated the need for escalating supervisory actions.

This review resulted in a unique observation regarding the approach to premembership examinations. Whitman satisfied the eligible bank criteria and did not require a premembership examination. During its first examination in 2005, FRB San Francisco identified regulatory violations and internal control deficiencies, which resulted in an enforcement action and downgrades to the bank's asset quality and management component ratings. Several of the deficiencies had been identified by prior regulators. We did not conclude that the lack of a premembership examination contributed to Whitman's failure. However, in our opinion, the deficiencies and regulatory violations that FRB San Francisco identified during its initial examination evidence the need to revisit the approach to premembership examinations.

Lessons Learned

We believe that Whitman's failure offers lessons learned that can inform future supervision of banks with similar characteristics and circumstances. Whitman's failure illustrates the risks associated with

1. unresolved corporate governance weaknesses, including ineffective board of directors' oversight, a dominant CEO and senior management, a weak internal audit program, and an internal audit function that lacks independence

2. pursuing a rapid growth strategy in a new business activity, particularly when it is outside the bank's traditional market area

3. high concentrations in CRE and concentrations of credit to individual borrowers without an adequate credit risk management program

Furthermore, this failure highlights

1. the need for close scrutiny and immediate and forceful supervisory action when examiners detect significant and pervasive corporate governance deficiencies and/or increased credit risk exposure coupled with a lack of appropriate controls

2. the importance of examiners taking appropriate supervisory action to correct early indicators of internal control weaknesses and holding management accountable for failing to address fundamental and persistent weaknesses

Although Whitman did not require a premembership examination, FRB San Francisco identified significant internal control and corporate governance weaknesses during its first examination of Whitman in 2005. While we did not conclude that this situation caused the failure, we believe that it indicates the need to revisit the supervisory approach to premembership examinations.

Recommendation

We recommend that the Director of the Division of Banking Supervision and Regulation

1. Review the supervisory approach for premembership examinations and determine whether enhancements to the current approach outlined in SR Letter 11-2 are appropriate

Management's Response

In the response dated March 11, 2013, the Division Director of BS&R acknowledged the conclusions and lessons learned in the report. Specifically, the Division Director noted, "Whitman's failure illustrates the risks associated with aggressive growth and high concentrations of credit and the importance of establishing appropriate corporate governance, internal controls, and credit risk management practices. It further illustrates the need for scrutiny and forceful supervisory action where significant and unresolved weaknesses exist."

Additionally, the Division Director concluded, "Because some of Whitman's weaknesses were identified at the first examination of the bank after it became a state member bank, BS&R staff will follow up on the report's recommendation to review the supervisory approach for pre-membership examinations and determine whether enhancements to the current approach outlined in SR Letter 11-2 are needed."

OIG Comment

In our opinion, the actions described by the Division Director are responsive to our recommendation. The recommendation will remain open pending follow-up on the actions to ensure that the recommendation is fully addressed.

Appendix A
Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)

A valuation reserve established and maintained by charges against the bank'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. The reserve must be sufficient to absorb probable losses inherent in the institution's loan and lease portfolio.

Call Reports

Reports of Condition and Income are commonly known as Call Reports. Every state member bank is required to file a consolidated Call Report normally as of the close of business on the last calendar day of each calendar quarter, i.e., the report date.

Cease-and-desist Order

A formal supervisory enforcement action against a financial institution or an institution-affiliated party that violates a law, rule, regulation, written commitment, or written agreement, or that is engaged in unsafe or unsound business practice. The order may require a financial institution or institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The provisions of a cease-and-desist order and the problems identified at the institution are more severe than those of a written agreement, which is the least severe type of formal supervisory enforcement action.

Classified Assets

Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Classified assets are 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 its continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE) Loans

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.

Commitment Letter

An informal supervisory action generally used to correct minor problems or to request periodic reports addressing certain aspects of a bank's operations. Commitment letters may be used when there are no significant violations of law or unsafe or unsound practices and when the bank and its officers are expected to cooperate and comply.

Concentration

A significant amount of direct or indirect extensions of credit and contingent obligations that possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations.

Construction and Land Development Loans; also known as Construction, Land, and Land Development Loans

A subset of commercial real estate loans, secured by real estate (including nonagricultural vacant land), for (1) onsite construction of industrial, commercial, residential, or farm buildings and (2) land development, including preconstruction preparatory work such as laying sewer and water pipes.

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 onsite bank examination. Formal enforcement actions consist of written agreements, temporary cease-and-desist orders, cease-and-desist orders, prohibition and removal orders, and PCA directives; informal enforcement actions include commitment letters, board resolutions, and memoranda of understanding.

Liquidity

The ability to accommodate decreases in liabilities and 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.

Matters Requiring Board Attention

A page or section of the examination report used to inform the bank's board of directors of the most significant issues identified during the examination.

Nonaccrual

Nonaccrual status means loans with overdue interest payments and uncertainty regarding collection of principal; no interest income is recognized on these loans for reporting purposes.

Noncore Funding

Funding that can be very sensitive to changes in interest rates, such as brokered deposits, certificates of deposit greater than $100,000, federal funds purchased, and borrowed money.

Other Real Estate Owned (OREO)

Real estate acquired by a lender through foreclosure in satisfaction of a debt. A loan secured by foreclosed real estate is counted as a nonperforming loan in reporting loan quality in Call Reports to bank supervisory agencies.

Prompt Corrective Action (PCA)

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 when an institution becomes financially troubled, action is taken to resolve the problems of the institution and incur the least possible long-term loss to the DIF. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

Supervision and Regulation (SR) Letters

SR letters are issued by the Federal Reserve Board's Division of Banking Supervision and Regulation. They address significant policy and procedural matters of continuing relevance to the Federal Reserve Board's supervisory effort. SR letters are for distribution to supervised institutions as well as Reserve Banks.

Tier 1 Capital

The sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

Underwriting

Detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history; and the lender's evaluation of the borrower's credit needs and ability to pay.

Written Agreement

A formal supervisory enforcement action that is generally issued when a financial or an institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Federal Reserve Board or a Federal Reserve Bank that may require the financial institution or the institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. This enforcement action is the least severe of the formal enforcement actions.

Appendix B
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:

adequacy of ***c**apital*
quality of ***a**ssets*
capability of ***m**anagement*
quality and level of ***e**arnings*
adequacy of ***l**iquidity*
***s**ensitivity* to market risk

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. The highest rating, 1, indicates the strongest performance and risk management practices and the least degree of supervisory concern, while 5 indicates the weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definitions

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 their 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. As there are no material supervisory concerns, the supervisory response is informal and limited.

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 board of directors and management are not satisfactorily addressing or resolving weaknesses and problems. Financial institutions in this group generally are not capable of withstanding business fluctuations and may be significantly noncompliant with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required; 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 for these 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 C
Management's Response

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: March 11, 2013

To: Michael P. VanHuysen, Acting Associate Inspector General for Inspections and Evaluations and Senior OIG Manager

From: Michael S. Gibson, Director, Banking Supervision and Regulation ***/signed/***

Subject: In-Depth Review of the Failure of Bank of Whitman

The staff of the Division of Banking Supervision and Regulation has reviewed the draft In-Depth Review of the Failure of Bank of Whitman (Whitman), Colfax, Washington, prepared by the Office of Inspector General. The report finds that Whitman failed, among other reasons, because of inadequate corporate governance and risk management over internal controls and expansion activities, as well as a buildup of concentrations of credit that were subsequently negatively impacted by declining market conditions. Whitman was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco) under delegated authority from the Board.

The report notes that FRB San Francisco complied with the Federal Reserve pre-membership requirements when Whitman converted to a state member bank in 2004 and examination frequency guidelines for the time frame we reviewed, 2005 through 2011, and that the Reserve Bank conducted regular offsite monitoring. Further, the reported noted that FRB San Francisco and the State conducted seven full scope examinations and three target examinations during the review period and executed three enforcement actions. However, the report concludes that FRB San Francisco missed some opportunities to take early and more decisive action to address the bank's weaknesses.

Banking Supervision and Regulation (BS&R) staff acknowledges the conclusions and lessons learned in the report. Whitman's failure illustrates the risks associated with aggressive growth and high concentrations of credit and the importance of establishing appropriate corporate governance, internal controls, and credit risk management practices. It further illustrates the need for scrutiny and forceful supervisory action where significant and unresolved weaknesses exist.

Because some of Whitman's weaknesses were identified at the first examination of the bank after it became a state member bank, BS&R staff will follow up on the report's recommendation to review the supervisory approach for pre-membership examinations and determine whether enhancements to the current approach outlined in SR Letter 11-2 are needed.

Office of Inspector General
Board of Governors of the Federal Reserve System
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