Board of Governors of the Federal Reserve System

Material Loss Review of First Community Bank

Office of Inspector General

August 2011

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

OFFICE OF INSPECTOR GENERAL

August 23, 2011

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Mr. Parkinson:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of First Community Bank (First Community). Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. The FDI Act requires that we

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

First Community was supervised by the Federal Reserve Bank of Kansas City (FRB Kansas City), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the State of New Mexico Financial Institutions Division (State). The State closed First Community on January 28, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. On February 24, 2011, the FDIC Inspector General notified us that First Community's failure would result in an estimated loss to the DIF of $260 million, or 10.6 percent of the bank's $2.46 billion in total assets.

First Community failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which resulted in a commercial real estate (CRE) loan concentration, particularly in construction, land, and land development (CLD) loans. The bank expanded into new markets by merging with multiple banks between 2001 and 2007. This strategy resulted in the bank developing significant concentrations in CRE and CLD loans that made First Community particularly vulnerable to real estate market declines. The Board of Directors' and management's failure to adequately manage the bank's CRE and CLD credit risk, coupled with weakening real estate markets, led to rapid asset quality deterioration. Mounting losses depleted the bank's earnings and eroded capital, which prompted the State to close First Community and appoint the FDIC as receiver on January 28, 2011.

With respect to supervision, FRB Kansas City complied with the examination frequency guidelines for the timeframe we reviewed, 2005 through 2011, and conducted regular off-site monitoring. During this period, FRB Kansas City and the State conducted six full scope examinations, five target examinations, and one visitation; executed three enforcement actions; and implemented the applicable PCA provisions.

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 Kansas City's supervision of First Community revealed that FRB Kansas City identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

We believe that examiners should have held bank management accountable for failing to develop and implement appropriate CRE risk management practices in a timely manner. Examiners stated in 2005 and 2006 examination reports that CRE lending was "the bank's strategic niche." In January 2007, the Federal Reserve Board issued Supervision and Regulation Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. In an August 2007 examination report, examiners noted that First Community's management was slow to develop and implement a program to manage the bank's CRE concentration risk, yet the bank received a CAMELS composite 2 rating, and all components were rated 2. During a subsequent June 2008 joint full scope examination and CRE target review, examiners noted asset quality deterioration and credit risk management weaknesses that resulted in an MOU and a downgrade to the bank's CAMELS composite rating. Despite this and the examiners' warning that the bank's large concentration of CLD loans in deteriorating markets heightened the risk to capital, FRB Kansas City deemed the bank's CRE risk assessment program generally adequate. In 2009, further asset quality deterioration resulted in a Written Agreement and additional CAMELS composite and component rating downgrades. In August 2009, examiners criticized management for (1) not controlling the risks associated with the bank's high CRE concentration; (2) not fully and expeditiously implementing CRE risk management practices; and (3) failing to provide sufficient oversight of the lending function. In our opinion, First Community's high concentration in CRE and CLD loans warranted stronger criticism during the August 2007 examination, potentially including component rating downgrades.

Finally, in our opinion, the bank's insider board and dominant Chief Executive Officer (CEO) operating model also warranted more supervisory criticism prior to the August 2009 examination. While FRB Kansas City criticized the bank's insider board and dominant CEO during a January 2009 examination, the August 2009 examination was the first examination to attribute First Community's deteriorating financial condition, in part, to its corporate governance model. The Federal Reserve System's *Commercial Bank Examination Manual* highlights the importance of bank director independence to appropriately manage the bank's affairs. In this situation, we believe that the bank's dominant CEO and insider board contributed to the bank's continued pursuit of an aggressive growth strategy and its failure to adapt to changing business conditions.

While we believe that FRB Kansas City had opportunities for earlier and more forceful supervisory action, it is not possible for us to predict the effectiveness or impact of any corrective measures that might have been taken by the bank. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected First Community's financial deterioration or the ultimate cost to the DIF.

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that First Community's failure highlights several lessons learned that can be applied when supervising banks with similar characteristics. In our opinion, banks with a dominant CEO, an aggressive growth strategy, and high CRE and CLD loan concentrations require heightened supervisory attention. In particular, First Community's failure illustrates (1) the potential for a dominant CEO coupled with an insider board to be slow to react to recent regulatory guidance and dynamic market conditions; (2) the risks associated with the use of mergers to implement an aggressive growth strategy to expand into new markets; and (3) the importance of timely implementing a robust credit risk assessment program designed to identify and control CRE and CLD concentrations.

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

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

Sincerely,

Anthony J. Castaldo

Anthony J. Castaldo
Associate Inspector General
for Inspections and Evaluations

cc: Chairman Ben S. Bernanke
Vice Chair Janet L. Yellen
Governor Daniel K. Tarullo
Governor Elizabeth A. Duke
Governor Sarah Bloom Raskin
Mr. Kevin Moore

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Background

First Community Bank (First Community) was established in Taos, New Mexico, in 1922 and became a state member bank in 1938. In 1988, the bank established a parent holding company, First State Bancorporation.[1] First Community was supervised by the Federal Reserve Bank of Kansas City (FRB Kansas City), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the State of New Mexico Financial Institutions Division (State). The bank's total assets increased from $830 million in 2001 to $3.4 billion by the end of 2007 because of the bank's aggressive growth strategy and expansion of its commercial real estate (CRE) lending activities. By July 2007, First Community had 65 branches throughout four states: New Mexico, Colorado, Utah, and Arizona.

The State closed First Community on January 28, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that First Community's failure would result in a $260 million loss to the Deposit Insurance Fund (DIF), or 10.6 percent of the bank's $2.46 billion in total assets at closing. On February 24, 2011, we received notice of the FDIC determination that First Community's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act, as amended (FDI Act), a material loss to the DIF is defined as any estimated loss in excess of $200 million.[2]

Objectives, Scope, and Methodology

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

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

To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Kansas City, the State, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by First Community, examination reports issued from 2005 through 2011, examination work papers prepared by FRB Kansas City and the State, and relevant FDIC documents. Appendixes at the end of this report contain a glossary of key banking and regulatory terms and a description of the CAMELS rating

[1] In November 1993, First Community's holding company made its first public offering of its stock.

[2] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, enacted on July 21, 2010, the $200 million materiality threshold applies if the loss occurred during the period January 1, 2010, through December 31, 2011. Section 38(k) of the FDI Act had previously defined a material loss to the DIF as the greater of $25 million or 2 percent of the institution's total assets.

system.[3] We conducted our fieldwork from February 2011 through July 2011 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

First Community failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which resulted in a CRE loan concentration, particularly in construction, land, and land development (CLD) loans.[4] The bank expanded into new markets by merging with multiple banks between 2001 and 2007. This strategy resulted in the bank developing significant concentrations in CRE and CLD loans that made First Community particularly vulnerable to real estate market declines. The Board of Directors' and management's failure to adequately manage the bank's CRE and CLD credit risk, coupled with weakening real estate markets, led to rapid asset quality deterioration. Mounting losses depleted the bank's earnings and eroded capital, which prompted the State to close First Community and appoint the FDIC as receiver on January 28, 2011.

Dominant Chief Executive Officer and "Inside" Board of Directors

First Community's Chief Executive Officer (CEO) played a dominant role in developing the bank's growth strategy and CRE focus.[5] During First Community's growth period from 2001 to 2007 (shown in Chart 1 on the next page), the bank's Board of Directors consisted solely of "inside directors" who served as senior management officials at the bank. The CBEM highlights the importance of diversification on corporate boards and director independence to effectively manage a bank's affairs. In our opinion, the bank's insider board and dominant CEO were fundamental weaknesses that allowed the CEO to determine the strategic direction for the institution without input from independent directors.[6]

Aggressive Growth Strategy

To realize its growth objectives, First Community pursued a strategy that involved multiple bank mergers between 2001 and 2007. As shown in Chart 1, the bank's total assets more than quadrupled from $830 million in 2001 to $3.4 billion by year-end 2007. In 2002, First Community merged with First Community Industrial Bank of Denver, Colorado, which had total assets of $413 million. This merger resulted in a 68 percent annual growth rate in total assets and enabled First Community to expand into Colorado and Utah markets. Over the next three years, the bank grew by 55 percent as total assets increased to over $2 billion by 2005. In 2006, First Community continued to grow by merging with two New Mexico banks, AccessBank, with

[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. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

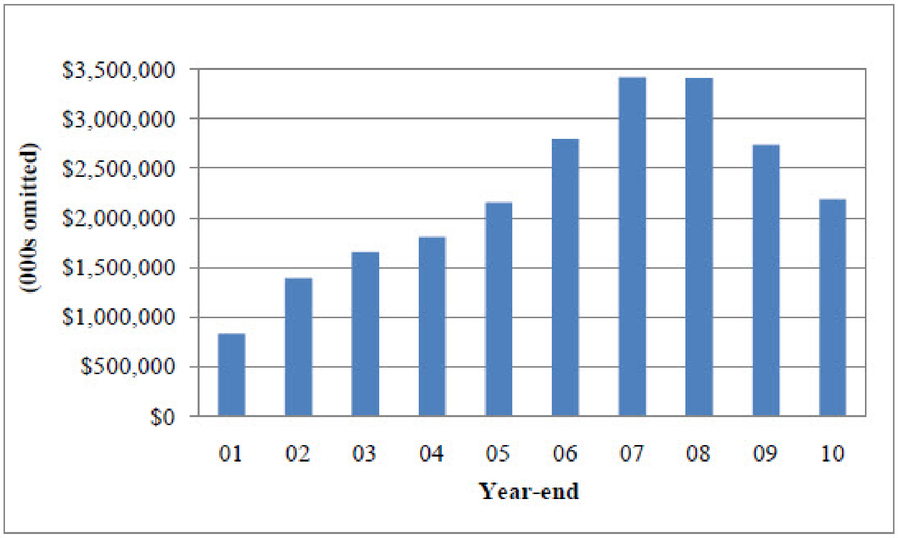
[4] CLD loans are a subset of CRE loans that provide funding for acquiring and developing land for future development and/or construction and provide interim financing for residential or commercial structures.

[5] The bank's CEO also served as chairman of First Community's Board of Directors.

[6] First State Bancorporation did have independent directors; however, the holding company did not hold board meetings jointly with the bank until 2009.

total assets of $366 million, and Ranchers Banks, which had total assets of $111 million. In 2007, First Community completed a merger with Heritage Bank of Louisville, Colorado, with total assets of $449 million. By 2007, the bank's total assets peaked at $3.4 billion.

Chart 1: Total Assets



Aggressive Loan Portfolio Growth Resulted in High CRE and CLD Loan Concentrations

As shown in Chart 2 on the next page, the bank's total loans increased 87 percent from $1.5 billion in 2005 to $2.8 billion in 2008 primarily because of the bank's merger activity. In addition to the CRE and CLD loan portfolio growth resulting from the mergers, the bank continued to increase its CRE and CLD lending activities. By 2007, CRE and CLD loans comprised more than 74 percent of First Community's loan portfolio. Despite management's subsequent efforts to diversify the loan portfolio, CRE and CLD remained the predominant segments in the portfolio.

Chart 2: Total Loans

As shown in Chart 3a, First Community's CRE loan concentration as a percentage of total risk-based capital increased from 568 percent in 2005 to 735 percent in 2008 and exceeded its peer group average from 2005 through 2010.[7] As illustrated in Chart 3b, the bank's CLD loan concentration also consistently exceeded its peer group averages and increased from 199 percent in 2005 to 321 percent in 2008. In 2009 and 2010, the bank's declining capital caused CRE and CLD concentration levels to spike further.[8] In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. CLD concentrations are particularly risky because the developer's capacity to repay the loan is typically subject to the success of the underlying construction project.

[7] First Community was in two peer groups from 2005 to 2010. Peer group 1 consisted of all insured commercial banks having assets of $3 billion and more, and peer group 2 consisted of all insured commercial banks having assets between $1 billion and $3 billion. First Community was in peer group 2 in 2005, 2006, 2009, and 2010 and in group 1 during 2007 and 2008.

[8] According to the Federal Reserve Board's Supervision and Regulation Letter 07-1 (issued in January 2007), *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported loans for construction, land development, and other land 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 3a: Total CRE Loan Concentration

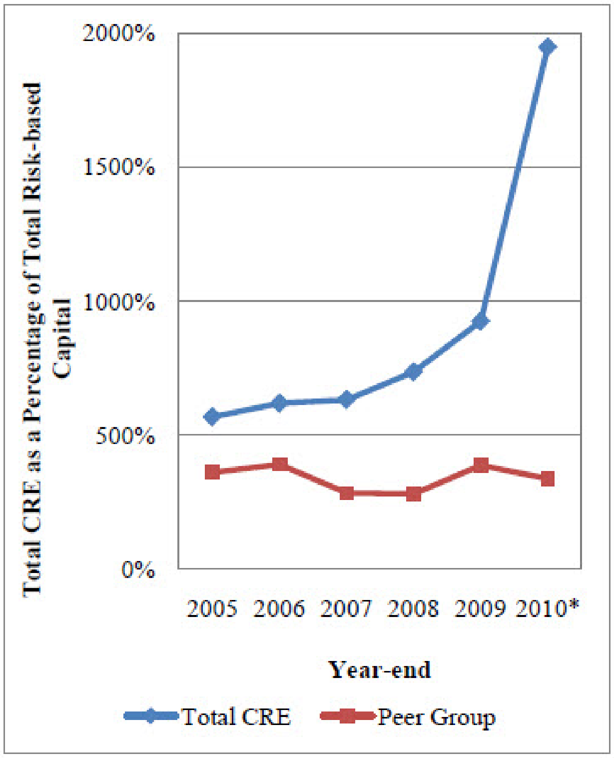
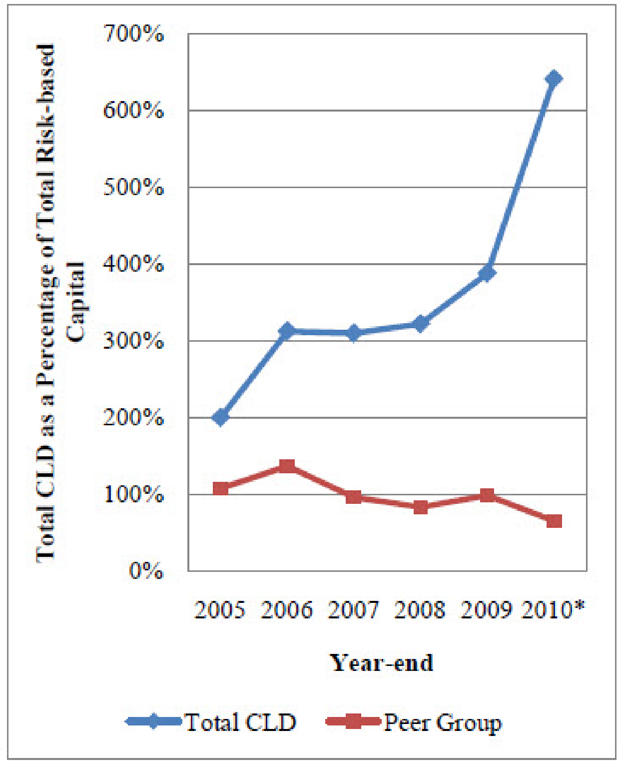


Chart 3b: Total CLD Loan Concentration



***Total CRE and CLD concentrations are as of 09/30/2010.**

Board of Directors and Management Failed to Manage the Bank's Concentration Risk

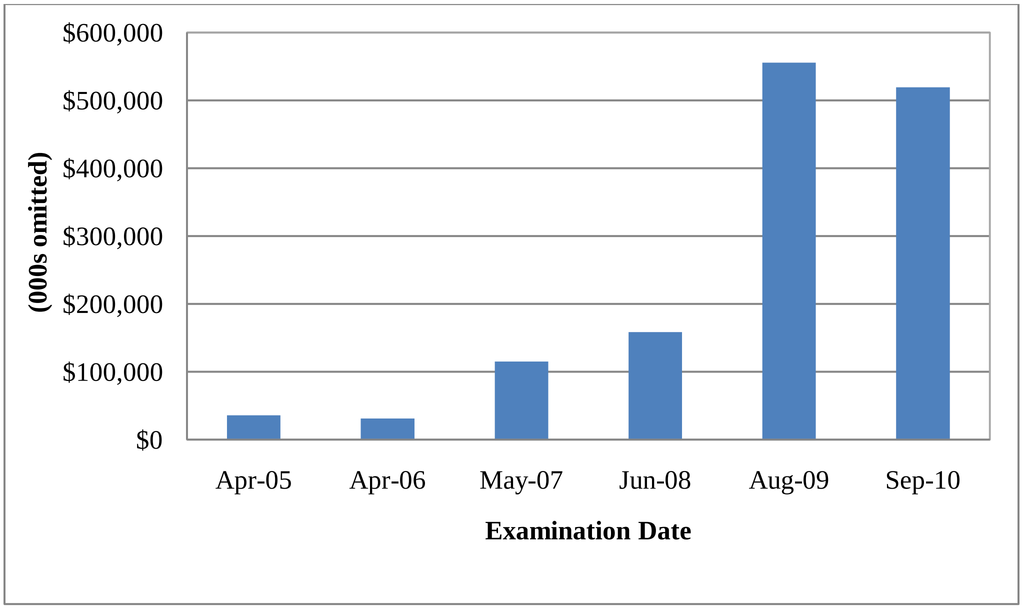
According to examiners, the Board of Directors and management were slow to implement a program that effectively identified, monitored, and controlled the bank's CRE and CLD concentration risk. Even though the bank's CRE and CLD concentrations exceeded the guidelines described in Supervision and Regulation (SR) Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, management failed to fully and expeditiously implement the CRE risk management practices set forth in the SR letter. In addition, examiners stated that management did not (1) effectively manage the growth or identify weaknesses in policies and procedures; (2) enforce sound credit management; and (3) adapt the bank's business strategy following initial signs of real estate market declines. The absence of appropriate risk management practices further increased First Community's vulnerability to declines in the real estate market.

In June 2008, FRB Kansas City concluded that the bank's CRE concentration risk assessment program was generally adequate, although examiners noted the need for enhanced management reporting information. By year-end 2008, First Community's credit risk management deficiencies became more evident based on deterioration in the bank's CRE and CLD loan portfolios. Examiners stated that weak credit underwriting, insufficient managerial oversight, a production-driven lending culture, expansion into unfamiliar markets, and improper risk diversification strategies resulted in a significant increase in the level of adversely classified assets.

Loan Portfolio Losses and Provision Expenses Eroded Capital

Declining economic conditions in the bank's key market areas resulted in significant asset quality deterioration. As shown in Chart 5, First Community's classified assets increased substantially from $32 million in 2006 to $116 million in 2007. Classified assets continued to increase in subsequent years as a result of real estate market declines: between 2007 and 2009, the bank's classified assets increased 381 percent from $116 million to $558 million.

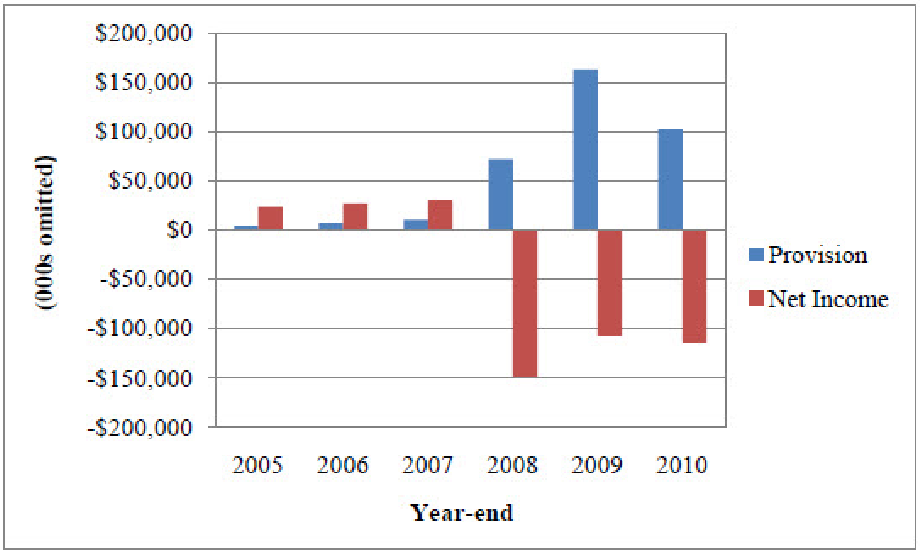
Chart 5: Classified Assets



The growth in classified assets required corresponding increases in First Community's provision expense. As shown in Chart 6 on page 15, the 2008 provision expense of $72 million, coupled with goodwill impairments of $126 million, depleted the bank's earnings by contributing to a net loss of $149 million at year-end 2008.[9] In 2009 and 2010, First Community continued to have growth in classified assets, resulting in high provision expenses—$163 million and $102 million, respectively. Accordingly, the bank experienced large losses of $108 million in 2009 and $115 million in 2010, which significantly eroded First Community's capital.

[9] Goodwill is an intangible asset shown on an institution's balance sheet and is often created through acquisitions. The amount of goodwill is the difference in the asset's fair market value and the price paid at the time of acquisition. The goodwill impairments acknowledged the bank's declining fair market value.

Chart 6: Impact of Provision Expense on Earnings



FRB Kansas City implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled financial institutions. In April 2009, FRB Kansas City notified First Community that the bank fell from *well capitalized* to *adequately capitalized* under the PCA guidelines, due to the large loss recognized in 2008. In June 2009, the bank sold Colorado branch locations, and a gain from the sale resulted in the bank returning to *well capitalized* status.

In November 2009, FRB Kansas City notified the bank it had become *adequately capitalized* as a result of further losses. First Community's financial condition continued to deteriorate; and in May 2010, FRB Kansas City advised the bank that it had become *undercapitalized*, which resulted in FRB Kansas City requiring the bank to submit an acceptable capital restoration plan. The bank submitted an acceptable capital restoration plan in June 2010. Nevertheless, rapidly declining asset quality and mounting losses put additional strain on First Community's capital, and FRB Kansas City notified the bank of its *significantly undercapitalized* status in July 2010. In August 2010, the Federal Reserve Board issued a PCA Directive that required First Community to (1) raise additional capital to achieve the *adequately capitalized* PCA designation or (2) be acquired by or merge with another depository institution. In November 2010, FRB Kansas City deemed the bank *critically undercapitalized*. First Community failed to comply with the PCA Directive, and the State closed the bank on January 28, 2011.

Supervision of First Community Bank

FRB Kansas City complied with the examination frequency guidelines for the timeframe we reviewed, 2005 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Kansas City and the State conducted six full scope examinations, five target examinations, and one visitation; executed three enforcement actions—a Memorandum of Understanding (MOU), a Written Agreement, and a PCA Directive; and implemented the applicable provisions of PCA.

As shown in Table 1 on the next page, the bank received CAMELS composite 2 (satisfactory) ratings from 2005 to January 2008. A June 2008 full scope examination downgraded First Community's CAMELS composite rating to 3 (fair) and double downgraded the earnings component rating to 4. As a result, First Community entered into an MOU in September 2008 to improve the deficiencies noted during the examination.[10]

During a subsequent target examination that began in January 2009, examiners noted First Community's unsatisfactory condition and downgraded the bank's CAMELS composite rating to 4 (marginal). All component ratings received downgrades, with liquidity and sensitivity to market risk each receiving double downgrades. In July 2009, First Community entered into a Written Agreement that addressed a variety of weaknesses.[10]

An August 2009 full scope examination further downgraded the bank's CAMELS composite rating to 5 (critically deficient). During the examination, all CAMELS components received 5 ratings, except sensitivity to market risk, which received a 4 rating. Examiners noted First Community's critically deficient condition and expressed concern about the bank's continued viability.

A subsequent examination that began in April 2010 assigned the bank another CAMELS composite 5 rating, and all component ratings remained the same as the previous examination. The bank's PCA position fell to *significantly undercapitalized* in July 2010, and the Federal Reserve Board issued a PCA Directive in August 2010 that required First Community to become *adequately capitalized* or be acquired by, or merge with, another depository institution. A September 2010 full scope examination resulted in another CAMELS composite 5 rating, and all components received 5 ratings. The State closed First Community on January 28, 2011, and appointed the FDIC as receiver after the bank was unable to comply with the PCA Directive.

Our analysis of FRB Kansas City's supervision of First Community revealed that examiners identified the bank's fundamental weaknesses, including having high concentrations in CRE and CLD loans and having a dominant CEO and an insider Board of Directors, but did not take early and forceful supervisory action to address those weaknesses.

[10] First State Bancorporation also entered into the MOU, as well as the subsequent Written Agreement.

Table 1: First Community Supervisory Overview

Examination			Agency Conducting Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
4/4/2005	6/15/2005	Full	Joint	2	2	1	2	2	2	2	
11/1/2005	11/10/2005	Visitation	FRB	n/a							
12/12/2005	12/16/2005	Liquidity/ Market Risk Target	FRB	n/a							
4/3/2006	5/26/2006	Full	Joint	2	2	1	2	2	2	2	
5/14/2007	8/9/2007	Full	Joint	2	2	2	2	2	2	2	
11/26/2007	1/10/2008	Mortgage Target [a]	FRB	2	2	2	2	2	2	2	
6/2/2008	8/27/2008	Full	Joint	3	3	3	3	4	2	2	MOU
		CRE Target [b]	FRB	n/a							
1/26/2009	4/24/2009	Asset Quality Target	Joint	4	4	4	4	5	4	4	Written Agreement
8/3/2009	12/23/2009	Full	Joint [c]	5	5	5	5	5	5	4	
4/5/2010	7/22/2010	Asset Quality Target	Joint [c]	5	5	5	5	5	5	4	PCA Directive
9/13/2010	1/6/2011	Full	Joint [c]	5	5	5	5	5	5	5	

[a] Review of First Community's residential mortgage origination division, First Community Mortgage.
[b] FRB Kansas City's review of First Community's CRE, conducted in conjunction with the full scope examination.
[c] FDIC participated in this joint examination.

2005 Full Scope Examination Resulted in a CAMELS Composite 2 Rating

In April 2005, FRB Kansas City led a joint full scope examination that assigned the bank a CAMELS composite 2 rating. Examiners rated asset quality 1 (strong), and all other components received 2 ratings. The financial condition of the bank continued to be rated satisfactory because of the bank's positive financial performance during its expansion. The June 2005 examination report stated that oversight of First Community was effective and shared by the Boards of Directors of both the bank and the bank holding company. While First Community's loan portfolio had a large concentration of real estate loans, examiners noted that the concentration reflected "the bank's strategic niche" in the market.

According to examiners, the bank established new branch facilities and regional presidents in new markets and added a number of new staff to the loan operations in 2005. Examiners commented that the Board of Directors and management had no plans for additional mergers in the near-future because the bank needed to focus on (1) integrating and developing management; (2) effectively managing operational changes associated with the integrations; and (3) achieving deposit growth.

FRB Kansas City Conducted a Visitation in November 2005 and Initiated a Liquidity and Market Risk Review in December 2005

FRB Kansas City conducted a visitation in November 2005 to review and assess management's efforts toward developing First Community's compliance program. Examiners determined that management expended adequate resources to enhance the program.

In December 2005, FRB Kansas City requested that examiners from the Federal Reserve Bank of Chicago (FRB Chicago), which had experience examining treasury operations at large community banks, conduct an independent assessment of the bank's liquidity and market risk management practices. FRB Chicago conducted the review and deemed the bank's liquidity risk management "satisfactory" and market risk management "fair." FRB Chicago examiners recommended further enhancements to the bank's liquidity risk management practices and also required that management fulfill the risk management requirements of SR Letter 96-13, *Joint Policy Statement on Interest Rate Risk*.[11]

2006 Joint Full Scope Examination Resulted in Another CAMELS Composite 2 Rating

The State led a joint full scope examination that began in April 2006 that preserved the bank's prior CAMELS composite and component ratings. In the May 2006 examination report, examiners observed that First Community's aggressive asset growth in the previous three years required an increased use of non-core funding sources, primarily Federal Home Loan Bank borrowings. However, examiners noted that mergers with AccessBank and Ranchers Banks in January 2006 boosted First Community's liquidity position.

Examiners preserved the bank's strong asset quality rating and highlighted the bank's strong credit administration, loan documentation practices, and accurate loan grading system. First Community's classified assets decreased from $36 million at the 2005 examination to $32 million, despite a $148 million increase in total loans in 2005. According to examiners, the bank's loan growth mainly occurred in real estate construction and development loans, and CRE lending remained "the bank's strategic niche." Examiners also noted that capital was satisfactory in relation to First Community's expansion and risk profile.

[11] SR Letter 96-13 provides guidance to banks on prudent interest rate risk management principles, which include appropriate board and senior management oversight and a comprehensive risk management process that effectively identifies, measures, monitors, and controls risk.

March 2007 Heritage Bank Merger

First Community merged with Colorado based Heritage Bank on March 1, 2007. Heritage was a state member bank with $449 million in total assets, operating 13 offices in Colorado. FRB Kansas City had examined Heritage as of March 2006 and assigned the bank a CAMELS composite 3 rating because its financial condition had declined from the previous examination due to persistently weak earnings hampered by high levels of real estate owned, high overhead expenses, and increased funding costs. FRB Kansas City had conducted a target review in November 2006, focusing on asset quality and the allowance for loan and lease losses (ALLL), but did not assign ratings. Based on the Federal Reserve Board and FRB Kansas City's assessment of the merger application and First Community's pro-forma financial condition resulting from the merger, it was determined that First Community would remain in satisfactory condition following the merger.[12]

In hindsight, we believe that FRB Kansas City should have required First Community's management to demonstrate its ability to successfully integrate the institutions it had previously acquired outside the bank's traditional market area before it pursued additional mergers or acquisitions. In 2005, management asserted that the bank was not planning new acquisitions in the near-future, and management and the Board of Directors acknowledged the need to focus on developing existing management and organizational infrastructure within the bank's markets based on its recent expansion into new markets. However, in January 2006, First Community departed from this integration focus by merging with AccessBank and Ranchers Banks, and in March 2007, it merged with Heritage. These three mergers further increased First Community's total assets by more than $900 million and directly contradicted management's previously stated intentions to refrain from further growth in the near future and to focus on integration.

May 2007 Joint Full Scope Examination Revealed Declining Asset Quality

A May 2007 joint full scope examination resulted in another CAMELS composite 2 rating. Asset quality was downgraded to 2 due to a significant increase in classified assets from $32 million to $116 million. Examiners attributed approximately 30 percent of First Community's classified loans to the March 2007 merger with Heritage Bank. FRB Kansas City also stated that the Colorado markets, primarily acquired during the Heritage merger, were declining because of the housing slump. Examiners noted management's plan to sell many of the problem assets acquired through the Heritage merger.

According to examiners, First Community's loan portfolio grew 34 percent in 2006 as the bank expanded into several new markets. The bank continued to have a high concentration in CRE loans, which represented 628 percent of total risk-based capital. Additionally, CLD loans (1) increased from 13 percent of total loans in 2004 to 37 percent by the first quarter 2007 and (2) accounted for 326 percent of total risk-based capital as of March 2007. Despite the bank's

[12] FRB Kansas City was not required to conduct a pre-merger examination of Heritage because the guidance outlined in SR Letter 98-28, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*, applied to mergers with institutions that had not previously been examined by a Reserve Bank. Subsequently, SR Letter 98-28 was superseded by SR Letter 11-2, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*, but the pre-merger examination requirement remained the same.

highly concentrated loan portfolio and examiners' comments that management was slow to develop and implement a sound program to manage CRE loan concentration risk, FRB Kansas City did not downgrade the bank's CAMELS component rating for management.

The August 2007 examination report noted deficiencies identified during First Community's internal loan review in September 2006. The bank's loan review deemed credit administration satisfactory overall, but assessed credit administration at several branches as "needing improvement" and "unsatisfactory" due to a lack of (1) proper documentation and controls over construction loan inspections and draws and (2) proper approval and documentation of policy exceptions. Examiners noted substantial progress toward addressing the deficiencies, but warned that additional efforts were needed to ensure proper documentation and compliance.

The examination report noted that the bank's Board of Directors continued to be comprised exclusively of insiders and dominated by the bank CEO, but examiners commented that the Boards of Directors of the bank and the bank holding company effectively managed First Community's affairs.

Target Examination of First Community Mortgage Was Conducted in November 2007

In November 2007, FRB Kansas City conducted a target examination of First Community's mortgage division, First Community Mortgage (FCM), to assess FCM's mortgage loan origination risk exposure. The target examination retained the bank's previously issued CAMELS composite and component ratings. The January 2008 examination report described FCM's operations as sound and its risk management systems as satisfactory. Examiners stated that there were no supervisory issues identified during the review, but made several recommendations to further improve FCM's operations.

June 2008 Joint Full Scope Examination Resulted in a CAMELS Composite Downgrade and a Memorandum of Understanding

In June 2008, the State led a joint full scope examination that resulted in a CAMELS composite rating downgrade to 3. The earnings component was double-downgraded to 4, while the capital, asset quality, and management components all received single downgrades. FRB Kansas City examiners also conducted a CRE target review in conjunction with the full scope examination.

Examiners observed significant asset quality deterioration as classified assets increased 37 percent from $116 million during the 2007 examination to $159 million. Examiners concluded that the bank's credit risk management was weak and that credit risk was high and increasing. The bank's CRE and CLD loan concentrations remained high at 629 percent and 318 percent of total risk-based capital, respectively. Although examiners deemed First Community's CRE concentration risk assessment program adequate, examiners warned that the bank's large concentration of CLD loans in deteriorating markets heightened the risk to capital.

During the CRE target review, examiners learned that management had not developed sufficiently detailed CRE loan portfolio data until the fourth quarter of 2007. Examiners again highlighted management's slow response to modify the bank's overall business plan and credit strategy given signs of economic decline. Examiners also commented that the Board of Directors and senior management could have modified the bank's business plan if its CRE risk assessment program had been implemented before the bank pursued its growth strategy.

While the August 2008 examination report noted weakened residential real estate construction and development markets as a primary contributor to the bank's credit problems, examiners also attributed responsibility to the bank's management. Examiners described First Community's business model as "a rapidly growing real estate lender operating with minimally acceptable capital and loan loss reserves." Examiners criticized management for its (1) insufficient risk management processes; (2) failure to timely modify the bank's business model in a declining market condition; (3) concentration in CRE and CLD loans; (4) deviations from sound credit management; and (5) failure to augment the bank's capital. Examiners also questioned the bank's insider Board structure and effectiveness, while stating that inclusion of several outside directors on the bank holding company's Board of Directors mitigated those weaknesses.

FRB Kansas City, the State, and First Community executed an MOU in September 2008. The MOU addressed, among other things, weaknesses in the bank's Board of Directors and management oversight, asset quality improvement, the ALLL, capital and earnings plans, and the budget.

January 2009 Asset Quality Joint Target Examination Resulted in a CAMELS Composite Rating Downgrade and a Written Agreement

A joint asset quality target examination that began in January 2009 further downgraded the bank's CAMELS composite rating to 4. FRB Kansas City concluded that the bank was in *troubled condition*, and all CAMELS components received 4 ratings except earnings, which received 5.[13] During the examination, First Community's PCA designation fell from *well capitalized* to *adequately capitalized*, and the bank became subject to restrictions on brokered deposits.

Examiners noted that classified assets increased from $159 million to $422 million in eight months and attributed this significant asset quality deterioration to the bank's expansion into unfamiliar markets, a poorly designed and supervised loan officer incentive program, and weak underwriting practices that deviated from bank policy. In addition, examiners stated that insufficient risk diversification strategies resulted in a significant concentration within CRE loans; 58 percent of the bank's total loan portfolio consisted of non-owner occupied CRE loans. In addition, examiners highlighted the stress in the bank's Utah and Colorado markets. The April 2009 examination report stated that (1) the bank closed its Utah branches and exited that market and (2) management planned to further reduce expenses by selling an additional 20 branch locations in Colorado.

[13] As defined in section 225.71(d) of the Board's Regulation Y, a state member bank or holding company is in *troubled condition* if it (1) has a composite rating, determined at its most recent examination, of 4 or 5; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the bank's financial condition; or (3) is informed in writing by the Federal Reserve Board or Reserve Bank that it is in *troubled condition*.

Examiners criticized the Board of Directors' and management's deficient performance and inadequate risk management practices. Examiners stated that management disregarded warning signs identified during loan reviews of Utah and Colorado branches. Examiners described management as "surprised by an adverse chain of events" and "slow to recognize the root causes of problems." According to examiners, the CEO continued to dominate policy and strategic decisions, and the bank's Board of Directors lacked independence because it consisted of senior bank officers. Examiners commented that First Community pursued a rapid growth strategy without (1) sufficient risk management processes; (2) adequate loan policies; (3) effective controls over underwriting; (4) CRE concentration risk limits; and (5) a sufficient management information system. According to examiners, each of these factors contributed to the bank's declining asset quality. Examiners also criticized management for the bank's production-driven credit culture and management's "permissive" oversight of its lending staff. In July 2009, FRB Kansas City, the State, and the bank entered into a Written Agreement to address weaknesses identified during the examination.

August 2009 Joint Full Scope Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating

In August 2009, FRB Kansas City began a joint full scope examination that resulted in a CAMELS composite rating downgrade to 5. All CAMELS components received 5 ratings except the sensitivity to market risk component, which remained at 4. Examiners labeled First Community's condition "critically deficient" and expressed heightened concern over the bank's viability.

First Community's loan classifications increased $136 million in six months, or 32 percent, from $422 million to $558 million. Examiners noted that approximately 19 percent of the bank's assets were comprised of classified loans. The bank continued to have a significant concentration in CRE loans, which represented 546 percent of total risk-based capital. Examiners stated that the bank had little prospect for improving earnings in the foreseeable future because of rapidly declining asset quality.

The sale of First Community's Colorado branches temporarily returned the bank to *well capitalized* status in June 2009, but the bank became *adequately capitalized* in November 2009 due to further asset quality deterioration. Examiners stated that First Community's aggressive growth strategy resulted in CRE and CLD concentrations that required significant loan loss provisions, depleted the bank's earnings, and put its capital at risk. While acknowledging the bank's plan to raise capital by selling common stock, examiners expressed skepticism over the plan's likelihood to succeed.

Examiners considered management critically deficient because the Board of Directors and management did not (1) control the risks associated with the bank's high CRE concentration; (2) provide sufficient oversight of the lending function; (3) properly address and monitor a poorly designed loan officer incentive program; (4) fully and expeditiously implement the CRE risk management practices; (5) ensure and plan for sufficient liquidity; and (6) maintain reasonable capital. Examiners criticized the Board of Directors for allowing the CEO to dominate the affairs of the bank. Examiners indicated that as First Community grew and expanded its markets, the CEO did not effectively manage the growth or identify deficiencies in corporate governance and failed to timely adapt to changing business conditions. Examiners also found First Community's management information systems insufficient and stated that a lack of accurate information hampered informed and timely management decisions and actions.

April 2010 Asset Quality Target Examination Maintained First Community's CAMELS Composite Rating

In April 2010, FRB Kansas City conducted a joint target examination that resulted in another CAMELS composite 5 rating. All CAMELS component ratings remained the same, while the bank's PCA designation fell from *adequately capitalized* to *undercapitalized* during the examination. Examiners stated that the bank suffered a capital decline of $108 million from loan losses and emphasized the need for immediate capital assistance.

Asset quality deteriorated significantly, and classified assets continued to increase, presenting an imminent threat to First Community's capital and continued viability. Classified assets increased to $569 million and represented approximately 21 percent of the bank's assets. In addition, the bank continued to have a large CRE concentration despite a $384 million reduction in CRE loans since 2008. CRE loans accounted for 727 percent of total risk-based capital due to the bank's substantial capital declines. In the July 2010 examination report, examiners stated that management's past unsatisfactory supervision of lending practices and inadequate risk diversification led to the bank's critically deficient asset quality.

In July 2010, First Community's PCA designation dropped to *significantly undercapitalized*. In August 2010, the Federal Reserve Board issued a PCA Directive that directed First Community to (1) increase the bank's equity to return the bank to *adequately capitalized*; (2) enter into or close a contract to be acquired by another depository institution; or (3) take other necessary measures to make the bank *adequately capitalized*.

September 2010 Joint Full Scope Examination Resulted in Another CAMELS Composite 5 Rating

FRB Kansas City led a joint full scope examination that began in September 2010. First Community's CAMELS composite and all components received 5 ratings. Asset quality remained critically deficient and, according to examiners, presented an imminent threat to First Community's viability. The bank's classified assets remained high (approximately 20 percent of the total assets), and a high level of special mention loans, coupled with borrowers' declining financial conditions, signaled a continued declining trend in asset quality.

Further asset quality deterioration resulted in First Community becoming *critically undercapitalized* under PCA guidelines in November 2010, and examiners stated that, without immediate external financial assistance, "the bank will fail." Management was unable to raise capital, and the State closed the bank on January 28, 2011, and appointed the FDIC as receiver.

Conclusions and Lessons Learned

First Community failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which resulted in a CRE loan concentration, particularly in CLD loans. The bank expanded into new markets by merging with multiple banks between 2001 and 2007. This strategy resulted in the bank developing significant concentrations in CRE and CLD loans that made First Community particularly vulnerable to real estate market declines. The Board of Directors' and management's failure to adequately manage the bank's CRE and CLD credit risk, coupled with weakening real estate markets, led to rapid asset quality deterioration. Mounting losses depleted the bank's earnings and eroded capital, which prompted the State to close First Community and appoint the FDIC as receiver on January 28, 2011.

With respect to supervision, FRB Kansas City complied with the examination frequency guidelines for the timeframe we reviewed, 2005 through 2011, and conducted regular off-site monitoring. During this period, FRB Kansas City and the State conducted six full scope examinations, five target examinations, and one visitation; executed three enforcement actions; and implemented the applicable PCA provisions.

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 Kansas City's supervision of First Community revealed that FRB Kansas City identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

We believe that examiners should have held bank management accountable for failing to develop and implement appropriate CRE risk management practices in a timely manner. Examiners stated in the 2005 and 2006 examination reports that CRE lending was "the bank's strategic niche." In January 2007, the Federal Reserve Board issued SR Letter 07-01 concerning sound risk management practices for CRE concentrations. In the August 2007 examination report, examiners noted that First Community's management was slow to develop and implement a program to manage the bank's CRE concentration risk, yet the bank received a CAMELS composite 2 rating, and all components were rated 2. During a subsequent June 2008 joint full scope examination and CRE target review, examiners noted asset quality deterioration and credit risk management weaknesses that resulted in an MOU and a downgrade to the bank's CAMELS composite rating. Despite this and the examiners' warning that the bank's large concentration of CLD loans in deteriorating markets heightened the risk to capital, FRB Kansas City deemed the bank's CRE risk assessment program generally adequate. In 2009, further asset quality deterioration resulted in a Written Agreement and additional CAMELS composite and component rating downgrades. In August 2009, examiners criticized management for (1) not controlling the risks associated with the bank's high CRE concentration; (2) not fully and expeditiously implementing CRE risk management practices; and (3) failing to provide sufficient oversight of the lending function. In our opinion, First Community's high concentration in CRE and CLD loans warranted stronger criticism during the August 2007 examination, potentially including component rating downgrades.

Finally, in our opinion, the bank's insider board and dominant CEO operating model also warranted more supervisory criticism prior to the August 2009 examination. While FRB Kansas City criticized the bank's insider board and dominant CEO during a January 2009 examination, the August 2009 examination was the first examination to attribute First Community's deteriorating financial condition, in part, to its corporate governance model. The CBEM highlights the importance of bank director independence to appropriately manage the bank's affairs. In this situation, we believe that the bank's dominant CEO and insider board contributed to the bank's continued pursuit of an aggressive growth strategy and its failure to adapt to changing business conditions.

While we believe that FRB Kansas City had opportunities for earlier and more forceful supervisory action, it is not possible for us to predict the effectiveness or impact of any corrective measures that might have been taken by the bank. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected First Community's financial deterioration or the ultimate cost to the DIF.

Lessons Learned

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that First Community's failure highlights several lessons learned that can be applied when supervising banks with similar characteristics. In our opinion, banks with a dominant CEO, an aggressive growth strategy, and high CRE and CLD loan concentrations require heightened supervisory attention. In particular, First Community's failure illustrates (1) the potential for a dominant CEO coupled with an insider board to be slow to react to recent regulatory guidance and dynamic market conditions; (2) the risks associated with the use of mergers to implement an aggressive growth strategy to expand into new markets; and (3) the importance of timely implementing a robust credit risk assessment program designed to identify and control CRE and CLD concentrations.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response is included as Appendix 3. The Director concurred with our observations and lessons learned.

Appendixes

Appendix 1 – 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.

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.

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 (CLD) Loans; also known as Construction, Land, and Land Development (CLD) Loans

A subset of commercial real estate loans, secured by real estate (including non-agricultural vacant land), for (1) on-sight construction of industrial, commercial, residential, or farm buildings, and (2) land development, including pre-construction preparatory work such as laying sewer and water pipes.

Appendix 1 (continued)

Enforcement Actions

The Federal Reserve Board has a broad range of enforcement powers that include formal or informal enforcement actions that may be taken, typically after the completion of an on-site bank examination. Formal enforcement actions consist of Written Agreements, Temporary Cease-and-Desist Orders, Cease-and-Desist Orders, Prohibition and Removal Orders, and Prompt Corrective Action Directives; while informal enforcement actions include Commitments, Board Resolutions, and Memoranda of Understanding.

Goodwill

An intangible asset representing the difference between the purchase price of an asset and its fair market value. Goodwill is created when a bank pays a premium to acquire the assets of another bank in a take-over transaction.

Memorandum of Understanding (MOU)

A highly structured written, but informal, enforcement action that is signed by both the Reserve Bank and the member bank's Board of Directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management. There are three types of informal supervisory actions, and their order, by increasing severity, is commitment, board resolution, and MOU.

Non-core 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.

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

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.

Appendix 1 (continued)

Written Agreement

A formal supervisory enforcement action that is generally issued when a financial institution 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 2 – CAMELS Rating System

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

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

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2 (continued)

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of Banking Supervision and Regulation

Date:	August 17, 2011
To:	Mark Bialek, Inspector General
From:	Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***
Subject:	Material Loss Review of First Community Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of First Community Bank (First Community) of Taos, New Mexico, prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act, as amended. The report finds that First Community failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which resulted in a CRE loan concentration, particularly in CLD loans. The bank expanded into new markets by merging with multiple banks between 2001 and 2007. This strategy resulted in the bank developing high concentrations in CRE and CLD loans that made First Community particularly vulnerable to real estate market declines. The bank's Board of Directors' and management's failure to adequately manage the bank's CRE and CLD credit risk, coupled with weakening real estate markets, led to rapid asset quality deterioration. First Community was supervised by the Federal Reserve Bank of Kansas City (FRB Kansas City) under delegated authority from the Board.

FRB Kansas City complied with examination frequency guidelines for the time period that was reviewed, 2005 through 2011. During this time FRB Kansas City and the State conducted six full scope examinations, five targeted examinations, one visitation and conducted regular off-site monitoring. Further, supervisors executed three enforcement actions with the bank including a Memorandum of Understanding, a Written Agreement and a PCA Directive. The report recognizes that examiners identified key weaknesses that contributed to the bank's failure, but concludes that they did not act on opportunities to take earlier and more forceful supervisory action to address those weaknesses. The report states that it is not possible to determine whether alternative supervisory actions would have affected First Community's eventual decline.

Banking Supervision and Regulation staff concurs with the lessons learned in the report. Specifically, staff concurs with the report's observations that First Community's corporate governance structure, growth strategy, and CRE concentration warranted earlier, heightened supervisory attention. First Community's failure illustrates the importance of an independent bank board of directors that can react more quickly to regulatory expectations and market conditions. Moreover, the failure reinforces the need for a bank Board of Directors and management to understand the risks associated with the use of mergers to implement a growth strategy, particularly into new markets, and to have an effective risk management program in place to identify and control risks prior to pursuing growth.

Appendix 4 – Office of Inspector General Principal Contributors to This Report

Chie N. Hogenmiller, Project Leader and Senior Auditor

Leigh C. Pasborg, Auditor

Michael P. VanHuysen, Office of Inspector General Manager