Board of Governors of the Federal Reserve System

Material Loss Review of Barnes Banking Company

Office of Inspector General

Septembert 2010

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

OFFICE OF INSPECTOR GENERAL

September 1, 2010

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

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of Barnes Banking Company (Barnes). The FDI Act, as amended, requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) is material, which is currently defined as an estimated loss that exceeds $200 million. The FDI Act specifically requires that we

- review the institution's supervision, 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.

Barnes 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 Utah Department of Financial Institutions (State). The State closed Barnes in January 2010, and the Federal Deposit Insurance Corporation (FDIC) was appointed receiver. On March 3, 2010, the FDIC Inspector General notified us that Barnes' failure would result in an estimated loss to the DIF of $266.3 million, or 35.7 percent of the bank's $745.5 million in total assets.

Barnes failed because its Board of Directors and management did not effectively control the risks associated with the bank's aggressive growth strategy that led to a commercial real estate (CRE) loan concentration, particularly in residential construction, land, and land development (CLD) loans. The bank continued to originate CLD loans in 2007 and 2008, despite apparent weaknesses in Utah's real estate market and economy. The Board of Directors' and management's failure to effectively manage the resulting credit risk, in conjunction with declining market conditions, led to rapid asset quality deterioration. The resulting loan losses depleted earnings and eroded capital, which prompted the State to close Barnes.

FRB San Francisco complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During the period covered by our review, FRB San Francisco and the State conducted six full scope and two target examinations, executed two formal enforcement actions, and implemented all applicable provisions of PCA.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or the loss to the DIF. We believe that circumstances noted during a 2007 full scope examination—including repeated regulatory criticisms, declining market trends, and continuing growth of Barnes' CLD loan portfolio—provided FRB San Francisco an opportunity to pursue earlier, more forceful supervisory action. The examination cited several deficiencies regarding credit risk management, CRE concentrations monitoring, allowance for loan and lease losses methodology, and other critically important control processes. Additionally, examiners expressed concern over (1) Barnes' aggressive growth in CRE lending despite evidence of pronounced economic weaknesses within that market segment, and (2) "continued inaction" by the bank to resolve prior recommendations. We believe that other supervisory actions were warranted at the conclusion of the 2007 examination, such as downgrading CAMELS ratings or executing an informal enforcement action.

We also believe that a June 2008 credit risk target examination provided another opportunity to pursue earlier, more forceful supervisory action. The target examination provided strong evidence that Barnes' risk profile and financial condition had significantly changed, and examiners repeated prior criticisms. While FRB San Francisco subsequently performed a separate ratings assessment and downgraded several CAMELS ratings, an enforcement action was not executed until May 2009, nearly one year after the target examination was initiated. Further, although not explicitly required by supervisory guidance, examiners decided not to attend a full Board of Directors meeting following the target examination or assessment. Given the history of repeated recommendations, continued market deterioration, and additional growth of the bank's CLD loan portfolio, FRB San Francisco could have taken such actions as (1) conducting a formal exit meeting with the Board of Directors, (2) considering more aggressive ratings downgrades, or (3) executing an enforcement action.

While we believe that FRB San Francisco had opportunities for earlier and more forceful supervisory actions, it is not possible for us to predict the effectiveness or impact of any such actions. Therefore, we cannot evaluate the degree to which earlier or more forceful supervisory responses might have affected Barnes' financial deterioration or the ultimate cost to the DIF.

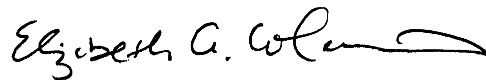
Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Barnes' failure points to valuable lessons learned that can be applied when supervising community banks with similar characteristics. In our opinion, Barnes' failure illustrates the need for close regulatory scrutiny and a forceful supervisory response when financial institutions increase credit risk exposure within a weakened or deteriorating market segment. Additionally, we believe that—although not explicitly required by supervisory guidance—examiner attendance at a Board of Directors

meeting can be a prudent supervisory practice when a target examination notes a significant change in the institution's financial condition and risk profile.

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

We appreciate the cooperation that we received from FRB San Francisco 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,



Elizabeth A. Coleman
Inspector General

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

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Background

Barnes Banking Company (Barnes), a community bank headquartered in Kaysville, Utah, was a state member bank of the Federal Reserve System. The bank was founded in 1891, and for the next 100 years was a single branch office bank with assets that gradually increased but stayed under $100 million. During the 1990s, Barnes began expanding its branch office network, and, by 1999, it had assets totaling over $340 million. By 2005, the bank had expanded to 10 branch offices in Utah, primarily within the Salt Lake City and Ogden metropolitan areas. In the past decade, Barnes pursued a growth strategy focused on commercial real estate (CRE) lending—specifically residential construction, land, and land development (CLD) lending—and the bank's total assets increased to nearly $1.0 billion by 2008. Barnes 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 Utah Department of Financial Institutions (State).

The State closed Barnes on January 15, 2010, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that the bank's failure would result in a $266.3 million loss to the Deposit Insurance Fund (DIF), or 35.7 percent of the bank's $745.5 million in total assets. In a letter dated March 3, 2010, the FDIC Inspector General advised us that the FDIC had determined that Barnes' failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, a material loss to the DIF is defined as any estimated loss in excess of $200 million.[1]

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* and relevant supervisory guidance. We interviewed staff and collected data from the Federal Reserve Board in Washington D.C., FRB San Francisco, and the State. We also reviewed correspondence, surveillance reports, enforcement actions, regulatory reports filed by Barnes, safety and soundness Reports of Examination (examination reports) issued between 2004 and 2009, and examination work papers prepared by FRB San Francisco. Appendixes at the end of this report contain a glossary that defines key banking and regulatory

[1] 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. Prior to the enactment of the Dodd-Frank Act, section 38(k) of the FDI Act defined a material loss to the DIF as the greater of $25 million or 2 percent of the institution's total assets.

terms and a description of the CAMELS rating system.[2] We conducted our fieldwork from March 2010 through June 2010, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

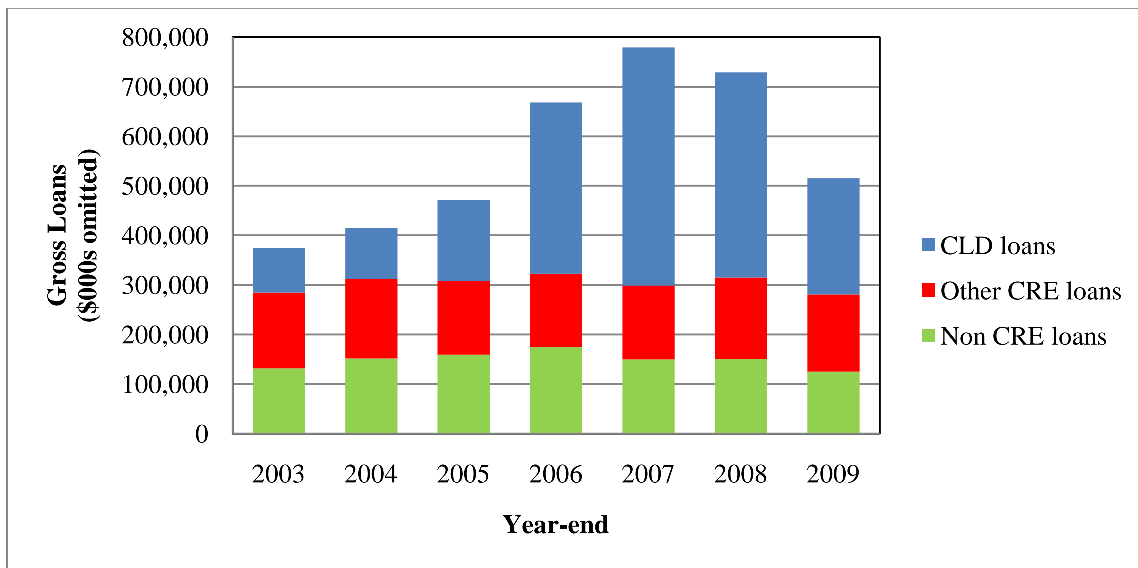
Cause of the Failure

Barnes failed because its Board of Directors and management did not effectively control the risks associated with the bank's aggressive growth strategy that led to a CRE loan concentration, particularly in CLD loans. The bank continued to originate CLD loans in 2007 and 2008, despite apparent weaknesses in Utah's real estate market and economy. The Board of Directors' and management's failure to effectively manage the resulting credit risk, in conjunction with declining market conditions, led to rapid asset quality deterioration. The resulting loan losses depleted earnings and eroded capital, which prompted the State to close Barnes and appoint the FDIC as receiver on January 15, 2010.

Growth Resulted in High CLD Loan Concentrations

Barnes pursued a growth strategy that focused on residential CLD lending. As shown in Chart 1, from 2003 through 2007, Barnes' total loan portfolio more than doubled, with most of the growth centered in CLD lending. The bank's CLD loan portfolio grew more than five-fold, from $90.1 million in 2003 to a peak of $479.8 million in 2007.

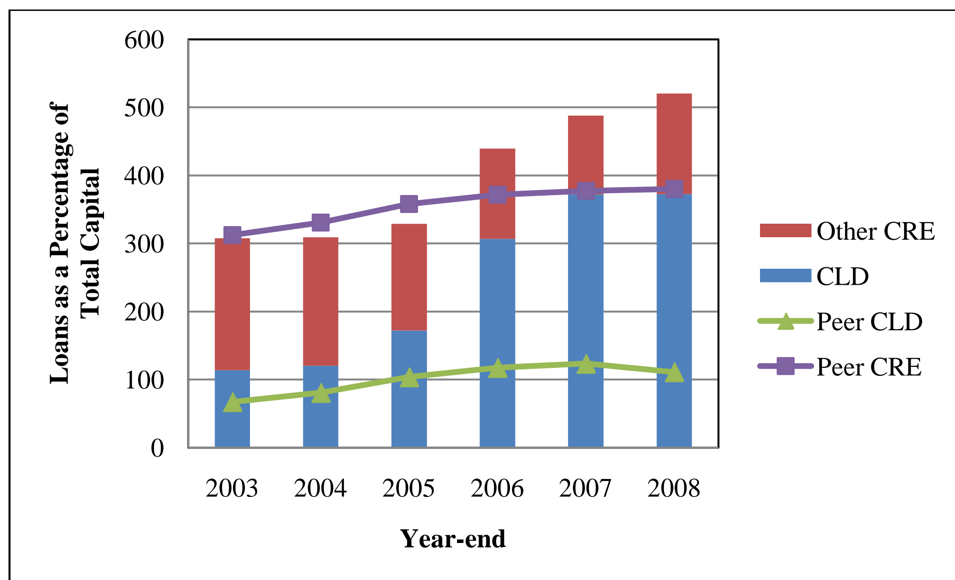
Chart 1: Loan Growth



[2] 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.

Barnes' aggressive growth led to high concentrations in CRE and CLD loans.[3] As shown in Chart 2, Barnes' CRE loans grew to over 500 percent of total capital by 2008, with CLD loans representing 373 percent of total capital. Barnes' CLD concentration was considerably higher than its peer group and more than tripled from 2004 through 2008, substantially increasing the bank's risk profile.[4]

Chart 2: CRE and CLD Loans as a Percentage of Total Capital



Barnes' Strategy Relied on a Strong Real Estate Market and Continued Positive Economic Conditions

The bank's growth strategy relied on Utah's historically high population growth, low unemployment, and steady home price appreciation. Utah consistently ranked as one of the fastest growing states over the past two decades. This robust population growth, in part, drove demand for new homes. Additionally, as shown in Chart 3, home prices in Utah appreciated over 10 percent annually from 2005 through 2007. These factors fueled a period of speculative building throughout Utah. During this time, Barnes provided speculative CLD loans to developers and home builders across the state.

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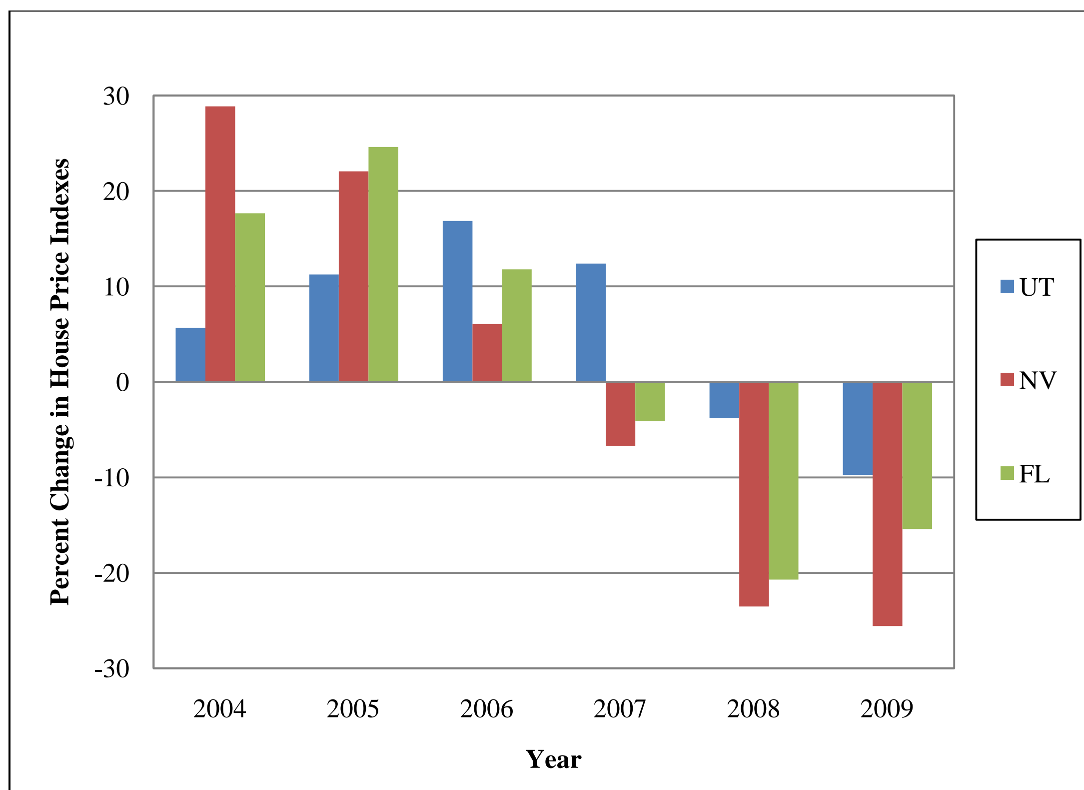
[3] According to the Federal Reserve Board's Supervision and Regulation Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate,* an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported CLD loans represent 100 percent or more 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.

[4] Barnes' peer group included all insured commercial banks having assets between $300 million and $1 billion.

Chart 3: Annual Percentage Changes in Home Price Appreciation for Select States



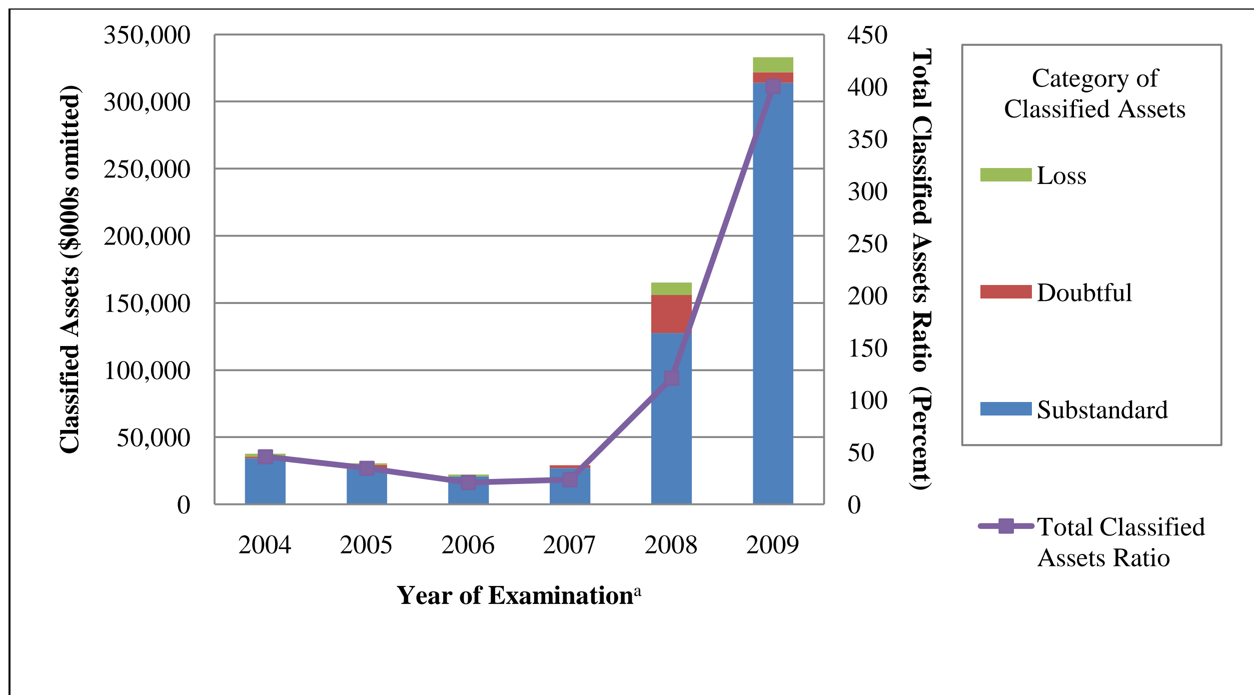
As illustrated in Chart 3, home prices in Utah continued to appreciate in 2007, unlike states such as Nevada and Florida, where once robust residential real estate markets experienced significant declines. However, Utah's real estate market showed signs of weakness in mid-2007, when new home sales registered a sharp decline. Subsequently, home builders' and developers' construction projects were delayed or abandoned as inventories of finished homes and vacant developed lots rose. As a result, the value of raw land and vacant developed lots dropped steeply. Furthermore, Utah's unemployment rate more than doubled over a three-year period, rising from 2.8 percent in 2007, to 6.6 percent in 2009, largely due to a 22.6 percent decrease in construction jobs.

Asset Quality Deterioration Driven by CLD Loans

The bank's high CLD loan concentration, coupled with the decline in Utah's real estate market, led to rapid asset quality deterioration in 2008 and 2009. Credit weaknesses in the bank's loan portfolio were driven by CLD loans, which accounted for approximately 81 percent of all classified assets in 2008. As shown in Chart 4, Barnes' classified assets increased from $29.0 million in 2007, to $332.9 million in 2009. Over the same period, the bank's total classified assets ratio rose from 23.6 percent to 400.1 percent. [5]

[5] Total classified assets ratio is the bank's total classified assets as a percentage of its Tier 1 capital plus the allowance for loan and lease losses.

Chart 4: Barnes' Classified Assets



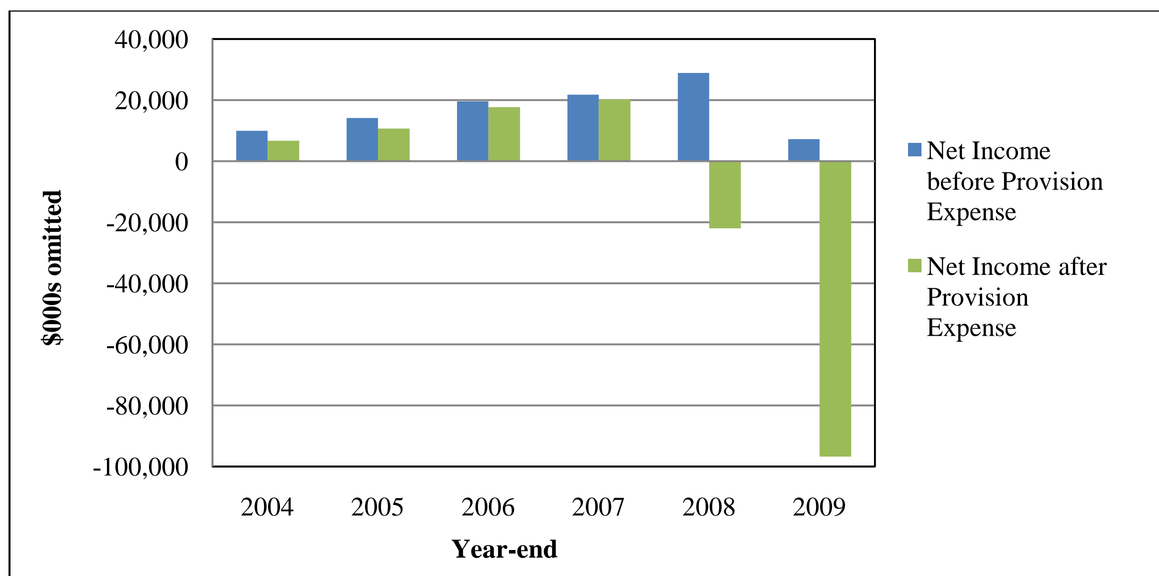
[a] Full scope examinations only.

Barnes' Board of Directors and management were slow to recognize weakening market conditions and continued to increase the bank's credit risk exposure by extending and renewing loans without requiring updated appraisals or performing adequate analyses of borrowers' and guarantors' financial conditions. Additionally, despite evidence of economic weaknesses in the CLD market segment, Barnes originated approximately $286 million of new CLD loans between May 2007 and September 2008. Examiners noted that management failed to effectively control the bank's increased credit risk exposure. By the third quarter of 2008, Barnes' loan portfolio included over 2,500 vacant developed lots, which, according to examiners, constituted more than a five-year supply. Furthermore, examiners noted that the Board of Directors and management did not have a "bank-wide strategic plan to reduce the bank's high levels of problem credits."

Loan Loss Provision Expenses Eroded Capital

The growth in classified assets prompted corresponding increases in Barnes' allowance for loan and lease losses (ALLL). As shown in Chart 5, in both 2008 and 2009, the bank was profitable until it recorded loan loss provision expenses. In 2008, a $50.9 million provision expense resulted in a net loss of $21.9 million; in 2009, a $103.9 million provision expense resulted in a $96.7 million net loss.

Chart 5: Impact of Provision Expense on Earnings



The combined $154.8 million provision expenses related to loan losses in 2008 and 2009 eliminated earnings and significantly affected the bank's historically strong capital. FRB San Francisco implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA levels. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies in troubled depository institutions. Barnes was notified that it had fallen to the *undercapitalized* PCA designation on June 26, 2009, and was prohibited from, among other things, accepting, renewing, or rolling over brokered deposits.[6] Less than five months later, FRB San Francisco informed Barnes that it had fallen to *significantly undercapitalized*. Finally, as a result of the October 2009 examination findings, Barnes fell to *critically undercapitalized* on December 7, 2009. A PCA Directive was issued on December 22, 2009, that required the bank, by January 15, 2010, to become *adequately capitalized* or to merge with or be acquired by another regulated depository institution.

In addition to liquidity constraints resulting from the brokered deposit restrictions, deposit outflows prompted by negative press reports in December 2009 further strained Barnes' liquidity position. Specifically, press reports concerning potential regulatory actions and customer account safety resulted in deposit withdrawals totaling approximately $100 million (or 14 percent of deposits). Despite these liquidity constraints, Barnes was able to maintain an adequate liquidity position. However, Barnes failed to comply with the PCA Directive, and the State closed the bank on January 15, 2010.

[6] Section 29 of the FDI Act stipulates that any bank that falls to less than *well capitalized* (as defined under PCA) cannot accept, renew, or roll over brokered deposits, unless a waiver is obtained from the FDIC.

Supervision of Barnes Banking Company

FRB San Francisco complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During the period covered by our review, FRB San Francisco and the State conducted six full scope and two target examinations; executed two formal enforcement actions, a Written Agreement and a PCA Directive; and implemented all applicable provisions of PCA.

As shown in Table 1, the bank received CAMELS composite 2 (satisfactory) ratings from 2004 through 2007, but a June 2008 credit risk target examination led to a ratings assessment that resulted in a downgrade to a composite 3 (fair) rating. A September 2008 full scope examination resulted in a further downgrade to a CAMELS composite 4 (marginal) rating, along with a triple downgrade of the earnings component to a 5 (critically deficient) rating, and the execution of a Written Agreement in May 2009 to address a variety of serious deficiencies.

Examiners performed a target examination in April 2009 that resulted in a downgrade to a CAMELS composite 5 rating. During a subsequent full scope examination that began in October 2009, examiners found that Barnes had not complied with several provisions of the May 2009 Written Agreement. Further, examiners concluded that, without immediate recapitalization, the bank's failure was imminent. The Federal Reserve Board issued a PCA Directive on December 22, 2009, that required Barnes to become *adequately capitalized* or merge with or be acquired by another regulated depository institution by January 15, 2010.

Our analysis of FRB San Francisco's supervision of Barnes revealed that examiners repeatedly cited concerns regarding the bank's credit risk management, CRE concentration monitoring, and ALLL methodology. We believe that these recurrent examination criticisms warranted earlier and more forceful supervisory actions.

Table 1: Barnes Supervisory Overview

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
10/12/2004	12/22/2004	Full	Joint FRB Led	2	2	3	2	2	2	2	
10/17/2005	12/12/2005	Full	Joint State Led	2	2	3	3	2	2	1	2003 Written Agreement terminated [a]
10/16/2006	12/14/2006	Full	FRB	2	2	2	2	1	2	1	
10/15/2007	12/4/2007	Full	Joint State Led	2	2	2	2	1	2	2	
6/9/2008	7/9/2008	Target	Joint State Led	NA	NA	NA	NA	NA	NA	NA	
6/9/2008	7/23/2008	Ratings Assessment	FRB[b]	3	2	3	3	2	2	2	
9/8/2008	1/30/2009	Full	Joint FRB Led	4	3	4	4	5	3	3	Written Agreement
4/13/2009	7/20/2009	Target	Joint FRB Led	5	5	5	5	5	5	4	
10/13/2009	12/11/2009	Full	Joint State Led	5	5	5	5	5	5	5	PCA Directive

[a] This Written Agreement was executed on March 12, 2003, as a result of deficiencies noted within Barnes' Bank Secrecy Act program.

[b] Due to the weaknesses noted during the June 9, 2008, joint target examination, FRB San Francisco conducted a review and assessment of the bank's supervisory ratings.

2004 and 2005 Examinations Cited Repeat Deficiencies

The 2004 and 2005 full scope examinations each resulted in CAMELS composite 2 ratings, and Barnes' asset quality component was assigned a 3 rating in both examinations due to high levels of classified assets. During these examinations, several deficiencies were noted. Most significantly, each examination report cited multiple deficiencies in the bank's credit risk management processes and CRE concentration monitoring that required the Board of Directors' attention.

The December 2004 examination report indicated that credit risk management deficiencies from prior examinations had not been fully resolved and recommended that Barnes make additional

enhancements to establish a sound credit risk management program commensurate with the bank's increased size, complexity, and anticipated growth. Specifically, examiners recommended that Barnes' loan grading, loan review, appraisal review, and problem loan processes be improved. Examiners also criticized Barnes' monitoring of CRE concentrations, which reached approximately 300 percent of capital by June 2004. Examiners recommended that management (1) implement CRE limits and sub-limits, (2) incorporate loan concentration risks into its strategic planning and the bank's ALLL methodology, (3) increase the frequency of reporting to the Board of Directors, (4) perform stress testing during underwriting, and (5) update policies to reflect current practices.

The December 2005 examination report noted that prior recommendations regarding credit risk management and CRE concentrations monitoring had not been fully addressed. Examiners (1) repeated recommendations regarding loan grading, problem loan processes, sub-limits, strategic planning, ALLL methodology, and stress testing; and (2) downgraded the management component to a 3 rating. Examiners cited a notable shift in Barnes' CRE portfolio as the bank's CLD loans increased from 121 percent of total capital in 2004, to 172 percent in 2005.

2006 Examination Resulted in CAMELS Component Upgrades

FRB San Francisco began a full scope examination in October 2006, which resulted in a CAMELS composite 2 rating and upgraded component ratings for asset quality, management, and earnings. The December 2006 report noted improvements in credit administration practices and monitoring of CRE concentrations. Additionally, examiners concluded that the Board of Directors was sufficiently "engaged," and that policies, procedures, and limits were generally adequate. Unlike prior examination reports, which cited several matters requiring the Board of Directors' attention, there was only one such matter, liquidity contingency planning, in the 2006 examination report.

While the bank's overall condition was determined to be satisfactory, the examination report cited increased credit risk due to rapid growth in CRE loans, specifically CLD loans, which had more than doubled since the prior examination. Barnes' CLD concentration reached 247 percent of capital as of June 30, 2006, which was considerably higher than the Federal Reserve System's 12th district bank average of 114 percent.[7] Although the loan growth noted in 2006 was significant, examiners stated that Barnes' management planned to reduce the bank's exposure to speculative CLD lending.

2007 Examination Resulted in a CAMELS Composite 2 Rating

In October 2007, the State led a joint full scope examination that resulted in the same CAMELS ratings as the FRB examiners had assigned in the 2006 examination, with the exception of the sensitivity to market risk component, which was downgraded to a 2. Examination results were first communicated to the Board of Directors during a November 2007 meeting. The December 2007 examination report cited deficiencies in credit risk management and CRE concentrations monitoring, deficiencies that had also been noted in the 2004 and 2005 examinations. In

[7] FRB San Francisco oversees the 12th district of the Federal Reserve System, which includes nine western states and some U.S. territories. It is the largest district in terms of demographic, geographic, and economic size.

addition, examiners stated that "the greatest regulatory concern [at Barnes] is the rapid growth in the CRE portfolio during a time of pronounced economic weaknesses in this market segment."

Examiners noted that Barnes' CRE concentration had reached 473 percent of capital, largely as a result of a 68 percent increase in the CLD portfolio. Examiners expressed explicit concern over the "disconnect" between Barnes' Board of Directors' vote to expand CRE lending limits, while simultaneously acknowledging that the CRE market was deteriorating. Examiners also urged management to re-evaluate, fully document, obtain Board of Directors approval, and improve segmenting of CRE concentration limits and sub-limits.

Examiners repeated specific criticisms regarding the bank's loan grading, stress testing, strategic planning, and ALLL methodology processes. The examination report also cited concerns regarding repeat external audit findings, including a deficiency in segregating duties within the credit function that allowed loan officers to review, approve, and fund loans. Prudent internal controls require the segregation of duties so that one individual cannot both approve and disburse funds. Examiners stated that the bank's continued inaction to "resolve these outstanding recommendations reflects poorly on the quality of board oversight and may result in additional supervisory oversight or action" should the recommendations continue to be unresolved.

2008 Target Examination Cited Repeat Deficiencies and Led to a Ratings Assessment that Resulted in a CAMELS Composite Downgrade

In June 2008, the State led a joint credit risk target examination. The results of the review were jointly communicated in a July 9, 2008, supervisory letter that cited significant weaknesses in the bank's internal loan grading process, ALLL methodology, extensions and renewals, and appraisals and evaluations. Additionally, examiners downgraded several loans, and the bank's total classified assets ratio increased by approximately 167 percent from the prior examination. Examiners repeated many of the same credit risk management deficiencies noted in the 2004, 2005, and 2007 full scope examinations. These deficiencies were exacerbated by an increasing volume of problem CLD loans attributed to the declining values of the underlying collateral. Examiners noted a "material change" in land values and indicated that Barnes' borrowers' primary source of repayment—the sale of developed lots—had, in many cases, "evaporated."

At the conclusion of the target examination, FRB San Francisco determined there was "strong evidence that the financial condition and risk profile of the institution has significantly changed." Subsequently, FRB San Francisco independently performed a review and assessment of the bank's CAMELS ratings in accordance with existing supervisory guidance.[8] In a supervisory letter dated July 23, 2008, FRB San Francisco downgraded Barnes' composite, asset quality, and management CAMELS ratings to 3, and the bank's earnings component was downgraded to 2. Examiners determined that capital remained satisfactory because the bank's risk-based capital ratios remained well above peer and required regulatory levels.

[8] The Federal Reserve Board's Supervision and Regulation Letter 99-17, *Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System*, requires that supervisory ratings be revised whenever there is strong evidence that the financial condition or risk profile of an institution has significantly changed.

Examiners emphasized that oversight by the Board of Directors and management needed improvement. FRB San Francisco cautioned that Barnes' weak risk management practices might not adequately identify, measure, monitor, or control problems and significant risks. Examiners also noted that additional provision expenses resulting from recently downgraded loans would have a significant effect on earnings. We were told that due to these regulatory concerns, examiners decided to begin the 2008 full scope examination two months earlier than planned, rather than attend a full Board of Directors meeting to communicate the results of the target examination or assessment. According to FRB San Francisco, this strategy was followed, in part, because a full scope examination would provide the opportunity to gather additional facts needed to convince the Board of Directors of the severity of Barnes' condition and to coordinate a unified message with the State. Supervisory guidance contained within the Federal Reserve System's *Commercial Bank Examination Manual* does not explicitly require a meeting for this circumstance, but it does suggest that examiners should attend a full board meeting after a target examination when "deemed appropriate and desirable by the Reserve Bank."

2008 Full Scope Examination Resulted in a Downgrade to a CAMELS Composite 4 Rating and a Written Agreement

In September 2008, FRB San Francisco led a joint full scope examination, which resulted in a downgrade to a CAMELS composite 4 rating. FRB San Francisco presented examination findings to the Board of Directors in November 2008, and a January 2009 examination report downgraded asset quality and management to 4; capital, liquidity, and sensitivity to market risk to 3; and earnings to 5. Examiners noted an "excessive number of repeat criticisms," as well as unsafe and unsound banking practices, which resulted in a May 2009 Written Agreement.

Examiners expressed a high degree of concern regarding a substantial increase in problem loans and continued growth in the bank's CLD loan portfolio. Examiners concluded that Barnes' asset quality was deficient, and noted that nonaccrual loans had reached $90 million, up from $1.6 million at the 2007 examination. Due to the pervasive asset quality deterioration, examiners also determined that the bank's ALLL was insufficient. Examiners required the bank to record a minimum provision expense of $18.7 million to bring the ALLL to a minimally acceptable level. Additionally, Barnes had originated more than $286.2 million in new CLD loans from May 2007 through mid-2008, and examiners cautioned that the increase presented a significant, yet unrealized, risk to the bank.

2009 Examinations Resulted in Downgrades to CAMELS 5 Ratings, and PCA Provisions Were Implemented

FRB San Francisco led a joint credit risk target examination in April 2009 to ascertain management's progress in correcting deficiencies identified in prior examinations. However, due to the severe and continued deterioration of asset quality, examiners expanded the scope of the target review to include a reassessment of all CAMELS ratings. In the examination report issued in July 2009, examiners downgraded the composite CAMELS rating to 5. All of the components were assigned 5 ratings, with the exception of sensitivity to market risk, which was downgraded to 4. Examiners again determined that Barnes' ALLL was critically underfunded and required a provision expense of at least $50.3 million. This additional provision expense,

combined with other regulatory reporting corrections, resulted in revised capital calculations that placed the bank in the *undercapitalized* PCA category. Examiners concluded that Barnes' failure was highly probable without immediate outside financial assistance.

Beginning in October 2009, the State led a joint full scope examination that focused on asset quality within Barnes' CLD loan portfolio, as well as compliance with the May 2009 Written Agreement. Barnes received another CAMELS composite 5 rating, and all CAMELS components were also assigned 5 ratings. The December 2009 examination report cited rising loan delinquencies and defaults, driven by the bank's highly concentrated CLD loan portfolio and the continued decline of economic conditions. Adversely classified assets exceeded 400 percent of Tier 1 capital plus the ALLL. The bank's ALLL was again found to be underfunded, requiring an additional provision expense of at least $34.6 million. The aggregate effect of the additional provision expenses eliminated earnings and significantly reduced the bank's capital position. During the examination, Barnes was notified that it had fallen to the *significantly undercapitalized* PCA designation.

Based on the examination results, Barnes was determined to be *critically undercapitalized* on December 7, 2009. A PCA Directive was issued on December 22, 2009, that, among other things, required Barnes to (1) restore itself to *adequately capitalized* by raising additional capital, or (2) merge with, or be acquired by, another depository institution. Barnes failed to raise capital or merge with another institution, and the State closed the bank on January 15, 2010, and appointed the FDIC as receiver.

Conclusion and Lessons Learned

Barnes failed because its Board of Directors and management did not effectively control the risks associated with the bank's aggressive growth strategy that led to a CRE loan concentration, particularly in CLD loans. The bank continued to originate CLD loans in 2007 and 2008, despite apparent weaknesses in Utah's real estate market and economy. The Board of Directors' and management's failure to effectively manage the resulting credit risk, in conjunction with declining market conditions, led to rapid asset quality deterioration. The resulting loan losses depleted earnings and eroded capital, which prompted the State to close Barnes and appoint the FDIC as receiver on January 15, 2010.

With respect to supervision, FRB San Francisco complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this period, FRB San Francisco and the State conducted six full scope and two target examinations, executed two formal enforcement actions, and implemented all applicable PCA provisions.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or the loss to the DIF. We believe that circumstances noted during the 2007 full scope examination, including repeated regulatory criticisms, declining market trends, and continuing growth of Barnes' CLD loan portfolio, provided FRB San

Francisco an opportunity to pursue earlier, more forceful supervisory action. The examination cited several deficiencies, some of which were repeated from earlier examinations; however, only the sensitivity to market risk CAMELS component rating was downgraded. The report criticized Barnes' credit risk management, CRE concentrations monitoring, ALLL methodology, and other critically important control processes. Additionally, examiners expressed concern over Barnes' aggressive growth in CRE lending despite evidence of "pronounced economic weaknesses" within that market segment. Examiners cautioned that "continued inaction" by the bank to resolve prior recommendations reflected poorly on the quality of the Board of Directors' oversight, and might result in additional supervisory oversight or action. Although examiners began a credit risk target examination in June 2008, we believe that other supervisory actions were warranted at the conclusion of the 2007 examination, such as downgrading CAMELS ratings or executing an informal enforcement action.

We believe that the June 2008 credit risk target examination also provided an opportunity for FRB San Francisco to pursue earlier, more forceful supervisory action. The target examination provided strong evidence that Barnes' risk profile and financial condition had significantly changed. Additionally, examiners noted repeat criticisms regarding Barnes' credit risk management. While FRB San Francisco subsequently performed a separate ratings assessment and downgraded several CAMELS ratings, an enforcement action was not executed until nearly one year after the June 2008 target examination was initiated. Further, although not explicitly required by supervisory guidance, examiners decided not to attend a full Board of Directors meeting following the target examination or assessment. Given the history of repeated recommendations, continued market deterioration, and additional growth of the bank's CLD loan portfolio, FRB San Francisco could have taken such actions as (1) conducting a formal meeting with the Board of Directors, (2) considering more aggressive ratings downgrades, or (3) executing an enforcement action.

While we believe that FRB San Francisco had opportunities for earlier and more forceful supervisory actions, it is not possible for us to predict the effectiveness or impact of any such actions. Therefore, we cannot evaluate the degree to which earlier or more forceful supervisory responses might have affected Barnes' financial deterioration or the ultimate cost to the DIF.

Lessons Learned

Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Barnes' failure points to valuable lessons learned that can be applied when supervising community banks with similar characteristics. In our opinion, Barnes' failure illustrates the need for close regulatory scrutiny and a forceful supervisory response when financial institutions increase credit risk exposure within a weakened or deteriorating market segment. Additionally, we believe that—although not explicitly required by supervisory guidance—examiner attendance at a Board of Directors meeting can be a prudent supervisory practice when a target examination notes a significant change in the institution's financial condition and risk profile.

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 the conclusion and lessons learned contained in the report.

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.

Brokered Deposits
A deposit purchased from a broker acting as an agent for depositors. The broker pools certificates of deposit from many small investors and markets them to financial institutions, usually in blocks nearing $100,000, and negotiates a higher rate for certificates of deposit placed with the purchaser. Federal law prohibits undercapitalized banks and thrifts from accepting brokered deposits.

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.

Collateral
An asset pledged as security to ensure payment or performance of an obligation. If the borrower defaults, the asset pledged may be taken and sold by the lender to fulfill completion of the original contract.

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.

Appendix 1 (continued)

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.

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.

House Price Index (HPI) (issued by the Federal Housing Finance Agency)
A weighted, repeat-sales index that measures the average price changes in repeat sales or refinancings on the same properties. It is a broad measure of the movement of single-family home prices. The four-quarter percentage change in home values is simply the price change relative to the same quarter one year earlier.

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.

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*.

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.

Appendix 1 (continued)

Uniform Bank Performance Report (UBPR)
An analytical tool created for bank supervisory, examination, and bank management purposes. The report facilitates evaluation of a bank's current condition, trends in its financial performance, and comparisons with the performance of its peer group.

Written Agreement (WA)
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, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2 (continued)

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: August 25, 2010

To: Elizabeth A. Coleman, Inspector General

From: Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***

Subject: Material Loss Review of Barnes Banking Company

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Barnes Banking Company (Barnes) of Kaysville, Utah, prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act. The report finds that Barnes failed because its Board of Directors and management did not effectively control the risks associated with the bank's aggressive growth strategy that led to a CRE loan concentration. This aggressive strategy, combined with declining market conditions, led to rapid asset quality deterioration and loan losses, which depleted earnings and eroded capital resulting in Barnes' closure on January 15, 2010. Barnes was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco) under delegated authority from the Board.

Banking Supervision and Regulation staff concurs with the conclusions and lesson learned in the report. FRB San Francisco complied with examination frequency guidelines for the time period that was reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this period, FRB San Francisco and the State of Utah conducted six full scope and two targeted examinations, executed two formal enforcement actions, and implemented all applicable PCA provisions. The report notes that circumstances identified during the 2007 full scope examination, such as repeated regulatory criticisms, declining market trends, and continuing loan growth, provided an opportunity to pursue earlier, more forceful supervisory action. Further, the report notes that the 2008 credit target examination provided strong evidence that Barnes' risk profile and financial condition had significantly changed. The report identifies several actions that FRB San Francisco could have taken following the target exam including conducting a formal exit meeting with the Board of Directors, considering more aggressive ratings downgrades, or executing an enforcement action. The report also states that it is not possible to predict the effectiveness or impact of any such actions and, therefore, does not evaluate the degree to which earlier or more forceful supervisory responses might have affected the ultimate cost to the DIF. FRB San Francisco accelerated the start date for its September 2008 full scope examination following the identification of weaknesses during the June 2008 target examination.

The report identifies lessons learned applicable to banks with similar characteristics and circumstances. Specifically, the report highlights the need for close regulatory scrutiny and a forceful supervisory response when financial institutions increase credit risk exposure within a weakened or deteriorating market segment and suggests that examiner attendance at a Board of Directors meeting can be a prudent supervisory practice.

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

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