Office of Inspector General

Material Loss Review of the Bank of the Commonwealth

Board of Governors of the Federal Reserve System

April 2012

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

OFFICE OF INSPECTOR GENERAL

April 12, 2012

Mr. Michael S. Gibson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Mr. Gibson:

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 the Bank of the Commonwealth (Commonwealth). Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) was 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
- 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

The Federal Reserve Bank of Richmond (FRB Richmond), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and the Commonwealth of Virginia State Corporation Commission, Bureau of Financial Institutions (State) supervised Commonwealth. Due to FRB Richmond and the State's concerns about the continued viability of the bank given its deteriorating capital position, the State closed Commonwealth on September 23, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that Commonwealth's failure would result in a $268.3 million loss to the DIF, or 27.5 percent of the bank's $974.9 million in total assets at closing. On October 12, 2011, the FDIC's Office of Inspector General notified our office that Commonwealth's failure would result in a material loss to the DIF.

Commonwealth failed because of the convergence of several factors, including corporate governance weaknesses, an aggressive growth strategy that resulted in concentration risk, insufficient credit risk management practices, and pervasive internal control weaknesses. These factors, combined with deteriorating real estate markets, led to rapid asset quality deterioration. Commonwealth failed to acknowledge the full extent of problem loans in its portfolio and adequately reserve against prospective losses. It also engaged in unsafe and unsound banking practices to mask its financial condition. Mounting losses depleted earnings and eroded capital, which prompted the State to close Commonwealth and appoint the FDIC as receiver.

With respect to supervision, FRB Richmond did not comply with the examination frequency guidelines for the time frame we reviewed, 2000 through 2011. Specifically, the 2006 full-scope examination did not occur within a year of the prior full-scope examination as required by Supervision and Regulation Letter 97-8, *Revisions to Examination Frequency Guidelines for State Member Banks*.

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 Richmond's supervision of Commonwealth revealed that FRB Richmond identified the bank's fundamental weaknesses during the 2000 examination but not did take early and decisive action to resolve those weaknesses. Credit risk management was a recurring issue at the bank in subsequent years. Further, FRB Richmond did not detect management's similar inappropriate response to asset quality deterioration noted during the 2000 full-scope examination and repeated during the October 2009 full-scope examination. We believe that FRB Richmond had multiple opportunities between 2007 and 2011 to take stronger supervisory action by implementing more aggressive enforcement actions or downgrading Commonwealth's CAMELS composite or component ratings to address the bank's persistent deficiencies. In our opinion, more forceful supervisory action could have mitigated the loss to the DIF.

The need for stronger supervisory action has been a consistent theme in our prior failed bank reviews, as highlighted in our September 2011 *Summary Analysis of Failed Bank Reviews*. While this aspect of Commonwealth's failure is consistent with the overall themes contained in our prior reports, this material loss review resulted in unique findings. For example, our prior reports have not identified the need for a Reserve Bank to recommend the use of the Federal Reserve Board's cease-and-desist authority or removal order authority for management officials. While we understand that those authorities should only be used when necessary, we believe that the unique circumstances surrounding Commonwealth's failure warranted such actions.

We believe that the following findings noted during this material loss review represented unique circumstances and issues in FRB Richmond's supervision of Commonwealth:

- In 2009, FRB Richmond examiners did not detect management's similar inappropriate response to asset quality deterioration consisting of (1) failing to acknowledge the bank's problem loans and (2) making additional loans to troubled borrowers, even though similar issues were raised in FRB Richmond's 2000 examination and the 2001 board resolution. The October 2009 examination also did not address that this similar inappropriate response to asset quality deterioration had evolved into a deliberate effort to conceal the bank's financial condition. FRB Richmond's failure to detect these similarities led to an insufficient supervisory response following the 2009 examination.

- Certain FRB Richmond examination reports did not appear to comply with *Commercial Bank Examination Manual* (CBEM) section 1000.1 because those reports failed to adequately address the business risks associated with specific findings.

- Specific FRB Richmond examination staff did not consult with the local ethics officer in accordance with FRB Richmond's code of conduct despite the fact that those staff members considered a former FRB Richmond examiner employed by the bank in a key senior management position, who engaged in potentially suspicious activity, to be a friend or colleague.

- FRB Richmond did not respond to situations involving potentially suspicious activity in accordance with the expectations outlined in CBEM section 5020.1.

We believe that Commonwealth's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Commonwealth's failure illustrates (1) the risks associated with consolidating corporate authority in a single individual; (2) the risks associated with CRE loan concentrations, particularly CLD, and concentrations with individual borrowers; and (3) the importance of establishing appropriate credit risk management practices and internal controls prior to pursuing an aggressive growth strategy. Further, this failure illustrates the importance of assuring that examiners are aware of and consider prior supervisory actions when assessing an institution and developing a supervisory strategy, particularly when subsequent enforcement actions are necessary to address issues previously raised in earlier enforcement actions. The failure also highlights that Reserve Banks need to (1) assure that bank management resolves risk management weaknesses and internal control deficiencies, (2) appropriately determine the information that should be contained in an examination report and convey significant details concerning important findings, and (3) take aggressive and appropriate supervisory action when previously noted weaknesses continue or similar behaviors emerge.

We also made four recommendations to improve FRB Richmond's and the Federal Reserve Board's supervisory activities. We provided our draft to the Division of Banking Supervision and Regulation for review and comment. The Division Director stated that Banking Supervision and Regulation staff concurred with the conclusions, lessons learned, and recommendations in the report. The response is included as Appendix 3.

We appreciate the cooperation that we received from FRB Richmond and Federal Reserve Board staff during our review. The principal contributors to this report are listed in Appendix 4.

This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

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
Ms. Jennifer Burns

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Background

The Bank of the Commonwealth (Commonwealth) began operations in 1971 in Norfolk, Virginia, as a state nonmember bank and converted to state member bank status in 1982. In 1988, Commonwealth Bankshares, Inc. (Bankshares), a holding company, was established and acquired Commonwealth. Bankshares listed its common stock on the NASDAQ National Market in 2000.[1] Commonwealth's business activities focused on commercial real estate (CRE) lending, specifically construction, land, and land development (CLD) lending, in southeastern Virginia and northeastern North Carolina. The Federal Reserve Bank of Richmond (FRB Richmond), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and the Commonwealth of Virginia State Corporation Commission, Bureau of Financial Institutions (State) supervised Commonwealth.

Due to FRB Richmond and the State's concerns about the continued viability of the bank given its deteriorating capital position, the State closed Commonwealth on September 23, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that Commonwealth's failure would result in a $268.3 million loss to the Deposit Insurance Fund (DIF), or 27.5 percent of the bank's $974.9 million in total assets at closing. On October 12, 2011, the FDIC's Office of Inspector General notified our office that Commonwealth'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. 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)[2]
- ascertain why the institution's problems resulted in a material loss to the DIF
- make recommendations for preventing any such loss in the future

Before conducting our review, we became aware of investigations concerning this institution.[3]

This report consists of five major sections. The Objectives, Scope, and Methodology section describes the purpose of our review, the review period, and the standards governing our review. The Causes of Commonwealth's Failure section contains our assessment of the contributing causes that led to the bank's failure. The Supervision of Commonwealth section provides an examination-by-examination description of FRB Richmond's and the State's supervision of the institution and assesses FRB Richmond's supervisory approach. The Conclusions, Lessons Learned, and Recommendations section summarizes the results of our analysis, describes the lessons to be learned from this failure, and conveys our recommendations to improve the Federal Reserve Board's Division of Banking Supervision and Regulation's oversight of Reserve Bank

[1] Prior to 2000, the company's stock was traded on the Over-the-Counter Bulletin Board. Over-the-counter securities are not listed and traded on a formal exchange.

[2] PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies in troubled depository institutions.

[3] This material loss review fulfills a statutory mandate and does not serve any investigative purpose.

supervisory activities and FRB Richmond's supervision of state member banks. The Analysis of Comments section includes the Director of the Division of Banking Supervision and Regulation's assessment of our findings and observations.

Objectives, Scope, and Methodology

This evaluation sought to determine why Commonwealth's failure resulted in a material loss to the DIF and assessed FRB Richmond's supervision of Commonwealth during our period of review, 2000 through 2011. We extended our review period beyond the typical five-year period due to the corporate governance and credit risk management issues noted during FRB Richmond's 2000 full-scope examination that were addressed by an informal enforcement action implemented in 2001. We conducted our fieldwork from October 2011 through March 2012 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

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 Richmond, the State, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by Commonwealth, examination reports issued from 2000 through 2011, examination work papers prepared by FRB Richmond, 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 system.[4]

Causes of Commonwealth's Failure

Commonwealth failed because of the convergence of several factors, including corporate governance weaknesses, an aggressive growth strategy that resulted in concentration risk, insufficient credit risk management practices, and pervasive internal control weaknesses. These factors, combined with deteriorating real estate markets, led to rapid asset quality deterioration. Commonwealth failed to acknowledge the full extent of problem loans in its portfolio and adequately reserve against prospective losses. It also engaged in unsafe and unsound banking practices to mask its financial condition. Mounting losses depleted earnings and eroded capital, which prompted the State to close Commonwealth and appoint the FDIC as receiver on September 23, 2011.

Corporate Governance Weaknesses Not Addressed

The bank had a series of corporate governance weaknesses that should have been warning signs for examiners. Many of these weaknesses coincided with Commonwealth's pursuit of its aggressive growth strategy, creating an unstable governance foundation to support such growth.

[4] 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 indicating the least regulatory concern and 5, the greatest concern.

Concentrated Leadership

Commonwealth consolidated authority in one person who served as the president, chief executive officer (CEO), and chairman of the board (hereinafter referred to as the CEO). This authority allowed the CEO to exercise broad dominance and control over the institution's affairs. In 2000, FRB Richmond examiners identified situations in which the CEO exceeded limits on his lending authority by extending unsecured overdrafts to two loan customers. We believe that this should have been an early warning sign concerning the CEO's willingness to circumvent limits on his authority. Examiners also highlighted employees' reluctance to discuss problems with the CEO. Without open communication, which was a persistent issue during the CEO's tenure, operational weaknesses and internal control issues remained unresolved. Because management was reluctant to discuss such issues with the CEO and alternatives to address and resolve the issues internally were limited, Commonwealth employees raised concerns in confidence directly with FRB Richmond examiners on a number of occasions.

Ineffective Board of Directors

Examiners frequently criticized Commonwealth's board of directors for less-than-satisfactory oversight. In 2000, FRB Richmond examiners noted that board members were unaware of multiple loans to problem borrowers. In addition, examiners repeatedly noted that the board members had not reviewed and approved key policies, such as the bank's Loan Policy and Asset Liability Management Policy, in a timely manner. In 2002 and 2005, FRB Richmond examiners indicated that the bank's board of directors had not monitored key credit risks. In 2008, State examiners noted that management information systems were severely impaired, which limited the reliability of the information flowing to the board members and prevented an accurate assessment of risk in the loan portfolio. As a result, examiners concluded that bank management and the board of directors may not have been aware of the magnitude of risk at the institution, given the lack of effective credit risk monitoring. In a 2010 examination report, FRB Richmond concluded that "management . . . including the board of directors, have been negligent in their duty to manage the affairs of the institution in a safe and sound manner." In general, examiners noted the board of directors' delays in (1) reacting to economic developments, (2) acknowledging the need to raise additional capital, and (3) resolving supervisory recommendations. In our opinion, these frequently expressed concerns about the board of directors' oversight constituted a significant warning sign that the board of directors was not an effective check on the CEO's authority.

Weak Internal Audit Program

Significant weaknesses in the bank's internal audit program increased Commonwealth's operational risk profile and allowed internal control deficiencies to emerge and persist. As early as 2000, the bank was performing few internal audits covering high risk areas and had not hired a qualified internal auditor. In 2002, a joint examination report repeated that Commonwealth's internal audit program still did not cover all of the bank's high-risk areas, and subsequent examinations reiterated this finding. In 2003, the bank failed to perform any internal audits, and FRB Richmond once again recommended that the bank hire a qualified internal auditor and emphasized that "strong internal controls require that areas of high risk to the Bank be reviewed regularly." In April 2004, the bank hired a qualified internal auditor. In a 2008 examination report, FRB Richmond examiners recommended that the bank expand the scope of its internal audit activities by providing adequate resources to the internal audit department. Examination reports we reviewed indicated that the internal audit program suffered from a chronic lack of resources, thereby limiting its effectiveness. In 2009, FRB Richmond examiners also criticized the design of the internal audit program by indicating that the internal audit function should not report to the senior vice president of operations.

In addition, examiners noted instances in which Commonwealth's management did not provide adequate information to the bank's Audit Committee in 2004 and 2009, and a situation in which management failed to implement internal audit recommendations in 2009. In 2004, examiners noted that Audit Committee meeting minutes did not refer to any reports evaluating internal controls, even though audit committees typically have responsibility for overseeing the effectiveness of internal controls. In addition, we observed one apparent instance in which the CEO held a draft internal audit report for three years before Audit Committee members received the report in 2009. The report identified multiple significant findings related to a large borrower relationship and the loan officer in charge of that relationship. Our analysis revealed no explanation for the three-year delay. Examiners also noted that management had not fully implemented corrective actions approved by the Audit Committee in 2009 in response to prior internal audit reports. In our opinion, Commonwealth's inability to identify and resolve operational and internal control issues constituted a warning sign concerning the ineffectiveness of the internal audit program and the Audit Committee.

No Chief Credit Officer until 2010

Commonwealth operated without a Chief Credit Officer (CCO) to oversee credit risk management and credit administration and to manage the composition of the loan portfolio until 2010. The bank relied on two senior loan officers working in conjunction with the CEO to oversee the loan portfolio. In 2009, examiners recommended diversifying management of the loan portfolio since the two senior loan officers managed 60 percent of the bank's total loan portfolio and it was not possible for two loan officers to actively monitor so many loans. The examiners also noted that "to avoid potential conflict and independence issues, loan officers should not have any input or control over credit administration issues regarding loans in their portfolios." In our opinion, the absence of a CCO contributed to loan portfolio oversight weaknesses by allowing employees engaged in loan origination activities to perform oversight responsibilities typically conducted by a CCO. This consolidation of authority in key personnel allowed Commonwealth's CEO and two senior lenders to operate beyond conventional limits on authority.

Aggressive Growth Strategy Resulted in Concentration Risk and Improved Earnings Prior to Declines in the Local Economy

The bank pursued an aggressive growth strategy under the CEO's leadership that focused on CRE lending and particularly on CLD loans. Examiners acknowledged the bank's significant loan growth as early as 2000 and its aggressive growth plan in 2005. Management remained committed to the strategy, as evidenced by Commonwealth's goal in its 2007 strategic plan to increase total assets from $840 million to $1 billion by 2009. Management exceeded that goal, and total assets more than quadrupled from 2001 to 2009—increasing 465 percent from $230 million to $1.3 billion.

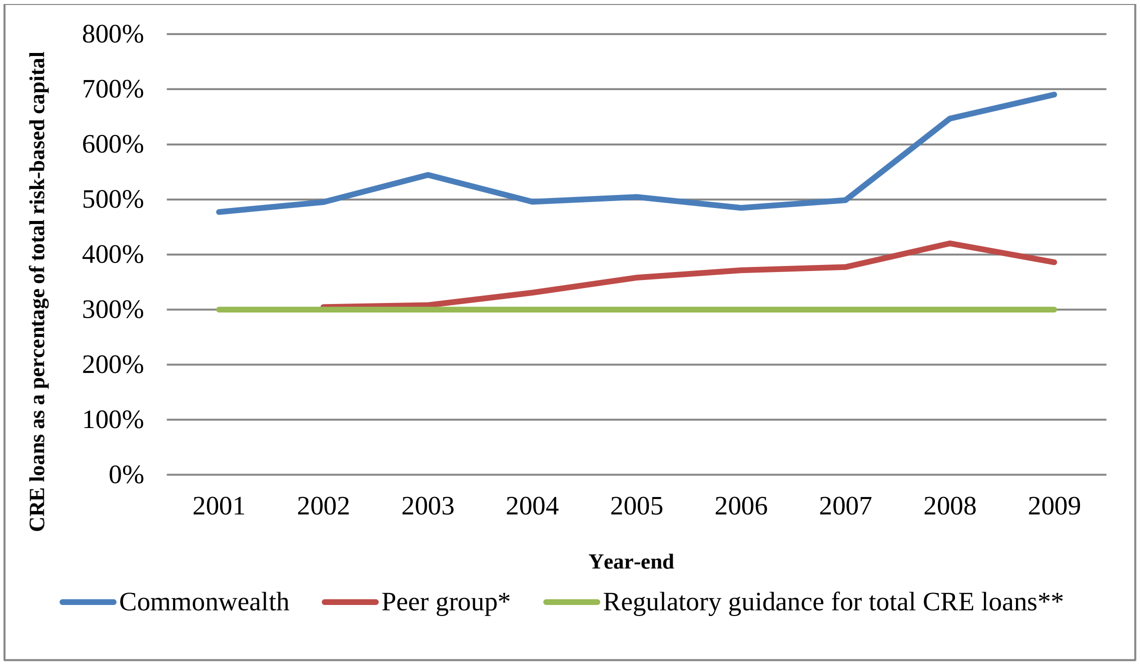
Aggressive Growth Remained Focused on CRE Lending and Increased the Bank's CLD Concentration

The bank had a concentration in CRE loans at the outset of our review period. In 2000, FRB Richmond examiners noted that the bank's CRE concentration contributed to its high level of credit risk and recommended that it establish appropriate concentration limits. Supervision and Regulation (SR) Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate*, acknowledges that credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans.[5] Commonwealth's CRE loans accounted for 477 percent of total risk-based capital in 2001, as shown in chart 1. While Commonwealth's total assets grew by 267 percent from 2001 to 2007, the bank's CRE concentration remained relatively stable at around 500 percent of total risk-based capital, indicating that CRE lending growth remained consistent with overall portfolio growth on a percentage basis.[6] Therefore, Commonwealth's vulnerability to real estate market declines remained elevated.

[5] The Federal Reserve Board, the Office of the Comptroller of the Currency, and the FDIC issued final interagency guidance that preceded the release of SR Letter 07-01. 71 Fed. Reg. 74,580 (2006). The SR Letter indicates that the previously issued guidance applies to state member banks.

[6] According to the Federal Reserve Board's SR Letter 07-01, an institution presents potential significant CRE concentration risk if it meets the following criteria: (1) total reported loans for CLD 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 increased by 50 percent or more during the prior 36 months.

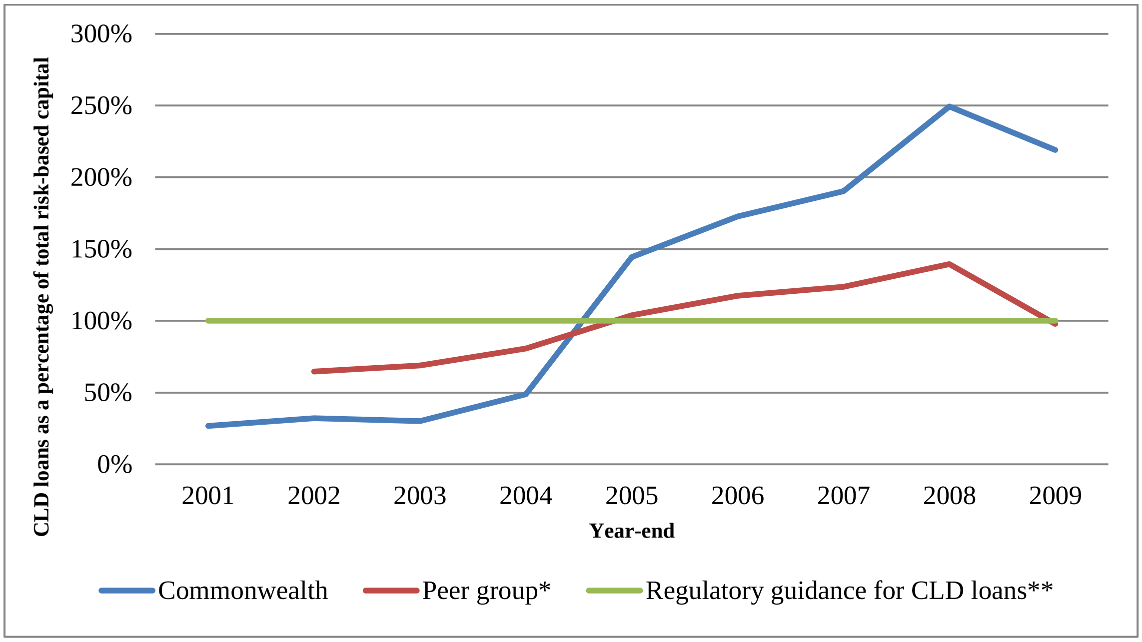
Chart 1: Total CRE Loan Concentration



* Peer group data became available in 2002.
** SR Letter 07-01 became effective in 2007; depiction of the CRE concentration guidelines prior to 2007 is for illustrative purposes only.

Within Commonwealth's CRE loan portfolio, the bank developed a concentration in CLD loans, as illustrated in chart 2. CLD loan concentrations generally present heightened risk because developers' capacity to repay loans is contingent on whether they can either obtain long-term financing or find a buyer for the completed project. From 2001 to 2008, Commonwealth's CLD loan concentration increased from 27 percent to 250 percent, as the bank's CRE portfolio increasingly comprised CLD loans. SR Letter 07-01 encourages banks with CLD concentrations exceeding 100 percent to adopt strong risk management practices.

Chart 2: Total CLD Loan Concentration



* Peer group data became available in 2002.

** SR Letter 07-01 became effective in 2007; depiction of the CLD concentration guidelines prior to 2007 is for illustrative purposes only.

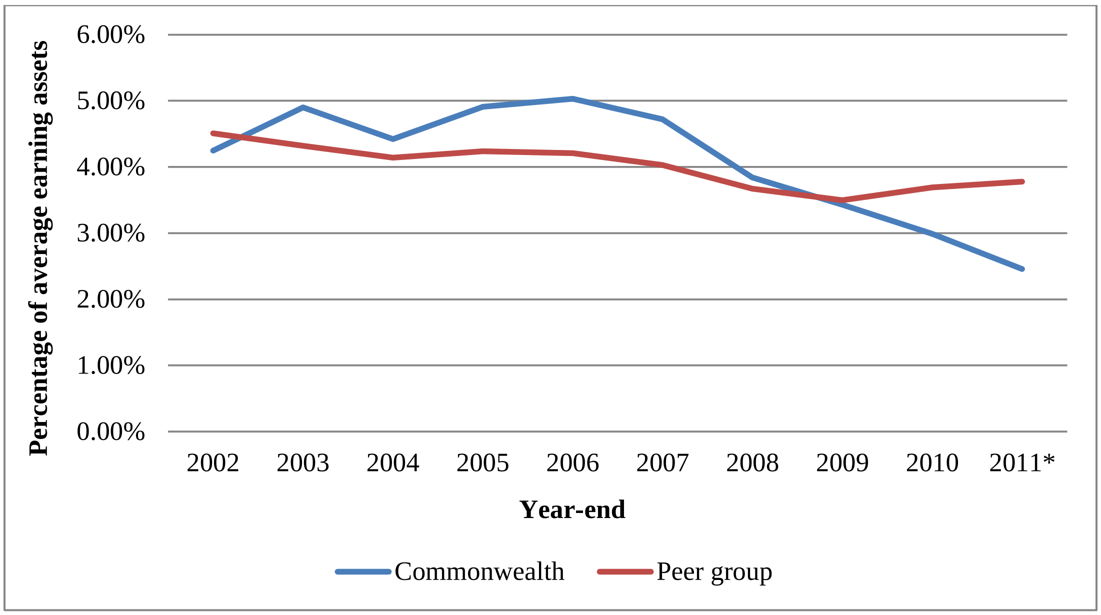
Commonwealth Developed Significant Loan Exposures to Related Borrowers

In addition to significant CRE loan concentrations, Commonwealth developed significant loan exposures to related borrowers. Although legal lending limits established by many states generally restrict exposure to individual and related borrowers as a percentage of capital, FRB Richmond examiners indicated that Virginia does not require that loans to related borrowers, such as family members, associates, or partnerships, be aggregated, as long as each loan has a separate and distinct source of repayment. As a result, Commonwealth made numerous loans to related borrowers that appeared to benefit a sole borrower. An October 2009 examination noted that three large borrowing relationships constituted 93 percent of the bank's capital. One of these relationships amounted to nearly $40 million—approximately 30 percent of the bank's capital—and had been identified in the examination report as a problem relationship. In 2009, examiners conducted a detailed assessment of another relationship in response to information provided by a bank employee. As a result, examiners began to uncover the interconnectedness of this complex lending relationship and identified instances in which the loans benefited a sole borrower. The customer relationships involving multiple loans to related borrowers increased the risk that a single borrower experiencing financial difficulties could significantly affect the bank's capital position and ultimately contributed to Commonwealth's failure.

Aggressive Growth Resulted in Improved Earnings

Management's aggressive growth strategy also resulted in improved earnings performance. From 2000 through 2002, Commonwealth's net interest margin decreased due to low loan yields and high funding costs resulting from intense local competition for deposits.[7] Subsequently, however, the bank's CRE lending growth resulted in improved earnings due to the higher yields on CRE loans. As a result, Commonwealth's net interest margin substantially exceeded the peer group average from 2003 through 2007, as illustrated in chart 3. In addition, the bank's net income grew from $794,000 in 2001 to more than $12 million in 2007, or by more than 1400 percent, due to rapid growth of the bank's CRE loan portfolio and its strong net interest margin.

Chart 3: Net Interest Margin



*As of 6/30/11

Adequate Credit Risk Management Framework Not Developed

Commonwealth's board of directors and management failed to establish a credit risk management framework and infrastructure commensurate with the risks in the bank's loan portfolio. FRB Richmond examiners repeatedly noted that the bank's risk management capabilities had not kept pace with the bank's aggressive growth. Our analysis indicated that the bank had significant credit risk management problems in 2000, these issues continued to persist following the release of the 2001 board resolution, and these weaknesses became even more pronounced in the years preceding Commonwealth's failure.

In 2000, examiners determined that Commonwealth's credit risk was high because of weak risk management practices and a concentration in CRE loans. During its 2000 examination, the bank's difficulties with problem loan recognition became apparent when 75 percent of the loan classifications represented downgrades from internal risk ratings assigned by the bank. Examiners noted that loan review was "essentially nonexistent," which prevented Commonwealth from accurately identifying loan risk. The 2000 examination identified

[7] Net interest margin is a performance metric used to evaluate a bank's profitability by measuring the difference between interest income generated and the interest paid.

significant weaknesses related to loan underwriting, risk identification, and loan administration. The examination resulted in an informal enforcement action in the form of a board resolution. The weaknesses examiners identified included (1) extensions of credit to classified borrowers, without the support of current financial information or analysis; (2) failure to recognize problem loans in a timely manner, contributing to a "woefully inadequate" allowance for loan and lease losses (ALLL); (3) failure to establish limits for credit concentrations; and (4) stale classified assets, including overdrafts and other real estate owned (OREO), resulting in losses.

Although the bank's earnings performance, asset quality, and supervisory ratings generally improved following the 2000 examination, examiners repeatedly noted many similar credit risk management weaknesses from 2001 to 2008, including

- problem loan recognition, specifically delays in downgrading internal loan risk ratings based on deteriorating loan performance
- deficiencies in the ALLL methodology
- lack of limits, monitoring, and stress testing related to credit concentrations
- stale overdrafts
- lack of current borrower financial information, particularly for commercial loans
- numerous documentation exceptions in loan files
- Regulation H and Y violations pertaining to loan-to-value (LTV) exceptions and appraisals, respectively[8]

Despite these weaknesses, Commonwealth's earnings exceeded peer group averages from 2003 to 2007, in part because of its minimal classified assets.

Adequate Internal Controls Not Established

The board of directors and management also failed to establish adequate internal controls to assure that the bank operated in a safe and sound manner. CBEM Section 5017.1 indicates that

> [a] comprehensive system of internal controls is essential for a bank to safeguard its assets and capital, and to avoid undue reputational and legal risk. Senior management is responsible for establishing an appropriate system of internal controls and monitoring compliance with that system. Although no single control element should be relied on to prevent fraud and abuse, these acts are more easily perpetrated when proper segregation and rotation of duties do not exist.[9]

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[8] The Federal Reserve Board's Regulation H, Subpart J, Appendix C, states that the aggregate amount of all loans in excess of the supervisory LTV limits should not exceed 100 percent of total capital. Moreover, within the aggregate limit, total loans for all commercial, agricultural, multifamily, or other non-one- to four-family residential properties should not exceed 30 percent of total capital. An institution will receive increased supervisory scrutiny as the total of such loans approaches these levels. The Federal Reserve Board's Regulation Y, Subpart G, (1) identifies which real estate-related financial transactions require the services of an appraiser, (2) prescribes which categories of federally related transactions shall be appraised by a State certified appraiser and which by a State licensed appraiser, and (3) prescribes minimum standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of the Federal Reserve Board.

[9] Segregation of duties refers to the notion of separating responsibilities within an institution to assure that no employee is in a position to both perpetrate and conceal errors or fraud.

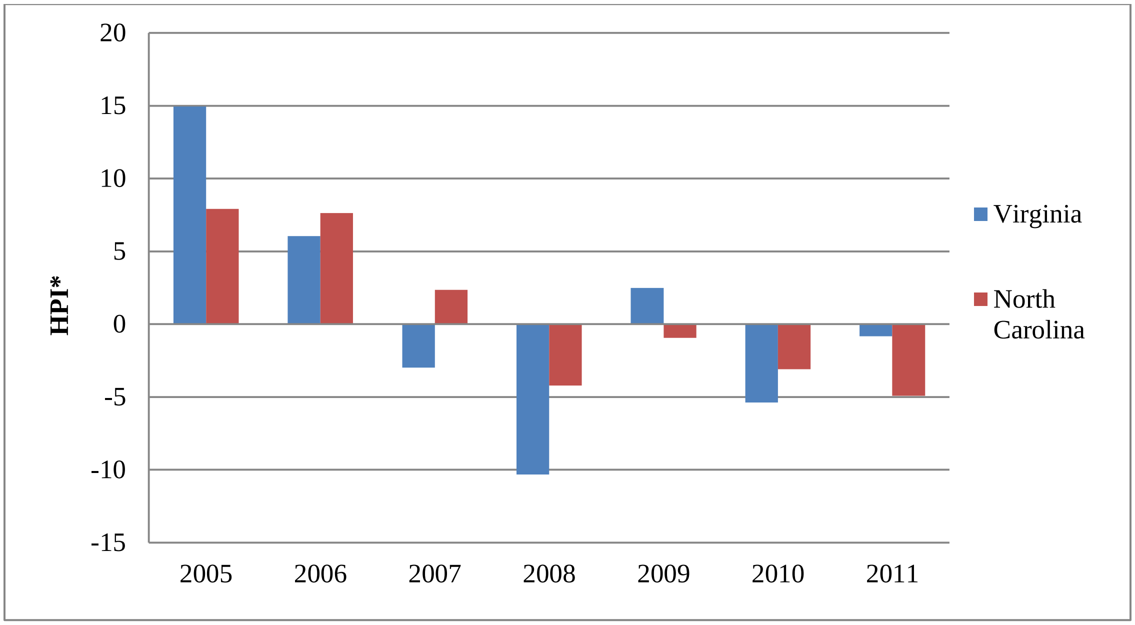
Commonwealth allowed clear violations of segregation of duties principles to develop within key functions, which increased the bank's fraud risk. Specifically, the two loan officers managing the majority of the loan portfolio also had the authority to (1) sign disbursement checks, (2) authorize general ledger tickets to cover loan payments, (3) authorize customer loan draw requests, and (4) inspect construction projects. To effectively minimize fraud risk, loan origination staff should not sign disbursement checks. Similarly, loan officers should not have any role in accounting processes or controls given their lack of independence and the conflicts presented by their interest in the performance of their loans. In our opinion, these control failures allowed the two loan officers to have too much control over the lending function, thereby exposing Commonwealth to fraud risk.

The loan officers' authority also extended to cashier's checks. Based, in part, on concerns raised by a bank employee, examiners reviewed Commonwealth's controls surrounding cashier's checks. During the October 2009 examination, FRB Richmond examiners noted three instances in which a loan officer authorized customer accounts to be overdrawn to purchase cashier's checks. Examiners also noted a violation of bank policy when a loan officer authorized the purchase of a cashier's check with a personal check drawn on another institution. The check was later returned due to insufficient funds. We believe that the bank's internal control weaknesses further increased Commonwealth's risk profile by presenting the opportunity for key employees to engage in unsafe and unsound practices.

Real Estate Market Decline Deteriorated Asset Quality

As a result of Commonwealth's high CRE and individual borrower concentrations, weak internal control framework, and credit risk management weaknesses, the bank was extremely vulnerable to real estate market deterioration. Commonwealth's asset quality began to deteriorate as the real estate sector weakened in Virginia and North Carolina in 2007, as illustrated in chart 4.

Chart 4: Housing Price Index (HPI) for Virginia and North Carolina



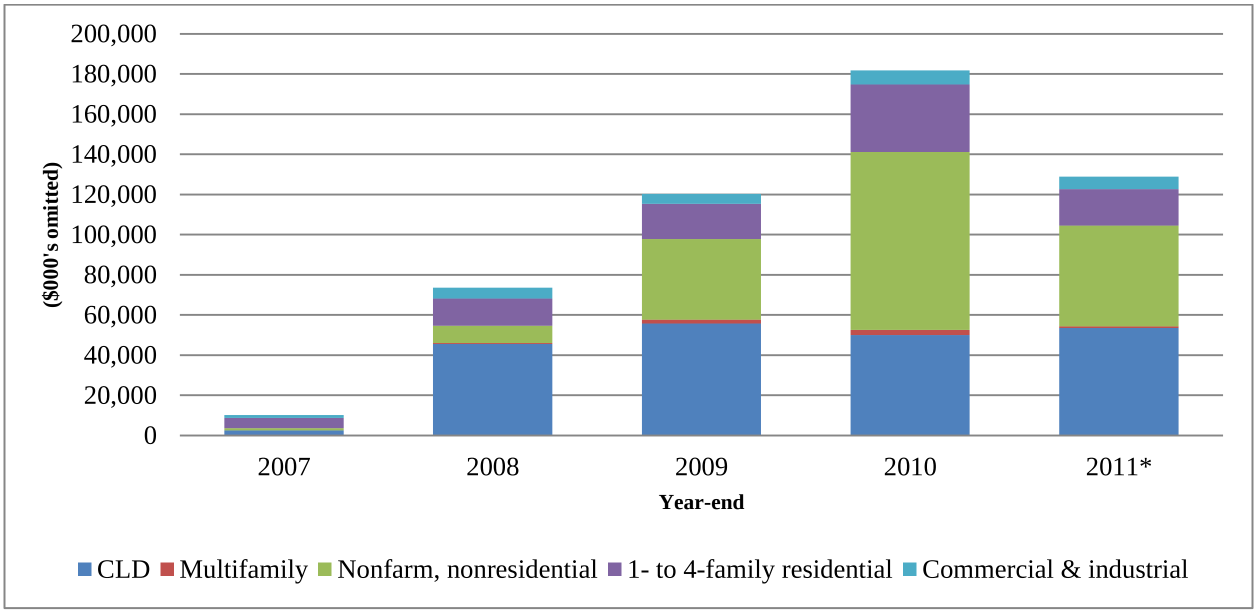
*The HPI is a broad measure of the movement of single-family house prices. The HPI is a weighted repeat-sales index that measures average price changes in repeat sales or refinancing on the same properties.

Specifically, the bank's CLD portfolio deteriorated as borrowers struggled to complete and sell their residential construction projects. A September 2008 examination noted that classified assets increased from $8 million at the time of the previous examination, or 7 percent of tier 1 capital and the ALLL, to $80 million, or 65 percent of tier 1 capital and the ALLL. The trend continued, as classified assets increased 235 percent to approximately $268 million by October 2009, or 178 percent of tier 1 capital and the ALLL.

As illustrated in chart 5, the bank's delinquencies were primarily composed of CRE loans, with approximately half of delinquencies attributed to CLD loans in 2009.[10] Loan losses peaked at approximately $40 million in 2009, with nearly $20 million attributable to CLD loans.

[10] Total CRE includes CLD; multifamily; and nonfarm, nonresidential loans.

Chart 5: Delinquent and Nonaccrual Loans by Type



*As of 6/30/11

Deliberate Practices Masked Full Extent of Commonwealth's Problem Loans

We believe that the board of directors and management's failure to implement appropriate credit risk management capabilities and internal controls created the opportunity for Commonwealth to engage in a series of unsafe and unsound practices designed to mask the bank's true financial condition. These efforts became increasingly apparent from 2008 through 2010.

<u>Practices Observed in 2008</u>

During a September 2008 examination, State examiners noted the bank's hesitancy to recognize the severity of problems in the loan portfolio as evidenced by the large number of loans downgraded during the examination. Examiners determined that Commonwealth kept loans current by (1) inappropriately using interest reserves and capitalizing interest on loans, (2) extending loan maturities without full collection of interest, and (3) accepting separate notes for interest payments. These practices masked the true condition of the underlying loans by creating the appearance that many of the bank's nonperforming loans were performing.

Unsafe and Unsound Practices Observed in 2009

During its October 2009 full-scope examination, FRB Richmond noted that Commonwealth relied on a series of unsafe and unsound practices to mask the past-due status of criticized and classified loans, including (1) changing loan terms to keep loans current; (2) applying loan payments to interest only when contractual terms required both principal and interest; (3) overdrawing customer deposit accounts to make loan payments; (4) using interest reserves to keep loans current when construction had not proceeded as planned; (5) capitalizing delinquent interest, overdrafts, and other fees at maturity into new notes; (6) using funds from related entities, without authorization, to make loan payments; (7) extending interest due dates in cases when payments had not been made; (8) extending additional principal to cover payment shortfalls; and (9) permitting loan officers to authorize general ledger tickets to cover loan payments.[11] The severity of these findings caused FRB Richmond to implement a formal enforcement action and insist that loan officers have no credit administration involvement with loans in their portfolios, including loans they originated.

During the October 2009 examination, FRB Richmond examiners noted that the bank had a high volume of loans with change-in-terms agreements. Commonwealth used these agreements to modify loan terms to, among other things, increase loan amounts or extend the loan term or payment dates to keep loans current. Examiners noted that, in general, the bank's liberal use of change-in-terms agreements made it difficult to determine how loans were actually performing and could mask the actual delinquency rates in the loan portfolio. Examiners indicated that many of these loans appeared to be troubled debt restructurings, which should have been reported as such on the bank's Call Report and reflected in the bank's internal systems. Examiners also noted 33 past-due loans that had been omitted from an internal management report.

During the October 2009 examination, examiners began to discover the risks associated with the bank's large, complex relationships, in part because a bank employee suggested that FRB Richmond scrutinize a particular relationship. Examiners determined that the senior loan officer in charge of the relationship was "excessively accommodating" to the borrower. Although the borrower's debt had been interest only for an extended period of time, the bank continued to make loans to the borrower and increase the borrower's overall debt. Commonwealth also either (1) renewed the borrower's loans when they came due even if the obligations had not been satisfied, or (2) paid them off with proceeds from new loans. Examiners highlighted their difficulties in attempting to quantify the entire borrower relationship due to the multitude of related entities involved, such as limited liability companies, partnerships, and business associates.

FRB Richmond's analysis indicated that loan proceeds that were disbursed to one entity actually benefited another related entity and that some loan proceeds were used to pay down debt at another local institution. Due to the "excessively accommodating" treatment from the senior loan officer in charge of the relationship, FRB Richmond's Bank Secrecy Act (BSA) specialist

[11] Criticized loans includes "special mention" loans that are exhibiting signs of weakness but have not been classified as substandard, doubtful, or loss.

reviewed the loan officer's deposit accounts at Commonwealth and the loan customer's deposit accounts at another local institution for signs of suspicious activity.[12]

Additional Practices Noted in 2010

During an October 2010 target examination, examiners determined that bank management took additional steps to mask the full extent of its problem assets. Examiners determined that the bank had financed multiple purchases of the properties in its OREO portfolio with minimal financial analysis of the borrowers and on "extremely generous" terms.[13] This practice allowed management to remove OREO properties from the bank's books and replace each foreclosed property with a performing loan collateralized by the previously foreclosed property. In addition, the bank accounted for OREO properties that required improvements at their as-complete value, rather than at their fair market value. Examiners recommended that the bank write down the value of these properties. The bank also accounted for several OREO properties without a current appraisal, which also potentially exposed the bank to further write-downs.

Further, Commonwealth funded loans to improve its OREO properties. In several instances, examiners determined that the bank disbursed loan proceeds for construction either fully at closing or without evidence that any work had been performed. In one instance, the bank filed a suspicious activity report (SAR) on the borrower after examiners conducted a site visit to the applicable property and determined that no construction had occurred.[14]

Deficient ALLL Level and Methodology Resulted in Provision Expenses and Losses

Bank management also failed to adequately reserve against potential loan losses. As a result, the bank routinely incurred significant provision expenses to bring the ALLL to a level commensurate with the actual risk of loss. The October 2009 examination required Commonwealth to increase the ALLL by $20 million as of September 30, 2009, which resulted in a refiling of the bank's third quarter 2009 Call Report. Examiners also noted multiple issues with the bank's reserve methodology, including that (1) the methodology did not account for a prolonged downturn in asset quality, (2) many impairment calculations were based on outdated appraisals, and (3) loans classified during the examination needed to be assessed for impairment. Provision expenses for year-end 2009 totaled $54 million, resulting in losses of nearly $25 million, as noted in chart 6.

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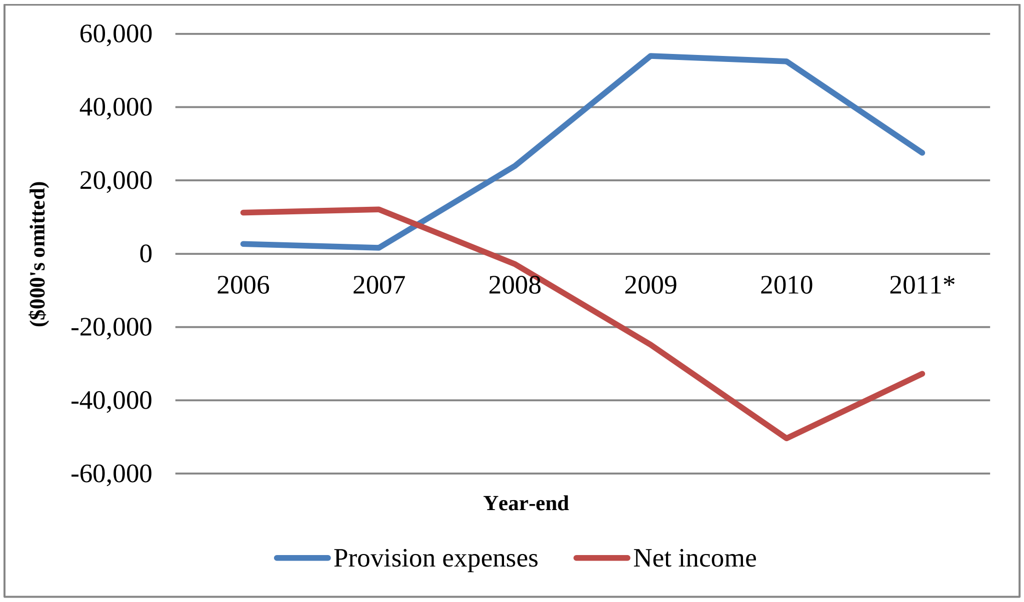
[12] FRB Richmond could not identify any indications of direct payments involving the customer and the senior loan officer. The limited scope of this review is described in greater detail in the Supervision of Commonwealth section of this report.

[13] This portfolio typically consists of the bank's inventory of foreclosed properties.

[14] Suspicious activity reporting requirements generally require depository institutions to file a report with law enforcement officials upon detecting or suspecting a violation of criminal law.

Chart 6: Provision Expenses and Net Income



*As of 6/30/11

Due to persistent and severe asset quality deterioration, Commonwealth continued to increase the level of its ALLL, resulting in provision expenses of $53 million in 2010. The bank's earnings could not absorb these expenses, and the institution experienced losses of $50 million in 2010. Examiners again noted issues with the bank's recognition of problem assets and reserve methodology during a May 2011 examination and required an additional $21 million provision expense to adequately fund the reserve as of second quarter 2011. As a result, losses amounted to $33 million as of June 30, 2011.

Losses Eroded Capital and Resulted in Bank Closure

FRB Richmond implemented the PCA provisions of the FDI Act and timely notified Commonwealth when the bank reached various PCA categories. In 2008, Commonwealth applied for more than $28 million in Troubled Asset Relief Program funds through the Capital Purchase Program, but withdrew its application in 2009. Given the asset quality deterioration and weak economic conditions, Commonwealth's holding company injected $15 million into the bank during the first quarter of 2009. However, FRB Richmond anticipated further losses during a June 2009 target examination and required the bank to develop a capital plan. FRB Richmond determined that the bank's capital plan was insufficient because the plan needed to better address the bank's compliance with regulatory capital ratios and PCA guidelines.

In October 2009, Commonwealth refiled its September 30, 2009, Call Report due to $20 million in provision expenses required by examiners. As a result, the bank temporarily fell below *well capitalized* status during the examination. However, Commonwealth remained *well capitalized* as of September 30, 2009, due to a $4 million injection from the holding company. During the joint examination that began in May 2010, examiners noted that the bank's capital levels were critically deficient relative to its risk profile and anticipated that Commonwealth's capital would decline beneath *well capitalized* status in the fall of 2010. In July 2010, FRB Richmond implemented a written agreement requiring Commonwealth to submit a written plan to maintain sufficient capital. FRB Richmond approved the bank's plan in August 2010. The bank failed to raise additional capital, and it fell to *adequately capitalized* as of September 30, 2010, following $30 million in provision expenses. As a result, the bank could not accept, renew, or roll over any brokered deposits without prior approval from the FDIC.[15]

By year-end 2010, Commonwealth had become *undercapitalized*. Commonwealth dropped to *critically undercapitalized* as of June 30, 2011, when continued losses, largely attributable to provision expenses, and management's inability to raise additional capital caused the bank's tangible equity ratio to fall below 2 percent.[16] The Federal Reserve Board issued a PCA directive on July 1, 2011, that, among other things, required the bank to accomplish the following within 30 days of the directive's date: (1) raise additional capital or take other measures to achieve the *adequately capitalized* PCA designation; or (2) be acquired by, or merge with, another depository institution. Commonwealth failed to comply with the terms of the directive. Mounting losses in the CRE portfolio, along with required provision expenses, eroded the bank's capital and caused the bank to drop from *well capitalized* to *critically undercapitalized* within nine months. The State closed the bank on September 23, 2011, and appointed the FDIC as receiver.

Supervision of Commonwealth[17]

Our analysis of FRB Richmond's supervision of Commonwealth during our period of review, 2000 through 2011, revealed that examiners identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address these weaknesses.

Additionally, we determined that FRB Richmond did not comply with the Federal Reserve Board's examination frequency requirements and guidelines for our period of review.[18] Under

[15] As of June 30, 2010, approximately 41 percent of the bank's total deposits were brokered deposits, thereby increasing the bank's liquidity risk.

[16] CBEM defines the tangible equity ratio as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of mortgage servicing assets allowable in tier 1 capital.

[17] Throughout this section of the report, we use the term "examiners" to generally refer to the examination staff conducting the examination being discussed. As applicable, the term may refer to FRB Richmond examiners, State examiners, or examination staff from both entities for joint examinations.

[18] 12 C.F.R. 208.64 generally requires Reserve Banks to conduct an annual full-scope examination of state member banks, subject to certain exceptions. 12 U.S.C. 326 and the alternate examination approach permit a Reserve Bank to rely on examinations performed by a state supervisor to satisfy this requirement. State officials mentioned to us that they are subject to separate standards for conducting timely examinations. The Reserve Bank must assure that it satisfies applicable timeliness and scope requirements regardless of whether the State conducts the examination.

the alternate examination approach, FRB Richmond was responsible for assuring that required examinations were conducted in a timely manner. The 2006 full-scope examination, however, did not occur within a year of the prior full-scope examination, as required by 12 CFR 208.64 and SR Letter 97-8, *Revisions to Examination Frequency Guidelines for State Member Banks*.

During the period covered by our review, FRB Richmond and the State conducted 11 full-scope examinations and 4 target examinations; executed 5 enforcement actions—3 board resolutions, a written agreement, and a PCA directive; and implemented the applicable provisions of PCA. The bank's supervisory history is outlined in table 1 below.

Table 1: Commonwealth Supervisory Overview

Examination			Agency Conducting the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
10/30/00	12/29/00	Full	FRB Richmond	3	3	3	3	4	2	3	Board resolution adopted 02/20/01
11/05/01	01/25/02	Full	Joint	3	2	2	2	4	2	3	
12/02/02	01/09/03	Full	FRB Richmond	2	2	2	3	2	2	2	Board resolution released BSA board resolution adopted 02/18/03
01/05/04	04/20/04	Full	State	2	2	2	2	2	2	2	
01/12/04	04/09/04	Target BSA	FRB Richmond	NA	NA	NA	NA	NA	NA	NA	BSA board resolution released
01/10/05	03/07/05	Full	FRB Richmond	2	2	2	2	2	2	2	
08/14/06	09/26/06	Target liquidity	FRB Richmond	NA	NA	NA	NA	NA	NA	NA	
10/16/06	12/27/06	Full	State	2	1	2	2	1	2	1	
11/28/07	01/11/08	Full	FRB Richmond	2	1	2	2	1	2	2	
09/29/08	01/23/09	Full	State	3	2	4	3	4	2	2	Board resolution adopted 04/21/09
06/08/09	08/13/09	Target asset quality and liquidity	FRB Richmond	3	3	4	3	3	3	2	
10/19/09	03/19/10	Full	FRB Richmond[a]	5	5	5	5	5	5	5	Written agreement executed 07/02/10
05/03/10	08/31/10	Full	Joint[b]	5	5	5	5	5	5	5	
10/18/10	03/15/11	Target asset quality and overall financial condition	FRB Richmond[a]	5	5	5	5	5	5	5	
05/09/11	08/25/11	Full	FRB Richmond[a]	5	5	5	5	5	5	5	PCA directive issued 07/01/11

[a]The State and the FDIC participated in this examination.
[b]The FDIC participated in this examination.

October 2000 Full-Scope Examination Resulted in a Board Resolution

As a result of an October 2000 examination, FRB Richmond assigned Commonwealth a CAMELS composite rating of 3 (fair) and characterized Commonwealth's overall performance as less than satisfactory. Each of the bank's CAMELS components received 3 ratings, except for the earnings and liquidity components, which were rated 4 and 2, respectively. FRB Richmond noted significant and pervasive weaknesses during this examination, which resulted in an informal enforcement action in the form of a board resolution. Those weaknesses included (1) the board of directors' failure to exercise proper oversight, and (2) Commonwealth's declining financial performance.

Examiners stated that the volume of classified assets was unacceptable and reflected weak credit risk management practices. Asset quality deterioration and related provision expenses had strained the bank's earnings. Weak earnings, coupled with asset growth, contributed to the fall of Commonwealth's capital ratios below *well capitalized* status for PCA purposes.

In the examination report, FRB Richmond commented on the CEO's dominance over the institution's policies and decision-making. Examiners noted that several members of the management team were reluctant to discuss issues with the CEO and expressed concern that issues may not be resolved in a timely manner or communicated to the board of directors. Examiners also found that the CEO had exceeded his unsecured lending authority in granting overdrafts to two customers. Further, FRB Richmond noted that board members were not always aware of (1) loans made to problems borrowers, or (2) policy exceptions. FRB Richmond noted that Commonwealth exceeded policy limits for liquidity targets and interest rate risk tolerances approved by the board of directors. Examiners noted that some policy limits may have been unrealistic given the bank's aggressive growth strategy. With respect to interest rate risk, examiners noted that management had no plans "to reduce the current exposure or to return within risk tolerances." In our opinion, these examples demonstrated the CEO's willingness to circumvent the board of directors and ignore policy limits and restrictions on his authority. These examples should have been warning signs that the CEO was excessively dominant at the institution.

Examiners noted additional significant weaknesses. Examiners recommended that Commonwealth expand internal audit coverage of high risk areas and noted that the bank had not hired a qualified internal auditor. FRB Richmond determined that the bank's credit risk was high and increasing due to a combination of weak risk management practices and a concentration in CRE loans, with 51 percent of the loan portfolio consisting of CRE loans, compared to a 25 percent peer group average. Within the CRE portfolio, examiners also noted a concentration in loans to hotels and motels. Examiners noted that loan review was "essentially nonexistent." Further, 75 percent of loans classified by examiners represented downgrades from internal risk ratings assigned by the bank.

Examiners also identified significant weaknesses related to loan underwriting, risk identification, and loan administration. Specific findings included (1) extensions of credit to classified borrowers without current financial information or analysis to support additional credit; (2) failure to recognize problem loans in a timely manner, contributing to a "woefully inadequate" ALLL; (3) failure to establish limits for credit concentrations; and (4) stale classified assets, including foreclosed properties and overdrafts, resulting in losses.

As a result of the weaknesses noted during this examination, FRB Richmond and the State implemented an informal enforcement action in the form of a board resolution. Commonwealth's board of directors adopted a board resolution requiring the bank to (1) not lend to borrowers with classified loans without the board of directors' prior approval, (2) analyze current financial information of the borrower prior to making a loan, (3) maintain an adequate ALLL and review the adequacy quarterly, (4) establish a program of independent loan review to assure timely recognition of problem loans, (5) develop a written strategic plan, and (6) review liquidity and interest rate risk policies and obtain prior approval of exceptions from the board of directors.

In our opinion, the significant findings noted during this examination warranted a stronger supervisory response than a board resolution. As outlined in CBEM section 5040.1, a board resolution represents a series of commitments formalized by the bank's board of directors and reflected in the corporate minutes. By contrast, a memorandum of understanding (MOU) is another type of informal enforcement action that is a "highly structured written, but informal, agreement" signed by the Reserve Bank and the bank's board of directors. CBEM Section 5040.1 indicates that "an MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management." In our opinion, Commonwealth's multiple deficiencies made an MOU more appropriate because this type of action would have (1) better conveyed the severity of the issues and the urgent need to resolve them, and (2) provided FRB Richmond the opportunity to prescribe and agree to the required corrective actions and applicable time frames for those actions.

November 2001 Joint Full-Scope Examination Resulted in Component Rating Upgrades

A November 2001 joint full-scope examination resulted in upgrades to Commonwealth's CAMELS component ratings for capital, asset quality, and management. Despite those component ratings upgrades, the bank's CAMELS composite rating remained a 3, largely because of the bank's poor earnings, which resulted in a CAMELS component 4 rating. Examiners noted that the board resolution should not be lifted until the bank attained a satisfactory rating. Examiners again commented that the CEO continued "to be heavily involved in all aspects of the bank and its parent company."

During the examination, examiners noted improvement in the bank's asset quality. Commonwealth's classified assets decreased from 45.2 percent during the prior examination to 20.5 percent of tier 1 capital plus the ALLL. In addition, Commonwealth's holding company injected $6.5 million to return the bank to *well capitalized* status. Despite the bank's improved asset quality and capital augmentation, examiners determined that the bank's earnings were insufficient to support operations and maintain appropriate capital and ALLL levels. Examiners noted that Commonwealth's earnings were weak due to its high funding costs, which resulted from competition for deposits.

Despite the bank's improved asset quality and capital position, internal control and credit risk management weaknesses continued to surface. While Commonwealth arranged for a third party to conduct loan reviews as recommended by examiners, management did not recognize problem loans or downgrade its loan ratings in a timely manner. Although examiners cited this issue during the 2000 examination, it was not identified as a repeat finding in 2001.

Examiners also noted several errors on the bank's Call Report and cited a contravention of Regulation H's LTV guidelines and a violation of Regulation Y's appraisal requirements. Specifically, examiners identified a situation in which an appraiser sent an appraisal to the borrower rather than the bank. Also, although not identified as a violation of Regulation Y, examiners identified another loan for which the appraised value of the collateral matched the purchase price identically. In our opinion, these issues were possible early indications of problems with the independence of the bank's appraisals.

December 2002 Full-Scope Examination Resulted in CAMELS Composite Rating Upgrade and Release of the Board Resolution

During a December 2002 full-scope examination, FRB Richmond concluded that Commonwealth's overall condition was satisfactory, upgraded the bank's CAMELS composite rating to 2 (satisfactory), and released the bank from the 2001 board resolution. Each CAMELS component received a 2 rating, except for the management component rating, which was downgraded to 3. Examiners again concluded that the CEO dominated policy decisions at Commonwealth.

The 2 rating for the earnings component represented a double upgrade from the 4 rating assigned during the previous examination. Examiners noted improvement in the bank's return on average assets and net interest margin. FRB Richmond attributed the improvements to longer-term certificates of deposits repricing at lower rates while Commonwealth received above-average loan rates.

In the examination report, FRB Richmond noted improvements in the bank's asset quality and credit risk management practices. Examiners mentioned that they now considered the bank's risk rating system to be reliable. No risk rating downgrades were identified as a result of the examination and classified assets declined to their lowest level in three years and were beneath peer averages. Despite improved loan portfolio performance and some risk management enhancements, FRB Richmond again noted Commonwealth's need to (1) obtain current financial information from borrowers to verify their ability to repay, (2) monitor the CRE concentration risk within the loan portfolio, and (3) incorporate additional factors into the ALLL methodology to reflect historical losses, special mention loans, and local economic conditions.

In addition, FRB Richmond identified another contravention of Regulation H's LTV guidelines. In this instance, the customer received a loan that represented 111 percent of the appraised value of the collateral. Regulation H established a supervisory LTV limit of 75 percent of the collateral value for that loan type. Moreover, examiners determined that the internal audit program needed to be strengthened because it did not cover all of Commonwealth's high-risk areas. Examiners again noted that policies and procedures did not match the bank's practices and that Commonwealth operated outside of many of its own policy guidelines.

FRB Richmond noted that operational, legal, and reputational risks were increasing at Commonwealth due to weaknesses in the bank's BSA compliance program, anti-money-laundering efforts, and monitoring and identification of suspicious activity. As a result of this examination, the board of directors adopted a board resolution that focused on enhancements to ensure a sound BSA program. Specifically, the BSA board resolution required Commonwealth to, among other things, (1) enhance or develop systems to monitor unusual client activity; (2) implement a "know your customer" statement of policy and internal controls; and (3) revise and improve internal controls surrounding identification of high-risk activity, account monitoring, account closures, and due-diligence standards.

January 2004 Full-Scope State Examination Resulted in Management Component Rating Upgrade

As a result of a January 2004 examination, the State maintained Commonwealth's satisfactory CAMELS composite rating and upgraded the bank's management component rating from 3 to 2. Examiners highlighted the bank's *well capitalized* status and improved earnings performance. Nevertheless, the examination report highlighted three matters requiring the board of directors' attention: (1) no internal audits were performed in 2003, (2) the bank's asset liability management and loan policies had not been reviewed and approved by the board of directors on an annual basis, and (3) the ALLL level was deficient based on the level and severity of loan classifications. Examiners also noted that only one written loan review report was provided to the bank in 2003, although quarterly reviews had been conducted pursuant to an outsourcing arrangement. The written loan review report, contained in examination work papers, addressed the lack of current financial information in Commonwealth's loan files.

Examiners recommended that the bank hire a full-time internal auditor. In addition to the lack of audits performed in 2003, examiners also noted that the Audit Committee's meeting minutes did not discuss any reports evaluating internal controls. Examiners emphasized that regular review of the high-risk areas is necessary for a strong system of internal controls. In our opinion, the failure to conduct regular audits of high-risk activities was another significant warning sign that Commonwealth's internal controls were not effective. The bank ultimately hired an internal auditor in March 2004.

Examiners noted additional management changes that were scheduled to occur in 2004: the bank's chief financial officer planned to resign in April, and Commonwealth hired a new senior lender. However, even with these anticipated changes, the confidential section of the report again noted that the CEO continued to dominate policymaking and decision-making.

January 2004 Target BSA Examination Released the BSA Board Resolution

As a result of a January 2004 target BSA examination, FRB Richmond released the BSA board resolution upon concluding that the weaknesses noted during the December 2002 examination had been corrected.

January 2005 Full-Scope Examination Resulted in Satisfactory Ratings

As a result of an FRB Richmond January 2005 full-scope examination, Commonwealth received a CAMELS composite 2 rating, with each of the CAMELS components also receiving 2 ratings. FRB Richmond noted minimal problem assets, satisfactory earnings, and adequate capital. Examiners mentioned that the bank's capital had recently increased following a stock offering, and management intended to conduct an additional offering if strong loan demand continued. The examination report also highlighted that Commonwealth had recently filled the positions of chief financial officer, controller, and internal auditor. FRB Richmond mentioned that examiners detected no "material weaknesses" in the lending function, except for the risk management weaknesses related to the CRE concentration, which are discussed below.

Despite the satisfactory ratings, FRB Richmond noted that Commonwealth's weak credit and market risk management practices required the immediate attention of the board of directors. Specifically, examiners determined that weak risk management practices concerning the high concentration of CRE loans persisted. FRB Richmond noted that Commonwealth's CRE concentration was 576 percent of tier 1 capital plus the ALLL. Based on Commonwealth's elevated CRE concentration, examiners recommended that management and the board of directors implement the following credit risk management enhancements: (1) adopt limits for CRE concentrations, (2) formalize a concentration analysis process, and (3) conduct annual stress testing of the CRE portfolio. According to the examination report, examiners expected that Commonwealth would formally address these issues and other weaknesses, including detailing appraisal review procedures, in its loan policy.

Despite the prior release of the BSA board resolution in 2004, examiners noted a series of issues related to the BSA program. Examiners noted that the identification and reporting of suspicious activity would be enhanced by the bank's adopting a "know your customer" policy. This recommendation was previously contained in the BSA board resolution, which suggests that the release of the enforcement action may have been premature because a key component of the enforcement action remained unresolved. Examiners also recommended several enhancements to the BSA compliance program, including (1) providing additional discussion details regarding SARs in the board minutes, and (2) expanding internal audit testing to cover the integrity of monitoring reports.

Based on applicable criteria, the bank's next full-scope examination should have commenced by March 2006, but it did not start until October 2006. The August 2006 FRB Richmond target examination discussed below failed to satisfy either the examination frequency or scope guidelines. At the time, SR Letter 97-8 required an on-site full-scope examination at least once during each 12-month period, unless an institution had less than $250 million in total assets and met certain conditions. If those conditions were met, full-scope examinations could occur every 18 months. Commonwealth had more than $250 million in total assets in 2005, so the bank did not qualify for the 18-month full-scope examination cycle for insured depository institutions. FRB Richmond materials we reviewed acknowledged the failure to satisfy the examination requirements.

August 2006 Liquidity Target Examination Determined Satisfactory Liquidity Risk Management

In August 2006, FRB Richmond initiated a liquidity target examination because of the bank's high level of loan growth since the January 2005 full-scope examination and its resulting reliance on noncore funding. Examiners noted that Commonwealth's reliance on noncore funding was "well in excess of peer comparisons." FRB Richmond concluded that Commonwealth's liquidity risk management remained satisfactory and appropriate given the bank's funding strategy. Examiners recommended that the bank enhance its contingency funding plan to provide realistic options in the event that market-based funding solutions became unavailable.

October 2006 Full-Scope State Examination Retained a Satisfactory CAMELS Composite Rating

Beginning in October 2006, the State conducted a full-scope examination that resulted in a CAMELS composite 2 rating. The State upgraded the bank's CAMELS component ratings for capital, earnings, and sensitivity from 2 to 1. Asset quality, liquidity, and management components received 2 ratings. Overall, examiners considered the bank to be in satisfactory condition. Examiners attributed the capital upgrade to a $36.5 million injection from the holding company during the previous 12 months to support branch expansion and loan growth. In addition, strong earnings resulted in the bank's return on average assets exceeding its peer group, although the bank's cost of funds also remained above peer due to local competition for deposits.

Despite strong capital and earnings performance, classified assets increased from $1.2 million during the January 2005 full-scope examination to $8.3 million. The State identified multiple credit risk management weaknesses, some of which had been identified during previous examinations. Examiners noted that not all nonaccrual loans were reviewed and reported to the board and recommended incorporating procedures into the bank's Loan Policy to monitor all nonaccrual loans. In addition, the bank failed to charge off overdrafts in a timely manner. Further, examiners identified numerous loan file documentation exceptions, such as missing or stale borrower financial information and cash flow analyses. The State noted that internal loan review was generally not performed. Although Commonwealth established limits on its credit concentrations, examiners noted that these guidelines had not been incorporated into the bank's Loan Policy.

November 2007 Full-Scope Examination Retained a Satisfactory CAMELS Composite Rating

In November 2007, FRB Richmond began a full-scope examination that resulted in a CAMELS composite rating of 2. FRB Richmond preserved all of the bank's previously assigned component ratings except for the sensitivity component, which examiners downgraded from 1 to 2. Although examiners determined that risk management practices were generally satisfactory, they concluded that the bank's risk management infrastructure had not kept pace with the bank's growth. Among other things, they identified that credit risk and internal audit required the immediate attention of the board of directors.

Examiners noted that strong earnings and holding company support augmented the bank's capital position. Bankshares provided $18 million in capital support to the bank in 2006. Examiners mentioned that the bank's capital and liquidity would support management's aggressive growth plans. Additionally, FRB Richmond determined that Commonwealth had a manageable level of problem assets.

As a result of the examination, FRB Richmond identified a significant deficiency related to loan administration. The examination report listed improving the controls surrounding CLD disbursements as the first matter for the directors' attention, but the examination report did not describe the findings that led to the required action. Examination work papers indicated that Commonwealth's decentralized funding process for CLD loans lacked reasonable oversight. Section 1000.1 of the CBEM outlines the Federal Reserve Board's expectations for examination reports. An examination report should be "a comprehensive summary supervisory report" that discusses "each of the major business risks." In our view, FRB Richmond's examination report failed to meet this standard. Given the importance of mitigating credit and fraud risk by assuring that funds disbursed for construction purposes were used appropriately and timely, we believe that this finding warranted a more thorough explanation in the examination report and represented another warning sign concerning the effectiveness of the bank's internal controls.

Examiners identified "an inordinate number of loans" with missing or stale financial information. As a result, FRB Richmond expected Commonwealth to establish processes to ensure timely receipt and analysis of borrowers' current financial statements and identify documentation exceptions. The examination report identified this finding as a repeat deficiency from the previous State examination, but failed to mention that this finding had been identified during multiple previous examinations.

Additionally, during the examination, examiners noted numerous credit risk management deficiencies that required corrective action. FRB Richmond acknowledged that "borrowing relationships continue to increase in size and complexity." Examiners sought to address this increasing complexity by recommending that the bank improve its loan approval process and adjust the scope of its loan review activities. Examiners recommended (1) incorporating cost analysis and feasibility studies for CRE loans, (2) identifying the source of the LTV calculations included in loan presentation summaries, (3) enhancing loan approval presentations by incorporating analysis of the contingent liabilities of guarantors, (4) incorporating global cash flow analysis into annual loan reviews, (5) committing adequate resources to loan review, and (6) conducting annual loan reviews of all borrowing relationships of $1 million or more. In addition to these credit-related recommendations, FRB Richmond noted that Commonwealth needed to (1) strengthen the appraisal review process of CLD loans to ensure adequate collateral coverage, and (2) develop systems to effectively identify critical documentation exceptions. Despite the significant and pervasive weaknesses noted during the examination and a CRE concentration well above levels indicative of a potentially significant exposure to CRE concentration risk, FRB Richmond determined that the bank achieved general compliance with the guidance contained in SR Letter 07-01.

In addition, FRB Richmond noted that Commonwealth's internal audit program provided insufficient coverage of the bank's high-risk areas. Examiners determined that the internal audit program needed additional qualified resources because it had insufficient staffing to perform specialized audits, such as information technology, BSA, and interest rate risk. Examiners recommended that management add staff to the internal audit function or outsource a portion of the bank's internal audit to a third-party vendor. Examiners also recommended that the CEO permit an executive session at Audit Committee meetings to allow for discussion of findings without bank management present.

FRB Richmond also raised concerns about weaknesses in the bank's BSA compliance program. FRB Richmond expected Commonwealth to expand transaction testing conducted as part of the BSA audit to evaluate the bank's suspicious activity monitoring capabilities and reporting systems.

In our opinion, the significant credit risk management issues noted during this examination warranted, at a minimum, component ratings downgrades to asset quality and management. Further, the scope and severity of the internal control and credit risk management issues noted during this examination also warranted an informal enforcement action in the form of an MOU.

September 2008 Full-Scope State Examination Resulted in a CAMELS Composite Downgrade and a Board Resolution

As a result of a September 2008 full-scope examination, the State downgraded the bank's CAMELS composite rating to 3. All component ratings received downgrades, except for liquidity and sensitivity, which both remained a 2. The bank's CAMELS component rating for earnings received a triple downgrade from 1 to 4, and asset quality received a double downgrade from 2 to 4. The CAMELS component ratings for capital and management were downgraded to 2 and 3, respectively. State examiners characterized the board of directors' and management's oversight as less than satisfactory, primarily due to Commonwealth's weak credit risk management practices. According to the State, the bank's focus on loan growth overshadowed the need for effective credit administration and underwriting practices. In the confidential section of the examination report, the State noted the CEO's dominance and control over the institution.

The State determined that Commonwealth's asset quality had deteriorated significantly due to a sharp increase in classified assets and credit risk management weaknesses. Classified assets increased by almost 900 percent, from $8 million during the prior examination to approximately $80 million. During the examination, classified assets represented 65 percent of tier 1 capital and the ALLL. Examiners noted that management appeared hesitant to recognize the severity of problems in the loan portfolio, as evidenced by the large number of loans downgraded during the examination. Due to the bank's inaccurate identification of risk in the loan portfolio, Commonwealth increased its ALLL by $20 million to make it commensurate with the risk of loss in the loan portfolio during the third quarter 2008.

State examiners noted that the bank's CRE loan concentration increased to 609 percent of total risk-based capital. State examiners recommended that the bank segment the loan portfolio by type to improve its CRE credit risk management practices. Examiners also identified numerous credit administration deficiencies, including (1) "voluminous" loan file documentation exceptions; (2) lack of current borrower financial statements; (3) lack of global cash flow analysis for borrowers; (4) missing summary information for leased properties concerning tenants, anticipated rents, and lease terms; (5) lack of change-in-terms agreements and purposes of loan renewals in loan files; and (6) lack of independent inspection reports in construction draw files.

With respect to internal controls, State examiners noted that loan officers could sign loan disbursement checks, conduct inspections on construction projects, and authorize draw requests for loans they originated, representing a significant weakness in key controls designed to prevent fraud. Examiners recommended that the bank develop controls to mitigate its operational and reputational risks in this area. In addition, the State noted that the internal audit program continued to require additional resources. Further, the State identified three appraisals that violated Regulation Y's requirements. For BSA program transaction monitoring purposes, the State recommended that Commonwealth transition from manual processes to automated systems to monitor suspicious activity.

As a result of the examination, the State and FRB Richmond implemented a joint informal enforcement action by recommending that the bank's Board of Directors adopt a board resolution to address Commonwealth's weaknesses. Commonwealth's board of directors adopted a board resolution that required the board members to assess management's qualifications and expertise to perform its roles and responsibilities. The board resolution required the bank to perform a written analysis prescribing specific actions to strengthen management and improve supervision by the board of directors. The board resolution also required that Commonwealth (1) develop an ongoing process to review all problem loans to accurately determine potential losses, (2) ensure that the internal loan risk rating process results in timely and accurate loan grades, and (3) maintain an adequate ALLL. We believe, however, that the reemergence or continuation of previously noted weaknesses warranted a formal enforcement action, in the form of a written agreement, to clearly convey the need for urgent action in resolving these recurring and fundamental weaknesses.[19] In addition, the fact that written agreements are publicly disclosed enforcement actions might have served to motivate the board of directors and management to resolve the bank's weaknesses.

Although the State recommended that the bank establish effective internal controls to govern the funding of loan disbursements, the independence of project inspections, and the authorization for draw requests, FRB Richmond and the State did not address this recommendation in the joint board resolution. We believe that this recommendation warranted inclusion in the enforcement action due to the significance of the findings.

June 2009 Target Examination Maintained the CAMELS Composite 3 Rating but Resulted in Changes to Component Ratings

In June 2009, FRB Richmond conducted a target examination to evaluate Commonwealth's compliance with the board resolution and its progress addressing previously noted credit risk

[19] CBEM section 5040.1 indicates that a written agreement is appropriate "when circumstances warrant a less severe form of formal supervisory action." The "less severe" comparison refers to other formal enforcement actions, including cease-and-desist orders and temporary cease-and-desist orders.

management weaknesses. The target examination also assessed the bank's asset quality and liquidity position. The target examination maintained the bank's CAMELS composite and management component 3 ratings, but downgraded the component ratings for capital and liquidity to 3. The asset quality and sensitivity ratings remained 4 and 2, respectively, but FRB Richmond upgraded the bank's earnings component rating from 4 to 3.

Examiners noted that the condition of the loan portfolio had deteriorated since the previous examination and that the ALLL was underfunded by $3 to $4 million. Examiners acknowledged Commonwealth's progress addressing many of the weaknesses noted during the previous examination. Nevertheless, risk management remained less than satisfactory. Specifically, examiners noted that credit risk management practices related to the bank's CRE loan concentration continued to require improvements.

FRB Richmond noted that Bankshares had provided $15 million to Commonwealth during the first quarter of 2009 to augment its capital position. Examiners anticipated that further asset quality deterioration would eliminate the benefits to be derived from this capital injection. Further, examiners concluded that capital levels were not commensurate with the risk in the loan portfolio, particularly given the bank's CRE loan concentration. Examiners noted that "capital preservation has become critical." In addition, examiners recommended that Commonwealth reduce its reliance on noncore funding sources because this reliance significantly increased the bank's inherent liquidity risk. FRB Richmond required the bank to develop, implement, and submit a plan to reduce its liquidity risk that identified specific target ratios.

We believe that FRB Richmond appropriately accelerated the examination cycle to conduct this examination given the deterioration in the bank's financial condition and the risk management concerns identified during the prior examination. However, in our opinion, the examination report did not sufficiently support the component upgrade for earnings. The examination report only discussed the bank's earnings to note that the current earnings would cover the additional $3 to $4 million provision expense and would not result in a net loss for the second quarter. In our view, avoiding further losses did not warrant a component rating upgrade, especially given the reasonable likelihood that asset quality deterioration would continue to strain earnings.

October 2009 Full-Scope Examination Resulted in CAMELS Composite and Component 5 Ratings and Initiated a Written Agreement

As a result of the October 2009 FRB Richmond full-scope examination, examiners downgraded Commonwealth's CAMELS composite and all component ratings to 5. The transmittal letter to the board of directors accompanying the examination report highlighted examiners' conclusion that the board of directors and management "have been negligent in their duty to manage the affairs of the institution in a safe and sound manner" and "risk management practices, particularly with regard to credit and internal audit, are in dire need of attention." Equally significant, examiners noted that management used a series of unsafe and unsound banking practices to mask the bank's financial condition. Because of these findings, FRB Richmond required the bank to conduct an assessment of the structure of senior management and the board of directors. The purpose of the assessment was to assure that Commonwealth had adequate staffing and oversight to manage the institution in a safe and sound manner.

Asset Quality Deteriorated Further

Commonwealth had experienced further asset quality deterioration since the target examination completed in August 2009. Classified assets increased to 178 percent of tier 1 capital and the ALLL, from 94 percent during the previous target examination. Examiners concluded that loan administration weaknesses and poor compliance with guidance for CRE loans contained in SR Letter 07-01 were major contributing factors to the decline in asset quality. Further, examiners required Commonwealth to refile its third quarter 2009 Call Report upon concluding that Commonwealth underfunded the ALLL by $20 million.

Pervasive Credit Risk Management and Internal Control Issues Included Unsafe and Unsound Banking Practices

The examination resulted in numerous matters requiring the immediate attention of the board of directors, particularly related to credit risk management and internal controls. Many of the findings repeated issues and concerns raised during prior examinations. Specifically, examiners identified significant and pervasive weaknesses related to the bank's (1) appraisal review function, (2) problem loan recognition and reporting of the status of each borrowing relationship, (3) proper and timely identification of troubled debt restructurings, (4) charge-off of loan balances in excess of the fair value of collateral, (5) ALLL methodology, and (6) compliance with risk management recommendations contained in SR Letter 07-01 for CRE loan concentrations. The report once again highlighted the bank's unacceptable level of documentation exceptions in customer loan files; the continued weakness of the internal audit program, including management's hesitancy to respond to Audit Committee recommendations; and the need for appropriate control and documentation of collateral draws and releases. We believe that FRB Richmond responded appropriately by downgrading the bank's CAMELS composite and all component ratings to 5 to send a clear message to the senior management and the board of directors concerning the severity of its findings.

The examination report noted particular concern with the unsafe and unsound practices management used to mask the past-due status of criticized and classified loans. Despite the prominence of these findings in the examination report and the transmittal letter's admonishment that these practices constituted "a serious matter and must cease immediately," the examination report provided minimal context for the findings. The examination report included a bulleted list containing a phrase to describe each unsafe and unsound practice, but provided no additional description concerning how the practices developed, the employees involved, or the potential risks and ramifications associated with the practices. Our review revealed that examiner work papers provided additional details surrounding these findings that were not incorporated into the examination report. In our view, the examination report failed to meet CBEM section 1000.1 requirements for a thorough discussion of applicable business risks. We believe that the report should have provided the board members with the details of the situation.

Assessment of Large, Complex Borrowing Relationship Resulted in a SAR Filing

The examination report failed to describe FRB Richmond's concerns related to the relationship between a senior loan officer who was a former FRB Richmond examiner and a specific borrower. Upon receiving a tip from a bank employee, examiners scrutinized one large, complex borrowing relationship and determined that the loan officer was "excessively accommodating" to the borrower. In addition, FRB Richmond examiner work papers outlined a number of unsafe and unsound practices connected to this relationship, including loan proceeds that were disbursed to one entity in the relationship but that actually benefited another related entity, and some of the loan proceeds were used to service debt at another institution. This represented an inappropriate use of loan funds given the purpose of the loan. FRB Richmond used a BSA specialist to review the senior loan officer's deposit accounts at Commonwealth and the borrower's deposit accounts at another local institution for signs of potentially suspicious activity. Despite the concerns noted in the examiner work papers, the examination report, including the confidential section, did not describe this large, complex customer relationship; the risks associated with such relationships; or examiners' suspicions of insider abuse. We believe that these findings and concerns about suspicious activity warranted thorough treatment in the examination report, especially given examiners' prior concerns noted in 2007 over increasingly complex borrower relationships.

Further, we believe that FRB Richmond's review of the senior loan officer's deposit accounts at Commonwealth and the loan customer's deposit accounts at another local institution could not offer a reasonable assurance that insider abuse was not occurring. In our opinion, FRB Richmond should have required the bank to immediately hire a forensic accountant to review the bank's books and records to determine the extent of unsafe and unsound practices associated with all large borrower relationships and to assess the bank's fraud risk, especially since FRB Richmond examiners had only scrutinized one of the bank's many large complex borrowing relationships.

FRB Richmond recommended that Commonwealth file a SAR on the senior loan officer given FRB Richmond's suspicions of insider abuse, which the bank did file in February 2010. Examiners noted, however, that the SAR contained a technical error—it transposed the senior loan officer's first and last names—and provided a "bare minimum" description of the facts and circumstances surrounding the situation. One FRB Richmond examiner speculated that the technical error may have been a deliberate attempt to hinder law enforcement officials' ability to locate the SAR when searching for the employee's last name. Section 5020.1 of the CBEM outlines the Federal Reserve Board's expectations for reporting suspected criminal violations, including how to handle situations in which a bank submits an inadequate SAR or fails to file a report. In our opinion, FRB Richmond should have followed those expectations upon noting the deficient filing by requiring an amended SAR filing or directly filing the SAR itself, particularly given the weaknesses previously identified in the bank's BSA compliance program and the possibility that the technical error may have been deliberate. When the Office of Inspector General questioned why FRB Richmond did not file a SAR, examiners raised concerns about the SAR filer "safe harbor" provision not applying to a Reserve Bank SAR filing.[20] We believe that an amended SAR or a Reserve Bank SAR filing would have been consistent with the CBEM and would have resulted in a more effective description of the situation for law enforcement officials.

[20] 31 U.S.C. 5318(g)(3) generally provides protection from civil liability for all reports of suspicious transactions made to appropriate authorities, including supporting documentation, regardless of whether such reports are filed pursuant to the SAR instructions.

Certain FRB Richmond Examination Staff Should Have Consulted with the Local Ethics Officer

During our interviews, multiple FRB Richmond examination employees involved in this examination referred to the former FRB Richmond examiner, who served as one of the bank's senior loan officers, as a "friend" or colleague. In our opinion, these relationships coupled with the fact that the former FRB Richmond examiner had possibly engaged in suspicious activity, suggests that the examination staff, at a minimum, should have consulted with FRB Richmond's ethics officer regarding whether recusals were appropriate. FRB Richmond interviewees mentioned that the Reserve Bank did not have standard protocols for addressing situations presenting an appearance of a conflict-of-interest. However, section 5.1 of FRB Richmond's code of conduct indicates that

> an employee should avoid any situation that might give rise to an actual conflict of interest or even the appearance of a conflict of interest . . . Where the circumstances might cause a reasonable person to question the employee's impartiality or otherwise give rise to an appearance of a conflict of interest, the employee should not participate in a matter unless he or she has informed the Bank of the situation and received authorization from the Bank's Ethics Officer.

We believe that consultations with FRB Richmond's ethics officer would have allowed the ethics officer to fully evaluate the facts and circumstances surrounding the relationships between the former employee and the current examination staff and determine whether recusal or any other corrective action was necessary.

Additional Significant Internal Control Weaknesses

Examiners also identified internal control deficiencies surrounding basic practices in the lending function, some of which were brought to the attention of examiners by a bank employee. Examiners concluded that loan officers had authorized general ledger tickets to cover loan payments for troubled borrowers and identified three instances in which a loan officer authorized customer accounts to be overdrawn in order to purchase cashier's checks. Examiners also noted an instance in which a loan officer authorized the purchase of a cashier's check with a personal check drawn on another institution, against bank policy. The check was later returned due to insufficient funds. We believe that the bank's internal control weaknesses further increased Commonwealth's risk profile by presenting the opportunity for key employees to engage in unsafe and unsound practices.

Examination Resulted in a Written Agreement

As a result of this examination, examiners determined that the bank was not in compliance with the majority of the provisions of the 2009 board resolution and initiated a formal enforcement action in the form of a written agreement. The written agreement was not executed until July 2010, after the next examination (which had been accelerated) commenced. We believe that the enforcement action should have been implemented in a more timely manner to quickly address the significant problems identified during the examination.

The 2010 written agreement expanded the provisions of the 2009 board resolution and, among other things, required (1) a written plan to strengthen credit risk management, to include loan portfolio limits and stress testing; (2) written lending and credit administration programs addressing underwriting standards and segregation of duties, respectively; (3) a charge-off of all assets classified as "loss"; (4) a written program to maintain an adequate ALLL and enhanced ALLL methodology; (5) a written capital plan that accounted for the volume of classified loans, loan concentrations, ALLL requirements, current and projected asset growth, and projected retained earnings; and (6) a written liquidity and funds management plan designed to improve management of the liquidity position.

We believe that the board of directors' and management's failure to operate the institution in a safe and sound manner allowed pervasive credit risk management and internal control weaknesses to remain unresolved for far too long and significantly increased the bank's fraud risk. In our opinion, the unsafe and unsound practices noted during this examination evidenced management's deliberate effort to mask Commonwealth's true financial condition. We believe that FRB Richmond examiners failed to address the bank's persistent weaknesses and detect management's similar inappropriate response to asset quality deterioration cited during the 2000 full-scope examination. Specifically, the 2000 examination findings and this examination evidenced management's (1) failure to recognize the full extent of its problem loans and (2) willingness to extend additional loans to troubled borrowers. In our opinion, the fact that these issues evoked a similar inappropriate response to asset quality deterioration should have influenced FRB Richmond's supervisory approach, especially since the unsafe and unsound practices noted during this examination evidenced management's deliberate effort to mask the bank's condition. FRB Richmond examiners, however, did not review the 2000 full-scope examination or the 2001 board resolution materials as part of this examination.

Section 5040.1 of the CBEM indicates that the Federal Reserve Board may use its cease-and-desist order (C&D) authority, among other circumstances, after noting (1) a violation of law or regulation or (2) an unsafe and unsound business practice. The CBEM also indicates that a C&D can be used to compel an affirmative action to correct a violation or practice. Based on our review of this examination report and FRB Richmond's supporting work papers, examiners suspected potential violations of law and the examination report cited multiple unsafe and unsound business practices. We believe that FRB Richmond should have recommended that the Federal Reserve Board adopt a C&D given the severity of the situation and the criteria under which C&D authority may be exercised. We recognize that this authority is reserved for unique circumstances; however, we believe that this recommendation was warranted under the circumstances. We believe that the C&D also should have formalized our finding mentioned above concerning the need for a forensic investigation of all large borrower relationships and communicated the bank's need to report any suspicious activity via SAR filings.

FRB Richmond required an independent assessment regarding the structure of senior management and the board of directors, including its committees. FRB Richmond anticipated that the assessment would result in adequate staffing, with the requisite ability, experience, and other qualifications to competently perform its duties, and oversight to manage the institution in a safe and sound manner. An independent assessment is a standard supervisory response when examiners lose confidence in management. We believe that FRB Richmond should have recommended a removal order for the CEO. Section 5040.1 of the CBEM outlines the Federal Reserve Board's removal authority under 12 U.S.C. 1818(e). Among other things, the Federal Reserve Board may initiate a removal order when an "institution-affiliated party" directly or indirectly (1) violates any law or regulation, (2) engages in any unsafe and unsound practice, or (3) breaches a fiduciary duty. Accordingly, we believe that FRB Richmond should have recommended a removal order because the CEO's dominant oversight contributed to the unsafe and unsound practices noted during the examination. In addition, examiners' conclusion that the board of directors was negligent in its duty to operate the institution in a safe and sound manner coupled with the CEO's role as chairman of the board of directors further supports a removal order based on a possible breach of a fiduciary duty.

May 2010 Joint Full-Scope Examination Retained the CAMELS Composite 5 Rating

A joint full-scope examination that began in May 2010 maintained the bank's CAMELS composite and component 5 ratings. FRB Richmond and the State accelerated this examination due to the severity of the findings during the prior examination. Despite $19 million in capital support from the holding company over the course of the previous year, examiners concluded that the bank's capital levels were not commensurate with its risk profile. The examination report characterized the bank's condition as critically deficient and identified asset quality deterioration as the primary impediment to improved condition. Because the written agreement had not been finalized, examiners did not assess compliance with the board resolution.

Asset quality deteriorated further as classified assets increased to 222 percent of tier 1 capital and the ALLL. The associated provision expenses negatively affected earnings and capital. Examiners identified continued credit risk management weaknesses related to the bank's internal loan risk ratings, inconsistent preparation of global cash flow analyses, and loan file documentation exceptions. Examiners also noted that inadequate risk management practices related to the bank's significant exposure to CRE loan concentrations persisted, particularly given the lack of CRE loan portfolio stratification and stress testing. In March 2010, Commonwealth hired a CCO to address its credit administration weaknesses. Examiners noted that corrective actions would take time to become effective due to the high level of classified assets and the volume of credit administration weaknesses.

Prior to this examination, in March 2010, Commonwealth completed the independent management study required by the October 2009 examination. The study, performed by an independent third party, recommended separating the responsibilities of the CEO and chairman of the board of directors to allow the directorate to speak more freely and improve its oversight. In April 2010, the CEO resigned from the chairman responsibilities at the bank and the holding company. Our interviews indicated that FRB Richmond anticipated that the study would recommend the removal of the CEO. The study also concluded that one of the senior loan officers, the former FRB Richmond employee, did not have the core skills, competencies, experience, and qualifications to perform his role and recommended that the bank either make significant revisions to his current role or arrange for a separation from the bank. This individual left the bank in December 2010. In our opinion, FRB Richmond should have recommended a removal order for the CEO based on the prior examination to (1) facilitate a more timely management change and (2) eliminate the possibility that the independent assessment might conflict with FRB Richmond's preferred course of action.

October 2010 Target Examination Focused on Asset Quality and the Financial Condition of the Bank

FRB Richmond's asset quality and overall financial condition target examination that began in October 2010 maintained the bank's CAMELS composite and component 5 ratings. The examination also evaluated Commonwealth's compliance with the 2010 written agreement. Examiners noted that Commonwealth's asset quality was critically deficient due to the high level of problem assets, particularly nonaccrual loans. Provision expenses associated with the asset quality deterioration resulted in capital ratios declining below *well capitalized* status for PCA purposes as of September 30, 2010.

Examiners once again recommended enhancements to the bank's credit risk management of CRE loans, consistent with guidance contained in SR Letter 07-01. Specifically, examiners noted that (1) the board of directors did not review sufficient information concerning CRE concentrations, (2) management did not provide reports on individual industry trends or appropriately stratify the CRE loan portfolio for monitoring purposes, and (3) the bank did not perform any stress testing on individual loans or its overall portfolio.

As a result of this examination, examiners uncovered additional practices that the bank used to mask the actual status of problem assets. Specifically, examiners determined that the bank had financed multiple purchases of its OREO with minimal financial analysis of the borrower and on "extremely generous" terms. These purchases allowed the bank to remove OREO from its books and originate a performing loan collateralized by the property. Further, the bank used potentially deceptive accounting practices in its treatment of these properties by booking OREO properties that required improvements at their as-complete value, rather than at their fair market value. As a result, examiners recommended that the bank write down the value of several properties. Additionally, management valued several OREO properties without a current appraisal. This practice also exposed the bank to further write-downs. When the bank did order new appraisals on foreclosed properties, it did not require an independent appraisal review. Examiners identified multiple appraisals that were inconsistent with legal requirements that originated from the same appraiser. Although examiner work papers specifically noted that this appraiser was no longer permitted to perform appraisals for the bank based on FRB Richmond's recommendation, the examination report did not mention this restriction.

In addition to questionable accounting and appraisal practices, Commonwealth funded loans to improve its OREO properties in its portfolio. Examiners determined that the bank disbursed construction loan proceeds for three properties either fully at closing or without evidence that any work had been performed. In one instance, examiners subsequently conducted a site visit and determined that the expected construction had never taken place. The bank filed a SAR on that borrower as a result. In the other two instances, we were not able to locate SAR filings. Section 5020.1 of the CBEM outlines the conditions under which a SAR should be filed. It states that a filing should occur if an examiner "uncovers a situation that is known or suspected to involve a criminal violation." In our opinion, the two situations not covered by SARs should have raised reasonable suspicions of possible criminal activity, even without conducting site visits. In our estimation, FRB Richmond should have referred these situations to Commonwealth for further investigation and SAR filings as warranted. Although examiner work papers noted that controls over disbursements was a repeat finding from the previous examination, the finding was not identified as such by FRB Richmond in the examination report. Further, we noted that controls over loan disbursements had been raised by examiners on multiple prior examinations.

This examination demonstrated that the bank continued to engage in unsafe and unsound practices to mask its true financial condition. We believe that these practices support our position that FRB Richmond should have implemented a C&D based on the October 2009 full-scope examination. Nevertheless, FRB Richmond did not adjust its enforcement strategy.

Following this examination, FRB Richmond met with the members of the board of directors who were not Commonwealth employees to encourage them to request that the CEO retire. In December 2010, the CEO retired and the CCO became the interim CEO. The bank removed the CEO's interim designation in May 2011. In our opinion, although FRB Richmond acted appropriately to encourage the removal of the CEO, we believe that the removal should have occurred sooner.

May 2011 Full-Scope Examination Retained the CAMELS Composite 5 Rating

As a result of a May 2011 full-scope examination, FRB Richmond maintained Commonwealth's CAMELS composite 5 rating. FRB Richmond noted that the bank's overall condition continued to deteriorate and that failure was likely. Examiners noted that asset quality deterioration and significant provision expenses had eroded capital and adversely affected earnings performance. As of June 30, 2011, Commonwealth became *critically undercapitalized* due to $26 million in provision expenses taken during the year.

Commonwealth's asset quality remained critically deficient as the level of classified assets at the examination increased to 386 percent of tier 1 capital and the ALLL. Examiners noted Commonwealth's efforts to identify and address the full extent of problem loans in the bank's portfolio and that credit risk management had improved following the implementation of new lending policies and procedures.

Due to losses associated with the bank's deteriorating asset quality, earnings performance remained critical. Examiners noted that the bank experienced a net loss of $50 million in 2010 as a result of $52 million in provision expenses. The bank's expenses also increased in 2010 due to personnel and administrative costs associated with the bank's loan portfolio. Examiners did not expect these expenses to decline in 2011.

Examiners noted that the bank's management submitted a capital restoration plan to raise $100 million through issuance of capital stock. Although this amount would have been sufficient to raise the bank to *well capitalized* PCA levels, examiners concluded that Commonwealth would need to raise more capital to address future losses. Commonwealth failed to raise any capital. Therefore, the State closed the bank on September 23, 2011, and appointed the FDIC as receiver.

Conclusions, Lessons Learned, and Recommendations

Commonwealth failed because of the convergence of several factors, including corporate governance weaknesses, an aggressive growth strategy that resulted in concentration risk, insufficient credit risk management practices, and pervasive internal control weaknesses. These factors, combined with deteriorating real estate markets, led to rapid asset quality deterioration. Commonwealth failed to acknowledge the full extent of problem loans in its portfolio and adequately reserve against prospective losses. It also engaged in unsafe and unsound banking practices to mask its financial condition. Mounting losses depleted earnings and eroded capital, which prompted the State to close Commonwealth and appoint the FDIC as receiver on September 23, 2011.

With respect to supervision, FRB Richmond did not comply with the examination frequency guidelines for the time frame we reviewed, 2000 through 2011. Specifically, the 2006 full-scope examination did not occur within a year of the prior full-scope examination as required by SR Letter 97-8.

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 Richmond's supervision of Commonwealth revealed that FRB Richmond identified the bank's fundamental weaknesses during the 2000 examination but did not take early and decisive action to resolve those weaknesses. Credit risk management was a recurring issue at the bank in subsequent years. Further, FRB Richmond did not detect management's similar inappropriate response to asset quality deterioration noted during the 2000 full-scope examination and repeated during the October 2009 full-scope examination. We believe that FRB Richmond had multiple opportunities between 2007 and 2011 to take stronger supervisory action by implementing more aggressive enforcement actions or downgrading Commonwealth's CAMELS composite or component ratings to address the bank's persistent deficiencies. In our opinion, more forceful supervisory action could have mitigated the loss to the DIF.

The need for stronger supervisory action has been a consistent theme in our prior failed bank reviews, as highlighted in our September 2011 *Summary Analysis of Failed Bank Reviews*. While this aspect of Commonwealth's failure is consistent with the overall themes contained in our prior reports, this material loss review resulted in unique findings. For example, our prior reports have not identified the need for a Reserve Bank to recommend the use of the Federal Reserve Board's C&D authority or removal order authority for management officials. While we understand that those authorities should only be used when necessary, we believe that the unique circumstances surrounding Commonwealth's failure warranted such actions.

We believe that the following findings noted during this material loss review represented unique circumstances and issues in FRB Richmond's supervision of Commonwealth:

- In 2009, FRB Richmond examiners did not detect management's similar inappropriate response to asset quality deterioration consisting of (1) failing to acknowledge the bank's problem loans and (2) making additional loans to troubled borrowers, even though similar issues were raised in FRB Richmond's 2000 examination and the 2001 board resolution. The October 2009 examination also did not address that this similar inappropriate response to asset quality deterioration had evolved into a deliberate effort to conceal the bank's financial condition. FRB Richmond's failure to detect these similarities led to an insufficient supervisory response following the 2009 examination.

- Certain FRB Richmond examination reports did not appear to comply with CBEM section 1000.1 because those reports failed to adequately address the business risks associated with specific findings.

- Specific FRB Richmond examination staff did not consult with the local ethics officer in accordance with FRB Richmond's code of conduct despite the fact that those staff members considered a former FRB Richmond examiner employed by the bank in a key senior management position, who engaged in potentially suspicious activity, to be a "friend" or colleague.

- FRB Richmond did not respond to situations involving potentially suspicious activity in accordance with the expectations outlined in CBEM section 5020.1.

We have four recommendations described below to address these issues and improve FRB Richmond's and the Federal Reserve Board's supervisory activities.

Lessons Learned

We believe that Commonwealth's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Commonwealth's failure illustrates (1) the risks associated with consolidating corporate authority in a single individual; (2) the risks associated with CRE loan concentrations, particularly CLD, and concentrations with individual borrowers; and (3) the importance of establishing appropriate credit risk management practices and internal controls prior to pursuing an aggressive growth strategy. Further, this failure illustrates the importance of assuring that examiners are aware of and consider prior supervisory actions when assessing an institution and developing a supervisory strategy, particularly when subsequent enforcement actions are necessary to address issues previously raised in earlier enforcement actions. The failure also highlights that Reserve Banks need to (1) assure that bank management resolves risk management weaknesses and internal control deficiencies, (2) appropriately determine the information that should be contained in an examination report and convey significant details concerning important findings, and (3) take aggressive and appropriate supervisory action when previously noted weaknesses continue or similar behaviors emerge.

Recommendations

1. **We recommend that the Director of the Division of Banking Supervision and Regulation confirms that FRB Richmond's Senior Vice President of Supervision, Regulation, and Credit takes steps to assure that FRB Richmond's examination reports comply with CBEM section 1000.1, to include assessing the Reserve Bank's examination report review process to assure that each step in the review process is necessary and valuable.**

Section 1000.1 of the CBEM outlines the Federal Reserve Board's expectations for examination reports. Examination reports should be "a comprehensive summary supervisory report" that, among other things, discusses "each of the major business risks." Our analysis revealed multiple instances in which FRB Richmond's examination reports failed to meet this standard. FRB Richmond examination reports presented report findings at a summary level and, in some instances, did little to contextualize Commonwealth's deficiencies.

As an example, a section of the report resulting from the October 2009 full-scope examination listed a series of phrases to describe unsafe and unsound practices related to masking the full extent of the bank's problem loans. However, the Asset Quality section of the report did not expand on the description of those findings; instead, that section of the report merely referred back to the prior section of the report that contained the bulleted list without providing any additional details. In our opinion, this represented a failure by FRB Richmond to communicate the severity of the circumstances and the need for urgent action. The report provided no context for how this pervasive effort to hide Commonwealth's true financial condition developed and offered no reference point concerning the scope and magnitude of these issues.

During our interviews, FRB Richmond examination staff referred to Commonwealth's pervasive internal control weakness as a situation "like nothing I have ever seen" and that it "would have taken years to discover all of the problems." The pervasiveness of these issues and their potential direct impact on financial results should have suggested, at a minimum, the possibility of a conscious and deliberate effort by management to misrepresent the institution's actual financial condition. Nevertheless, the report, including its confidential section, remained silent on that issue. Because we have not observed similar deficiencies or omissions during our prior failed bank reviews, we believe that the Director of the Division of Banking Supervision and Regulation should confirm that FRB Richmond's Senior Vice President of Supervision, Regulation, and Credit takes steps to assure that FRB Richmond's examination reports comply with CBEM section 1000.1 that include assessing the Reserve Bank's examination report review process to assure that each step in the review process is necessary and valuable.

An FRB Richmond examiner provided a possible insight by mentioning that FRB Richmond's examination report review process has many layers that provide "way too many opportunities for dilution." In our opinion, FRB Richmond's assessment of the review process should include discussions with FRB Richmond examination staff at every level. We expect that this assessment will result in suggestions for improving the current process, including time frames for implementing those suggested improvements.

2. **We recommend that the Director of the Division of Banking Supervision and Regulation consider defining the circumstances when examination supervisors should refer to prior enforcement actions when developing a supervisory strategy for an institution that requires an enforcement action.**

FRB Richmond staff conducting examinations in 2009 did not appear to be aware of Commonwealth's 2001 board resolution. During our review, we learned that current guidelines for examination preparation require examiners to review the prior full-scope examination. We did not identify similar guidance for prior enforcement actions. The 2001 board resolution raised a series of issues that appeared to evidence that management had a similar inappropriate response to asset quality deterioration that had evolved into a deliberate effort to conceal the bank's true condition. The similar inappropriate response included (1) failing to acknowledge the full extent of the bank's problem loans, and (2) extending additional credit to problem borrowers.

In our opinion, effective supervision requires awareness of prior enforcement actions to assure that similar behaviors can be detected. In this situation, management's similar inappropriate response to asset quality deterioration was not detected and, therefore, did not appear to appropriately influence FRB Richmond's supervisory strategy. We recommend that the Director of the Division of Banking Supervision and Regulation consider defining the circumstances when examination supervisors should refer to prior enforcement actions when developing a supervisory strategy for an institution that requires an enforcement action.

3. **We recommend that the Director of the Division of Banking Supervision and Regulation assure that (a) FRB Richmond adopts measures to prevent examination staff from being assigned to particular reviews without confirming the independence of the assigned staff and (b) FRB Richmond's Senior Vice President of Supervision, Regulation, and Credit implements reinforcement training regarding the bank's code of conduct and expectations for handling possible conflicts-of-interest.**

One of Commonwealth's senior lenders was a former FRB Richmond examiner who engaged in potentially suspicious activity at Commonwealth. This former examiner worked at multiple institutions in the Norfolk area and satisfied "cooling off" requirements outlined in FRB Richmond's code of conduct prior to accepting a position at Commonwealth. FRB Richmond interviewees mentioned that the significant time period that elapsed between his employment with the Reserve Bank and Commonwealth mitigated the risk of a possible conflict-of-interest, since many junior staffers did not know the former FRB Richmond employee. Nevertheless, certain interviewees who participated in the October 2009 full-scope examination of Commonwealth referred to the former employee as a "friend" or colleague. In our opinion, these relationships and the former employee's possible involvement in potentially suspicious activity evaluated during that examination suggested that FRB Richmond's local ethics officer should have been consulted regarding the requirements of the code of conduct. We believe that consultations with FRB Richmond's ethics officer would have allowed the ethics officer to fully evaluate the facts and circumstances surrounding the relationships between the former employee and the current examination staff and determine whether recusal or any corrective action was necessary.

Interviewees said that FRB Richmond did not have standard protocols or approaches for addressing possible conflict-of-interest situations, although, as mentioned above, FRB Richmond had a code of conduct. This is our first failed bank review that addresses an appearance of possible conflict-of-interest issues related to former Reserve Bank examination staff. In our opinion, the Director of the Division of Banking Supervision and Regulation should assure that FRB Richmond adopts measures to prevent examination staff from being assigned to particular reviews without confirming the independence of the assigned staff. We also recommend that FRB Richmond's Senior Vice President of Supervision, Regulation, and Credit implement reinforcement training regarding FRB Richmond's code of conduct and expectations for handling possible conflicts of interest.

4. **We recommend that the Director of the Division of Banking Supervision and Regulation issue supplemental guidance reiterating the unique circumstances outlined in CBEM section 5020.1 that might warrant the filing of a SAR by a Federal Reserve Bank. This guidance should address the applicability of "safe harbor" provisions to SAR filings by Reserve Banks.**

As a result of the 2009 examination, FRB Richmond encouraged Commonwealth to file a SAR to address a loan officer's handling of a large, complex loan relationship. Examiners noted that the SAR eventually submitted by Commonwealth contained a technical error—it transposed the loan officer's first and last names—and the SAR narrative provided a "bare minimum" description of the facts and circumstances surrounding the situation. Section 5020.1 of the CBEM outlines the Federal Reserve Board's expectations for reporting suspected criminal violations, including how to handle situations in which a bank submits an inadequate SAR or fails to file a report. FRB Richmond did not require an amended filing or file its own SAR in accordance with section 5020.1, despite acknowledgments by certain examination staff that the SAR submitted by Commonwealth would be of little use to law enforcement officials.

Certain examination staff also mentioned concerns about the applicability of the SAR filer "safe harbor" provision to a Reserve Bank SAR filing. Those staff members indicated that FRB Richmond may not have filed a SAR because of those concerns. In our opinion, guidance is necessary to reiterate the unique circumstances that warrant SAR filings by Reserve Banks and also to eliminate any potential concerns among all Reserve Bank examination staff concerning the applicability of safe harbor provisions to those filings.

Analysis of Comments

We provided our draft to the Division of Banking Supervision and Regulation for review and comment. The Division Director stated that Banking Supervision and Regulation staff concurred with the conclusions, lessons learned, and recommendations in the report. The response is included as Appendix 3.

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.

Board Resolution

An informal supervisory enforcement action that represents a number of commitments made by a bank's board of directors. The commitments are incorporated into the bank's corporate minutes.

Call Reports

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

Cease-and-Desist Order (C&D)

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

Classified Assets

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

Appendix 1 (continued)

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 in which 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 nonagricultural vacant land), for (1) on-site construction of industrial, commercial, residential, or farm buildings; and (2) land development, including preconstruction preparatory work such as laying sewer and water pipes.

Enforcement Actions

Informal or formal actions the Federal Reserve Board may take, 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; informal enforcement actions include commitments, board resolutions, and memorandums of understanding.

Noncore Funding

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

Other Real Estate Owned (OREO)

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

Appendix 1 (continued)

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. PCA is intended to ensure that action is taken at the time an institution becomes financially troubled, so that the deposit insurance fund incurs the least possible long-term loss. Depending on a bank's capitalization, the capital categories include *well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized,* and *critically undercapitalized*.

Supervision and Regulation (SR) Letters

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

Underwriting

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

Written Agreement

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

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

Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. The highest rating, 1, indicates the strongest performance and risk management practices and the least degree of supervisory concern, while a 5 indicates 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, within the framework of the six components listed above.

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 also 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.

Appendix 2 (continued)

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 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.

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. These institutions have serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The board of directors and management are not satisfactorily addressing or resolving the weaknesses and problems. Financial institutions in this group generally are not capable of withstanding business fluctuations and may be significantly noncompliant with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institutions' size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed for the financial institutions to remain viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund, 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:	April 11, 2012
To:	Anthony J. Castaldo – Associate Inspector General for Inspections and Evaluations
From:	Michael S. Gibson, Director, Banking Supervision and Regulation ***/signed/***
Subject:	Material Loss Review of the Bank of the Commonwealth

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The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of The Bank of the Commonwealth (Commonwealth), Norfolk, Virginia 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 Commonwealth failed due to weaknesses in corporate governance, credit risk management, and internal controls combined with an aggressive growth strategy that resulted in concentration risk. Moreover, the report finds that Commonwealth failed to recognize the extent of problem loans and sufficiently reserve for credit losses, and the bank engaged in unsafe and unsound practices to mask its problems. Commonwealth was supervised by the Federal Reserve Bank of Richmond (FRB Richmond) under delegated authority from the Board.

The report notes that FRB Richmond did not fully comply with examination frequency guidelines for the time period that was reviewed, 2000 through 2011, because of a missed mandate during the 2006 examination cycle. Furthermore, the report concludes that FRB Richmond had identified fundamental weaknesses at Commonwealth during the 2000 examination but did not take decisive action to resolve those weaknesses, and those weaknesses recurred in subsequent years. The report also concludes there were opportunities between 2007 and 2011 for FRB Richmond to take stronger supervisory action. Specific concerns about the supervision of Commonwealth are noted in the report – including – missed detection of inappropriate bank responses; report of examination content inconsistent with requirements; potential compromise of examiner independence; and insufficient supervisory response to suspicious activities of Commonwealth.

Banking Supervision and Regulation staff concurs with the conclusions and lessons learned in the report. Regarding the recommendations made in the report, the Division will confirm that FRB Richmond's Senior Vice President of Supervision, Regulation, and Credit addresses the recommendations related to report of examination content and review process and adoption of measures to confirm independence of examination staff. In addition, the Division will issue supplemental guidance for suspicious activity report filings by Federal Reserve Banks. Lastly, the Division will consider defining circumstances when examination staff should refer to prior enforcement actions when developing a supervisory strategy.

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

Karen M. Goldfarb, Project Leader and Auditor

Michael A. Olukoya, Auditor

Michael P. VanHuysen, Office of Inspector General Manager