Board of Governors of the Federal Reserve System

Review of the Failure of Pierce Commercial Bank

Office of Inspector General

September 2011

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

OFFICE OF INSPECTOR GENERAL

September 29, 2011

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

Dear Mr. Parkinson:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Inspector General of the Board of Governors of the Federal Reserve System (Federal Reserve Board) conducted an in-depth review of the failure of Pierce Commercial Bank (Pierce). Pierce began operations on December 8, 1997, as a de novo state member bank headquartered in Tacoma, Washington. Pierce was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Federal Reserve Board, and by the Washington Department of Financial Institutions (State). The State closed Pierce on November 5, 2010, and named the Federal Deposit Insurance Corporation (FDIC) as receiver.

Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurs between January 1, 2010, and December 31, 2011. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal bank agency

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

In addition, the Dodd-Frank Act requires an in-depth review of bank failures that result in losses below the materiality threshold when the Inspector General of the appropriate federal banking agency determines that the loss exhibits "unusual circumstances." According to the FDIC, the bank's total assets at closing were $217.8 million, and its failure resulted in an estimated $24.8 million loss to the DIF. While the loss is below the materiality threshold, we conducted an in-depth review, after determining that Pierce's failure presented unusual circumstances because of fraud allegations associated with the bank's mortgage lending activities. When unusual circumstances are identified, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review.

Pierce failed because its Board of Directors and management did not adequately control the risks associated with the bank's residential mortgage lending activities. Specifically, the Board of Directors and senior management allowed the mortgage banking division—PC Bank—to operate independently without appropriate oversight and failed to conduct adequate strategic planning or implement robust internal controls. PC Bank pursued an originate-to-distribute business model that involved originating residential mortgages to be sold in the secondary market. Although this business model appeared to transfer the credit risk associated with mortgage loans to investors, Pierce remained exposed to the risk that investors could demand that the bank repurchase loans or reimburse investors for losses, subject to certain conditions. Examiners ultimately uncovered possibly fraudulent activity at PC Bank related to employees misrepresenting borrower financial information and steering customers into loans for which they were not qualified. These practices led to the bank incurring losses resulting from significant investor repurchase and indemnification demands.

In addition, inadequate credit risk management and weak underwriting made the bank's commercial loan portfolio susceptible to declining economic conditions. Although Pierce received $6.8 million in Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP) funds in January 2009, mounting losses resulting from investor repurchase and indemnification demands and commercial loan portfolio deterioration due to declining economic conditions eliminated the bank's earnings, depleted capital (including the TARP funds), and eventually led to the bank's failure. The State closed Pierce on November 5, 2010, and appointed the FDIC as receiver.

With respect to supervision, FRB San Francisco complied with the safety and soundness examination frequency guidelines and conducted regular off-site monitoring for the time frame we reviewed, 2003 to 2010. During this time frame, FRB San Francisco and the State conducted six full scope safety and soundness examinations, one limited scope safety and soundness examination, and one target safety and soundness examination and executed two formal enforcement actions: a Cease-and-Desist Order and a PCA Directive. In addition, FRB San Francisco conducted two full scope consumer compliance examinations, one target consumer compliance examination, and a joint target examination of PC Bank.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or a loss to the DIF. Our analysis of FRB San Francisco's supervision indicated that examiners missed several opportunities to conduct the detailed testing necessary to more accurately assess the bank's risk profile. While it is not possible to determine whether detailed testing would have resulted in earlier detection of the fraud, such testing likely would have identified the control weaknesses that created an opportunity for fraudulent activity.

Section 1000.1 of the *Commercial Bank Examination Manual* (CBEM) states that examiners should assess the effectiveness of the Board of Directors' and management's oversight by confirming that management assessed the risks associated with new business activities and implemented the infrastructure and internal controls necessary to manage those risks. During a 2004 full scope examination, examiners observed the absence of strategic planning for PC Bank and the significant growth in PC Bank's mortgage origination volumes. In our opinion, these factors warranted detailed testing to confirm that the Board of Directors and management had implemented the internal controls necessary to manage the risks associated with a new business activity. However, that testing did not occur during the 2004 full scope examination and, in our opinion, represented a missed opportunity to apply CBEM guidance related to new business activities.

The risk-focused examination approach outlined in the CBEM encourages examiners to conduct detailed testing consistent with the risks and adequacy of risk management processes surrounding a particular activity. We believe that PC Bank's elevated risk profile was not reflected in the Decision Factors Analysis conducted during the 2007 safety and soundness examination. Specifically, we believe that the Decision Factors Analysis did not detect certain risks or acknowledge the significance of other potential risks, and FRB San Francisco should not have deferred detailed testing until the next examination.

We also believe that FRB San Francisco did not sufficiently assess the risk associated with the bank's recourse obligations or closely supervise its off-balance sheet reserve to mitigate the risk associated with the bank's secondary market credit activities. Supervision and Regulation Letter 97-21, *Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities*, requires banks to incorporate the full range of risk of their secondary market credit activities into their overall risk management systems. The guidance indicates that supervisors and examiners should determine whether institutions are recognizing the risks of secondary market credit activities by, among other things, (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the Board of Directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. In our opinion, FRB San Francisco was late to identify these risks, and the expenses associated with addressing investor repurchase and indemnification demands ultimately contributed to the bank's failure.

In late November 2008, Pierce's holding company applied for TARP funds under the CPP, and FRB San Francisco evaluated the application. In applying Treasury's evaluation guidance, FRB San Francisco concluded that Pierce qualified for a presumptive approval because of the bank's financial performance measures as of September 30, 2008, and the fact that examiners did not have concerns about Pierce's viability. We believe that FRB San Francisco complied with the process outlined in the Treasury guidance for banks that had not been examined during the previous six months and the limited decision-making criteria available at the time. However, as discussed below, the evaluation might have had different results if examiners had appropriately identified Pierce's risk profile earlier and taken stronger supervisory action sooner.

In our opinion, FRB San Francisco had multiple opportunities to conduct detailed testing consistent with CBEM's expectations. If FRB San Francisco had acted on those opportunities sooner, it would have likely resulted in (1) a more accurate assessment of the bank's risk profile and (2) earlier CAMELS composite and component rating downgrades, such as the downgrades issued during the July 2009 safety and soundness examination once examiners realized the extent of the bank's weaknesses. Because the time span during which these opportunities presented themselves coincided with the bank's growth period, earlier detection might have mitigated the loss to the DIF and resulted in the CAMELS composite rating downgrades necessary to preclude the bank from receiving TARP CPP funds. Nevertheless, it is not possible to determine whether alternative supervisory action might have prevented the failure.

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Pierce's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Pierce's failure demonstrates the importance of (1) examiners appropriately identifying key risks early; (2) examiners conducting timely detailed testing of new business activities consistent with CBEM expectations; (3) active Board of Directors and management oversight of the bank's business activities; and (4) banks incorporating secondary market credit activities into overall risk management systems, including setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. This failure also demonstrates that recurring weaknesses in strategic planning, compliance with laws and regulations, and internal controls can indicate broader corporate governance and risk management deficiencies.

We provided you with our draft report for review and comment. In your response, which is included as Appendix 4, you concurred with our conclusions, lessons learned, and recommendations and stated that the division will identify how to best reinforce supervisory expectations related to corporate governance and will cross-reference CBEM sections to guidance addressing secondary market assets sales.

We appreciate the cooperation that we received from FRB San Francisco and Federal Reserve Board staff during our review. The Office of Inspector General principal contributors to this report are listed in Appendix 5. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

Anthony J. Castaldo

Anthony J. Castaldo
Associate Inspector General
for Inspections and Evaluations

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

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Background

Pierce Commercial Bank (Pierce) began operations on December 8, 1997, as a de novo state member bank headquartered in Tacoma, Washington.[1] The bank's single branch focused primarily on meeting the banking needs of the local medical community. In December 2002, Pierce entered into a new business activity—originating mortgage loans to be sold in the secondary market—and expanded those activities in 2004 through a new division, PC Bank, located in Puyallup, Washington. This new business activity generated significant fee income for Pierce. The bank was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the Washington Department of Financial Institutions (State).

The State closed Pierce on November 5, 2010, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. According to the FDIC, the bank's total assets at closing were $217.8 million, and its failure resulted in an estimated loss to the Deposit Insurance Fund (DIF) of $24.8 million as of July 31, 2011. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), a material loss to the DIF is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. However, the Dodd-Frank Act requires an in-depth review of any bank failure that creates a loss to the DIF when the Inspector General of the appropriate federal banking agency determines that the loss exhibits "unusual circumstances." We believe that Pierce's failure presented unusual circumstances because of fraud allegations associated with the bank's mortgage lending activities. We have provided our report to the Office of Inspector General's investigations section for further review and analysis.

Objectives, Scope, and Methodology

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

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

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed and collected relevant data from FRB San Francisco, State, and Federal Reserve Board staff. We also reviewed correspondence,

[1] Supervision and Regulation (SR) Letter 91-17, *Application and Supervision Standards for De Novo State Member Banks*, defines a de novo bank as a state member bank that has been in operation for five years or less.

surveillance reports, regulatory reports filed by Pierce, examination reports issued from 2003 through 2010, examination work papers prepared by FRB San Francisco, and relevant FDIC documents. Appendixes at the end of this report contain a glossary that defines key banking and regulatory terms and a description of the CAMELS rating system.[2] We conducted our fieldwork from January 2011 through March 2011 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

Pierce failed because its Board of Directors and management did not adequately control the risks associated with the bank's residential mortgage lending activities. Specifically, the Board of Directors and senior management allowed the mortgage banking division—PC Bank—to operate independently without appropriate oversight and failed to conduct adequate strategic planning or implement robust internal controls. PC Bank pursued an "originate-to-distribute" business model that involved originating residential mortgages to be sold in the secondary market. Although this business model appeared to transfer the credit risk associated with mortgage loans to investors, Pierce remained exposed to the risk that investors could demand that the bank repurchase loans or reimburse investors for losses, subject to certain conditions. Examiners ultimately uncovered possible fraudulent activity at PC Bank related to employees misrepresenting borrower financial information and steering customers into loans for which they were not qualified. These practices led to bank losses as a result of significant investor repurchase and indemnification demands.

In addition, inadequate credit risk management and weak underwriting made the bank's commercial loan portfolio susceptible to declining economic conditions. Although Pierce received $6.8 million in Troubled Asset Relief Program (TARP) funds under the Department of the Treasury's (Treasury's) Capital Purchase Program (CPP) in January 2009, mounting losses resulting from investor repurchase and indemnification demands and commercial loan portfolio deterioration due to declining economic conditions eliminated the bank's earnings, depleted capital (including the TARP funds), and eventually led to the bank's failure. The State closed Pierce on November 5, 2010, and appointed the FDIC as receiver.

Pierce Allowed PC Bank to Operate Without Bank Oversight

Pierce's Board of Directors allowed PC Bank to operate independently with its own management, loan officers, supporting processors, and underwriters, even though Pierce funded the division's loans. In 2004, Pierce hired three "top residential mortgage producers" from a local bank to run PC Bank's mortgage lending activities. Pierce had not established a formal strategic plan for PC Bank by June 2004, even though FRB San Francisco safety and soundness examiners noted that creating and continuing to grow this new mortgage division increased Pierce's risk profile. PC Bank operated in Puyallup, less than 10 miles from Pierce's headquarters in Tacoma, but Pierce management did not conduct routine oversight activities such as on-site visitations or loan reviews to evaluate the effectiveness of the mortgage division's

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

internal controls and practices. In addition, FRB San Francisco safety and soundness examiners commented that the bank's internal audit function had not conducted meaningful audits of PC Bank's operations and that the Audit Committee was reactive in addressing audit issues, particularly those relating to the residential mortgage lending operations. According to FRB San Francisco safety and soundness examiners, Pierce's lack of oversight and involvement in the mortgage division's operations allowed PC Bank to develop a control environment that allowed loans to be approved by "any means necessary." PC Bank's incentive compensation program also contributed to this environment because it emphasized the division's growth focus and rewarded loan volume without providing similar incentives to assure loan quality.

Mortgage Origination Volume and Income at PC Bank Increased Rapidly

An increasing local demand for mortgage loans resulted in significant loan origination growth for PC Bank, which primarily focused on originating Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Veterans Administration, and Federal Housing Administration (FHA) mortgage products for sale in the secondary mortgage market.[3] Monthly origination volumes increased to $17.2 million in July 2004 from monthly volume ranges between $1.1 and $3.9 million during the first half of 2004. Loan volumes continued to increase in subsequent years. By 2007, annual origination activity reached approximately $496 million and increased to $579 million in 2008. By 2009, the mortgage division had originated and sold approximately $2.4 billion in mortgages. The magnitude of the bank's mortgage lending activities was particularly noteworthy given Pierce's total asset size never exceeded $300 million.

PC Bank produced significant noninterest income for Pierce by selling its mortgage products in the secondary market. Pierce's noninterest income increased from $866,000 in 2003, prior to the establishment of PC Bank, to $13.4 million in 2007. Examiners noted that the mortgage division generated approximately 27.4 percent of Pierce's 2007 consolidated income. Despite noting the high volume of originations and the substantial growth of the division compared to the size of the bank, FRB San Francisco safety and soundness examiners noted during 2007 that PC Bank continued to be effectively managed with "conservative and prudent lending practices" contributing to the division's success.

Risks in PC Bank's Secondary Market Activities

According to Supervision and Regulation (SR) Letter 97-21, *Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities*, certain secondary market credit activities may expose an institution to essentially the same credit risk as traditional lending activities, even though a particular transaction may appear to isolate the institution from this risk. Therefore, SR letter 97-21 requires banks to incorporate the full range of risk of their

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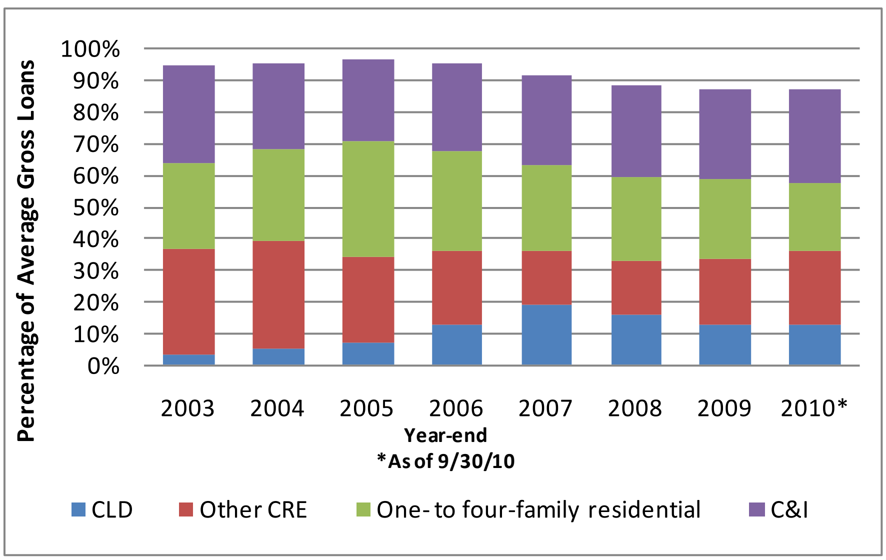
[3] PC Bank originated loans in accordance with criteria established by each government entity listed above. In addition, private investors provided automated underwriting systems that allowed for loan pre-approvals if certain criteria specified by the investor were met.

secondary market credit activities into their overall risk management systems to mitigate these credit risks.[4] Although PC Bank removed the loans it originated from Pierce's balance sheet by selling them in the secondary market, the bank remained exposed to losses on these loans due to the recourse provisions associated with the loan sales. These recourse provisions permitted investors to request that Pierce either repurchase the loans or reimburse the investor for losses under certain conditions. Those conditions could include failure to comply with investor underwriting guidelines, early payment defaults (when the borrower defaults within 90 to 180 days of origination), misrepresentation of borrower financial information, or fraud. Given the magnitude of PC Bank's loan sales, Pierce faced significant exposure to the risk that it could incur credit-related losses if investors demanded recourse on loans originated by the division.

Concentrations in Pierce's Loan Portfolio Heightened Credit Risk

Pierce's loan portfolio accounted for the majority of its assets and, as illustrated in Chart 1, the portfolio was comprised of one- to four-family residential; commercial and industrial (C&I); construction, land, and land development (CLD); and other commercial real estate (CRE) loans.

Chart 1: Loan Portfolio Composition

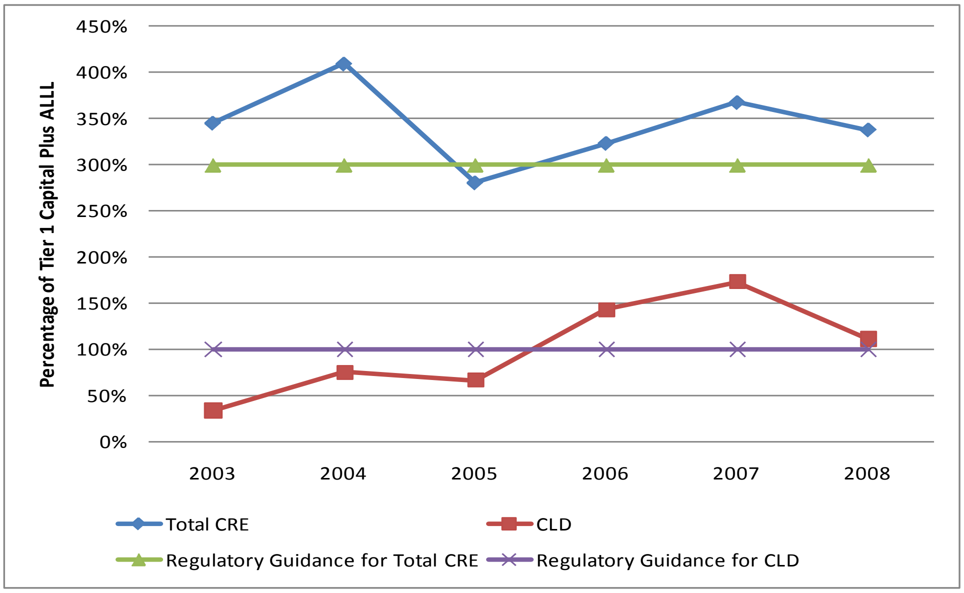


As early as 2004, examiners highlighted the credit risks associated with the bank's CRE lending concentrations, given Pierce's total CRE concentration of 363 percent of tier 1 capital plus the allowance for loan and lease losses (ALLL). In general, CRE concentrations, coupled with weak loan underwriting, increase an institution's vulnerability to downturns in the market. As illustrated in Chart 2, the bank's CRE and CLD concentrations increased between 2005 and

[4] The guidance indicates that supervisors and examiners should determine whether institutions are recognizing the risks of secondary market credit activities by, among other things, (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the Board of Directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding.

2007.[5] Management reduced the bank's CRE and CLD concentrations in 2008 to more modest levels. Nevertheless, Pierce's remaining CRE and CLD concentrations and the credit risk associated with its sold mortgages increased the bank's vulnerability to a market downturn.

Chart 2: Total CRE and CLD as a Percentage of Tier 1 Capital Plus the ALLL[a]



[a]SR letter 07-01 became effective in 2007. The chart depicts the CRE and CLD concentration guidelines established by the SR letter prior to 2007 for illustrative purposes only.

Pierce Received TARP Funds in January 2009

In late November 2008, Pierce's holding company applied for funds through the TARP's CPP. FRB San Francisco applied the Department of Treasury's guidance, *Process for Evaluation of QFI* [Qualified Financial Institutions] *Participation in the TARP Capital Purchase Program*, and concluded that Pierce qualified for "presumptive approval" status. Based on Treasury's guidance, FRB San Francisco had to evaluate specific financial performance data to make that determination because, although Pierce's most recent CAMELS composite rating was a CAMELS composite 2 (satisfactory), it was not issued within the previous six months.[6] FRB San Francisco acknowledged that the most recent examination report (November 2007) contained outdated performance information, so examiners used the bank's September 30, 2008, regulatory reports to calculate the required financial performance ratios. FRB San Francisco concluded that the ratios met the guidelines and that the bank's satisfactory CAMELS composite

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[5] According to SR Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate, Sound Risk Management Practices*, an institution presents potential significant CRE concentration risk if it meets the following criteria: (1) total reported loans for construction, land development, and other land represent 100 percent or more of an institution's total capital; or (2) total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

[6] Under the TARP guidance, institutions that were placed in the presumptive approval category had, among other things, a CAMELS composite rating of 1or 2 within the last six months. Institutions with a CAMELS composite 2 rating issued more than six months ago and 3-rated institutions could also qualify for presumptive approval status if those institutions had acceptable performance ratios.

rating indicated there were no significant concerns regarding the bank's viability.[7] Further, the bank holding company and the bank were not subject to any enforcement actions or monitoring reports at the time of the application. On January 23, 2009, the holding company received $6.8 million in TARP funds. Of the $6.8 million, $4.5 million augmented the bank's capital and the remainder was used to retire holding company debt and cover future operating expenses.

Consumer Complaints, Loan Default Rates, and Repurchase and Indemnification Requests Increase in 2009

In 2007 and 2008, the State of Washington Attorney General's Office received multiple consumer complaints regarding mortgages originated at PC Bank. In December 2008, the State contacted FRB San Francisco about 16 consumer complaints that had accumulated and requested that FRB San Francisco participate in a target review of the bank's complaint process. The consumers' complaints indicated that PC Bank employees misrepresented information in loan applications. Specifically, consumers alleged that PC Bank employees fraudulently misrepresented the information included in their loan applications by inflating home sales prices or misstating income, property tax, and borrower financial information. On January 12, 2009, FRB San Francisco Consumer Affairs (Consumer) and the State began a target review. In the January 23, 2009, joint examination report, examiners recommended that a full scope consumer compliance examination occur to further investigate the allegations.

During a July 2009 safety and soundness examination, FRB San Francisco examiners observed that the delinquency rates on loans originated by PC Bank continued to rise, prompting investors to review loans originated by PC Bank for defects and make repurchase and indemnification requests to recoup losses. Investors cited early payment defaults and misrepresentations in the loan files as the reasons for their demands. Pierce's management did not formally track these requests, which made it difficult for both management and examiners to determine the bank's losses and overall exposure to these requests.

During the same July 2009 examination, FRB San Francisco safety and soundness examiners began to identify the scope of the alleged fraudulent lending practices at PC Bank when they found multiple loans where borrowers did not meet underwriting or investor guidelines. According to examiners, consistent with the consumer and investor complaints, loan files included inflated borrower income, understated borrower debt levels, and falsified deposit balance and appraisal verifications. Given the magnitude of PC Bank's mortgage origination activity—the division originated and sold approximately $2.4 billion in mortgages by 2009—and the potential scope of the alleged fraud, examiners expected repurchase and indemnification demands to continue to increase substantially.

The bank's mortgage originations declined in 2009 to approximately $245 million from approximately $579 million in 2008 as the bank curtailed its mortgage lending activity and

[7] Examples of these performance ratios include (1) classified assets/net tier 1 capital plus ALLL, (2) CLD loans/total risk-based capital, and (3) non-performing loans plus other real estate owned/net tier 1 capital plus ALLL.

consolidated mortgage lending operations.[8] In July 2009, the U.S. Department of Housing and Urban Development (HUD) terminated Pierce's FHA origination approval agreement because the default and claim rate on FHA loans originated by PC Bank exceeded the average lender in HUD's Seattle Office jurisdiction by 256 percent. This action effectively eliminated the bank's FHA loan origination activity. In December 2009, FRB San Francisco issued a Cease-and-Desist Order (C&D Order) that required Pierce to cease all residential mortgage underwriting and origination activities without prior written approval of FRB San Francisco and the State.

Exposure to Recourse Demands and Related Expenses Increased Substantially at PC Bank

As examiners anticipated, Pierce incurred significant expenses due to the volume of repurchase and indemnification requests. Examiners estimated that Pierce had repurchased approximately $4 million in residential mortgage loans by July 2009 and settled approximately $7.3 million in indemnification claims with several investors by the end of 2009.[9]

Due to the lack of reporting, tracking, and monitoring of repurchase and indemnification demands, examiners required Pierce to hire forensic accountants to determine the magnitude of the bank's exposure to these requests. On March 12, 2010, a forensic accountant issued a report indicating that Pierce had $1.03 billion in potential contingent liability exposure.[10] Pierce maintained an off-balance sheet reserve to mitigate anticipated losses arising from this exposure.[11] Given the bank's increasing exposure to recourse demands during 2009, management increased the off-balance sheet reserve to $2.04 million as of March 2010, from $31,000 as of August 2007. The forensic accountant recommended, however, that management further increase the off-balance sheet reserve by $4.94 million upon determining the scope of Pierce's contingent liability exposure. The bank made the recommended provision to the off-balance sheet reserve, for a total of $6.98 million, and re-filed its December 31, 2009, Call Report to reflect the increase, as illustrated in Chart 3.

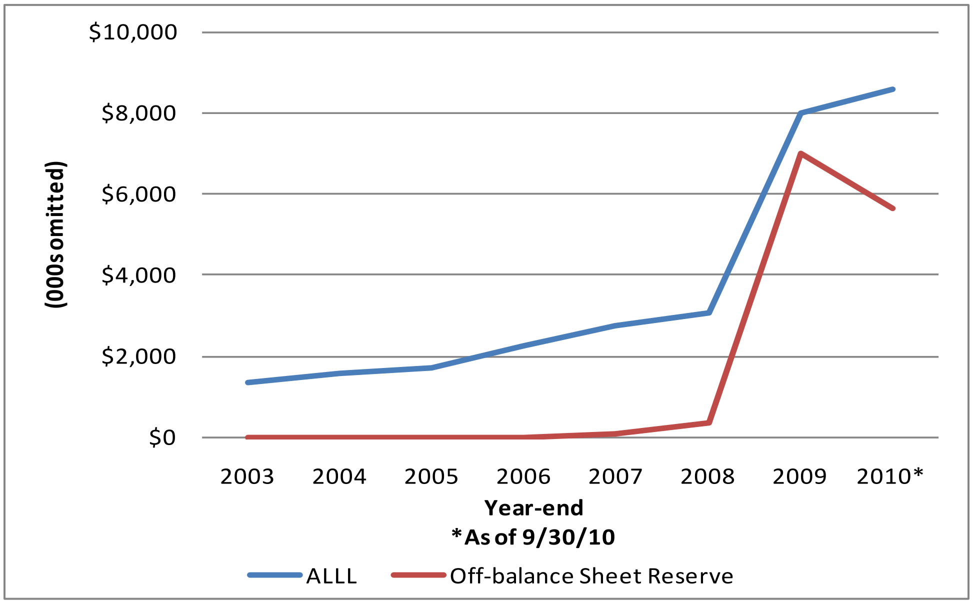
[8] PC Bank officially closed in mid-2009. In September 2009, FRB San Francisco required Pierce to cease all mortgage origination activity before it issued the October 2009 safety and soundness examination report and the Cease-and-Desist Order, due to the detection of pervasive fraud.

[9] Examiners could not confirm the accuracy of these numbers due to the bank's lack of reporting, tracking, and monitoring.

[10] Contingent liabilities are financial obligations that are dependent on future events or actions of another party.

[11] According to the CBEM and Federal Financial Institutions Examination Council Call Report Instructions, when conditions for accrual of a loss under Statement of Financial Accounting Standard 5 are met for off-balance sheet items, an institution should maintain and report, as a separate liability account, an allowance that is appropriate to cover estimated credit losses on off-balance sheet loan commitments. In addition, "recourse liability accounts" arising from asset transfers with recourse that are reported as sales are considered separate and distinct from the ALLL and the allowance for credit losses on off-balance sheet credit exposures. For the purposes of this report, consistent with language used in examination and other related reports, we will refer to the reserve related to the loans sold with recourse as the off-balance sheet reserve.

Chart 3: ALLL and Off-balance Sheet Reserve



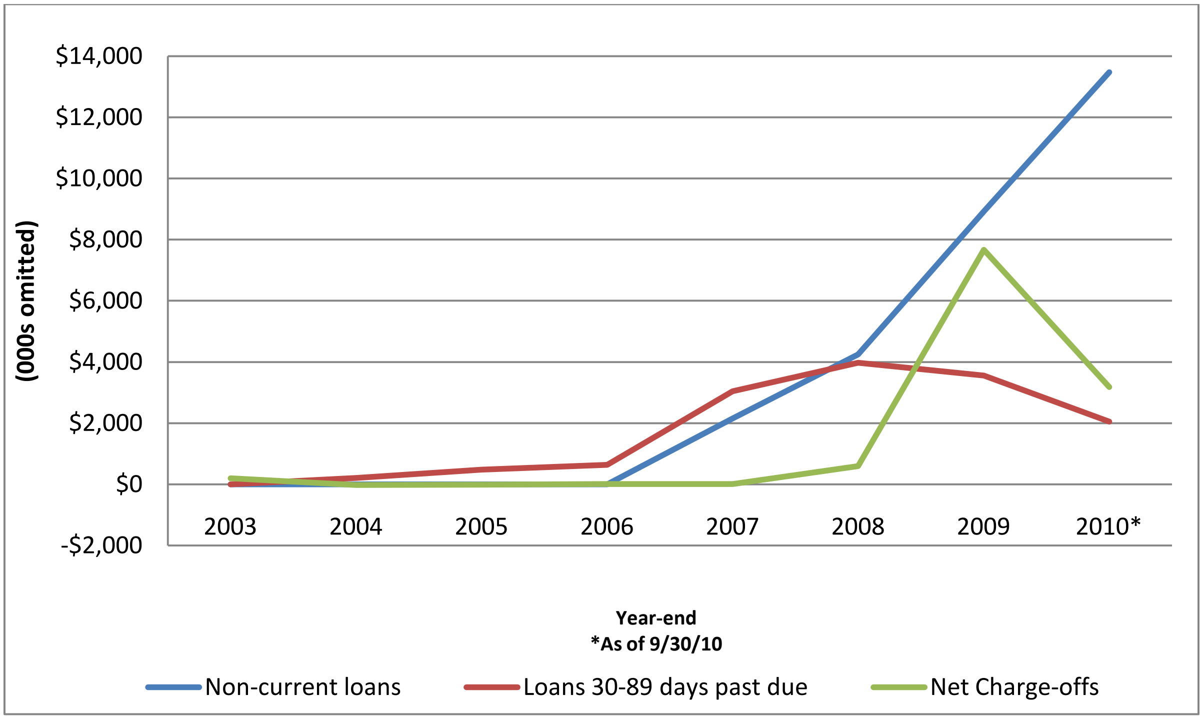
In 2009 and 2010, Pierce incurred an estimated $18.3 million in expenses due to loan repurchases, investor settlements, and enhancements to the off-balance sheet reserve. These expenses significantly reduced the bank's earnings and depleted capital.

Asset Quality Deteriorated as Economic Conditions Worsened

During a January 2009 examination, State examiners noted asset quality deterioration as the bank's classified assets increased from 4.6 percent of tier 1 capital and the ALLL as of June 2007 to 32.6 percent as of December 2008. Examiners attributed the declines in asset quality to the significant impact of the declining real estate market and the recession. Despite the increase in classified assets, examiners concluded that asset quality and credit administration practices remained satisfactory. In a July 2009 examination, FRB San Francisco safety and soundness examiners noted continued asset quality deterioration, as classified assets rose from $3.1 million to $12.9 million between December 31, 2009, and June 30, 2009. FRB San Francisco also noted additional concerns related to FHA loans—default rates for these loans increased from 3 percent to 7 percent during the first quarter of 2009 due to allegations of fraud. During a November 2009 examination, FRB San Francisco safety and soundness examiners noted that further declines in the local economy resulted in significant asset quality deterioration, with classified assets increasing to 99.4 percent of tier 1 capital and the ALLL and delinquent loans and charge-offs rising substantially. As illustrated in Chart 4, noncurrent loans more than doubled in one year from $4.2 million in December 2008 to $8.9 million as of December 31, 2009.[12] According to examiners, the rise in noncurrent loans from year-end 2008 to 2009 primarily resulted from delinquencies in the CLD ($1.09 million increase), one- to four-family residential ($985,000 increase), and C&I ($1.69 million increase) loan portfolios.

[12] Noncurrent loans are loans more than 90 days past due or on nonaccrual.

Chart 4: Delinquencies and Charge-offs



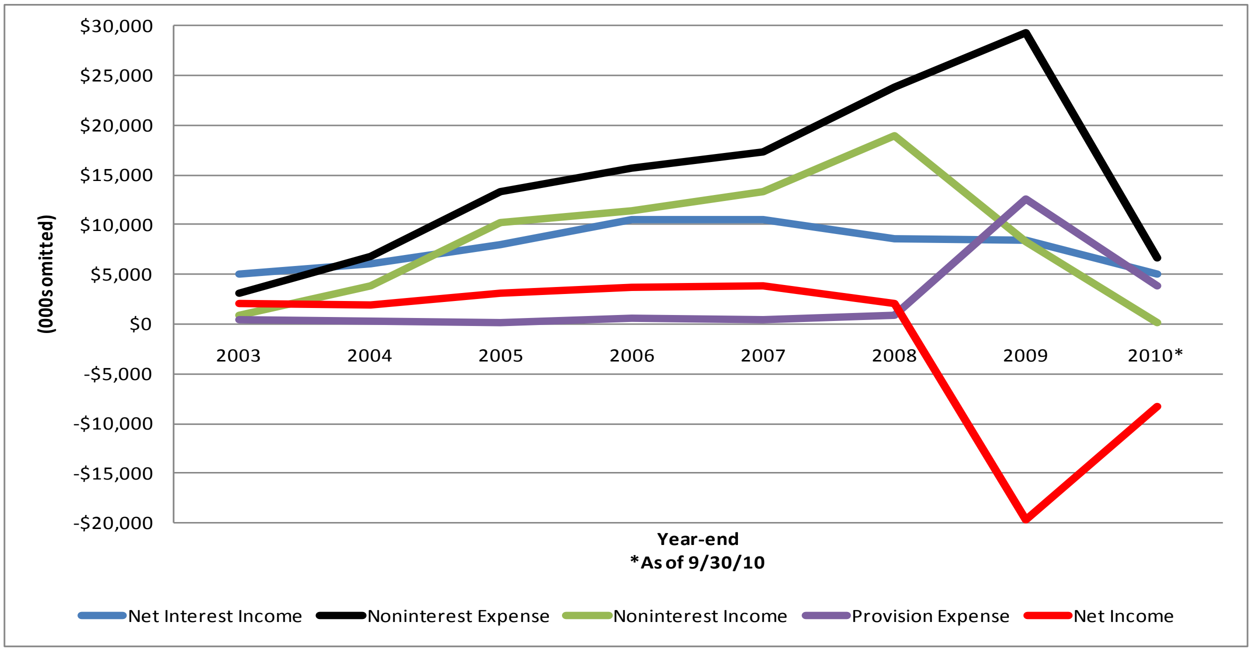
During a November 2009 examination, FRB San Francisco safety and soundness examiners noted that the bank's credit risk was high and continuing to increase and that management did not have a strategy to reduce its risk exposure. Examiners highlighted increasing risk exposure in the loan portfolio due to CRE concentrations; ineffective credit risk management practices; an inadequate ALLL; poor risk identification and loan monitoring practices; and a significant increase in problem assets, particularly in the CLD portfolio. Examiners attributed the severity of the deterioration to weak underwriting and credit administration practices coupled with poor management responses to the worsening economic and real estate environment. Examiners also indicated that management had not identified problem loans in a timely manner, and they downgraded more than 28 percent of the sampled loans' internally assigned loan grades.

Asset quality deterioration in multiple segments of the bank's loan portfolio contributed to the failure by increasing the bank's provision expenses and actual losses. Pierce's classifications increased due to asset quality deterioration in CLD loans and loans secured by one- to four-family residential properties. In addition, Pierce's C&I and one- to four-family residential loans experienced severe asset quality deterioration that required loans to be charged off—86 percent of all charge-offs in 2009 occurred in these segments of the bank's loan portfolio.

Losses Accumulated and Depleted Capital

As shown in Chart 5, multiple factors contributed to the bank's sharp drop in net income in 2009. Beginning in July 2009, restrictions on mortgage originations decreased mortgage loan sales, which caused a sharp decline in noninterest income. Meanwhile, loan repurchases, settled indemnification requests, and increases to the off-balance sheet reserve resulted in increased noninterest expenses, which further strained the bank's net income. Finally, the bank's provision expenses increased between 2008 and 2009, as Pierce took a substantial provision totaling $12.6 million at year-end 2009 and $3.8 million by third quarter 2010. As a result, the bank incurred losses of $19.7 million by year-end 2009 and $8.3 million by the third quarter of 2010.

Chart 5: Net Income



Mounting losses eroded the bank's capital and caused capital ratios to decline. FRB San Francisco implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies in troubled depository institutions. Despite the capital injection from TARP funds in early 2009, risk-based capital ratios fell below the *well capitalized* PCA threshold as of the third quarter 2009.[13] On February 16, 2010, FRB San Francisco notified Pierce that it had become *undercapitalized* as of the fourth quarter 2009 and required the bank to submit an acceptable capital restoration plan by March 8, 2010. Examiners deemed the bank's initial and revised capital restoration plan submissions unacceptable because the plans lacked details of commitments from outside investors.

On March 26, 2010, FRB San Francisco deemed the bank *significantly undercapitalized* after the bank re-filed its year-end 2009 Call Report to reflect an increase in the off-balance sheet reserve of $4.94 million. Although capital ratios temporarily improved after board members and senior management personally contributed approximately $2.6 million in March 2010 to augment capital, Pierce remained *significantly undercapitalized* as of April 30, 2010.[14] As a result, the Federal Reserve Board issued a PCA Directive on June 10, 2010, that, among other things,

[13] This change occurred following the bank's re-filing of the third quarter 2009 Call Report to reflect an additional provision expense of $8.2 million.

[14] The capital injection included $140,000 from the holding company.

required Pierce to accomplish the following within 60 days: (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.

In a final attempt to raise capital, Pierce pursued a private placement in August 2010, but this did not succeed. The bank also submitted a capital plan in August 2010, but FRB San Francisco deemed it unacceptable because it was not based on reasonable assumptions. Following a re-filing of the June 30, 2010, Call Report to reflect an additional provision to the reserve, Pierce was notified on September 15, 2010, that it had become *critically undercapitalized* as of the second quarter 2010. The State closed the bank on November 5, 2010, and appointed the FDIC as receiver.

Supervision of Pierce Commercial Bank

FRB San Francisco complied with the safety and soundness examination frequency guidelines and conducted regular off-site monitoring for the time frame we reviewed, 2003 to 2010. During this time frame, FRB San Francisco and the State conducted six full scope safety and soundness examinations, one limited scope safety and soundness examination, and one target safety and soundness examination and executed two formal enforcement actions: a C&D Order and a PCA Directive.

As shown in Table 1 on page 19, Pierce had a CAMELS composite 2 (satisfactory) rating until a limited scope examination downgraded the bank to 4 (marginal) in October 2009. Prior to the CAMELS composite rating downgrade, Pierce's holding company applied for TARP CPP funds, and FRB San Francisco evaluated the application in late November 2008. By late January 2009, the holding company received TARP CPP funds. An October 2009 limited scope examination report also resulted in a December 2009 C&D Order. During this examination, FRB San Francisco discovered the scope of the possibly fraudulent activities at Pierce. In March 2010, FRB San Francisco further downgraded Pierce to a CAMELS composite 5 (unsatisfactory) rating. As a result of declining capital levels, the Federal Reserve Board implemented a PCA Directive. A July 2010 target examination evaluated the bank's progress in addressing previously noted weaknesses, but did not assign CAMELS composite or component ratings.

In addition to these safety and sound soundness examinations, examiners from FRB San Francisco Consumer conducted two full scope compliance consumer examinations, a target consumer compliance review, and a joint target review of the mortgage division. The bank received a satisfactory rating for its compliance with consumer protection laws and regulations in an October 2006 examination. In September 2007, FRB San Francisco Consumer performed a target consumer compliance review to assess the bank's progress towards addressing the deficiencies noted in the October 2006 examination. On January 12, 2009, FRB San Francisco and the State performed a joint target examination focused on PC Bank's policies and procedures, after the State of Washington Attorney General's Office received consumer complaints related to apparent violations of the Real Estate Settlement Procedures Act

(RESPA).[15] The review recommended a full scope compliance and Community Reinvestment Act (CRA) examination due to allegations of fraud and the mortgage division's lack of a compliance management program.[16] As a result of a July 2009 full scope compliance examination, the bank received unsatisfactory ratings for its compliance management program and compliance with consumer protection laws and regulations.

Our analysis of FRB San Francisco's supervision revealed that in 2004 examiners did not conduct the detailed testing of PC Bank's internal controls that were necessary to confirm that Pierce's Board of Directors and management identified and appropriately controlled the risks associated with the bank's new business activity, mortgage banking. Further, we believe that FRB San Francisco should have conducted detailed testing of the mortgage division's origination activities and the internal controls surrounding those activities no later than the 2007 safety and soundness examination. Examiners did not discover the full extent of the internal control weaknesses and possible fraudulent activity until the July 2009 limited scope safety and soundness examination.

[15] RESPA requires lenders, mortgage brokers, or servicers of home loans to provide borrowers with pertinent and timely disclosures regarding the nature and costs of the real estate settlement process. The law also protects borrowers against certain abusive practices, such as kickbacks, and places limitations upon the use of escrow accounts.

[16] CRA is intended to encourage each depository institution covered by the act to meet the credit needs of the communities in which it is chartered, consistent with the safe and sound operation of such institutions.

Table 1: Supervisory Overview of Pierce

Examinations			Agency Conducting the Examination	Consumer Compliance Rating	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope				Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
2/24/2003	4/10/2003	Full	State	N/A	2	2	1	2	2	2	2	
8/6/2004	11/9/2004	Full	FRB San Francisco	N/A	2	2	2	2	2	2	2	
1/30/2006	3/23/2006	Full	State	N/A	2	2	2	2	2	2	2	
10/30/2006	1/3/2007	Full - Consumer	FRB San Francisco	2	N/A	N/A	N/A	N/A	N/A	N/A	N/A	
9/10/2007	10/18/2007	Target – Consumer	FRB San Francisco	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	
9/10/2007	11/6/2007	Full	FRB San Francisco	N/A	2	2	1	2	2	2	2	
1/12/2009	1/23/2009	Target – Consumer	Joint	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	
1/29/2009	4/2/2009	Full	State	N/A	2	2	2	2	2	2	2	
7/13/2009	3/18/2010	Full – Consumer	FRB San Francisco	5	N/A	N/A	N/A	N/A	N/A	N/A	N/A	
7/20/2009	10/2/2009	Limited	FRB San Francisco	N/A	4	4	3	5	5	4	3	Cease-and-Desist
11/16/2009	3/19/2010	Full	FRB San Francisco	N/A	5	5	5	5	5	5	4	PCA Directive
7/12/2010	10/7/2010	Target[a]	Joint	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	

[a] Target examination focused on asset quality. No composite or component ratings were assigned.

February 2003 Full Scope State Examination Resulted in a CAMELS Composite 2 Rating

In February 2003, the State conducted a full scope examination that resulted in a CAMELS composite 2 rating. Examiners noted that the bank's positive earnings exceeded its peer group averages and supported rapid capital growth. Management expected the bank's asset growth to slow since the bank had recently reached its goal of $100 million in total assets. The State indicated that the bank's liquidity position had greatly improved, but loan growth continued to outpace deposit growth.

Examiners commended the Board of Directors' active oversight. The April 2003 examination report noted that the Board of Directors and the senior management team were in the process of formalizing a strategic plan that would cover the bank's five- to six-year goals, objectives, and target ratios. Examiners noted that the new plan would project slower growth and describe potential expansion into new financial services, address the need for new office space, and outline the prospective hiring of key employees. Examiners stated that the bank hired two employees from a local bank in 2002 to administer a newly formed mortgage banking department.

The examination report noted that the bank's focus on lending to the medical community insulated its exposure to slowing economic conditions because most of the medical clients were expanding their businesses during this period. Examiners indicated that Pierce's underwriting of medical loans appeared sound and was strengthened by management's familiarity with its customers. According to examiners, solid underwriting and minimal loan-to-value ratio (LTV) exceptions mitigated the bank's concentration in commercial real estate lending.

Examiners also noted that management improved its focus on complying with the insider lending requirements contained in Regulation O by identifying each of its officers and directors.[17] The State indicated that all insider loans had been approved by the Board of Directors and that tracking of those loans appeared to be sound, but examiners cautioned that management should continue to closely monitor all insider transactions.

August 2004 Full Scope FRB San Francisco Examination Resulted in Another CAMELS Composite 2 Rating

In August 2004, FRB San Francisco began a full scope examination that resulted in another CAMELS composite 2 rating. Examiners highlighted Pierce's (1) active director participation in Board meetings, (2) capable and experienced senior management, and (3) ability to rely on earnings to augment capital. FRB San Francisco downgraded Pierce's CAMELS rating for asset quality to 2 (satisfactory), but noted that the bank's satisfactory asset quality mitigated concerns about its below-peer capital position.

According to examiners, the bank's continued growth and addition of PC Bank increased its risk profile. FRB San Francisco indicated that PC Bank's monthly loan origination volume increased

[17] Subpart A, Section 215.4(a)(1) of Regulation O generally prohibits a member bank from extending credit to any insider of the bank unless the extension of credit is made on substantially the same terms as those prevailing at the time for comparable transactions with other persons who are not covered by this part and who are not employed by the bank.

significantly in July 2004 to $17.2 million compared to the $1.1 million to $3.9 million monthly volume ranges during the first six months of 2004. Despite the significant increase in this new business activity, examiners only conducted a "high-level review" of this activity. They recommended that management (1) devise a strategic plan for the division that outlined the broad goals for mortgage banking and assured consistency with the bank's overall strategic plan; and (2) prepare a business plan and budget for the division to enable an assessment of its overall performance.

Section 1000.1 of the CBEM states that examiners should assess the effectiveness of the Board of Directors' and management's oversight by confirming that management assessed the risks associated with new business activities and implemented the infrastructure and internal controls necessary to manage those risks. In our opinion, the fact that management had not developed a strategic plan for a new business activity while monthly loan origination volume increased by 341 to 1463 percent during the prior six-month period should have been a "red flag" concerning the adequacy of management's planning and risk assessment. We believe that the lack of adequate planning and risk evaluation were likely indicators that the Board of Directors and management had not effectively identified the risks associated with the new business activity or tailored the bank's controls to accommodate rapid growth. These possibilities should have prompted FRB San Francisco to conduct detailed testing of PC Bank's operations.

The November 2004 examination report did raise the following four matters requiring Board of Directors' attention: (1) strategic planning, (2) information security program, (3) business continuity program, and (4) compliance with Regulation O requirements. With respect to the strategic plan, the Chief Executive Officer (CEO) indicated that the Board had adopted a six-year budget following discussions between senior management and the Board members about strategic planning. However, the CEO acknowledged that a formal strategic plan had not been finalized and agreed to prepare a written plan by the end of December 2004.

Examiners noted that CRE lending and C&I lending comprised 41 and 28 percent of the bank's loan portfolio, respectively. The examination report highlighted that CRE represented 362.7 percent of Pierce's tier 1 capital plus the ALLL. According to examiners, management acknowledged the bank's CRE and industry concentration in the medical field. FRB San Francisco recommended that management develop strategies to manage the risk associated with "committing large portions of the bank balance sheet to specific loan types or industry."

FRB San Francisco also raised specific concerns about the bank's compliance management program. Examiners acknowledged management's efforts to establish a customer information security program, but noted that the program lacked (1) Board of Directors' monitoring and oversight and (2) appropriate training of employees. In addition, the examination report highlighted instances of unapproved appraisers performing appraisals and situations where the bank did not review appraisals to confirm that they conformed to the bank's standards. Finally, examiners also noted the need for improved monitoring of loans to insiders to eliminate the appearance of conflicts of interest.

January 2006 Full Scope State Examination Resulted in Another CAMELS Composite 2 Rating

In January 2006, the State began a full scope examination that resulted in another CAMELS composite 2 rating, and each CAMELS component received a 2 rating. Examiners noted that the bank had low classified assets, sufficient earnings and satisfactory capital, effective Board of Directors and management oversight, and sufficient liquidity. The examination report acknowledged the bank's ability to grow while increasing its return on assets and capital ratios. However, examiners reiterated the need for improved strategic planning. The State's examination report did not contain a detailed assessment of PC Bank's operations or internal controls.

The March 2006 examination report noted that management effectively evaluated possible new business opportunities, but formal strategic planning had not occurred since November 2004. Examiners mentioned that a strategic planning session should occur in 2006, including a full analysis of the bank's strengths, weaknesses, opportunities, and threats. The examination report emphasized the need for such planning concerning the bank's mortgage banking department. The CEO once again acknowledged that strategic planning had been overlooked in 2005 and reiterated the intent to formally address strategic planning in 2006. In our opinion, Pierce's inability, or unwillingness, to resolve prior examination comments on key topics like strategic planning should have resulted in heightened scrutiny of PC Bank during future examinations.

The examination report noted the appropriateness of the bank's methodology for calculating its ALLL given the complexity of the loan portfolio. However, examiners commented that the bank did not appropriately consider potential losses related to off-balance sheet commitments. Examiners mentioned that management should review historical funding of off-balance sheet commitments to determine an appropriate risk factor for this category and incorporate this factor into the reserve methodology.

The examination report noted that the bank was in violation of several sections of FDIC rules and regulations related to appraisals and real estate lending standards. Specifically, examiners mentioned that the bank's informal process of estimating values for collateral properties on some loan relationships did not include sufficient documentation to constitute an evaluation. In addition, the loan policy had not been reviewed and approved by the Board of Directors on an annual basis, and the bank's Real Estate Loan Policy contained guidelines that contradicted the general loan policy. Examiners also observed that some loans exceeded the maximum supervisory LTV limits.

During this examination, the State observed that the bank's CRE concentration decreased to 314 percent. The examination report characterized the bank's loan portfolio as a "reasonable mix" with a "moderate" concentration. Examiners encouraged the bank to implement quarterly reporting to the Board of Directors and establish policy limits on concentration levels as a percentage of tier 1 capital.

Examiners also noted that management should resume using an audit matrix to track all audit findings to ensure that the bank's Audit Committee identified responsible managers or departments and resolved issues in a timely manner. The bank's management indicated that audit tracking had been overlooked and agreed to reinstate the audit tracking matrix.

Consumer Affairs Examinations in 2006 and 2007

In October 2006, Consumer examiners from FRB San Francisco began a consumer compliance and CRA examination. The January 2007 examination report noted that the bank's overall compliance with consumer protection laws and regulations remained satisfactory and assigned a consumer compliance rating of 2.[18] Nevertheless, examiners identified "material weaknesses" in the bank's compliance framework that could result in future downgrades. Specifically, the bank lacked a fair lending program and maintained no infrastructure to manage fair lending risks.[19] Additionally, examiners mentioned that mortgage lending origination staff "does not understand the implications of discriminatory practices against protected groups."

Examiners stated that the lack of a fair lending program was a significant concern given the mortgage division's substantial growth and large volume of sub-prime loans. Examiners indicated that in a two-year period, the bank's fair lending risk increased significantly due to its exponential growth in residential mortgage lending. The bank's mortgage loan volume increased from 368 loans in 2004 to an annualized projection of 2,700 loans in 2006, a projected increase of 634 percent. FRB San Francisco highlighted the need for active Board and senior management involvement to create and implement a fair lending program. In our opinion, the lack of a fair lending program demonstrated that management failed to identify a fundamental risk associated with mortgage lending and represented another significant red flag indicating that management may not have acknowledged other fundamental risks associated with the bank's mortgage lending and secondary market credit activities. We believe that this additional red flag suggested a need to closely scrutinize PC Bank's origination activities and supporting internal controls.

In addition to the fair lending concerns, examiners noted significant violations of data collection requirements for the Home Mortgage Disclosure Act (HMDA).[20] Examiners noted that the volume of errors found in the bank's 2005 data exceeded acceptable thresholds. Management attributed the data errors to the fact that the bank's staffing levels had not kept pace with the significant increase in mortgage volume. Bank staff concentrated on data input and did not verify the information by comparing it to source data. Examiners concluded that internal control weaknesses explained the unacceptably high error rates in the bank's HMDA data.

[18] The examination report indicated that an institution in this category is in a generally strong compliance position. Management is capable of administering an effective compliance program. Although a system of internal operating procedures and controls has been established to ensure compliance, violations have nonetheless occurred. These violations, however, involve technical aspects of the law or result from oversight on the part of operating personnel. Modification in the bank's compliance program and/or the establishment of additional review/audit procedures may eliminate many of the violations. Compliance training is satisfactory. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.

[19] The fair lending laws prohibit discrimination in credit transactions, including transactions related to residential real estate.

[20] HMDA provides the public with information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located, aids public officials in distributing public-sector investments so as to attract private investment to areas where it is needed, and assists in identifying possible discriminatory lending patterns and enforces anti-discrimination statutes.

In addition to these concerns, examiners noted regulatory violations regarding (1) adverse action disclosure requirements contained in the Equal Credit Opportunity Act (ECOA), (2) annual escrow account analysis requirements according to RESPA and (3) requirements for calculating finance charges according to the Truth in Lending Act.[21] The examination report concluded that an expanding consumer residential mortgage division substantially increased Pierce's inherent-risk profile. Examiners further noted that the bank's increasing real estate mortgage lending focus created heightened supervisory concern and an increasing risk trend. Based on the significance of these findings, examiners scheduled a follow-up review within 12 months to assess the effectiveness of the bank's corrective action.

In September 2007, Consumer examiners from FRB San Francisco began a target consumer compliance review to assess management's actions to address the fair lending risks and HMDA data collection deficiencies noted during the October 2006 consumer compliance examination. The October 2007 examination report concluded that HMDA data collection was now satisfactory and that the bank had created a strong foundation to support a comprehensive and robust fair lending program. Examiners noted that while the fair lending program development was not fully completed, management's responsiveness and action steps taken to date demonstrated the bank's commitment to developing a satisfactory fair lending program.

September 2007 Full Scope FRB San Francisco Examination Resulted in Another CAMELS Composite 2 Rating and a Component Rating Upgrade

In September 2007, FRB San Francisco began a full scope examination that resulted in another CAMELS composite 2 rating. Examiners upgraded the bank's asset quality component rating from a 2 to 1 because they considered asset quality strong with modest and stable CRE concentrations. The November 2007 examination report noted that management of the mortgage banking operations continued to be effective, and favorable market conditions enabled Pierce to significantly grow PC Bank since its inception in 2004. According to examiners, the mortgage division generated nearly 27.4 percent of the bank's consolidated net income, and mortgage loans held for sale represented 19.3 percent of the bank's total loans.

During the examination, FRB San Francisco assessed PC Bank's mortgage operations by completing the Mortgage Banking Core Analysis Decision Factors (Decision Factors Analysis) examination procedures.[22] Upon completing the Decision Factors Analysis, examiners concluded that PC Bank's internal controls were sound and included adequate segregation of duties and appropriate independent review. The examination report indicated that the Board of Directors and management adequately identified, monitored, and controlled the risks posed by the bank's mortgage lending activities. The examination report summary related to the Decision Factors Analysis identified several factors that supported this conclusion, including that PC Bank (1) no longer engaged in sub-prime lending activities, (2) followed conservative and prudent

[21] Section 202.9 of Regulation B, which implements ECOA, requires that an adverse action notice disclose the name and address of the federal agency responsible for enforcing the act and the financial institution that issued the notice. The Truth in Lending Act states that the creditor shall furnish the consumer with a periodic statement that discloses the amount of various charges applicable to the account during the billing cycle.

[22] The Mortgage Banking Core Analysis Decision Factors consist of 89 questions on various topics. If the analysis identifies adverse findings, the CBEM requires additional expanded procedures that would constitute detailed testing.

lending practices, and (3) had only one indemnification request in its limited history. Because there were no adverse findings, FRB San Francisco recommended that examiners conduct detailed testing of loans held for sale, automated underwriting, and loan origination and underwriting during the next examination.

In our opinion, FRB San Francisco's Decision Factors Analysis did not detect certain risks or acknowledge the significance of other potential risks noted during the review. Examiners did not (1) cite the lack of bank oversight of PC Bank as a risk factor or (2) acknowledge that PC Bank's sole indemnification request did not accurately reflect its increasing risk of repurchase and indemnification requests given the high mortgage origination volumes.

In addition, FRB San Francisco detected other potential red flags during the Decision Factors Analysis, but did not acknowledge the significance of those potential issues. First, FRB San Francisco noted that PC Bank's three senior managers received "generous" incentive compensation packages in 2006 of $1.8 million, $470,000, and $450,000, respectively. Examiners concluded that the compensation packages were not "unsafe and unsound practices." The Decision Factors Analysis, however, did not address whether the compensation program included any incentives to originate quality loans or presented any potential risks. Second, FRB San Francisco identified a sole bank employee as "a key monitoring and control point in the mortgage banking process" to detect and investigate suspected fraudulent activity. However, the Decisions Factors Analysis did not describe the employee's monitoring processes or qualifications for the role, and, more importantly, did not identify the concentration of responsibility in a sole employee as a potential operational risk.

The risk-focused examination approach outlined in the CBEM encourages examiners to conduct detailed testing consistent with the risks and the adequacy of risk management processes surrounding a particular activity. We believe that PC Bank's elevated risk profile was not reflected in the Decision Factors Analysis, and FRB San Francisco should not have deferred detailed testing until the next examination.

Pierce Applied for and Received TARP Funds

In late November 2008, Pierce's holding company applied for TARP funds under the CPP. FRB San Francisco evaluated the application using Treasury's guidelines and concluded that Pierce qualified for presumptive approval status because of Pierce's financial performance ratios as of September 30, 2008, because examiners did not question Pierce's viability. Examiners relied on these ratios to evaluate the application because Pierce's most recent examination had been issued more than six months earlier. In our opinion, FRB San Francisco complied with Treasury's guidelines and the limited decision-making criteria available at the time.[23]

[23] In September 2009, the Federal Reserve Board's Office of Inspector General issued a report entitled *Audit of the Board's Processing of Applications for the Capital Purchase Program under the Troubled Asset Relief Program* that reached a similar overall conclusion concerning the processing of TARP applications by the various Reserve Banks.

January 2009 Joint Target Examination Focused on Mortgage Lending

The State of Washington Attorney General's Office received 16 complaints between 2007 and December 2008 concerning PC Bank that included allegations of fraud and misrepresentation during the loan origination process and raised concerns regarding improper payments that violated RESPA. In December 2008, the State contacted FRB San Francisco to inform the Reserve Bank that the State planned to conduct a targeted review of the mortgage division.

On January 12, 2009, FRB San Francisco Consumer examiners and the State began a joint target review of the policies and procedures of the mortgage division. Examiners found, among other things, that (1) the Board of Directors and management oversight of the mortgage operations was less than satisfactory, (2) the compliance management program within mortgage operations was less than satisfactory, (3) the staff knowledge concerning compliance requirements was weak, (4) the complaint investigation process was less than satisfactory, and (5) the internal controls within the mortgage operations were less than satisfactory.

Examiners also found that the mortgage division originated 2,267 loans totaling $496 million in 2007 and 2,268 loans for $579 million in 2008, with minimal or non-existent compliance processes and widespread RESPA violations. Specifically, examiners noted that PC Bank engaged in joint advertising with service providers and paid fees disproportionate to the level of advertising received, suggesting that the arrangement effectively resulted in the payment of prohibited fees. Examiners also stated that PC Bank provided free catered meals to brokers and builders who provided referrals. According to examiners, several managers at the mortgage division formed independent limited liability companies (LLCs) to carry out a variety of business objectives, including purchasing leads, developing residential real estate, and pursuing other business opportunities and personal interests. Examiners found that the bank made several payments directly to these LLCs.

Examiners recommended a full-scope compliance and CRA examination due to concerns relating to (1) the potential for fraud, deception, and widespread regulatory violations that would cause significant harm to consumers; (2) the potential involvement by bank employees in these activities; and (3) the lack of a compliance management program.

January 2009 Full Scope State Examination Resulted in Another CAMELS Composite 2 Rating

On January 29, 2009, the State began a full scope examination that resulted in another CAMELS composite 2 rating. The April 2009 examination report downgraded the asset quality component rating from 1 to 2, as classified assets increased from 4.6 percent at the previous safety and soundness examination to 32.6 percent as of year-end 2008. Examiners noted that classified assets were comprised primarily of CLD loans and other loans to real estate developers and mortgage investors. However, examiners concluded that credit administration practices were satisfactory.

The examination report indicated that the bank's strategic plan, which was created in May 2007, required revisiting to ensure that it remained "relevant given current economic conditions."

Specifically, examiners noted that the plan should address key assumptions, such as the stability of the housing market; rate assumptions and their impact on loan and deposit growth; and capital sources and uses, including the recently acquired CPP funds. Once again, the bank's CEO acknowledged the need to update the strategic plan and committed to revising and reapproving the plan by April 2009.

With respect to PC Bank, the examination report noted some potential weaknesses in oversight and regulatory compliance, possible instances of mortgage fraud involving loan officers, and apparent violations of RESPA for improper payments to realtors, but did not include a discussion of the magnitude of the possible fraud. In addition, the bank began to experience a higher volume of repurchase and indemnification requests in 2008. According to examiners, the losses approached $1 million and were attributed to poor training and lax underwriting. Examiners noted that management made a $1 million provision to the reserve for off-balance sheet credit exposure. The bank also fired one of the principals at the mortgage division.

Despite (1) the fraud allegations, (2) the likelihood of future significant increases in repurchase demands if those fraud allegations were confirmed, and (3) the risk presented by the already increasing trend in repurchase and indemnification requests, the State issued Pierce a satisfactory rating. In our opinion, FRB San Francisco missed an opportunity to conduct this examination as a joint safety and soundness review. We believe that the findings noted during the January 2009 joint target examination of Pierce's mortgage operations, including those related to bank employees potentially engaging in fraudulent activity, warranted an immediate joint full scope examination.

July 2009 Consumer Affairs Full Scope Examination

On July 13, 2009, FRB San Francisco Consumer examiners began a full scope examination. The examination report noted significant weaknesses in the bank's compliance management program and assigned a consumer compliance rating of 5.[24] Examiners identified approximately 100 regulatory violations, some of which had been previously noted in examination findings or internal audit reports, but many of which went undetected by the bank's internal controls. Many of the violations resulted in harm to consumers. Examiners commented that the scope of the potentially fraudulent practices at PC Bank constituted an unfair or deceptive act or practice in violation of the Federal Trade Commission (FTC) Act.[25]

Examiners also noted significant breakdowns in Pierce's oversight of PC Bank, whose principals conducted business in an unsafe and unsound manner by engaging in potentially fraudulent activities that exposed the bank to significant financial risk. According to examiners, the bank's Board of Directors and management allowed the mortgage lending principals to operate independently of the bank, with no effective oversight, few controls, and minimal reporting

[24] According to the examination report, five rated institutions require the strongest supervisory attention and monitoring. The rating indicates substantial noncompliance with the consumer statutes and regulations, management's demonstrated unwillingness or inability to operate within the scope of consumer statutes and regulations, and unproductive prior efforts by regulatory authorities to obtain voluntary compliance. The rating also indicates that discrimination, substantial overcharges, or practices resulting in serious repeat violations are present.

[25] The FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." The prohibition applies to all persons engaged in commerce, including banks.

requirements. Examiners indicated that Pierce's senior management did not consider the need for retrospective corrective action when presented with potentially illegal activities that occurred at PC Bank.

Examiners also noted that internal audits were ineffective in detecting areas of non-compliance, particularly as they related to the bank's residential real estate lending activities. Examiners recommended that the Board of Directors enhance the internal audit program by, among other things, (1) improving audit committee oversight, (2) conducting a robust risk assessment of consumer compliance risks, (3) ensuring that the scope of the assessment addresses key risks in the bank's lending and deposit-related activities, (4) ensuring that all audit exceptions are included in the audit exceptions tracking report, and (5) attending to audit independence concerns by ensuring that the bank's compliance officer is not responsible for conducting internal audits. These internal audit weaknesses limited the bank's ability to identify issues internally and report those issues to the Board of Directors. As a result, the Board of Directors and senior management did not receive the information needed to adequately oversee the bank's compliance risk profile.

July 2009 Limited Scope FRB San Francisco Examination Resulted in a Double Downgrade to the CAMELS Composite Rating and a Cease-and-Desist Order

On July 20, 2009, concurrent with the on-going FRB San Francisco Consumer examination, FRB San Francisco began a limited scope safety and soundness examination that resulted in a CAMELS composite rating double downgrade from 2 to 4. The management and earnings CAMELS component ratings received triple downgrades from 2 to 5, while capital and liquidity received double downgrades from 2 to 4. In addition, FRB San Francisco imposed a C&D Order as a result of this examination.

The October 2009 examination report focused primarily on Board of Directors and management oversight, internal controls, and financial risk exposure related to the mortgage operations. According to examiners, significant oversight breakdowns occurred that allowed the mortgage division principals to operate in an unsafe and unsound manner. Examiners explained that the lack of oversight allowed the principals to engage in a potentially widespread pattern of fraudulent activities that exposed the bank to significant financial risk, particularly given the recourse obligations associated with loans sold to investors. The examination report emphasized that the Board of Directors and senior management took little action to prevent these issues or address the risks.

Examiners noted that the Board of Directors and management did not demonstrate the ability to identify, measure, monitor, or control operational and financial risk—most notably within PC Bank's residential mortgage operations. According to examiners, the Board of Directors and management did not implement appropriate risk management procedures to establish proper oversight before or after expanding the mortgage division in 2004. The examination report listed PC Bank's internal control weaknesses, which included (1) no centralized tracking of repurchase or indemnification requests; (2) no procedures to ensure proper lending approvals as required by the loan policy; (3) no follow-up on underwriting exceptions; (4) no guidelines to ensure appropriate segregation of duties or ensure that one person does not exert undue influence over the origination, underwriting, processing, and selling of mortgage loans; (5) no procedures to identify or assess potential conflicts of interests between the bank and the mortgage operation's senior management affiliated business; and (6) no meaningful internal audits of the mortgage operations. In addition, as discussed below, examiners criticized management's "neither quick nor adequate" response to the discovery of issues that included potential conflicts of interest associated with the LLCs and kickback allegations.

Examiners described the conflicts of interest associated with three PC Bank principals setting up their own independent LLCs. Examiners identified approximately 30 LLCs where one or more of the principals were partners. In May 2008, an external auditor identified that the bank paid the LLCs for various activities, including advertising and promotions. Examiners reviewed invoices for 2007 and 2008 and found $50,000 in payments to the LLCs that could not be supported or explained, demonstrating the lack of bank oversight over the division. In addition, a PC Bank principal instructed employees to fund a $1.5 million loan for a business partner in one of the LLCs without prior approval.

The examination report further noted that Pierce's recourse obligations threatened the viability of the institution. Between 2004 and 2009, PC Bank sold over $2.4 billion in mortgages to investors. The contracts related to those sales permitted investors to require the bank to repurchase loans or indemnify the investor for certain deficiencies identified in the underlying loans, including fraud. In response to this risk, the bank increased the reserve for off-balance sheet exposure by an additional $1.9 million. In our opinion, examiners should have identified the bank's recourse obligations as a key risk earlier given the magnitude of its loan originations and secondary market credit activities. According to examiners, the increase in classified assets and the magnitude of the bank's recourse obligations resulted in an elevated level of supervisory concern. Total classified assets increased from $3.1 million to $12.9 million between December 31, 2008, and June 30, 2009, primarily due to continued CLD loan deterioration.

Examiners cited a series of matters requiring immediate attention. Notably, examiners directed the Board to cease all mortgage originations until appropriate financial, risk management, and consumer protection controls were in place and the exposure associated with off-balance sheet activity was mitigated. Examiners recommended that Pierce develop monitoring and tracking of repurchase and indemnification requests for reporting to the Board of Directors. In addition, FRB San Francisco required the bank to hire a forensic accountant to review and determine the extent of the alleged fraudulent activities and the bank's exposure to recourse obligations. Finally, examiners emphasized the need to develop a consumer compliance risk management program.

As a result of this examination, FRB San Francisco implemented a formal enforcement action in the form of a C&D Order on December 4, 2009, which required the Board of Directors to address a variety of issues, including oversight of management and bank operations, corporate governance, loan portfolio growth, loan policies and procedures, consumer compliance program, internal audit, strategic planning and budgeting, and capital planning.

November 2009 Full Scope FRB San Francisco Examination Resulted in a CAMELS Composite Rating Downgrade from a 4 to 5 and a PCA Directive

In November 2009, FRB San Francisco commenced a full scope examination that downgraded Pierce's CAMELS composite rating from 4 to 5. All CAMELS components received 5 ratings, except for sensitivity, which received a 4. Examiners noted the bank's "extremely unsafe and unsound condition" and that its capital levels did not support the bank's risk profile. According to examiners, Pierce had high and increasing credit risk and no strategy to reduce its exposure.

The March 2010 examination report noted that management and director oversight had deteriorated and was now critically deficient. FRB San Francisco noted seriously weak credit risk management practices and noncompliance with laws and regulations. According to examiners, the Board and management failed to adequately respond to rapidly changing real estate market conditions and satisfactorily address a number of examination and audit findings and recommendations. FRB San Francisco commented that Pierce had conducted no meaningful internal audits of PC Bank and the bank's Audit Committee has been reactive in addressing audit findings, particularly those related to the residential mortgage lending program.

The examination report cited, among other things, a series of matters related to the Board of Directors' and management's oversight and asset quality that required immediate attention. Examiners observed that management exhibited its inability to correct problems or implement appropriate controls to identify, measure, and mitigate increasing credit risk exposure despite PC Bank ceasing its mortgage lending activities. FRB San Francisco also noted continuing asset quality deterioration, as classifications increased 303 percent since the prior examination, from $9.2 million to $28.2 million. Examiners attributed rising classifications to the deterioration in the CLD loan portfolio and loans secured by one- to four-family residential properties. In addition, examiners downgraded management's loan ratings for 15 of 24 CLD loans. FRB San Francisco noted that the bank did not effectively manage its modest CRE concentration levels during the real estate downturn and a weakening economy.

Examiners commented that capital was critically deficient, despite the $4.5 million capital injection resulting from TARP's CPP during the first quarter of 2009. According to examiners, capital ratios deteriorated due to poor loan portfolio performance and the related provision expense increases. Furthermore, FRB San Francisco commented that the bank's earnings, which historically augmented capital, were critically deficient due to the additional provisions needed to support an appropriate ALLL level and high settlement costs related to the residential mortgage operations.

As a result of this examination, FRB San Francisco issued a PCA Directive on June 10, 2010, that, among other things, required Pierce to (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.

July 2010 Joint Target Examination Focused on Asset Quality; No CAMELS Composite or Component Ratings Were Assigned

In July 2010, FRB San Francisco began a joint asset quality target examination that did not assign CAMELS composite or component ratings because the target review focused on the bank's progress in addressing the asset quality problems and deficiencies noted during the prior full scope examination.

The October 2010 examination report noted that liberal underwriting standards, inaccurate loan grades, and inadequate credit administration practices, including the untimely recognition of nonaccrual loans and charge-offs, persisted and exacerbated Pierce's already heightened credit risk. According to examiners, management failed to manage or control the significant credit risk in the portfolio; therefore, Pierce remained vulnerable to declining economic conditions. The bank's underwriting, risk identification, and credit administration weaknesses overshadowed incremental enhancements in credit risk management.

The examination report cited a series of matters requiring immediate attention related to capital adequacy, asset quality, the ALLL, and credit risk management. In addition, examiners noted a matter requiring attention related to external credit review and Audit Committee oversight. Examiners commented that while the credit review process evidenced some improvements from the previous examination, several concerns remained regarding the quality of the reviews and the documentation supporting the assigned risk grades.

Further asset quality deterioration eroded capital and threatened the bank's viability. Examiners noted that capital was critically deficient and not commensurate with the bank's risk profile. The examination report noted that in August 2010, the bank made efforts to raise capital through a private placement. These efforts failed, and the State closed the bank on November 5, 2010, and appointed the FDIC as receiver. The Treasury noted in a January 2011 quarterly report to Congress that the TARP funds provided to Pierce would not be recovered.

Conclusions, Lessons Learned, and Recommendations

Pierce failed because its Board of Directors and management did not adequately control the risks associated with the bank's residential mortgage lending activities. Specifically, the Board of Directors and senior management allowed the mortgage banking division—PC Bank—to operate independently without appropriate oversight and failed to conduct adequate strategic planning or implement robust internal controls. PC Bank pursued an originate-to-distribute business model that involved originating residential mortgages to be sold in the secondary market. Although this business model appeared to transfer the credit risk associated with mortgage loans to investors, Pierce remained exposed to the risk that investors could demand that the bank repurchase loans or reimburse investors for losses, subject to certain conditions. Examiners ultimately uncovered possibly fraudulent activity at PC Bank related to employees misrepresenting borrower financial information and steering customers into loans for which they were not qualified. These practices led to the bank incurring losses resulting from significant investor repurchase and indemnification demands.

In addition, inadequate credit risk management and weak underwriting made the bank's commercial loan portfolio susceptible to declining economic conditions. Although Pierce received $6.8 million in TARP CPP funds in January 2009, mounting losses resulting from investor repurchase and indemnification demands and commercial loan portfolio deterioration due to deteriorating economic conditions eliminated the bank's earnings, depleted capital (including the TARP funds), and eventually led to the bank's failure. The State closed Pierce on November 5, 2010, and appointed the FDIC as receiver.

With respect to supervision, FRB San Francisco complied with the safety and soundness examination frequency guidelines and conducted regular off-site monitoring for the time frame we reviewed, 2003 to 2010. During this time frame, FRB San Francisco and the State conducted six full scope safety and soundness examinations, one limited scope safety and soundness examination, and one target safety and soundness examination and executed two formal enforcement actions: a C&D Order and a PCA Directive. In addition, FRB San Francisco conducted two full scope consumer compliance examinations, one target consumer compliance examination, and a joint target examination of PC Bank.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or a loss to the DIF. Our analysis of FRB San Francisco's supervision indicated that examiners missed several opportunities to conduct the detailed testing necessary to more accurately assess the bank's risk profile. While it is not possible to determine whether detailed testing would have resulted in earlier detection of the fraud, such testing likely would have identified the control weaknesses that created an opportunity for fraudulent activity.

Section 1000.1 of the CBEM states that examiners should assess the effectiveness of the Board of Directors' and management's oversight by confirming that management assessed the risks associated with new business activities and implemented the infrastructure and internal controls necessary to manage those risks. During an August 2004 full scope examination, examiners observed the absence of strategic planning for PC Bank and the significant growth in PC Bank's mortgage origination volumes. In our opinion, these factors warranted detailed testing to confirm that the Board of Directors and management had implemented the internal controls necessary to manage the risks associated with a new business activity. However, that testing did not occur during the August 2004 full scope examination and, in our opinion, represented a missed opportunity to apply CBEM guidance related to new business activities.

The risk-focused examination approach outlined in the CBEM encourages examiners to conduct detailed testing consistent with the risks and the adequacy of risk management processes surrounding a particular activity. We believe that PC Bank's elevated risk profile was not reflected in the Decision Factors Analysis conducted during the 2007 safety and soundness examination. Specifically, we believe that the Decision Factors Analysis did not detect certain risks or acknowledge the significance of other potential risks, and FRB San Francisco should not have deferred detailed testing until the next examination.

We also believe that FRB San Francisco did not sufficiently assess the risk associated with the bank's recourse obligations or closely supervise its off-balance sheet reserve to mitigate the risk associated with the bank's secondary market credit activities. SR Letter 97-21 requires banks to incorporate the full range of risk of their secondary market credit activities into their overall risk management systems. The guidance indicates that supervisors and examiners should determine whether institutions are recognizing the risks of secondary market credit activities by, among other things, (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the Board of Directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. In our opinion, FRB San Francisco was late to identify these risks, and the expenses associated with addressing investor repurchase and indemnification demands ultimately contributed to the bank's failure.

In late November 2008, Pierce's holding company applied for TARP funds under the CPP, and FRB San Francisco evaluated the application. In applying Treasury's evaluation guidance, FRB San Francisco concluded that Pierce qualified for a presumptive approval because of the bank's financial performance measures as of September 30, 2008, and the fact that examiners did not have concerns about Pierce's viability. We believe that FRB San Francisco complied with the process outlined in the Treasury guidance for banks that had not been examined during the previous six months and the limited decision-making criteria available at the time. However, as discussed below, the evaluation might have had different results if examiners had appropriately identified Pierce's risk profile earlier and taken stronger supervisory action sooner.

In our opinion, FRB San Francisco had multiple opportunities to conduct detailed testing consistent with CBEM's expectations. If FRB San Francisco had acted on those opportunities sooner, it would have likely resulted in (1) a more accurate assessment of the bank's risk profile and (2) earlier CAMELS composite and component rating downgrades, such as the downgrades issued during the July 2009 safety and soundness examination once examiners realized the extent of the bank's weaknesses. Because the time span during which these opportunities presented themselves coincided with the bank's growth period, earlier detection might have mitigated the loss to the DIF and resulted in the CAMELS composite rating downgrades necessary to preclude the bank from receiving TARP CPP funds. Nevertheless, it is not possible to determine whether alternative supervisory action might have prevented the failure.

Lessons Learned

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Pierce's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Pierce's failure demonstrates the importance of (1) examiners appropriately identifying key risks early; (2) examiners conducting timely detailed testing of new business activities consistent with CBEM expectations; (3) active Board of Directors and management oversight of the bank's business activities; and (4) banks incorporating secondary market credit activities into overall risk management systems, including setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. This failure also demonstrates that recurring weaknesses in strategic planning, compliance with laws and regulations, and internal controls can indicate broader corporate governance and risk management deficiencies.

Recommendations

1) We recommend that the Director of the Division of Banking Supervision and Regulation issue guidance that reinforces the importance of the corporate governance principles outlined in the CBEM.

This failure highlights the importance of effective corporate governance consistent with the expectations outlined in the CBEM. In this failure, examiners did not (1) identify the risks associated with allowing a bank division to operate independently from the Board of Directors' and management's oversight until it was too late; (2) evaluate the effectiveness of the Board of Directors' and management's oversight, to include confirming that the Board of Directors and management assessed the risks associated with a new business activity and implemented the infrastructure and internal controls necessary to manage those risks; or (3) confirm that the internal audit program and compliance management program could effectively detect, escalate, and resolve internal control weaknesses. In our opinion, these omissions contributed to PC Bank's unchecked mortgage origination growth and significant internal control deficiencies, which allowed pervasive mortgage fraud to remain undetected. Because the CBEM already addresses the Board's expectations for effective corporate governance, we recommend that the Director of the Division of Banking Supervision and Regulation issue guidance that reinforces the importance of fundamental corporate governance principles contained in the CBEM. We believe that this guidance, at a minimum, should reinforce the importance of (1) active Board of Directors and management oversight of all business activities, (2) directors and management understanding and controlling the risks associated with new products or activities, and (3) strong and effective key control programs like internal audit and compliance management.

2) We recommend that the Director of the Division of Banking Supervision and Regulation cross-reference several components of guidance previously issued by the Federal Reserve Board to assist examiners in identifying the risks associated with secondary market asset sales.

As part of our work, we attempted to identify Federal Reserve Board guidance concerning risk management practices for banks conducting secondary market credit activities. We noted that Federal Reserve Board guidance is contained in multiple SR letters and throughout various sections of the CBEM, but there were no cross-references between many of the components. In our opinion, the CBEM section on "Loan Portfolio Management: Comprehensive Mortgage Banking Examination Procedures" should be cross-referenced with SR Letter 97-21, *Risk Management and Capital Adequacy of Exposures Arising From Secondary Market Credit Activities*. In addition, these documents should be cross-referenced with the CBEM section on the "Allowance for Loan and Lease Losses: Estimated Credit Losses in Credit Related Accounts" and the "Interagency Policy Statement on the Allowance for Loan and Lease Losses." In our opinion, these references will provide examiners with a comprehensive listing of the guidance necessary to determine the level of risk associated with banks that pursue an originate-to-distribute business model and the appropriate risk management practices to mitigate those risks.

Analysis of Comments

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director concurred with our conclusions, lessons learned, and recommendations and stated that the division will identify how to best reinforce supervisory expectations related to corporate governance and will cross-reference CBEM sections to guidance addressing secondary market assets sales. His response is included as Appendix 4.

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.

Call Reports

The 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 Order)

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

Classified Assets

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

Commercial Real Estate (CRE) Loans

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

Appendix 1 (continued)

Concentration

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

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

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

Enforcement Actions

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

Liquidity

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

Nonaccrual

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

Prompt Corrective Action (PCA)

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

Appendix 1 (continued)

Supervision and Regulation (SR) Letters

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

Tier 1 Capital

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

Underwriting

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

Appendix 2 – CAMELS Rating System

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

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

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2 (continued)

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Consumer Compliance Rating System

Consumer Compliance Ratings are defined and distinguished as follows:

One

An institution in this category is in a strong compliance position. Management is capable of and staff is sufficient for effectuating compliance. An effective compliance program, including an efficient system of internal procedures and controls, has been established. Changes in consumer statutes and regulations are promptly reflected in the institution's policies, procedures and compliance training. The institution provides adequate training for its employees. If any violations are noted, they relate to relatively minor deficiencies in forms or practices that are easily corrected. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations. Violations and deficiencies are promptly corrected by management. As a result, the institution gives no cause for supervisory concern.

Two

An institution in this category is in a generally strong compliance position. Management is capable of administering an effective compliance program. Although a system of internal operating procedures and controls has been established to ensure compliance, violations have nonetheless occurred. These violations, however, involve technical aspects of the law or result from oversight on the part of operating personnel. Modification in the bank's compliance program and/or the establishment of additional review/audit procedures may eliminate many of the violations. Compliance training is satisfactory. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.

Three

Generally, an institution in this category is in a less than satisfactory compliance position. It is a cause for supervisory concern and requires more than normal supervision to remedy deficiencies. Violations may be numerous. In addition, previously identified practices resulting in violations may remain uncorrected. Overcharges, if present, involve a few consumers and are minimal in amount. There is no evidence of discriminatory acts or practices. Although management may have the ability to effectuate compliance, increased efforts are necessary. The numerous violations discovered are an indication that management has not devoted sufficient time and attention to consumer compliance. Operating procedures and controls have not proven effective and require strengthening. This may be accomplished by, among other things, designating a compliance officer and developing and implementing a comprehensive and effective compliance program. By identifying an institution with marginal compliance early, additional supervisory measures may be employed to eliminate violations and prevent further deterioration in the institution's less than satisfactory compliance position.

Appendix 3 (continued)

Four

An institution in this category requires close supervisory attention and monitoring to promptly correct the serious compliance problems disclosed. Numerous violations are present. Overcharges, if any, affect a significant number of consumers and involve a substantial amount of money. Often practices resulting in violations and cited at previous examinations remain uncorrected. Discriminatory acts or practices may be in evidence. Clearly, management has not exerted sufficient effort to ensure compliance. Its attitude may indicate a lack of interest in administering an effective compliance program, which may have contributed to the seriousness of the institution's compliance problems. Internal procedures and controls have not proven effective and are seriously deficient. Prompt action on the part of the supervisory agency may enable the institution to correct its deficiencies and improve its compliance position.

Five

An institution in this category is in need of the strongest supervisory attention and monitoring. It is substantially in noncompliance with the consumer statutes and regulations. Management has demonstrated its unwillingness or inability to operate within the scope of consumer statutes and regulations. Previous efforts on the part of the regulatory authority to obtain voluntary compliance have been unproductive. Discrimination, substantial overcharges, or practices resulting in serious repeat violations are present.

Appendix 4 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date:	September 21, 2011
To:	Anthony Castaldo, Associate Inspector General
From:	Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***
Subject:	In Depth Review of Pierce Commercial Bank, Tacoma, Washington

The staff of the Division of Banking Supervision and Regulation (BS&R) has reviewed the draft In Depth Review Report (Report) on the failure of Pierce Commercial Bank (Pierce) of Tacoma, Washington, prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act. The Report finds that Pierce failed because its board of directors and management did not adequately control the risks associated with the bank's residential mortgage lending activities. Specifically, the board of directors and senior management allowed the mortgage banking division, PC Bank, to operate independently without appropriate oversight. Examiners ultimately discovered possible fraudulent activity at PC Bank related to employees misrepresenting borrower financial information and directing customers into loans for which they were not qualified. Additionally, Pierce's commercial loan portfolio became susceptible to declining economic conditions as a result of inadequate credit risk management and weak underwriting. Escalating losses resulting from investor repurchase and indemnification demands and deterioration in the commercial loan portfolio eliminated the bank's earnings and depleted capital, which eventually led to the bank's failure. Pierce was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco) under delegated authority from the Board.

BS&R staff concurs with the conclusions, lessons learned, and recommendations in the Report. The Report revealed that the FRB San Francisco complied with the examination frequency guidelines and conducted regular offsite monitoring for the time frame that was reviewed, 2003 through 2010. However, in hindsight, examiners had not conducted sufficiently detailed reviews of PC Bank's internal controls early on to properly assess whether Pierce's board of directors and management identified and controlled the risks associated with the bank's mortgage banking activity. Consequently, the full extent of the internal control weaknesses and apparent fraudulent activity were undiscovered until the July 2009 limited-scope safety-and-soundness examination. Pierce's failure illustrates the importance of a rigorous corporate governance structure whereby the board of directors and senior management fully understand risks, as well as the need to have an effective risk management program to identify and control risks.

Regarding the recommendations made in the report, Division staff will cross-reference sections of the *Commercial Bank Examination Manual* with guidance previously issued by the Federal Reserve Board to assist examiners in identifying the risks associated with secondary market asset sales. In addition, staff will review existing guidance related to corporate governance and determine how best to reinforce supervisory expectations, particularly with regards to the three points covered under the recommendation.

Appendix 5 – Office of Inspector General Principal Contributors to This Report

Saurav B. Prasad, Project Leader and Auditor

Karen M. Goldfarb, Auditor

Michael P. VanHuysen, Office of Inspector General Manager