Board of Governors of the Federal Reserve System

Material Loss Review of San Joaquin Bank

Office of Inspector General

May 2010

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

OFFICE OF INSPECTOR GENERAL

May 12, 2010

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

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of San Joaquin Bank (San Joaquin). The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) is material—that is, it exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

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

San Joaquin 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 California Department of Financial Institutions (State). The State closed San Joaquin on October 16, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On November 12, 2009, the FDIC Inspector General notified us that San Joaquin's failure would result in an estimated loss to the DIF of $90.4 million, or 11.7 percent of the bank's $771.8 million in total assets.

San Joaquin failed because its Board of Directors and management did not effectively control the risks associated with the bank's rapid loan growth that led to a high concentration in commercial real estate (CRE) loans and, in particular, construction, land, and land development (CLD) loans tied to the Bakersfield real estate market. The loan growth and high concentrations occurred when the Bakersfield real estate market was experiencing significant price appreciation. A decline in the local real estate market, coupled with the bank's failure to effectively manage the increased credit risk associated with San Joaquin's highly concentrated loan portfolio, resulted in deteriorating asset quality and significant losses. Mounting losses impaired earnings, eroded capital, and strained the bank's liquidity. Efforts to meet a regulatory deadline requiring San Joaquin to be acquired by or merge with another financial institution were unsuccessful, and the State closed the bank on October 16, 2009, appointing the FDIC as receiver.

With respect to supervision, FRB San Francisco complied with the examination frequency guidelines for the timeframe we reviewed, 2006 through 2009, and conducted regular off-site monitoring. During that time, FRB San Francisco and the State conducted three full scope safety and soundness examinations and one target examination. Additionally, the bank was placed under two enforcement actions, a Memorandum of Understanding (MOU) signed in December 2008 and a Written Agreement executed in April 2009.

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. In our opinion, an April 2007 examination performed by FRB San Francisco provided an opportunity for stronger supervisory action. Examiners noted that San Joaquin's CRE loan concentration ranked among the highest for state member banks supervised by FRB San Francisco. Examiners also cited management's plan for additional loan growth, despite signs of a slowing real estate market. In our opinion, these circumstances offered an early opportunity for FRB San Francisco to encourage management to mitigate the risk of asset quality deterioration from further market declines.

Further, we believe that the significance of the issues raised during a July 2008 State examination warranted a timely enforcement action compelling management to mitigate credit risk management weaknesses and the risks associated with the declining real estate market. The State examination report issued in July 2008 noted that San Joaquin's financial condition had become less than satisfactory. Examiners noted that actual asset growth for 2007 was 16 percent, or double management's projection. In addition, the bank's level of construction, residential, and lot development loans had increased notably, yet the sharp decline in the Bakersfield real estate market had not been analyzed by management. According to examiners, despite declining collateral values, San Joaquin continued to grant credit extensions without obtaining updated appraisals or reevaluating borrowers' creditworthiness. Examiners also questioned whether earnings would remain positive and continue to augment capital. An informal enforcement action in the form of an MOU developed jointly with the State was issued in December 2008, approximately five months after the State's examination report was issued.

While we believe that a stronger supervisory action in 2007 and a more timely enforcement action in 2008 were warranted, it is not possible to determine the degree to which any such actions would have affected the bank's subsequent decline or the failure's cost to the DIF.

Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that San Joaquin's failure points to a valuable lesson learned that can be applied when supervising community banks with similar characteristics. In our opinion, San Joaquin's failure illustrates that banks with exceptionally high CRE and CLD loan concentrations require a swift and forceful supervisory response when signs of market deterioration first become evident.

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 conclusion and lesson learned. His response is included as Appendix 3.

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

Sincerely,

Elizabeth A. Coleman

Elizabeth A. Coleman
Inspector General

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

Board of Governors of the Federal Reserve System

Material Loss Review of San Joaquin Bank

Office of Inspector General

May 2010

Table of Contents

Background

San Joaquin Bank (San Joaquin), a community bank headquartered in Bakersfield, California, commenced operations as a California state-chartered nonmember bank in 1980. Through its four Bakersfield branch offices, San Joaquin focused on commercial, construction, and agricultural real estate lending within Bakersfield. In October 2006, San Joaquin became a state member bank subject to supervision 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 California Department of Financial Institutions (State).

The State closed San Joaquin on October 16, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $90.4 million loss to the Deposit Insurance Fund (DIF), or 11.7 percent of the bank's $771.8 million in total assets. In a letter dated November 12, 2009, the FDIC Inspector General advised us that the FDIC had determined that San Joaquin's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

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

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

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed FRB San Francisco, State, and Federal Reserve Board staff and collected relevant data from FRB San Francisco records. We also reviewed correspondence, surveillance reports, regulatory reports filed by San Joaquin, Reports of Examination (examination reports) issued between 2007 and 2009, and examination work papers prepared by FRB San Francisco. Appendixes at the end of this report contain a glossary that defines key banking and regulatory terms and a description of the CAMELS rating system.[1] We conducted our fieldwork from January 2010 through April 2010 in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

---

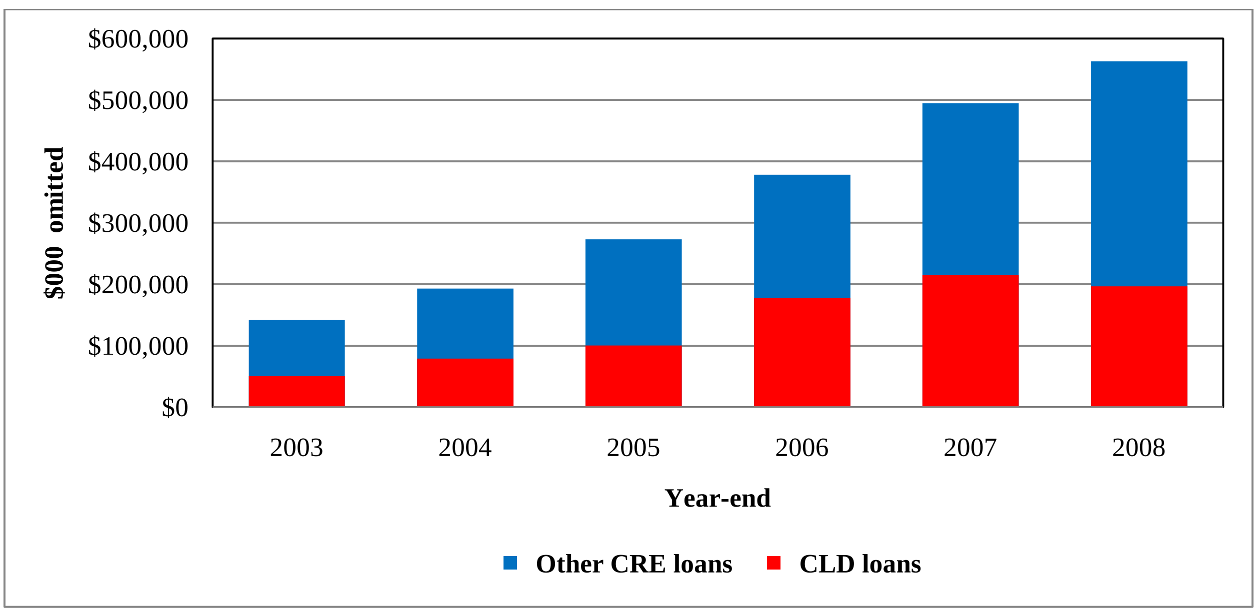
[1] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the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

Cause of the Failure

San Joaquin failed because its Board of Directors and management did not effectively control the risks associated with the bank's rapid loan growth that led to a high concentration in commercial real estate (CRE) loans and, in particular, construction, land, and land development (CLD) loans in the Bakersfield real estate market. The loan growth and high concentrations occurred when the Bakersfield real estate market was experiencing significant price appreciation. A decline in the local real estate market, coupled with the bank's failure to effectively manage the increased credit risk associated with San Joaquin's highly concentrated loan portfolio, resulted in deteriorating asset quality and significant losses. Mounting losses impaired earnings, eroded capital, and strained the bank's liquidity. Efforts to meet a regulatory deadline for, among other things, San Joaquin to be acquired by or merge with another financial institution were unsuccessful, and the State closed the bank on October 16, 2009, appointing the FDIC as receiver.

San Joaquin's growth was driven primarily by CRE loans, including CLD loans for residential and commercial property, in the Bakersfield real estate market. As shown in Chart 1 below, from 2003 to 2008, CRE loans almost quadrupled from $142.0 million at year-end 2003, to $562.8 million at year-end 2008. During this period, CLD loans also increased approximately 300 percent from $50.1 million to $196.4 million.

Chart 1: Growth in CRE and CLD Loans



Beginning in 2006, San Joaquin's loan growth outpaced core deposits, and the bank began to increase its non-core deposit sources, such as borrowings from the Federal Home Loan Bank (FHLB) and brokered deposits. Reliance on non-core funding sources, particularly brokered deposits, is considered a risky strategy for banks. Brokered deposits can have a significantly negative effect on liquidity because brokered deposit investors have no relationship to the bank and are only seeking the highest possible return. In addition, section 29 of the FDI Act stipulates that any bank that falls to less than *well capitalized* (as defined under PCA) cannot accept, renew, or roll over brokered deposits, unless a waiver is obtained from the FDIC. Therefore, these funds may not be available in times of financial stress or adverse changes in market conditions.

As shown in Chart 2a below, San Joaquin's CRE loan concentration was approximately 530 percent of total risk-based capital in 2006, the year it became a state member bank. Examiners noted that the bank's CRE loan concentration ranked among the highest for financial institutions supervised by FRB San Francisco.[2] San Joaquin's CRE loan concentration reached 665 percent of total risk-based capital by December 31, 2008, and historically, San Joaquin was well above its peer group.[3] As illustrated in Chart 2b, the bank's CLD loan concentration also consistently exceeded its peer group and reached 264 percent by December 31, 2007. In general, concentrations may pose a substantial risk to the safety and soundness of a financial institution because concentrations of credit increase vulnerability to changes in the marketplace.

Chart 2a: CRE Loan Concentration

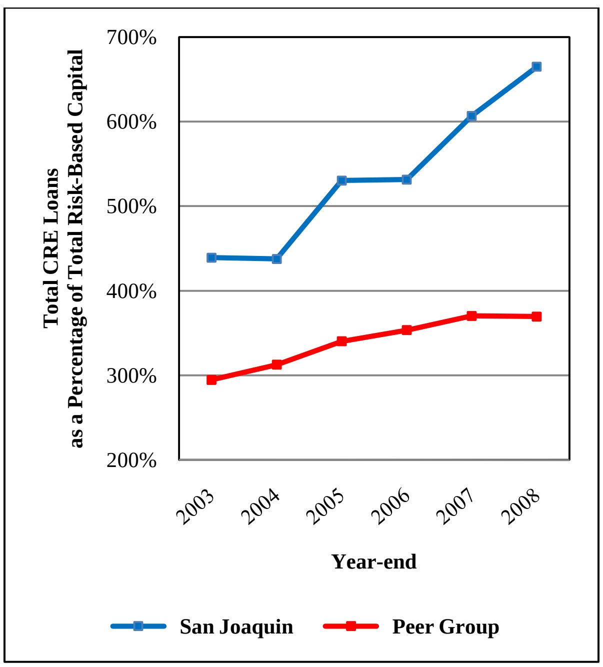
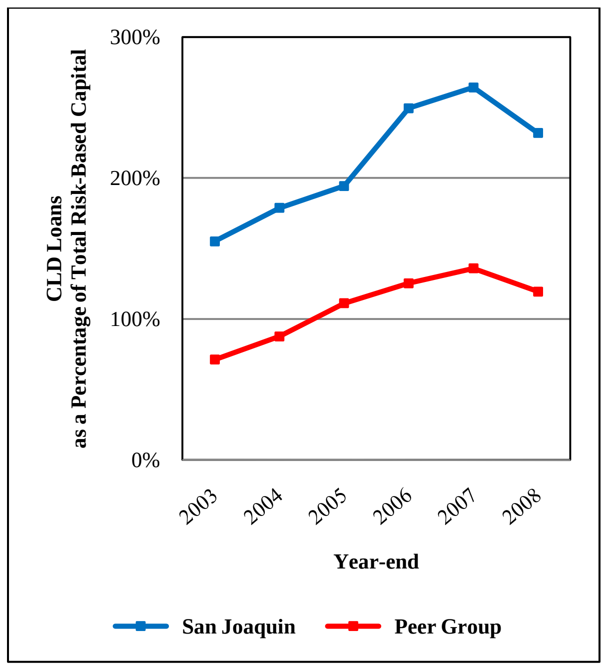


Chart 2b: CLD Loan Concentration



According to examiners, San Joaquin's CLD loan concentration notably increased the bank's susceptibility to housing market fluctuations. As shown in Chart 3, in 2004 and 2005, house prices in the Bakersfield Metropolitan Statistical Area (MSA) appreciated 31.5 percent and

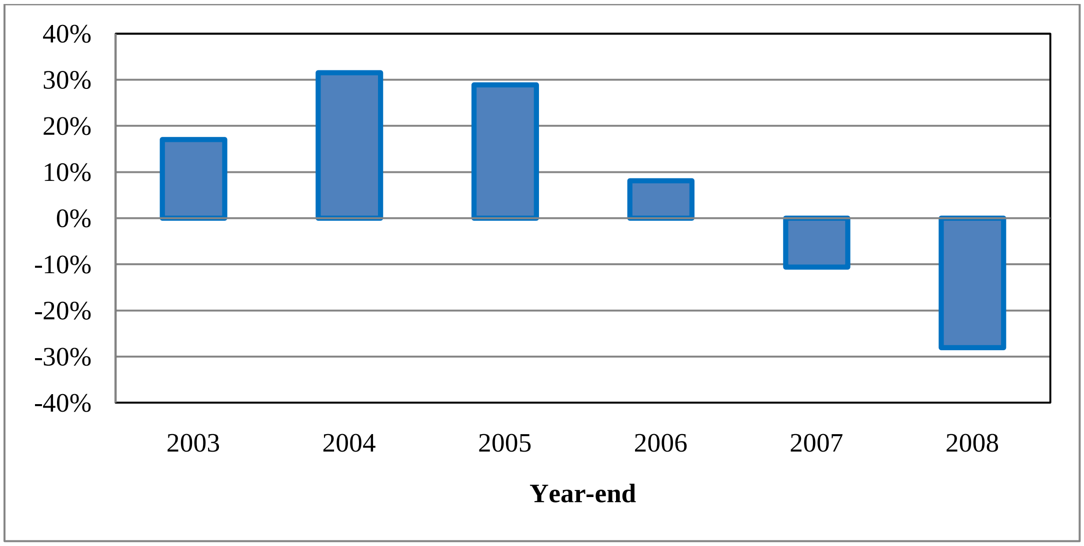
---

[2] According to Supervision and Regulation Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate*, an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported 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.

[3] Peer group included all insured commercial banks having assets between $300 million and $1 billion.

28.9 percent, respectively. By 2007, house prices in the Bakersfield MSA registered a 10.6 percent decline and subsequently fell 28.1 percent in 2008, resulting in its housing appreciation level being ranked 286th out of the 292 MSAs in the nation.

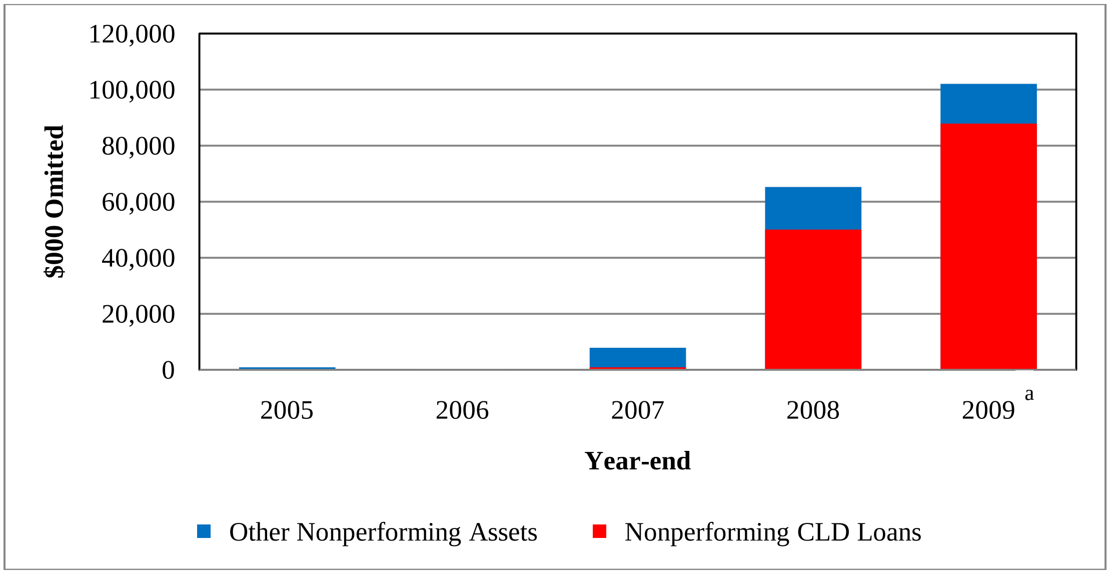
Chart 3: Annual Percentage Changes in Bakersfield, California, House Prices



The softening housing market resulted in substantial job losses in Bakersfield, where approximately 12 percent of the area's jobs were housing-related. The softening real estate market also affected foreclosure activity in Bakersfield. During the first six months of 2007, foreclosure filings were issued for 1 in every 47 households in the Bakersfield MSA, ranking the area 8th highest for foreclosures among the nation's 100 largest cities. In addition, for the 12-month period ending August 31, 2007, Kern County, California, which includes Bakersfield, registered the 12th highest increase in foreclosure activity among California's 58 counties.

The decline in Bakersfield's real estate market, coupled with weakening economic conditions, led to significant asset quality deterioration. As shown in Chart 4, San Joaquin's nonperforming assets increased from $0.8 million at year-end 2005, to $102.0 million on March 31, 2009, with CLD loans comprising $83.0 million, or 81 percent, of the $102.0 million. Similarly, classified assets rapidly increased from $4.1 million at year-end 2005, to $179.3 million (4,273 percent) by March 31, 2009.

Chart 4: Nonperforming Assets

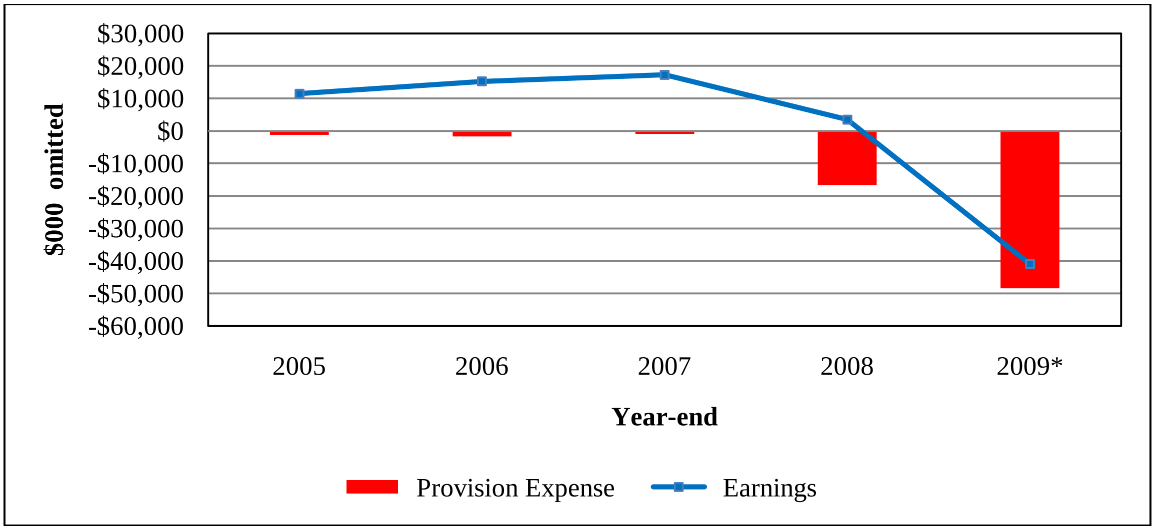


[a] Data as of March 31, 2009

Examiners noted that management pursued a concentration in real estate loans without fully mitigating the risk, and failed to take early action to minimize potential loan portfolio deterioration. San Joaquin's Board of Directors and management were slow to recognize the weakening market conditions and continued to extend and renew loans without requiring updated appraisals or performing analyses of borrowers' and guarantors' financial capacity. In addition, according to examiners, as of December 31, 2007, the bank did not have "sufficient risk management practices and policies in place to adequately measure, monitor, and control the residential construction risk."

The growth in classified assets prompted corresponding increases in San Joaquin's loan loss provision expense. As shown in Chart 5, the bank's provision expense increased from $0.9 million in 2007, to $16.6 million in 2008. Despite the substantial increase in provision expense, San Joaquin's earnings registered a net gain of $3.5 million in 2008, and the bank remained *well capitalized*. However, the continued increase in nonperforming assets led to an additional provision expense of $48.4 million for the nine months ended September 30, 2009, a 192 percent increase from the prior year. The 2009 provision expense contributed to a net loss of $41.0 million, which significantly reduced San Joaquin's capital.

Chart 5: Impact of Provision Expense on Earnings



*Data as of September 30, 2009

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. On June 12, 2009, San Joaquin was notified that it was no longer *well capitalized* and, therefore, could not accept, renew, or roll over any brokered deposits. On July 2, 2009, FRB San Francisco informed the Board of Directors that the bank was deemed *undercapitalized* and was required to submit an acceptable capital restoration plan within 30 days. The bank's deteriorating capital position further strained liquidity as (1) the FHLB reduced the bank's borrowing capacity, and (2) access to credit from Federal Reserve Banks was subject to certain limits.[4]

San Joaquin's capital restoration plan was deemed unacceptable, and the bank was declared *significantly undercapitalized* on September 18, 2009. The Federal Reserve Board issued a PCA Directive on September 21, 2009, that, among other things, required San Joaquin to accomplish the following by October 15, 2009: (1) raise additional capital to achieve the *adequately capitalized* PCA designation or (2) be acquired by or merge with another depository institution. San Joaquin failed to raise capital or merge with another institution, and the State closed the bank on October 16, 2009.

Supervision of San Joaquin Bank

FRB San Francisco complied with the examination frequency guidelines for the timeframe we reviewed, 2006 through 2009, and conducted regular off-site monitoring. As shown in Table 1, FRB San Francisco and the State conducted three full scope examinations and a target examination focused on asset quality before San Joaquin's failure in October 2009. The bank received a CAMELS composite 2 (satisfactory) rating for the initial examination conducted by

[4] Credit from a Federal Reserve Bank to an institution that is *undercapitalized* may be extended or outstanding for no more than 60 days during which the institution is undercapitalized in any 120-day period.

FRB San Francisco. The bank received a CAMELS composite 3 (fair) rating as a result of a February 2008 examination conducted by the State. During this examination, the asset quality and liquidity CAMELS components were double downgraded from 1 to 3. As a result of this examination, San Joaquin's condition was deemed less than satisfactory and a Memorandum of Understanding (MOU) was executed with the bank's Board of Directors on December 2, 2008.

Examiners began an asset quality target examination in October 2008 that resulted in San Joaquin being downgraded to a CAMELS composite 4 (marginal) rating. Subsequently, a Written Agreement was issued in April 2009 to address the bank's weaknesses, including strategic and capital plans, internal policies and programs, credit extension practices, asset quality, and the Allowance for Loan and Lease Losses (ALLL).

Later in 2009, FRB San Francisco and the State began a full scope examination that revealed continued asset quality deterioration and resulted in the bank being downgraded to a CAMELS composite 5 (unsatisfactory) rating. During the April 2009 full scope examination, FRB San Francisco found that San Joaquin was noncompliant with the provisions of the Written Agreement and had a capital restoration plan that was unacceptable. The Federal Reserve Board subsequently issued a PCA Directive on September 21, 2009, that required San Joaquin to become *adequately capitalized* or be acquired by or merge with another depository institution by October 15, 2009. San Joaquin was unable to comply with the Directive, and the State closed the bank on October 16, 2009.

In hindsight, we believe that the April 2007 examination performed by FRB San Francisco provided an opportunity for stronger supervisory action and that a more timely enforcement action in 2008 was warranted.

Table 1: San Joaquin Supervisory Overview

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions/PCA Notifications
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
4/2/2007	5/30/2007	Full	FRB	2	2	1	2	2	1	2	
2/25/2008	7/28/2008	Full	State	3	3	3	3	3	3	2	Memorandum of Understanding
10/20/2008	1/15/2009	Asset Quality Target	FRB	4	4	4	4	4	4	2	Written Agreement
4/20/2009	8/14/2009	Full	Joint	5	5	5	5	5	5	4	PCA Directive

FRB San Francisco's Initial Full Scope Examination Was Conducted in 2007

FRB San Francisco's initial examination of San Joaquin began in April 2007 and resulted in a CAMELS composite 2 (satisfactory) rating. The asset quality and liquidity components were both rated 1 (strong), due to minimal nonaccrual loans and relatively low levels of non-core funding. Although the bank was considered satisfactory based upon its financial condition and performance, FRB San Francisco noted that San Joaquin continued to hold high concentrations in CRE loans that were primarily secured by properties located in Bakersfield. Moreover, San Joaquin's CRE loan concentration level ranked among the highest for state member banks supervised by FRB San Francisco. However, according to the examination report, the credit risk from concentrations was well managed, and adequate processes for identifying and measuring CRE concentration levels had been implemented. In addition, examiners relied on management reports indicating that a change in regulatory guidance related to the definition of CRE would decrease San Joaquin's CRE concentration from 531.4 percent to 286.8 percent.

The May 2007 examination report emphasized that San Joaquin's organizational structure was more typical of a bank much smaller in size. Examiners noted that management understood that the bank's current organizational structure may not be adequate to support continued growth and the expansion of banking activities. Management acknowledged that continued growth would likely require additional depth in the management team and modifications in the organizational structure, including adding a dedicated risk management position and additional support for the Chief Credit Officer.

Examiners cited credit risk as moderate and stable despite noting, "The Bakersfield MSA is being impacted by softening in some segments of the real estate market with rising foreclosure rates for residential properties." Examiners stated, "The bank's construction lending is very well managed and predictions are for a 'soft landing' for the local housing market." In addition, FRB San Francisco noted that management targeted total asset growth of 8 percent for 2007.

February 2008 State Examination Resulted in a Downgrade to a CAMELS Composite 3 Rating

In February 2008, the State began a full scope examination that resulted in a CAMELS composite 3 (fair) rating. The July 2008 examination report double downgraded asset quality and liquidity based on an increase in adversely classified loans and an increased reliance on non-core funding sources. State examiners noted that the overall condition of the bank had deteriorated and deemed the bank's overall financial condition to be less than satisfactory.

Examiners noted that actual asset growth for 2007 was 16 percent, or double management's projection. According to examiners, as of December 31, 2007, San Joaquin's CRE concentration increased to 606.8 percent of total risk-based capital, instead of decreasing to the 286.8 percent projected the prior year.

Contrary to the April 2007 examination findings, the July 2008 examination report revealed "several deficiencies in San Joaquin's credit administration and risk management practices" that warranted "immediate improvement in order to prohibit further deterioration of the bank's construction, residential, and lot development loan portfolio." Examiners noted that the bank's level of construction, residential, and lot development loans had increased notably and that the sharp decline in Bakersfield's real estate market had not been analyzed by management. Specifically, examiners criticized management's ability to proactively recognize potential problem loans to ensure appropriate monitoring. In addition, according to examiners, despite declining collateral values, management continued to grant credit extensions on land development loans and loans to construct single family residences without (1) obtaining updated appraisals, or (2) reevaluating borrowers' creditworthiness. Although earnings appeared satisfactory, the State questioned whether earnings would remain positive and continue to support operations and augment capital. In addition, examiners questioned the adequacy of the ALLL methodology.

Approximately five months after the examination report was issued, the State and FRB San Francisco jointly executed an MOU with the Board of Directors on December 2, 2008, to correct identified weaknesses. The MOU required the Board of Directors to, among other things, submit strategic and capital plans, adopt a plan to enhance credit risk management practices, implement and adhere to acceptable lending and collection policies, improve liquidity monitoring, and achieve and maintain an appropriate ALLL.

October 2008 Target Examination Resulted in a Downgrade to a CAMELS Composite 4 Rating

In response to the asset quality deterioration discovered in the State's July 2008 examination, FRB San Francisco initiated an asset quality examination in October 2008. Based on the initial results of the target examination, FRB San Francisco expanded the scope to include a review and assessment of all CAMELS components except sensitivity to market risk. The examination revealed that San Joaquin had serious financial and managerial deficiencies that required close supervisory attention. The examination report issued in January 2009 resulted in San Joaquin being downgraded to a CAMELS composite 4 (unsatisfactory) rating. Institutions in this group pose a risk to the DIF, and failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved. All CAMELS components were downgraded from 3 ratings to 4 ratings, except for sensitivity, which carried forward its 2 rating from the previous examination.

FRB San Francisco noted "significant deterioration" in the bank's asset quality. According to examiners, San Joaquin's critically deficient asset quality resulted from a dramatic decline in the real estate market, coupled with deficient credit risk management practices. FRB San Francisco identified $24.5 million in problem loans not previously classified by the bank. In addition, examiners stated that management had yet to fully assess the potential loan losses in the bank's construction loan portfolio. Although management projected positive net income, examiners noted that the projection did not consider the need for additional loan loss provisions. Examiners concluded that the increase in adversely classified assets caused by the deficient credit risk management practices, coupled with potential loan losses in the bank's portfolio of construction loans, posed a serious threat to San Joaquin's earnings and capital.

Upon completing the examination, FRB San Francisco considered San Joaquin to be in troubled condition. In April 2009, FRB San Francisco executed a Written Agreement with San Joaquin that detailed specific items that the Board of Directors was required to address to restore the bank's safety and soundness, including formally documenting strategic and capital plans, revising internal policies and programs, restricting extensions of credit, and improving asset quality and the ALLL.

April 2009 Joint Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating

FRB San Francisco and the State began a full scope examination in April 2009. As a result of the examination, San Joaquin was downgraded to a CAMELS composite 5 (unsatisfactory) rating. Banks in this group exhibit extremely unsafe and unsound practices or conditions and pose a significant risk to the DIF because failure is highly probable.

Examiners noted that CRE concentrations remained extremely high. As of March 31, 2009, CRE represented 1,013.4 percent of total risk-based capital (the highest level among state member banks supervised by FRB San Francisco), while CLD loans totaled 342.5 percent (the sixth highest level among state member banks supervised by FRB San Francisco). According to examiners, CRE and CLD loans accounted for the majority of the nonaccrual and problem loans held by the bank.

In the August 2009 report, examiners concluded that San Joaquin's condition had continued to deteriorate and that the bank's deficient asset quality, capital, earnings, and liquidity posed a direct threat to the institution's viability. The examination report stated, "An imprudent business strategy that focused on high risk construction and land development (C&LD) lending activities coupled with ineffective board and management oversight and deficient risk management processes, has been the catalyst to the bank's declining, unsatisfactory condition." Examiners reiterated that management oversight and credit administration practices did not ensure accurate loan grading; and, during the examination, FRB San Francisco identified $63.0 million in problem loans not previously classified by the bank.

In response to the bank's troubled condition, a PCA Directive was executed on September 21, 2009, that, among other things, required San Joaquin to (1) restore itself to *adequately capitalized* by raising additional capital, or (2) merge with or be acquired by another depository institution. San Joaquin failed to raise capital or merge with another institution, and the State closed the bank on October 16, 2009.

Conclusion and Lesson Learned

San Joaquin failed because its Board of Directors and management did not effectively control the risks associated with the bank's rapid loan growth that led to a high concentration in CRE loans and, in particular, CLD loans tied to the Bakersfield real estate market. The loan growth and high concentrations occurred when the Bakersfield real estate market was experiencing significant price appreciation. A decline in the local real estate market, coupled with the bank's failure to effectively manage the increased credit risk associated with San Joaquin's highly concentrated loan portfolio, resulted in deteriorating asset quality and significant losses.

Mounting losses impaired earnings, eroded capital, and strained the bank's liquidity. Efforts to meet a regulatory deadline requiring San Joaquin to, among other things, be acquired by or merge with another financial institution were unsuccessful, and the State closed the bank on October 16, 2009, appointing the FDIC as receiver.

With respect to supervision, FRB San Francisco complied with the examination frequency guidelines for the timeframe we reviewed, 2006 through 2009, and conducted regular off-site monitoring. During that time, FRB San Francisco and the State conducted three full scope safety and soundness examinations and one target examination. Additionally, the bank was placed under two enforcement actions, an MOU signed in December 2008 and a Written Agreement executed in April 2009.

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. In our opinion, the April 2007 examination performed by FRB San Francisco provided an opportunity for stronger supervisory action. Examiners noted that San Joaquin's CRE loan concentration ranked among the highest for state member banks supervised by FRB San Francisco. Examiners also cited management's plan for additional loan growth, despite signs of a slowing real estate market. In our opinion, these circumstances offered an early opportunity for FRB San Francisco to encourage management to mitigate the risk of asset quality deterioration from further market declines.

Further, we believe that the significance of the issues raised during the July 2008 State examination warranted a timely enforcement action compelling management to mitigate credit risk management weaknesses and the risks associated with the declining real estate market. The State examination report issued in July 2008 noted that San Joaquin's financial condition had become less than satisfactory. Examiners noted that actual asset growth for 2007 was 16 percent, or double management's projection. In addition, the bank's level of construction, residential, and lot development loans had increased notably, yet the sharp decline in the Bakersfield real estate market had not been analyzed by management. According to examiners, despite declining collateral values, San Joaquin continued to grant credit extensions without obtaining updated appraisals or reevaluating borrowers' creditworthiness. Examiners also questioned whether earnings would remain positive and continue to augment capital. An informal enforcement action in the form of an MOU developed jointly with the State was issued in December 2008, approximately five months after the State's examination report was issued.

While we believe that stronger supervisory action in 2007 and more timely enforcement action in 2008 were warranted, it is not possible to determine the degree to which any such actions would have affected the bank's subsequent decline or the failure's cost to the DIF.

Lesson Learned

Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that San Joaquin's failure points to a valuable lesson learned that can be applied when supervising community banks with similar characteristics. In our opinion, San Joaquin's failure illustrates that banks with exceptionally high CRE and CLD loan concentrations require a swift and forceful supervisory response when signs of market deterioration first become evident.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response is included as Appendix 3. The Director concurred with the conclusion and lesson learned contained in the report. He stated that examiners (1) noted San Joaquin's high CRE concentration and management's plan for additional growth, despite signs of a slowing real estate market, and (2) questioned whether earnings would remain positive and continue to augment capital. The Director concurred with the report's conclusion that the circumstances offered an early opportunity for stronger supervisory action in 2007, and a timely enforcement action in 2008 compelling management to mitigate credit risk management weaknesses and the risks associated with the declining real estate market. The Director also agreed that San Joaquin's failure illustrates that banks with exceptionally high CRE and construction, land, and land development loans require a swift and forceful supervisory response, and that timely coordination of joint enforcement actions is critical.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
The ALLL is a valuation reserve established and maintained by charges against the financial institution'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. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.

Brokered Deposits
Brokered deposits are deposits that are placed in a savings institution by a broker who gathers funds from others and packages the funds in batches of $100,000. The broker then shops for financial institutions paying the highest rates and invests in multiple $100,000 certificates of deposit, which typically pay the highest rates of interest and are federally insured.

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

Collateral
Collateral is the property or properties securing or being improved by the extension of credit.

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

Concentration
A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets are similarly affected by adverse economic, financial, or business conditions and, in the aggregate, may pose risk to the safety and soundness of the institution.

Construction and Land Development (CLD) Loans
CLD loans are the subset of commercial real estate loans that provide funding for acquiring and developing land for future development and/or construction and provide interim financing for residential or commercial structures.

Appendix 1 (continued)

Enforcement Actions
The Federal Reserve Board has a broad range of enforcement powers that include formal or informal enforcement actions that may be taken, typically after the completion of an on-site bank examination. Formal enforcement actions consist of Cease-and-Desist Orders and Written Agreements, while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Liquidity
Liquidity is 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.

Memorandum of Understanding (MOU)
An MOU is a highly structured written, but informal, enforcement action that is signed by both the applicable Reserve Bank and the member bank's Board of Directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management.

Non-core Deposits
Non-core deposits include federal funds purchased, Federal Home Loan Bank advances, subordinated notes and debentures, certificates of deposit of more than $100,000, and brokered deposits.

Non-core Deposit Sources
Non-core deposit sources are volatile funding sources that include liabilities that either are uninsured or are raised outside the bank's stable, local market.

Nonperforming Assets
Nonperforming assets are the sum of (1) total loans and lease financing receivables past due 90 or more days and still accruing interest, (2) total nonaccrual loans and lease financing receivables, and (3) the total of other real estate owned.

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

Tier 1 Capital
Tier 1 capital is a regulatory capital measure that may include common shareholder's equity (common stock, surplus, and retained earnings), non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

Appendix 1 (continued)

Written Agreement
A Written Agreement is a formal, legally enforceable, and publicly available enforcement action to correct practices that are believed to be unlawful, unsafe, or unsound. All Written Agreements must be approved by the Board's Director of the Division of Banking Supervision and Regulation and General Counsel.

Appendix 2 – CAMELS Rating System

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

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

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2 (continued)

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of Banking Supervision and Regulation

Date:	May 11, 2010
To:	Elizabeth A. Coleman, Inspector General
From:	Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***
Subject:	Material Loss Review San Joaquin Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of San Joaquin Bank, Bakersfield, California, prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report finds that San Joaquin Bank failed because its Board of Directors and management did not effectively control the risks associated with the bank's rapid loan growth and resulting high concentration in commercial real estate (CRE) loans tied to the Bakersfield real estate market, which was experiencing significant price appreciation. A decline in the local real estate market, combined with the bank's failure to effectively manage the increased credit risk associated with the concentrated portfolio resulted in deteriorating asset quality and significant losses. Mounting losses impaired earnings, eroded capital, and strained liquidity. San Joaquin Bank was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco) under delegated authority from the Board.

We concur with the conclusion and lesson learned contained in the report. FRB San Francisco complied with the examination frequency guidelines for the period reviewed, 2006 through 2009. During that time there were three full scope safety and soundness examinations and one asset quality target examination. Examiners noted the high CRE concentration and cited management's plan for additional loan growth, despite signs of a slowing real estate market. Further, examiners questioned whether earnings would remain positive and continue to augment capital. FRB San Francisco worked closely with the State supervisory authority and the bank was placed under an MOU in December 2008 and a Written Agreement in April 2009. Nonetheless, we concur with the report's conclusion that the circumstances offered an early opportunity for stronger supervisory action in 2007, and a timely enforcement action in 2008 compelling management to mitigate credit risk management weaknesses and the risks associated with the declining real estate market was warranted. We also concur, however, that it is not possible to determine the degree to which such actions would have affected the bank's subsequent decline or the failure's cost to the FDIC deposit insurance fund.

Appendix 3 (continued)

The report highlights a lesson learned applicable to banks with similar characteristics. Specifically, the report indicates that the bank's failure illustrates that banks with exceptionally high CRE and construction, land, and land development loans require a swift and forceful supervisory response. Timely coordination of joint enforcement actions is critical.

Board staff appreciates the opportunity to comment on the Material Loss Review and welcomes the report's observations and contribution to understanding the reasons for San Joaquin Bank's failure.

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

Kimberly A. Whitten, Project Manager

Timothy P. Rogers, Team Leader for Material Loss Reviews and Senior Auditor

Anthony J. Castaldo, Assistant Inspector General for Inspections and Evaluations