Office of Inspector General

August 2009
Report No. AUD-09-019

Material Loss Review of 1st Centennial Bank, Redlands, California

AUDIT REPORT

Office of Audits

oig

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Federal Deposit Insurance Corporation

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of 1st Centennial Bank, Redlands, California (1st Centennial). On January 23, 2009, the State of California, Department of Financial Institutions (CDFI), closed 1st Centennial and named the FDIC as receiver. On February 11, 2009, the FDIC notified the OIG that 1st Centennial's total assets at closing were $784 million, with a material loss to the Deposit Insurance Fund (DIF) estimated at $226.6 million. As of July 17, 2009, the estimated loss to the DIF had decreased to $215.4 million.

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) provisions of section 38. Our ability to evaluate supervisory efforts prior to the April 2008 examination was limited because the retention of work papers beyond one examination is generally discouraged in accordance with FDIC policies.

Background

1st Centennial was insured on August 1, 1990 and was headquartered in Redlands, California. At closing, the bank had six branches in Southern California. The bank was fully owned by 1st Centennial Bancorp, a bank holding company, but did not have any affiliates or subsidiaries.

1st Centennial's loan portfolio was concentrated in commercial real estate (CRE) loans, including acquisition, development, and construction (ADC) loans in single-family residence (SFR) tract construction. These CRE/ADC loans were also highly concentrated geographically in Southern California's Inland Empire. Beginning in 2007, the Inland Empire was affected by a decline in land and residential home values as well as high levels of unemployment.

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Audit Results

Cause of Failure and Material Loss - 1st Centennial failed primarily due to bank management's pursuit of asset growth concentrated in high-risk CRE/ADC loans without adequate loan underwriting and credit administration practices. In addition to a concentration in CRE/ADC loans, the bank also concentrated its loan portfolio in one geographic area that experienced a severe economic downturn, further increasing the risk to the bank. The bank did not ensure that underwriting adequately considered the borrowers' ability to repay and the adequacy of the underlying collateral. Credit administration practices did not sufficiently ensure that CRE/ADC loans were adequately managed and monitored. Examiners determined that 1st Centennial's asset quality was seriously deficient at the FDIC's April 2008 examination, primarily due to deterioration in the bank's CRE/ADC loan portfolio. Also, examiners found that the bank became increasingly dependent on wholesale funding, including brokered deposits. The examiners concluded that bank management failed to implement adequate risk management controls to effectively mitigate loan portfolio risk and ensure that the allowance for loan and lease losses (ALLL) was properly funded. Significant provisions to the ALLL reduced earnings, eroded capital, and tightened the bank's liquidity position. Ultimately, the bank became critically undercapitalized and failed.

Assessment of FDIC Supervision and PCA Implementation - The FDIC and CDFI conducted timely examinations of 1st Centennial from 1990 until its closing in 2009 and identified the primary causes of 1st Centennial's failure. There were, however, two areas in which the FDIC's supervisory activities regarding 1st Centennial could have been improved. These areas were related to (1) the supervisory efforts to address the bank's CRE/ADC loan concentrations and (2) the timeliness of the FDIC's formal enforcement actions.

Examiners identified the bank's high CRE/ADC concentration as early as the 2004 examination. The April 2006 FDIC examination concluded that the high level of construction loans—representing 611 percent of Tier 1 Capital—posed a potential risk to the bank. However, examiners also reported that (1) bank management was effectively monitoring and managing the risk associated with such a concentration and (2) management recognized the need to prudently balance the loan portfolio as the bank continued to grow. Accordingly, the FDIC did not take action to limit those concentrations. High concentration levels were also found in other examinations including the CDFI February 2007 examination which noted that the CRE concentration represented over 581 percent of Tier 1 Capital but did not make recommendations to address this condition.

The April 2008 FDIC examination reported $110 million of adverse classifications, composed primarily of CRE/ADC loans, that resulted in a significant and rapid deterioration of the bank's financial condition. To address the deterioration, the bank agreed to raise $30 million in additional capital by August 1, 2008, which did not occur. As a result of the 2008 examination, the FDIC and state regulatory agency proposed a Cease and Desist Order (C&D) to address the bank's significant deterioration and inadequate risk management controls. The bank entered into extended negotiations with the FDIC and the CDFI regarding the provisions of the C&D and, ultimately, refused to stipulate to the order. The FDIC pursued additional action, a Notice of Charges, which was pending when the bank failed. The FDIC and CDFI conducted a joint visitation of the bank during November 2008 and found that the CRE/ADC loan portfolio and bank's overall financial condition had deteriorated further. Accordingly, the CDFI issued the bank a capital demand letter, and the FDIC downgraded the bank's ratings and issued a PCA Notification Letter on December 19, 2008, indicating that the bank was *Critically Undercapitalized*. These actions were too late to address the bank's problems. 1st Centennial became *Adequately Capitalized* after filing its September 30, 2008 *Report of Condition and Income* on October 31, 2008. As discussed above, the FDIC formally notified the bank that it was C*ritically Undercapitalized* based on the results of the November 2008 visitation in accordance with PCA provisions.

The FDIC OIG plans to issue a series of summary reports on material loss reviews and will make appropriate recommendations related to the failure of 1st Centennial and other FDIC-supervised banks at that time.

Management Response

On August 4, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. In its response, DSC stated that 1st Centennial failed due to the bank's risk associated in its loan concentrations and funding strategies and due to a decline in its local real estate market. DSC also stated that 1st Centennial's recovery efforts were significantly hampered by other market events that led to a large volume of deposit withdrawals and secondary mortgage market upheaval. In addition, the Director stated that DSC (1) conducted an internal analysis following 1st Centennial's failure, (2) has taken specific steps to limit growth that is funded by volatile non-core deposits, and (3) recognizes the threat that institutions with high-risk profiles, such as 1st Centennial's pose to the DIF.

To view the full report, go to www.fdicig.gov/2009reports.asp

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Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits
Office of Inspector General

DATE: August 11, 2009

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/**Signed**/
FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of 1st Centennial Bank, Redlands, California*
(Report No. AUD-09-019)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of 1st Centennial Bank (1st Centennial). On January 23, 2009, the California Department of Financial Institutions (CDFI) closed the institution and named the FDIC as receiver. On February 11, 2009, the FDIC notified the OIG that 1st Centennial's total assets at closing were $783.5 million with an estimated loss to the Deposit Insurance Fund (DIF) of $226.6 million. As of July 17, 2009, the estimated loss to the DIF had decreased to $215.4 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); ascertains why the institution's problems resulted in a material loss to the DIF; and makes recommendations to prevent future losses.

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38 of the FDI Act. Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of terms; Appendix 3 contains the FDIC's comments to the report;

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[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices, including internal control systems; and compliance with applicable laws and regulations; and (2) issues related guidance to institutions and examiners.

Appendix 4 contains a chronology of significant events; and Appendix 5 contains a list of acronyms used in the report.

This report presents the FDIC OIG's analysis of 1st Centennial's failure and the FDIC's efforts to ensure 1st Centennial's management operated the bank in a safe and sound manner. The FDIC OIG plans to issue a series of summary reports on our observations on the major causes, trends, and common characteristics of financial institution failures resulting in a material loss to the DIF. Recommendations in the summary reports will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

1st Centennial, insured by the FDIC on August 1, 1990, was a state, nonmember bank with six branches and was headquartered in Redlands, California. 1st Centennial provided traditional banking activities within the Southern California area and focused extensively on commercial real estate (CRE) loans, including acquisition, development, and construction (ADC) loans in single-family residence (SFR) tract construction. The bank was fully owned by 1st Centennial Bancorp, a bank holding company, but did not have any affiliates or subsidiaries.

DSC's Los Angeles North Field Office and CDFI performed regular safety and soundness examinations of 1st Centennial, conducting five examinations from May 2004 through April 2008. The FDIC performed examinations in 2004, 2006, and 2008,[3] while California's CDFI performed examinations in 2005 and 2007. In addition, the FDIC and CDFI conducted a visitation in November 2008 that focused solely on a review of the bank's CRE/ADC construction loan portfolio.[4]

1st Centennial specialized in CRE/ADC loans for SFR tract construction, which was significantly concentrated in the Inland Empire (Riverside, California-San Bernardino, California, metropolitan area) of Southern California. 1st Centennial experienced record profitability in 2007. On October 12, 2007, 1st Centennial issued a press release stating that the bank had record third-quarter earnings of $2.2 million and $6.2 million for the year to date. However, the bank suffered significant losses in 2008, and on August 7, 2008, 1st Centennial issued a press release stating that the bank had posted a $2.8 million quarterly loss. By December 31, 2008, 1st Centennial's losses exceeded $50 million.

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[3] The FDIC's 2004 and 2006 examinations were conducted under the FDIC's *Maximum Efficiency, Risk Focused, Institution Targeted (MERIT) Guidelines*. The FDIC followed MERIT guidelines, dated January 27, 2004, in performing examinations for *Well Capitalized* banks with a 1 or 2 composite rating for the two most recent examinations and that met other criteria in the guidelines. MERIT guidelines were rescinded on March 12, 2008 after a 2007 DSC study showed that examiners were appropriately risk-scoping examination activities based on institution risk and that the MERIT procedures were no longer necessary.

[4] Although the FDIC and CDFI initiated a visitation and loan review, neither of those efforts was completed before the bank failed. Therefore, although the FDIC provided a draft report on the November visitation results, neither the FDIC nor the CDFI issued a final report on the visitation results.

Details on 1st Centennial's financial condition for the calendar years 2005 through 2008, and March 31, 2008 follow in Table 1.

Table 1: Financial Condition of 1st Centennial

	12-31-2008	03-31-2008	12-31-2007	12-31-2006	12-31-2005
Total Assets ($000s)	$797,959	$715,231	$689,104	$550,672	$455,732
Total Deposits ($000s)	$678,570	$495,332	$479,035	$457,956	$402,309
Total Loans ($000s)	$508,917	$524,668	$521,449	$431,941	$386,529
Net Loan Growth Rate	(7.36)%	15.76%	20.75%	11.82%	23.74%
Net Income (Loss) ($000s)	($50,002)	($1,150)	$9,353	$8,992	$6,031
Loan Mix (% of Avg. Gross Loans):					
All Loans Secured by Real Estate	61.13%	62.60%	61.39%	60.92%	64.29%
Construction and Development (ADC)	42.09%	45.55%	42.39%	38.61%	37.60%
CRE - Nonfarm/nonresidential	15.11%	13.95%	15.10%	18.19%	22.58%
Multifamily Residential Real Estate	1.12%	1.14%	1.25%	1.47%	1.19%
1-4 Family Residential – excluding Home Equity Lines of Credit	2.75%	1.91%	2.05%	2.47%	2.84%
Home Equity Loans	1.74%	1.43%	1.47%	1.79%	1.71%
Commercial and Industrial Loans	36.14%	34.58%	36.04%	37..57%	34..81%
Funding:					
Net Loans/Deposits	70.26%	104.65%	107.43%	93.07%	94.74%
Core Deposits/Average Assets	63.50%	56.20%	62.89%	70.42%	69.93%
Brokered/Average Assets	23.81%	6.49%	7.75%	6.89%	6.41%
Large Time/Average Assets	11.05%	13.19%	15.61%	15.67%	13.82%
Federal Home Loan Bank (FHLB) Borrowings/Average Assets	11.07%	10.25%	2.92%	0%	4.81%
Net Non-Core Dependency Ratio	68.39%	44.12%	40.49%	28.60%	11.68%
Examination/Visitation Dates	**11-24-2008**[a]	**04-07-2008**	**02-26-2007**	**04-24-2006**	**01-31-2005**
Examination Conducted By	**FDIC and CDFI**	**FDIC**	**CDFI**	**FDIC**	**CDFI**
Component/Composite Ratings[b]	555555/5	444443/4	221122/2	221121/2	212232/2
Adverse Classifications Ratio	1,049%	177.62%	7.11%	8.85%	8.44%

Source: Uniform Bank Performance Reports (UBPR) and Reports of Examination (ROEs) for 1st Centennial.

[a] FDIC visitation and CDFI visitation.

[b] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

The growth in adverse classifications in 2008 from 1st Centennial's deteriorating CRE/ADC loan portfolio reduced earnings (causing a $50 million loss), due in part to a large increase ($32 million) in the allowance for loan and lease losses (ALLL), and decreased capital. The growth in the adverse classifications also affected 1st Centennial's liquidity because past-due loan payments increased. 1st Centennial bought approximately $300 million in brokered deposits during the second half of 2008, thereby increasing total deposits and total assets for 2008.

CAUSES OF FAILURE AND MATERIAL LOSS

The failure of 1st Centennial and resulting material loss to the DIF was due to bank management's pursuit of rapid asset growth concentrated in high-risk CRE/ADC loans without adequate risk management controls and loan underwriting and credit administration practices. The fact that those CRE/ADC loans were concentrated in SFR construction and in one geographic area increased the risk in the bank's loan portfolio. Losses in the CRE/ADC loan portfolio, driven by a downturn in the economy, severely eroded earnings, capital, and liquidity, and the bank increased its dependence on wholesale funding sources. The bank failed due to a lack of capital as a result of these loan losses. The resulting loss to the FDIC's DIF was estimated at $226.6 million but decreased to $215.4 million, as of July 17, 2009.

Local Economic Impact

The Inland Empire and other areas in California experienced some of the highest rates of home price appreciation in the first half of the decade.[5] Rapid population growth in this area spurred higher-than-average rates of home construction. According to Moody's, the Riverside economy contracted amid weakened house construction activity and the United States and global downturns in industrial production. As indicated in Table 2, which follows, certain indicators showed that the economic conditions in California, and particularly the Inland Empire, were slowing considerably during 2007 and 2008.

Table 2: Indicators of Economic Downturn in California

Year	Total Employment (Thousands)	Personal Income Growth Rate	Single Family Construction Permits	Mortgage Originations	Personal Bankruptcies
California					
2006	15,060	7.7%	107,714	729,134	37,107
2007	15,173	5.2%	68,266	556,452	69,110
2008	15,000	3.2%	32,879	366,989	126,819
Riverside, California					
2006	1,267.7	7.8%	33,498	99,532	4,051
2007	1,270.9	4.4%	16,019	61,324	8,814
2008	1,223.0	1.6%	5,750	41,033	18,338

Source: Moody's Economy.com, *Précis STATE*®, April 2009.

[5] *FDIC Quarterly*, 2009, Volume 3, No. 1, article entitled, *The 2009 Economic Landscape: The Sand States: Anatomy of a Perfect Housing-Market Storm*.

Examiners concluded that the market downturn and the declining housing market in the Inland Empire were partially responsible for 1st Centennial's financial deterioration. However, examiners also indicated that, while the distressed housing market negatively impacted asset quality, inadequate credit administration and internal controls caused further erosion of the loan portfolio. 1st Centennial's bank management stated that the housing market was deteriorating at such an accelerated pace that it was difficult for them to properly evaluate the bank's loan portfolio.

Deficient Asset Quality and Inadequate Risk Management Controls

Examiners found 1st Centennial's asset quality to be seriously deficient during the FDIC's April 2008 examination, primarily due to deterioration in the bank's CRE/ADC loan portfolio. The examiners also found that bank management failed to implement adequate risk management controls to effectively recognize loan portfolio risk, ensure the proper use of interest reserves, institute a sound loan approval process, and appropriately fund the ALLL. In addition, at the 2008 examination, examiners noted that (1) internal control weaknesses in underwriting and credit administration in the bank's Construction Loan Department appeared to have gone uncorrected by management for many years, and (2) the internal loan review function was inadequate. Examiners also concluded that the CRE/ADC concentration, coupled with inadequate internal controls, resulted in extremely high levels of adversely classified assets, significant provisions to the ALLL, negative earnings, capital erosion, and a tightened liquidity position. Further, examiners reported that the deterioration in the bank's asset quality would not have been as severe had bank management implemented strong internal controls before the economic downturn, when the bank's financial condition was better.

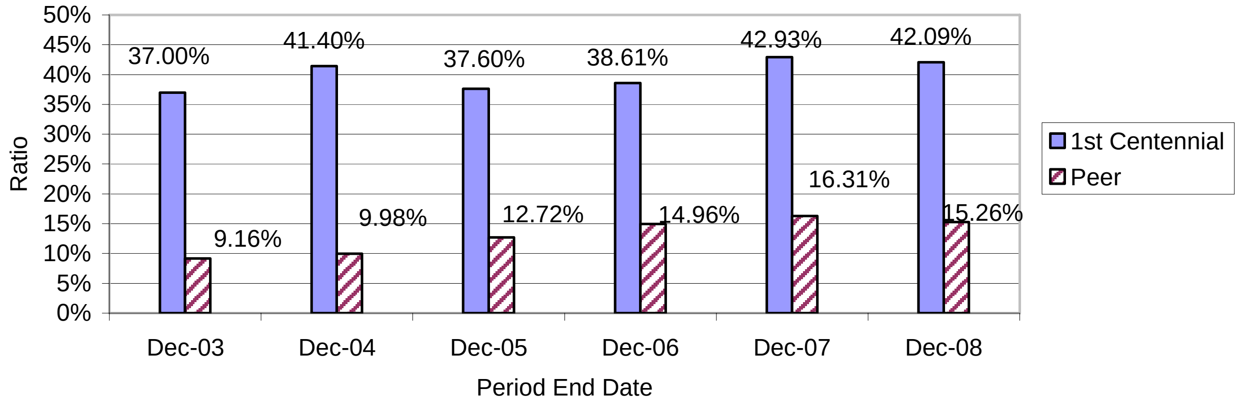
1st Centennial's asset quality received a 2 (satisfactory) rating during the 2004, 2006, and 2007 examinations; and a 1 (strong) rating during the 2005 examination. The April 2008 examination and November 2008 visitation progressively downgraded asset quality to 4 and 5, respectively. The downgrades indicated that the bank's level of risk and problem assets were significant and inadequately controlled, subjecting the bank to high levels of actual and potential losses. During the November 2008 visitation, examiners concluded that 1st Centennial's asset quality had become critically deficient and presented an imminent threat to the bank's viability.

Excessive CRE/ADC Loan Concentrations

Examiners identified substantial loan losses, payment delinquencies, and management deficiencies during 2008 that were centered in 1st Centennial's CRE/ADC loan concentrations. 1st Centennial had implemented a high-growth strategy in CRE/ADC loans, beginning in 2004. In addition to concentrating in high-risk CRE/ADC loans, the bank had two further concentrations of its loan portfolio. Specifically, the portfolio was significantly concentrated in SFR tract construction loans and was geographically concentrated within the bank's local market area in the Inland Empire.

1st Centennial's high CRE/ADC loan concentrations are shown in Figure 1, which follows. The bank's CRE/ADC concentration ranged from 37 percent to 42.9 percent of average total loans between 2003 and 2008. The bank was consistently in the 93rd to 98th percentile of its peer group for this measure. In contrast, the peer group's CRE/ADC concentration measure ranged from 9.16 percent to 16.31 percent during the same period.

Figure 1: ADC Loans as a Percentage of Average Loans



Source: UBPRs for 1st Centennial.

As part of their examinations, examiners identified and measured the extent of 1st Centennial's CRE/ADC loan concentrations as a percentage of the bank's Tier 1 Capital. The examiners' review of the CRE/ADC loan concentrations during the 2004, 2006, 2007, and 2008 examinations and 2008 visitation determined that the concentrations represented the following levels of Tier 1 Capital:

- 2004 examination–659 percent,
- 2006 examination–611 percent,
- 2007 examination–581 percent,
- 2008 examination–568 percent, and
- 2008 visitation–569 percent.

The bank's CRE/ADC loans were further concentrated in SFR tract construction loans. Examiners determined that SFR tract construction loans represented high percentages of the bank's CRE/ADC portfolio as follows:

- 2004 examination–63 percent,
- 2006 examination–68 percent,
- 2007 examination–78 percent, and
- 2008 visitation–46 percent.[6]

[6] The 2008 ROE did not include specific percentages on the level of SFR concentration.

A geographic distribution summary performed during the 2007 examination showed that the CRE/ADC loan portfolio was also geographically concentrated with almost 90 percent of the CRE/ADC construction projects located in the Inland Empire (Riverside and San Bernardino counties), as indicated below.

- 55.8 percent in Riverside County, California;
- 33.4 percent in San Bernardino County, California; and
- 10.8 percent in other Southern California counties (Imperial, Los Angeles, Orange, San Diego, and Ventura)

1st Centennial's ADC loans increased from 292 percent to 383 percent of total capital between December 31, 2006 and December 31, 2007, exceeding the regulatory threshold of 100 percent for this measure. The percentage of ADC loans to total capital on December 31, 2008, was 1,264 percent. However, the December 31, 2008 percentage was high, due, in part, to the bank's extensive losses resulting in a reduced capital level. Regarding the level of ADC loans to total capital, 1st Centennial was consistently in the 90^{th} to 96^{th} percentile of its peer group.

Loan Losses and Classifications

According to the April 2008 ROE and the November 2008 draft visitation report, a high level of CRE/ADC loan losses had accrued due to a combination of external and internal factors during 2008. In addition, the bank's internal loan grading system was considered inadequate and was not effectively classifying loans, leading to the untimely recognition of problem assets, an inaccurate ALLL, and a misrepresentation of the bank's capital and earnings. During the examination and visitation, examiners' recognition of problem assets and the subsequent downgrade of numerous loans resulted in adversely classified assets, including Other Real Estate Owned (OREO), which severely affected the ALLL and significantly eroded the bank's capital.

External factors, in large part, caused the bank to suffer increased loan losses, which affected the viability of the institution. Most significantly, reductions in land and residential home values, a significant increase in the unemployment rates, and poor single-family home sales in the Inland Empire caused a substantial number of the bank's CRE/ADC borrowers to stop developing their projects, cease making payments, or refuse to invest additional funds into a project.

Additional problems within the institution affected the bank's ability to weather the economic downturn. Internal control inadequacies and poor bank management oversight identified by examiners in 2008 included inappropriate use of interest reserves and an inadequate interest reserve policy, an ineffective loan grading system, a weak loan approval process, and a lack of current borrower financial statements to assess the borrower's and/or guarantor's ability to repay the loan in light of declining collateral value—all of which contributed to the bank's loan losses. Examiners found several loans where the bank either had not placed the loan into a non-accrual status or had delayed placing the loans into a non-accrual status when payments were 100 to 160 days past due.

Delays in placing loans in a non-accrual status postponed accrued interest reversals, where needed, and prevented timely recognition of the problem status of loans so that the bank could initiate appropriate collection or other activities.

Problems Related to the Allowance for Loan and Lease Losses

Although the loan portfolio grew steadily, the ALLL remained relatively constant without significant increases, and adverse classifications actually declined between the 2006 and 2007 examinations (as noted in Table 3 below). However, as previously discussed, during the FDIC's April 2008 examination and November 2008 visitation, examiners identified a substantial amount of loan downgrades. The loan downgrades identified in the April 2008 examination resulted in the need for an additional $6.0 million provision for 1st Centennial's ALLL. Table 3, which follows, presents the amount of assets that were adversely classified during examinations and the visitation conducted between 2004 through 2008, the ALLL funding level that 1st Centennial computed, and the increases needed to the ALLL that examiners computed. The examiners performing the November 2008 visitation did not recompute the bank's ALLL based on the additional loan downgrades identified.

Table 3: 1st Centennial's Adversely Classified Assets and ALLL

	Asset Quality (Dollars in Thousands)					
	Examiner Adversely Classified Asset Amounts				**ALLL Amounts**	
Examination/ Visitation Date	**Substandard**	**Doubtful**	**Loss**	**Total Adversely Classified Items**	**ALLL Computed by 1st Centennial**	**Increase in ALLL Computed by Examiners**
May 2004	$2,202	$54	$0	$2,256	$2,449	$0
January 2005	$2,955	$289	$10	$3,254	$3,448	$0
April 2006	$4,110	$490	$0	$4,600	$5,376	$0
February 2007	$4,244	$50	$0	$4,294	$5,741	$0
April 2008	$106,318	$217	$3,038	$109,573	$6,317	$6,000
November 2008*	$75,800	$23,800	$16,300	$115,900	$22,600	Not computed*

Source: FDIC and CDFI ROEs and UBPRs for 1st Centennial.
* Although the FDIC reviewed the ALLL during this visitation, the draft visitation report did not include information related to a computed increase to the ALLL. Amounts are as of October 31, 2008.

In the April 2008 and prior examinations, the FDIC and CDFI examiners consistently concluded that the bank's ALLL methodology was adequate. The FDIC's November 2008 draft visitation report stated that loan deterioration necessitated large provisions to the ALLL, and thus reduced the bank's capital position but did not specifically conclude on the adequacy of the ALLL methodology. The bank's external auditors did not identify deficiencies in either the bank's methodology or provisions to the ALLL during the annual financial statement audits performed for the years ending December 31, 2005, December 31, 2006, and December 31, 2007.

Table 4, below, shows 1st Centennial's net income (loss) and ALLL as of year-end for 2004 through 2008. As indicated in Table 4, the need for a substantial increase in the ALLL during 2008, coupled with actual losses that year was a primary cause of the net loss for the year.

Table 4: 1st Centennial's Net Income (Loss) and ALLL (Dollars in Thousands)

	Dec 2004	**Dec 2005**	**Dec 2006**	**Dec 2007**	**Dec 2008**
Net Income	$3,757	$6,031	$8,992	$9,353	$(50,002)
ALLL	$4,137	$5,376	$5,741	$6,805	$32,140

Source: UBPRs for 1st Centennial.

Significant Loan Underwriting and Credit Administration Problems

Significant loan underwriting and credit administration problems were identified during the April 2008 examination and November 2008 visitation. According to DSC, prior examinations did not identify similar problems because the bank either did not have problem assets, such as OREO, or problem assets were small in number. The ROEs for 2004 through 2007 described loan underwriting and credit administration in terms such as adequate, satisfactory, and prudent. The ROEs for the 2004 and 2006 FDIC examinations also included examiner recommendations for improvement in various aspects of the bank's loan underwriting and credit administration controls. For example, in the 2004 ROE, examiners recommended that 1st Centennial's BOD and management (1) continue to closely monitor the bank's real estate and construction loan concentrations; (2) implement a construction loan software program for detailed reports on the loan portfolio; (3) consider analyzing a sample of construction loans on a periodic basis, comparing actual performance of a project to the planned performance; and (4) present the results of such analysis to the bank's loan committee. In its response to the FDIC, 1st Centennial stated that the bank had initiated a process to address the 2004 recommendation. In addition, the 2006 ROE included minor recommendations to enhance concentration monitoring and reporting.

Loan underwriting and credit administration problems that were identified during the April 2008 examination and reported in the ROE included, but were not limited to, the following:

- untimely non-accrual recognition,
- ineffective internal loan grading system,
- weak loan approval process,
- inadequate administration of OREO, and
- failure to report a violation to Appendix A of Part 365 of the FDIC's Rules and Regulations concerning loans that exceeded the supervisory loan-to-value limits.

High-Risk Owner-Occupied Single-Family Home Construction. In 2008, examiners also identified risks in the owner-occupied SFR construction portfolio due to liberal loan underwriting standards and incomplete borrower information. The bank allowed borrowers to qualify for loans without verifying the borrower's income or assets. Additionally, 1st Centennial made these loans at 80 percent loan-to-value at origination in a declining real estate market. Further, 1st Centennial did not require loans under $1 million to be reviewed and approved by the bank's loan committee. The examiners' review of these loans showed that information on the borrower's ability to repay the loan was incomplete.

Inappropriate Interest Reserve Payments. According to the April 2008 ROE, 1st Centennial used interest reserves to make interest payments totaling $781,000 for seven loans. Those loans had a total outstanding balance of $30.3 million. All seven loans were construction loans for which either construction progress had stopped or the units developed could not be sold. Instead of requiring the debtors and/or investors to make the interest payments, the bank improperly made the interest payments from the interest reserve portion of the loan funding. A total of $244,314 in improper loan interest payment entries were made during 2007 and $536,708 during 2008.

The $781,000 in inappropriate interest payments improperly increased the bank's capital and earnings, delayed the recognition of the non-accrual status of these seven loans, and delayed activities to minimize losses attributable to these loans. In addition, examiners identified weak internal controls associated with the use of interest reserves that included (1) a lack of segregation of duties, (2) a lack of senior management monitoring and oversight of troubled and criticized loans with interest reserves, and (3) weak policies and procedures for the use of interest reserves.

November 2008 Visitation Results. The FDIC November 2008 visitation also identified many of the same loan underwriting and credit administration problems (the FDIC did not issue a final report on the visitation results) identified in the April 2008 examination. According to examiners, these underwriting and credit administration problems further exacerbated the bank's losses due to construction loans continuing to falter since the April 2008 examination as a result of the continuing decline in sales and market values. Many of the bank's loan files were incomplete and included only stale financial statements for the borrowers and guarantors, making it more difficult for the bank to determine a borrower's and guarantor's financial capability and seek repayment from the borrower's and guarantor's assets. These deficiencies increased the bank's reliance on the property's collateral value for repayment of the loan, which is risky in a declining real estate market. In addition, examiners stated that 1st Centennial's credit administration was weak due to understaffing and unqualified staff.

Wholesale Funding

Examiners found that 1st Centennial had relied on varying amounts of brokered deposits and FHLB borrowings during the examinations performed between May 2004 and February 2007 (as shown in Table 5 which follows), and that 1st Centennial's reliance on those funds was generally in line with other banks in the bank's peer group. However, during the April 2008 examination, examiners found that 1st Centennial had (1) shifted to a high-risk wholesale funding strategy during 2007 due to competition for local deposits, (2) experienced a deficient core liquidity position since September 2007, and (3) increased its reliance on brokered deposits to maintain liquidity. In addition, examiners determined that the bank's shift to a liability funding strategy in 2007, combined with deteriorating loans and liquidity, created a high-risk environment for which bank management had not established adequate controls. Further, 1st Centennial needed to (1) implement additional controls and reporting to improve its management of liquidity operations and (2) develop a more detailed contingency liquidity plan (CLP) to provide guidance for anticipated liquidity problems.

Table 5: 1st Centennial's Funding Sources by Examination Date

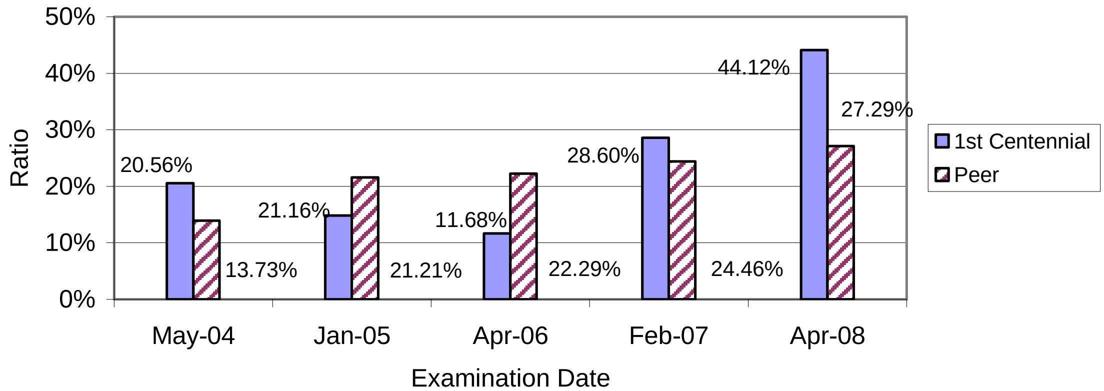
	Examination Date (Dollars in $000)				
Funding Sources Other Than Core Deposits*	**May 04**	**Jan 05**	**Apr 06**	**Feb 07**	**Apr 08**
Brokered deposits	$10,605	$10,928	$27,666	$50,234	$60,756
FHLB Borrowings less than 1 year	$10,000	$20,000	0	0	$64,500
FHLB Borrowings greater than 1 year	0	0	0	0	$15,000
Certificates of Deposits over $100,000	$33,387	$40,078	$60,093	$109,101	$91,504
Total	**$53,992**	**$71,006**	**$87,759**	**$159,335**	**$231,760**

Source: UBPRs for 1st Centennial.

* In addition to the non-core funding sources listed above, 1st Centennial also had other sources of funding, such as lines of credit with other financial institutions. Access to non-core funding may have been restricted as the bank's financial condition deteriorated.

A key metric of the risks related to a bank's liquidity management is the net non-core funding dependence ratio. This ratio is an indication of the degree to which the bank relies on non-core volatile liabilities, such as brokered deposits; FHLB borrowings to fund long-term earning assets; and certificates of deposit over $100,000. Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. As noted in Figure 2, which follows, although 1st Centennial's reliance on non-core/volatile liabilities was higher than the bank's peer group at the May 2004 examination, the January 2005 and April 2006 examinations determined that the bank was generally in line with its peer group. However, the bank's net non-core funding dependence ratios of 28.60 and 44.12 percent were higher than the bank's peer group as of the February 2007 and April 2008 examinations, respectively. In addition, during the November 2008 visitation, the bank's dependence ratio had increased to 68.39 percent. According to DSC officials, the increase in 1st Centennial's brokered deposits and overall net non-core funding dependence during 2008 was in anticipation of liquidity events related to increasing levels of core deposit withdrawals. DSC officials also stated that 1st Centennial anticipated those substantial deposit withdrawals due to expected negative press associated with the firing of the bank's Chief Executive Officer and Chief Credit Officer, and with other bank failures that had occurred in 1st Centennial's local market area.

Figure 2: Net Non-Core Funding Dependence



Source: OIG review of ROEs and UBPRs for 1st Centennial.

After the FDIC meeting with the bank's BOD on June 20, 2008 to discuss examination results, 1st Centennial's BOD reported that depositors withdrew over $130 million in deposits during July and August 2008. During this same period, 1st Centennial purchased $224 million in brokered deposits to provide the liquidity needed to address its actual and potential core deposit withdrawals. By the end of October 2008, the bank had purchased $303 million in brokered deposits. The bank used excess funds primarily to purchase negotiable securities. As the bank's financial condition became critical, the FDIC monitored 1st Centennial's liquidity. On October 31, 2008, regulatory restrictions prohibited the bank's further use of brokered deposits as a funding source without first obtaining a waiver from the FDIC.

ASSESSMENT OF FDIC SUPERVISION

The FDIC and CDFI conducted timely examinations of 1st Centennial from 2004 until the bank closed in 2009. Examiners identified and reported on 1st Centennial's concentrations and the risks that those concentrations presented. In addition, examiners made recommendations related to the need for adequate monitoring and reporting. However, there were two areas where the FDIC's supervisory activities regarding 1st Centennial could have been improved. These two areas related to supervisory actions needed to address the bank's high CRE/ADC concentration and the implementation of a formal enforcement action after the bank's condition had deteriorated. (See the *Chronology of Significant Events* in Appendix 4 of this report for additional details.)

At the April 2008 examination, examiners downgraded 1st Centennial's composite rating from 2 to 4, indicating unsafe and unsound practices or conditions and an imminent threat to the bank's viability. The transmittal letter for the April 2008 ROE stated that the FDIC considered 1st Centennial to be "troubled" for purposes of section 32 of the FDI Act, which would require 1st Centennial to notify the FDIC of any management changes, and

Part 359 of the FDIC Rules and Regulations, which placed certain restrictions on payments to institution-affiliated parties. In December 2008, examiners further downgraded 1st Centennial's composite rating to 5, indicating extremely unsafe and unsound practices or conditions that pose a significant risk to the DIF and that the bank had a high probability of failure.

1st Centennial attempted to raise $30 million in capital by August 1, 2008 but was unsuccessful. To address examination concerns, including those related to concentrations, inadequate risk management controls, and other safety and soundness issues, the FDIC and CDFI jointly sent the bank a draft Cease and Desist Order (C&D) on October 8, 2008.

Negotiations ensued between the bank and the FDIC and CDFI over C&D language until November 12, 2008, when 1st Centennial broke off further negotiations and stated that it would not stipulate to the proposed C&D. On November 14, 2008, the FDIC issued 1st Centennial a Notice of Charges (NOC) that contained provisions similar to those in the C&D. The NOC was still pending an administrative hearing when the bank failed on January 23, 2009.

The CDFI and FDIC performed a joint visitation of the bank in November 2008 that identified further losses and deterioration in 1st Centennial's CRE/ADC loan portfolio. The bank was issued a capital demand letter, PCA notification letter, and letter notifying 1st Centennial of downgrades to the bank's CAMELS ratings on December 19, 2008. The Capital Demand Letter required the bank to raise $78 million in additional capital within 60 days ($60 million within 30 days, followed by an additional $18 million) to replenish the losses in the bank's capital. Unfortunately, 1st Centennial was unable to raise the needed capital and was closed by the CDFI on January 23, 2009.

Supervision Related to the CRE/ADC Concentration

Based on our review, the FDIC could have increased supervisory efforts concerning the risk inherent in the bank's CRE/ADC loan concentration. The FDIC had identified 1st Centennial's CRE/ADC loan concentrations in each of its examinations, starting in 2004, but determined that the risk was mitigated based on the bank's policies, controls, and monitoring activities. As noted below, examinations prior to 2008 noted significant concentrations and made recommendations to 1st Centennial to improve issues, including, but not limited to, monitoring and reporting practices.

The 2004 ROE reported that the high concentration of real estate loans, and more specifically, construction loans, remained an added risk to the bank that required management's continued close attention. Regarding the 2004 examination, the FDIC concluded that the bank had a strong capital level, which mitigated some of the risk associated with the concentration. Further, the 2005 ROE stated that asset quality was strong, and the 2006 ROE noted that although the bank was operating with a concentration in construction lending, management was effectively monitoring and managing this risk.

According to the December 2006 joint guidance entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, CRE lending, in general, and construction lending, in particular, may require a greater level of supervisory oversight. Although the guidance was not intended to limit financial institutions' CRE lending, the guidance states that an institution may be identified for further supervisory analysis of the level and nature of risk if it has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or

- 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.

The 2007 ROE noted that the bank continued to have substantial land and development concentrations but that management had effectively controlled the bank's credit risks. Given that the CRE/ADC loan concentrations (shown on page 6 of this report) far exceeded the supervisory criteria in the 2006 CRE guidance, additional examiner attention to the associated risks was warranted. For example, the CRE lending guidance emphasized that financial institutions should hold capital commensurate with the level and nature of the risk presented by CRE concentrations. An assessment of capital adequacy by the institution may have been warranted under these circumstances. In addition, the guidance reminds institutions that strong risk management practices are essential elements of a sound CRE lending program, particularly when an institution has a concentration in CRE/ADC loans. FDIC officials stated that examiners cautioned 1st Centennial's BOD and management in various ROEs regarding the risks associated with the bank's large CRE/ADC concentration.

By the April 2008 examination, FDIC examiners had determined that 1st Centennial's asset quality was deficient and had seriously deteriorated as of March 31, 2008 when adversely classified assets totaled $109.6 million and the ALLL needed to be increased by $6.0 million. Examiners determined that while the market negatively affected the institution, 1st Centennial's BOD and management's lack of controls and oversight of the CRE portfolio played an important part in the significant losses. Examiners determined that adversely classified assets were centered in the CRE/ADC loan portfolio with loan classifications comprising $101.9 million (93 percent) of the $109.6 million and OREO asset classifications comprising the remaining 7 percent. The $109.6 million of adversely classified assets represented 177.6 percent of 1st Centennial's Tier 1 Capital plus reserves ($61.7 million). The 2008 examination findings stand in sharp contrast to the 2007 and prior examination results.

The April 2008 ROE stated that the bank's capital had deteriorated to a level insufficient for the bank's high-risk profile. The *Risk Management Manual of Examination Policies* (Examination Manual) states that the "FDIC is not precluded from requiring an institution to maintain a higher capital level based on the institutions particular risk profile." We found no evidence prior to the 2008 examination that the FDIC had considered the deterioration of capital or the need to increase capital to support the bank's increased risk profile and the significant CRE/ADC and geographic concentration. In 2008, 1st Centennial responded to the capital insufficiency by stating that the bank planned to raise $30 million in capital by August 1, 2008 through an investment banking firm but was ultimately unsuccessful in generating the needed capital.

Although examiners identified and reported 1st Centennial's CRE/ADC loan concentration, including the types and extent; inadequate risk management controls; and inadequate loan underwriting and credit administration practices; additional supervisory action related to those risks was not taken until October 2008, as discussed in detail later in this section of this report.

Formal Enforcement Action Implementation

The FDIC pursued formal enforcement action after the June 20, 2008 meeting with 1st Centennial's BOD regarding the April 2008 examination because of the bank's deteriorated condition and composite 4 rating. However, the final ROE was not formally transmitted to the bank until August 13, 2008. San Francisco Regional Office (SFRO) officials explained that the delay in issuing the final ROE occurred because of staff assignments but that the SFRO had been in contact with 1st Centennial management during that period to discuss the examination findings and recommendations. For example, 1st Centennial senior management submitted a *Criticized Assets Action Plan* to the SFRO in response to the April 2008 examination findings and recommendations.

The FDIC and CDFI jointly pursued a Section 8(b) C&D and formally transmitted the proposed C&D to the bank on October 8, 2008. The proposed C&D required the bank, among other things, to:

- increase Tier 1 Capital by no less than $30 million;
- develop or revise, adopt, and implement a policy for determining the adequacy of the ALLL;
- develop or revise, adopt, and implement a written liquidity and funds management policy; and
- provide a plan to eliminate reliance on brokered deposits.

After conducting 5 weeks of negotiations with 1st Centennial management over the terms of the proposed C&D, bank management notified the FDIC on November 12, 2008 that it would not stipulate to the C&D. The FDIC then issued an NOC on November 14, 2008 that required a judicial hearing with a Federal Administrative Law Judge prior to becoming effective. The NOC contained a broad range of supervisory restrictions on bank operations that were similar to those contained in the proposed C&D. The NOC was still pending judicial review and adjudication when the bank failed on January 23, 2009.

Additional Supervisory Action

The CDFI started an independent examination of the bank on November 17, 2008 to review and assess 1st Centennial's construction loan portfolio to obtain up-to-date information needed to issue a C&D that would become effective on issuance. The FDIC joined the CDFI examination loan review and began a visitation on November 24, 2008, which was later to become a joint FDIC/CDFI visitation. The visitation reviewed the construction loan portfolio as of October 31, 2008 and resulted in examiners classifying $115.4 million in construction loans, which represented 55.4 percent of the bank's construction loan portfolio.

The SFRO staff met with 1st Centennial management along with CDFI and officials from the Board of Governors of the Federal Reserve System[7] on December 19, 2008 when bank management received a letter notifying the bank of downgrades in the CAMELS ratings, a PCA deficiency letter, and a capital demand letter. The downgrade letter downgraded the bank's composite and all component ratings to a 5 (critically deficient). The PCA deficiency letter notified bank management that 1st Centennial's capital category was *Critically Undercapitalized*. The capital demand letter informed the bank that $60 million in capital was required within 30 days and that an additional $18 million in capital was required within 60 days for a combined total of $78 million in additional capital.

Actions Taken Subsequent to 1st Centennial's Failure

The SFRO established a 2009 regional operational goal to ensure that enforcement actions are presented to the financial institution within 30 days of the examination completion date. The SFRO has also streamlined the process used to shorten the time needed to coordinate and issue a C&D with CDFI. Additionally, DSC has begun issuing an examination exit letter to 4 or 5 composite-rated institutions that they must notify the FDIC prior to any material change in their balance sheet to include large brokered deposit acquisitions. The SFRO has also taken steps to strengthen offsite monitoring of financial data by enhancing current offsite monitoring with reports that identify and rank institutions with characteristics that include concentrations and high levels of wholesale funding.

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[7] The Board of Governors of the Federal Reserve System provided regulatory supervision for the bank's holding company, 1st Centennial Bancorp.

IMPLEMENTATION OF PCA

Enforcement actions addressing 1st Centennial's capital deficiencies were taken in accordance with PCA capital-related provisions. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized.

The FDIC evaluated 1st Centennial's capital position and assigned a capital component rating of 2 in the 2006 and 2007 examinations, indicating a satisfactory capital level. Subsequently, the 2008 examination downgraded the bank's capital rating to a 4, indicating an insufficient level of capital for the bank's high-risk profile. Bank management indicated to examiners that it would raise $30 million in capital by August 1, 2008, but that effort never materialized. As a result, the FDIC proposed a C&D in October 2008 that contained several capital-related provisions even though the bank's reported PCA capital ratios had been in the W*ell Capitalized* range. These provisions included:

- maintaining Tier 1 Capital at, or in excess of, 11 percent of the bank's total assets;
- implementing a written profit plan; submitting to the FDIC and CDFI a written strategic plan and comprehensive budget; and,
- restricting the payment of dividends without prior written consent of the FDIC and CDFI.

As discussed earlier, the FDIC's attempt to issue a C&D to 1st Centennial was not timely, and the C&D was ultimately not issued. The bank was subsequently deemed *Adequately Capitalized* with the filing of the bank's September 30, 2008 *Report of Condition and Income* (Call Report). Accordingly, upon the bank's filing of its Call Report, the availability of brokered deposits became restricted.

Examiners concluded that the bank's capital was critically deficient based on information as of November 30, 2008. The FDIC submitted an interim downgrade letter to the bank, downgrading the capital rating to a 5 and categorizing the bank as *Critically Undercapitalized.* The FDIC formally notified the bank of this categorization in a PCA Notification Letter, dated December 19, 2008. The letter stated that the bank was subject to the mandatory requirements of section 38 of the FDI Act including, but not limited to, submission of a written capital restoration plan, restrictions on asset growth, and payments of dividends. Some of these requirements reiterated provisions included in the proposed C&D. On December 19, 2008, CDFI informed 1st Centennial that CDFI may take "extreme action against the bank" unless the bank merged with another institution, sold its business to another depository institution, or increased capital by $78 million. The bank was unsuccessful in accomplishing any of those actions and was subsequently closed January 23, 2009.

PCA's focus is on capital, and capital can be a trailing indicator of an institution's financial health. In addition, the use of PCA Directives can depend on the accuracy of capital ratios in a financial institution's Call Reports. 1st Centennial's reported capital ratios remained in the *Well Capitalized* to *Adequately Capitalized* range long after its operations had begun to deteriorate as noted in the April 2008 ROE.

CORPORATION COMMENTS AND OIG EVALUATION

On August 4, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 3 of this report. In its response, DSC noted that 1st Centennial's asset growth and concentration of CRE/ADC loans began in 2004 as a result of the expanding population in Southern California's Inland Empire where the bank's branch offices were located. DSC noted that when the bank began its concentration of CRE/ADC loans, it had strong capital levels and was well above the minimum levels of *Well Capitalized* for PCA purposes. The response further noted that FDIC examinations made specific recommendations to 1st Centennial's management for improving, monitoring, and analyzing the bank's loan concentrations.

DSC stated that 1st Centennial failed due to the risk embedded in its loan concentrations and funding strategies and due to a decline in the bank's local real estate market. The response further noted that the bank's recovery efforts from the loan losses were negatively affected by other market events that caused a large volume of deposit withdrawals and an upheaval in the secondary mortgage market. Further, DSC acknowledged that 1st Centennial's management had delayed the implementation of the C&D in 2008 through protracted negotiations and refusal to stipulate to the action. The OIG takes no exception to these comments.

The Director also stated that subsequent to 1st Centennial's failure, DSC (1) conducted an internal analysis, (2) has taken specific steps to limit growth that is funded by volatile non-core deposits, and (3) recognizes the threat that institutions with high-risk profiles, such as 1st Centennial's pose to the DIF.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted the audit from March to July 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it may not have been feasible to address certain aspects of the standards, as described on the next page.

Scope and Methodology

The scope of this audit included an analysis of 1st Centennial's operations from March 31, 2004 until its failure on January 23, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution from 2004 to 2009.

To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the FDIC and CDFI from 2004 to 2008.

- Reviewed the following:

  - Bank data and correspondence maintained at DSC's SFRO and Los Angeles North Field Office.

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

  - Records of the bank's external auditor.

  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in San Francisco, California.

  - DSC examiners in Los Angeles who participated in 1st Centennial examinations.

- Met with officials from the CDFI to discuss their historical perspective of the institution, its examinations, state banking laws, and other activities regarding the CDFI's supervision of the bank.

- We performed the audit field work at the DSC offices in Los Angeles and San Francisco, California.

Our ability to evaluate the adequacy of DSC supervisory efforts was restricted by the lack of FDIC examination work papers for the 2006 FDIC examination which resulted in a 2 composite rating for the bank. We were informed that the 2006 examination work papers had been destroyed prior to the commencement of our review. According to DSC, it was a common practice to destroy work papers for examinations that resulted in a 1 or 2 composite rating after a subsequent examination had been completed. Regional Directors Memorandum 01-039, *Guidelines for Examination Workpapers and Discretionary Use of Examination Documentation Modules*, dated September 25, 2001, and the Examination Manual notes that, with some exceptions, the retention of work papers beyond one examination is generally discouraged.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance With Laws and Regulations

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of 1st Centennial's management controls pertaining to its operations as discussed in the body of this report.

For purposes of the audit, we did not rely on computer-processed data to support our significant findings and conclusions. Our review centered on interviews, ROEs and correspondence, and other evidence to support our audit.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the

Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

GLOSSARY OF TERMS

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of loan.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
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 may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS

FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

August 4, 2009

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of 1st Centennial Bank, Redlands, California (Assignment No. 2009-019)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of 1st Centennial Bank (1st Centennial), which failed on January 23, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Audit Report received on July 20, 2009.

Beginning in 2004 1st Centennial pursued asset growth concentrated in commercial real estate/acquisition, development, and construction (CRE/ADC) loans, primarily as a result of expanding population in Southern California's Inland Empire. 1st Centennial's branches were located in the Inland Empire. Thus, its lending was concentrated in that geographic area. When 1st Centennial began holding notable CRE/ADC concentrations in 2004, its capital levels were strong and well above minimum levels to be "Well Capitalized" for Prompt Corrective Action purposes. FDIC examinations in 2004, 2006, and 2008 made specific recommendations to the Board for improving, monitoring and performing internal analyses of its concentrations, with a formal enforcement action recommended after the April 2008 examination. After protracted negotiations, 1st Centennial's Board refused to stipulate to the Cease and Desist Order, and the FDIC filed a Notice of Charges.

1st Centennial failed due to the risk embedded in its loan concentrations and funding strategies and due to a decline in its local real estate market. Recovery efforts were also significantly hampered by other market events that led to a large volume of deposit withdrawals and secondary mortgage market upheaval. DSC conducted an internal analysis following the failure of 1st Centennial and has taken specific steps to limit growth that is funded by volatile non-core deposits. We recognize the threat that institutions with high-risk profiles, such as 1st Centennial, pose to the Deposit Insurance Fund; and we continue to look for and implement improvements to our supervisory program.

Thank you for the opportunity to review and comment on the Draft Audit Report.

CHRONOLOGY OF SIGNIFICANT EVENTS

Date	Event
5-24-2004	Full-scope FDIC examination - UFIRS ratings were 2-2-2-2-2-2/2. 1st Centennial's overall financial condition was satisfactory.
1-31-2005	Full-scope CDFI examination - UFIRS ratings were 2-1-2-2-3-2/2. 1st Centennial was stated to be fundamentally sound.
4-24-2006	Full-scope FDIC examination - UFIRS ratings were 2-2-1-1-2-1/2. 1st Centennial's overall financial condition continued to be satisfactory. The bank used a limited amount of brokered deposits as a funding source.
2-26-2007	Full-scope CDFI examination - UFIRS ratings were 2-2-1-1-2-2/2. The condition of the bank was satisfactory.
4-7-2008	Full-scope FDIC examination - UFIRS ratings were 4-4-4-4-4-3/4. 1st Centennial needed to raise $30 million in capital by August 1, 2008.
5-22-2008	FDIC completed fieldwork on examination.
6-11-2008	FDIC held an exit meeting with 1st Centennial's management.
6-20-2008	FDIC held a meeting with 1st Centennial's BOD to discuss the ROE and that the FDIC/CDFI would propose a joint C&D based upon the weaknesses identified in the ROE.
8-8-2008	FDIC started daily liquidity monitoring.
8-13-2008	FDIC sent the April 2008 final ROE to 1st Centennial's BOD.
9-16-2008	Proposed C&D sent to CDFI for review.
9-30-2008	CDFI discussed C&D changes with the FDIC; 1st Centennial letter sent to the FDIC discussed setting up a meeting to discuss the bank's capital plan, loan portfolio, ALLL, and brokered deposits.
10-8-2008	Joint C&D sent to 1st Centennial.
10-28-2008	Proposed C&D language was negotiated between the FDIC and 1st Centennial.
10-31-2008	1st Centennial notified the FDIC that the bank's capital category would decline from *Well Capitalized* to *Adequately Capitalized* based on the filing of the September 30, 2008 Call Report.
11-12-2008	1st Centennial's management notified the FDIC that they would not stipulate to the proposed C&D; the FDIC commenced onsite liquidity monitoring.
11-14-2008	The FDIC issued the NOC to 1st Centennial.
11-17-2008	The CDFI began a full-scope examination of 1st Centennial which was later changed to a visitation.
11-24-2008	The FDIC started a visitation of 1st Centennial.
12-19-2008	Joint FDIC/CDFI interim downgrade letter sent to 1st Centennial based on November 30, 2008 financial data – UFIRS ratings were 5-5-5-5-5-5/5. The CDFI Capital Demand letter required the bank to raise $78 million in capital. The FDIC issued a *Critically Undercapitalized* PCA notification letter to the bank.
01-08-2009	1st Centennial forwarded the Capital Restoration Plan to the FDIC and CDFI.
01-23-2009	The CDFI closed 1st Centennial and appointed the FDIC as receiver.

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CDFI	California Department of Financial Institutions
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
MERIT	Maximum Efficiency, Risk Focused, Institution Targeted Guidelines
NOC	Notice of Charges
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
ROE	Report of Examination
SFR	Single-Family Residence
SFRO	San Francisco Regional Office
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institution Rating System