Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-11-006

Material Loss Review of Frontier Bank, Everett, Washington

December 2010

Office of Inspector General

Executive Summary

Material Loss Review of Frontier Bank, Everett, Washington,

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Why We Did The Audit

On April 30, 2010, the Washington Department of Financial Institutions (DFI) closed Frontier Bank (Frontier), Everett, Washington and named the FDIC as receiver. On June 2, 2010, the FDIC notified the Office of Inspector General (OIG) that Frontier's total assets at closing were $3.3 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $1.3 billion. As of September 3, 2010, the estimated loss to the DIF had decreased to $1.27 billion, or about 39 percent of the institution's total assets. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review (MLR) of the failure of Frontier.

The audit objectives were to (1) determine the causes of Frontier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Frontier, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. In addition, the OIG engaged KPMG LLP to review certain issues related to the bank's failure.

Background

Frontier, headquartered in Everett, Washington, was established as a state nonmember bank and insured in 1978. In 2002, citing efficiencies to be derived by having the bank and parent holding company supervised by the same regulator, the bank became a Federal Reserve member. The bank was 100 percent owned by Frontier Financial Corporation (FFC), a one-bank holding company. The parent company's stock was publicly traded and widely held, with directors and officers controlling less than 10 percent. In November 2005, citing a desire to be supervised locally, the institution reverted to a state nonmember bank. In 2006 and 2007, FFC acquired NorthStar Bank and the Bank of Salem, respectively, and merged them into Frontier.

Frontier operated 48 branches in western Washington and 3 in Oregon. The bank's main office was located in Snohomish County, Washington. More than half of the bank's total deposits were in Snohomish County, with the institution holding the highest market share in the county at more than 16 percent. The majority of Frontier's lending was in commercial real estate (CRE), with a particular focus on residential acquisition, development, and construction (ADC) loans. Frontier relied increasingly on Internet certificates of deposit, brokered deposits, and Federal Home Loan Bank borrowings to fund its loan growth.

Audit Results

Causes of Failure and Material Loss

Frontier's failure was attributed primarily to weak Board and management oversight of its high CRE and ADC loan concentrations. Specifically, the Board and management did not establish risk management practices commensurate with the risks associated with this lending, some of which involved speculative construction lending. Weak credit administration and loan underwriting practices contributed to the asset quality problems that developed when the bank's real estate lending markets deteriorated. Further, although the bank was considered *Well Capitalized* until March 20, 2009, capital levels did not support the risks associated with its high CRE and ADC concentrations.

As the economy and real estate market started to decline, the bank's loan losses and increases in the allowance for loan and lease losses eroded capital, weakened liquidity, and led to negative earnings. The holding company injected $5 million in capital during August 2008 but was unable to provide additional financial support for the bank or raise additional capital through other sources once the economy and real estate market declined. In addition, the bank increasingly relied upon potentially volatile non-core funding sources to support its loan growth. The DFI closed Frontier because the institution was unable to raise sufficient capital to support its operations.

The FDIC's Supervision of Frontier

The FDIC, in coordination with the DFI, provided ongoing supervisory oversight of Frontier through regular onsite risk management examinations and two visitations. Through its supervisory efforts, the FDIC identified key risks in Frontier's operations and brought these risks to the attention of the bank's Board and management through examination and visitation reports. Such risks included the institution's weak credit administration and loan underwriting practices, and reliance on potentially volatile funding sources. Further, examiners consistently reported that Frontier had concentrations in CRE and ADC loans and made recommendations related to establishing limits for and monitoring those concentrations. Examiners also reported apparent violations of laws and regulations and contraventions of statements of policy and guidance associated with the institution's lending practices. As a result of the 2008 examination, the FDIC and the DFI issued a Cease and Desist Order.

Although Frontier's financial performance was considered satisfactory at the time of the 2007 examination, in hindsight, a more proactive approach to the bank's risks and performance may have been warranted to address high concentrations in CRE and ADC loans, increased reliance on non-core funding to support growth, and weak credit administration and loan underwriting practices. Such an approach could have included lowering key supervisory ratings and pursuing informal action to obtain an earlier commitment from the Board to diversify the bank's loan portfolio, and/or requiring the bank to maintain higher capital levels commensurate with the risks associated with high CRE and ADC concentrations.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons it has learned from institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, reiterated broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations to its supervised institutions and examiners. The FDIC has also recently provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 2, 2010, the Director, DSC, provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of Frontier's failure. With regard to our assessment of the FDIC's supervision of Frontier, DSC's response discussed the number of examinations conducted between 2006 and 2010 described in our report. Further, DSC's response reiterated that the 2008 joint FDIC/DFI examination revealed that Frontier's condition was unsatisfactory with deficiencies of such magnitude that a composite "4" rating was assigned and a C&D issued. The 2009 examination concluded that asset quality had further deteriorated, operating losses were rapidly eroding capital, and liquidity was inadequate, and Frontier was downgraded to a composite "5" rating. Frontier was unable to raise capital from external sources to support its operations and remain viable.

DSC indicated that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations, such as Frontier, and referenced guidance that the division has issued to remind examiners to take appropriate actions when risks associated with those concentrations are imprudently managed. DSC also stated that supervisory guidance has been issued to enhance the division's supervision of institutions with concentrated CRE/ADC lending and reliance on volatile non-core funding.

Contents

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

Office of Material Loss Reviews
Office of Inspector General

DATE: December 2, 2010

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

/Signed/

FROM: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of Frontier Bank, Everett, Washington*
(Report No. MLR-11-006)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review of the failure of Frontier Bank, (Frontier), Everett, Washington. The Washington Department of Financial Institutions (DFI) closed the institution on April 30, 2010, and named the FDIC as receiver. On June 2, 2010, the FDIC notified the OIG that Frontier's total assets at closing were $3.3 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $1.3 billion. As of September 3, 2010, the estimated loss to the DIF had decreased to $1.27 billion, or about 39 percent of the institution's total assets.[1] The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

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. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review were to (1) determine the causes of Frontier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Frontier, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. In addition, the OIG engaged KPMG LLP (KPMG) to review certain issues related to the bank's failure.

[1] Frontier's estimated loss is the highest in the State of Washington, fourth highest of FDIC-supervised institutions that have failed and have resulted in a material loss from February 2007 to August 2010, and eighth highest of all banks that failed and resulted in a material loss from February 2007 through August 2010.

This report presents our analysis of Frontier's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[2]

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, otherwise known as the CAMELS ratings. Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

Frontier, headquartered in Everett, Washington, was established as a state nonmember bank and insured in 1978. In 2002, citing efficiencies to be derived by having the bank and parent holding company supervised by the same regulator, the bank became a Federal Reserve member. The bank was 100 percent owned by Frontier Financial Corporation (FFC), a one-bank holding company. The parent company's stock was publicly traded and widely held, with directors and officers controlling less than 10 percent. In November 2005, citing a desire to be supervised locally, the institution reverted to a state nonmember bank. In 2006 and 2007, FFC acquired NorthStar Bank and the Bank of Salem, respectively, and merged them into Frontier.[3]

Frontier operated 48 branches in western Washington and 3 in Oregon. The bank's main office was located in Snohomish County, Washington. More than half of the bank's total deposits were in Snohomish County, with the institution holding the highest market share in the county at more than 16 percent. The majority of Frontier's lending was in commercial real estate (CRE), with a particular focus on residential acquisition, development, and construction (ADC) loans. Frontier relied increasingly on Internet certificates of deposit (CDs), brokered deposits, and Federal Home Loan Bank (FHLB) borrowings to fund its loan growth. Table 1 provides details on Frontier's financial condition as of March 31, 2010 and for the 5 preceding calendar years.

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[2] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of our report.
[3] FDIC officials stated that loans from NorthStar Bank and the Bank of Salem did not have a negative impact on Frontier's loan portfolio.

Table 1: Selected Financial Information for Frontier, 2005 to 2010

Financial Measure ($000s)	Mar-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets	$3,250,734	$3,592,123	$4,099,493	$3,873,712	$3,156,353	$2,599,503
Total Loans	$2,670,113	$2,869,503	$3,778,733	$3,624,967	$2,921,304	$2,402,962
Total Deposits	$2,846,886	$3,125,495	$3,280,887	$2,943,389	$2,455,266	$2,061,785
Net Income (Loss)	$45,063	$285,595	$12,110	$75,946	$69,473	$52,091
FHLB Advances	$360,326	$375,479	$429,417	$469,761	$350,033	$248,000
Brokered Deposits	$315,180	$366,872	$561,038	$130,817	$44,940	$16,943
Past Due Ratio	25.16%	24.52%	11.49%	.57%	.30%	.21%
Total Risk-Based Capital/Risk Weighted Assets	1.09%	3.38%	10.60%	10.62%	11.92%	11.39%

Source: Uniform Bank Performance Reports (UBPR) for Frontier.

Causes of Failure and Material Loss

Frontier's failure was attributed primarily to weak Board and management oversight of the institution's high CRE and ADC loan concentrations. Specifically, the Board and management did not establish risk management practices commensurate with the risks associated with this lending, some of which involved speculative construction lending.[4] Weak credit administration and loan underwriting practices contributed to the asset quality problems that developed when the bank's real estate lending markets deteriorated. Further, although the bank was considered *Well Capitalized* until March 20, 2009, capital levels did not support the risks associated with its high CRE and ADC concentrations.

As the economy and real estate market started to decline, the bank's loan losses and increases in the allowance for loan and lease losses (ALLL) eroded capital, weakened liquidity, and led to negative earnings. The holding company injected $5 million in capital in August 2008 but was unable to provide additional financial support for the bank or raise additional capital through other sources once the economy and real estate market declined. In addition, the bank increasingly relied upon potentially volatile non-core funding sources to support its loan growth. The DFI closed Frontier on April 30, 2010 because the institution was unable to raise sufficient capital to support its operations.

[4] Speculative construction lending involves the financing of projects for which a buyer has not yet been identified.

Board and Management Oversight

The FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) states that the quality of an institution's management, including its Board and executive officers, is perhaps the single most important element in the successful operation of an institution. According to the Examination Manual, the Board has overall responsibility and authority for formulating sound policies and objectives for the institution and for effectively supervising the institution's affairs. Executive officers, such as the President and Chief Executive Officer and the Chief Lending Officer, have primary responsibility for managing the day-to-day operations and affairs of the bank.

Frontier's Board pursued growth and focused on CRE and ADC loans without establishing effective risk management practices commensurate with the risks associated with the resulting concentrations. As early as the 2005 examination, examiners cautioned the bank's management that the level of concentrations could pose risks to the bank, particularly if the bank's asset quality and capital deteriorated in the event of a downturn in property values or general economic conditions.

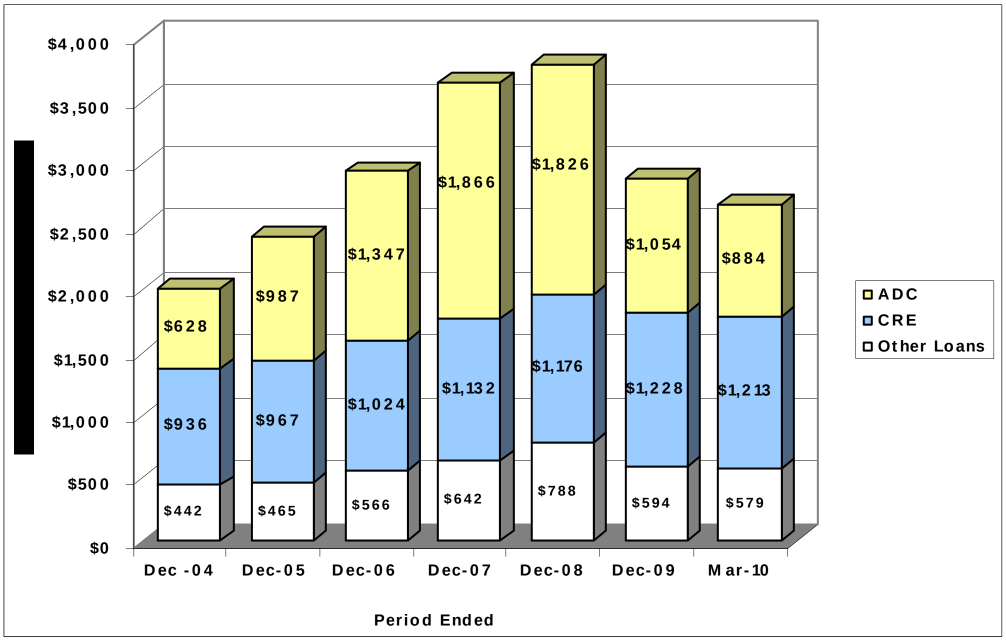
Frontier was cited for credit administration deficiencies at each examination from 2005 to 2009. In addition, the bank was cited for loan underwriting weaknesses in 2005, 2007, and 2008 and various violations of laws and regulations and contraventions of policy statements from 2006 to 2010. In particular, the bank was cited for appraisal violations at three examinations and one visitation and for contravention of policy statements regarding the ALLL at one examination and one visitation.

Other indications of bank management's pursuit of growth in spite of regulatory concerns were: (1) the bank's holding company was unsuccessful in completing an acquisition of another bank in 2008 because the FDIC had concerns with Frontier's consumer compliance program; and (2) Frontier's Board and management were still focusing on increasing the bank's lending operations in October 2008, despite the fact that, in August 2008, regulators had informed them that the bank's CAMELS component ratings and overall composite rating would be downgraded because of the bank's significant deterioration.

Concentrations in CRE and ADC Loans

Frontier's growth strategy led to concentrations in CRE and ADC loans, which ultimately caused the bank to fail. Frontier experienced significant asset growth—increasing from $2.2 billion at year-end 2004 to over $4 billion at year-end 2008. To fund the growth, Frontier became increasingly reliant on non-core funding sources, especially brokered deposits, which went from $8.3 million at year-end 2004 to over $734 million by the end of March 2009. During that same period, gross loans grew from approximately $2 billion at year-end 2004 to approximately $3.8 billion by the end of 2008. Figure 1 illustrates the general composition and growth of Frontier's loan portfolio in the years preceding the institution's failure.

Figure: Composition and Growth of Frontier's Loan Portfolio, 2004 to 2010



Source: OIG analysis of Consolidated Reports of Condition and Income (Call Reports) for Frontier.

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). Although the Joint Guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint Guidance, an institution that 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 may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

- Total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

As of December 31, 2007, Frontier's non-owner occupied CRE loans and ADC loans represented 754 percent and 469 percent, respectively, of the institution's total capital. This trend continued through December 2008 when non-owner occupied CRE loans and ADC loans represented 770 percent and 468 percent, respectively, of the institution's total capital. These levels are significantly higher than the criteria defined in the Joint Guidance as possibly warranting further supervisory analysis.

In addition, Frontier's concentrations in CRE and ADC loans were well above the institution's peer group[5] averages. Tables 2 and 3 illustrate the trend in the bank's CRE and ADC loan concentrations, respectively, relative to total capital and total loans, and as compared to the institution's peer group.

Table 2: Frontier's CRE Concentrations Compared to Peer Group*

Period Ended	CRE Loans as a Percent of Total Capital			CRE Loans as a Percent of Total Loans		
	Frontier	Peer Group	Frontier Percentile	Frontier	Peer Group	Frontier Percentile
Dec 2005	674%	360%	96	81%	48%	95
Dec 2006	659%	253%	98	81%	35%	97
Dec 2007	754%	284%	98	83%	38%	96
Dec 2008	770%	280%	97	79%	38%	96
Dec 2009	2,363%**	262%	99	80%	38%	98

Source: UBPR data for Frontier.
* Percentages for Frontier and peers include owner-occupied CRE.
**The CRE concentration percentage was high because capital had declined to an extremely low level, rather than because of asset growth.

Table 3: Frontier's ADC Concentrations Compared to Peer Group

Period Ended	ADC Loans as a Percent of Total Capital			ADC Loans as a Percent of Total Loans		
	Frontier	Peer Group	Frontier Percentile	Frontier	Peer Group	Frontier Percentile
Dec 2005	340%	107%	97	41%	14%	94
Dec 2006	374%	76%	97	46%	11%	97
Dec 2007	469%	96%	98	51%	13%	98
Dec 2008	468%	83%	98	48%	11%	98
Dec 2009	1,091%*	62%	99	37%	9%	98

Source: UBPR data for Frontier.
*The ADC concentration percentage was high because capital had declined to an extremely low level, rather than because of asset growth.

Inadequate risk management practices, coupled with the decline in the Seattle, Washington area real estate market in 2007, caused Frontier's CRE and ADC loan portfolios to deteriorate. Specifically, as borrowers defaulted on loans, the bank's other real estate owned (OREO)[6] increased from zero in 2005, to $10 million in 2008, to more than $191 million by March 2010.

From 2005 to 2007, Frontier's adversely classified assets were 19 percent, 13 percent, and 16 percent of Tier 1 Capital and reserves, respectively, and the past due and nonaccrual loans were less than 1 percent of total loans. Regulators considered these levels to be manageable and of limited supervisory concern. However, ADC lending

[5] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. Frontier's peer group included insured commercial banks having assets greater than $3 billion.
[6] OREO is property taken over by a bank through loan foreclosures.

involves a greater degree of risk than permanent financing for finished residences or commercial buildings. These risks generally include adverse changes in market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans. Indeed, the downturn in the economy and real estate market in late 2007 began to negatively impact the quality of Frontier's assets, particularly its ADC loan portfolio. As shown in Table 4, adversely classified assets grew significantly from 2008 to 2010, as did past-due and nonaccrual loans.

Table 4: Frontier's Adversely Classified Assets

Examination/Visitation Date	Adversely Classified Assets*	Past-Due and Nonaccrual Loans**
March 14, 2005	19%	0.9%
May 8, 2006	13%	0.3%
June 4, 2007	16%	0.5%
July 21, 2008	103%	4 %
March 23, 2009	188%	14%
August 3, 2009	360%	27%
January 11, 2010	558%	28%

Source: Examination Reports for Frontier.
*Ratio is a percentage of Tier 1 Capital and reserves.
**Ratio is a percentage of total loans.

Frontier's risk management practices for CRE and ADC lending did not evolve as the risk of the bank's portfolio increased. In that regard, from 2005 to 2009, examiners reported the following concerns with Frontier's credit risk management practices:

- In 2005, management had not implemented all of the CRE recommendations from prior examinations, as expected, and the CRE loan concentration risk remained a heightened concern, even with the sound quality of the CRE loan portfolio.

- In 2006, Frontier had the largest CRE concentration among Washington State chartered banks with assets over $1 billion, and ranked in the top 10 within the FDIC's San Francisco region. Examiners made recommendations to improve bank management's practices for monitoring and reporting concentrations. By 2007, concentration reporting had been enhanced, but the sophistication of monitoring and risk measurement systems was not commensurate with the complexity of the portfolio.

- In 2008, the bank's risk management practices relative to CRE and ADC lending were inadequate and not commensurate with the excessive concentration levels and troubled real estate market. By 2009, management improved monitoring of concentration risk in that (1) the Board had adopted new lower risk limits in January 2009, (2) management reduced the level of ADC loan commitments, and (3) the bank improved monitoring of the permanent CRE portfolio. However, the losses in the loan portfolio reflected continued erosion in property values, particularly land and residential lots.

Credit Administration and Loan Underwriting

According to the Examination Manual, the degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. Placing undue reliance upon a property's appraised value in lieu of an adequate initial assessment of a debtor's repayment ability is a potential mistake.

Examinations from 2005 to 2007 generally found Frontier's credit risk management practices to be adequate, although examiners made some recommendations to improve related controls. In particular, the June 2007 examination report noted that the bank's internal monitoring system was not commensurate with the complexity of the portfolio and that bank management should ensure that the credit support staff levels kept pace with the fast approval/high volume production environment. Examiners recommended, among other things, enhancements to the bank's: (1) documentation of material underwriting facts; (2) credit policy; and (3) ALLL methodology.

The July 2008 examination determined that Frontier's credit administration and risk management practices were grossly inadequate and required immediate attention. The majority of the loan problems were attributed to management's relaxed lending standards, a lack of emphasis being placed on secondary repayment sources, and a delayed recognition of problem loans. Although management had begun to recognize the severity of the asset quality problems, it had not been able to proactively identify and control significant risks.

FIL-22-2008, entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, dated March 17, 2008, recommends key risk management processes to help institutions with significant ADC and CRE concentrations manage through changes in market conditions, such as managing CRE loan portfolios closely and maintaining updated financial and analytical information. In spite of this additional guidance, Frontier failed to adequately improve the bank's credit risk management practices, and many of the weaknesses examiners identified in Frontier's credit risk management practices in the 2008 examination can be associated with one or more of the key risk management processes discussed in FIL-22-2008. Specifically,

- **Risk measurement information systems.** Various loan reports could not be reconciled to the system as of the loan review date, and system limitations did not allow for the tracking of project status by builder.

- **Nonaccrual loans.** A request for placing loans on nonaccrual was not acted upon in a timely manner.

- **Loan servicing.** Procedures were not uniform across branches, interest reserves were tracked on manual ledger cards rather than an automated system, a credible report identifying loans to one borrower did not exist, and workout responsibilities needed to be clarified among lending personnel and the special assets departments.

- **Borrower repayment.** The primary source of repayment was not materializing for many borrowers and bank management was looking to guarantors for repayment; however, global debt service calculations were not consistently in loan files and asset verification was limited.

At the August 2009 examination, examiners reported that Frontier's management had revised the bank's lending and collection policy. However, the revised policy did not: (1) specifically require current and complete financial information; (2) contain specific provisions requiring the Board to determine whether the lending staff had the expertise to properly supervise construction loans; or (3) contain specific provisions requiring the Board to determine that adequate procedures were in place to monitor any construction involved before funds were disbursed.

Allowance for Loan and Lease Losses (ALLL)

According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (Policy Statement on ALLL), the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. As a result, each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the ALLL.

Examinations from 2005 to 2007 generally found that Frontier's ALLL methodology and funding were satisfactory, but examiners made recommendations to enhance the methodology. The July 2008 examination report concluded that the ALLL was underfunded by at least $23 million, primarily as a result of increased adversely classified assets. Further, procedures for implementing Financial Accounting Standards (FAS) No.114[7] needed improvement, including providing a written justification for using list prices instead of current appraised values of loans.

The August 2009 examination and 2010 visitation reports stated the ALLL methodology needed strengthening, with the ALLL underfunded by $140 million and $30 million, respectively. Specifically, the 2010 visitation report stated that implementation of FAS No. 5[8] and FAS No. 114 requirements were flawed because outdated allocation factors were used and the fair value calculations were often based on appraisals over 6 months old, with no adjustments for changes in market value.

[7] FAS No. 114, Accounting by Creditors for Impairment of a Loan, is one of the principal sources of guidance on accounting for impairment in a loan portfolio under Generally Accepted Accounting Principles (GAAP).

[8] GAAP's FAS No. 5 provides accounting guidance for loss contingencies on a pool basis.

Table 5 provides a summary of the growth in Frontier's adversely classified items and corresponding increases in ALLL funding for examinations and visitations from March 2005 to January 2010.

Table 5: Frontier's Allowance for Loan and Lease Losses

Examination/ Visitation Date	Total Classified Assets	ALLL Computed By Frontier	Increase in ALLL Required by Examiners
(Dollars in Millions)			
March 14, 2005	$49,335	$30,500	0
May 8, 2006	$43,648	$38,730	0
June 4, 2007	$58,035	$41,755	0
July 21, 2008	$446,021	$78,722	$23,000
March 23, 2009	$861,975	$112,556	N/A*
August 3, 2009	$1,305,683	$ 98,582	$140,000
January 11, 2010	$1,203,800	$151,349	$30,000

Source: Examination reports and Call Reports for Frontier.
*The adequacy of the ALLL was not in the scope of the visitation.

As the loan portfolio deteriorated and the ALLL was appropriately funded, the bank's earnings and capital were negatively impacted. Specifically, Frontier's earnings decreased from $76 million, as of December 31, 2007; to negative $12 million as of December 31, 2008; and to negative $286 million, as of December 31, 2009.

Reliance on Non-Core Funding

In the years preceding its failure, Frontier became increasingly dependent on non-core funding sources to support loan growth and maintain adequate liquidity. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. According to the Examination Manual, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

As shown in Table 6, as early as 2004, Frontier began to increasingly rely on non-core, potentially volatile liabilities, including large time deposits, brokered deposits, and FHLB borrowings, to fund strong loan growth that had outpaced core deposits.

Table 6: Frontier's Funding Sources

Period Ended	Core Deposits ($000s)*	Time Deposits $100,000 or More ($000s)	Brokered Deposits ($000s)	FHLB Borrowings ($000s)
December 2004	$1,512,970	$283,472	$8,313	$175,088
December 2005	$1,590,058	$471,726	$16,943	$248,000
December 2006	$1,910,091	$545,173	$44,940	$350,033
December 2007	$2,111,016	$832,373	$130,817	$469,761
December 2008	$2,384,010	$896,878	$561,038	$429,417
December 2009	$2,294,988	$830,509	$366,872	$375,479

Source: UBPR data for Frontier.
*Core deposits may include some deposits of less than $100,000 obtained through the bank's use of an Internet listing service and brokered deposits representing time deposits of less than $100,000.

Examination reports from 2005 to 2007 indicated that Frontier's liquidity position was considered to be satisfactory, although examiners made recommendations to improve the bank's contingency liquidity plan at each of those examinations. The July 2008 Joint examination found that liquidity was unsatisfactory and funds management practices needed improvement. The bank had become increasingly reliant on noncore funding sources, with brokered deposits increasing by nearly 259 percent to $427 million, representing 13 percent of the bank's deposit base.

At the March 2009 visitation, liquidity levels were deficient. The bank's borrowing lines were restricted, and management could not accept or renew brokered deposits without a waiver from the FDIC. Other viable funding sources were limited to retail deposits, cash from loan payments and payoffs, the sale of assets, and/or external capital. In the August 2009 examination report, examiners stated that the bank's liquidity position was deficient and that the bank had essentially no borrowing capacity.

Capital Levels Commensurate with Risk Profile

From 2005 to 2007, Frontier's Capital component rating was a "2." During that timeframe, the bank's ADC concentrations were two to four times that of its peer group, and the CRE concentrations were significantly higher than its peer group. However, as shown in Table 7, the bank's Total Risk-Based Capital ratios were consistently below those of its peer group.

The Examination Manual states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed. In addition, the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for purposes of PCA. Had Frontier maintained higher capital ratios commensurate with its risk profile, the losses to the DIF may have been mitigated to some extent when the institution failed.

Table 7: Frontier's Total Risk-Based Capital Ratios Compared to Peers

	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Mar-10
	(Percent)					
Frontier	11.39	11.92	10.62	10.60	3.38	1.09
Peers	12.17	12.11	11.73	12.36	13.93	14.55

Source: UBPRs for Frontier.

While risk in Frontier's CRE and ADC loan portfolio increased significantly between 2005 and 2008, the institution's capital ratios did not increase proportionally to that risk. The 2008 examination report stated that capital was less than satisfactory and did not support the elevated risk profile of the institution. Examiners noted that the rapid deterioration within the loan portfolio clearly illustrated the elevated risk to capital and the concentration in real estate lending was of heightened regulatory concern, as this portfolio exhibited significant weaknesses.

The March 2009 visitation found that the bank's capital was insufficient to support the high level of credit risk and strained the bank's liquidity position. At the August 2009 examination, examiners recognized that, although management had worked diligently to raise additional capital, immediate financial assistance was needed for the bank to remain viable. Specifically,

- Frontier's management submitted a capital plan to the FDIC on April 20, 2009. The plan contained projections for three scenarios with financial projections: no additional capital; $115 million in additional capital; and $230 million in additional capital.

- On July 2, 2009, Frontier's management signed a merger and acquisition agreement with a private equity investor. The private equity investor submitted an application to become a bank holding company to the Federal Reserve Bank (FRB) of San Francisco. Due to unresolved issues, the application could not be approved by the October 10, 2009 agreement date.

The January 2010 visitation report stated that the bank's capital levels continued to shrink, which resulted in the bank falling to the *Critically Undercapitalized* capital category per the PCA provisions of Part 325 of the FDIC Rules and Regulations. Examiners stated that immediate assistance from shareholders or other external sources of financial support was required. However, Frontier's management was unable to raise the additional capital to support the bank's operations, and the bank was subsequently closed on April 30, 2010.

The FDIC's Supervision of Frontier

The FDIC, in coordination with the DFI, provided ongoing supervisory oversight of Frontier through regular onsite risk management examinations and two visitations. Through its supervisory efforts, the FDIC identified key risks in Frontier's operations and brought these risks to the attention of the bank's Board and management through examination and visitation reports. Such risks included the institution's weak credit administration and loan underwriting practices, and reliance on potentially volatile funding sources. Further, examiners consistently reported that Frontier had concentrations in CRE and ADC lending and made recommendations related to establishing limits for and monitoring those concentrations. Examiners also reported apparent violations of laws and regulations and contraventions of statements of policy and guidance associated with the institution's lending practices. As a result of the 2008 examination, the FDIC and the DFI issued a Cease and Desist (C&D).

Although Frontier's financial performance was considered satisfactory at the time of the 2007 examination, in hindsight, a more proactive approach to the bank's risks and performance may have been warranted to address high concentrations in CRE and ADC loans, increased reliance on non-core funding to support growth, and weak credit administration and loan underwriting practices. Such an approach could have included lowering key supervisory ratings and pursuing informal action to obtain an earlier commitment from the Board to diversify the bank's loan portfolio, and/or requiring the bank to maintain higher capital levels commensurate with the risks associated with high CRE and ADC concentrations.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons it has learned from institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, reiterated broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations to its supervised institutions and examiners. The FDIC has also recently provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

Supervisory History

From 2006 to 2010, the FDIC and the DFI conducted four examinations of Frontier.[9] In addition, the FDIC and the DFI conducted a joint visitation in March 2009, and the FDIC conducted a final visitation in January 2010. The FDIC and the DFI also pursued an enforcement action. Table 8 summarizes key supervisory information pertaining to these examinations, visitations, and enforcement action.

[9] The 2005 examination was conducted by the DFI and the FRB of San Francisco.

Table 8: Frontier's Examination History, 2005 to 2010

Examination/ Visitation Start Date (Exit Meeting Date)	Examination Visitation (Issuance Date)	Agency	Supervisory Ratings (UFIRS)	Contraventions and/or Violations	Supervisory Action
3-14-05 (4-25-05)	6-13-05	FRB-DFI	222122/2	None.	None.
5-8-06 (6-1-06)	6-29-06	FDIC-DFI	222122/2	✓	None.
6-4-07 (6-26-06)	7-24-07	FDIC-DFI	222121/2	✓	None.
7-21-08 (8-13-08)	12-22-08	FDIC-DFI	444343/4	✓	C & D**
3-23-09 (4-1-09)	7-30-09	FDIC-DFI	454453/4	Not Applicable*	Not Applicable***
8-3-09 (9-9-09)	12-30-09	FDIC-DFI	554554/5	✓	Monitored compliance with the C&D.
1-11-10 (2-5-10)	2-19-10	FDIC	CAMELS Composite 5 No Individual Component Ratings	✓	Continued to monitor compliance with the C&D.

Source: The FDIC's Virtual Supervisory Information on the Net (ViSION) and examination reports and associated transmittal letters for Frontier.
*The scope of the visitation did not include reviewing the bank's compliance with laws and regulations.
**Formal enforcement actions often take the form of C&Ds but under severe circumstances can also take the form of insurance termination proceedings. The C&D became effective on March 20, 2009.
***Since the C&D had been become effective 3 days prior to the start of the visitation, it was not assessed during the visitation.

The FDIC also conducted offsite monitoring of Frontier.[10] Specifically, Frontier appeared on the FDIC's offsite review list as of June 30, 2008 and again as of September 20, 2008 because of the bank's asset quality—both loan and total asset growth were above peer levels and the bank's past due ratio was approximately 4 percent. The resulting offsite reviews were ongoing while the July 21, 2008 examination process and report were being completed.[11] Frontier again appeared on the offsite review list as of June 30, 2009, a result of being included on the FDIC Washington Office's special report of institutions with potentially underfunded ALLLs. A review of the bank's ALLL was included in the joint examination, which began on August 3, 2009. Based on the serious

[10] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating system and the Growth Monitoring System. Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.
[11] The FDIC also prepared two Large Insured Depository Institution Program reports for Frontier that covered the 4th quarter of 2007 and the 1st quarter of 2008, respectively. Neither report identified any risks requiring immediate attention.

decline in the bank's condition at the July 2008 examination, the bank was "double-downgraded" in all CAMELS components and the composite rating, and the FDIC and DFI began pursuing a C&D for unsafe and unsound banking practices. The C&D became effective on March 20, 2009. Among other things, the C&D required the institution to:

- Retain qualified management and increase Board participation.

- Develop a capital plan and increase the bank's Tier 1 Capital in such an amount as to equal or exceed 10 percent of the bank's total assets, and thereafter maintain Tier 1 Capital in such an amount as to equal or exceed 10 percent of the bank's total assets.

- Develop or revise, adopt, and implement a comprehensive policy for determining the adequacy of the ALLL.

- Formulate a written plan to reduce the bank's risk exposure for each asset that was adversely classified.

- Revise, adopt, and implement written lending and collection polices to provide effective guidance and control over the bank's lending function.

- Revise the bank's Concentration Policy to limit concentrations in CRE and ADC loans.

- Develop or revise, adopt, and implement a written liquidity and funds management policy.

- Submit a plan to reduce the bank's reliance on non-core funding sources, including brokered deposits and borrowings, and reduce the bank's non-core funding dependency ratio.

Supervisory Response to Key Risks

Frontier had been considered a well-performing institution and received composite "2" supervisory ratings from 2005 through 2007. Examiners identified key risks and made recommendations to address certain of those risks at each examination. Such risks included the bank's significant concentrations in CRE and ADC lending, credit administration and loan underwriting weaknesses, and increased reliance on non-core funding. For the 2005 through 2007 examinations, regulators requested that bank management provide written responses to examiner recommendations, and, as a result, follow-up occurred at the next regularly-scheduled examination. Following deterioration of the bank's financial condition, examiners downgraded the bank in 2008 and took formal action in 2009 to address various unsafe and unsound practices. In hindsight, however, a more proactive approach to the bank's risks and performance in 2007 may have been prudent.

2005 Supervisory Activities

Prior to converting to a state nonmember bank, and having the FDIC as its primary federal regulator, Frontier was subject to an examination conducted jointly by the FRB and DFI. At that examination, FRB and DFI examiners found that the bank's financial condition remained sound, given the bank's strong and stable earnings performance and satisfactory and improving asset quality. The bank's liquidity also remained satisfactory although liquidity risk was rising to a moderate level since the last examination as reliance on non-core funding to support loan growth slightly increased. In addition, examiners highlighted the bank's somewhat liberal underwriting practices that were contrary to the bank's loan policy. Further, examiners noted that the bank's internal control structure and risk management practices often resembled those of a smaller community bank, rather than those of a $2 billion regional bank with moderate growth objectives. Examiners also expressed heightened concern with the bank's sizeable CRE concentration and corresponding risk management practices and made the following recommendations to improve monitoring of that concentration:

- Strategic and capital planning processes should be enhanced to consider the CRE loan concentration risk.

- Formal guidelines for performing annual updates on term CRE loans should be established.

- CRE loan concentration limits should be established as a percent of capital.

- Management should establish stress testing guidelines for variable rate term CRE loans to measure the exposure to cash flow from changes in vacancy and interest rates.

Capital was considered to be satisfactory given the risk of the institution. However, we noted that the bank's CRE and ADC concentrations were nearly double and triple those of its peer group, respectively, while the bank's Total Risk-Based Capital level was lower than that of the bank's peer group.

2006 Supervisory Activities

At the 2006 examination, examiners found that the bank's overall condition was satisfactory, with asset quality and credit risk management practices adequate as adverse classification ratios declined. Liquidity and funds management practices were considered satisfactory, although funding of significant loan growth through large CDs and long-term FHLB advances had caused liquidity to decrease. However, examiners did recommend that management:

- Enhance and expand concentration monitoring.

- Correct apparent appraisal violations and real estate lending practice contraventions and improve associated policies and procedures.

- Improve real estate appraisal/evaluation procedures.

- Address the repeat recommendations on liquidity contingency planning.

Capital was considered to be satisfactory given the risk of the institution. However, we noted that the bank's CRE and ADC concentrations remained double and triple those of its peer group, respectively, while the bank's Total Risk-Based Capital level continued to be lower than that of the bank's peer group.

In addition, we noted that since the last examination, loans had grown from approximately $2 billion to approximately $2.7 billion (a 35-percent increase) with ADC loans increasing from approximately $628 million to over $1.1 billion (an 80-percent increase). Further, brokered deposits increased from $8.3 million to over $25 million (a 201-percent increase).

<u>2007 Supervisory Activities</u>

Examiners found Frontier's overall condition and asset quality to be satisfactory at the 2007 examination with strong earnings, sensitivity to market risk well-controlled, and sufficient liquidity management. However, the bank had increased its reliance on FHLB borrowings and brokered deposits, and adversely classified assets had slightly increased.

Examiners did recommend improvements related to the bank's: (1) credit administration and loan underwriting; (2) credit support staffing levels to permit documentation of underwriting and concise monitoring updates; (3) liquidity contingency planning, a repeat recommendation from the 2005 and 2006 examinations; (4) real estate concentration measurement and monitoring capability, which did not sufficiently demonstrate assumed risk or direction of risk; (5) credit policy; and (6) ALLL methodology.

Further, with respect to the CRE concentrations, examiners stated that:

- The Strategic Plan should be expanded to address CRE concentration rationale relative to overall growth objectives and financial targets.

- Concentrations contingency planning as expressed in the capital plan should be supported by periodic assessment of marketability of the portfolio, including an evaluation of the institution's capacity to access the secondary market and comparison of internal underwriting standards with those of the secondary market.

- The internal monitoring system was not commensurate with the complexity of the portfolio.

- Credit risk constituted the primary liquidity risk, given the tight on-balance sheet liquidity and a highly “loaned up” position maintained at or near 120 percent of total deposits.

Although capital was considered to be sufficient to support the institution’s risk profile, we noted that Frontier’s Total Risk-Based Capital was lower than that of the bank’s peer group, while Frontier’s CRE and ADC concentrations were significantly higher than those of the peer group.

In addition, since the 2006 examination, loans had grown from approximately $2.7 billion to over $3 billion (a 13-percent increase), with ADC loans increasing from approximately $1.1 billion to over $1.4 billion (a 28-percent increase). During that same timeframe, brokered deposits increased from just over $25 million to approximately $84 million (236-percent increase).

<u>2008 Supervisory Activities</u>

Examiners identified rapid deterioration in Frontier’s condition, with poor asset quality and the level of adversely classified assets being unacceptability high, having increased seven-fold since the previous examination and representing 102 percent of Tier 1 Capital and ALLL. Credit administration and risk management practices were grossly inadequate, with examiners noting that the credit review function reported directly to the Chief Credit Officer, which was a potential conflict of interest. Capital and liquidity levels were unsatisfactory, and earnings needed improvement. Examiners stated that CRE concentrations continued to be very high and should be reduced.

The proposed ratings were 343332/3, and the DFI and FDIC met with bank management on August 13, 2008 to discuss the tentative findings. The examination report was submitted to the SFRO for review on August 25, 2008. As is generally the case for institutions with proposed composite ratings of “3”, the SFRO received a recommendation for informal action in the form of a memorandum of understanding (MOU) from the examination team. Meanwhile, economic conditions were reportedly causing further deterioration of the bank's condition, complicating various matters of concern, and making it even more critical to determine the appropriate supervisory response. After extended consultation with the DFI, the final examination report was issued on December 22, 2008. In comparison to the 2007 examination report, the 2008 final examination report reflected a “double-downgrade” to a composite “4” and “double-downgrades” in all of the CAMELS components to 444343.

The FDIC also began pursuing a C&D on December 11, 2008 and started weekly monitoring of Frontier’s liquidity on December 19, 2008. The C&D became effective on March 20, 2009, 3 months after the final 2008 examination report was issued. By that time, the bank had further deteriorated, with capital declining, past due and non-accrual ADC loans increasing from slightly more than 6 percent to over 35 percent, brokered deposits more than doubling from $354 million to over $734 million, and net income declining from approximately 1 percent to a negative 3 percent. Further, as the bank foreclosed on loans, the bank's OREO went from $3.7 million to approximately $19 million.

FDIC officials indicated that a C&D is an effective tool if issued when the risks are emerging. In the case of Frontier, the effectiveness of the C&D was limited because the risks were already embedded in the institution. FDIC officials stated that the FDIC could have been more proactive in recognizing the risks that were building at earlier examinations. In that regard, as discussed previously, examiners identified risks and deficiencies during the 2006 and 2007 examinations and recommended actions to address them. However, earlier supervisory action aimed at securing more comprehensive corrective action in key areas may have been warranted in connection with the 2007 examination, considering that Frontier had the highest CRE and ADC concentrations in Washington and the bank's capital levels were lower than those of its peer group when the examination was conducted. Further, we noted that most of the provisions in the March 2009 C&D were generally related to risks and deficiencies that had been identified in those two prior examinations.

2009 Supervisory Activities

A limited scope joint visitation was conducted in March 2009 to assess Frontier's financial condition. Examiners reported that the bank's overall condition continued to deteriorate. Liquidity was deficient, as available funding sources were limited to on-balance sheet liquidity. Asset quality was also critically deficient. An excessive level of non-current and past due loans centered in the ADC portfolio contributed to the growing volume of internally classified loans. Earnings performance and capital were unsatisfactory, given the high risk profile of the loan portfolio. As a result, the Asset Quality and Liquidity components were further downgraded to a "5".

Examiners also reported that, in December 2008, Frontier made changes to its Board and senior executive team, with a new Chairman of the Board, a new CEO, and a new President. Further, bank management formed the Special Assets Group (SAG) to handle and manage the growing number of internally classified loans supported by 22 full-time employees, which increased to 34 at this visitation.

In August 2009, a full-scope joint examination was conducted. Examiners reported that Frontier's overall condition had continued to deteriorate since the last examination, even though management had made significant progress by: (1) forming the SAG to resolve problem credits, (2) restructuring the credit review function, and (3) identifying cost savings. Nevertheless, examiners stated that the level of problem assets was "objectionably" high and threatened the institution's viability; capital protection was insufficient for the high risk profile of the bank; operating losses were rapidly eroding capital levels; liquidity was inadequate due to the high level of nonearning assets, reliance on non-core funding sources, and limited borrowing capacity; and sensitivity to market risk was unsatisfactory due to limited capital support and negative earnings. Examiners noted that, although management had worked diligently toward raising additional capital, immediate financial assistance was needed for the bank to remain viable. The Capital and Earnings components were further downgraded to a “5” and Sensitivity to Market Risk was further downgraded to a “4”.

2010 Supervisory Activities

The FDIC conducted a final visitation in January 2010 that focused on asset quality, the adequacy of the ALLL, and capital levels. Examiners stated in the visitation report that capital levels continued to shrink and the bank fell into the *Critically Undercapitalized* capital category per the PCA provisions of Part 325 of the FDIC Rules and Regulations. The level of adversely classified assets remained substantial and threatened the institution’s viability, and necessary loan loss reserve provisions remained high as did the level of non-earning assets. As a result, capital levels had shrunk significantly, and the ability to absorb even moderate losses was severely limited.

Supervisory Lessons Learned

DSC’s Examination Manual and the FDIC’s *Formal and Informal Actions Procedures Manual* include provisions for examiners to make formal recommendations or initiate formal or informal enforcement actions designed to address and correct identified weaknesses in a bank’s financial condition, performance, risk management practices, or regulatory compliance. Examination recommendations are intended to improve the bank’s safety and soundness practices, and examiners should obtain affirmative commitments from the bank’s management and its Board to correct problems and weaknesses. The Examination Manual also includes a provision that examiners should consider management’s responses to previous regulatory and auditor recommendations when assigning the management rating. The Examination Manual further states that

> …to effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking…when corrective action is not taken until conditions have deteriorated it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

In retrospect, Frontier’s risk profile was increasing by the 2007 examination, and a more proactive supervisory approach may have been warranted at that time. Specifically, greater emphasis on emerging risks, risk management practices, and management’s responsiveness to prior recommendations would have been prudent when assigning ratings. To that end, downgrades in the Management, Asset Quality, and/or Capital component ratings, along with a downgrade in the composite rating, could have led to an informal action — either a bank board resolution or an MOU — and provided the FDIC with a better means to obtain Frontier’s commitment to improve: (1) monitoring of the CRE concentration risks; (2) credit administration and loan underwriting practices; and (3) liquidity contingency planning, all of which proved to be key factors in the bank’s eventual failure in 2010.

On January 26, 2010, the FDIC issued guidance to its examiners that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed.[12] Specifically, the guidance defines a standard approach for communicating matters requiring Board attention (MRBA) (e.g., examiner concerns and recommendations) in examination reports. The guidance also states that examination staff should request a response from the institution regarding the actions that it will take to mitigate the risks identified during the examination and correct noted deficiencies. In addition, regional management should ensure: (1) MRBA items are addressed in the letter transmitting the examination report to the bank and (2) bank responses are appropriate and address supervisory concerns. Finally, the institution should provide periodic progress reports for MRBA items that may require more time to correct or implement.

With respect to the bank's doubling its brokered deposits while the 2008 examination report was being processed and the C&D was being issued, in February 2009, the FDIC began issuing "Dear CEO" letters to banks that were likely to be downgraded to a composite "4" or "5" and in some cases a "3."[13] The letter states that banks are required to obtain a non-objection from the FDIC Regional Director before engaging in any transactions that would materially change the balance sheet composition, including growth in total assets of 5 percent or more or significant changes in funding sources, such as by [if applicable] increasing brokered deposits or volatile funding. These are interim requirements until the Report of Examination and any corrective program are finalized.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved. Based on the supervisory actions taken with respect to Frontier Bank, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

Frontier was considered *Well Capitalized* for PCA purposes until March 20, 2009. The bank fell to *Adequately Capitalized* at that time as a result of the issuance of a joint C&D that contained a capital provision directing Frontier to increase its Tier 1 Capital "in such

[12] DSC Regional Directors Memorandum, entitled, *Matters Requiring Board Attention* (Transmittal No. 2010-003).
[13] The formal/official guidance related to the CEO letter was issued in September 2009 and was officially announced in the September 2009, RD Memorandum/Transmittal No. 2009-042, entitled, *Issuing Examination Letters to Troubled Institutions*.

an amount as to equal or exceed 10 percent" of the bank's total assets.[14] Section 325.103 of the FDIC Rules and Regulations states that a bank is deemed *Well Capitalized* if it meets or exceeds the capital ratios defined in the section and is not subject to a written agreement, order, capital directive, or prompt corrective action directive issued by the FDIC pursuant to Section 8 of the FDI Act.[15] As an *Adequately Capitalized* institution, Frontier was restricted from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC.[16] The C&D further stated that the level of Tier 1 Capital to be maintained during the life of the Order would be in addition to a fully funded ALLL. Table 10 illustrates Frontier Bank's capital levels relative to the PCA thresholds for *Well Capitalized* institutions for the quarters ending December 31, 2008 through March 31, 2010.

Table 9: Frontier's Capital Levels

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well-Capitalized Thresholds	**5 percent or more**	**6 percent or more**	**10 percent or more**	
Frontier's Capital Levels				
12/31/08	8.53	9.32	10.60	*Well Capitalized*
3/31/09	7.37	8.85	10.13	*Adequately Capitalized**
6/30/09	6.49	7.86	9.13	*Adequately Capitalized**
9/30/09	3.19	4.06	5.35	*Significantly Undercapitalized*
12/31/09	1.65	2.09	3.38	*Critically Undercapitalized*
3/31/10	.43	.54	1.09	*Critically Undercapitalized*

Source: UBPRs for Frontier.

* Frontier's capital category was lowered to *Adequately Capitalized* as of the March 20, 2009 C&D.

On December 2, 2009, the FDIC notified Frontier that it was *Significantly Undercapitalized* based on the institution's September 30, 2009 Call Report data. Further, the FDIC informed Frontier that, as of September 30, 2009, it was subject to the mandatory requirements of section 38, including submission of a capital plan and restrictions on asset growth, acquisitions, new activities, new branches, payment of dividends, or making other capital distributions, management fees, or senior executive compensation. Frontier submitted a capital plan on January 15, 2010, and the FDIC notified the bank on February 11, 2010, that the plan was inadequate.

[14] The FDIC did not formally notify Frontier of its new PCA category because FDIC policy does not require written notification to institutions when they fall to *Adequately Capitalized*. FDIC policy does require written notification to institutions when they fall to *Undercapitalized*, *Significantly Undercapitalized*, or *Critically Undercapitalized*.

[15] The minimum capital ratios defined in Section 325.103 for *Well Capitalized* institutions are: (1) total risk based capital of 10 percent or higher; (2) Tier 1 risk-based capital of 6 percent or higher; and (3) leverage capital of 5 percent or greater. Actions under Section 8 of the FDI Act constitute formal proceedings against respondents.

[16] FDIC officials stated that Frontier's management did not apply for a brokered deposit waiver.

On February 19, 2010, the FDIC notified Frontier that it was *Critically Undercapitalized* based on the January 11, 2010 visitation. The FDIC also informed Frontier that because the bank had not submitted an acceptable capital restoration plan, the bank became subject to the mandatory requirements of Section 38 on February 11, 2010, which included the submission of a capital restoration plan and restrictions on asset growth, acquisitions, new activities, and payment of dividends. The FDIC issued a Supervisory PCA Directive on March 16, 2010, requiring bank management to, among other things, recapitalize the bank within 30 days; refrain from obtaining, renewing, or rolling over any brokered deposits; and restrict the interest rates that the bank paid on deposits.

On October 22, 2008, Frontier applied for $116 million in funds under the Troubled Asset Relief Program (TARP).[17] Frontier withdrew its application on May 28, 2009. As previously mentioned, Frontier's management signed a merger and acquisition agreement with a private equity investor in July 2009. The private equity investor submitted an application to become a bank holding company to the FRB, San Francisco. However, due to unresolved issues, the application could not be approved by the October 10, 2009 deadline. The institution failed on April 30, 2010.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On December 2, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Frontier's failure. With regard to our assessment of the FDIC's supervision of Frontier, DSC's response discussed the number of examinations conducted between 2006 and 2010 described in our report. Further, DSC's response reiterated that the 2008 joint FDIC/DFI examination revealed that Frontier's condition was unsatisfactory with deficiencies of such magnitude that a composite "4" rating was assigned and a C&D issued. The 2009 examination concluded that asset quality had further deteriorated, operating losses were rapidly eroding capital, and liquidity was inadequate, and Frontier was downgraded to a composite "5" rating. Frontier was unable to raise capital from external sources to support its operations and remain viable.

DSC indicated that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations, such as Frontier, and referenced guidance that the division has issued to remind examiners to take appropriate actions when risks associated with those concentrations are imprudently managed. DSC also stated that supervisory guidance has been issued to enhance the division's supervision of institutions with concentrated CRE/ADC lending and reliance on volatile non-core funding.

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[17] TARP was established under the Emergency Economic Stabilization Act of 2008. The Act established the Office of Financial Stability within the United States Department of the Treasury (Treasury). Under TARP, Treasury will purchase up to $250 billion of senior preferred shares from qualifying institutions as part of the Capital Purchase Program.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the DIF incurs a material loss with respect to an insured depository institution, 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 Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. 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 this performance audit from September 2010 to November 2010 in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of Frontier's operations from 2005 until its failure on April 30, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination reports prepared by FDIC, DFI, and FRB examiners from 2005 to 2010.

- Reviewed the following:

    - Bank data contained in UBPRs and Call Reports.

    - Correspondence files from DSC's SFRO and Seattle Field Office.

    - Select examination workpapers related to loans.

Objectives, Scope, and Methodology

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

  - Pertinent DSC policies and procedures and various banking laws and regulations.

- DSC's ViSION Modules, including Supervisory Tracking & Reporting.

We also interviewed FDIC Regional Office and Field Office officials responsible for supervisory oversight of Frontier.

We engaged KPMG to perform audit procedures designed to assess the bank's credit risk management practices and use of brokered deposits, as well as to assess the FDIC's supervisory response to risks in those areas. As part of its audit work, KPMG reviewed a non-statistical sample of 10 borrower relationships to determine if the FDIC had reviewed and classified borrower loans as appropriate. Specifically, KPMG reviewed the examination report loan write-up, loan line sheet, and other loan-related documentation and any relevant loan records that may have been retained by DRR and determined for the sampled loans whether:

- the examiners adequately assessed their collectability and assigned a classification to the loans, when appropriate;

- any impairment calculated by the examiners was properly reflected in the examiners' ALLL analysis;

- any loan underwriting or credit administration weaknesses identified were consistent with the credit risk management weaknesses and conclusions documented in the examination report; and

- Frontier management identified losses for each loan within the sample (and related Other Real Estate) and reflected those losses in the bank's ALLL analysis in a timely manner.

KPMG conducted its work in accordance with GAGAS.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand Frontier's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

Objectives, Scope, and Methodology

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including reports of examination, correspondence files, and testimonial evidence to corroborate data obtained from systems that was used to support our audit conclusions.

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.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and providing interim financing for residential or commercial structures.
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)	The ALLL 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. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	The report filed by a bank pursuant to 12 United States Code (U.S.C.) 1817(a)(1), which requires each insured State nonmember bank and each foreign bank having an insured branch which is not a Federal branch to make to the Corporation reports of condition in a form that shall contain such information as the Board of Directors may require. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
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.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 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.

Glossary of 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.
FDIC's Supervision Program	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 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.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Memorandum of Understanding (MOU)	An informal corrective administrative action for institutions considered to be of supervisory concern but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, this action is to be considered for all institutions rated a composite "3".
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
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 Deposit Insurance Fund. Part 325, subpart B, 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 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. 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.

Glossary of Terms

Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Tier 1 (Core) Capital	In general, this term is defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in financial subsidiaries subject to section 12 C.F.R. part 362; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.
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 data reported in Reports of Condition and Income submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
CRE	Commercial Real Estate
DFI	Department of Financial Institutions
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
FRB	Federal Reserve Board
GAAP	Generally Accepted Accounting Principles
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
ROE	Report of Examination
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

FDIC

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

December 1, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson [signed by Sandra L. Thompson]
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Frontier Bank, Everett, Washington (Assignment 2010-072)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a Material Loss Review of Frontier Bank (Frontier), which failed on April 30, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on November 3, 2010.

Frontier failed primarily because of the Board's and management's decision to concentrate the loan portfolio in commercial real estate (CRE) and acquisition, development and construction (ADC) loans, and its failure to implement prudent risk management practices necessary to monitor and manage the portfolio. Frontier's capital levels did not support the risks associated with its high CRE and ADC concentrations. Additionally, Frontier relied heavily on volatile funding sources, including brokered deposits and FHLB borrowings, which contributed to its liquidity problems and subsequent failure.

From 2006 to 2010, the FDIC and the Washington Department of Financial Institutions (DFI) provided ongoing supervisory oversight of Frontier with four on-site risk management examinations, supplemented by two on-site visitations. The 2008 joint examination revealed the condition of Frontier was unsatisfactory with deficiencies of such magnitude that a composite "4" rating was assigned and a Cease and Desist order issued. The 2009 examination concluded asset quality had further deteriorated, operating losses were rapidly eroding capital, and liquidity was inadequate. Frontier was further downgraded to a composite "5" rating. Frontier was unable to raise capital from external sources to support its operations and remain viable.

We recognize that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations, such as Frontier, and we have updated guidance reminding examiners to take appropriate actions when those risks are imprudently managed. DSC issued a Financial Institution Letter (FIL) to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. Additionally, DSC issued a FIL in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance our supervision of institutions with concentrated CRE/ADC lending and reliance on volatile non-core funding.

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