Office of Inspector General

Office of Audits
Report No. AUD-11-013

Material Loss Review of FirsTier Bank, Louisville, Colorado

August 2011

Office of Inspector General

Executive Summary

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Why We Did The Audit

On January 28, 2011, the Colorado Division of Banking (CDB) closed FirsTier Bank (FirsTier), Louisville, Colorado, and the FDIC was appointed receiver. On February 24, 2011, the FDIC notified the Office of Inspector General (OIG) that FirsTier's total assets at closing were $808 million and the estimated loss to the Deposit Insurance Fund (DIF) was $243 million. As of June 30, 2011, the estimated loss had decreased to $225 million. 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 of the failure of FirsTier.

The objectives of the review were to (1) determine the causes of FirsTier's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of FirsTier, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

FirsTier was a state-chartered, nonmember bank headquartered in Louisville, Colorado, which is located approximately 20 miles northwest of Denver. The institution opened in November 2003 after receiving regulatory approval to purchase certain assets and liabilities of the Louisville, Colorado, branch of Enterprise Bank, N.A., of Omaha, Nebraska. FirsTier was wholly owned by the FirsTier Bancorp, Inc., a one-bank holding company. The bank, and its affiliate, FirsTier Bank of Kimball, Nebraska, formed a chain banking organization that was under the control of one family. In addition to its main office in Louisville, the institution operated eight branches in Colorado.

The organizers of FirsTier previously operated another bank under the same name in Northglenn, Colorado (referred to herein as the former FirsTier Bank—FFTB). FFTB and an affiliate bank in Nebraska were sold to Compass Bank, Birmingham, Alabama, in 2001. The last safety and soundness examination of FFTB, conducted jointly by the FDIC and CDB, identified significant management weaknesses, including rapid asset growth without adequate policies and procedures, a high concentration in real estate construction and land development loans, and apparent regulatory violations. As part of the sales agreement with Compass Bank, the organizers of FFTB signed a 2-year non-compete agreement. After the agreement expired, FirsTier was formed.

FirsTier's lending activities focused on commercial real estate (CRE), with a particular emphasis on residential acquisition, development, and construction (ADC) projects. The institution used Internet certificates of deposits (CD), and, beginning in 2008, brokered deposits and Federal Home Loan Bank advances, to support loan growth and the bank's operations.

Audit Results

Causes of Failure and Material Loss

FirsTier failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the bank's rapid growth and heavy concentration in ADC loans. Soon after it opened, FirsTier departed from the business plan projections it submitted with its application for federal deposit insurance by embarking on a rapid growth strategy centered in ADC lending. FirsTier's management continued to deviate from the bank's business plans in subsequent years. By the close of 2006, more than half of FirsTier's $236 million loan portfolio consisted of ADC loans, representing 463 percent of the bank's total capital. This exposure made the institution vulnerable to a sharp downturn in the Colorado real estate market. Adding to this vulnerability was a general decline in the institution's capital levels from 2004 to 2008, when risk in the loan portfolio was increasing.

Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in FirsTier's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. Further, FirsTier relied on non-core funding sources, particularly Internet CDs and brokered deposits, to support loan growth and the bank's operations. These funding sources became restricted when FirsTier's credit risk profile deteriorated, straining the institution's liquidity position. The CDB closed FirsTier on January 28, 2011 because the institution was insolvent and was unable to raise sufficient capital to support its operations.

The FDIC's Supervision of FirsTier

The FDIC, in coordination with the CDB, provided ongoing supervisory oversight of FirsTier through regular onsite risk management examinations, visitations, and offsite monitoring activities. In addition, because FirsTier was a newly chartered institution, it was subject to annual examinations during the first 3 years of operation. Through its supervisory efforts, the FDIC identified key risks in FirsTier's operations and brought these risks to the attention of the institution's Board and management. Such risks included the bank's significant concentration in ADC loans, weak loan underwriting and credit administration practices, reliance on non-core funding sources, and the need for higher capital levels. Additionally, the FDIC and the CDB made numerous recommendations for improvement and issued an enforcement action to address the institution's rapidly deteriorating financial condition and weak risk management practices.

On August 28, 2009, the FDIC issued Financial Institution Letter (FIL)-50-2009, entitled *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*. The FIL, which is based on the perspectives gained from the recent banking crisis, states that a number of newly insured institutions pursued changes in their business plans during the first few years of operation that led to increased risk and financial problems where accompanying controls and risk management practices were inadequate. Common risks cited in the FIL include rapid growth, over-reliance on volatile funding, concentrations without compensating management controls, and significant deviations from approved business plans. In the case of FirsTier, the bank materially deviated from its approved business plan soon after it opened by embarking on a rapid growth strategy centered in risky ADC lending and supported by potentially volatile funding. Examiners promptly identified the deviation and requested that management revise the plan. However, the revised plan, to which the FDIC did not object, largely reflected the new direction and actions already taken by the bank. In light of the prior regulatory history of the bank's owners and management team, such a deviation in business strategy may have warranted greater supervisory concern and/or action. Under the FDIC's current approach to supervision, such business plan deviations would be subject to prior FDIC approval and a more in-depth analysis to assess the potential risk to the institution and the DIF. In addition, when an institution implements a material change in its business plan without providing prior notice or obtaining the FDIC's approval, the assessment of civil money penalties or other enforcement action would be considered.

Recognizing that FirsTier's financial condition and markets were generally favorable during earlier examinations, the FDIC could have placed greater emphasis on the institution's growing risk profile during and after the January 2007 examination. Such emphasis could have included a more aggressive pursuit of the institution establishing and maintaining prudent limits on its growing ADC loan concentration and holding higher levels of capital. In addition, the ratings assigned during the June 2008 CDB examination did not fully reflect (on a forward-looking basis) the substantial risk associated with the institution's ADC loan exposure in a weakening real estate market. Examiners became sharply critical of the bank's risk management practices during the July 2009 examination and issued a Cease and Desist Order in January 2010. However, by that time, the institution's lending markets had deteriorated significantly, making remedial efforts difficult. A more proactive supervisory approach may have influenced the bank to curb its ADC lending, increase its capital levels, and strengthen risk management before the bank's lending markets deteriorated.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from bank failures during the financial crisis. In recognition of the elevated risk that newly chartered institutions pose to the DIF, the FDIC extended the de novo period from 3 to 7 years for purposes of onsite examinations, capital maintenance, and other requirements, including that the institutions obtain prior approval from the FDIC before making material changes in their business plans. The FDIC also has reiterated to its supervised institutions and examiners broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations. In addition, the FDIC provided training to its examination workforce in 2009-2010, wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

Based on the supervisory actions taken with respect to FirsTier, the FDIC properly implemented the applicable PCA provisions of section 38 of the FDI Act.

Management Response

The Director, Division of Risk Management Supervision (RMS), provided a written response, dated August 19, 2011, to a draft of this report. In the response, RMS reiterated the causes of failure and the supervisory activities described in the report. The response noted that the FDIC issued a FIL in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, the response referenced a 2009 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition,* issued by RMS to enhance FDIC supervision of institutions with concentrated CRE lending and reliance on volatile, non-core funding sources. The response also mentioned the 2009 FIL, entitled *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*, issued by RMS to expand the traditional de novo period, which requires more stringent supervision, from 3 to 7 years, and tightened oversight of de novo business plan changes during this 7-year period.

Contents

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

Office of Audits
Office of Inspector General

DATE: August 24, 2011

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

/Signed/

FROM: Mark F. Mulholland
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of FirsTier Bank, Louisville, Colorado* (Report No. AUD-11-013)

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 Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of FirsTier Bank (FirsTier), Louisville, Colorado. The Colorado Division of Banking (CDB) closed the institution on January 28, 2011, and the FDIC was named receiver. On February 24, 2011, the FDIC notified the OIG that FirsTier's total assets at closing were $808 million, and the estimated loss to the Deposit Insurance Fund (DIF) was $243 million. As of June 30, 2011, the estimated loss had decreased to $225 million. The estimated loss for FirsTier exceeds the $200 million MLR threshold for losses occurring from January 1, 2010 to 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 FirsTier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of FirsTier, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our

MLRs, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

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 key terms, Appendix 3 contains a list of acronyms, and Appendix 4 contains the Corporation's comments on this report.

Background

FirsTier was a state-chartered, nonmember bank headquartered in Louisville, Colorado, which is located approximately 20 miles northwest of Denver. The institution opened in November 2003 after receiving regulatory approval to purchase certain assets and liabilities of the Louisville, Colorado, branch of Enterprise Bank, N.A., of Omaha, Nebraska. FirsTier was wholly owned by the FirsTier Bancorp, Inc., a one-bank holding company. The bank, and its affiliate, FirsTier Bank of Kimball, Nebraska, formed a chain banking organization (CBO) that was under the control of one family.[2] In addition to its main office in Louisville, the institution operated eight branches in Colorado.

The organizers of FirsTier previously operated another bank under the same name in Northglenn, Colorado (referred to herein as the former FirsTier Bank—FFTB). FFTB and an affiliate bank in Nebraska were sold to Compass Bank, Birmingham, Alabama, in 2001. The last safety and soundness examination of FFTB, conducted jointly by the FDIC and CDB, identified significant management weaknesses, including rapid asset growth without adequate policies and procedures, a high concentration in real estate construction and land development loans, and apparent regulatory violations. As part of the sales agreement with Compass Bank, the organizers of FFTB signed a 2-year non-compete agreement. After the agreement expired, FirsTier was formed.

FirsTier's lending activities focused on commercial real estate (CRE), with a particular emphasis on residential acquisition, development, and construction (ADC) projects. The institution used Internet certificates of deposit (CD), and, beginning in 2008, brokered deposits and Federal Home Loan Bank (FHLB) advances, to support loan growth and the bank's operations. Table 1 provides selected financial information for the institution as of December 31, 2010, and for the 6 preceding calendar years.

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[1] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of this report.
[2] A CBO is defined in the *Glossary of Terms*, Appendix 2, of this report.

Table 1: Financial Information for FirsTier, 2004-2010

Financial Data ($000s)	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec- 09	Dec-10
Total Assets	55,234	140,295	284,271	483,252	782,686	868,621	764,090
Total Deposits	48,382	121,939	259,713	438,820	606,104	758,110	718,797
Total Loans	48,082	123,258	236,326	441,030	715,576	703,173	558,876
Net Income (Loss)	(215)	719	2,965	4,891	2,122	(36,045)	(28,303)
Brokered Deposits	-	-	-	-	112,333	77,150	14,467
FHLB Advances	-	-	-	-	88,797	73,042	41,817

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

Causes of Failure and Material Loss

FirsTier failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the bank's rapid growth and heavy concentration in ADC loans. Soon after it opened, FirsTier departed from the business plan projections it submitted with its application for federal deposit insurance by embarking on a rapid growth strategy centered in ADC lending. FirsTier's management continued to deviate from the bank's business plans in subsequent years. By the close of 2006, more than half of FirsTier's $236 million loan portfolio consisted of ADC loans, representing 463 percent of the bank's total capital. This exposure made the institution vulnerable to a sharp downturn in the Colorado real estate market. Adding to this vulnerability was a general decline in the institution's capital levels from 2004 to 2008, when risk in the loan portfolio was increasing.

Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in FirsTier's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. Further, FirsTier relied on non-core funding sources, particularly Internet CDs and brokered deposits, to support loan growth and the bank's operations. These funding sources became restricted when FirsTier's credit risk profile deteriorated, straining the institution's liquidity position.

Conditions in FirsTier's primary lending areas began to show signs of decline in 2007. By July 2009, the quality of the bank's loan portfolio had deteriorated significantly, with the majority of problems centered in ADC loans. FirsTier's 2009 examination report noted that, despite signs of economic weakness, the bank continued to originate ADC loans during 2008 and 2009. Further deterioration in the loan portfolio occurred in 2010. The associated provisions for loan losses depleted FirsTier's earnings, eroded its capital, and strained its liquidity. The CDB closed FirsTier on January 28, 2011 because the institution was insolvent and was unable to raise sufficient capital to support its operations.

Business Plan Deviations

The FDIC requires applicants for federal deposit insurance to submit business plans that, among other things, define adequate policies, procedures, management expertise, and the ability to attract and maintain adequate capital. Institutions are required to operate within the parameters of their business plans and to provide written notice to the FDIC of proposed changes during the de novo period.[3] Business plans represent an important management tool for setting goals and measuring progress. However, as described below, FirsTier did not make effective use of its business plans to manage and guide the institution's business practices. Instead, the bank continually deviated from its business plans and then revised them to reflect its changing business practices.

Soon after it opened for business, FirsTier deviated from the business plan projections it submitted with its application for federal deposit insurance by embarking on a rapid growth strategy centered in ADC lending. During a May 2004 visitation, examiners noted that FirsTier was "exceeding projections in virtually every area" of its business plan and that the bank's plan appeared obsolete. Because the bank's growth strategy represented a material departure from the original proposal on which its deposit insurance was granted, the FDIC requested a revised business plan. The bank submitted a revised business plan in July 2004 that projected total assets of $263 million by year-end 2006 (versus $62 million as described in the original plan) and $1 billion within 10 years. The revised plan also permitted branch expansion and discussed the possibility of using Internet CDs, which were not contemplated in the original business plan, and a greater concentration in ADC loans. In addition, the plan adjusted the bank's assumptions in such areas as deposit volume, capital, and earnings.

By January 2007, FirsTier's business plan was again outdated. Specifically, the bank's branch expansion had surpassed the projections in the plan, competitive conditions had changed, and management was increasing the use of Internet deposits. Examiners recommended during the January 2007 examination that the bank revise it business plan. Although FirsTier subsequently modified its business plan, it had become outdated by the July 2009 examination given the ongoing downturn in the bank's lending markets and the institution's deteriorating financial condition.

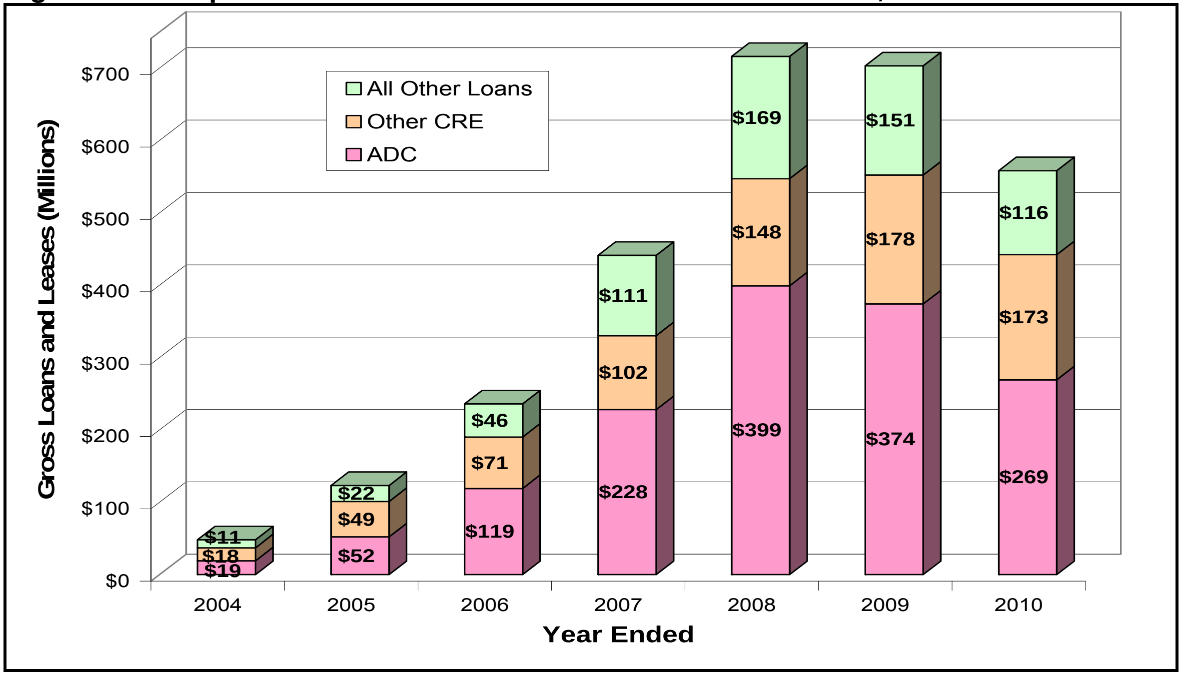
Aggressive Growth Concentrated in ADC Lending

During the 4-year period ended December 31, 2008, FirsTier grew its loan portfolio from $48 million to $716 million (or nearly 1,400 percent). The majority of this growth was in ADC loans, which grew from $19 million to $399 million (an increase of 2,000 percent) during this same period. Such growth outpaced FirsTier's peer group[4] by a wide margin. FirsTier's ADC lending included speculative loans for construction and land development

[3] In August 2009, the FDIC changed the de novo period from 3 years to 7 years.
[4] 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. FirsTier's peer group included all insured institutions with assets between $300 million and $1 billion.

projects in the Denver metropolitan area.[5] Figure 1 illustrates the general composition and growth of FirsTier's loan portfolio in the years preceding the institution's failure.

Figure 1: Composition and Growth of FirsTier's Loan Portfolio, 2004-2010



Source: Call Reports for FirsTier.

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 shown in Table 2, FirsTier's ADC loan concentrations as a percentage of total capital significantly exceeded the levels defined in the Joint Guidance as possibly warranting

[5] Speculative loans involve financing projects for which a buyer has not yet been identified.

further supervisory analysis. Further, FirsTier's ADC loans as a percentage of total capital and total gross loans substantially exceeded the bank's peer group averages.

Table 2: FirsTier'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		
	FirsTier	Peer Group	FirsTier Percentile	FirsTier	Peer Group	FirsTier Percentile
Dec 2003	24.82	20.83	71	8.80	12.05	49
Dec 2004	260.99	80.30	94	39.62	16.63	88
Dec 2005	272.64	121.31	88	42.53	19.94	92
Dec 2006	462.65	140.39	95	50.42	22.52	93
Dec 2007	491.21	169.27	96	51.72	24.05	92
Dec 2008	524.86	111.47	98	55.72	14.47	99
Dec 2009*	1,067.58	84.94	99	53.20	11.33	99

Source: UBPR data for FirsTier.
*The increase in ADC loans as a percentage of total capital was largely attributable to a decrease in capital rather than new ADC lending.

ADC lending generally involves a greater degree of risk than permanent financing for finished residences or commercial buildings. Associated risks 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.

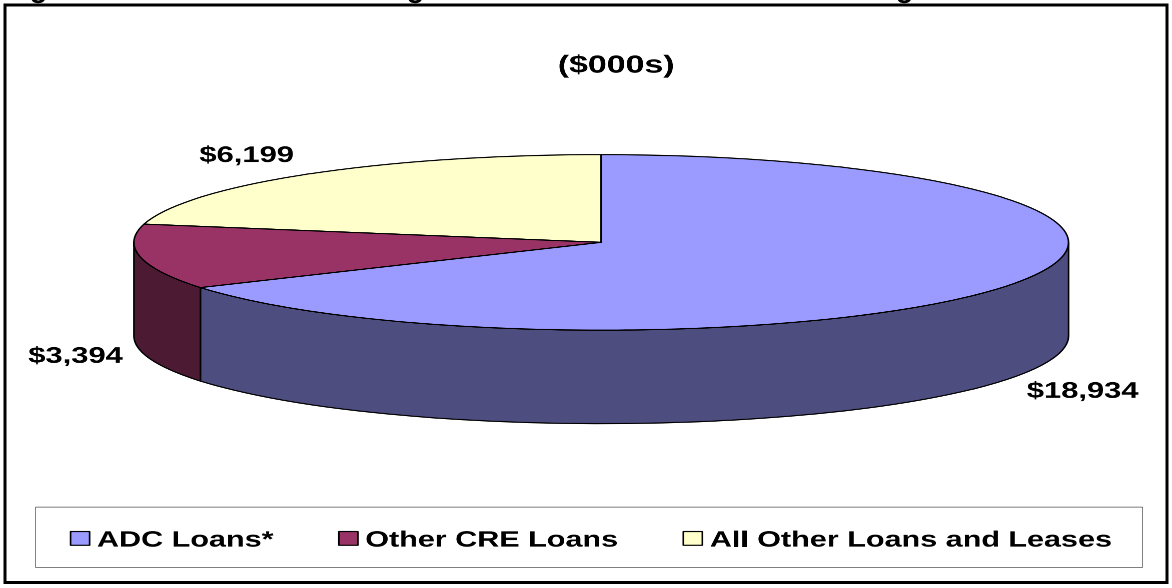
Although FirsTier had implemented certain controls for managing its CRE and ADC loan concentrations, its concentration risk management practices were not adequate. Among other things, the institution's ADC loan concentration limits were particularly high. According to the July 2009 examination report, FirsTier's loan policy allowed up to 900 percent of Tier 1 Capital for ADC loans, up to 500 percent of Tier 1 Capital for land development loans, and up to 400 percent of Tier 1 Capital for speculative construction loans. Such limits exposed the institution to significant risk of potential adverse market conditions. FirsTier also had a geographical concentration of ADC loans in the markets north of the Denver metropolitan area, further increasing the bank's concentration risk. Additionally, the institution had not performed appropriate stress testing in its CRE and ADC loan portfolios to assess the impact that various economic scenarios might have on the institution's asset quality, capital, earnings, and liquidity, as described in the Joint Guidance.

<u>ADC Loan Losses</u>

At the time of the July 2009 examination, FirsTier's adversely classified assets were $115 million (or 171 percent of Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL)), posing significant risk to the institution. Approximately $96 million of the classifications consisted of loans, the majority of which were ADC loans. By the September 2010 examination, adversely classified assets had increased to $284 million (or

552 percent of Tier 1 Capital plus the ALLL). The majority of these classifications consisted of ADC loans. In its Call Report for the year-ended December 31, 2010, FirsTier reported that nearly 25 percent of its total loan portfolio was in a non-accrual status. Further, about 39 percent of the bank's ADC loan portfolio was not performing at that time. As reflected in Figure 2, the majority of loan charge-offs in 2010 pertained to ADC loans.

Figure 2: FirsTier's Net Charge-offs on Loans and Leases During 2010



Source: Call Reports for FirsTier.
*ADC loans include over $7 million in write-offs related to 1-4 family residential ADC loans.

Oversight of the Lending Function

Ineffective Board and management oversight of the lending function contributed to the asset quality problems that developed when FirsTier's lending markets deteriorated. Examination reports issued from 2004 to 2007 generally concluded that FirsTier's loan underwriting and credit risk management practices were adequate, although the reports did describe various risk factors and contained some recommendations for control improvements. One of the more notable risks was described in the January 2007 examination report. Specifically, the report stated that while the loan policy provided a range of 50–100 percent of the bank's capital for land acquisition and development loans, the actual funded amount for this loan type was 303 percent. In addition, the loan policy defined a range for ADC loans of 200-300 percent of capital. However, commitments for such loans at that time were 688 percent, with the amount funded at nearly 500 percent. The report recommended that management revisit the loan policy in view of the bank's practices and consider whether the policy or practices should be amended.

Examiners became progressively more critical of FirsTier's underwriting and credit administration practices during subsequent examinations and visitations. During the June 2008 examination, examiners recommended that management:

- Implement a monitoring process for loans with interest reserves[6] that were running out or totally exhausted, particularly for borrowers whose construction or land development projects had slowed or experienced stale sales.

- Strengthen the loan policy to clarify when real estate owned needed to be reappraised and the frequency with which financial statements and tax returns were due after loans were originated.

- Improve appraisal practices by having appraisal reviews completed by a qualified reviewer other than the lender handling the transaction.

The July 2009 examination report was sharply critical of FirsTier's loan underwriting, credit administration, and related risk management practices. According to the report, the bank had originated increasingly large ADC loans during the prior 3 years to borrowers who were highly leveraged with considerable obligations at other institutions. According to the report, the bank's underwriting was characterized by insufficient analysis of repayment sources, weak secondary repayment capacity, and limited borrower equity. In addition, the bank's practice of capitalizing interest prevented ADC loans from being recognized as past-due or non-accrual, despite a high volume of development projects experiencing almost no sales during the prior 18 months. Further, loans with interest reserves were not being tracked or reviewed by the Board. The report also noted that, among other things:

- Procedures for identifying problem assets and administering the bank's internal watch list were inadequate.

- Appraisal review practices were insufficient. Specifically, examiners identified many appraisals where the vacant land use absorption period appeared aggressive given the troubled real estate market and lack of sales. Further, many appraisals used comparable transactions that occurred 12-18 months prior, which exhibited much stronger economic conditions. Internal reviews did not raise concerns regarding these assumptions.

- Loans for real estate development were made to borrowers whose debt service capacity was limited to the sale of the collateral, without a reliable secondary repayment source, and bank management did not encourage or require borrowers to maintain minimum liquidity levels.

[6] An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance.

- The ALLL[7] was underfunded by at least $8.5 million, primarily as a result of inadequate risk allocations for the CRE loan concentration, loans graded "Watch," the weak economy, and other environmental factors.

- There were apparent violations of laws and/or regulations, including some related to appraisal requirements.

Although the April 2010 visitation noted some improvement in FirsTier's credit administration practices, weaknesses persisted in a number of areas, including appraisal reviews, internal loan grading, and the ALLL amount and methodology. In addition, the bank's financial condition was deteriorating rapidly. By the time the September 2010 examination report was completed, FirsTier had a negative capital position.

Reliance on Non-Core Funding Sources

FirsTier relied on non-core funding sources, such as Internet CDs, brokered deposits, and FHLB advances, to fund its operations (including its lending activities). 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 FDIC *Risk Management Manual of Examination Policies* (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.

During the November 2004 examination, FirsTier's President advised examiners that management had decided to use Internet deposits, as needed, to help supplement liquidity, offset any runoff of deposits, and fund a substantial volume of pending loans. During the December 2005 examination, examiners noted that the bank's continued rapid growth was straining the institution's liquidity and that time deposits acquired through the Internet had grown to $18 million. By June 2008, Internet deposits totaled $100 million. In addition, the bank had begun acquiring brokered deposits, which totaled $23 million as of May 12, 2008, and FHLB advances, which totaled $20 million as of March 31, 2008, to support loan growth. The June 2008 examination report noted that FirsTier's liquidity position was less than satisfactory, with nontraditional funding sources in the aggregate representing a significant portion of the bank's asset funding, and continued aggressive growth with limited on-balance sheet liquidity presenting increased risk.

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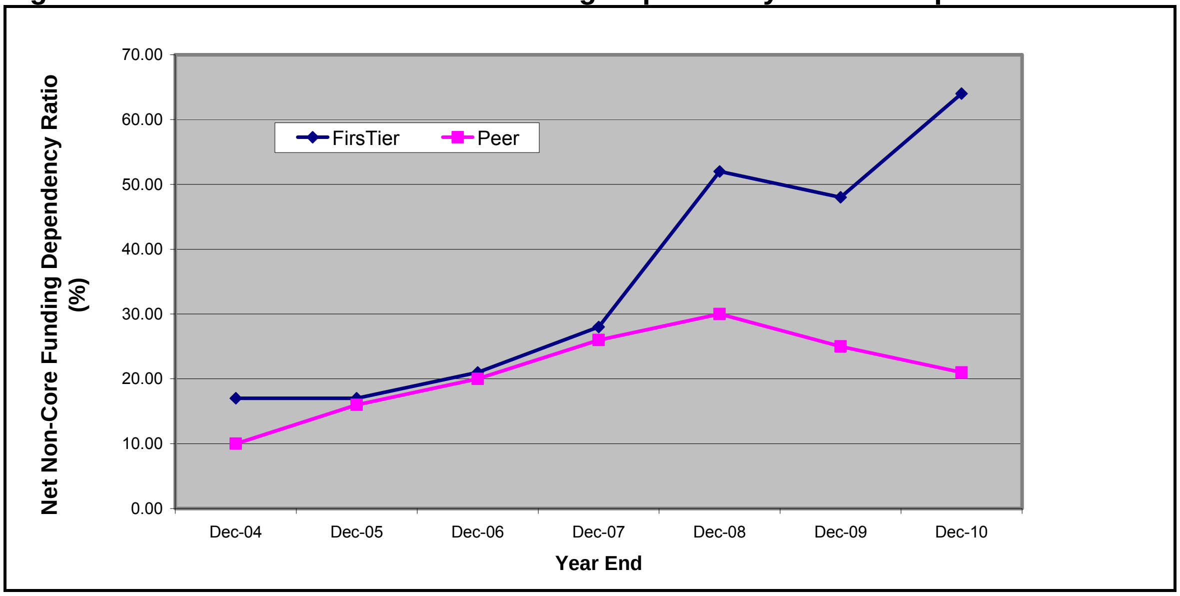
[7] According to the Interagency Policy Statement on the Allowance for Loan and Lease Losses (Policy Statement on ALLL), the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. As a result, each institution is responsible for developing,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

As reflected in Figure 3, FirsTier's net non-core funding dependency ratio[8] rose significantly when the bank began to acquire brokered deposits and FHLB advances in 2008. Notably, the bank's net non-core funding dependency ratio was much higher than its peer group, starting in 2008, with the institution ranking in the 90th to 99th percentile of its peers.

Figure 3: FirsTier's Net Non-Core Funding Dependency Ratio Compared to Peer



Source: UBPRs for FirsTier.

By the July 2009 examination, brokered deposits totaled $174 million, Internet deposits totaled $67 million, and FHLB advances totaled $89 million. According to the examination report, funding of the bank's rapid asset growth necessitated extensive use of non-core funding sources. In addition, the bank's liquidity was limited, its external lines of credit were becoming restricted, and its reliance on non-core funding threatened the viability of the institution. Examiners determined that FirsTier's liquidity position had improved by the September 2010 examination, but that liquidity risk remained high given the bank's poor financial condition and heavy reliance on non-core funding sources. According to the September 2010 examination report, the bank was working to replace its brokered deposits (which had become restricted due to its capital position and a January 2010 Cease and Desist Order (C&D)) with Internet deposits.[9] At that time, brokered deposits had declined to $15 million (or 2 percent of total deposits), and Internet deposits had increased to $235.2 million. The bank's liquidity position remained strained until its failure.

Capital Levels Relative to CRE and ADC Loan Growth

While risk in the loan portfolio increased from 2004 to 2008 due to FirsTier's aggressive ADC loan growth, capital levels remained relatively constant or declined. This trend

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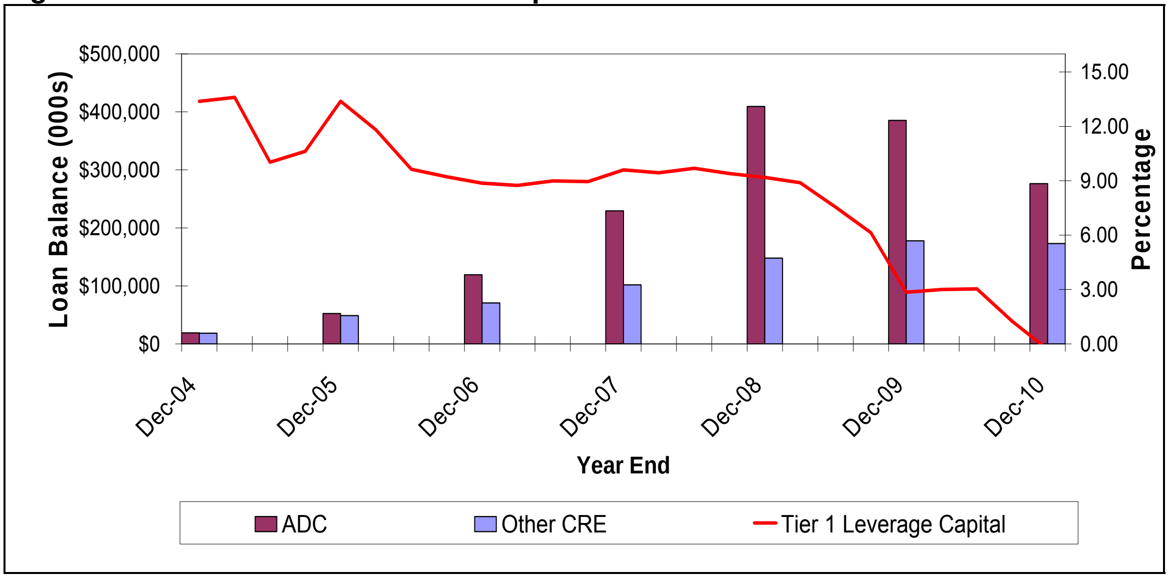
[8] A bank's net non-core funding dependency ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year).
[9] Management never applied for a brokered deposit waiver.

limited the bank's ability to absorb losses due to unforeseen circumstances and contributed to the losses incurred by the DIF when the institution failed. Figure 4 illustrates the trend in FirsTier's Tier 1 Capital ratio relative to ADC and other CRE loans.

Figure 4: Trend in FirsTier's Tier 1 Capital Relative to CRE and ADC Loan Growth



Source: UBPRs for FirsTier.

The Examination Manual states that institutions should maintain capital commensurate with the level and nature of risks to which the institutions 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. Maintaining higher capital levels may have restrained FirsTier's loan growth and/or limited, to some extent, the losses incurred by the DIF.

The FDIC's Supervision of FirsTier

The FDIC, in coordination with the CDB, provided ongoing supervisory oversight of FirsTier through regular onsite risk management examinations, visitations, and offsite monitoring activities. In addition, because FirsTier was a newly chartered institution, it was subject to annual examinations during the first 3 years of operation. Through its supervisory efforts, the FDIC identified key risks in FirsTier's operations and brought these risks to the attention of the institution's Board and management. Such risks included the bank's significant concentration in ADC loans, weak loan underwriting and credit administration practices, reliance on non-core funding sources, and the need for higher capital levels. The FDIC and the CDB also made numerous recommendations for improvement and issued an enforcement action to address the institution's rapidly deteriorating financial condition and weak risk management practices.

On August 28, 2009, the FDIC issued Financial Institution Letter (FIL)-50-2009, entitled *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*. The FIL, which is based on the perspectives gained from the recent banking crisis, states that a number of newly insured institutions pursued changes in their business plans during the first few years of operation that led to increased risk and financial problems where accompanying controls and risk management practices were inadequate. Common risks cited in the FIL include rapid growth, over-reliance on volatile funding, concentrations without compensating management controls, and significant deviations from approved business plans.

In the case of FirsTier, the bank materially deviated from its approved business plan soon after it opened by embarking on a rapid growth strategy centered in risky ADC lending and supported by potentially volatile funding. Examiners promptly identified the deviation and requested that management revise the plan. However, the revised plan, to which the FDIC did not object, largely reflected the new direction and actions already taken by the bank. In light of the prior regulatory history of the bank's owners and management team, such a deviation in business strategy may have warranted greater supervisory concern and/or action. Under the FDIC's current approach to supervision, such business plan deviations would be subject to prior FDIC approval and a more in-depth analysis to assess the potential risk to the institution and the DIF. In addition, when an institution implements a material change in its business plan without providing prior notice or obtaining the FDIC's approval, the assessment of civil money penalties or other enforcement action would be considered.

Recognizing that FirsTier's financial condition and markets were generally favorable during earlier examinations, the FDIC could have placed greater emphasis on the institution's growing risk profile during and after the January 2007 examination. Such emphasis could have included a more aggressive pursuit of the institution establishing and maintaining prudent limits on its growing ADC loan concentration and holding higher levels of capital. In addition, the ratings assigned during the June 2008 CDB examination did not fully reflect (on a forward-looking basis) the substantial risk associated with the institution's ADC loan exposure in a weakening real estate market. Examiners became sharply critical of the bank's risk management practices during the July 2009 examination and issued a C&D in January 2010. However, by that time, the institution's lending markets had deteriorated significantly, making remedial efforts difficult. A more proactive supervisory approach may have influenced the bank to curb its ADC lending, increase its capital levels, and strengthen risk management before the bank's lending markets deteriorated.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from bank failures during the financial crisis. In recognition of the elevated risk that newly chartered institutions pose to the DIF, the FDIC extended the de novo period from 3 to 7 years for purposes of onsite examinations, capital maintenance, and other requirements, including that the institutions obtain prior approval from the FDIC before making material changes in their business plans. The FDIC has also reiterated broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations to its supervised institutions and examiners. In addition, the FDIC provided training to its examination workforce in 2009-2010, wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

Supervisory History

From 2004 to 2011, the FDIC and/or the CDB conducted six onsite examinations and three visitations of FirsTier. The frequency of this examination activity was consistent with relevant statutory requirements.[10] Table 3 summarizes key supervisory information pertaining to FirsTier in the years preceding its failure.

Table 3: Onsite Examinations and Visitations of FirsTier, 2004-2011

Examination or Visitation Start Date	Examination or Visitation	Regulator(s)	Supervisory Ratings (UFIRS*)	Violations and/or Contraventions	Informal or Formal Action Taken***
5/17/04	Visitation	FDIC	No ratings given.	None	None
11/29/04	Examination	FDIC/CDB	222322/2	1	None
12/12/05	Examination	FDIC/CDB	212322/2	4	None
1/16/07	Examination	FDIC/CDB	222222/2	4	None
6/02/08	Examination	CDB	222332/2	6	None
7/20/09	Examination	FDIC	555555/5	4	C&D effective January 22, 2010.
4/12/10	Visitation	FDIC	No ratings given.	Not Applicable**	C&D still in effect.
9/2/10	Examination	FDIC/CDB	555555/5	12	C&D still in effect.
1/3/11	Visitation	FDIC/CDB	No ratings given.	Not Applicable**	C&D still in effect.

Source: OIG analysis of examination reports and information in the Virtual Supervisory Information On the Net (ViSION) system for FirsTier.
* See the report Glossary for a definition of UFIRS, which establishes the CAMELS rating system.
**These visitations did not assess the bank's compliance with laws and regulations.
*** Informal enforcement actions often take the form of Bank Board Resolutions (BBR) or Memoranda of Understanding. Formal enforcement actions often take the form of C&Ds or Supervisory Directives.

Offsite Monitoring

The FDIC's offsite monitoring procedures generally consisted of contacting FirsTier's management from time to time to discuss current and emerging business issues and using

[10] Section 10(d) of the FDI Act states that the appropriate federal banking agency shall, not less than once during each 12-month period, conduct a full-scope, onsite examination of each insured depository institution. According to the Act, the annual examination interval may be increased to 18 months for small institutions that meet certain conditions.

automated tools[11] to help identify potential supervisory concerns. FirsTier initially appeared on the FDIC's Offsite Review List (ORL)[12] in March 2008 due to the bank's heavy concentration in construction and non-residential real estate loans. The FDIC did not take immediate action at that time due to the upcoming June 2008 examination. The examination found that the overall condition of the bank was satisfactory but that risk management practices needed improvement in a number of areas. FirsTier remained on the ORL until October 2009. At that time, the examiners conducting the July 2009 examination had determined that the bank's overall financial condition was critically deficient.

In January 2010, the FDIC conducted an off-site CBO review of FirsTier and its affiliate, FirsTier Bank, Kimball, Nebraska. The review found that FirsTier's overall capital position was deficient and that the ability of the bank's parent holding company to service its debt was questionable.

Enforcement Action

Based on the results of the July 2009 examination, the FDIC issued a C&D effective January 22, 2010. The C&D remained in effect until the bank was closed in January 2011. Among other things, the order required FirsTier to:

- Increase the Board's participation in the affairs of the bank.
- Submit a written capital plan to increase Tier 1 Capital.
- Submit a written plan to reduce the aggregate total of ADC loan concentrations.
- Make a provision to the ALLL in the amount of at least $8.5 million and amend prior Call Reports filed on or after June 30, 2009, if necessary, to accurately reflect the financial condition of the bank as of the date of each report.
- Develop and submit (1) a written plan to improve the bank's liquidity position and (2) a contingency liquidity plan.
- Review the bank's loan policy and procedures for effectiveness and, based upon the review, make all necessary revisions to the loan policy in order to strengthen the bank's lending procedures and abate additional loan deterioration.
- Eliminate and/or correct all violations of laws and regulations and implement procedures to ensure future compliance.

[11] 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.
[12] The ORL identifies institutions warranting heightened supervisory oversight.

The FDIC's Consideration of Management When Granting Federal Deposit Insurance

As mentioned in the *Background* section of this report, the organizers of FirsTier had previously operated another bank under the same name in Northglenn, Colorado (i.e., FFTB) that was sold to Compass Bank in 2001.

The last safety and soundness examination conducted of FFTB found the bank to be in less-than-satisfactory condition and resulted in an informal enforcement action.[13] We reviewed the FDIC's assessment of FirsTier's application for federal deposit insurance to determine whether consideration was given to the applicants' prior regulatory history.

The FDIC Board has statutory responsibility for acting on applications for federal deposit insurance by all depository institutions. Within the FDIC, this responsibility has been delegated to the Division of Risk Management Supervision (RMS). RMS evaluates insurance applications in relation to the following seven factors defined in section 6 of the FDI Act: (1) the financial history and condition of the institution, (2) the adequacy of the capital structure, (3) future earnings prospects, (4) the general character and fitness of management, (5) the risk presented by the institution to the DIF, (6) the convenience and needs of the community to be served by the institution, and (7) whether the institution's corporate powers are consistent with the purposes of the FDI Act. RMS conducts investigations to assess these statutory factors. In general, applicants receive deposit insurance if all seven statutory factors (plus the considerations required by the National Historic Preservation Act and the National Environmental Policy Act of 1969) are resolved favorably and compliance is noted with the *FDIC Statement of Policy on Applications for Deposit Insurance*.

The statutory factor pertaining to the general character and fitness of management includes consideration of past regulatory experience. We found that the FDIC documented its consideration of this statutory factor in a Report of Investigation, correspondence, and other papers (collectively referred to herein as records). These records contain extensive information and analyses, including the results of interviews with FirsTier's owners and management team members, regarding the regulatory problems that existed at FFBT. The records reflect concerns about the applicants' responsibility for risk management weaknesses and compliance problems that developed at FFBT. However, examiners noted that such concerns must be weighed against other relevant factors, including the satisfactory manner in which the applicants managed FFBT between 1992 and 2000. Further, the records indicate that the FDIC weighed assurances provided by the applicants that growth at FirsTier would be slower than at FFBT and that previous mistakes pertaining to compliance and safety and soundness would not recur. The records show that the FDIC found the general character and fitness of FirsTier's management to be favorable.

[13] The examination for FFTB, which began on March 20, 2000, resulted in a supervisory composite rating of "3." Weaknesses identified during the examination included seven apparent violations of regulations, an increasing level of problem assets, high concentrations in CRE and ADC loans, an unsatisfactory liquidity position and funds management strategy, aggressive asset growth, and deficient policies and procedures. The bank adopted a BBR to address the deficiencies identified during the examination.

Supervisory Response to Key Risks

In the years preceding FirsTier's failure, the FDIC and the CDB identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and recommendations. In addition, the FDIC issued a C&D in early 2010. A summary of supervisory activities related to the bank's key risks follows.

2004 Supervisory Activities

The FDIC conducted a 6-month visitation of FirsTier in May 2004 to ascertain the de novo bank's progress and adherence to the FDIC's Order granting deposit insurance. Examiners determined that FirsTier was exceeding the projections in the bank's approved business plan in "virtually every area," including growth and operating losses. Because the business plan appeared to be obsolete and current growth plans represented a material change from the original proposal on which deposit insurance had been granted, the FDIC requested an updated business plan. Examiners concluded that while the bank's rapid growth was a concern, the experience of the management team and the substantial resources of ownership mitigated some of that concern. Examiners further noted that the revival in the overall economy and the strength of the local economy was aiding the bank's business. FirsTier provided the FDIC with a revised business plan on July 27, 2004, and the bank was subsequently notified that the FDIC had no objection to the plan.

Examiners determined during the November 2004 examination that the bank's overall condition was sound, despite more rapid growth than originally planned. Notably, the bank had no classified assets. The examination report noted that the bank's loan portfolio was concentrated in ADC loans and that capital, although satisfactory, remained well below the peer level for typical new banks in Colorado, especially in view of the rapid growth strategy being pursued. Further, the examination report noted that management had begun to use potentially volatile Internet deposits to support loan growth and operations. The bank's earnings were also found to be less than satisfactory.

2005 Supervisory Activities

The December 2005 joint examination report stated that FirsTier's overall financial condition was satisfactory. At that time, the bank had no classified assets, and loan administration practices were adequate. However, FirsTier continued to experience strong asset growth, which was reducing the bank's risk-based capital ratios. Although earnings improved following the prior examination, earnings continued to be less than satisfactory and insufficient to augment capital or fully support the bank's rapid growth. Our analysis of the September 2005 financial data that was used to prepare for the examination found that FirsTier's capital ratios were lower than that of its peer group. The report indicated that the bank was dependent on capital injections to maintain a *Well Capitalized* position.

Additionally, our analysis of the September 2005 financial data, used to prepare for the examination, found that FirsTier's ADC concentration was 358 percent of Tier 1 Capital, which was more than three times the level of its peer group. However, this ADC loan concentration dipped in the following months, and the examination report noted that FirsTier had an ADC loan concentration of 263 percent of Tier 1 Capital. According to the report, the bank's ADC lending had significantly higher risks than other types of loans, and this continued to be an area of potential concern. Further, the report noted that the bank's rapid growth was straining the institution's liquidity and that oversight in this area needed improvement.

2007 Supervisory Activities

The January 2007 joint examination report, which covered FirsTier's financial condition as of September 30, 2006, stated that the bank continued to operate in a satisfactory manner. Examiners downgraded the Asset Quality component from a "1" to a "2" based on some deterioration in the loan portfolio.[14] The report stated that although the relative volume of these problem loans was not significant, their development in only the third year of the bank's existence warranted some concern.

Examiners noted that FirsTier continued to pursue a strategy of rapid expansion that outpaced its peers by a wide margin. Specifically, loans grew from approximately $103 million to approximately $216 million (a 110-percent increase), with ADC loans increasing from $45 million to over $108 million (a 140-percent increase). Much of this growth was supported by potentially volatile Internet CDs. In addition, the bank had opened five branches, with an additional opening planned for 2007. According to the report, FirsTier's business plan had not been updated since 2004, and it was outdated in many respects. Among other things, branch expansion had surpassed the number projected in the plan, competitive conditions had continued to change, and management had made increased use of Internet deposits. Examiners encouraged the bank to update its business plan.

The bank's capital ratios were experiencing wide fluctuations due to the bank's aggressive growth and continued capital injections.[15] At the time of the examination, the bank's Tier 1 Leverage Capital ratio was 9.23 percent, down from 10.63 percent at the prior examination. In addition, the bank's Total Risk-Based Capital ratio was 10.4 percent, slightly above the minimum requirement for maintaining a *Well Capitalized* position. Such ratios were well below the bank's peer group ratios. Although earnings were much improved since the prior examination, they were not sufficient to significantly augment capital.

Notably, FirsTier's ADC loan concentration had increased to 457 percent of total capital, presenting significant risk to the institution. Such concentrations were substantially higher than the bank's peer group average and much greater than the limits in the bank's own loan policy. According to the examination report, the loan policy provided for a range of 50-100 percent of capital for land acquisition/development loans, but the actual volume committed was 342 percent of capital, and the funded amount was 303 percent of capital.

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[14] Adversely classified assets increased from 0 at the December 2005 examination to 14 percent of Tier 1 Capital and the ALLL.
[15] At the time of the examination, $16.8 million in capital injections had been made since the bank's inception, with an additional $6 million planned for 2007.

In addition, the loan policy permitted a range of 200-300 percent of capital for ADC loans, but commitments for such loans were 688 percent of capital. The examination report recommended that management consider whether its loan policy or practices should be changed, while determining more clearly the extent of such risk the Board was willing to assume.

2008 Supervisory Activities

Examiners determined during the June 2008 CDB examination that FirsTier's overall condition was satisfactory. At that time, the institution had a moderate level of classified assets[16] and credit risk management practices exhibited weakness in several areas. For example, examiners noted that the bank needed to better oversee and monitor its CRE concentration, improve its market analysis and appraisal practices, perform stress testing of the loan portfolio, and strengthen the loan policy and loan loss reserve methodology.

The bank continued to experience rapid growth, with total loans increasing from $216 million at the prior examination to $516 million and ADC loans increasing from $108 million to over $276 million. At the time of the examination, FirsTier's ADC loan concentration had grown to 527 percent of Tier 1 Capital, presenting significant risk to the bank should a downturn in the real estate market occur. Much of the bank's loan growth was funded using Internet CDs and, beginning in 2008, using brokered deposits and FHLB advances. Examiners determined that FirsTier's liquidity risk management practices were less than satisfactory.

While the bank remained *Well Capitalized* for purposes of PCA, the institution's capital ratios had declined during each of the past three examination periods and continued to trail peer group averages. In addition, earnings were deteriorating and insufficient to provide for capital augmentation. The examination report concluded that FirsTier's capital levels were marginally satisfactory given the risks associated with the bank's rapid growth and loan concentrations. According to the examination report, management indicated that additional capital support was available, if needed, from the bank's holding company and shareholders.

Notwithstanding the examiners' conclusion that the bank's financial condition was satisfactory, the composite and capital component ratings assigned during the examination – both being "2" – did not fully reflect, on a forward-looking basis, the substantial risk associated with the institution's ADC loan exposure in a weakening real estate market. Had these ratings been lowered, it is more likely that supervisory action would have been pursued.

2009 Supervisory Activities

Examiners determined during the July 2009 FDIC examination that FirsTier's overall financial condition was critically deficient and assigned the bank a composite "5" rating.

[16] Adversely classified assets increased from approximately 14 percent of capital at the previous examination to over 28 percent of capital.

Examiners noted that the bank pursued a strategy of rapid and high-risk CRE loan growth in prior years supported by non-core, credit-sensitive funds, such as FHLB advances, brokered deposits, and Internet CDs. Examiners also noted that despite evidence of a slowing economy and soft real estate market, management continued to pursue ADC lending throughout 2008. Following the prior examination, loans grew from $516 million to $728 million (a 41-percent increase), with ADC loans increasing from $276 million to over $389 million (a 41-percent increase). In addition, the bank's reliance on brokered deposits to fund loan growth increased from $8 million to $174 million.

Examiners concluded that in order to support the bank's rapid growth, the Board declined to establish reasonable concentration limits. Specifically, FirsTier's loan policy allowed up to 900 percent of Tier 1 Capital for ADC loans, up to 500 percent of Tier 1 Capital for land development loans, and up to 400 percent of Tier 1 Capital for speculative construction loans. Such limits exposed the institution to significant risk of potential adverse market conditions.

Examiners determined that FirsTier's business plan was of limited benefit as it was general and not based on a formal assessment of the risks associated with the bank's high asset growth rate and heavy CRE concentrations. The plan also did not reflect an assessment of the need to enhance the capital commensurate with the increased CRE concentration risks and provided only a limited discussion of funding sources or liquidity. Although FirsTier's management revised its business plan in February 2009, examiners found that it still did not address important matters, such as the need to reduce the bank's concentration levels, establish and maintain an appropriate level of capital, and provide for satisfactory oversight of the loan portfolio.

Weak loan underwriting or credit administration standards for real estate development lending compounded the problems experienced at the bank. For example, examiners noted that the bank made development loans to borrowers without reliable secondary sources of repayment or liquidity. In addition, as conditions in FirsTier's lending markets deteriorated, management relied on appraisals with unrealistic assumptions, and interest reserves were used extensively to delay the recognition of loan problems. Further, asset quality deteriorated substantially, with adversely classified assets increasing to 171 percent of Tier 1 Capital plus the ALLL.

<u>2010 and 2011 Supervisory Activities</u>

Based on the results of the July 2009 examination, the FDIC issued a C&D effective January 22, 2010. The C&D remained in effect until the bank was closed in January 2011. An FDIC visitation to assess FirsTier's financial condition and management's compliance with the C&D was conducted on April 12, 2010. Examiners found that the overall condition of the bank continued to be extremely poor, with operating losses depleting capital to a critical level. Further, the bank had an extremely high volume of adversely classified assets, which totaled 420 percent of Tier 1 Capital and the ALLL. Significant exposure to CRE loans also created a high potential that loan losses and other real estate owned (OREO)[17] write-downs would result in additional capital erosion in 2010. Examiners also found that asset quality had deteriorated further since the last examination, and liquidity continued to be a concern since the bank was subject to brokered deposit restrictions and limited access to alternative sources of funding.

According to the September 2010 joint examination report, management was focusing on reducing the bank's problem loans, but the deterioration in the loan portfolio had accelerated in the prior 12 months and was considered to be excessive. CRE and ADC loan concentrations had resulted in an elevated risk profile that exposed the bank to the full impact of the downturn in the real estate market. Although FirsTier's management injected $3 million into the bank during the examination, examiners stated that capital continued to decline, and the bank was considered to be *Critically Undercapitalized* for PCA purposes. Further, the bank continued to rely heavily on non-core funding, with the net non-core funding dependence ratio more than double that of the bank's peer group at 54 percent. Notably, the bank was cited for 12 apparent violations of laws and regulations and/or contraventions of statements of policy, which included violations of appraisal requirements and the State of Colorado's special lending authority.

A final visitation focusing on asset quality, ALLL adequacy, and capital was conducted on January 3, 2011. At that time, examiners determined that the bank was insolvent and needed immediate capital support. The CDB closed FirsTier on January 28, 2011 because the institution was insolvent and was unable to raise sufficient capital to support its operations.

Supervisory Lessons Learned

FirsTier materially deviated from its approved business plan soon after it opened by embarking on a rapid growth strategy centered in ADC lending. To support this growth, the bank procured potentially volatile Internet CDs, which were not addressed in the bank's original business plan. FirsTier's revised business strategy resulted in the institution assuming significantly greater risk than was contemplated when the bank applied for deposit insurance. In light of the prior regulatory history of the bank's owners and management team, such a business strategy may have warranted greater supervisory concern and/or action. Under the FDIC's current approach to supervision, business plan deviations (such as those experienced at FirsTier) would be subject to prior FDIC approval and a more in-depth analysis to assess the potential risk to the institution and the DIF. In addition, when an institution implements a material change in its business plan without providing prior notice or obtaining the FDIC's approval, the assessment of civil money penalties or other enforcement action would be considered.

Recognizing that FirsTier's financial condition and markets were generally favorable during earlier examinations, the FDIC could have placed greater emphasis during the January 2007 examination on the institution establishing and maintaining prudent limits on its growing ADC loan concentration and holding higher levels of capital. At that time, FirsTier's ADC loan concentration was 457 percent of total capital, and its Total Risk-

[17] OREO is property taken over by a bank through foreclosures.

Based Capital ratio was 10.4 percent, slightly above the minimum requirement for maintaining a *Well Capitalized* position. Notwithstanding the examiners' conclusion that the bank's financial condition was satisfactory during the June 2008 CDB examination, the composite and capital component ratings assigned did not fully reflect (on a forward-looking basis) the substantial risks associated with the bank's exposure to ADC loans in a declining real estate market and the institution's weak risk management practices. Had these ratings been lowered, it is more likely that a supervisory action would have been pursued.

Examiners became sharply critical of the bank's risk management practices during the July 2009 examination and issued a C&D in January 2010. However, by that time, the institution's lending markets had deteriorated significantly, making remedial efforts difficult. A more proactive supervisory approach may have influenced the bank to curb its ADC lending, increase its capital levels, and strengthen its risk management before the bank's lending markets deteriorated.

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. In recognition of the elevated risk that newly chartered institutions pose to the DIF, the FDIC extended the de novo period from 3 to 7 years for purposes of onsite examinations, capital maintenance, and other requirements, including that the institutions obtain prior approval from the FDIC before making material changes in their business plans. The FDIC also has reiterated to its supervised institutions and examiners broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations. In addition, the FDIC provided training to its examination workforce in 2009-2010, wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized. Further, 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.[18]

Implementation of PCA

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve the problems of insured depository institutions at the least possible cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan (CRP), mandatory restrictions defined under

[18] RMS Regional Directors Memorandum entitled, *Matters Requiring Board Attention* (Transmittal No. 2010-003).

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 FirsTier, the FDIC properly implemented the applicable PCA provisions of section 38.[19] Notably, the FDIC formally notified the bank when its PCA capital category fell below *Adequately Capitalized*, reviewed and evaluated the bank's CRPs, reviewed and monitored the institution's Call Report information, and conducted discussions with management regarding its efforts to raise needed capital. Table 4 illustrates FirsTier's capital levels relative to the PCA thresholds for *Well Capitalized* institutions as reported in the bank's Call Reports. A chronological description of the changes in FirsTier's capital categories and the FDIC's implementation of PCA follow the table.

Table 4: FirsTier's Capital Levels Relative to PCA Thresholds, 2008-2010

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**	
FirsTier's Capital Levels				
12/31/08	9.19	9.40	10.40	*Well Capitalized*
3/31/09	8.90	9.25	10.51	*Well Capitalized*
6/30/09	7.55	8.27	9.53	*Adequately Capitalized*
9/30/09	6.14	7.11	8.37	*Adequately Capitalized*
12/31/09	2.85	3.72	5.02	*Significantly Undercapitalized*
3/31/10	3.00	3.83	5.13	*Significantly Undercapitalized*
6/30/10	3.04	4.07	5.35	*Significantly Undercapitalized*
9/30/10	1.24	1.59	2.90	*Critically Undercapitalized*
12/31/10	(0.30)	(0.40)	(0.40)	*Critically Undercapitalized*

Source: UBPRs for FirsTier.

FirsTier was considered *Well Capitalized* for PCA purposes until the completion of the July 2009 examination. In a letter dated October 30, 2009, the FDIC notified FirsTier's Board that, based on the results of the July 2009 examination, the bank had fallen to an *Undercapitalized* position as of June 30, 2009.[20] The letter included a reminder regarding the restrictions imposed on *Undercapitalized* institutions, including restrictions pertaining to brokered deposits, and requested a CRP within 45 days. In a letter dated November 9, 2009, FirsTier's Board Chairman and Chief Executive Officer advised the FDIC that the bank's internal computations indicated that the institution was *Adequately Capitalized* as of June 30, 2009 and since that time, the bank had further strengthened its capital position.

[19] As discussed later in this section, we did note exceptions to procedures related to implementing a PCA Supervisory Directive and reviewing a CRP.

[20] Examiners determined that the bank needed to make an additional provision of $8.5 million as of June 30, 2009 and that management had overstated capital by $10.8 million by including noncontrolling interests in consolidated subsidiaries that provided no meaningful capital support. After making these adjustments, FirsTier's Total Risk-Based Capital ratio fell to 7.99 percent, rendering the institution *Undercapitalized*.

Because FirsTier was reporting an *Adequately Capitalized* position, it did not submit a CRP.

In January 2010, the FDIC issued a C&D requiring FirsTier to submit a CRP within 45 days that required the bank to achieve and maintain a Tier 1 Leverage Capital ratio equal to or greater than 10 percent of average total assets and a Total Risk-Based Capital ratio equal to or greater than 13 percent of total risk-weighted assets. In a letter dated February 10, 2010, the FDIC notified FirsTier's Board that the bank had fallen to an *Undercapitalized* position based on its December 31, 2009 Call Report.[21] The letter requested that the bank submit a CRP by March 12, 2010. FirsTier submitted a CRP, dated March 12, 2010. In a letter dated March 25, 2010, the FDIC notified the bank's Board that the CRP was unacceptable because, among other things, it did not include specific commitments from equity investors, and key financial projections did not appear realistic.

In a letter dated March 31, 2010, the FDIC notified FirsTier's Board that, based on its failure to submit an acceptable CRP, the institution was subject to applicable provisions of section 38 related to *Significantly Undercapitalized* institutions. The letter included a *Notice of Intent to Issue a Supervisory Prompt Corrective Action Directive,* which contained various provisions, including requirements for the bank to submit a revised CRP and become *Adequately Capitalized* within 30 days. On April 15, 2010, FirsTier's Board submitted a response to the *Notice of Intent to Issue a Supervisory Prompt Corrective Action Directive* pursuant to section 308.201(d) of the FDIC Rules and Regulations. In the response, the bank disputed the FDIC's decision not to accept the CRP and provided additional information regarding the bank's plans to raise new capital.

After considering the assertions made in the bank's response, the FDIC determined that immediate prompt corrective action was needed to carry out the purposes of section 38. Accordingly, the FDIC implemented a Prompt Corrective Action Supervisory (PCAS) Directive effective April 21, 2010. In support of its decision to issue the PCAS Directive, the FDIC noted the CRP was dependent upon the bank's plans to raise $60 million through a private placement of stock—an assumption that the FDIC deemed unreasonable given the bank's financial condition. Due to an oversight, the PCAS Directive stated that the bank could appeal the directive to the FDIC. However, section 308.201 of FDIC Rules and Regulations does not permit PCAS Directives to be appealed when an institution has been provided prior notice of the directive and an opportunity to respond. As a result, FirsTier expended unnecessary resources filing an appeal. The FDIC advised FirsTier's Board that the bank had no basis to appeal the PCAS Directive in a letter dated August 23, 2010.

The FDIC notified FirsTier's Board in a letter dated May 18, 2010 that the institution had fallen to a *Significantly Undercapitalized* position based on the March 31, 2010 Call Report. The letter included a reminder regarding the restrictions imposed on *Significantly*

[21] FirsTier subsequently amended its December 31, 2009 Call Report to reflect a *Significantly Undercapitalized* position.

Undercapitalized institutions and requested the bank to submit a CRP by May 21, 2010. FirsTier submitted a revised CRP on May 21, 2010. In a letter dated August 23, 2010, the FDIC advised FirsTier's Board that its revised CRP was unacceptable because it was not materially different from the prior March and April 2010 submissions.[22]

In a letter dated October 29, 2010, the FDIC notified FirsTier's Board that, based on an analysis of the findings of the then ongoing September 2010 examination, the bank had fallen to a *Critically Undercapitalized* position. The letter included a reminder regarding the restrictions imposed on *Critically Undercapitalized* banks. The letter also stated that the bank had not yet filed an acceptable CRP and requested that the institution submit a revised CRP as soon as possible. On November 16, 2010, FirsTier submitted a revised CRP. In a letter dated January 13, 2011, the FDIC notified FirsTier's Board that the CRP appeared unlikely to succeed in restoring the bank's capital because it was not based on realistic assumptions, budget projections were unreasonable, and net operating losses threatened the viability of the bank. Moreover, the bank's holding company had not been successful in raising needed capital or securing an acceptable party to acquire or merge with the bank. Further, the holding company's guarantee of capital was contingent upon the successful completion of a $60-$70 million private offering. As a result, the FDIC determined that the revised CRP was not acceptable.

Although FirsTier's management explored a number of strategic alternatives for raising capital, such as working with private equity firms to obtain investments and applying for funds under the Department of the Treasury's Capital Purchase Program, these efforts were ultimately unsuccessful. The CDB closed the institution on January 28, 2011 because the institution was insolvent and was unable to raise sufficient capital to support its operations.

OIG Evaluation of Corporation Comments

The Director, RMS, provided a written response, dated August 19, 2011, to a draft of this report. That response is provided in its entirety as Appendix 4 of this report. In the response, RMS reiterated the causes of failure and the supervisory activities described in the report. The response noted that the FDIC issued a FIL in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, the response referenced a 2009 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition,* issued by RMS to enhance FDIC supervision of institutions with concentrated CRE lending and reliance on volatile, non-core funding sources. The response also mentioned the 2009 FIL, entitled *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised*

[22] The FDIC's written notification to the bank regarding the acceptability of the CRP was not made within 60 calendar days as prescribed by section 325.104(c) of the FDIC Rules and Regulations. However, FirsTier was operating under a C&D with a capital maintenance provision, and the FDIC had regular discussions with management regarding the bank's efforts to improve its capital position. As a result, in our view, the delayed notification was inconsequential to the supervision or the failure of the bank.

Depository Institutions, issued by RMS to expand the traditional de novo period, which requires more stringent supervision, from 3 to 7 years, and tightened oversight of de novo business plan changes during this 7-year period.

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) 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 FirsTier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from March 2011 to July 2011 in accordance with generally accepted government auditing standards. 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 FirsTier's operations from January 2004 until its failure in January 2011. 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 and visitation reports prepared by the FDIC and the CDB from May 2004 to January 2011.

- Reviewed the following:

    - Selected examination work papers prepared by the FDIC from 2004 to 2011.

    - Bank data contained in UBPRs and Call Reports.

Objectives, Scope, and Methodology

- o Correspondence in the Dallas and Kansas City Regional Offices and the Denver Field Office.

- o Various other reports prepared by the Division of Resolutions and Receiverships (DRR) and RMS relating to the bank's closure. We also reviewed records provided by DRR that would provide insight into the bank's failure.

- o Information in the FDIC's Virtual Supervisory Information On the Net system.

- o Pertinent RMS policies, procedures, and guidelines, as well as applicable laws and regulations.

- Interviewed the following officials:

  - o RMS regional officials from the Dallas and Kansas City Regional Offices.

  - o An RMS examiner from the Denver Field Office.

  - o CDB officials in Denver, Colorado.

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

Consistent with our audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in the FDIC's systems, reports, and examination reports, and interviews of RMS and CDB examiners to obtain an understanding of FirsTier's management controls pertaining to the causes of failure and material loss as discussed in the body of this report.

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 examination and visitation reports, correspondence files, and testimonial evidence to corroborate data obtained from the systems, which 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 MLR, we did not assess the strengths and weaknesses of RMS's annual performance plan in meeting the requirements of the Results Act

Objectives, Scope, and Methodology

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

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations. The results of our tests are 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 addition, the OIG issued an audit report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were 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.

Further, with respect to more in-depth 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, *Prompt Corrective Action*, and section 39, *Standards for Safety and Soundness*) in the banking crisis. The OIG also began an evaluation in July 2011 to study the characteristics and related supervisory approaches that may have prevented FDIC-supervised institutions with significant ADC loan concentrations from being designated as problem banks or failing during the recent financial crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction, and that provide 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.
Affiliate	Under section 23A of the Federal Reserve Act (12 U.S.C. section 371c), an affiliate generally includes, among other things, a bank subsidiary, or a company that (1) controls the bank and any other company that is controlled by the company that controls the bank, (2) is sponsored and advised on a contractual basis by the bank, or (3) is controlled by or for the benefit of shareholders who control the bank or in which a majority of directors hold similar positions in the bank.
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 BBR 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	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council’s (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC’s Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.

Glossary of Terms

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.
Chain Banking Organization (CBO)	According to the FDIC *Case Manager Procedures Manual*, a chain banking organization is a group of insured institutions that are controlled, directly or indirectly, by an individual acting alone, through, or in concert with any other individual(s). The individual(s) must own or control 25 percent or more of the institutions' voting securities, the power to control in any manner the election of a majority of the directors of the institutions, or the power to exercise a controlling influence over the management or policies of the institutions.
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.
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.
De novo bank	Prior to the issuance of FIL-50-2009 on August 28, 2009, and for the purposes of FDIC-supervised institutions, this term referred to an institution within its first 3 years of operation. FIL-50-2009 changed the de novo period for newly-chartered FDIC-supervised institutions from 3 years to 7 years. De novo banks are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency.
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 RMS (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.

Glossary of Terms

Federal Home Loan Bank (FHLB)	The FHLB System provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to its members. Advances are available to members with a wide variety of terms to maturity, from overnight to long term, and are collateralized. Advances are designed to prevent any possible loss to FHLBs, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail. To protect their position, FHLBs have a claim on any of the additional eligible collateral in the failed bank. In addition, the FDIC has a regulation that reaffirms FHLB priority, and FHLBs can demand prepayment of advances when institutions fail.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Financial Reform 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.
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 ORL. Regional management is responsible for implementing procedures to ensure that offsite review findings are factored into examination schedules and other supervisory activities.
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, 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 U.S.C. section 1831(o), 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 undercapitalized categories.

Glossary of Terms

Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, 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 securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from data in Call Reports submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the 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
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CBO	Chain Banking Organization
CD	Certificate of Deposit
CDB	Colorado Division of Banking
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FFTB	Former FirsTier Bank
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
MLR	Material Loss Review
OIG	Office of Inspector General
OREO	Other Real Estate Owned
ORL	Offsite Review List
PCA	Prompt Corrective Action
PCAS	Prompt Corrective Action Supervisory
RMS	Division of Risk Management Supervision
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.C.	United States Code

Corporation Comments

FDIC

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

August 19, 2011

TO: Mark F. Mulholland
Assistant Inspector General for Audits

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of FirsTier Bank, Louisville, CO

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of FirsTier Bank (FirsTier) which failed on January 28, 2011. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on July 25, 2011.

FirsTier failed due to the Board's and management's ineffective oversight of the credit underwriting practices and lending function. The risks associated with a heavy concentration of Acquisition, Development and Construction (ADC) loans contributed to a decline in the quality of the loan portfolio. FirsTier continued to originate ADC loans during 2008 while real estate markets were weakening. FirsTier relied on non-core funding sources, specifically internet certificates of deposit and brokered deposits, to support loan growth and operations. By July 2009, FirsTier's loan portfolio had significantly deteriorated requiring increases in the provision for loan losses that depleted earnings, eroded capital and strained liquidity. FirsTier was unable to raise additional capital to sustain safe and sound operations.

From 2004 to 2011 the FDIC and the Colorado Division of Banking conducted six on-site risk management examinations, three on-site visitations and offsite monitoring. As a newly chartered de novo institution, FirsTier was subject to more frequent examinations during the first three years of operation. FirsTier deviated from its business plan and embarked on a strategy of rapid growth and concentration in ADC loans. Examiners identified key risks in FirsTier's operations, brought these to the attention of the Board and management, and made recommendations for improvement. In 2009, examiners downgraded FirsTier and issued a Cease and Desist Order. At the January 2011 visitation, examiners determined FirsTier was insolvent and in need of immediate capital support.

RMS recognized the threat that institutions with high risk profiles, such as FirsTier, pose to the Deposit Insurance Fund, particularly de novo institutions during the first seven years of operation. The FDIC issued new or enhanced guidance based on lessons learned in supervising institutions such as FirsTier during the financial crisis. For example, the FDIC issued a Financial Institution Letter (FIL) in 2008 on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS 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 lending and reliance on volatile non-core funding. In addition, the FDIC issued a FIL in 2009 entitled *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions* that expanded the traditional de novo period, which requires more stringent supervision, from three to seven years, and tightened oversight of de novo business plan changes during this seven-year period.

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