Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-016

Material Loss Review of Millennium State Bank of Texas, Dallas, Texas

January 2010

Office of Inspector General

Executive Summary

Material Loss Review of Millennium State Bank of Texas, Dallas, Texas

Report No. MLR-10-016
January 2010

Why We Did The Audit

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review of Millennium State Bank of Texas (MSB), Dallas, Texas.

On July 2, 2009, the Texas Department of Banking (TDB) closed MSB and named the FDIC as receiver. On July 22, 2009, the FDIC notified the OIG that MSB's total assets at closing were $121.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $46.9 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act to conduct a material loss review of the failure of MSB, and retained KPMG for this purpose.

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

Background

MSB was a state-chartered, nonmember bank that was insured by the FDIC on August 20, 2003. MSB was headquartered in Dallas, Texas, with a branch office in Houston, Texas. The bank had no holding company, subsidiaries, or affiliates.

MSB pursued a lending strategy focused on funding small businesses, mostly utilizing Small Business Administration (SBA) loans where the SBA either guaranteed the loans or subordinated its interest in the real estate collateral. Specific commercial real estate (CRE) industry concentrations included loans collateralized by hotels, convenience stores, and car washes. To fund portfolio growth, the bank relied upon the issuance of certificates of deposit (CDs). The primary source of earnings for MSB was from gains on the sale of the guaranteed portions of the SBA loans.

Audit Results

Causes of Failure and Material Loss

MSB's failure can be attributed to inadequate management and Board oversight, an aggressive growth strategy centered in CRE lending, weak loan underwriting and credit administration, poor earnings, and an inadequate funding strategy. Throughout its history, the FDIC and TDB repeatedly criticized MSB's management practices and strategy. In their final Report of Examination, the regulators attributed the bank's extremely weakened condition to: (1) a flawed, original business plan that was not sufficiently adjusted through time to the bank's risk profile, (2) an inexperienced Board, and (3) the inability of the Board to administer the bank's affairs at critical points. In May 2009, examiners specifically noted that the strategy of using high-cost CDs sourced from the Internet to fund SBA loans in high-risk sectors resulted in unacceptable risk. In addition, examiners noted that lending practices included loans to businesses in which the principals had limited experience, and the underwriting was based on high cash flow projections or adjustments to historical cash flows. Examiners also noted that MSB's strategy of using high-cost CDs sourced from the Internet to fund high-risk SBA loans resulted in unacceptable risk. In comparison with the bank's peer group, MSB's level of CRE concentrations was high, making it vulnerable to any downturn in the CRE market. Efforts by the Board to diversify the loan portfolio from specific industry concentrations, however, were unsuccessful.

The FDIC's Supervision of MSB

Throughout its supervision of MSB, the FDIC identified key risks in MSB's management practices and operations and brought these risks to the attention of the institution's Board and management through regular discussions and correspondence, examination reports, and visitations. Key risks identified by examiners included inadequate Board and management oversight, weak risk management practices pertaining to the institution's rapid loan growth and significant loan concentrations, poor loan underwriting and credit administration practices, and reliance on high-cost funding sources. The FDIC and TDB conducted three separate visitations beginning as early as March 2004 and seven on-site examinations beginning in August 2004.

To encourage improvements in MSB's operations, the FDIC relied principally on examiner suggestions to address identified risks and did not impose any informal or formal enforcement actions until December 2007. Based on the FDIC and state observations at each examination, in retrospect, a stronger supervisory response at earlier examinations may have been prudent in light of the nature and extent of the risks and the institution's lack of adequate or timely corrective action. Stronger supervisory action early in the institution's formative years may have influenced MSB's Board and management to limit the significant level of risk assumed during the institution's rapid growth period. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. However, capital levels turned out to be a lagging indicator of the institution's financial condition.

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On January 15, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of MSB's failure and the FDIC's supervision of the bank. DSC stated that the failure of MSB demonstrates why stringent supervisory attention is necessary for de novo institutions. DSC has extended its supervisory program so that these institutions receive a full-scope examination every year for 7 years, as opposed to 3 years. De novo business plans are being closely monitored against approved financial projections throughout the 7-year period. A Financial Institution Letter issued in August 2009 describes the program changes for de novo institutions and warns that changes in business plans undertaken without required prior notice may subject an institution or its insiders to civil money penalties.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: January 22, 2010

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

/Signed/

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

SUBJECT: *Material Loss Review of Millennium State Bank of Texas, Dallas, Texas* (Report No. MLR-10-016)

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. The report did not contain recommendations, thus a response was not required. However, the Division of Supervision and Consumer Protection provided a written response on January 15, 2010. We incorporated the information into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mike Lombardi, Audit Manager, at (703) 562-6328. We appreciate the courtesies extended to the audit staff.

Attachment

cc: Thomas J. Dujenski, Regional Director, DSC
Christopher E. Drown, Chief, Office of Internal Control and Review, DSC
James H. Angel, Jr., Director, OERM

Table of Contents

Part I

Report by KPMG LLP **I-1**
Material Loss Review, Millennium State Bank of Texas, Dallas, Texas

Part II

OIG Evaluation of Management Response **II-1**

Corporation Comments **II-2**

Part I

Report by KPMG LLP

Material Loss Review
Millennium State Bank of Texas
Dallas, Texas

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Contents

Executive Summary **I-3**

Background **I-5**

Causes of Failure and Material Loss **I-6**
Management and Board Oversight I-6
Deviation from Business Plan I-6
General Oversight I-7
Violations of Regulatory Requirements I-8
Growth Strategy Centered in CRE Lending I-9
Loan Underwriting and Credit Administration I-10
Funding and Earnings Strategies I-11

The FDIC'S Supervision of MSB **I-13**
Supervisory History I-13
Supervisory Response to Key Risks I-15
Supervisory Concern Related to MSB's Board and Management I-16
Supervisory Concern Related to CRE Concentrations and Underwriting I-18
Implementation of PCA I-20

Appendices **I-22**
1. Objectives, Scope and Methodology I-22
2. Glossary of Terms I-25
3. Acronyms I-27

Tables
1. Financial Condition of MSB I-6
2. MSB's CRE Concentration Relative to Peers I-9
3. On-Site Examinations, Visitations and Actions I-14
4. Supervisory Concerns Related to MSB's Board and Management I-16
5. MSB's PCA Capitalization Categories I-20

Figures
1. Projected Versus Actual Asset Growth I-7
2. Comparison of Time Deposits versus Total Deposits for MSB I-12

KPMG LLP

2001 M Street, NW
Washington, DC 20036

January 22, 2010

Executive Summary

Stephen M. Beard
Assistant Inspector General for Material Loss Reviews
Federal Deposit Insurance Corporation
3501 North Fairfax Drive
Arlington, VA 22226

RE: Transmittal of Results for the Material Loss Review Report for Millennium State Bank of Texas, Dallas, Texas

Dear Mr. Beard:

This letter is to acknowledge delivery of our performance audit report on the results of the Material Loss Review for Millennium State Bank of Texas (MSB), Dallas, Texas in accordance with Task Assignment Number 09-10 dated 08/22/2009. The objectives of this performance audit were to: (1) determine the causes of MSB's failure and resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of MSB, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Performance Audit Results

MSB's failure can be attributed to inadequate management and Board of Directors (Board) oversight, an aggressive growth strategy centered in Small Business Administration (SBA) loans collateralized by Commercial Real Estate (CRE), weak loan underwriting and credit administration, poor earnings and an inadequate funding strategy. The institution had rapid growth in loans to businesses in which the principals had limited industry experience. Underwriting was based upon unrealistic reliance on historical cash flows to justify overly optimistic projections. These factors led to an over exposure to high risk loans secured by CRE. In comparison with the bank's peer group, which consisted of banks with assets between $100 million and $300 million, MSB's CRE concentration was high, which made the bank vulnerable to downturns in local economic conditions. Efforts by the bank's Board and management to diversify the loan portfolio from specific industry concentrations were unsuccessful. Moreover, the use of high-cost Certificates of Deposit (CD) sourced from the Internet to fund SBA loans resulted in high risk for the institution.

In discussions and correspondence with MSB's Board and management, Reports of Examination (ROE), and visitations the FDIC noted concerns about the risk profile of the bank. Key risks identified by examiners included inadequate Board and management oversight, weak risk management practices pertaining to the institution's rapid loan growth, poor loan underwriting and credit administration practices, and reliance on high cost funding sources. Regulators conducted three separate visitations beginning as early as March 2004, and seven on-site examinations beginning in August 2004.

The FDIC relied principally on suggestions and persuasion to encourage the Board and management to address risks identified. Regulators did not impose any informal or formal enforcement actions until December, 2007. Based on the FDIC and State observations at each examination, in retrospect, a stronger supervisory response at earlier examinations may have been prudent in light of the nature and extent of the risks and the institution's lack of adequate or timely corrective action. Earlier and stronger supervisory action may have influenced MSB's Board and management to limit the significant level of risk assumed during the institution's rapid growth period. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

With respect to Prompt Corrective Action (PCA), the FDIC followed PCA guidance, but PCA had little or no impact on minimizing the loss to the DIF. Capital levels turned out to be a lagging indicator of the institution's financial condition.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the performance 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.

The information included in this report was obtained during our fieldwork, which occurred during the period from August 31, 2009 through December 3, 2009.

Yours truly,

KPMG LLP

Background

On July 2, 2009, the Texas Department of Banking (TDB) closed Millennium State Bank of Texas (MSB) and named the FDIC as receiver. On July 22, 2009, the FDIC notified the Office of Inspector General (OIG) that MSB's total assets at closing were $121.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $46.9 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act to conduct a material loss review of the failure of MSB, and retained KPMG for this purpose.[1]

MSB was a state-chartered, non-member bank that was insured on August 20, 2003. MSB was headquartered in Dallas, Texas and opened a second permanent location on October 6, 2007, in Houston, Texas. The bank had no holding company, subsidiaries, or affiliates.

The bank's management pursued a lending strategy focused on funding small businesses, mostly utilizing Small Business Administration[2] (SBA) loans where the SBA either guaranteed the loan or subordinated its interest in the real estate collateral. Specific Commercial Real Estate (CRE) industry concentrations included loans collateralized by hotels, convenience stores, and car washes. To fund portfolio growth, the bank relied upon the issuance of Certificates of Deposit (CDs). The primary source of earnings for MSB was from gains on the sale of the guaranteed portions of the SBA loans.[3]

Table 1 provides details on MSB's financial condition as of December 2008, and for the three preceding calendar years.

---

[1] In conducting this performance audit and preparing this report, KPMG relied primarily on information provided by the FDIC OIG and DSC. Appendix I, Objective, Scope and Methodology, describes in greater detail the procedures used by KPMG.

[2] MSB used principally two SBA programs: 7(a) and 504. The 7(a) program is a federal loan guarantee program designed to help small businesses receive credit. The program provides loan originators a guarantee that if a loan defaults, the SBA will pay off a percentage of the remaining balance. Lenders and the SBA share the risk at different levels. Banks can sell in the secondary market the guaranteed or the un-guaranteed portion that is receiving the funding. The funds received from this program must be used by the borrower for expansion and renovation improvements, working capital, inventory, refinance and seasonal lines of credit.
The SBA Certified Development Company (CDC) (504) loan program provides financing for major fixed assets such as owner-occupied real estate and long term machinery and equipment. This program involves a loan from a bank secured with a first lien typically covering 50% of the project cost and a loan from the CDC secured with a second lien (secured 100% by the SBA) covering 40% of the cost and a contribution of at least 10% from the business that is receiving the funding. The funds received from this program must be used by the borrower to acquire fixed assets such as land, land improvements, construction of new facilities or purchasing long term machinery and equipment. Banks may sell the first lien loan in the secondary market.

[3] Supervisory History Memorandum, April 2009.

Table 1 Financial Condition of MSB

	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	$118,457	$127,509	$102,424	$69,821
Total Loans ($000s)	$91,108	$108,764	$75,958	$53,848
Total Deposits ($000s)	$108,967	$112,033	$90,132	$63,178
Net Income (Loss) ($000s)	($3,563)	($861)	($423)	$944

Source: Uniform Bank Performance Report (UBPR) for MSB (December 31, 2008)

Causes of Failure and Material Loss

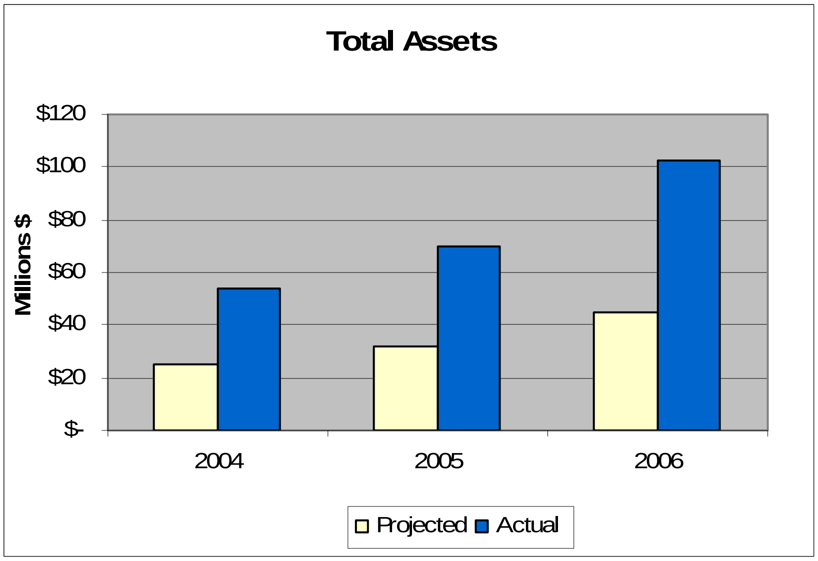
MSB's failure can be attributed to inadequate management and Board oversight, an aggressive growth strategy centered in CRE lending, weak loan underwriting and credit administration, poor earnings and an inadequate funding strategy. In the final Joint ROE on May 11, 2009, examiners noted that the bank's extremely weakened condition was attributed to the following: (1) a flawed original business plan that was not sufficiently adjusted through time to the bank's risk profile, (2) an inexperienced Board and, (3) the inability of the Board to administer the bank's affairs at critical points. Throughout the examination history, regulators made repeated criticisms of MSB's management practices and strategy. In May 2009, examiners specifically noted that the strategy of using high-cost CDs sourced from the Internet to fund SBA loans in high risk sectors resulted in unacceptable risk. In addition, examiners noted that lending practices included loans to businesses in which the principals had limited experience and underwriting was based on high cash flow projections or adjustments to historical cash flows. Based on figures in the December 31, 2008 UBPR, in comparison with the bank's peer group, MSB's level of CRE concentration was high. This made the bank vulnerable to any downturn in the CRE market. During the December 15, 2008 State examination, examiners noted that efforts by the Board to diversify the loan portfolio from specific industry concentrations were unsuccessful.

Management and Board Oversight

Deviation from Business Plan

As early as the August 2004 Joint ROE, examiners indicated that MSB was operating outside its original business plan. Examiners noted rapid growth in loans and deposits. At that point, the earnings deficit was greater than double management's original projections and breakeven would not be attainable by the 11th month of operations as initially projected. Figure 1 illustrates the actual asset growth for MSB versus its original business projections during its first three years of operations.

Figure 1 Projected Versus Actual Asset Growth



Source: UBPR Reports for MSB (December 31, 2008)

The 2005 Joint examination confirmed that the bank was still operating outside the parameters of its original business plan, and that management failed to notify the FDIC and the TDB of these changes as required by the conditions for approval of the charter and deposit insurance. Material changes from the original business plan included the use of high cost, large balance CDs to fund a significant portion of its operations, the creation of loan production offices outside its primary trade area in Dallas, Texas, and the extent of its SBA lending program.

During the July 2005 examination, it was also noted that MSB's business plan needed to be updated to reflect changes that had occurred since the bank opened. Examiners indicated that as of this examination MSB had no written strategic plan. MSB submitted a strategic plan in 2006 that had aggressive growth projections which predicted the bank would double in size by 2008.

In the 2007 Joint ROE, examiners indicated that MSB's Board's pro-forma projections for the five year period ending November 30, 2011, were inconsistent with the strategic plan dated November 30, 2006. Year-to-date interest expense exceeded the budget by 45 percent due to the unanticipated higher rates MSB had to pay to remain competitive. Further, earnings were more than $1.1 million short of budget projections.

General Oversight

In the July 2005 examination, examiners indicated that the bank's most senior executive was the dominant policy maker and had significant influence over the Board. By the August 2006 examination, issues with the Board became evident when one of its members was placed on involuntary leave. This was a result of this individual mishandling a specific credit line that led to a significant loss. Later, this person apparently violated the conditions of his suspension from the Board and was replaced.[4] Lack of attendance at Board meetings was specifically mentioned as a concern in the first two (2004 and 2005) ROEs. Examiners indicated in the August 2006 Joint ROE that MSB needed to hire a senior management official with experience in bank operations and knowledge of Federal and State regulations. During the exit Board meeting at the 2007 Joint examination, several outside directors claimed management had not informed them of a number of matters, including the payments made to a senior official in connection with SBA loan referrals.[5]

The May 2008 ROE indicated that the Board failed to exercise adequate control of the activities of a former senior official as these activities were the source of internal conflicts among the Board. This individual was terminated for cause on March 4, 2008, although he continued to serve on the Board as a director. This was one of several management changes since the previous examination.[6] The December 2008 State ROE indicated that the unsafe and unsound condition of MSB resulted from inadequate Board supervision, poor planning and weak management oversight. Examiners noted that asset diversification was disregarded by management and the Board as indicated by industry concentration levels. Also, the lack of Board effectiveness resulted in failure to act resolutely in addressing the eroding capital position and concentration risk.[7] Further, conflicts of interest and turnover were noted by examiners in the final Joint examination conducted in May 2009.

Violations of Regulatory Requirements

Regulatory and legal issues in MSB's operations were reported as early as the July 2005 Joint ROE, when several violations of banking laws and regulations were identified. These included Regulation O[8], lending limit restrictions, unauthorized branching activity and other regulations. Regulation O[9] prohibits a bank from extending credit to any insider of the bank in an amount that, when aggregated with all other extensions of credit to that person and their related interests, exceeds the lending limit of the bank. That lending limit is generally 15 percent of the bank's unimpaired capital and surplus. Examiners noted an apparent violation for advances to two directors and their related interests that exceeded the lending limitation provided for by Regulation O of 15 percent of unimpaired capital and surplus. Subsequently, an annual survey was conducted to identify all insiders and their related interests. The survey failed to disclose all of the related interests of several insiders, and included only those that had outstanding extensions of credit with the bank.[4] During the Joint August 2006 examination, examiners indicated that the apparent violation of Regulation O was due to an incomplete understanding of the law. In the same examination it was noted that the bank was in an apparent violation of section

---

[4] Report of Examination, August 28, 2006.
[5] DRR document on bank closing, June 15, 2009.
[6] Report of Examination, May 19, 2008.
[7] Report of Examination, December 15, 2008.
[8] The Federal Reserve Board's Regulation O is made applicable to State non-member banks by Section 18(j)(2) of the Federal Deposit Insurance Act. Section 215.8 of Regulation O requires maintenance of sufficient records, through an annual survey, to identify all insiders of the bank, and records of all extensions of credit, including the amount and terms of each extension of credit.
[9] Section 215.4(c).

325.5(f) of the FDI Rules and Regulation that requires that non-mortgage servicing assets be deducted from capital to the extent that they do not meet certain requirements. The bank was in apparent violation because it failed to perform required quarterly valuation assumptions of these assets and was therefore including ineligible portions in its Tier 1 Capital calculations.

The August 2007 Joint ROE noted one apparent violation of Regulation O for an overdraft of a Director. This was a repeat of an apparent violation cited in the 2005 ROE. Significant regulatory and legal issues continued as several irregular insider transactions involving top level executives were later identified. These included payment of referral fees without Board approval and a reciprocal bank-stock loan transaction totaling $100,000 to an officer of another banking institution.[5]

Growth Strategy Centered in CRE Lending

As a de novo institution, MSB pursued a strategy of lending to small businesses, particularly where the SBA either guaranteed the loan or subordinated its interest in the real estate collateral. MSB developed a high CRE concentration in relationship to its peer group as a result of this strategy.[10] Table 2 summarizes MSB's CRE concentrations in comparison to its peer group. As outlined below, MSB's volume of CRE loans as a percentage of total capital was significantly higher than its peer group as a de novo institution through 2006, and the variance became greater over time. The bank's CRE loans as a percentage of total capital jumped from 427 percent as of December 31, 2006 to 737 percent as of December 31, 2007, close to two times greater than its peer group.

Table 2 MSB's CRE Concentration Relative to Peers

Date	Millennium CRE Loans as a Percentage of Total Capital	Peer Group CRE Loans as a Percentage of Total Capital	Millennium CRE Loans as a Percentage of Average Gross Loans	Peer Group CRE Loans as a Percentage of Average Gross Loans
December 31, 2004	380%	235%	51.91%	49.65%
December 31, 2005	545%	314%	63.89%	51.73%
December 31, 2006	427%	337%	69.00%	53.84%
December 31, 2007	737%	401%	80.14%	56.87%
December 31, 2008	935%	340%	79.63%	48.09%

Source: UBPRs for MSB (December 31, 2008)

The July 2005 Joint ROE noted that rapid asset growth was impacting the bank's capital ratios. At the same examination, it was noted that MSB management failed to report loan industry concentrations to the Board. The industry concentrations grew from that point forward. For example, convenience store loans in 2005 represented 53 percent of Tier 1 Capital, climbing to 169 percent by the 2007 Joint examination. The December 2008 State ROE, indicated that risk management practices were inadequate and not commensurate with the concentration risk being assumed by the Board. Further, it should be noted that two of these concentrations had previously been brought to the Board's

[10] Uniform Bank Performance Report, December 31, 2008.

attention by examiners with direction to diversify the loan portfolio and reduce undue concentration risk.[7]

As discussed in Financial Institution Letter 104-2006 (FIL-104-2006) issued December 12, 2006, titled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. The December 2008 State ROE noted a failure to diversify the loan portfolio and failure to adequately monitor the collateral and cash flow position of borrowers in a declining economy, both of which were cited as reasons for the sharp deterioration in MSB's condition.

Loan Underwriting and Credit Administration

Deficiencies in loan underwriting practices were noted at the 2005 Joint examination when "risky" lending practices were first identified. During this examination, it was noted that these lending practices included loans to businesses in which the principals had limited experience in their field and underwriting was based on high cash flow projections or adjustments to historical cash flow. The 2005 Joint ROE indicated that the lending practices at that time were of regulatory concern and coupled with considerable loan growth could potentially result in a high level of future problem loans. Examiners identified loan documentation exceptions totaling $9.8 million or 38 percent of the dollar volume of loans reviewed. Excessive loan growth and the related increase in work load appeared to have contributed to the level of exceptions.[11] Risk identification procedures required improvement as the internal loan risk grading system was not commensurate with regulatory classifications. The failure of management to properly risk rate credits resulted in downgrades by examiners, indicating the bank's Allowance for Loan and Lease Losses (ALLL) did not properly reflect the level of risk in its loan portfolio.

Loan underwriting deficiencies were still noted in the 2006 Joint ROE. During the first three years of operation, the bank sustained $923,000 in loan charge offs. This was of regulatory concern for a de novo bank.[4] The level of past due loans and the rapid deterioration of five large lines of credit noted in the August 2006 Joint ROE contributed to underwriting concerns at that examination. Tighter lending standards and better collection efforts were suggested by the examiners. Documentation exceptions were still significant in the August 2007 Joint ROE. In this report, documentation exceptions were uncovered in 28 percent of loans that were reviewed. In addition, examiners noted that problem credits were not being properly identified by management.

Weaknesses were also found in credit administration practices related to the ALLL methodology at the August 2007 Joint examination. Several loans were downgraded resulting in an inadequately funded ALLL. Examiners indicated that additional provision expenses were required to bring the ALLL to an appropriate level, considering the amount of risk within the portfolio. By the May 2008 examination, classified assets were 60.41 percent of Tier 1 capital plus the ALLL. Almost all of these loans were to SBA

[11] Report of Examination, July 25, 2005.

program borrowers who experienced problems after their first few years of operations following the initial underwriting of the loan. During the May 2008 FDIC examination, examiners recommended that MSB re-evaluate its ALLL methodology, in particular to validate the historical loss factors. The rate of documentation exceptions remained high at 34 percent.

Sharp deterioration in MSB's financial condition was noted in the December 2008 State ROE. Specific deficiencies in underwriting and credit administration included:

- Poor choice of risk;
- Over-lending in light of collateral support;
- Limited ability of repayment through cash flow or the sale of collateral;
- Failure to diversify risk in the loan portfolio;
- Lending to persons with limited background in the line of business; and
- Failure to adequately monitor the collateral and cash flow position of borrowers in a declining economy.

Documentation exceptions were considered excessive at approximately one third of the dollar volume of loans reviewed at the December 2008 State examination. Problem loan identification was considered inadequate as shown by the large volume of examiner classification downgrades (approximately $7.3 million). Loan losses were mainly a consequence of failure to adequately collateralize credits at inception and monitor collateral values during the term of the loan and the course of the transactions.[7] The final joint examination conducted in May 2009 showed adversely classified assets totaled 328 percent of Tier 1 capital plus the ALLL.

Funding and Earnings Strategies

MSB's first ROE in August 2004 revealed that non-core and volatile deposits of CDs over $99 thousand was the funding source that fueled the higher than expected loan growth. Examiners noted that the rates of these time deposits were among the highest in the nation, and the non-core funding ratio was in excess of MSB's own policy guidelines. The July 2005 Joint ROE indicated that MSB acquired a large volume of deposits through CDs with special rate offerings that were advertised on an Internet listing service. The amount of time deposits $99 thousand and greater totaled approximately 75 percent of deposits.[11]

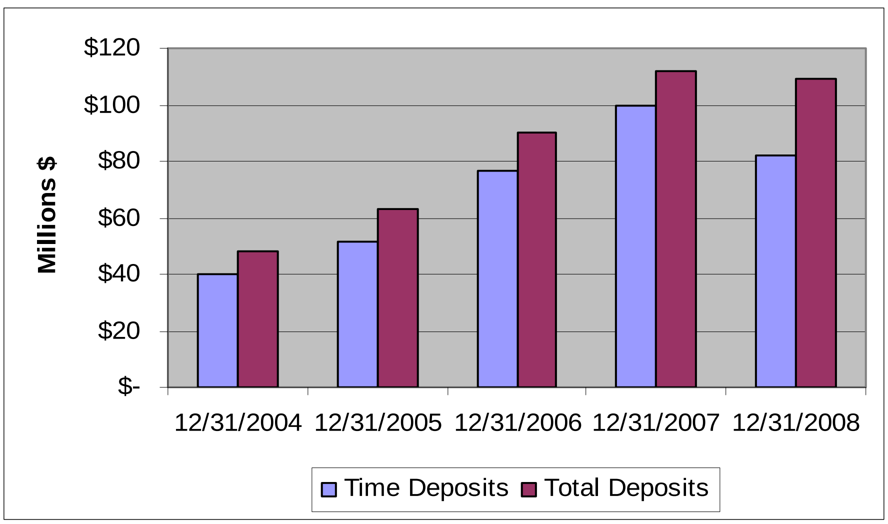
In the July 2005 Joint ROE, the main earnings source identified was from the sale of the guaranteed portions of SBA loans. As a consequence, MSB was retaining the entire credit risk of these exposures –that being the unguaranteed portion of the loan. Examiners noted that the bank would have been operationally unprofitable without that income source.

Earnings continued to be supported by the sale of the guaranteed portions of SBA loans as indicated in the August 2006 Joint ROE. At this examination it was noted that the bank's cost of funds remained above peers due to a significant reliance on time deposits. Overhead costs were well above its peers due to a large number of employees, high compensation levels and other elevated operating expenses. The net non-core funding dependency ratio of 12.37 percent indicated that the bank was partially reliant on potentially volatile liabilities to fund long-term earning assets.[4]

Earnings performance was considered deficient in the August 2007 Joint examination report. Examiners noted that revenue was not sufficient to support operations, provide for the accretion of capital and maintain an adequately funded ALLL in relation to the institution's growth and trends. Non-interest income continued to be comprised of proceeds from the sale and servicing of SBA loans. The bank continued to rely on CDs advertised nationally over the Internet with higher rates being paid than in the local market.[5]

Figure 2 illustrates the quantity of CD (Time) deposits versus total deposits.

Figure 2 Comparison of Time Deposits versus Total Deposits for MSB



Source: UBPR reports for MSB (December 31, 2008)

At the May 2008 FDIC examination it was noted that the bank had incurred operating losses in the prior 2 years due to a combination of factors including, excessive overhead costs, large provision for loan losses, expensive funding and a highly sensitive interest rate risk position which resulted in a decline in the net interest margin. Specifically, examiners indicated that the interest expense levels were a reflection of an extraordinary dependency on high-cost time deposits.

By December of 2008, the State ROE indicated that the bank's earnings performance was critically deficient due to a combination of factors which included paying high rates for non-core deposits, elevated overhead expenses and high volume of nonperforming loans.

The FDIC'S Supervision of MSB

Through its supervisory efforts, the FDIC identified key risks in MSB's management practices and operations and brought these risks to the attention of the institution's Board and management through regular discussions and correspondence, ROEs, and visitations. Key risks identified by examiners included inadequate Board and management oversight, weak risk management practices pertaining to the institution's rapid loan growth and significant loan concentrations, poor loan underwriting and credit administration practices, and reliance on high cost funding sources. The FDIC and TDB conducted three separate visitations beginning as early as March, 2004, and seven on-site examinations beginning in August, 2004.

The FDIC relied principally on suggestions to address risks identified by examiners and did not impose any informal or formal enforcement actions until December, 2007. Based on the FDIC and State observations at each examination, in retrospect, a stronger supervisory response at earlier examinations may have been prudent in light of the nature and extent of the risks and the institution's lack of adequate or timely corrective action. Stronger supervisory action in the institution's formative years may have influenced MSB's Board and management to limit the significant level of risk assumed during the institution's rapid growth period. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

Supervisory History

The FDIC, in conjunction with TDB, provided ongoing supervision of MSB through regular on-site risk management examinations and periodic on-site visitations and off-site reviews. To its credit, the FDIC communicated continuously, both internally and with MSB as concerns arose, as documented by numerous emails and other documentation. In addition, the FDIC performed daily monitoring of MSB's liquidity position in the days preceding the institution's failure. Table 3 summarizes key information pertaining to the on-site risk management examinations and visitations that the FDIC and the TDB conducted of MSB from March, 2004, until the institution failed.

Table 3 On-Site Examinations, Visitations and Actions

Date	On-Site Supervisory Effort	Supervisory Ratings (UFIRS)*	Informal or Formal Action** Taken
03/23/04	FDIC Visitation	No Ratings	None
08/09/04	Joint Examination	212332/2	None
12/16/04	FDIC Visitation	No Ratings	None
07/25/05	Joint Examination	223222/2	None
03/06/06	Joint Visitation	No Ratings	None
08/28/06	Joint Examination	223322/2	None
08/27/07	Joint Examination	223432/3	BBR 12/12/07
05/19/08	FDIC Examination	333433/3	None
12/15/08	State Examination	555555/5	DL*** 1/26/09 Order of Supervision 1/26/09
05/11/09	Joint Examination	555555/5	C&D 5/19/09 Institution Closed 7/2/09

Source: Reports of Examination and Supervisory History Memorandum for MSB

*Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity 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.

**Informal actions often take the form of Bank Board Resolutions (BBR) or Memorandums of Understanding (MOU). Formal enforcement actions often take the form of Cease and Desist Orders, but under severe circumstances can also take the form of insurance termination proceedings.

***Texas Finance Code Section 35.001.DL (Determination Letter) states that if the banking commissioner determines from examination or other credible evidence that a state bank is in a condition that may warrant the issuance of an enforcement order under this chapter, the banking commissioner may notify the bank in writing of the determination, the requirements the bank must satisfy to abate the determination, and the time in which the requirements must be satisfied to avert further administrative action. (Source: http://www.banking.state.tx.us/lg_manual/35_001-013.htm)

As illustrated in Table 3, three visitations were conducted at MSB from 2004 to 2009 in addition to the required risk management examinations. The purpose of the two visitations conducted in 2004 was to assess MSB's business practices, such as management's asset growth goals, and to review the capital plan. The purpose of the visitation in 2006 was to review the strategic plan, follow up on criticisms from the previous examination, and monitor asset quality.

The FDIC and TDB instituted one informal action and one formal action between 2007 and the institution's failure. A brief description of these actions follows.

- **December 12, 2007 BBR.** Following the August 27, 2007 Joint examination, the FDIC and TDB required the Board to adopt a BBR. The BBR contained eight provisions addressing such areas as earnings, ALLL methodology, credit administration policies, volatile liabilities, documentation exceptions, violations of law, and policies and procedures governing transactions with insiders.
- **May 15, 2009 C&D.** MSB stipulated to a Cease and Desist Order (C&D) based on the critical condition of the bank. The C&D ordered MSB to take actions in the following areas: concentration reductions, capital increase and maintenance, charge off reduction, restriction on advances to classified borrowers, ALLL and

amended Consolidated Report of Condition and Income (Call Report), liquidity/asset/liability management, management and Board supervision, loan committee and loan review requirements, strategic plan and correction of violations, among others.

In addition, the TDB issued enforcement actions based on the December 15, 2008 State examination. A brief description of these enforcement actions follows:

- **January 26, 2009 DL and Order of Supervision.** Following the December 15, 2008 State examination, the State issued a Determination Letter (DL), effective January 26, 2009, and appointed a Supervisor, who began work onsite at MSB the following day. The terms of the DL called for a Tier 1 leverage ratio of 8 percent and a total Risk Based Capital (RBC) ratio of 10 percent, development of a liquidity and interest rate risk policy, daily liquidity monitoring, a reduction plan for classified assets, management review by an independent party, development of a budget and a strategic plan, ALLL adequacy, correction of loan administration deficiencies, establishment of effective internal and external loan reviews, correction of violations, and prohibition of dividends without prior State approval, among other matters.

Supervisory Response to Key Risks

A stronger supervisory response at earlier examinations may have been prudent in light of MSB's risk profile, lack of adequate or timely corrective action to address its weak risk management practices, and problems with Board governance and management oversight. For example, the FDIC could have required that MSB commit to a written plan and timeline for addressing key risks identified by examiners before 2007 and monitored MSB's performance relative to the plan. Among other things, the plan could have required MSB to:[12]

- Establish reasonable growth projections and parameters for ensuring that loan growth was appropriately constrained;
- Establish prudent risk management practices in its SBA loan portfolio;
- Mitigate the CRE credit concentration risk in its loan portfolio; and
- Reduce its dependence on high yield internet sourced CDs.

It is recognized that the December 2007 BBR, May 2009 C&D, and the January 2009 DL and Order of Supervision collectively responded to MSB's areas of risk. However, at the time these actions were taken, MSB's growth had already occurred and concentration levels relative to Tier 1 capital significantly exceeded the average for its peer group. Action steps to persuade the Board to make key changes earlier could have been taken to achieve better risk management practices.[13] According to the *DSC Formal and Informal Action Procedures Manual* (FIAP), "The FDIC generally uses MOUs instead of BBRs, especially when there is reason to believe the deficiencies noted during an examination

[12] Auditor comments based on interview with Case Manager.
[13] Auditor comments based on interview with Case Manager.

need a more structured program or specific terms to effect corrective action."[14] Instead of a BBR, an MOU could have been instituted as a stronger supervisory response based on the findings of the August 2007 Joint examination, and based on findings from prior examinations on which management and the Board had failed to take corrective actions.

The FDIC and TDB issued a C&D on May 15, 2009. Although a C&D was appropriate for the risks that were identified, the ultimate viability of the institution was already in serious question by the time the C&D was issued. By this time the Tier 1 Capital ratio was 1.59 percent; and given the rapid deterioration of asset quality, failure of the bank was already imminent unless there was an immediate infusion of capital.[15]

Supervisory Concern Related to MSB's Board and Management

As early as August 2004, examiners expressed concerns with regard to MSB's Board and management team. By the May 2009 Joint examination, examiners noted that the bank's extremely weakened condition could be attributed to a flawed original business plan and management inaction to adjust business strategies to the bank's changing risk profile. Examiners concluded that this resulted from an inexperienced Board and the inability of the Board to administer the bank's affairs at critical points. Table 4 summarizes the supervisory concerns related to the Board and management.

Table 4 Supervisory Concerns Related to MSB's Board and Management

Examiner Concerns	Examiner Comments
Attendance at Board Meetings	• In the August 9, 2004 examination, examiners noted that a review of the Board minutes revealed that out of 11 Board meetings, one director missed 5 and one director missed eight of the meetings. Examiners commented that in order to fulfill the fiduciary duties of a director, regular attendance at Board meetings was crucial. • In the July 25, 2005 Joint examination, examiners noted that attendance on the part of three directors required improvement. Further, in the 12 months prior to the 2005 examination, one director missed seven meetings, one director missed four meetings, and a third director missed three meetings. • The following year, during the August 28, 2006 Joint examination, examiners noted that one director attended only eight of 16 Board meetings held since the last examination. Examiners indicated that regular attendance at Board meetings was necessary for a director to properly fulfill his responsibility to the bank. • In December 2008 examiners indicated that Board committees had failed to function due to lack of director attendance.
Violations of Banking Laws and Regulations	• During the July 25, 2005 examination, examiners noted that numerous apparent violations of banking laws and regulations existed. These included Regulation O, lending limit restrictions, unauthorized branching activities, and other regulations. • In August 2006, examiners noted a repetition of an apparent infraction of

[14] DSC Formal and Informal Procedures (FIAP) Manual, pages 3-4.
[15] Report of Examination, May 11, 2009.

Examiner Concerns	Examiner Comments
	one section of Regulation O. • In August 2007, examiners again noted an apparent violation of one section of Regulation O.
Board and Management Oversight and Performance	• As early as July 2005, examiners noted that management performance and Board supervision needed improvement. Further, rapid loan growth caused operational and oversight weaknesses. • By the August 2006 examination, examiners noted that management was less than satisfactory and its overall performance was in need of improvement. • In August 2007, examiners listed Matters Requiring Attention (MRA). One of these MRAs was that management needed to improve its communication with the outside directors. Further, examiners indicated that executive management performance and Board supervision was less than satisfactory. A Senior Official at that time was noted to be the dominant policy maker and had significant influence over the decisions of the Board. • During the May and December of 2008 examinations, examiners noted that management's performance was less than satisfactory as evidenced by the overall condition of the bank. • The December 2008 examination indicated that management and Board performance needed to be significantly improved. Weaknesses were evident in credit selection and underwriting, collection efforts, and the depth and succession of management and staffing. Further, examiners noted that the Board had failed to provide adequate leadership and oversight.
Business Plan	• In July 2005, examiners noted that the bank had failed to notify its regulators of material changes to the bank's business plan, as required by The Order for Approval of Insurance and the Order Approving Charter. These material changes included the establishment of loan production offices outside the primary trade area, the use of potentially volatile Internet deposits, and the extent of the SBA lending program. • In August 2006, examiners noted that the amended strategic plan included rather aggressive growth projections and anticipated the bank would more than double in size by the end of 2008. • The December 2008 examination listed matters that required Board attention. Examiners noted that the Board and management needed to take immediate steps to improve the bank's overall condition by developing a strategic plan that was consistent with conditions and circumstances. • The final examination on May 2009 noted that the bank's extremely weak condition could be attributed to a flawed business plan, poor execution of the business plan, the lack of experience at the Board level, and the inability of the Board to administer the bank's affairs at critical junctures.

Source: Reports of Examination for MSB

From 2005 through 2009, examiners consistently made note of the management and Board issues. Examiners noted that MSB's most senior official was a dominant policy maker who had significant influence over the Board.[5] For example, based on interviews with DSC personnel in Dallas, the bank's 2006 strategic plan was this individual's vision for the bank rather than the Board's vision. Further, the CAMELS component rating assigned to management remained at “3” during the July 2005, August 2006, August 2007, and May 2008 examinations. The May 2008 examination noted that several management changes were made to correct previous supervisory concerns. However, the changes were not completed in time to correct the bank’s deteriorating condition. By the December 2008 State examination, the management component rating was downgraded to “5”. The *Risk Management Manual of Examination Policies* states that a rating of 5 indicates that management and the Board have not demonstrated the ability to correct problems and implement appropriate risk management practices.[16] Based on examiner comments regarding MSB management from 2004 through 2009, more prompt and stronger supervisory action appeared to be warranted.

Supervisory Concern Related to CRE Concentrations and Underwriting

The July 2005 Joint examination noted asset quality as satisfactory and the level of classified loans was not considered excessive. However, examiners expressed concerns that lending practices and significant loan growth could result in an excessive level of future problem loans. Other examiner concerns included loans to borrowers with a lack of industry experience, overly optimistic projections and some credits that were risky from inception. The report indicated that MSB management did not report loan industry concentrations to the Board at that time and management had not been tracking real estate loans with high loan-to-value ratios. Examiners noted that management should regularly monitor and report specific loan industry concentrations to the Board in order to assess potential areas of vulnerability. This was in response to the fact that convenience store loans represented approximately 52 percent of Tier 1 capital.

Although by June 30, 2006, CRE concentrations levels were at 346 percent of total capital,[17] the August 2006 examination made no mention of CRE concentration issues. Some underwriting concerns were identified as the bank had sustained $923 thousand in charge offs in its first three years of operations. Examiners considered this level unfavorable, given that MSB was a de novo bank.

The following industry concentrations[18] in CRE lending were noted in the August 2007 Joint ROE as a percentage of tier 1 capital:

- Hotels – 182 percent
- Convenience Stores – 169 percent
- Car Washes – 102 percent

The 2007 Joint examination commented that the loan policy should be amended to include limits on concentrations and an exit strategy to reduce concentrations should economic conditions deteriorate in these industries.

[16] DSC Risk Management Manual of Examination Policies, section 1.1.
[17] Uniform Bank Performance Report, June 30, 2006.
[18] DSC's Risk Management Manual of Examination Policies, section 16-1 states that examiners may list industry concentrations of 100% or more of Tier 1 Capital in a schedule in the ROE.

At the May 2008 examination, an asset quality component rating of "3" was issued as asset quality had weakened, evidenced by an increased level of adversely classified assets. Classified items were 60.41 percent of Tier 1 capital plus the ALLL. The majority of classified items were loans that deteriorated in credit quality since the previous examination. Almost all of these loans were to SBA program borrowers who experienced problems after their first few years.[6] The hotel and motel concentration represented 257 percent of Tier 1 capital, while convenience store concentration represented 144 percent as of April 30, 2008. In this examination, examiners noted that efforts should have been made to diversify the loan portfolio and reduce concentrations in certain specific industries. Further, credit documentation exceptions increased to 43 percent of loans.

Seven months later during the December 2008 State examination, examiners noted that while management satisfactorily identified and reported concentrations of credit, previous ROEs had recommended that efforts be made to diversify the loan portfolio and reduce the bank's concentrations in certain specific industries. The examination noted that hotel and motel loans, an area in which an industry concentration had been repeatedly cited, contributed 45.5 percent of total classified assets. The examination noted the following weaknesses as the reason for the sharp deterioration of MSB's financial condition:

- Failure to adequately monitor the collateral and cash flow position of borrowers in a declining economy;
- Lending to persons with limited background in the line of business;
- Failure to diversify risk in the loan portfolio;
- Lending to borrowers with limited ability of repayment through cash flow or the sale of collateral;
- Over-lending in light of collateral support; and
- Poor choice of risk.

The Interagency guidelines issued December 12, 2006 titled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, discuss how rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. In this case adverse changes in the CRE market impacted MSB negatively.

Although there were repeated concerns by examiners on concentration levels, recommendations made, and enforcement actions issued, stronger or more detailed supervisory actions may have been appropriate in order to place greater pressure on management to establish prudent concentration limits and controls commensurate with risk. When the BBR was instituted in 2007 a stronger supervisory action may have been warranted considering the level of risk and management's lack of corrective action to repeated examiner suggestions in prior years. By the time the C&D was instituted in 2009 the bank's failure was already imminent.

Implementation of PCA

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. However, capital levels turned out to be a lagging indicator of the institution's financial condition.

Table 5 illustrates that MSB was considered well capitalized for PCA purposes until the December 2008 State examination when the institution was already at serious risk of failure.

Table 5 MSB's PCA Capitalization Categories

Examination as of Date	Capitalization Category	Informal or Formal Action Taken
6/30/2004	Well Capitalized	None
6/30/2005	Well Capitalized	None
6/30/2006	Well Capitalized	None
6/30/2007	Well Capitalized	BBR 12/12/07
3/31/2008	Well Capitalized	None
9/30/2008	Adequatelly Capitalized	DL 1/26/09 Order of Supervision 1/26/09
3/31/2009	Significantly Undercapitalized	C&D 5/19/09 Institution Closed 7/2/09

Source: Reports of Examination for MSB

Following the December 15, 2008 State examination, due to the bank's adequately capitalized status, and pursuant to Section 337.6 of the FDIC Rules and Regulation, MSB could not solicit deposits that exceeded more than 75 basis points than the prevailing effective yields on insured deposits of comparable maturity in its normal market area without prior FDIC approval.[3]

The Call Report as of March 31, 2009, showed that the bank had fallen to the Significantly Undercapitalized category. As a consequence, the FDIC notified MSB's Board that subject to section 38 of the FDI Act, a capital restoration plan was required.[19] This was further reiterated during the May 2009 Joint examination, when the Board and shareholders were urged to take immediate steps to restore capital to an acceptable level commensurate with the bank's risk profile. Following receipt of the State's finalized examination report, the Dallas Regional Office began preparing a C&D which became

[19] Prompt Corrective Action Notification, May 5, 2009.

effective May 19, 2009, the terms of which called for the infusion of $3.3 million in new capital within 30 days to increase the Tier 1 leverage, Tier 1 RBC, and total RBC ratios to 6.52%, 8.81%, and 10.07%, respectively. The C&D required reduction plans for classified assets and concentrations, ALLL adequacy, development of a budget, a strategic plan, a profit plan, a written liquidity plan, restriction on dividends without prior FDIC and State approval, and correction of violations, among other matters. The FDIC adhered to its own policy when the PCA category for MSB fell to Significantly Undercapitalized based on the analysis of the March 31, 2009 Report of Condition, by subjecting the institution to capital restoration requirements. However, by the time these actions were enacted MSB's financial condition had already severely deteriorated.

Appendices

1. Objectives, Scope and Methodology

Objectives

We performed this performance audit to satisfy the requirements of section 38(k) of the FDI Act, which provides, in general, that if a deposit insurance fund 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 FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38. We evaluated whether capital was an adequate indicator of safety and soundness and examiner's compliance with PCA guidelines.

We conducted this performance audit from August to December 2009 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 as described in the Scope and Methodology section, 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 Millennium State Bank from August 20, 2003, until its failure on July 2, 2009. 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 utilized the following techniques:

- Analyzed examination and visitation reports prepared by the FDIC and the TDB examiners from August 2004 to July 2009.

- Reviewed the following documentation:

    - Financial institution data and correspondence maintained at the DSC's Dallas Regional Office and Dallas Field Office, as provided to KPMG by DSC.

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

    - Pertinent DSC policies and procedures.

- Interviewed the relevant FDIC officials having supervisory responsibilities pertaining to MSB, which included DSC examination staff in the Dallas Region.

- Interviewed appropriate officials from the TDB to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

- Researched various banking laws and regulations, including Texas state laws.

KPMG relied primarily upon the materials provided by the FDIC OIG and DSC, including information and other data collected during interviews. KPMG did not perform specific audit procedures to ensure the information and data were complete and accurate. KPMG is, however, aware that Circular 12000.1, Cooperation with the Office of Inspector General, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the FDIC and the bank. KPMG relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, ROEs, and interviews of examiners to understand Millennium State Bank's management controls pertaining to 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 ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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

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

2. Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.

Term	Definition
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831 (o), by establishing a framework for taking prompt corrective supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

3. Acronyms

Acronym	Definition
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CD	Certificate of Deposit
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DL	Determination Letter
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIAP	Formal and Informal Action Procedures
FIL	Financial Institution Letter
GAAP	Generally Accepted Accounting Principles
MOU	Memorandum of Understanding
MRA	Matters Requiring Attention
MSB	Millennium State Bank of Texas
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RBC	Risk-Based Capital
ROE	Report of Examination
SBA	Small Business Administration
TDB	Texas Department of Banking
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

OIG Evaluation of Management Response

OIG Evaluation of Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On January 15, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of MSB's failure and the FDIC's supervision of the bank. DSC stated that the failure of MSB demonstrates why stringent supervisory attention is necessary for de novo institutions. DSC has extended its supervisory program so that these institutions receive a full-scope examination every year for 7 years, as opposed to 3 years. De novo business plans are being closely monitored against approved financial projections throughout the 7-year period. A Financial Institution Letter issued in August 2009 describes the program changes for de novo institutions and warns that changes in business plans undertaken without required prior notice may subject an institution or its insiders to civil money penalties.

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

January 15, 2010

MEMORANDUM TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Millennium State Bank of Texas, Dallas, Texas (Assignment No. 2009-063)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Millennium State Bank of Texas (MSB) which failed on July 2, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on December 23, 2009.

The Report concludes that MSB failed due to inadequate management and Board oversight, an aggressive growth strategy centered in commercial real estate lending, weak loan underwriting and credit administration, poor earnings, and an inadequate funding strategy. MSB never reached consistent operational profitability and relied on the gains on the sale of loans to achieve positive earnings. Additionally, MSB's significant dependence upon volatile, high-cost internet certificates of deposit eroded the net interest margin which, when combined with high overhead costs and excessive loan losses, depleted earnings and capital and ultimately lead to MSB's failure.

From the time of MSB's opening In 2003 until it was closed, the FDIC and Texas Department of Banking (TDB) performed seven examinations and three on-site visitations. As a result of significant deficiencies noted at the August 2006 examination, MSB was placed under an informal enforcement action. Supervisory attention to MSB continued through regular examinations and offsite monitoring. Subsequent to the December 2008 TDB examination, MSB was placed under a formal enforcement action as a result of significant deterioration of the loan portfolio and the Board and management's inability to implement necessary corrective measures.

The failure of MSB demonstrates why stringent supervisory attention is necessary for de novo institutions. DSC has extended its supervisory program so that these institutions receive a full scope examination every year for seven years, as opposed to three years. De novo business plans are being closely monitored against approved financial projections throughout the seven year period. A Financial Institution Letter issued in August 2009 describes the program changes for de novo Institutions and warns that changes in business plans undertaken without required prior notice may subject an institution or its insiders to civil money penalties.

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