Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-029

Material Loss Review of Venture Bank, Lacey, Washington

April 2010

Office of Inspector General

Executive Summary

Material Loss Review of Venture Bank, Lacey, Washington

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Why We Did The Audit

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review of Venture Bank (Venture), Lacey, Washington.

On September 11, 2009, the Washington State Department of Financial Institutions (WA DFI) closed Venture and named the FDIC as receiver. On October 9, 2009, the FDIC notified the OIG that Venture's total assets at closing were $992.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $240.1 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 Venture 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

Venture was established as a state nonmember bank that became insured on May 24, 1979 and operated 19 offices in the Washington counties of Thurston, Pierce, King, and Lewis, as of June 30, 2008. The bank was 100-percent owned by, and the only banking and significant subsidiary of, Venture Financial Group, Inc. (VFG), a registered bank holding company. Ownership of VFG was widely held.

Venture's assets were concentrated in commercial real estate (CRE), with a significant portion of those loans in the acquisition, development and construction (ADC) portfolio. Venture also had significant asset concentrations in its investment portfolio, in government-sponsored enterprise preferred stock and complex securities. Further, the bank relied on brokered deposits as a source of funding.

Audit Results

Causes of Failure and Material Loss

Venture's failure was due to ineffective oversight by the institution's Board and management. Weak risk management practices, high concentrations in CRE and ADC lending, investments in higher-risk securities such as collateralized debt obligations (CDOs), and dependence on non-core funding sources exposed the bank to substantial risk in declining market conditions. Further, loan-related losses and securities write-downs were responsible for the depletion of earnings and the erosion of capital.

The FDIC's Supervision of Venture

Through its supervisory efforts, the FDIC identified many of the key risks at Venture and brought these risks to the attention of the bank's Board and management through examinations, visitations, offsite reviews, and supervisory actions. Concerns identified by examiners included significant loan concentrations, asset growth strategies funded by non-core and high-cost deposits, and weak risk management practices. Up to and including the August 2007 FDIC examination, the FDIC relied principally on examiner recommendations made to bank management to address the risks identified by examiners.

Formal supervisory action did not occur until the WA DFI issued a Supervisory Directive in October 2008, as a result of findings at the September 2008 joint FDIC and WA DFI examination. This action was followed by the FDIC's issuance of a Supervisory PCA Directive in February 2009 as well as a Notice of Charges and of Hearing (Notice) in March 2009. The Notice was issued because Venture would not stipulate to a Cease and Desist Order being pursued by the FDIC jointly with the WA DFI to address supervisory concerns identified at the 2008 examination.

In retrospect, a stronger supervisory response at the 2007 examination may have been prudent given the nature and extent of the risks that existed in the bank's loan and investment portfolios. Stronger supervisory action in 2007 could have influenced Venture's Board and management to limit the significant level of risks assumed, established a more appropriate supervisory tone, and prompted Venture's Board and management to take more timely and adequate actions to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

With respect to PCA, the FDIC properly implemented applicable provisions of section 38. However, capital levels turned out to be a lagging indicator of the institution's financial condition. Other factors identified in earlier examinations, including loan portfolio concentrations, reliance on non-core funding, and improvements recommended in risk management practices, were advance indicators of the bank's heightened risk profile.

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 April 7, 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 Venture's failure and the FDIC's supervision of the bank. DSC stated that stronger supervisory follow-up to assess the progress of recommended corrective actions could have been taken, particularly in light of the risks associated with concentrations in CRE/ADC loans and investments in CDOs. DSC has issued updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations. Additionally, DSC issued a Financial Institution Letter in 2009 to insured institutions, entitled *Risk Management of Investments in Structured Credit Products*, providing clarification to existing guidance and strongly recommending vigilant due diligence and appropriate internal controls related to these securities.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: April 9, 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 Venture Bank, Lacey, Washington*
(Report No. MLR-10-029)

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 April 7, 2010. We incorporated the response 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: Stan Ivie, Regional Director, DSC
Christopher E. Drown, Chief, Office of Internal Control and Review, DSC
James H. Angel, Jr., Director, OERM

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Part I

Report by KPMG LLP

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Venture Bank
Lacey, Washington

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP
2001 M Street, NW
Washington, DC

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KPMG LLP
2001 M Street, NW
Washington, DC 20036

April 7, 2010

Executive Summary

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

Material Loss Review Report for Venture Bank, Lacey, Washington

Dear Mr. Beard:

This report represents the results of our work conducted to address the performance audit objectives relative to the Material Loss Review for Venture Bank (Venture), Lacey, Washington. The objectives of this performance audit were to (1) determine the causes of Venture's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of Venture, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Causes of Failure

Venture's failure was due to ineffective Board and management oversight which included weak risk management practices, high concentrations in commercial real estate (CRE) and acquisition, development and construction (ADC) lending, investments in higher-risk securities, and dependence on non-core funding sources. These practices and investment strategies exposed the bank to substantial risk in declining market conditions. Further, loan-related losses and securities write-downs were responsible for the depletion of earnings and the erosion of capital.

Evaluation of Supervision

Through its supervisory activities, the FDIC identified many of the key risks at Venture Bank. Concerns identified by examiners included significant loan concentrations, asset growth strategies funded by non-core and high-cost deposits, and weak risk management practices. These concerns were noted by the FDIC through examinations, visitations, off-site reviews, and supervisory actions. From 2005 until the bank failed, the FDIC conducted examinations in 2005 and 2007, the Washington State Department of Financial Institutions (WA DFI) conducted an examination in 2006, and one examination was conducted jointly in 2008. The FDIC also conducted two visitations in 2009.

The FDIC relied principally on examination recommendations to address risks identified by examiners. Collectively, the FDIC and the WA DFI did not impose any supervisory actions until a Supervisory Directive was issued by the WA DFI in October 2008 as a result of findings at the September 2008 Joint examination. Additional supervisory actions were taken in 2009 when a

Supervisory PCA Directive was issued as well as a Notice of Charges and of Hearing (Notice), as Venture would not stipulate to a Cease and Desist (C&D) Order.

In retrospect, it appears that a stronger supervisory response at the 2007 examination may have been prudent given the nature and extent of the risks that existed in the bank's loan and investment portfolios. Stronger supervisory actions in 2007 could have influenced Venture's Board and management to limit the significant level of risks assumed. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate actions to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

Prompt Corrective Action

The FDIC properly implemented the Prompt Corrective Action (PCA) provisions of section 38. However, capital levels turned out to be a lagging indicator of the institution's financial condition. Other factors identified in earlier examinations, including loan portfolio concentrations, reliance on noncore funding, and improvements recommended in risk management practices, were advance indicators of the bank's heightened risk profile.

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 draft report was obtained during our fieldwork, which occurred during the period from January 20, 2010 through April 7, 2010.

Very truly yours,

KPMG LLP

Background

On September 11, 2009, the WA DFI closed Venture and named the FDIC as receiver. On October 9, 2009, the FDIC notified the Office of Inspector General (OIG) that Venture's total assets at closing were $992.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $240.1 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 Venture, and retained KPMG for this purpose.[1]

Venture was established in Lacey, Washington as a state non-member bank that became insured on May 24, 1979. The bank was first established under the name of Lacey Bank. The name was changed to First Community Bank of Washington on December 21, 1981 and again to Venture Bank on May 27, 2003. The bank was 100 percent owned by Venture Financial Group, Inc. (VFG), a registered bank holding company. VFG was incorporated under the laws of the State of Washington in November 1983 as First Community Bancorp, Inc. and was renamed First Community Financial Group, Inc. in 1992 and later renamed to VFG in May 2003. The bank was the only banking and significant subsidiary of VFG. Ownership of VFG was widely held.

Venture had successfully acquired and integrated several small community banks. The last merger completed was in September 2005 when the bank acquired Redmond National Bank (Redmond), Redmond, Washington for $132 million. Venture operated 19 offices in four Washington counties: Thurston, Pierce, King, and Lewis as of June 30, 2008. The bank's main office, located in Thurston County, held over 70 percent of the institution's total deposits.

Venture's assets were concentrated in commercial real estate (CRE), with a significant portion of those loans in the acquisition, development and construction (ADC) portfolio. Venture also had significant asset concentrations in its investment portfolio in government sponsored enterprise (GSE) preferred stock and complex securities. Further, the bank relied on brokered deposits as a source of funding.

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

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[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.

Table 1: Financial Condition of Venture

Financial Measure	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	1,130,175	1,182,225	977,042	751,959
Total Loans ($000s)	751,626	765,728	711,453	596,636
ADC as a Percentage of Total Loans	47.61	47.90	42.68	31.13
CRE as a Percentage of Total Loans	81.37	78.62	79.49	81.64
Total Investments ($000s)	279,186	296,937	170,278	68,407
ALLL* ($000s)	25,240	10,975	8,917	8,434
Total Deposits ($000s)	1,022,489	838,235	771,864	515,474
Core Deposits** ($000s)	595,034	628,618	580,564	398,667
Time Deposits*** ($000s)	688,194	353,774	343,081	225,448
Net Income (Loss) ($000s)	($84,500)	$12,600	$12,558	$10,130

Source: Uniform Bank Performance Reports (UBPRs) for Venture.
* Allowance for Loan and Lease Losses.
** Time Deposits under $100 thousand are included in Core Deposits.
*** Includes time deposits over and under $100 thousand.

Causes of Failure and Material Loss

Venture's failure was due to ineffective Board and management oversight which included weak risk management practices, high concentrations in CRE and ADC lending, investments in higher-risk securities, and dependence on non-core funding sources. These practices and investment strategies exposed the bank to substantial risk in declining market conditions. Further, loan-related losses and securities write-downs were responsible for the depletion of earnings and the erosion of capital.

Management and Board Oversight

Risk Management

From 2004 through 2008, Venture's management exhibited a high tolerance for risk that included policies allowing excessive concentration in CRE and ADC lending, investment portfolio concentrations in complex securities, and a funding strategy for its asset growth through non-core deposits that was unsustainable after the bank's capital levels declined. Details regarding the impact of these policies and strategies are discussed in subsequent sections of this report.

As an example of Venture's weak risk management, in four consecutive examinations from 2005 through 2008, examiners recommended that management develop and implement models to perform stress testing[2] of the CRE portfolio. By the last Joint examination on September 22, 2008, stress testing still had not been implemented. In addition, Venture's risk profile included investments in complex securities for which examiners at a January 2009 Visitation noted that management was not adequately identifying, measuring, and monitoring critical performance

[2] Testing the CRE portfolio is done to quantify the variability of risk under changing market conditions.

factors. Based on interviews and DSC supervisory documentation, it appears that Venture's management generally had a high tolerance for risk.[3]

Apparent Violations and Contraventions of Policy

Apparent violations of law and contraventions of policy were further indications of weaknesses in management and Board oversight, though some of the cited apparent violations were technical in nature. During the May 16, 2005 examination, examiners noted an apparent violation of the Federal Reserve Board's Regulation O for the lack of approval on a director's loan. The following year, at the June 26, 2006 State examination, examiners cited violations of Part 353 of the FDIC Rules and Regulations in regard to the filing of Suspicious Activity Reports (SAR), and Federal Reserve Board Regulation W.[4] In addition, examiners also noted contraventions related to loan-to-value (LTV) exception reporting and bank-owned life insurance policies (BOLI).

At the August 13, 2007 examination, examiners noted two apparent Bank Secrecy Act (BSA) violations, an apparent violation of Part 323 of the FDIC Rules and Regulations related to real estate appraisals, and a contravention of Appendix A of Part 365 of the FDIC Rules and Regulations in regard to LTV limits.

Further, during the June 2009 visitation, examiners noted that management was in apparent violation of Section 7 of the FDI Act, as it had failed to file accurate Call Reports for March 31, 2009 by not appropriately providing for the allowance for loan and lease losses (ALLL). At the same visitation, the bank was also found to be in violation of the *Interagency Policy Statement on the ALLL*, Appendix A to Part 365 – *Interagency Guidelines for Real Estate Lending Policies* and Appendix A to Part 364 – *Interagency Guidelines Establishing Standards for Safety and Soundness*.

Concentrations in CRE and ADC Lending

Concentrations in CRE and ADC lending played a significant role in the quality and composition of Venture's assets and the bank's growth from 2004-2008. Concentrations in CRE and ADC lending at the November 2004 examination totaled 360 percent and 101 percent of Tier 1 Capital plus the ALLL, respectively. At the May 2005 examination, examiners again noted that Venture had significant loan concentrations, with CRE lending representing 364 percent and ADC-related loans accounting for 253 percent of Tier 1 Capital plus the ALLL.

At the June 2006 State examination, examiners noted that concentrations were generally in compliance with internal limits. However, examiners also noted that this was partially because

[3] From 2002 until 2005, the bank engaged in payday lending, which was also an indication of the bank's penchant for risk-taking.

[4] Regulation W implements Section 23B(a)2(C) of the Federal Reserve Act. The bank was in apparent violation of Section 223.51 of Regulation W which states that a bank and its subsidiary may engage in the furnishing of services to an affiliate only on terms that are substantially the same as comparable transactions with nonaffiliated companies. The bank was not reimbursed for time spent by bank employees on holding company matters. (Source: Report of Examination, June 6, 2006)

the limits were extremely broad and would allow the bank to take undue risk. Examiners indicated that management tracked concentrations by geographic distribution and concentration reports were reviewed by the Board quarterly.

The December 12, 2006, Joint Guidance[5] titled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), does not establish specific CRE lending limits, but defines criteria to identify institutions potentially exposed to significant CRE concentration risk. According to the guidance, a bank 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:

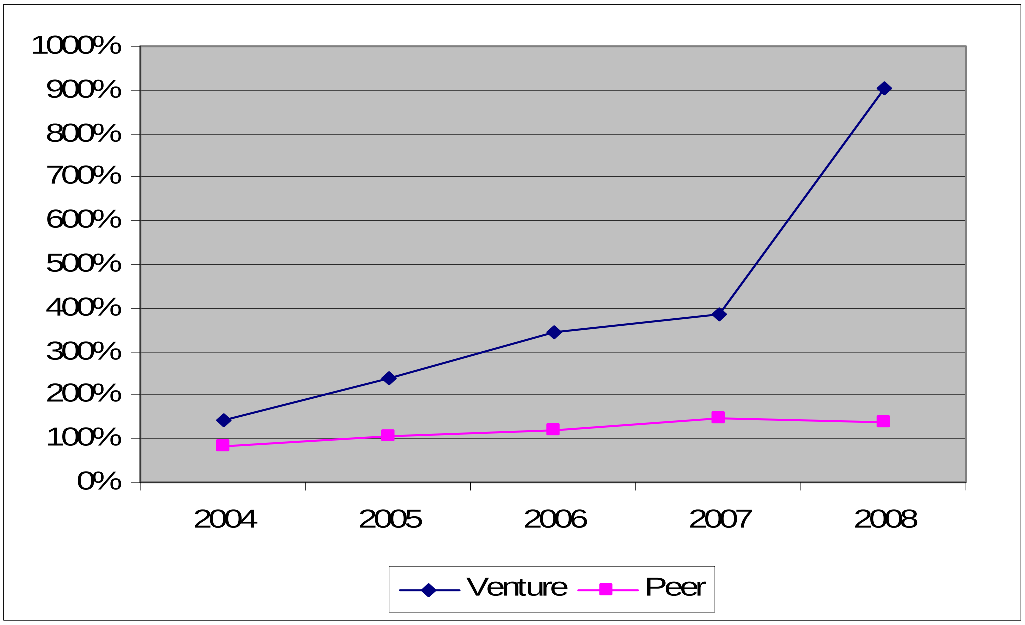
- Total reported loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of Total Capital; or
- Total CRE loans representing 300 percent or more of Total Capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Figure 1 shows Venture's ADC concentration levels as a percentage of Total Capital compared to its peer group[6] at the end of each calendar year from 2004 to 2008. As represented, the concentration level exceeded 100 percent since 2004 and as of year-end 2006 was significantly higher than the bank's peers.

[5] Guidance issued jointly by the FDIC, Treasury, and Federal Reserve on December 12, 2006. Based on this Guidance, the FDIC issued a Financial Institution Letter (FIL-104-2006) titled *Commercial Real Estate Lending, Joint Guidance*.

[6] Venture's peer group included all commercial banks having assets between $1 billion and $3 billion.

Figure 1: Venture's ADC Concentration as a Percentage of Total Capital Compared to Peer Group



Source: UBPRs for Venture.
Note: The concentration level at year-end 2008 was largely due to a substantial decrease in Venture's capital level.

CRE concentration levels were also high in comparison to the bank's peer group. From 2005 through 2007, CRE concentration levels were greater than 600 percent as a percentage of Total Capital at year-end, while the peer group concentration level ranged from 357 percent to 405 percent during the same timeframe.

At the August 2007 examination, examiners noted that CRE concentrations (including unfunded and excluding owner-occupied) represented 790 percent of Tier 1 Capital plus the ALLL, with the largest component being ADC loans totaling 594 percent of Tier 1 Capital plus the ALLL. Examiners also noted that although the level of adversely classified assets was manageable, improvements in portfolio monitoring were necessary. Specifically, examiners emphasized that to improve the monitoring of ADC loans, management should require more frequent inventory updates from builders and develop management reports to track inventory by builder.

Examiners at the September 2008 Joint examination noted that real estate values were generally declining in the bank's market area and residential and land lot values were severely depressed. Nonaccrual loans increased more than $58 million from year-ends 2007 to 2008 and represented more than $61 million. Asset classifications had soared and represented over 17 percent of total assets. Loan classifications were concentrated in the real estate ADC loan portfolio, which portended a long and protracted workout process in an unfavorable real estate market. Examiners also noted that ADC loans totaled $401 million or 49 percent of total loans as of the July 31, 2008 loan review date. Examiners at the September Joint 2008 examination noted that Venture's ADC concentration exceeded all but 1.5 percent of the banks and thrifts nationally.

At the same examination, examiners noted that concentration monitoring had improved, but stress testing had never been implemented. Examiners indicated that had management implemented stress testing, it may have been more cognizant of the emerging risks the bank would have to confront in a declining real estate market. Examiners at the June 2009 visitation noted that risk in the loan portfolio had significantly increased since the September 2008 examination. Real estate values in western Washington had seen an increase in the rate of depreciation, and builders' liquidity had tightened or disappeared as sales were very slow or nonexistent. Loans classified during the visitation totaled $248 million, resulting in an extremely high Adversely Classified Coverage Ratio[7] of 324 percent. Table 2 summarizes Venture's loan portfolio deterioration from 2005 through 2008.

Table 2: Venture's Total Nonaccrual Loans and Leases, Loans and Leases 30-89 Days Past Due, and Other Real Estate Owned from 2005 through 2008

Year Ended	Total Nonaccrual Loans and Leases (thousands)	Loans and Leases 30-89 Days Past Due (thousands)	Other Real Estate Owned (thousands)
2008	$61,301	$38,370	$11,903
2007	$3,007	$8,206	$68
2006	$691	$477	$34
2005	$2,186	$419	$474

Source: UBPR for Venture.

As illustrated above, of particular note are total nonaccrual loans climbing from $3.0 million in 2007 to $61.3 million the following year. By May 31, 2009, the nonaccrual loans represented more than $103 million.

As discussed in the Joint Guidance, rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. In comparison with the bank's peer group, Venture's level of CRE concentration was high and made the bank vulnerable to any downturn in the CRE market. It appears that adverse changes in the economy coupled with the bank's elevated risk exposure to CRE lending had a negative impact on the bank's equity through increased chargeoffs and increased loan loss provisions.

Investment Strategy

In addition to problems and deterioration in Venture's loan portfolio, there was also a precipitous decline in the value of the bank's investment portfolio beginning in 2008, specifically in government sponsored enterprise (GSE) preferred stock and Collateralized Debt Obligations (CDOs).

During 2006, the bank's total investments were more than $170 million, which represented 17 percent of total assets. By 2007, the bank's total investments climbed to more than $296 million, which represented 25 percent of total assets. Examiners did not consider the bank's investment portfolio to be risky at the 2006 and 2007 examinations. At the time of the 2006 and 2007

[7] Total Adversely Classified Items divided by Tier 1 Capital Plus the ALLL.

examinations, the investments were rated investment grade.[8] While the investment strategy had not significantly changed, deterioration in the existing investments had occurred and examiners at the September 2008 Joint examination indicated that the securities portfolio, which as of June 30, 2008 was more than $295 million, contained very high-risk instruments. Half of the portfolio consisted of Trust Preferred CDOs, zero coupon bonds, derivative securities, corporate bonds, and preferred stock. Another 18 percent of the portfolio consisted of higher yielding private-label Collateralized Mortgage Obligations (CMOs).[9] According to examiners, in aggregate, these instruments represented elevated credit risk, liquidity risk and interest rate risk to the institution.

The Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities[10] notes that institutions should establish credit risk and concentration limits on investment types. Such limits may define concentrations relating to a single or related issuer or counterparty, a geographical area, or obligations with similar characteristics. Further, complex and illiquid instruments can often involve greater risk than actively traded, more liquid securities. Frequently, this higher potential risk arising from illiquidity is not captured by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate, decreasing the market value of the instrument below the modeled value.

Table 3 provides details on the percentage of Venture's investment portfolio in Asset-Backed Securities (which includes CDOs) and CMOs, and the percentile compared to its peer group. Venture was significantly invested in CMOs by year-end 2006, and as of year-end 2007, Venture was over the 91st percentile in both types of investments as compared with peers.

[8] Investment grade refers to a security that is rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations.
[9] Investment instruments are further defined and explained in the glossary contained in Appendix 2 of this report.
[10] This policy was adopted by the FDIC and other members of the Federal Financial Institutions Examination Council in 1998.

Table 3: Venture's Percentage and Percentile of Asset-Backed Securities and CMOs in the Investment Portfolio Compared to Peer Group

Date	Asset-Backed Security* Percentage of Investment Portfolio	Percentile in Comparison to Peer Group	CMO & REMIC[11] Mortgage Backs as a Percentage of Investment Portfolio	Percentile in Comparison to Peer Group	Total Investments (thousands)	Total Investments as a Percentage of Total Assets
12/31/05	0%	N/A***	2%	**	$68,407	9%
12/31/06	0%	N/A***	52%	96	$170,278	17%
12/31/07	13%	98	45%	91	$296,937	25%
12/31/08	11%	99	83%	99	$279,186	24%

Source: OIG Analysis of UBPRs for Venture.
*Asset-Backed Securities include CDO investments.
** Information not available on percentile in comparison to peer in UBPR Report.
*** The percentile in comparison to peer is not applicable as asset-backed securities were not part of the portfolio at that time.

Government Sponsored Enterprise Preferred Stock

Examiners at the September 2008 examination noted that as of June 30, 2008, Venture's investments in Fannie Mae - Federal National Mortgage Association (FNMA) and Freddie Mac - Federal Home Loan Mortgage Corp (FHLMC) preferred stock had a book value of $42.3 million. Those securities lost most of their value when the agencies were placed in conservatorship by the Federal Housing Finance Agency on September 7, 2008. The market depreciation of $40.1 million was classified "Loss" for this examination, and the $2.2 million balance was classified Substandard. Examiners noted that even with the estimated tax benefit, the loss reduced the Total Risk-Based Capital Ratio by approximately 170 basis points.

CDOs

The January 2009 Visitation Report noted that between March and August 2007, management purchased subordinate tranches of two CDOs valued at more than $42 million. The CDOs were both primarily comprised of trust preferred securities[12] issued by bank holding companies from across the country. An additional segment of the respective asset pools was debt issued by entities that issue credit default swaps.[13] In the report, examiners noted that management was unaware of the latter, and that while management did have prospectuses for the CDOs, management did not document its analysis or support its due diligence efforts.

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[11] A REMIC is an entity that is formed for the purpose of holding a fixed pool of mortgages secured by an interest in real property and issuing multiple classes of interests therein to investors.
[12] Trust preferred securities are hybrid instruments possessing characteristics typically associated with debt obligations.
[13] Credit default swaps are a type of credit derivative similar to an insurance contract providing the buyer with protection against specific credit risks.

The two CDOs were in the mezzanine tranche level, which is a junior tranche level. The June 2007 DSC *Capital Markets Examination Handbook* (Handbook) notes that senior tranches benefit from low correlation, which translates into high diversification. In contrast, junior tranches have low diversification which assumes higher loss probability, but can be compensated through potentially higher investment returns. Therefore, Venture assumed more risk in these investments in return for the potential of higher income. The Handbook notes the following risks that should be considered prior to CDO investment and while the investment is held:

- Capital structure risk;
- Credit risk;
- Correlation risk;
- Liquidity risk; and
- Operational risk.

Examiners at the September 2008 Joint examination noted that the collateral pools underlying both of these securities included the preferred debt of the defunct IndyMac Bank, as well as several institutions that deferred dividends on their trust preferred obligations. The market value of both securities was severely depreciated (indicating a 60-75 percent loss as of September 30, 2008) and the only trades occurring were distressed sales. Examiners noted that management had not evaluated either of these securities for impairment prior to the examiners' proposed classification. The combined classifications of these CDOs and the FNMA and FHLMC preferred stock represented 95 percent of June 30, 2008 Tier 1 Capital. In August 2008, the CDOs were downgraded to sub-investment grade by Moody's.

At the January 2009 visitation, examiners noted that the market for the CDOs had been adversely affected because the securities were thinly traded due to the structured nature of the securities, the underlying performance of the collateral pools, and generally poor performance of the financial sector. Further, management's identification, measurement, and monitoring of the critical performance factors were weak. The lack of documented analysis and management's limited understanding of fundamental factors to analyze the CDOs reflected inadequate attention to regulatory and accounting guidance, especially in the context of the materiality of the assets in question.

Following the January 2009 visitation, a dispute arose between the bank and the FDIC regarding the timing and the amount of the Other Than Temporary Impairment (OTTI) to record on the CDOs. Examiners noted that the reputational risk associated with imposing a formal supervisory action, the deteriorating financial condition, and the riskier PCA capital category could cause significant and sustained erosion of the deposit base and raised significant doubt as to the bank's ability to hold the CDOs to maturity. The distressed value of the CDOs did not provide any meaningful liquidity support to the bank and Venture was unlikely to realize any recapture of impaired value in the CDOs. The determination on OTTI made on July 27, 2009, as noted in an Amended Notice of Charges,[14] was that the CDOs were subject to OTTI with a split classification between Doubtful and Loss and they should be written down to the bank's fair

[14] August 31, 2009.

value estimate of 42 cents on the dollar as originally reported on the bank's December 31, 2008 Call Report.

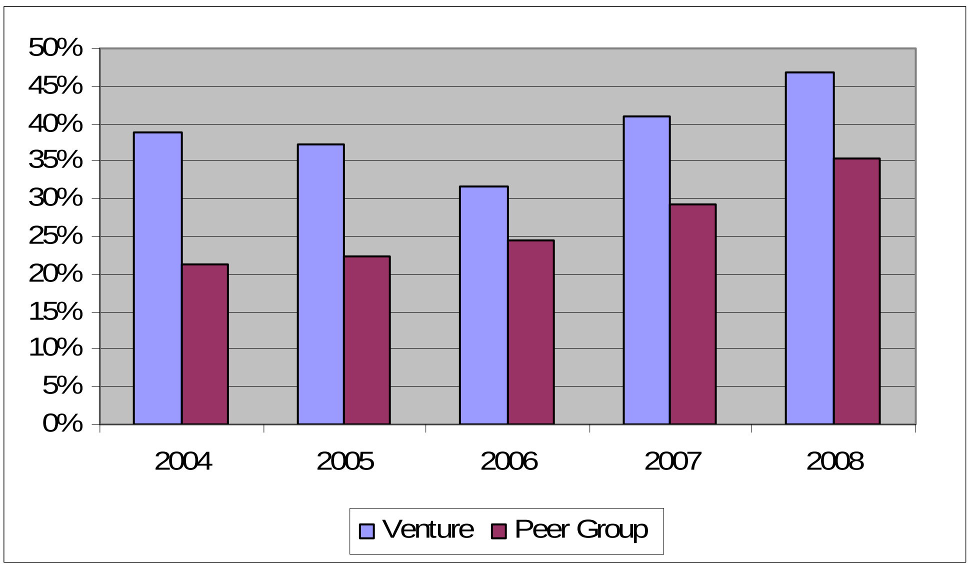
The decrease in value of the investment portfolio beginning in 2008 added to the rapid decline in Venture's asset quality, which ultimately was a contributing factor to the bank's failure.

Funding Strategies

Examiners at the June 2006 examination indicated that the Net Non-core Funding Dependency Ratio[15] had increased from 36.07 percent at the previous examination to 41.31 percent. At the August 2007 examination, examiners noted that Venture's dependence on non-core funding was 38.47 percent.

Figure 2 illustrates that Venture had a steady reliance on non-core deposits, which increased as the Net Non-core Funding Dependency Ratio increased to more than 40 percent at a critical juncture in Venture's asset growth.

Figure 2: Venture's Non-core Funding Dependency Ratio Compared to Peer Group



Source: UBPRs for Venture, as of year-end.

Examiners at the September 22, 2008 Joint examination noted that total borrowing capacity had declined due to the bank's lower capital level, depreciation of collateral used for pledging, and the Federal Home Loan Bank's (FHLB) decision to require physical possession of collateral documents. As of September 29, 2008, the bank reported net available borrowing capacity at the FHLB of $117 million, based on the collateral value of the blanket lien. In early October 2008, the FHLB changed the bank's collateral requirement from the blanket lien to physical

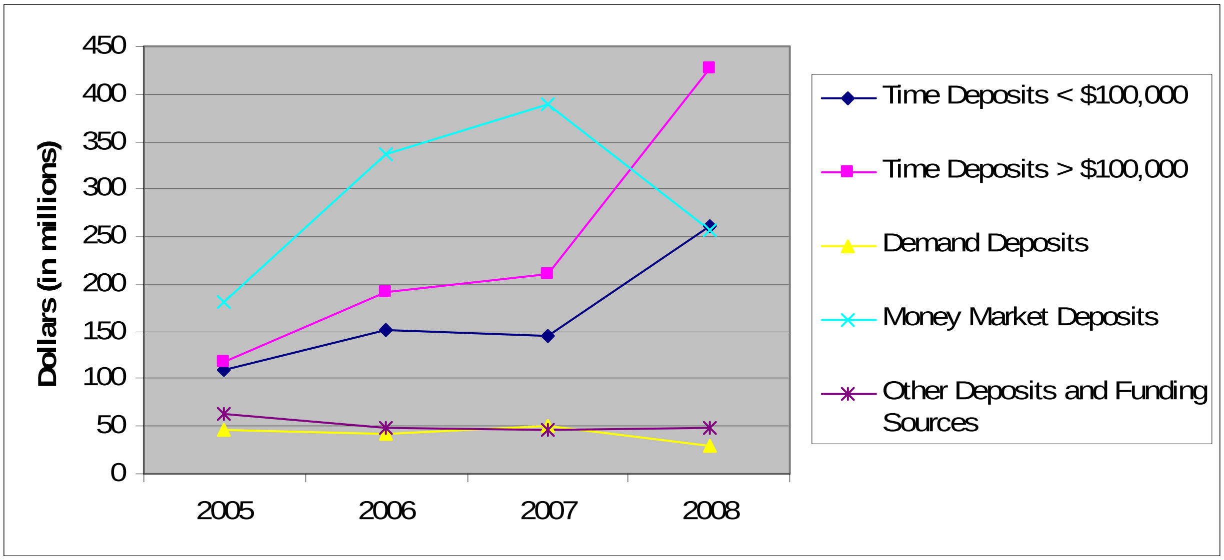
[15] Measures the degree to which the bank is funding longer-term assets with non-core funding. Non-core funding includes funding that can be very sensitive to changes in interest rates such as brokered deposits, CDs greater than $100 thousand, and borrowed money.

possession. This action significantly reduced the bank's borrowing capacity to a maximum of $49 million.

Examiners at the September 22, 2008 Joint examination noted that the bank had relied increasingly on brokered deposits to fund operations. Between June 2007 and June 2008, brokered deposits increased from 16 percent to 27 percent of total deposits, and further increased to approximately 39 percent by September 8, 2008. On that date, the bank received notification from the FDIC of its lowered capital status to *Adequately Capitalized* and to cease the acceptance of brokered deposits as required.[16] The bank subsequently used high-rate retail certificates of deposit (CDs) and Internet deposits to replace the runoff and pay down borrowing lines. By October 31, 2008, approximately 50 percent of total deposits consisted of brokered and Internet deposits, including high-rate retail CDs that exceeded the market. The bank had offered special incentives such as a 25-month CD with a rate of 5.05 percent and a 13-month CD at 4.50 percent.

Figure 3 illustrates the increasing level at which time deposits or CDs were being used as a funding source to replace brokered deposits. CDs of $100,000 or more as of December 31, 2008 accounted for more than $427 million, representing an increase of 103 percent from the prior year. CDs under $100,000 also experienced an 80 percent increase over the prior year and accounted for more than $260 million in deposits. Money market deposits decreased significantly over the same time period. The bank's increased reliance on high-rate CDs made deposits less replaceable as the CDs reached maturity, particularly in a declining interest rate environment.

Figure 3: Venture's Funding Sources – Year-Ends 2005-2008



Source: UBPRs for Venture.

[16] Further deterioration noted at the September 22, 2008 examination lowered the bank to *Undercapitalized* status as of June, 30, 2008.

Examiners at the January 2009 Visitation noted that internal liquidity cash flow projections prepared by bank management were heavily reliant on the continued acquisition and rollover of deposits through an Internet deposit solicitation service. Asset growth funded by brokered deposits made it difficult for the bank to adjust to a declining economic landscape. Given its shrinking borrowing capacity, the bank had limited alternative funding sources to replace these deposits and opted to fund its growth through higher cost CDs. Therefore the ability to maintain acceptable capital and liquidity levels became challenging for the institution.

The FDIC's Supervision of Venture

Through its supervisory activities, the FDIC identified many of the key risks at Venture Bank. Concerns identified by examiners included significant loan concentrations, asset growth strategies funded by noncore and high-cost deposits, and weak risk management practices. These concerns were noted by the FDIC through examinations, visitations, off-site reviews and supervisory actions. From 2005 until the bank failed, the FDIC conducted examinations in 2005 and 2007, the WA DFI conducted an examination in 2006, and one examination was conducted jointly in 2008. The FDIC also conducted two visitations in 2009.

The FDIC relied principally on examination recommendations to address risks identified by examiners. Collectively, the FDIC and WA DFI did not impose any supervisory actions until a Supervisory Directive was issued by the WA DFI in October 2008, as a result of findings at the September 2008 Joint examination. Additional supervisory actions were taken in 2009 when a Supervisory PCA Directive was issued as well as a Notice of Charges and of Hearing (Notice) as Venture would not stipulate to a Cease and Desist (C&D) Order.

In retrospect, it appears that a stronger supervisory response at the 2007 examination may have been prudent given the nature and extent of the risks that existed in the bank's loan and investment portfolios. Stronger supervisory actions in 2007 could have influenced Venture's Board and management to limit the significant level of risks assumed. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate actions to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

Supervisory History

The FDIC in conjunction with WA DFI provided ongoing supervision of Venture through regular on-site risk management examinations, on-site visitations and off-site reviews. Table 4 summarizes key information pertaining to the on-site risk management examinations and visitations that the FDIC and the WA DFI conducted from May 2005 until the institution failed.

Table 4: Venture's Examination History from May 2005 to June 2009

Date	On-Site Supervisory Effort	Supervisory Ratings (UFIRS)*	Supervisory Action Taken
5/16/05	FDIC	222122/2	None
6/26/06	WA DFI	222222/2	None
8/13/07	FDIC	222222/2	None
9/22/08	FDIC/WA DFI	554554/5	Supervisory Directive 10/23/08
1/22/09	FDIC Visitation	No Ratings*	Supervisory PCA Directive 2/13/09 Notice of Charges and of Hearing 3/30/09
6/15/09	FDIC Visitation	Risk Management Composite Rating: 5	Amended Notice of Charges and of Hearing 8/31/09

Source: ROEs for Venture and DSC supervisory documents.
*Visitation focused on CDOs and no ratings were assigned at the visitation.

Supervisory Directive: On October 23, 2008, the WA DFI issued a Supervisory Directive due to the bank's less than satisfactory financial condition based on the September 22, 2008 examination.

Among other things, the Supervisory Directive required Venture to:

- Implement a plan to restore and maintain a *Well Capitalized* capital level for Prompt Corrective Action (PCA) purposes;
- Provide daily reports to the WA DFI and FDIC on liquidity position; and
- Furnish written progress reports to the WA DFI and FDIC within ten days of the end of each month during the life of the Supervisory Directive.

Supervisory PCA Directive: Based on the decline of Venture's PCA status to *Undercapitalized*, the FDIC issued a Supervisory PCA Directive on February 13, 2009. This followed Venture's submission of a capital restoration plan in December 2008 that was rejected by the FDIC. The PCA Directive noted that the bank's condition continued to deteriorate, and the bank's management had not demonstrated the ability to return the institution to a safe and sound condition. Further detail on this supervisory action is provided in the *Implementation of PCA* section of the report.

Notice of Charges and of Hearing: A C&D was sent to the bank on December 16, 2008. Venture's management was not responsive to the C&D and as a result, the FDIC issued a Notice dated March 30, 2009. An FDIC memorandum accompanying the Notice indicated that a C&D pursuant to Section 8(b) of the FDI Act was being pursued jointly with the WA DFI to address supervisory concerns identified at the prior examination. The memorandum noted that there were no indications that management would consent and that the prospects that management would stipulate to the C&D was unlikely due to management's expression of disagreement to the proposed provision requiring the recognition of OTTI on the two CDOs.[17]

On August 31, 2009, the FDIC issued an Amended Notice of Charges and of Hearing (Amended Notice). The Amended Notice noted continued deterioration in financial condition found at the June 2009 visitation. It also noted that if the bank would recognize OTTI on the CDOs, capital would become critically deficient.

The Amended Notice identified some of the following unsafe and unsound banking practices that were noted during the June 2009 visitation:

- The bank had continued to operate with an inadequate system to monitor the risks in its loan portfolio;
- The bank's March 31, 2009 Call Report figure of $346,000 in troubled debt restructured was significantly understated, while a more accurate estimate was $5 million;
- As of the September 2008 Joint examination, the bank's past due and non-accrual loans and leases represented 5.07 percent of total loans and leases. By March 31, 2009, as evidenced by the Call Report, that figure had increased to 17.77 percent; and
- The June 2009 visitation revealed that, at a minimum, an additional $19.2 million was needed to increase the bank's ALLL to $38.8 million. If such reserve position and other direct losses identified at the visitation were properly reflected in the March 31, 2009 quarterly results, Venture should have reported a net loss of more than $16 million.

On September 11, 2009, the WA DFI closed Venture due to poor asset quality, insufficient earnings, and inadequate capital.

Supervisory Response Related to Management and Board Oversight

At the 2005, 2006 and 2007 examinations, examiners noted concerns regarding loan concentration levels, existing risk management practices, and the lack of adequate loan concentration monitoring. At those examinations, the ALLL was generally considered to be sufficient given that loan classifications at those examinations were significantly lower and reflective of a more favorable economic environment. At the 2008 Joint examination, however, examiners noted that Board members failed to place limits on management's investment decisions and did not act to slow the steady increase in ADC loan concentrations. Examiners noted further that the Board was either unaware of or failed to grasp the potential threat to the bank's viability of increasing risk without corresponding increases in capital.

Examiners at the September 2008 Joint examination noted that the bank's methodology to determine an appropriate level for the ALLL was flawed, and it did not appear to comply with the requirements of FAS 114. While management chose to fund the reserve near the "middle" of the methodology's recommended range, examiners found that the ALLL should have been

[17] Further detail on the disagreement between the institution and the FDIC on the issue of OTTI can be found in the *Supervisory Concern Related to Venture's Investment Strategy* section in this report.

increased to the "high" end of the range, and in accordance with the bank's Loan Policy. Examiners noted that considering the $80 million in loans added to the watch list[18] between June 30, 2008 and September 30, 2008 and the need to increase the reserve to the maximum range, an ALLL of $26.3 million was required as of September 30, 2008. Provisions of $13.1 million were needed to reach that level from the level that existed as of the prior fiscal quarter.

The DSC *Risk Management Manual of Examination Policies* states that "the quality of management is often the single most important element in the successful operation of an insured institution, and is usually the factor that is most indicative of how well risk is identified, measured, monitored, and controlled" From 2005 through 2007, examiners assigned a "2" rating to the management component rating. In fact, the management component was not downgraded until the September 2008 Joint examination. We were informed that the FDIC had a tendency to look at the bank's financial results versus bank practices and to assign examination ratings accordingly.[19] The following factors indicate that a stronger supervisory response may have been warranted earlier than 2008:

- At the 2007 examination, examiners noted that the bank's concentration oversight program did not conform to the 2006 Joint Guidance;
- Increasingly high concentration levels in the ADC portfolio from 2005 though 2008;
- High concentration in complex investment securities from 2006 until the bank's failure;
- Repeated criticism for lack of stress testing from 2005 through 2008; and
- Aggressive growth strategy supported by noncore deposits.

Such a response may have included consideration of a lower management rating and/or requiring the bank to: modify loan policies to have more stringent and meaningful limits to lower CRE and ADC concentrations, implement stress testing, and formulate a plan to decrease dependence on non-core deposits.

Supervisory Response Related to Loan Concentrations

Examiners identified problems with Venture's loan concentrations at various points in time during the life of the institution. Table 5 summarizes the supervisory responses to the CRE and ADC concentrations from 2005 through 2008.

[18] The watch list is one of the primary tools banks use to track, manage, and report problem loans.
[19] Based on an interview with an Assistant Regional Director.

Table 5: Supervisory Responses to Venture's CRE and ADC Concentrations from 2005 through 2008

Examination as of Date	Asset Quality Component Rating	CRE Concentration as a Percentage of Total Capital	ADC Concentration as a Percentage of Total Capital	Examiner Comment
3/31/2005	2	499 percent	150 percent	Examiners noted that management should enhance the Loan Policy for real estate concentration monitoring. Examiners recommended that management develop and implement models to stress test the commercial real estate portfolio.
3/31/2006	2	613 percent	288 percent	Examiners noted that concentrations of credit in the construction/land development and CRE portfolios were significant. Examiners recommended that management implement a stress test model that measures the potential impact of CRE concentrations to earnings and capital.
6/30/2007	2	641 percent	369 percent	Examiners noted that CRE concentrations were quite high and additional monitoring of types of concentrations was needed. Examiners noted that management was reviewing various software packages to determine which would help them stress test the portfolio.
6/30/2008	5	641 percent	389 percent	Examiners noted that stress testing and improved concentration monitoring had been recommended in each of the past three examinations. Examiners noted that although concentration monitoring had improved, stress testing had never been implemented. Examiners noted that according to the FDIC's database of bank statistics, Venture's ADC concentration exceeded all but 1.5 percent of the banks and thrifts in the nation.

Source: ROEs and UBPRs for Venture.

As illustrated in Table 5, from 2005 through 2007, the asset quality component was rated "2". The first time the asset quality component was downgraded was during the last examination in September 2008. At that examination, examiners downgraded the asset quality component to "5" noting that the Board and management had failed to slow the steady increase in construction and development loan concentrations.

At the August 2007 examination, examiners informed management that they should bring the bank's concentration oversight program into conformance with the Joint Guidance. As discussed previously, the guidance does provide high-level indicators to assist examiners in identifying institutions potentially exposed to CRE concentration risk. However, it does not establish a CRE concentration limit.

During interviews regarding the asset quality rating for the 2007 examination, we were informed that the examination focus at that time was on the financial performance of the portfolio and not necessarily the underlying inherent risks.[20] Further, we were advised that an asset quality downgrade at that examination would have been challenging given a low adversely classified loan level of 8.76 percent.

The DSC *Risk Management Manual of Examination Policies* states that "an asset quality component rating of '2' indicates satisfactory asset quality and credit administration practices. The level and severity of classification and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities." Given management's risk tolerance and the bank's increasing ADC and CRE loan concentrations, a downgrade in the asset quality component at the 2007 examination may have been warranted. Further, requiring the bank to maintain higher capital levels to support the high concentrations may have been prudent.[21]

Supervisory Response Related to Venture's Investment Strategy

Venture's concentration in CMOs and REMIC-backed securities was high as early as 2006. In 2006, the peer group's CMO and REMIC-backed securities was 6.86 percent while Venture's concentration was 52.23 percent of its investment portfolio. As previously illustrated in Table 3, Venture was in the 96th percentile among its peer group in the level of this type of investment. Nevertheless, during the 2007 examination, examiners did not identify the risk in concentrations in specific investments that were held in the bank's portfolio. As noted in the January 2009 visitation report, the two CDOs purchased between March and August 2007 for more than $42 million were the same ones that had extensive loss in value beginning in 2008 and represented half of the bank's Tier 1 capital plus ALLL at the time of purchase. We were advised that investments were considered satisfactory by examiners because they were rated investment grade, even if there were concentrations in certain categories of investments, including complex securities.[22] At the September 2008 Joint examination, examiners noted that the combined classifications of these CDOs and the FNMA and FHLMC preferred stock represented 95 percent of June 30, 2008 Tier 1 Capital plus the ALLL.

At the 2007 examination, examiners noted that Venture's last investment internal audit was completed in 2005, and recommended that an investment audit be conducted on a more frequent basis, as the investment portfolio made up 21 percent of Venture's total average assets. However, the risk associated with concentrations in specific types of investments including

[20] Based on interviews with an Assistant Regional Director and a Field Supervisor.
[21] Based on interviews with an Assistant Regional Director and a Field Supervisor.
[22] Based on an interview with the 2008 Examiner-In-Charge (EIC).

CDOs and CMOs was not mentioned until the 2008 examination. Given the bank's high concentration in complex securities and the 1998 *Supervisory Policy Statement on Investment Securities*, additional supervisory attention to and discussion of the associated risks in the examination report may have been warranted at the August 2007 examination.

<u>OTTI</u>

At the September 2008 Joint examination, examiners noted that Venture held $42.7 million in two CDOs, the market value of both securities was severely depreciated (indicating 60-75 percent loss as of September 30, 2008), and the only trades taking place were clearly distressed sales. Examiners at the January 2009 visitation noted that the market for the CDOs had been adversely affected because the securities were thinly traded due to the structured nature of the securities, the underlying performance of the collateral pools, and generally poor performance of the financial sector. Following the January 2009 visitation, there was documented disagreement between the institution and the FDIC regarding the issue of declaring an OTTI on the CDOs.

DSC supervisory documentation noted that on March 10, 2009, the FDIC San Francisco Regional Office (RO) verbally informed the Chief Executive Officer (CEO) that the visitation report was being sent out and affirmed that a Notice of Charges would be issued since the bank would not agree to an OTTI provision in the C&D. On March 11, 2009, FDIC transmitted the January Visitation Report and notified the bank of its PCA capital category of *Significantly Undercapitalized* due to the conclusion of impairment in the two CDOs. The visitation transmittal letter acknowledged the receipt of a PCA Directive appeal by the bank. On April 6, 2009, the bank provided a written response to the January 2009 visitation, disagreeing with all findings and conclusions.

On May 11, 2009, Venture filed an "Appeal of Material Supervisory Determination"[23] with DSC resulting from the January Visitation. Among other things, the bank appealed the determination that the CDOs should have OTTI taken in the amount of more than $36 million and the valuation method regulators used to price the CDOs. The RO response to the appeal on May 21, 2009 recommended that the CDOs be priced at 15 cents on the dollar.

On May 29, 2009, Venture sent a letter to the FDIC Ombudsman stating that the bank had carefully evaluated the securities, as well as the underlying trust preferred securities and obtained a review of the securities by three independent securities consultant expert companies. The review determined that there was no OTTI, no adjustment would be required under GAAP, and the securities retained significant market value. The RO was not in agreement with the advice and conclusion of the experts, and deemed it necessary to carry the securities at a much lower value. An Amended Notice stated that on July 27, 2009 the bank's appeal of the Material Supervisory Determination was resolved and the bank was notified. The decision was that the CDOs were subject to an OTTI with a split classification between Doubtful and Loss.

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[23] Material supervisory determinations include, among other things, CAMELS and other types of examination ratings, conclusions regarding adequacy of loan loss reserve provisions, violations of statute or regulation, and any other supervisory determination (unless otherwise not eligible for appeal) that may impact the capital, earnings, operating flexibility, or capital category for prompt corrective action purposes of an institution, or otherwise affect the nature and level of supervisory oversight accorded an institution.

Accordingly, the bank was advised to write down the CDOs to the bank's fair value estimate of 42 cents on the dollar as originally reported on its December 31, 2008 Call Report.

The Amended Notice indicated that Venture filed an appeal with the Supervision Appeals Review Committee (SARC)[24] of the Material Supervisory Determination decision on August 26, 2009. On September 10, 2009, Venture responded to the Amended Notice that the CDOs were not "severely depreciated" and denied that the appeal of the Material Supervisory Determinations was ultimately resolved. In addition, the bank denied that the FDIC's decision was appropriate and denied that any OTTI should be taken. However, consistent with the FDIC's *Guidelines for Appeals of Material Supervisory Determinations*, the appeal was held in abeyance by DSC as the institution was insolvent and was closed by the WA DFI on September 11, 2009.

Supervisory Response Related to Venture's Funding Strategies

Examiners at the August 13, 2007 examination noted that the bank's dependence on non-core funding had increased to 38.47 percent as of June 30, 2007, from 31.63 percent at year-end 2006. Examiners indicated that management sufficiently monitored its level of non-core funding. Further, management was working on new products to gather core deposits; though management stated that the use of core deposits was more costly at times than the use of non-core deposits. According to the examination, secondary sources of liquidity totaled approximately $80 million and consisted of lines of credit from three other banks. Although 59 percent of the securities portfolio was pledged, approximately $84 million remained available for liquidity purposes. In addition, the bank had $74 million remaining on a line of credit from the FHLB and public funds were readily available to the bank.

Examiners at the September 22, 2008 Joint examination noted that liquidity had been negatively impacted by collateral and capital deterioration, and was critically deficient. Further, examiners noted that the funding structure was unsustainable, as the bank was relying on high-rate retail specials and deposits generated from Internet listing sites to replace runoff of brokered and retailed deposits and to fund operations. Balance sheet liquidity was limited due to depreciation in both the loan and securities portfolios. Secured funding sources were contracting, and the bank was at risk of a run on deposits.

The economic downturn negatively affected asset quality, harmed capital ratios, and impacted the bank's borrowing capacity. Based on the bank's net non-core funding dependency, a stronger supervisory response may have been warranted at the 2007 examination. The decline in the capital ratio category required the bank to cease the acceptance of brokered deposits. This development made it difficult for bank management to replace these deposits without relying on high-rate retail CDs and Internet deposits. A more robust response may have included further criticism of management or a supervisory action requiring the bank to limit its reliance on non-core funding sources.

[24] The SARC was established by the FDIC to independently review material supervisory determinations made for insured depository institutions that the Corporation supervises.

Effectiveness of Off-Site Review

The *Case Manager Procedures Manual* states that the "off-site review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately." The FDIC generates an Off-site Review List (ORL) each quarter and performs off-site reviews for each bank that appears on the list. Off-site reviews must be completed and approved 3½ months after each Call Report date.[25] This generally provides 45 days to complete the off-site reviews once Call Report Data is finalized. In the case of Venture, off-site review did not play a significant role in the supervisory approach to the institution.

In 2007, Venture had increasing risk indicators such as high lending concentration levels, asset growth in ADC lending, concentrations in the investment portfolio, and an increased reliance on non-core deposits to fuel this growth. For example, during the August 2007 examination, examiners noted management's increasing reliance on brokered deposits to fund loan growth. Examiners also noted that the bank maintained a significant concentration in CRE loans that represented 790 percent of Tier 1 Capital plus the ALLL, and ADC loans represented 594 percent.

One of the measures used to produce the ORL is the Statistical CAMELS Off-site Rating (SCOR) model, which uses statistical techniques to measure the likelihood that an institution will receive a rating downgrade at the next examination.[26] The output of the SCOR model is derived from historical examination results as well as Call Reports. Despite the risks discussed above, during 2007, SCOR did not flag Venture as having a high probability of being downgraded to a composite "3" or worse. Further, the bank's growth was not at a level that would have triggered inclusion on the ORL.

In 2009, the FDIC OIG issued an audit report[27] titled *FDIC's Controls Related to the Offsite Review List*. The report notes that the assumptions and methodologies used in SCOR had not been updated since 2003. The report states further that the off-site monitoring systems used to create the ORL are largely based on historical financial information, provided by the financial institution, that may not be accurate and may not fully consider current and emerging risks. The report notes that, as a result, the FDIC's off-site monitoring systems may not have been capturing a complete picture of the current and emerging risks facing 1-and 2-rated institutions or identifying those institutions at risk of significant ratings downgrades, as was the case with Venture in 2007. In 2008, Venture was identified twice for off-site review. The reviews were conducted but since an onsite review was already in progress at the time or recently completed, the results of the onsite examination were used as the primary supervisory tool.

In response to the OIG report, DSC indicated that the predictive accuracy of SCOR increases with deteriorating financial conditions in the business cycle, but agreed to review the ORL model

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[25] The FDIC also utilizes other off-site monitoring tools in addition to the ORL.

[26] SCOR is a financial model that uses statistical techniques, off-site data, and historical examination results to assign an off-site CAMELS rating and to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination. For 1- and 2-rated institutions, SCOR assigns a probability of downgrade to a "3" or worse rated institution.

[27] Report No. AUD-09-004, FDIC's Controls Related to the Offsite Review List; February 2009.

and its logical and conceptual soundness on a 4-year rotational basis. In that regard, in March 2009, DSC and the FDIC's Division of Insurance and Research (DIR) issued a memorandum to provide additional statistical evidence of the predictive accuracy of the SCOR model. This memorandum was intended to support the validation program initiated by DSC and DIR in 2008. Specifically, the memorandum documented the recent change in the performance of SCOR since the occurrence of major financial and economic events starting in the second quarter of 2007. The memorandum stated that the predictive accuracy of SCOR had increased significantly in recent periods. Notably, the accuracy of SCOR as of 2008 had risen to its highest levels since the inception of the model in 1986.

Consistent with the March 2009 memorandum's conclusions, Venture was identified on the ORL twice in 2008 as financial conditions deteriorated, and off-site reviews were conducted for Venture based on June 30, 2008 and September 30, 2008, Call Report data.

- The June 30, 2008 off-site monitoring review indicated an increased level in noncurrent loans from 0.4 percent as of December 31, 2007 to 4.71 percent as of June 30, 2008. Also, Venture notified the FDIC of another emerging issue; specifically, Venture's holding of $42.5 million in FNMA and FHLMC preferred stock. Examiners concluded that the level of problem loans in addition to the writedown of the FHLMC and FNMA stock would further impact the adequacy of capital and that risk was increasing and a downgrade at the September 2008 examination was expected.

- Another off-site review was triggered based on the September 30, 2008 Call Report. However, there was apparently little to be gained from an off-site review at this time and no conclusions were drawn by examiners because it was completed on December 16, 2008 soon after the Joint September 2008 on-site examination had already resulted in Venture being downgraded to a composite "5" safety and soundness rating.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations implements 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. Other factors identified in earlier examinations, including loan portfolio concentrations, reliance on noncore funding, and improvements recommended in risk management practices, were advance indicators of the bank's heightened risk profile.

Table 6 details Venture's PCA Category and actions taken at the various examinations and Call Reports.[28] The table illustrates that Venture was considered *Well Capitalized* for PCA purposes until the 2008 Joint examination, when the institution was already at serious risk of failure.

[28] "As-of" Dates

Table 6: Summary of PCA Capital Categories for Venture

As of Date	Capital Category	Action Taken
3/31/2005	Well Capitalized	None
3/31/2006	Well Capitalized	None
6/30/2007	Well Capitalized	None
6/30/2008	Under Capitalized	Supervisory Directive 10/23/2008
12/31/2008	Significantly Undercapitalized	Supervisory PCA Directive 2/13/09 Notice of Charges and Hearing 3/30/2009
6/30/2009	Critically Undercapitalized	Institution Closed 9/11/2009

Source: ROEs and DSC Supervisory Documentation.

On October 23, 2008, the WA DFI issued a Supervisory Directive based on the September 2008 examination. Among other items, it required Venture's Board of Directors to develop and implement a plan within 45 days to restore and maintain capital at *Well Capitalized* levels as defined under PCA guidelines. On November 4, 2008, the FDIC sent Venture a PCA Notification (Notification) indicating that the bank had fallen within the *Undercapitalized* capital category. According to the Notification, on October 31, 2008, Venture became subject to the mandatory requirements of Section 38, including submission of a capital restoration plan. Venture submitted the required capital restoration plan on December 23, 2008. On January 20, 2009, the FDIC sent Venture a letter informing the bank that the capital restoration plan was not acceptable and was rejected due to significant deficiencies. Some of the deficiencies included, but were not limited to, the following:

- The plan failed to achieve the level of capital required under the proposed C&D.
- The plan appeared to place significant reliance on the ability to improve asset quality and collect problem credits. Financial projections showed that provisions for loan losses would decrease significantly in 2009, with no provisions for 2010. Such projections were considered unrealistic given the current economic environment and the inherent risk in the loan portfolio, and were not supported by any detailed analysis of the loan portfolio and means for improvement.
- Board and management oversight and monitoring procedures were lacking.

On February 15, 2009, the bank submitted a revised Capital Restoration Plan.

Prior to the submission of the revised Capital Restoration Plan, on February 13, 2009, the FDIC issued a Supervisory PCA Directive (PCA Directive) for reasons including:

- The FDIC and WA DFI deemed the bank to be *Undercapitalized* due to significant concerns regarding the reliability of the bank's financial statements, including potential impairment in Venture's securities portfolio and continued decline in asset quality;
- The bank's condition continued to deteriorate; and
- Actions in the PCA Directive were necessary to carry out the purposes of Section 38 of the FDI Act.

Some of the requirements of the PCA Directive were for Venture to take actions to recapitalize the bank within 60 days; to not accept, renew or roll over any brokered deposit; and to restrict the interest rates that the bank paid on deposits to the prevailing rates of interest on deposits of comparable amounts and maturities paid by FDIC insured depository institutions in the State of Washington. Venture appealed the PCA Directive on March 3, 2009.

On March 11, 2009, the FDIC notified the bank that it had fallen within the *Significantly Undercapitalized* capital category for PCA purposes. The FDIC sent Venture a Notice dated March 30, 2009. The issuance from the FDIC noted that a C&D pursuant to Section 8(b) of the FDI Act was being pursued jointly with the FDIC and WA DFI to address supervisory concerns identified at the September 2008 Joint examination. The C&D was sent to the bank on December 16, 2008, and management had not been responsive. Further, various deadlines were extended to accommodate bank management's request to consider the C&D and discuss proposed provisions with the regulators. An FDIC internal memorandum noted that there were no indications that management would consent. In fact, management had clearly expressed that it would not agree or consent particularly to the proposed provision requiring the recognition of OTTI on the two CDOs, and that the prospect that management would stipulate to the C&D was unlikely.

On April 8, 2009 the FDIC sent the bank a letter rejecting the revised capital restoration plan. On May 7, 2009, the FDIC sent the bank a letter to address the bank's March 3, 2009 appeal of the PCA Directive. The letter indicated that DSC was unable to conclude in the bank's favor regarding its request to terminate the Directive. The RO and DSC were willing to allow for modification of the clause of the Directive which restricted the level of interest rates the bank may pay on deposits. On July 27, 2009, the bank was notified of the final determination of the split classification between doubtful and loss on the issue of OTTI.

On August 28, 2009, the FDIC sent the bank a PCA Notification advising the bank that it had fallen within the *Critically Undercapitalized* capital category for PCA purposes. The letter stated further that thus far the bank had failed to submit an acceptable capital restoration plan. The Total Risk-Based Capital Ratio was .62 percent as updated by the most recent estimated credit-related OTTI of approximately $30.4 million as of June 30, 2009. In addition to the required capital restoration plan, the letter required Venture to provide a summary of the specific steps taken by management to comply with the mandatory restrictions required under Section 38 by September 4, 2009. On this date, the bank sent a letter to the FDIC in regard to the August 28, 2009 PCA Notification. The letter stated that the bank should not be considered *Critically*

Undercapitalized based on the bank's disagreement that there should be any OTTI on the two CDOs. As discussed earlier, the bank's appeal was held in abeyance by DSC since the bank was insolvent and its failure was imminent; thus, the PCA Notification was appropriate.

Venture was unable to raise the required capital and on September 11, 2009, the WA DFI closed the bank due to poor asset quality, insufficient earnings, and inadequate capital, and named the FDIC as receiver.

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 conducted this performance audit from January 2010 to April 2010 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 Venture Bank from May 2005 until its failure on September 11, 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 FDIC and WA DFI examiners from May 2005 to June 2009.

- Reviewed the following documentation:

    - Financial institution data and correspondence maintained at the DSC's San Francisco Regional Office and Seattle 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 Venture, which included DSC examination staff in the San Francisco Region.

- Interviewed appropriate officials from the WA DFI 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 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.

We conducted interviews with DSC and WA DFI personnel 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 Venture’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.

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.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Reports) 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.
Collateralized Debt Obligation (CDO)	CDOs are a type of structured asset-backed security (ABS) whose value and payments are derived from a portfolio of fixed-income underlying assets. CDO securities are split into different risk classes, or tranches, whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher coupon payments (and interest rates) or lower prices to compensate for additional default risk.
Collateralized Mortgage Obligation (CMO)	CMOs are created when individual mortgage loans are packaged or pooled by issuers and offered to sale to investors. There are two types of issuers – agency and private label. Agency-issued mortgage-backed securities meet specific underwriting criteria whereas private label issues generally comprise nonconforming loans.

Glossary of Terms

Term	Definition
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.
Investment Grade	Investment grade generally means a security that is rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations.
Other Than Temporary Impairment (OTTI)	An impairment of a debt instrument occurs when the fair value of the security is less than its amortized cost basis. According to accounting standards, when the impairment is judged to be other than temporary, the cost basis of the individual security must be written down to fair value, thereby establishing a new cost basis for the security and the amount of the write-down must be included in earnings as a realized loss.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et seq, implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt 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.
Tranches	Multiple classes of equity and debt that are set in a senior or subordinate position to one another based upon seniority in bankruptcy and timing of repayment. The tranches are divided into three general categories: (1) senior tranche; (2) mezzanine tranche; and (3) equity tranche.
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.

Appendix 3

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ARD	Assistant Regional Director
BOLI	Bank-Owned Life Insurance
BSA	Bank Secrecy Act
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
CDO	Collateralized Debt Obligation
CMO	Collateralized Mortgage Obligation
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
EIC	Examiner-in-Charge
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FHLMC	Freddie Mac - Federal Home Loan Mortgage Corp
FIL	Financial Institution Letter
FNMA	Fannie Mae - Federal National Mortgage Association
GAGAS	Generally Accepted Government Auditing Standards
GSE	Government Sponsored Enterprise
LTV	Loan to Value
OIG	Office of Inspector General
ORL	Off-site Review List
OTTI	Other Than Temporary Impairment
PCA	Prompt Corrective Action
RO	Regional Office
ROE	Report of Examination
SEC	Securities and Exchange Commission
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
VFG	Venture Financial Group
WA DFI	Washington State Department of Financial Institutions

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 April 7, 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 Venture Bank's failure and the FDIC's supervision of the bank. DSC stated that stronger supervisory follow-up to assess the progress of recommended corrective actions could have been taken, particularly in light of the risks associated with concentrations in CRE/ADC loans and investments in CDOs. DSC has issued updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations. Additionally, DSC issued a Financial Institution Letter in 2009 to insured institutions, entitled *Risk Management of Investments in Structured Credit Products*, providing clarification to existing guidance and strongly recommending vigilant due diligence and appropriate internal controls related to these securities.

FDIC

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

April 7, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

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

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Venture Bank, Lacey, Washington (Assignment No. 2010-007)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Venture Bank (VB), Lacey, Washington which failed on September 11, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on March 18, 2010.

The Report concludes VB failed due to the Board of Directors' (Board) and management's weak risk management practices, aggressive loan growth centered in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans, and significant investments in higher risk collateralized debt obligation (CDO) securities. Loan growth was primarily funded with brokered deposits, Federal Home Loan Bank borrowings, and large time deposits. VB also concentrated investments in junior tranche CDOs, and preferred stock in the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC). Loan loss provisions and losses related to the deteriorating loan and CDO portfolios, and FNMA/FHLMC preferred stock contributed to declining earnings, and inadequate liquidity and capital levels.

The FDIC and the Washington Department of Financial Institutions jointly and separately conducted four full-scope examinations from 2005 through September 2009. Between 2005 and 2007, VB experienced significant asset growth in the expanding real estate market. When the real estate market declined sharply in Western Washington, VB's condition deteriorated at a similarly rapid pace, and at the September 2008 joint examination examiners downgraded asset quality, noting heightened risks from high concentrations in large construction and land development lending. A joint Supervisory Directive was issued in October 2008, requiring numerous corrective actions. VB's Board and management did not take sufficient corrective actions and were unable to raise required capital to remain viable.

Stronger supervisory follow-up to assess the progress of recommended corrective actions should have been taken, particularly in light of the risks associated with concentrations in CRE/ADC loans and investments in CDOs. DSC has updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations. Additionally, DSC issued a Financial Institution Letter in 2009 to insured institutions on Risk Management of Investments in Structured Credit Products, providing clarification to existing guidance and strongly recommending vigilant due diligence and appropriate internal controls related to these securities.

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