Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-008

Material Loss Review of Great Basin Bank of Nevada, Elko, Nevada

December 2009

Office of Inspector General

Executive Summary

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Why We Did The Audit

On April 17, 2009, the Nevada Financial Institution Division (NFID) closed Great Basin Bank (Great Basin) and named the FDIC as receiver. On June 5, 2009, the FDIC notified the Office of Inspector General (OIG) that Great Basin's total assets at closing were $228.8 million and the estimated material loss to the Deposit Insurance Fund (DIF) was $39.4 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Great Basin.

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

Background

Great Basin was a state-chartered nonmember bank, established by the NFID and insured by the FDIC on July 29, 1993. The institution was a full-service community bank with four branch offices and was wholly owned by a one-bank holding company. Great Basin had no subsidiaries or affiliates. The institution's loan portfolio included, but was not limited to, out-of-territory purchased participation loans from areas that experienced a significant economic downturn starting in 2007, and a concentration in commercial real estate (CRE) loans. Great Basin also invested in securities including, but not limited to, Federal National Mortgage Association (FNMA) securities.

Audit Results

Causes of Failure and Material Loss

Great Basin failed because its Board did not ensure that bank management identified, measured, monitored, and controlled the risk associated with the institution's lending activities. Specifically, Great Basin's Board and management failed to adequately assess the risk associated with expanding the loan portfolio through purchases of out-of-territory participation loans, particularly from 2006 through 2008. The bank also lacked effective risk management controls for its CRE loan portfolio. Additionally, poor risk management practices negatively impacted the bank's ability to effectively manage operations in a declining economic environment.

The weaknesses in Great Basin's loan portfolio were exacerbated by a downturn in the bank's market area and out-of-territory locations. Declining earnings, resulting from high provision expenses for deterioration in the loan portfolio, severely eroded the bank's capital. Additionally, losses associated with FNMA securities contributed to inadequate capital levels and reduced earnings. The NFID closed Great Basin due to the bank's *Significantly Undercapitalized* position.

The FDIC's Supervision of Great Basin

The FDIC and NFID provided ongoing supervision of Great Basin and performed six on-site examinations from June 2002 to January 2009. The FDIC also performed offsite monitoring in 2008 that resulted in a downgrade to the institution's ratings. The joint examinations included concerns and recommendations regarding weak risk management practices related to purchased participation loans and CRE loans, and loan underwriting and credit administration deficiencies. Examiners also reported apparent violations of law and contraventions of policy associated with the institution's lending practices. During the February 2008 examination, the FDIC and NFID recognized the significance of the bank's increased risk profile due to the increase in purchased participation loans and made several recommendations to improve the bank's monitoring and due diligence practices. Beginning in July 2003, and as the institution's condition deteriorated in February 2008 and January 2009, the FDIC and NFID took enforcement actions to address identified deficiencies.

The FDIC's supervisory and enforcement actions issued in July 2008 and April 2009 addressed most of the deficiencies at the bank. However, the action taken in July 2008 did not require Great Basin to obtain qualified management, a significant factor in the poor oversight of the purchased participation loan portfolio. Further, significant deterioration in Great Basin's asset quality had occurred before these actions were taken, and the effects of poor risk management practices, purchased participation loans, and the CRE concentration had significantly impacted the institution's financial condition, in general, and loan portfolio, in particular. Further, although the FDIC and NFID took action after the February 2008 examination to address the bank's deficiencies, bank management continued to purchase participation loans, increasing both the bank's risk profile and the probability, and ultimate realization, of significant losses to the institution.

With respect to PCA, we concluded that the FDIC properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for Great Basin.

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 December 2, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report.

DSC reiterated the OIG's conclusions regarding the causes of Great Basin's failure. DSC also stated that Great Basin's Board and management were expected to identify and control the third-party risks arising from the relationships for its purchased participation loan portfolio. With regard to the FDIC's supervision of Great Basin, DSC stated that examiners identified the risks associated with the purchased participations in 2008 as weaknesses in the bank's loan underwriting and credit administration became apparent. DSC further stated that the FDIC has issued guidance which outlines the basic elements for effective third-party risk management and for the performance of due diligence on purchased loan participations.

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

Office of Inspector General

DATE: December 4, 2009

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 Great Basin Bank of Nevada, Elko, Nevada* (Report No. MLR-10-008)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Great Basin Bank of Nevada, (Great Basin), Elko, Nevada. On April 17, 2009, the Nevada Financial Institution Division (NFID) closed the institution and named the FDIC as receiver. On June 5, 2009, the FDIC notified the OIG that Great Basin's total assets at closing were $228.8 million and the estimated material loss to the Deposit Insurance Fund (DIF) was $39.4 million.

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

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of

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

the institution, including implementation of the PCA provisions of section 38 of the FDI Act. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of key terms and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

This report presents the FDIC OIG's analysis of Great Basin's failure and the FDIC's efforts to ensure that its management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations, as warranted.

Background

Great Basin was a state-chartered nonmember bank, established by the NFID and insured by the FDIC effective July 29, 1993. Great Basin was a full-service community bank, and provided traditional banking services at a main office in Elko, Nevada and four branches in Elko, Winnemucca, Fallon, and Spring Creek, Nevada. The institution's loan portfolio included, but was not limited to, out-of-territory purchased participation loans and a concentration in commercial real estate (CRE) loans. Great Basin also invested in securities including, but not limited to, Federal National Mortgage Association (FNMA) securities.

The bank was wholly owned by a one-bank holding company, Great Basin Financial Corporation, and had no other subsidiaries or affiliates. Great Basin's stock was not publicly traded. The bank's Board of Directors (Board) collectively owned or controlled approximately 24 percent of the outstanding shares of the holding company, and the bank president held a 10-percent interest as the principal shareholder of the parent company.

Table 1 summarizes Great Basin's financial condition as of December 2008, and for the 5 preceding calendar years.

Table 1: Financial Condition of Great Basin

Financial Measure	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04	Dec-03
Total Assets ($000s)	$264,325	$253,612	$213,595	$184,911	$155,851	$133,068
Total Loans ($000s)	$141,951	$146,248	$145,471	$118,050	$94,442	$81,206
Total Deposits ($000s)	$241,262	$207,361	$196,688	$165,561	$130,254	$115,523
Net Income (Loss) ($000s)	($11,614)	$2,122	$1,682	$1,391	$1,352	$1,304

Source: Uniform Bank Performance Reports (UBPR) and Reports of Examination (ROE) for Great Basin.

Causes of Failure and Material Loss

Great Basin failed because its Board did not ensure that bank management identified, measured, monitored, and controlled the risk associated with the institution's lending activities. Specifically, Great Basin's Board and management failed to adequately assess the risk associated with expanding the loan portfolio through purchases of out-of-territory participation loans,[3] particularly from 2006 through 2008. The bank also lacked effective risk management controls for its CRE loan portfolio. Additionally, poor risk management practices negatively impacted the bank's ability to effectively manage operations in a declining economic environment.

The weaknesses in Great Basin's loan portfolio were exacerbated by a downturn in the bank's market area and out-of-territory locations. Declining earnings, resulting from high provision expenses for deterioration in the loan portfolio, severely eroded the bank's capital. Additionally, losses associated with FNMA securities contributed to inadequate capital levels and reduced earnings. The NFID closed Great Basin due to the bank's *Significantly Undercapitalized* position.

Board of Directors and Bank Management Oversight of Operations

Great Basin's Board and management failed to identify, measure, monitor, and control the risks related to the bank's operations. In addition, the Board did not ensure that the bank complied with laws, regulations, and interagency policy and implemented recommendations made by the bank's auditors and FDIC and NFID examiners in a timely and effective manner.

<u>Identifying, Measuring, Monitoring, and Controlling Risks</u>

According to the DSC *Risk Management Manual of Examination Policies* (Examination Manual), the quality of management is probably the single most important element in the successful operation of a bank. The Examination Manual also states that it is extremely important for bank management to be aware of their responsibilities and to discharge those responsibilities in a manner that will ensure the stability and soundness of the institution. According to the manual, it is not necessary for the Board to be actively involved in day-to-day operations of the bank. However, the Board must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established that translate the Board's goals, objectives, and risk limits into prudent operating standards.

At the joint FDIC and NFID February 2008 and January 2009 examinations,[4] examiners identified several areas in which Great Basin's Board and management had exhibited

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[3] A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions.
[4] Unless otherwise noted in this report, references to examination dates will refer to the month and year of the examination start dates.

poor risk management practices that contributed to the unsatisfactory financial condition of the institution. Regarding risk management, the examinations concluded that the Board and management:

- had been slow to recognize and address identified problem areas, including problem loans and associated losses;
- had not maintained an adequately funded allowance for loan and lease losses (ALLL); and
- needed to increase earnings and capital and improve liquidity management.

While examiners had previously noted the need for improvement in virtually all areas of bank operations, the joint FDIC and NFID January 2009 examination report concluded that (1) Great Basin management's decision to enter in complex out-of-area participation loans was the key reason the bank was near failure and (2) management was critically deficient and that Board performance and oversight needed significant improvement.

Apparent Violations and Contraventions of Policy

According to the Examination Manual, it is important for the bank's Board to ensure that bank management is cognizant of applicable laws and regulations, develop a system to effect and monitor compliance, and, when violations do occur, make correction as quickly as possible. Examiners cited apparent violations and contraventions in four out of five examinations of Great Basin from February 2005 to January 2009, involving:

- appraisals,
- real estate lending,
- asset quality,
- loan underwriting and credit administration, and
- other unsafe and unsound practices.

Further, citing the apparent violation of FDIC Rules and Regulations Part 337 – *Unsafe and Unsound Banking Practices* during the bank's January 2009 examination, examiners concluded that Great Basin was near failure due to bank management's past decisions and actions or inactions.

Implementation of Auditor and Examiner Recommendations

Prior to Great Basin's failure, the bank's auditors and FDIC and NFID examiners expressed concerns about the institution's risk management practices and made recommendations for improvement. However, the actions taken by Great Basin's Board and management were not timely or effective to adequately address those concerns. Our review of external auditor and examiner recommendations and FDIC examination reports for Great Basin indicated a well-documented pattern of recommendations made but lack of adequate attention by the bank to implement them. Specifically, Great Basin's external auditors, the FDIC, and NFID identified the need for the bank to improve loan underwriting and credit administration practices for participation loans and the CRE concentration. From December 2006 through September 2008, Great Basin's external auditors made recommendations to improve the approval and monitoring of purchased participations and CRE projects. The FDIC and NFID examiners also identified numerous credit administration and loan underwriting deficiencies as early as the July 2003 examination, and in subsequent examinations, including those conducted in February 2008 and January 2009.

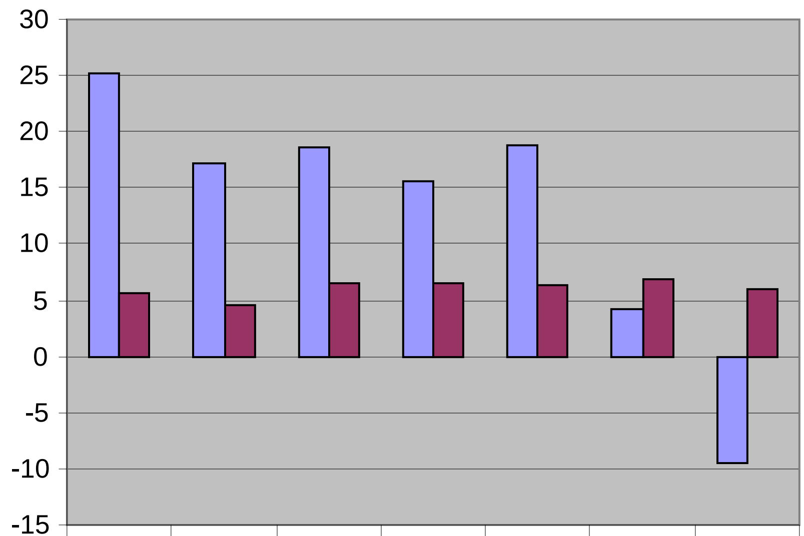
Examiners concluded in the February 2008 and January 2009 examination reports that bank management had failed to take adequate and timely action to sufficiently address auditor and examiner concerns. Specifically, at the joint FDIC and NFID February 2008 examination, examiners determined that the bank's credit administration practices for purchased participation loans were especially poor, identifying significant deficiencies in the bank's monitoring and due diligence practices for these loans and making recommendations for improvement. However, at the January 2009 examination, examiners found that Great Basin's loan underwriting and credit administration practices were still in need of improvement, and bank management's actions to address previously reported deficiencies were either not implemented in a timely manner or not effective.

Asset Growth Through Purchased Participation Loans Between 2006 and 2008

Great Basin's business strategy and lending activities involved purchased participation and CRE loans that, when combined, increased the size and risk of the bank's loan portfolio. According to the FDIC's February 2008 examination report, Great Basin's Board and management purchased out-of-territory participation loans to diversify the bank's loan portfolio. The geographic markets where the purchased participation loans were originated experienced significant economic downturns and, in turn, considerably impacted Great Basin's asset quality and financial condition. As discussed earlier, Great Basin's Board and management failed to develop and implement adequate risk management controls to address the risk associated with the significant growth in those loans.

Figure 1 shows Great Basin's asset growth rates for December 2003 through March 2009, compared to the bank's peer group. As indicated, Great Basin's asset growth rate consistently and significantly exceeded the bank's peer group through December 2007.

Figure 1: Great Basin's Asset Growth Rate Percentages Compared to Peers



	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Mar-09
Great Basin	25.15	17.12	18.65	15.51	18.73	4.22	-9.56
Peer	5.7	4.52	6.44	6.48	6.34	6.9	6

UBPR Period

Source: UBPRs for Great Basin.

Great Basin's asset growth between 2003 and 2005 consisted of growth in virtually all loan categories. However, Great Basin purchases of participation loans, which started as early as 2001,[5] significantly increased between 2006 and 2008, with Great Basin eventually purchasing approximately $33.2 million[6] in participation loans, resulting in a significant increase in the bank's risk profile. Although the remaining balances for the purchased participation loans totaled only $25.6 million, or about 16 percent, of the bank's loan portfolio as of November 30, 2008 (as shown in Figure 2 in the *Consideration of Risk Presented by Great Basin's Participation Loans* section of this report), the loans presented significant risk to Great Basin, which the bank's Board and management failed to adequately assess and control.

<u>Managing Risk Associated with Purchased Participation Loans</u>

Great Basin's decision to purchase participation loans without implementing adequate risk management controls, including the assessment of third-party risk, significantly increased the bank's risk profile and exposure to losses. The participation loans consisted of out-of-territory CRE and unsecured loans, with the greatest number of the purchased

[5] Information on the amount of participations that Great Basin purchased in 2001 was not available in the FDIC's examination records.
[6] Data regarding the original balances of Great Basin's purchased participation loans totaling $33.2 million as of March 31, 2009, is based on bank records provided to the OIG by the FDIC Division of Resolutions and Receiverships.

participation loans in CRE. Some of the complex, high-risk participation loans included mezzanine[7] financing in which Great Basin held junior lien positions and interest rates well above average prime rates.[8] The risk presented by the purchased participation loans, totaling $25.6 million as of November 30, 2008, became apparent at the January 2009 examination, when it was determined that the participation loans represented 45 percent of the bank's adversely classified loans, of which 22 percent were CRE purchased participation loans, and 85 percent of the loans classified as "Loss".

An institution's Board and senior management are ultimately responsible for managing activities conducted through third-party relationships, and identifying and controlling the risks arising from such relationships, to the same extent as if the activity were handled within the institution. A third-party relationship should be considered significant for various reasons including, but not limited to, whether the (1) relationship has a material effect on the institution's revenues or expenses; (2) third-party performs critical functions; or (3) third-party poses risks that could significantly affect earnings or capital.

Great Basin's purchase of participation loans from third-party brokers materially affected the bank's revenue, earnings, and capital, and the brokers performed critical functions related to loan underwriting and credit administration. Great Basin purchased participation loans from several entities, including finance companies, investment banks, and FDIC-insured nonmember and national banks. The borrowers and the properties that served as collateral for the loans were located in various parts of the country, including Georgia, Nevada, California, Florida, Louisiana, Kentucky, and Minnesota.

> Examiners sometimes find that a participation loan does not meet the financial institution's established underwriting standards, too often with predictable results. Institutions often "buy" the types of loans they cannot originate in their normal trade area; however, those institutions may lack lenders with sufficient expertise to analyze the participation loan.
>
> Institutions entering into participation arrangements can avoid common pitfalls and mitigate third-party risks by, among other things,
>
> - Conducting a thorough risk assessment to ensure that the proposed relationship is consistent with the institution's strategic plan and overall business strategy;
> - Conducting thorough due diligence to focus on the third party's financial condition, relevant experience, reputation, and the scope and effectiveness of its operations and controls;
> - Reviewing applicable accounting guidance to determine if the participation agreement meets the criteria for a loan sale or a secured borrowing. Key issues to consider include rights to repurchase and recourse arrangements; and
> - Developing a comprehensive monitoring program.
>
> Source: *Supervisory Insights, Summer 2007*.

Great Basin's Board and management did not implement adequate risk management controls, including conducting due diligence, performing independent credit analyses, or considering the borrower's ability to repay and the sufficiency of the underlying collateral. Also, Great Basin's loan policy did not sufficiently address purchased participation loans and the risk associated with the third-party relationships. Further, some of the purchased participation loans had questionable collateral values from the

[7] Mezzanine financing is extension of credit on a subordinated basis that is neither equity nor senior debt.
[8] Prime Rate is the base rate on corporate loans posted by at least 75 percent of the nation's 30 largest banks.

beginning, and some loan projects had problems early on that potentially impacted the feasibility of the entire project. As discussed previously, the February 2008 examination concluded that credit administration practices for purchased participation loans needed significant improvement; however, bank management continued to increase the purchased participation loan portfolio after the joint FDIC and NFID February 2008 examination. Finally, examiners determined at the January 2009 examination that loan administration practices were critically deficient for purchased participation loans, indicating that bank management had failed to adequately and timely address examiner concerns.

CRE Loan Concentration

Great Basin's total CRE loans ranged from about 218 percent of Tier 1 Capital at the February 2008 examination to 457 percent at the October 2006 examination. In addition, as shown in Table 2, Great Basin's CRE portfolio, as a percent of total loans, significantly exceeded the bank's peer group[9] averages from December 2003 through December 2008.

Table 2: Great Basin's Percentage of CRE Loans to Total Loans Compared to Peers from December 2003 to December 2008

Period Ended	CRE/Total Loans	
	Great Basin	Peer Group
	Percentages include owner-occupied CRE	
Dec-03	44.46	24.54
Dec-04	41.18	26.05
Dec-05	44.88	30.17
Dec-06	46.93	31.02
Dec-07	44.37	31.89
Dec-08	47.72	31.34

Source: UBPRs for Great Basin.

According to Financial Institution Letter (FIL)104-2006, entitled, *Concentrations in Commercial Real Estate, Sound Risk Management Practices*, dated December 12, 2006, concentrations can pose substantial potential risks and can inflict large losses on institutions. Although the guidance does not specifically limit a bank's CRE lending, it provides supervisory criteria for identifying financial institutions that may have potentially significant concentration in CRE loans, warranting greater supervisory scrutiny. Specifically, FIL-104-2006 provides guidance as to when greater supervisory scrutiny may be appropriate for financial institutions and describes a risk management framework that institutions should implement to effectively identify, measure, monitor,

[9] Commercial banks are assigned to one of 25 peer groups based on asset size, number of branches, and whether the bank is located in a metropolitan or non-metropolitan area. Great Basin's peer group was that of all insured commercial banks with assets between $100 million and $300 million in a non-metropolitan area with three or more full service offices.

and control CRE concentration risk. That framework includes effective oversight by bank management, including the Board and senior executives, portfolio stress testing and sensitivity analysis, sound loan underwriting and administration, and portfolio management practices.

At the January 2009 examination, when owner-occupied CRE is excluded, Great Basin's CRE loans represented about 579 percent of Total Capital, exceeding the 300 percent parameter established in the 2006 guidance warranting greater supervisory scrutiny. The increase in the CRE loans to Total Capital at the January 2009 examination was due, in part, to the significant decrease in the bank's capital position.

Inadequate Risk Management Practices for CRE Loans

Great Basin failed to establish and implement adequate controls to effectively address the bank's CRE loans. Examiners reported deficiencies in Great Basin's risk management practices for the CRE loans as early as July 2003. Recommendations related to the bank's inadequate CRE risk management practices were also noted in the examinations conducted in February 2005 through February 2008. Those recommendations were related, but not limited to, the following issues:

- defining and tracking speculative lending at a level commensurate with CRE lending activities,
- establishing adequate procedures to stress test individual projects and the total CRE portfolio,
- establishing guidelines for contingency planning to reduce concentrations in excess of policy limits and to adjust CRE limits during changing markets,
- including the December 12, 2006 CRE guidance in the bank's concentration policy,
- measuring all concentrations relative to Tier 1 Capital, and
- improving controls related to the use of interest reserves.

Although examiners for the January 2009 examination report concluded that Great Basin had made some improvements relative to CRE monitoring, numerous repeat deficiencies and recommendations were identified, and additional enhancements for concentration monitoring and reporting were necessary.

Adversely Classified Assets and Allowance for Loan and Lease Losses

As management began to recognize the deterioration in the bank's loan portfolio and as adverse classifications increased, additional provisions to the ALLL were required. Asset quality deteriorated to less than satisfactory with a rating[10] of "3" at the joint February

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

2008 examination. Adversely classified items as a percent of Tier 1 Capital plus ALLL totaled 30.08 percent. Further, during the February 2008 examination, purchased participation loans represented 99 percent of the $5.9 million of adversely classified items. Examiners concluded that a provision expense of $650,000 to $700,000 was needed to replenish the ALLL after adjusting for the loss classification identified at the February 2008 examination. Additionally, weaknesses identified in credit administration and monitoring of the participation loans at this examination adversely affected the bank's compliance with ALLL requirements. Bank management agreed to implement the ALLL methodology recommendations and made additional provisions to the ALLL.

Asset quality was downgraded to a rating of "5" at the January 2009 examination, indicating critically deficient asset quality or credit administration practices that presented an imminent threat to the institution's viability. Examiners concluded that the ALLL was underfunded by $5.0 million due to the identification of additional loan downgrades. Adversely classified items represented 199.5 percent of Tier 1 Capital and ALLL. Loss classifications, totaling $2.8 million, represented a 276 percent increase from the bank's prior examination. Table 3 shows the adversely classified items and ALLL for Great Basin for the July 2003 through January 2009 examinations.

Table 3: Great Basin's Adversely Classified Items and ALLL

Asset Quality (Dollars in Thousands)				
Examination Date	**Total Adversely Classified Items**	**Adversely Classified Items as a Percent of Tier 1 Capital plus ALLL**	**ALLL Computed by Great Basin**	**Increase in ALLL Computed by Examiners**
July 2003	$4,281	44.26%	$1,360	0
February 2005	$1,090	8.48%	$1,208	0
October 2006	$2,312	14.59%	$1,565	0
February 2008	$5,950	30.08%	$2,151	$700
January 2009	$24,519	199.47%	$6,620	$5,000

Source: ROEs and UBPRs for Great Basin.

Purchased participations and CRE loans made up a significant portion of the total adversely classified loans at the January 2009 examination—purchased participations, including purchased CRE participation loans, represented 45 percent of total classified loans[11] and CRE loans represented 37 percent.[12] In addition, purchased participations represented 85 percent of the loans classified as "Loss" at the January 2009 examination.

Investments in FNMA Securities

Great Basin experienced losses associated with its FNMA securities in 2008 that contributed to the bank's depleted capital and reduced the bank's earnings. In 2008, the

[11] Includes CRE-purchased participations and other types of purchased participation loans.
[12] Includes non-purchased participation CRE loans.

FDIC initiated a process to determine the extent to which FDIC-supervised banks were potentially exposed to FNMA and/or Federal Home Loan Mortgage Corporation preferred or common stock. On September 24, 2008, Great Basin management informed the FDIC that the bank needed to write-down its FNMA preferred stock by over $2 million at the end of September 2008, and that this would likely result in a reclassification of the bank's PCA category to *Adequately Capitalized*. In fact, the bank's $5.2 million in net losses as of September 30, 2008, which took into account the bank's losses in FNMA preferred stock, lowered the bank's capital category to *Undercapitalized*. On December 31, 2008, Great Basin reported $2.1 million in losses in FNMA preferred stock and $739,000 losses in mutual funds.

The FDIC's Supervision of Great Basin

The FDIC and NFID provided ongoing supervision of Great Basin and performed six on-site examinations from June 2002 to January 2009. The FDIC also performed offsite monitoring in 2008 that resulted in a downgrade to the institution's ratings. The joint examinations included concerns and recommendations regarding weak risk management practices related to purchased participation loans and CRE loans, and loan underwriting and credit administration deficiencies. Examiners also reported apparent violations of law and contraventions of policy associated with the institution's lending practices. During the February 2008 examination, the FDIC and NFID recognized the significance of the bank's increased risk profile due to the increase in purchased participation loans and made several recommendations to improve the bank's monitoring and due diligence practices. Beginning in July 2003, and as the institution's condition deteriorated in February 2008 and January 2009, the FDIC and NFID took enforcement actions to address identified deficiencies.

Supervisory History

The FDIC and NFID performed joint examinations of Great Basin in June 2002, July 2003, October 2006, February 2008, and January 2009. The FDIC performed an independent on-site examination of Great Basin in February 2005 and off-site monitoring in December 2008. Table 4 summarizes key information pertaining to examinations ending with the Cease and Desist Order (C&D) issued as a result of the January 2009 examination.

Table 4: Examination History of Great Basin From June 2002 to January 2009

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory/Enforcement Action
06/17/2002	3/31/2002	FDIC and NFID	332322/3	Bank Board Resolution (BBR) (adopted July 18, 2002)
07/21/2003	03/31/2003	FDIC and NFID	232222/2	BBR
02/28/2005	12/31/2004	FDIC	222222/2	BBR terminated
10/02/2006	06/30/2006	FDIC and NFID	222222/2	None
02/25/2008	12/31/2007	FDIC and NFID	333222/3	Memorandum of Understanding (MOU) (effective July 31, 2008)
12/9/2008*	09/30/2008	FDIC	544433/4	Continuation of MOU (effective July 31, 2008)
01/12/2009	12/31/2008	FDIC and NFID	555544/5	C&D (effective April 15, 2009)

Source: ROEs for Great Basin
* The FDIC conducted offsite monitoring during December 2008, determined that the bank's financial condition had substantially deteriorated, and downgraded the bank's CAMELS ratings.

A BBR, issued July 18, 2002, sought to address examiner concerns associated with asset quality during the June 2002 joint examination of the bank. In July 2003, Great Basin received a composite "2" rating, indicating that the institution's overall condition was satisfactory. However, asset quality remained a significant regulatory concern at the July 2003 examination, resulting in a component rating of "3". The July 2003 ROE reported that additional attention to improve asset quality and achieve sustainable earnings was warranted. Great Basin received composite "2" ratings in February 2005 and October 2006, and, at the February 2005 examination, examiners concluded that bank management had substantially satisfied the BBR provisions and terminated the action.

The February 2008 joint examination revealed that the overall condition of the institution was less than satisfactory due to asset quality deterioration combined with credit administration weaknesses, specifically in monitoring purchased participation loans and the bank's CRE concentration. The FDIC and NFID entered into an MOU based on the results of the examination which required Great Basin to:

- reduce the bank's risk exposure in adversely classified and special mention loans;
- improve the internal loan review program;
- improve information regarding the overall quality of the bank's loan portfolio, including participation loans;
- improve credit underwriting and administration activities;
- develop a plan to reduce loan concentration risk;
- improve the methodology for determining the adequacy of the ALLL; and
- implement a strategic plan that included a capital plan for improving capital levels.

On December 16, 2008, the FDIC completed an offsite review of the institution's September 30, 2008 Report of Condition and Income (Call Report) data, and noted that the bank's financial condition had deteriorated significantly as a result of asset quality problems centered in CRE loans and securities since the February 2008 examination. As a result, the FDIC issued an interim rating change on December 16, 2008 and downgraded the bank's ratings from 333222/3 to 544433/4.

Further, given the change in Great Basin's capital category to *Undercapitalized* as of September 30, 2008, the next examination, which was originally scheduled for February 2009, was accelerated to January 2009. This examination determined that Great Basin's overall financial condition was unsatisfactory and its future viability threatened unless the bank addressed its poor risk management practices immediately and improved its capital position.

As a result of the January 2009 examination, the FDIC and NFID proposed a C&D due to significant weaknesses involving Board oversight and management supervision, asset quality, earnings, and liquidity and the bank's failure to implement prior recommendations. Great Basin stipulated to the C&D on April 9, 2009 and the FDIC issued the order effective April 15, 2009. The C&D required Great Basin to, among other things:

- obtain and retain qualified management; and
- submit written plans to
    - increase Board participation,
    - increase Tier 1 Capital by no less than 12 percent and maintain it at 9 percent or above,
    - eliminate all assets classified as Loss and one-half of assets classified as Doubtful,
    - reduce the institution's CRE loan concentration, and
    - eliminate and/or correct all violations of law.

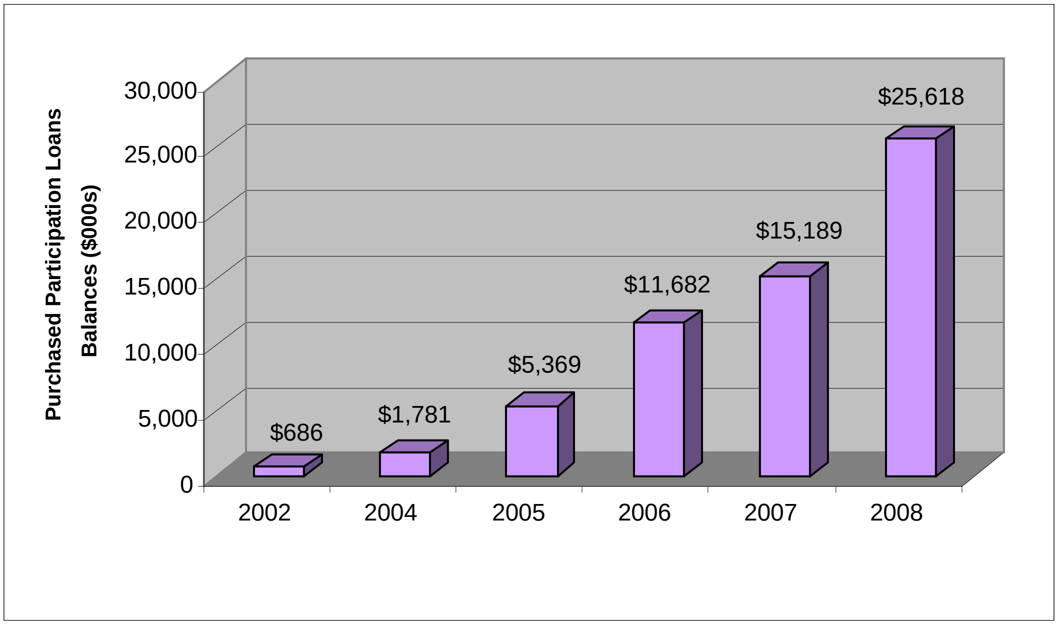
On April 17, 2009, the NFID closed Great Basin due to its severely deteriorated financial condition and the bank's inability to raise additional capital, and named the FDIC as receiver.

Consideration of Risk Presented by Great Basin's Purchased Participation Loans

Great Basin's growth in purchased participation loans resulted in elevated supervisory concern during the February 2008 examination with the FDIC making numerous recommendations to the Board and management to address deficiencies in Great Basin's credit administration practices for those loans. Similar concerns and recommendations were also noted at the January 2009 examination.

As discussed previously, Great Basin had purchased participation loans since at least 2001. Figure 2 illustrates the cumulative amount of the balances for Great Basin's purchased participation loans based on the year that Great Basin purchased the loans, as of November 30, 2008.[13]

Figure 2: Great Basin's Purchased Participation Loan Balances as of November 30, 2008



Source: FDIC January 2009 examination work papers for Great Basin.

Examiners are responsible for evaluating and reporting the extent to which institutions assess and mitigate third-party risk, such as the risk involved in relying on another institution to properly underwrite and administer a loan in which an institution has a participation interest. Specifically, the Examination Manual states that institutions that purchase participation loans (1) must make a thorough, independent evaluation of the transaction and the risks involved before committing any funds and (2) should apply the same standards of prudence, credit assessment, approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan.

The FDIC's review of purchased participations during examinations conducted before February 2008 was limited, due to the fact that those loans represented a small segment of the bank's loan portfolio when those examinations were conducted. During the pre-examination planning for the February 2008 examination, Great Basin's president informed the FDIC that the purchased participation loans were the weakest segment of the bank's loan portfolio, and the bank's external auditor informed the FDIC of concerns related to the bank's monitoring and oversight of the purchased participation loans and the bank's ALLL methodology for those credits. Consistent with that input, the examination report reflected that examiners conducted a detailed review of purchased participations, including all of the purchased participation loans on the bank's watch list that exceeded $250,000 and a sample of the purchased loans based on the broker

[13] Figure 2 does not include purchased participation loans for years 2002 through 2008 that may have been sold, charged off, or paid off; this information was not available in the FDIC's examination records.

involved in the transaction. That review determined that the bank's risk management, monitoring, and due diligence practices were not adequate. However, by the time the FDIC identified and reported the significant risk and control deficiencies associated with the purchased participation loans, Great Basin's exposure to substantial losses had measurably increased.

The February 2008 examination concluded that Great Basin's:

- Management had not performed proper due diligence on the purchased participation loans.
- Management and Board failed to identify and properly assess the loan participation markets they entered and had not implemented sound lending controls.
- Lending staff did not have the expertise to make informed credit decisions on these complex, high-risk participation loans.

After the February 2008 examination, the FDIC conducted offsite monitoring of Great Basin in December 2008 and determined that the bank's condition had deteriorated significantly as a result of asset quality problems centered in CRE loans and securities. Loan administration and credit and market monitoring were inadequate, and management had been slow to recognize and address problem areas, including those for purchased participations. In addition, deficiencies were noted in bank management's selection of risk and lending practices. Further, examiners determined that, as of September 30, 2008, nonaccrual loans had become significant, provisions of $4.6 million were required to fund the ALLL, and the bank's return on assets was negative 2.65 percent. As a result of these findings and other operational deficiencies, the FDIC downgraded Great Basin's composite and all of the component ratings.

Similar to the previous examination, the January 2009 examination also made recommendations associated with purchased participations, requesting bank management to develop (1) adequate lending policies for the complex construction and insurance company participation lending and (2) participation loan standards for pre-purchase due diligence and ongoing monitoring. However, Great Basin had already purchased more than $33.2 million in participation loans and had approximately $26 million still in the bank's loan portfolio, rendering these recommendations ineffective in mitigating the risk associated with its lending activities.

Supervisory Response to Great Basin's CRE Loan Concentration

Examination coverage and results associated with the bank's CRE loans for Great Basin follows.

- **July 2003 Examination.** The examination report noted a CRE concentration of 369 percent of Tier 1 Capital as of June 30, 2003, with no material credit underwriting weaknesses and mitigation of risk achieved through the bank's diversification practices. Examiners made recommendations related to the bank's monitoring and reporting of the CRE concentration.

- **February 2005 Examination.** Examiners concluded that overall underwriting and credit administration were satisfactory, but also included recommendations to improve the bank's loan-to-value limits and concentration calculations. In addition, examiners did not include a concentrations page or specifically report on the bank's CRE concentration in the February 2005 examination report because they concluded that Great Basin did not have a concentration that exceeded 100 percent of Tier 1 Capital. Further, the Summary Analysis of Examination Report for the February 2005 examination indicated that the bank did not have any concentrations. In actuality, according to Great Basin's UBPR as of December 31, 2004—the as of date for the February 2005 examination—the bank had a concentration in CRE of 302.55 percent of Total Capital, compared to the bank's peer group of 151.36 percent of Total Capital.

- **October 2006 Examination.** The examination report concluded that the bank's CRE concentration had increased to approximately 457 percent of Tier 1 Capital as of June 30, 2006, and 70 percent of the CRE was owner-occupied.

- **February 2008 Examination.** The joint FDIC and NFID February 2008 examination concluded that the bank's total funded CRE concentration represented 324 percent of Tier 1 Capital as of December 31, 2007. Examiners made several recommendations to improve asset quality, loan underwriting, and credit administration, including the use of interest reserves, associated with CRE loans.

Despite the repeated recommendations, the final examination report prior to Great Basin's failure in 2009 noted that significant improvement was needed in the Board's and management's oversight of the CRE concentration.

Sufficiency and Timeliness of Supervisory Actions

The FDIC and NFID issued an MOU as a result of the February 2008 examination and a C&D as a result of the January 2009 examination.

- **Memorandum of Understanding.** In July 2008, the FDIC issued the MOU as a result of the February 2008 examination. Although the MOU addressed the major deficiencies noted during the February 2008 examination regarding purchased participation loans and CRE concentration monitoring, the MOU did not contain a provision for qualified management, a significant factor in the poor oversight of the purchased participation loan portfolio.

- **Cease and Desist Order.** The FDIC and NFID issued a joint C&D effective April 15, 2009, 2 days before the bank was closed by NFID. According to FDIC regional office officials, various actions had to be resolved before the C&D could be issued. Those actions included (1) completing the January 2009 examination, which did not occur until March 9, 2009; (2) the need for the FDIC to discuss the C&D provisions with Great Basin's president and the bank's attorneys; and (3) the Board's agreement to stipulate to the C&D. Accordingly, the C&D was not ready for issuance until April 15, 2009.

The FDIC's supervisory and enforcement actions issued in July 2008 and April 2009 addressed most of the deficiencies at the bank. However, the action taken in July 2008 did not require Great Basin to obtain qualified management, a significant factor in the poor oversight of the purchased participation loan portfolio. Further, significant deterioration in Great Basin's asset quality had occurred before these actions were taken, and the effects of poor risk management practices, purchased participation loans, and the CRE concentration had significantly impacted the institution's financial condition, in general, and loan portfolio, in particular. Further, although the FDIC and NFID took action after the February 2008 examination to address the bank's deficiencies, bank management continued to purchase participation loans, increasing both the bank's risk profile and the probability, and ultimate realization, of significant losses to the institution.

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. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized. Table 5 provides Great Basin's capital ratios as of September 30, 2008 and December 31, 2008.

Table 5: Great Basin's Capital Ratios

	Capital Ratios	
Capital Category	September 30, 2008	December 31, 2008
Tier 1 Leverage Capital	4.32%	2.04%
Tier 1 Risk-Based Capital	6.25%	3.16%
Total Risk-Based Capital	7.52%	4.45%

Source: ROEs and UBPRs for Great Basin

We concluded that the FDIC properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for Great Basin. On December 2, 2008, the FDIC informed Great Basin that based on the September 30, 2008 Call Report data the bank was considered to be *Undercapitalized* as shown above for PCA purposes. Three months later, given the December 31, 2008 Call Report data, as stated above, the bank was categorized as *Significantly Undercapitalized* for PCA purposes. Accordingly, Great Basin became subject to the mandatory requirements of section 38, including submission of a capital restoration plan and restrictions on asset growth, acquisitions, new activities, and new branches. Further restrictions applied to the payment of dividends or management fees, or making any other capital distributions. Although Great Basin was not using brokered deposits, the bank's *Undercapitalized* position prohibited the bank from accepting, renewing, or rolling over any brokered deposits unless it obtained a waiver from the FDIC.

Great Basin's attempts to sell the bank and/or substantially increase capital were unsuccessful. In October 2008, the bank unsuccessfully contracted with an investment banker to market the sale of the bank as a strategy to resolve its capital needs. In March 2009, Great Basin increased its capital by approximately $1.1 million and increased its Tier 1 Leverage Ratio to 2.7 percent. However, the bank's problem assets and substantial negative earnings ($11.6 million) further impacted the bank's ability to raise capital.

On March 18, 2009, FDIC informed Great Basin that the capital plan submitted on December 23, 2008 was unacceptable, and needed to be revised due to unrealistic projections for capital levels, income, and assets. Great Basin and Great Basin Financial Corporation, the holding company for the bank, submitted a Troubled Asset Relief Program (TARP) application in December 2008. The FDIC returned the TARP application on March 18, 2009 stating that the viability of the bank was highly unlikely. Additionally, the FDIC stated in the March 18, 2009 letter to Great Basin that an acceptable capital plan for a "troubled institution" should not be reliant on the TARP Capital Purchase Program.

Corporation Comments

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 December 2, 2009, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

DSC reiterated the OIG's conclusions regarding the causes of Great Basin's failure. DSC also stated that Great Basin's Board and management were expected to identify and control the third-party risks arising from the relationships for its purchased participation loan portfolio. With regard to the FDIC's supervision of Great Basin, DSC stated that examiners identified the risks associated with the purchased participations in 2008 as weaknesses in the bank's loan underwriting and credit administration became apparent. DSC further stated that the FDIC has issued guidance which outlines the basic elements for effective third-party risk management and for the performance of due diligence on purchased loan participations.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, 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 June 2009 to December 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained 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 Great Basin's operations from July 2003 until its failure in April 2009. Our review also entailed an evaluation of the regulatory supervision of the institution from July 2003 to January 2009.

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

- Analyzed examination reports prepared jointly by the FDIC and NFID for the July 2003, October 2006, February 2008, and January 2009 examinations and the FDIC February 2005 examination.

- Reviewed the following:

    - Work papers of the February 2008 and January 2009 examinations.

    - Documentation for offsite monitoring activities performed by the FDIC.

    - Bank data and correspondence maintained at DSC's San Francisco Regional Office and Phoenix Field Office.

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

- Audit reports of the bank's external auditor, McGladrey & Pullen, LLP, Las Vegas, Nevada.

- Work papers of the bank's external auditor for loan review, BankVision, Inc., Milpitas, California.

- Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

    - DSC management in Washington, D.C. and San Francisco, California and FDIC examiners from the Phoenix and Los Angeles Field Offices who participated in Great Basin examinations.

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

We performed the audit field work at the DSC office in Phoenix, Arizona.

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 Great Basin management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various 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 relevant to the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Objectives, Scope, and Methodology

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Bank Board Resolution (BBR)	BBRs are informal commitments adopted by a financial institution's Board (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. BBRs may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity. The FDIC is not a party to these resolutions, but may review or draft the documents as a means of initiating corrective action.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Federal National Mortgage Association (FNMA)	FNMA is a congressional chartered corporation which buys mortgages on the secondary market, pools them and sells them as mortgage-backed securities to investors on the open market. Monthly principal and interest payments are guaranteed by FNMA but not by the U.S. Government.
Loan-to-Value	Loan-to-value is the percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total value of the property securing or being improved by the extension of credit plus the amount of any readily marketable collateral and other acceptable collateral that secures the extension of credit.

Glossary of Terms

Term	Definition
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Special Mention Loans	Special Mention loans have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention loans are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from data reported in Consolidated Reports of Condition and Income submitted by banks.

Acronyms

ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
FNMA	Federal National Mortgage Association
MOU	Memorandum of Understanding
NFID	Nevada Financial Institutions Division
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

November 30, 2009

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

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Great Basin Bank of Nevada, Elko, Nevada
(Assignment No. 2009-046)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Great Basin Bank of Nevada (Great Basin) which failed on April 17, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on November 5, 2009.

The Report concludes that Great Basin's failure was due to the Board and senior management's ineffective risk management practices associated with overseeing lending activities. Great Basin's lending controls did not adequately assess the third-party risk of out-of-territory purchased loan participations, which resulted in significant loan losses. Declining earnings due to high loan loss provisions from a deteriorating loan portfolio and losses from Federal National Mortgage Association preferred stock contributed to inadequate capital levels and reduced earnings.

The FDIC and the Nevada State Banking Department provided on-going supervision performing five on-site examinations and off-site monitoring between 2003 and 2009, resulting in a downgrade of Great Basin's ratings in 2008. Joint on-site examinations noted regulatory concerns and made recommendations to correct ineffective risk management practices, commercial real estate concentrations, and loan underwriting and credit administration deficiencies.

Great Basin significantly increased its investment in purchased loan participations between the 2006 and 2008 examination. FDIC examiners identified the risks associated with these purchased loan participations in 2008, as weaknesses in loan underwriting and credit administration became apparent. By 2008, 16 percent of Great Basin's loan portfolio consisted of purchased loan participations. Ultimately the purchased participation portion of the loan portfolio accounted for 85 percent of Great Basin's losses, indicating the poor risk selection of these loans.

Great Basin's Board and management were expected to identify and control the third-party risks arising from such relationships to the same extent as if the activity, such as lending, were handled within the institution. FDIC issued a Financial Institution Letter on *Managing Third Party Risks* in June of 2008, which outlined the basic elements for effective third-party risk

Corporation Comments

management. Moreover, FDIC's *Summer 2007 Supervisory Insights Journal* provided risk management procedures for performing due diligence specifically on purchased loan participations.

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