Office of Inspector General

September 2009
Report No. AUD-09-026

Material Loss Review of Sherman County Bank, Loup City, Nebraska

AUDIT REPORT

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Federal Deposit Insurance Corporation

Report No. AUD-09-026 September 2009

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Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance Act, the OIG conducted a material loss review of the failure of Sherman County Bank (SCB), Loup City, Nebraska. On February 13, 2009, the Nebraska Department of Banking and Finance (NDBF) closed the SCB and named the FDIC as receiver. On March 4, 2009, the FDIC notified the Office of Inspector General (OIG) that SCB's total assets at closing were $126.6 million with a material loss to the Deposit Insurance Fund (DIF) estimated at $28 million. Since that time, the loss has decreased to $26.8 million.

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

SCB was a state-chartered nonmember bank that was established on June 27, 1932 and insured on January 1, 1934. SCB was headquartered in Loup City, Nebraska. At closing, the bank had three branch offices in Nebraska and one affiliate. Sherman County Management, Incorporated, a one-bank holding company, was the parent company of SCB.

SCB provided traditional banking activities within its local marketplace and specialized in agricultural lending. SCB participated in a Commodity Marketing Program that included 34 of the bank's agricultural customers, a program broker, and SCB as part of a third-party arrangement.

The FDIC has recognized the increased risk that third-party arrangements present to financial institutions and issued guidance in 2008 that describes a risk management framework to effectively identify, measure, monitor, and control those risks. That framework should include effective oversight by bank management, including the board of directors (BOD) and senior executives, and an effective third-party risk management program, including risk assessment, due diligence in selecting a third party, contract structuring and review, and oversight.

Audit Results

Causes of Failure and Material Loss - SCB failed primarily due to the bank BOD's and management's decision to increase and fund loan commitments without adequately considering the borrowers' ability to repay and the sufficiency of the underlying collateral. These loans were made to 34 agricultural customers participating in a Commodity Marketing Program (Program). The activities of the Program, principally the purchase and sale of commodity futures and options contracts, resulted in significant losses to these customers in late 2008 and early 2009. To facilitate continued Program trading, SCB increased and funded customer loan commitments, often in apparent violation of Nebraska's legal lending limits (LLL), to individual borrowers and without due regard for sound risk management controls, including those associated with assessing a customer's ability to repay and collateral asset value. SCB also relied heavily on volatile funding such as brokered deposits and large time deposits to fund the significant increases in its loans to Program participants. As SCB funded these loans, the bank's credit concentration related to the Program and the bank's overall risk exposure significantly increased. Ultimately, losses associated with these loans depleted capital and strained liquidity, resulting in the bank's failure.

Specifically, during late 2008 and early 2009, SCB increased loan commitments and resulting funding, totaling $46.2 million, to cover trades made by the Program's broker. During the same period, SCB increased its use of brokered and time deposits by $34 million to help fund these loans. The increases in these loan commitments resulted in over 300 apparent violations of the LLL totaling nearly $24 million. In addition, collateral for the Program loans was not sufficient to support the increased commitments. At the time of SCB's failure in February 2009, total collateral for the $62.2 million in Program loans was valued at $31.5 million, or a loan-to-value ratio of 198 percent. The FDIC classified $31.7 million of the $62.2 million in Program loans as loss, which significantly exceeded SCB's capital. SCB did not adequately assess the risk that the third-party arrangement posed to the bank prior to increasing loan commitments to Program participants.

Assessment of FDIC Supervision and Implementation of PCA – The FDIC and NDBF provided regular oversight of SCB, including conducting risk management examinations and visitations. However, we identified one area where the FDIC's supervision could have been improved. The FDIC could have taken earlier and more assertive action related to SCB's third-party arrangement for the Program. The FDIC's examinations of SCB conducted in 2005 and 2008 reviewed the Program; however, the extent of the reviews was limited, and review results were not adequately documented. Specifically, the FDIC reviews did not fully assess the risk that the third-party arrangement posed to SCB and ensure that the bank established and appropriately implemented controls necessary to identify, measure, monitor, and control those risks. In particular, as a result of the 2008 examination, the FDIC recognized that there were deficiencies in SCB's lending activities but did not ensure that SCB' Loan Policy included adequate guidance to limit: (1) loan commitments in relation to the borrower's ability to repay and collateral value for Program loans and (2) the concentration in Program loans.

In January 2009, SCB management informed the FDIC that the bank was likely insolvent due to losses on Program loans. As a result, the NDBF and FDIC took appropriate and immediate action. In February 2009, the FDIC conducted a visitation and issued a Prompt Corrective Action Notification on February 4, 2009, notifying the bank that SCB was considered to be *Critically Undercapitalized*. On February 5, 2009, the NDBF informed SCB that the bank needed to obtain additional capital totaling $34.1 million by February 12, 2009. In addition, the FDIC issued a Cease and Desist Order, on February 7, 2009, which required the bank to take various actions, including increasing capital and improving bank management and the quality of SCB's loan portfolio. However, the bank was not able to raise the additional capital. Earlier recognition of the significance of the risk that the third-party arrangement posed to SCB and deficiencies in SCB's loan policy could have led to elevated supervisory attention and more timely supervisory action.

Management Response

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC stated that SCB failed primarily due to the BOD's and management's decision to increase and fund loans without adequately considering the borrowers' ability to repay and the sufficiency of the underlying collateral. DSC stated that at the time of the July 2008 examination, the Program was operating within its parameters, and there was more than adequate commodity and market account collateral to repay the outstanding loans. DSC continued that examiners had discussed the importance of the Program hedging parameters and LLL with SCB management during the 2008 examination, yet management ignored internal controls and LLL only 3 months later. DSC acknowledged that earlier and more complete recognition of the risks posed by the single-broker arrangement and the weaknesses in SCB's internal controls could have led to elevated supervisory attention and more timely supervisory action. DSC also acknowledged the importance of commodity price protection programs to the agriculture industry and supports well-controlled risk management programs designed to hedge against commodity market price fluctuations.

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

Office of Audits
Office of Inspector General

DATE: September 4, 2009

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

/Signed/
FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Sherman County Bank, Loup City, Nebraska* (Report No. AUD-09-026)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Sherman County Bank (SCB). On February 13, 2009, the Nebraska Department of Banking and Finance (NDBF) closed the institution and named the FDIC as receiver. On March 4, 2009, the FDIC notified the OIG that SCB's total assets at closing were $126.6 million with an estimated loss to the Deposit Insurance Fund (DIF) of $28 million. Since that time, the loss decreased to $26.8 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 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 provides a summary of previous regulatory activities related to SCB; Appendix 3 contains a glossary of terms; and Appendix 5 contains a list of acronyms used in the report.

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[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.

This report presents the FDIC OIG's analysis of SCB's failure and the FDIC's efforts to ensure bank 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

SCB was a state-chartered savings bank, established on June 27, 1932 by the NDBF, and insured by the FDIC effective January 1, 1934.[3] SCB, which was headquartered in Loup City, Nebraska:

- had three branch offices—one each in Danneborg, Farwell, and St. Paul, which are located in Howard County, Nebraska—and one affiliate;
- provided traditional banking activities within its marketplace; and
- specialized in agricultural lending that included funding commodity marketing activities for farmers.

Sherman County Management, Incorporated, a one-bank holding company, was the parent company of SCB. Details on SCB's financial condition, as of December 31, 2008, and for the 4 preceding calendar years follow in Table 1.

[3] The Banking Act of 1933, which created the FDIC, was signed by the President on June 16, 1933. The FDIC began insuring institutions on January 1, 1934.

Table 1: Financial Condition of Sherman County Bank

	31-Dec-08	31-Dec-07	31-Dec-06	31-Dec-05	31-Dec-04
	(Dollars in Thousands)				
Total Assets	$135,431	$96,435	$90,829	$87,065	$85,760
Total Deposits	$90,647	$69,449	$65,853	$59,524	$60,187
Total Loans	$108,190	$66,134	$61,584	$55,295	$53,735
Total Agricultural Loans	$73,242	$29,645	$29,492	$24,474	$23,344
Total Brokered Deposits	$19,186	$990	$2,320	$271	$0
Loan Growth Rate	65.04%	7.76%	11.50%	3.18%	3.26%
Loan Mix (% of Loans)					
Agricultural Loans	55.05%	46.81%	46.59%	44.50%	45.82%
Loans Secured by Real Estate	29.79%	33.59%	33.48%	35.75%	35.54%
Commercial and Industrial Loans	10.02%	13.56%	13.84%	13.58%	12.47%
All Other Loans	1.87%	1.22%	1.02%	1.12%	1.04%
Loans to Individuals	3.63%	5.31%	5.58%	5.51%	5.56%
Funding					
Loans/Deposits	117.69%	93.08%	91.09%	90.38%	86.63%
Core Deposits/Average Assets	45.17%	58.95%	60.84%	59.41%	59.14%
Brokered/Average Assets	4.64%	1.82%	1.61%	.21%	0%
Large Time/Average Assets	15.46%	12.11%	11.59%	10.06%	10.80%
Borrowings/Average Assets	16.91%	17.97%	18.47%	20.81%	20.90%
Examination/Visitation Information	**02/02/09***	**7/21/08**	**1/16/07**	**5/31/05**	**11/17/03**
Examination Conducted By	FDIC and NDBF	FDIC	NDBF	FDIC	NDBF
Component/Composite Ratings[a]	555555/5[b]	222121/2	122121/2	222111/2	122111/2
Adverse Classifications Ratio	53%	2.55%	3.56%	4.88%	3.19%

Source: OIG analysis of Uniform Bank Performance Report (UBPR).
[a] 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.
[b] FDIC Visitation.

CAUSES OF FAILURE AND MATERIAL LOSS

SCB failed primarily due to the bank Board of Directors' (BOD) and management's decision to increase and fund loan commitments without adequately considering the borrowers' ability to repay and the sufficiency of the underlying collateral. These loans were made to 34 agricultural customers participating in a Commodity Marketing Program[4] (Program). The activities of the Program, principally the purchase and sale of commodity futures and options contracts, resulted in significant losses to these customers in late 2008 and early 2009. In order to facilitate continued Program trading, SCB increased and funded individual borrower's loan commitments,[5] often in apparent

[4] In 1999, SCB entered into a third-party arrangement for the benefit of some of its agricultural customers. Specifically, SCB began a Commodity Marketing Program with a third-party broker that was designed to assist these customers in the purchase and sale of futures and option contracts on commodities. A key component of this agreement was that the broker could make draws against the customer's loans. This key component remained unchanged (refer to Appendix 2 for additional information).
[5] SCB required participants to sign promissory notes to facilitate the funding for the Program.

violation of Nebraska's legal lending limits (LLL) and without due regard for sound risk management controls, including those associated with assessing the customers' ability to repay and collateral asset value. SCB also relied heavily on volatile funding such as brokered deposits and large time deposits to fund the significant increases in its loans to Program participants. As SCB funded these loans, the bank's credit concentration related to the Program and overall risk exposure significantly increased. Ultimately, losses associated with these loans depleted capital and strained liquidity, resulting in the bank's failure.

Specifically, during late 2008 and early 2009, SCB increased loan commitments and resulting funding that totaled $46.2 million to cover trades made by the Program's broker. During the same period, SCB increased its use of brokered and time deposits by $34 million to help fund these loans. The increases in these loan advances, totaling $23.9 million, resulted in over 300 apparent violations of the LLL. In addition, collateral for the Program loans was not sufficient to support the increased commitments. At the time of SCB's failure in February 2009, total collateral for the $62.2 million in Program loans was valued at $31.5 million, or a loan-to-value ratio of 198 percent. The FDIC classified $31.7 million of the $62.2 million in Program loans as loss, which significantly exceeded SCB's capital. SCB did not adequately assess the risk that the third-party arrangement posed to the bank prior to increasing loan commitments to Program participants.

Inadequate Risk Management Controls

SCB's BOD and senior management did not implement adequate risk management controls over the lending for the Program and failed to protect the operations of the bank. These control weaknesses included:

- credit concentration of, and open-ended funding[6] for, Program participant loans,
- material violations of the State of Nebraska's LLL,
- inadequate underlying collateral for Program participant loans, and
- inadequacy of, and noncompliance with, the bank's Loan Policy.

The BOD's failure to ensure that bank management implemented and followed adequate risk management controls, especially during the last quarter of 2008 and early 2009, materially affected the bank's overall financial condition, and eventually led to the bank's insolvency in February 2009.

Credit Concentration and Open-Ended Funding for Program Loans. SCB's BOD and management did not adequately address the risks associated with the concentration in agricultural loans for Program participants and the open-ended funding for those loans.

[6] Open-ended funding refers to SCB providing loan commitments without regard for the borrower's ability to repay or the adequacy of the underlying collateral.

SCB's credit concentration related to the Program loans was first noted during the NDBF's January 2007 examination when these loans totaled $2.9 million or 34.78 percent of SCB's Tier 1 Capital. During the FDIC's July 2008 examination, the FDIC reported that the credit concentration was almost $16 million or 183 percent of Tier 1 Capital. By the time SCB failed, the concentration had increased to over $62 million. As of January 2009, $62.2 million or 78 percent of SCB's total agricultural loans were loans advanced by SCB to cover commodity trading activities for the Program participants. All of these loans were adversely classified by examiners in February 2009. Further, examiners determined that SCB had only $12.5 million in capital and reserves, which was insufficient to cover the adverse classifications of $62.2 million. In addition, the associated collateral, which is discussed later in this report, was grossly inadequate. Table 2 summarizes the Program loans for the period May 2005 to January 2009.

Table 2: Concentration in Program Loans

Loan Category	**Examination Date** (Dollars in Thousands)		
	January 2007	**July 2008**	**January 2009**
Total Program Loans ($000)	$2,900	$16,000	$62,200
Program Loans as a Percentage of Total Agricultural Loans	11%	47%	78%

Source: SCB's UBPRs and examination work papers.

From the July 2008 examination to early 2009, SCB management did not implement controls to limit the level of funding associated with the Program. Specifically:

- The third-party arrangement provided for open-ended funding to cover Program loans.
- SCB's Loan Policy did not include controls related to LLL, borrowers' ability to repay debt, and adequacy of collateral (these issues are discussed in more detail later in this report).

Implementation of such controls would have allowed the bank to (1) limit amounts loaned to Program participants, (2) ensure compliance with state laws regarding LLL, and (3) limit the negative financial consequences to the bank.

The documentation for the three-way arrangement entitled, *Security Agreement and Assignment of Hedging Account*,[7] included a control mechanism that would have protected the bank's viability if the BOD had implemented it. The agreement states:

> Whenever Secured Party deems it necessary for its protection, it shall be entirely without the consent or concurrence of or prior to Debtor, to direct

[7] Hedging refers to the practice of reducing price risk associated with the production, marketing, and processing of a commodity by taking opposite positions in futures or option markets.

> the Broker to liquidate any or all of the outstanding open positions in the Account.[8]

Contrary to this provision, SCB's BOD and management chose to continue to fund the loans. As a result, by January 2009, the concentration had increased by a total of $46.2 million as follows.

- $26.3 million in October 2008,
- $7.9 million in November 2008,
- $7.0 million in December 2008, and
- $5.0 million in January 2009.

According to DSC officials, had the bank implemented this control in September 2008 and liquidated the borrowers' accounts, the bank would not have failed.

According to SCB's Loan Committee minutes, in October 2008, committee members were concerned about the Program loans. The minutes also indicated that the committee planned to take action to limit the Program in the future. However, action to stop the funding either was not taken or was not effective because SCB continued to provide substantial funding for these loans. As the funding increased, the bank's risk and exposure also increased.

Part 364, Appendix A, *Interagency Guidelines Establishing Standards for Safety and Soundness*, states that an institution should establish and maintain loan documentation practices and prudent credit underwriting that:

- adequately account for concentrations of credit risk and

- identify the purpose of a loan and the source of repayment and assess the ability of the borrower to repay the indebtedness in a timely manner.

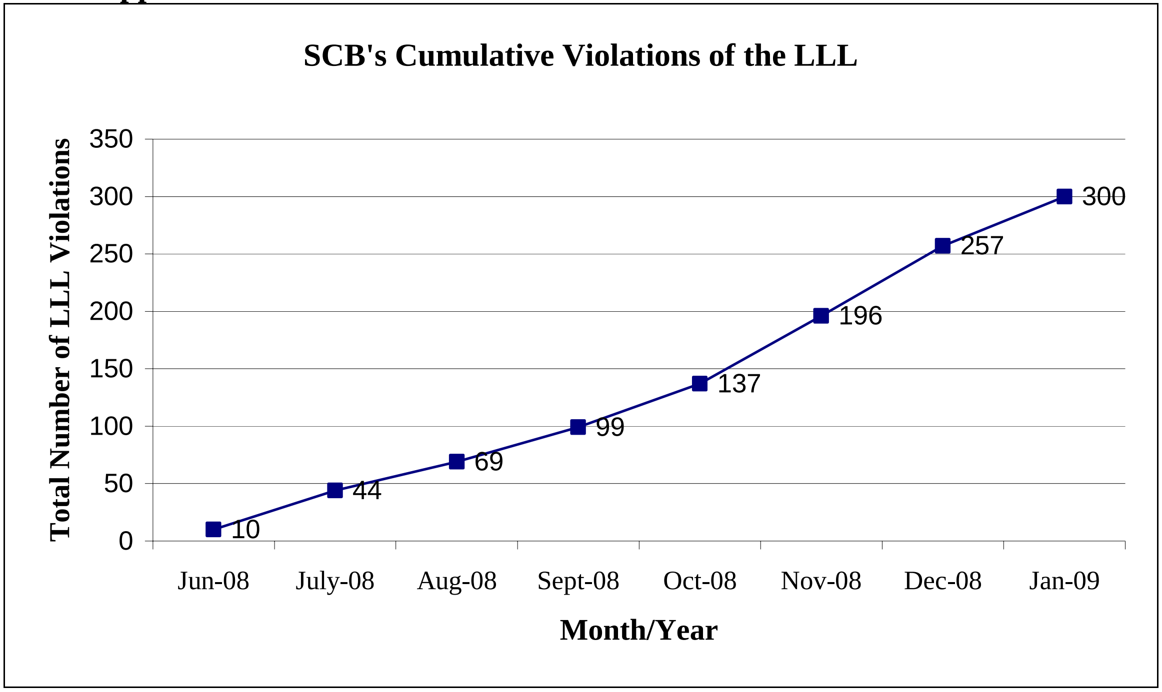
During the last quarter of 2008 and early 2009, SCB significantly increased the funding for 34 Program loans by $46.2 million without regard for the customers' ability to repay and in noncompliance with the State of Nebraska's LLL, as discussed in the following paragraphs. Further, SCB's BOD and management failed to effectively diversify the bank's loan portfolio during the end of 2008 and early 2009.

Material Violations of the State of Nebraska's LLL. SCB did not comply with the State of Nebraska's LLL laws designed to help banks avoid concentrations of lending to individuals. SCB violated Nebraska Statute 8-141, which states that a bank shall not directly or indirectly make loans to any one person or corporation which, in the aggregate, exceed 25 percent of the bank's Tier 1 Leverage Capital. However, examiners determined that from June 2008 through January 2009, SCB's advances, which totaled

[8] The Secured Party refers to SCB, Debtor refers to the Program participants, and Broker refers to the Futures Commission Merchant.

$23.9 million, to fund Program loans resulted in 300 violations of Nebraska's LLL. Figure 1, which follows, provides a summary of the apparent violations.

SCB's Apparent Violations of Nebraska's LLL



Source: NDBF's analysis of SCB loan documentation.

In the July 2008 Report of Examination (ROE), FDIC examiners cited the bank for five apparent violations of the state's LLL. Of the five advances that totaled $410,000, four advances, totaling $218,000, were extended beyond the LLL to fund some of the Program loans. During the FDIC's July 2008 examination, SCB:

- Took action to obtain participation loans to correct the LLL violations for these four loans. The fifth advance was in excess of the LLL for reasons other than Program loans.

- Agreed to improve day-to-day monitoring of lending to ensure that the bank did not exceed the LLL in response to the FDIC's recommendation.

Although SCB was cited for apparent LLL violations during the July 2008 examination, bank management disregarded its responsibility to comply with laws and regulations and failed to implement appropriate and effective corrective actions to avoid future apparent LLL violations.

According to the DSC *Risk Management Manual for Examination Policies* (Examination Manual):

- The underlying rationale for laws and regulations is the protection of the general public by establishing boundaries and standards within which banking activities may be conducted.

- It is important for BODs to ensure that executive management is cognizant of applicable laws and regulations and develop a system to effect and monitor compliance.

- BODs cannot be expected to be personally knowledgeable of all laws and regulations. However, the BOD should make certain that compliance with all laws and regulations receives high priority and violations are not knowingly committed by BOD members or anyone the bank employs.

SCB's BOD did not ensure that bank management complied with laws and regulations. Although bank management and the BOD were alerted to apparent LLL violations during the June 2008 examination and the bank took action to address those apparent violations, SCB's BOD did not ensure that timely and effective action was taken to prevent future violations.

Inadequate Underlying Collateral. SCB did not establish a loan review system to identify, monitor, and control the adequacy of the underlying collateral for the 34 Program loans to ensure the repayment of the debt. Part 364, Appendix A, *Interagency Guidelines Establishing Standards for Safety and Soundness*, states that an institution should establish and maintain loan documentation practices and prudent credit underwriting that provide for consideration, prior to credit commitment, of the:

- borrower's overall financial condition and resources,
- the financial responsibility of any guarantor,
- the nature and value of any underlying collateral, and
- the borrower's character and willingness to repay as agreed.

According to DSC's Examination Manual, each financial institution is expected to establish an internal loan-to-value limit, which should not exceed 65-85 percent depending on the loan category. However, SCB did not ensure that the collateral for the 34 loans was adequate to ensure the repayment of the debt. In addition, loan-to-value ratios for 29 of the 34 Program loans exceeded and, in some cases, significantly exceeded 85 percent. At the time of SCB's failure in February 2009, total collateral for those loans was valued at $31.5 million of the $62.2 million funded for the Program loans, or a loan-to-value ratio of 198 percent. Loan-to-value ratios for 16 (47 percent) of the 34 Program loans was more than 200 percent.

Contrary to this guidance, SCB did not adequately consider the concentration risk, ensure that the debt was secured by adequate collateral, and take steps to restrict/limit the amount of funding for the Program loans to ensure that the borrowers had the ability to repay the loans. In addition, SCB's BOD and management made loans for which the loan-to-value limits far exceeded industry standards.

Inadequacy of, and Noncompliance with, the Loan Policy. SCB's Loan Policy included some guidance related to agricultural loans but did not include all areas suggested in DSC's Examination Manual. SCB's loan guidance included lending limits, in terms of dollar value, for each loan officer and a general loan supervision policy and stated that all secured loans should have an ample margin of safety between the funds borrowed and the current market value of the collateral.

The Loan Policy addressed loan-to-value for real estate loans but did not specifically address the Program loans. Further, the Loan Policy (1) acknowledged that the bank had a concentration of credit in agricultural loans due to the nature of the bank's local economy and (2) stated that when concentrations of credit developed, the bank would attempt to sell participations out of the concentration until it was reduced to the lending limits specified in the Loan Policy. SCB's management did not comply with its Loan Policy guidelines.

According to SCB's Loan Policy, a concentration of credit was defined as direct, indirect, or contingent obligations of one individual or entity where the aggregate exposure exceeded 25 percent of the bank's capital. At the time of the January 2007 examination, Program loans represented 34.78 percent of the bank's Tier 1 Capital. The concentration in Program loans continued and significantly increased through the July 2008 examination and became more pronounced from September 2008 through January 2009. Contrary to the bank's Loan Policy, however, SCB did not take action to sell participations[9] from the concentration to comply with limits specified in the Loan Policy and significantly reduce the risk to the bank. Further, although SCB's Loan Policy addressed loan authorities for lending limits, the bank apparently violated LLL 300 times totaling nearly $24 million.

SCB's loan policies and procedures did not provide specific guidance related to monitoring the collateral values for commodity trading-related loans. In addition, FDIC guidance included in DSC's Examination Manual and the *Agricultural Lending Examination Documentation Module*, dated November 1997, relates to agricultural lending, underwriting, and loan administration. The guidance recommends that banks specializing in agricultural lending establish policies and procedures that address the:

- limitations on the amount loaned in relation to the value of the collateral for loans made by the bank and collateral margins to fund margin call loans; and

- limitations/thresholds on the maximum volume of agricultural loans in relation to total assets and plans for monitoring and taking appropriate

[9] As a result of the July 2008 examination, SCB took action to participate four of the Program loans for which the bank had apparently violated the LLL. This issue is discussed in more detail later in this report.

corrective action, if deemed necessary, on high-risk agricultural concentrations.

However, we found no evidence that SCB had incorporated this guidance into its loan policies and procedures. Specifically, SCB did not have policies related to the collateral limits for Program loans and did not set limitations/thresholds on the amounts loaned to Program participants or the volume of high-risk agricultural concentrations, which in this case, included the Program loans.

Inadequate ALLL Methodology and Funding

SCB's methodology for determining the ALLL did not comply with interagency policy. According to Financial Institution Letter (FIL) 105-2006, *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, dated December 13, 2006, each institution must analyze the collectibility of its loans and maintain an ALLL at a level that is appropriate and determined to be in accordance with Generally Accepted Accounting Principles (GAAP).[10] An appropriate ALLL covers estimated loan losses on individually evaluated loans that are determined to be impaired as well as estimated loan losses inherent in the remainder of the bank's loan and lease portfolio.

The July 2008 examination identified deficiencies in SCB's ALLL methodology, and examiners concluded that the methodology did not specifically evaluate loans for impairment and that reserve allocation calculations for loans not individually reserved for had not been quantified. SCB's president committed to modifying the ALLL methodology to adhere with the policy statement.

In October 2008, SCB's president requested additional time to develop and provide the FDIC with a revised ALLL methodology. The FDIC requested that SCB provide the revised ALLL information prior to December 31, 2008. We found no evidence that SCB had provided the revised ALLL methodology to the FDIC before the bank failed.

During the February 2009 visitation, examiners reported that SCB's ALLL of $1.5 million was insufficient to cover loan losses estimated at $31.7 million. As SCB's assets deteriorated, it became apparent that its ALLL was insufficient to absorb loan losses and could not be adequately funded.

Heavy Reliance on Volatile Funding Sources

SCB's management employed a funding structure that centered heavily on potentially volatile funding to cover its growth of high-risk agricultural loans. Those sources of funding included brokered deposits and time deposits of $100,000 or more. As stated in

[10] The policy provides key concepts and requirements pertaining to the ALLL included in GAAP and existing supervisory guidance and describes the nature and purpose of the ALLL; the responsibilities of BODs, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound loan grading system.

the DSC Examination Manual, a heavy reliance on potentially volatile liabilities to fund asset growth is a risky business strategy because the availability and access to these funds may be limited in the event of deteriorating financial or economic conditions, and assets may need to be sold at a loss in order to fund deposit withdrawals and other liquidity needs. However, SCB management did not establish policies or controls that adequately limited or mitigated the level of risk related to these funding sources. Table 3, which follows, summarizes SCB's dependence on high-cost volatile funds used for the significant increases in Program loans during 2008.

Table 3: Funding Sources Used for the Significant Increases in Program Loans

Examination Date	**Time Deposits of $100,000 or More** (in Thousands)	**Brokered Deposits** (in Thousands)	**Net Non-Core Funding Dependence** (Percent)	
			SCB	**Peer**
May 31, 2005	$8,862	0	30.08	10.62
January 16, 2007	$12,293	$1,564	33.57	14.36
July 21, 2008	$14,405	$98*	36.89	11.36
December 31, 2008	$29,468	$19,186	48.68	21.68

Source: UBPRs for SCB.
*The July 2008 examination used financial information dated March 31, 2008.

As indicated above:

- From the July 2008 examination to December 31, 2008, SCB's brokered deposits increased 1,800 percent—from approximately $98,000 to $19 million.

- Time deposits grew from approximately $14.4 million (a 105 percent increase) to $29.5 million during the last 6 months of 2008.

- During the last quarter of 2008, when SCB funded about $57 million in Program loans, brokered deposits grew from $2.9 million to $19 million, or 656 percent.

- SCB's net non-core dependence ratio significantly exceeded the bank's peer group from the May 2005 examination to the December 2008 examination.

The overall deterioration in the bank's condition affected its access to alternative sources of funding. Specifically, the FDIC issued a PCA Notification on February 4, 2009 that restricted the bank's use of brokered deposits.

Assessment of Third-Party Risk. SCB's BOD and management did not assess the risk that the third-party arrangement presented to the bank. The FDIC issued *Guidance for Monitoring Third Party Risks* (FIL-44-2008), dated June 8, 2008, which provides guidance to financial institutions regarding the assessment of risk associated with third-party arrangements. The guidance (1) describes potential risks arising from third-party arrangements, (2) outlines risk management principles that may be tailored to suit the complexity and risk potential of a financial institution's significant third-party arrangements, and (3) outlines the potential risks that may arise from the use of third parties. The guidance also addresses the following three basic elements of an effective third-party risk management program:

- risk assessment;
- due diligence in selecting a third party; and
- contract structuring, review, and oversight.

According to FIL-44-2008, the financial institution's BOD and senior management should understand the nature of associated risks, including, but not limited to:

Strategic risk - the risk arising from adverse business decisions, or the failure to implement appropriate business decisions in a manner that is consistent with the institution's strategic goals.

Reputation risk - the risk arising from negative public opinion. Third-party arrangements can result in dissatisfied customers, interactions not consistent with institution policies, inappropriate recommendations, security breaches resulting in the disclosure of customer information, and violations of law and regulation.

Operational risk - the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.

Transaction risk - risk arising from problems with service or product delivery. A third party's failure to perform as expected by the customers or financial institution due to reasons such as inadequate capacity, technological failure, human error, or fraud exposes the institution to transaction risk.

Credit risk - the risk that a third party, or any other creditor necessary to the third-party arrangement, is unable to meet the terms of the contractual arrangements with the financial institution or to otherwise financially perform as agreed.

Compliance risk - the risk arising from violations of laws, rules, or regulations or from noncompliance with internal policies or procedures or with the institution's business standards.

SCB's association with the Program resulted in the bank experiencing a negative impact in all of the above categories of risk.

The guidance states that the BOD and management are responsible for assessing these risks as follows:

- An institution's BOD and senior management are ultimately responsible for managing activities conducted through third-party arrangements and identifying and controlling the risks arising from such arrangements, to the same extent as if the activity were handled within the institution.

- Bank management should tailor the principles included in this guidance to each significant third-party arrangement, taking into consideration such factors as the complexity, magnitude, and nature of the arrangement and associated risks.

The failure of SCB's BOD and management to adequately assess the risk of the Program and their decision to increase and fund loan commitments without adequately considering the (1) borrowers' ability to repay and (2) sufficiency of the underlying collateral proved detrimental to the viability of the institution and resulted in the bank's failure and a material loss to the DIF.

ASSESSMENT OF SUPERVISION

The FDIC and NDBF performed oversight of SCB, including conducting risk management examinations and visitations. However, we identified one area where DSC's supervision could have been improved. The FDIC could have taken earlier and more assertive actions related to SCB's third-party arrangement. Specifically, the FDIC could have done more to consider the risk that the third-party arrangement posed to SCB. Although the examiners for the FDIC's 2005 and 2008 examinations discussed the Program with bank management, the FDIC did not fully assess the risk that the third-party arrangement and Program posed to SCB. The FDIC recognized during the July 2008 examination of SCB that there were deficiencies in the bank's lending activity. However, the FDIC did not ensure that SCB's Loan Policy included adequate guidance to limit (1) loan commitments in relation to collateral value or the borrower's ability to repay for Program loans and (2) the concentration in the Program loans.

Historical Snapshot of FDIC Supervision

The FDIC and NDBF performed alternating safety and soundness examinations of SCB in a timely manner, conducting a total of four examinations, beginning November 2003 through July 2008 (see Table 4, on the next page). The FDIC also conducted three visitations between March 2003 and December 2004 due to concerns over litigation and investigations directed at SCB's affiliated broker, the Program, and SCB and its holding company (refer to the discussion that follows on page 14 and Appendix 2). In addition, the FDIC conducted a visitation in February 2009 after SCB's management informed the FDIC of the significant deterioration in the bank's financial condition. SCB's composite ratings remained at 2 until the February 2009 visitation when the bank's composite rating was downgraded to 5, indicating extremely unsafe and unsound practices or conditions, critically deficient performance, and inadequate risk management practices.

Table 4: Examination Dates and CAMELS Ratings

Examination Date	Examination Conducted By	CAMELS Ratings
11/17/2003	State	122111/2
05/31/2005	FDIC	222111/2
01/16/2007	State	122112/2
07/21/2008	FDIC	222121/2
02/02/2009	Joint	555555/5

Source: ROEs for SCB.

The FDIC examiners identified and reported concerns such as apparent violations of laws and regulations and repeat apparent contraventions of interagency policies. In addition, the examiners made recommendations to SCB to improve risk management and loan underwriting and credit administration issues.

Further, to address examiner concerns documented during a Federal Reserve Bank (FRB) March 2004 visitation (refer to Appendix 2 for additional information), the FDIC and NDBF requested that SCB adopt a Bank Board Resolution (BBR), which the bank's BOD adopted on July 14, 2004. The BBR resulted from the FDIC's concerns over SCB's potential liability in an outstanding lawsuit by the Commodity Futures Trading Commission (CFTC) and National Futures Association (NFA) and required the bank to manage its capital position in anticipation of any judgment that might result from the suit. The BBR contained one provision restricting cash dividends, capital distributions, earnings distributions, or management fees in excess of $100,000 per calendar quarter, without the prior written consent of the FDIC and NDBF. Also, the FDIC placed SCB on a *Supervisory Watchlist* due to pending litigation and settlement as a result of the CFTC/NFA lawsuit. Once that lawsuit was settled in 2007, the FDIC removed SCB from the Watchlist.

In addition, in October 2008, SCB's holding company submitted an application to participate in the Troubled Asset Relief Program's (TARP) Capital Purchase Program, administered by the United States Department of the Treasury (Treasury), and requested $2.8 million in funds. In December 2008, the FDIC approved the request and referred it to the Treasury, which also approved SCB's TARP request. In January 2009, SCB's president and chairman requested a meeting with the FDIC and informed the FDIC that the bank was likely insolvent due to expected losses on loans related to activities directed by the Program's broker. During that meeting, SCB's president provided details regarding the Program and the bank's substantially deteriorated financial condition since the FDIC's last full-scope examination in July 2008. On January 30, 2009, SCB's president requested an increase in TARP funds. However, due to significant declines in the bank's financial condition and the inability to certify that there had not been a material change in the bank's status, SCB's president withdrew the bank's request for TARP funds.

As previously discussed, based on SCB's disclosure of the bank's financial deterioration, the FDIC initiated a visitation of SCB on February 2, 2009. On February 7, 2009, the FDIC issued a Cease and Desist Order (C&D), which required SCB to:

- Eliminate charge-offs of adversely classified assets and contingent liabilities.
- Maintain an appropriate ALLL.
- Increase and maintain a sufficient level of capital for a Total Risk-Based Capital Ratio of not less than 12 percent and a Tier 1 Leverage Capital Ratio of not less than 8 percent.
- Submit a written plan to the FDIC and NDBF, describing the primary means and timing by which to increase capital, as well as a contingency plan for the sale, merger, or liquidation of the bank.
- Not declare or pay any cash dividends without the prior written approval of the supervisory authorities.
- Not extend any additional credit to, or for the benefit of, any borrower who had a loan or other extension of credit or obligation with the bank that has been charged off or adversely classified.
- Eliminate and/or correct violations of law.
- Immediately improve liquidity and funds management to include a written liquidity analysis and projection for the sources and uses of funds.

On February 5, 2009, the NDBF informed SCB that the bank needed to obtain additional capital totaling $34.1 million by February 12, 2009. Because the bank was unable to raise the additional capital, the NDBF closed the bank on February 13, 2009.

OIG Assessment of FDIC Supervision

The FDIC provided regular examinations of SCB and reported some of the issues in the July 2008 examination that were ultimately related to the bank's failure. However, we concluded that the FDIC's supervision and assessment of the risk that the third-party arrangement presented to the bank, including an assessment of the bank's Loan Policy related to the Program, could have been improved. A more complete assessment would have included a determination of how the bank was measuring, monitoring, and controlling risks associated with the institution's significant third-party arrangement.

The FDIC's and other regulators' concerns regarding the Program date back to, at least, 2004. In conjunction with the FRB and NDBF, the FDIC conducted a visitation of SCB in March 2004 that focused on the CFTC and NFA investigation of the third-party commodity broker and the conflict of interest relating to the dual roles of SCB's vice president. The activities of the broker in SCB's third-party arrangement prompted lawsuits by some of the broker's customers (some of who were also SCB borrowers). The customers alleged that the broker had acted inappropriately by engaging in trading activities outside the scope of the Program and, consequently, caused significant losses to SCB customers who were participating in the Program.

Third-Party Risks Related to the Program. The FDIC could have done more to consider the risk presented by the Program to ensure that SCB established and appropriately implemented risk management controls over the Program's broker.

FDIC Follow-up on Regulatory Concerns. According to the FDIC, as part of its follow-up to the CFTC/NFA concerns, examiners reviewed documents to ensure that SCB management abided by the terms and provisions of the final CFTC/NFA agreement. The FDIC reviewed the Program during the visitation conducted in December 2004 and the FDIC examinations conducted in May 2005 and July 2008,[11] after the FRB issued its 2004 inspection report.[12] However, the FDIC did not adequately follow up on the risk that the third-party arrangement presented to SCB to ensure that the bank established and appropriately implemented controls to prevent excessive funding of high-risk agricultural loans.

During the 2005 and 2008 FDIC examinations, the FDIC assigned a Subject Matter Expert (SME) to review SCB's commodity marketing program. According to the FDIC, the SME performed a thorough evaluation of the marketing Program to determine whether the Program was working as intended and that Program objectives were in place. However, the analyses and results of the reviews of the Program were not summarized and documented in the ROEs or the related examination work papers, and these reviews did not consider the risk that the Program presented to SCB.

Heightened Risk to SCB. The third-party arrangement heightened risk to SCB because (1) the bank used only one broker for the Program, (2) the broker made "batch orders" for all participants at one time, (3) one bank (SCB) funded all of the loans for each of the 34 Program participants, and (4) the third-party agreement provided for open-ended funding. Although the agreement also allowed the bank to discontinue funding when deemed necessary, SCB did not implement this control. The third-party agreements that the bank and participants signed were in effect prior to the FDIC's 2009 visitation which occurred after a January 2009 meeting with SCB. In addition, the FDIC did not question (1) loan underwriting and credit administration weaknesses resulting in open-ended funding for the 34 Program loans and (2) Loan

[11] The NDBF conducted the 2007 examination of SCB.
[12] FRB's 2004 inspection concluded that risk management practices related to SCB's third-party arrangement with the broker, including oversight of trading strategies that the broker was authorized to offer to SCB customers, were inadequate and constituted a conflict of interest for the bank. The FRB made several recommendations to improve the bank's oversight of the third-party arrangement. Among other things, the FRB concluded that the third-party broker presented significant operational, legal, and reputational risk for the parent company.

Policy deficiencies that resulted in substantial risk to SCB, inadequate collateral, and material apparent violations of the State of Nebraska's LLL.

Examples of the FDIC's examination/visitation comments related to SCB's Program and the third-party broker are shown below in Table 5.[13]

Table 5: Examples of FDIC Comments Regarding the Program and SCB

Date	Examination Comments and/or Concerns
March 2004	The purpose of the visitation was to gain a better understanding of the broker's agricultural commodities marketing activities that prompted lawsuits by four of the broker's former customers and an investigation by the CFTC and NFA. The customers alleged that the broker had acted inappropriately by engaging in speculative rather than hedging transactions. The FRB identified inadequate risk management controls over SCB's broker.
December 2004	This visitation focused on the implications of negative publicity against SCB and the bank's holding company due to the CFTC/NFA law suit.
May 2005	SCB's holding company was affiliated with the broker and owned 50 percent of the brokerage company. After the 2004 FRB inspection, the only identified connection between the holding company and the brokerage firm was that the holding company continued to own a commercial building that it leased to the new, unaffiliated broker.
July 2008	The FDIC concluded that credit concentrations funded by SCB to cover the Program activities increased from $2.9 million, reported in the NDBF's 2007 examination, to $16 million, or 183 percent of Tier 1 Capital. SCB violated the state's LLL law by $410,000. Of this amount, $218,000 was extended to fund advances to cover trading activities. A substantial increase in 2008 agricultural operating costs, including costs to fund requirements for the broker's hedging activities, had required bank officials to arrange numerous credit participation loans to comply with legal lending requirements. The FDIC further concluded that although loan officers paid close attention to lending limitations at loan origination, improved monitoring of the day-to-day lending limit was warranted.
February 2009	On January 30, 2009, SCB's president informed the FDIC that approximately 35 borrowers* would sustain catastrophic losses related to the Program loans SCB had funded. The corresponding debt at SCB associated with the Program (fees and funding requests) was estimated by bank management to be about $60 million. According to the FDIC, SCB's president informed the FDIC that many of the borrowers did not have the capacity to repay the debt. According to the FDIC's problem bank memorandum, dated February 2, 2009, most of the bank's exposure appeared to relate to SCB's rapid increase in the funding of these loans during the fourth quarter of 2008 in an ill-fated attempt to offset significant declines in corn prices and associated losses to Program participants.

Source: FDIC examinations, visitations, and other supervisory documentation.
* It was later determined that there were only 34 borrowers.

As indicated above, the FDIC's assessment of the Program did not take into consideration the risk that the Program presented to SCB. SCB disclosed the bank's substantial financial deterioration to the FDIC on January 30, 2009, that is, reporting the substantial loan losses from advances made for the Program participants. As a result, the FDIC took

[13] The January 2007 NDBF examination concluded that SCB had found a "niche" in funding requirements for the Program participants, with SCB funding of $2.9 million in Program loans that represented 34.78 percent of Tier 1 Capital.

quick and decisive action 3 days later and began an onsite examination of SCB on February 2, 2009 to more accurately identify the extent of losses in the bank's loan portfolio.

Noncompliance with Examination Guidance Related to Third-Party Risk. During 2007, the FDIC included third-party-related guidance in (1) the FDIC's *Supervisory Insights Summer 2007* article and (2) a Regional Directors Memorandum (Transmittal 2008-020), *Guidance for Monitoring Third Party Risks*, dated June 8, 2008. However, FDIC examiners could have more fully considered and adequately documented their use or consideration of this guidance during the July 2008 examination of SCB.

Guidance in *Supervisory Insights Summer 2007*. This article addresses the benefits and potential risks associated with third-party agreements and offers some best practices to assist banks in avoiding the financial losses and reputation risks that can result from poorly managed third-party arrangements. The article also states that third-party arrangements can present risks and discusses how failure to manage these risks can expose a financial institution to everything from financial loss to regulatory action and loss of customer relationships. The article also states that inadequate management and control of third-party risks can result in a significant financial impact on an institution.

Guidance in Transmittal 2008-020. This guidance forms a general framework that BOD and senior management may use to provide appropriate oversight and risk management of any significant third-party arrangement. The principles and procedures outlined in this guidance should serve as a resource to ensure that risks arising from third-party arrangements are appropriately managed. The guidance also:

- states that supervisory efforts should be focused on assessing, measuring, monitoring, and controlling risks associated with an institution's significant third-party arrangement; and

- stresses the effects that third parties could have on key aspects of a bank's performance, such as earnings, asset quality, liquidity, rate sensitivity, and the institution's ability to comply with laws and regulations.

DSC's Examination Manual states that situations occasionally arise where the safety and soundness of an insured depository institution is materially affected by transactions, contracts, or business arrangements with parties that are not affiliated with the institution. When such situations arise, the FDIC should examine the other side of the transaction. The potential impact of these business relationships on the insured depository institution necessitates a complete understanding of the nature of the transaction and relationship and its effect on the insured institution. The guidance also states that, by statute, the FDIC has authority to obtain records of unaffiliated service providers and other counterparties relating to an insured financial institution. The information that the FDIC can obtain from an unaffiliated service provider or other counterparty is not limited to specific transactions with, or relating to, the insured depository institution but can extend to the financial books and records of the servicer or entity so long as such documents are needed in furtherance of an examination that relates to the affairs of an insured bank.

The FDIC could have done more to identify, evaluate, or monitor the risks associated with SCB's third-party arrangement. Not doing so resulted in the FDIC's inability to ensure that SCB had appropriate procedures in place to address the complexity and risk potential of the Program. Program participant losses escalated during the last quarter of 2008 and early 2009. Attempts to recover from the losses to Program participants resulted in significant loan advances, totaling $46.2 million, through the bank's open-ended funding practices, from October 2008 to January 2009, leading to SCB's failure on February 13, 2009.

Loan Policy. In the FDIC's July 2008 ROE, examiners recognized that SCB had significantly increased the amount of funding for Program loans, had apparent violations of the State of Nebraska's LLL, and needed to improve its day-to-day loan monitoring of lending to ensure the bank complied with the LLL requirements. However, the FDIC did not ensure that SCB's Loan Policy included adequate guidance to limit (1) loan commitments in relation to collateral value and a borrower's ability to repay Program loans and (2) the concentration in Program loans.

DSC's Examination Manual states that the examiner's evaluation of a bank's credit administration and loan policies and the quality of the loan portfolio are among the most important aspects of the examination process. However, FDIC examiners did not adequately assess SCB's loan policies and procedures to ensure that appropriate controls were in place to mitigate third-party risks related to the Program. As discussed on page 9 of this report, DSC's *Agricultural Lending Examination Documentation Module* provides guidance to examiners to use when evaluating agricultural lending. The bank's Loan Policy included some guidance related to agricultural loans (as discussed on page 9). However, the bank's Loan Policy did not include guidance related to:

- limitations on the amount loaned in relation to the value of the collateral for loans made by the bank and collateral margins to fund margin call loans (i.e., Program loans) and

- limitations/thresholds on the maximum volume of agricultural loans in relation to total assets and plans for monitoring and taking appropriate corrective action, if deemed necessary, on high-risk agricultural concentrations (i.e., Program loans).

The FDIC examiners did not ensure that SCB's Loan Policy and procedures (1) included adequate guidance to ensure that SCB's management adjusted collateral value, (2) considered the borrower's ability to repay before increasing loan commitments, or (3) set limitations/thresholds on the amounts advanced to program participants or the volume of higher-risk agricultural loans. SCB's Loan Policy addressed agricultural loans but did not specifically address possible concentrations in Program loans and the risk that the concentration might present to the bank. Greater supervisory concern by the FDIC regarding the adequacy of SCB's loan policies could have led to elevated supervisory attention and earlier supervisory action.

Conclusion. The FDIC could have done more to consider and mitigate the bank's risks associated with the Program before the bank's financial condition had significantly deteriorated. The FDIC's SME focused attention on some areas of the Program during the FDIC's 2005 and 2008 examinations. However, additional attention was needed to analyze/monitor the SCB's control weaknesses associated with the risks that the Program presented to the bank, including the concentration in Program loans, loan underwriting and credit administration deficiencies, inadequate loan policies, and apparent violations of the LLL. Although the FDIC issued examiner guidance related to third-party risk in 2007 and June 2008, that guidance was not fully used to assess the risk that SCB's third-party arrangement presented to the bank. FDIC officials stated that the three-way arrangement was a normal industry practice for agriculture-related loans and that the FDIC did not consider the arrangement to present elevated risk to the bank. However, all 34 Program participants used the same third-party broker to place trading orders, and the same bank, which in this case was SCB, funded the Program loans. The risk associated with the Program caused severe financial deterioration and ultimately led to SCB's failure and a material loss to the DIF.

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.

SCB was categorized as *Critically Undercapitalized*, under PCA provisions, just prior to its failure. As a result, the FDIC issued a C&D that contained a capital provision, directing SCB to increase its capital. The C&D was issued on February 7, 2009, 6 days before the bank was closed. SCB received a capital component rating of 1 or 2 for each of the four examinations conducted from November 2003 through July 2008. The capital component was downgraded to a 5 rating during the February 2009 visitation. The downgrade in February 2009 resulted from the bank's critically deficient level of capital due to severe asset quality problems and losses that rapidly eroded the bank's capital position.

Table 6, which follows, shows how SCB's capital ratios compared to the bank's peer group for three of the bank's examinations and as of December 31, 2008.

Table 6: SCB's Capital Ratios Compared to Peer Group

Examination Dates	Tier 1 Leverage Capital %		Tier 1 Risk-Based Capital %		Total Risk-Based Capital %	
	Bank	Peer	Bank	Peer	Bank	Peer
May 2005	9.29	9.62	13.46	14.58	14.73	15.72
Jan 2007	9.61	10.02	12.33	14.56	13.59	15.65
July 2008	8.98	9.77	10.63	14.24	11.87	15.27
Dec 2008*	8.96	9.31	9.51	13.01	10.74	14.09

Source: ROEs and UBPRs for SCB.
*UBPR dated December 31, 2008.

As indicated above, SCB's capital ratios were slightly below the bank's peer group through December 2008.

PCA's focus is on capital, and capital can be a lagging indicator of an institution's financial health. In addition, the use of PCA Directives depends on the accuracy of capital ratios in an institution's financial data. SCB's capital designation for PCA purposes remained in the *Well Capitalized* range through the July 2008 examination.[14] However, the BOD did not ensure that the institution had sufficient capital to support the significant increase in lending activities. Due to SCB's funding of $46.2 million for Program loans from October 2008 to January 2009, SCB's capital level fell to *Critically Undercapitalized* in January 2009. In February 2009, the FDIC notified the BOD of the bank's change in PCA category to *Critically Undercapitalized*, subjecting the bank to brokered deposit rate restrictions. On February 5, 2009, the NDBF notified the bank that a capital infusion of $34.1 million was required by February 12, 2009. However, SCB was unable to obtain additional capital and was closed on February 13, 2009.

CORPORATION COMMENTS

On September 3, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 4 of this report. In its response, DSC reiterated that SCB failed primarily due to the BOD's and management's decision to increase and fund loans without adequately considering the borrowers' ability to repay and the sufficiency of the underlying collateral. DSC also stated that the Program parameters were violated when the hedged position was allowed to lapse on September 26, 2008, and SCB continued to fund speculative positions. DSC also stated that while the Program loans represented a concentration at the time of the July 2008 examination, the Program was operating within its parameters and that there was more than adequate commodity and market account collateral to repay the outstanding loans. DSC continued that examiners had discussed the importance of the Program hedging parameters and LLL with SCB management during the 2008 examination, yet management ignored internal controls and LLL only 3 months later.

[14] In December 2008, SCB's holding company injected $2.5 million in capital into SCB to maintain the *Well Capitalized* ratio.

DSC acknowledged that earlier and more complete recognition of the risks posed by the single-broker arrangement and the weaknesses in SCB's internal controls could have led to elevated supervisory attention and more timely supervisory action. DSC also acknowledged the importance of commodity price protection programs to the agriculture industry and supports well-controlled risk management programs designed to hedge against commodity market price fluctuations.

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 the audit from February 2009 to August 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it may not have been feasible to address certain aspects of the standards, as described on the next page.

Scope and Methodology

The scope of this audit included an analysis of SCB's operations from November 2003 until its failure on February 13, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution from 2003 to 2009.

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

- Analyzed examination and visitation reports prepared by the FDIC and NDBF from 2003 to 2009.

- Reviewed the following:

  - Bank data and correspondence maintained at DSC's Kansas City Regional Office and Grand Island Field Office, and NDBF.

  - Bank records maintained by DRR in Dallas, Texas.

  - Records of the bank's external auditor prepared by Shonsey and Associates, Grand Island, Nebraska.

  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C.; Kansas City, Missouri; and Grand Island, Nebraska.

  - FDIC examiners from the DSC Grand Island Field Office who participated in SCB examinations.

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

We performed the audit field work at the DSC offices in Kansas City, Missouri, and Grand Island, Nebraska.

Our ability to evaluate certain issues related to the Program activities and related loans were restricted due to the lack of certain documents, such as copies of three-way agreements, promissory notes, and broker's records.

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

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of SCB's management controls pertaining to its operations 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, we 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 program audits of DSC operations.

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

ADDITIONAL REGULATORY ACTIVITIES RELATED TO SCB

2004 Lawsuit and Investigation

In 2004, the activities of the broker in SCB's third-party arrangement prompted lawsuits by some of the broker's customers (some of who were also SCB borrowers) as well as an investigation by the CFTC and NFA. The customers alleged that the broker had acted inappropriately by engaging in trading activities outside the scope of the Program (i.e., executed speculative transactions instead of hedging transactions) and, consequently, caused significant losses to SCB customers who were participating in the Program. At the time of the lawsuit and investigation, the broker was considered an "affiliated[15] broker" because 50 percent of the brokerage company was owned by SCB's holding company and 50 percent was owned by SCB's vice president who was also a loan officer of SCB. Because SCB's vice president was affiliated with the broker, the CFTC obtained a consent order of preliminary injunction against the broker and the bank's vice president. The injunction was agreed to by all parties and required the third-party broker and SCB's vice president to operate within the CFTC's rules and regulations.

As a result of CFTC/NFA investigation, the FDIC and NDBF conducted a visitation of SCB in March 2004 that focused on the commodity marketing activities of the affiliated broker. During the visitation, regulators identified a conflict of interest relating to the dual roles of SCB's vice president because he was acting as both a broker and a loan officer of SCB. On March 31, 2004, the CFTC and NFA requested that SCB's vice president, the bank's holding company—SCB, Incorporated, and SCB be removed from all ownership of and/or direct involvement in commodities trading. In May 2004, the CFTC and NFA approved a new unaffiliated broker[16] who took over management of the Program and continued to manage it until the bank's failure in February 2009. From May 2004 until January 2009, the new unaffiliated broker handled the Program's marketing strategies, and SCB continued to provide loan advances to the broker to fund participants' commodity trading accounts.

FRB Inspection

In conjunction with the March 2004 FDIC and NDBF visitation, the FRB, which is responsible for regulation and supervision of bank holding companies, conducted a targeted inspection of SCB, Incorporated, SCB's holding company, to (1) learn more about the trading losses incurred by that company's nonbank subsidiary, the then affiliated broker, (2) understand the issues surrounding the CFTC and NFA investigation of the broker; and (3) determine what effects, if any, the CFTC/NFA investigations might have on the parent company. The FRB determined that the overall financial condition of the parent company, a one-bank financial holding company, owning 100 percent of SCB and 50 percent of the brokerage company, had declined but was considered to be fair.

[15] An affiliate is a business concern owned or controlled in whole or in part by another concern.
[16] Although the new broker was considered to be unaffiliated, the brokerage firm consisted of employees of the prior affiliated broker and rented office space from SCB's holding company.

However, the financial condition of the brokerage company had deteriorated significantly and was considered to be unsatisfactory. The brokerage company's problems were directly related to customers' losses stemming from the broker's commodity brokerage activities.

The FRB concluded the following.

- SCB's BOD and management were not adequately overseeing the broker's investment strategies, activities, and personnel.

- The risk associated with SCB's financing loans for agricultural producers was a primary risk for the institution. The parent company's financial success was directly linked to the success of SCB, whose ability to maintain a steady course despite volatile swings in agricultural markets was paramount to the company's and the bank's success.

- The broker seemed to be a source of significant operational, legal, and reputational risk for the parent company.

Accordingly, as a one-bank holding company, the risk presented by the broker also spilled over to the bank—SCB. The FRB's inspection report outlined specific concerns, including the appropriateness of the broker's marketing strategies and the type of trades the broker made for the Program participants. The FRB's inspection resulted in recommendations to improve oversight and monitoring of the broker's activity by SCB management.

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 loan.
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.
Commodity Futures Trading Association	The federal regulatory agency established by the Commodity Futures Trading Act of 1974 to administer the Commodity Exchange Act.
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.
Margin	The required level of equity/funding that the Program participants were required to maintain in the commodity Program account.
National Futures Association	A self-regulatory organization whose members include futures commission merchants and introducing brokers. NFA is responsible—under CFTC oversight—for certain aspects of the regulation of futures commission merchants and introducing brokers, focusing primarily on the qualifications and proficiency, financial condition, retail sales practices, and business conduct of these futures professionals.
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.

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 Call Report data submitted by banks.

CORPORATION COMMENTS

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

September 3, 2009

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Sherman County Bank, Loup City Nebraska
(Assignment No. 2009-026)

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 Sherman County Bank (Sherman) which failed on February 13, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Audit Report (Report) received on August 6, 2009.

Sherman failed primarily due to Board and management's decision to increase and fund loans without adequately considering the borrower's ability to repay and the sufficiency of the underlying collateral. These loans were supposed to provide borrower funding for participation in a commodity market hedging program (Program) for corn crops and be fully secured at all times based upon the Program parameters. The Program parameters were violated when the hedged position was allowed to lapse on September 26, 2008, and Sherman continued to fund speculative positions. While the Program loans represented a concentration at the time of the July 2008 examination, the Program was operating within its parameters and there was more than adequate commodity and market account collateral to repay the outstanding loans. Examiners discussed the importance of the Program hedging parameters and legal lending limits with Sherman management and yet management ignored internal controls and legal lending limits only three months later.

The Report found that the FDIC and the Nebraska Department of Banking and Finance conducted timely and regular safety and soundness visitations and examinations of Sherman. The Report also found that the FDIC could have done more to consider the risk the third-party broker arrangement posed to Sherman. We acknowledge the Report's findings that earlier and more complete recognition of the risks posed by the single broker arrangement and the weaknesses in Sherman's internal controls could have led to elevated supervisory attention and more timely supervisory action. DSC also acknowledges the importance of commodity price protection programs to the agricultural industry and supports well-controlled risk management programs designed to hedge against commodity market price fluctuations.

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

ACRONYMS USED IN THE REPORT

Acronym	Definition
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CFTC	Commodities Futures Trading Commission
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
FRB	Federal Reserve Bank
GAAP	Generally Acceptable Accounting Principles
LLL	Legal Lending Limits
NDBF	Nebraska Department of Banking and Finance
NFA	National Futures Association
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SCB	Sherman County Bank
SME	Subject Matter Expert
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System