# Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-003

## Material Loss Review of New Frontier Bank, Greeley, Colorado

October 2009

Office of Inspector General

**Executive Summary**

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## Why We Did The Audit

On April 10, 2009, the Banking Board of the Colorado Division of Banking (CDB) closed New Frontier Bank (New Frontier) of Greeley, Colorado, and named the FDIC as receiver. On April 23, 2009, the FDIC notified the Office of Inspector General (OIG) that New Frontier's total assets at closing were $1.8 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $668.9 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 New Frontier.

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

## Background

New Frontier was established in December 1998 as a state-chartered, non-member bank. The institution had a total of three locations, consisting of a main office in Greeley, Colorado, and two full-service branches in nearby Windsor and Longmont, Colorado. New Frontier was wholly owned by the New Frontier Bancorp (Bancorp), a one-bank holding company. Much of New Frontier's lending consisted of acquisition, development, and construction (ADC) loans in Colorado and agricultural production, farmland, and dairy (agricultural) loans in Colorado, Kansas, and Texas.

## Audit Results

### Causes of Failure and Material Loss

New Frontier failed because its Board and management did not implement adequate risk management practices pertaining to (1) rapid growth and significant concentrations of ADC and agricultural loans, (2) loan underwriting and credit administration, and (3) heavy reliance on non-core funding sources. Examiners expressed concern about New Frontier's risk management practices in the years preceding the institution's failure and made a number of recommendations for improvement. However, the actions taken by New Frontier's Board and management to address these concerns and recommendations were not timely or adequate. Also contributing to New Frontier's losses was an incentive compensation program that paid a commission to a senior lending official based on the volume of loans and fees that the official originated.

When the institution's primary real estate and agricultural lending markets began to deteriorate in 2007 and 2008, respectively, weaknesses in New Frontier's risk management practices translated into a decline in the quality of the institution's ADC and agricultural loans. The losses and provisions associated with this decline quickly depleted the institution's capital and earnings, and significantly impaired its liquidity position. CDB closed New Frontier based on a determination that the institution did not have adequate capital, its business was being conducted in an unlawful or unsound manner, and it was unable to continue normal operations.

### The FDIC's Supervision of New Frontier

The FDIC, in conjunction with CDB, provided ongoing supervision of New Frontier through regular on-site risk management examinations, periodic on-site visitations, and quarterly off-site reviews. The FDIC also placed New Frontier on its supervisory watch list in February 2007 and coordinated with CDB to issue one informal enforcement action and one formal enforcement action, both in 2008, to address weak risk management practices identified by examiners. Further, the FDIC performed daily monitoring of the institution's liquidity position beginning in November 2008. Through its supervisory efforts, the FDIC identified risks in New Frontier's management practices and operations and brought these risks to the attention of the institution's Board and management. These risks included weak management practices pertaining to the institution's rapid loan growth, ADC and agricultural loan concentrations, loan underwriting and credit administration practices, and reliance on non-core funding sources.

The FDIC relied principally on recommendations to address risks identified by examiners and did not impose enforcement actions until early 2008. In retrospect, a stronger supervisory response at earlier examinations may have been prudent in light of the extent and nature of the risks and the institution's lack of adequate or timely corrective action. For example, the FDIC could have imposed an enforcement action requiring that New Frontier commit to a written plan and timeline for addressing key risks identified by examiners and monitored New Frontier's performance relative to the plan. Stronger supervisory action may have influenced New Frontier's Board and management to constrain their excessive risk taking during the institution's rapid growth period. It may also have prompted the Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

With regard to PCA, we concluded that the FDIC had properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for New Frontier. However, PCA's effectiveness in mitigating losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure. In the case of New Frontier, capital was a lagging indicator of the institution's financial health. New Frontier was considered well capitalized for PCA purposes until the FDIC and CDB issued a joint cease and desist order on December 2, 2008, that included a capital provision. As a result of the order, New Frontier's capital category dropped from well capitalized to adequately capitalized for PCA purposes. However, examiners had already concluded at that time that the overall financial condition of the institution was unsound and that the probability of its failure was high.

## Management Response

On October 20, 2009, the Director, DSC, provided a written response to a draft of this report. The response is provided in its entirety as Appendix 4 of this report. In its response, DSC reiterated the OIG's conclusions regarding the cause of New Frontier's failure. Regarding our assessment of the FDIC's supervision of New Frontier, DSC cited several supervisory activities, discussed in our report, that were undertaken to address key risks at the institution prior to its failure. In its response, DSC also recognized that strong supervisory attention is necessary for institutions like New Frontier that have high CRE and ADC concentrations supported by volatile funding sources. Accordingly, DSC has issued updated guidance reminding examiners to take appropriate action when such risks are imprudently managed.

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**Federal Deposit Insurance Corporation**
3501 Fairfax Drive, Arlington, VA 22226 Office of Inspector General

**DATE:** October 23, 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 New Frontier Bank, Greeley, Colorado* (Report No. MLR-10-003)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the FDIC Office of Inspector General (OIG) conducted a material loss[1] review of the failure of New Frontier Bank (New Frontier), Greeley, Colorado. The Banking Board of the Colorado Division of Banking (CDB) closed the institution on April 10, 2009, and named the FDIC as receiver. On April 23, 2009, the FDIC notified the OIG that New Frontier's total assets at closing were $1.8 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $668.9 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. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review were to: (1) determine the causes of New Frontier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of New Frontier, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of New Frontier's failure and the FDIC's efforts to ensure that New Frontier's Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common

[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.

characteristics of financial institution failures are identified in our material loss 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 DSC's supervision program and make recommendations as warranted. 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.

## Background

New Frontier was established in December 1998 as a state-chartered, non-member bank. The institution had a total of three locations, consisting of a main office in Greeley, Colorado, and two full-service branches in nearby Windsor and Longmont, Colorado. Much of New Frontier's lending consisted of acquisition, development, and construction (ADC) loans in Colorado, and agricultural production, farmland, and dairy (agricultural) loans in Colorado, Kansas, and Texas. New Frontier's ADC and agricultural loans were negatively impacted when the institution's primary real estate lending market experienced a downturn in 2007 and commodity prices for dairy products declined in 2008.

New Frontier was wholly owned by the New Frontier Bancorp (Bancorp), a one-bank holding company. Collectively, the institution's directors owned approximately 15 percent of Bancorp's outstanding stock. However, no individual shareholder owned more than 10 percent of Bancorp, and the company's shares were widely-held. Table 1 summarizes selected financial information for New Frontier for the quarter ending March 31, 2009, and for the 4 preceding calendar years ending December 31.

**Table 1: Selected Financial Information for New Frontier**

| Financial Measure | Mar-09 | Dec-08 | Dec-07 | Dec-06 | Dec-05 |
|---|---|---|---|---|---|
| Total Assets ($000s) | $1,774,588 | $2,009,347 | $1,973,669 | $1,322,021 | $795,404 |
| Total Deposits ($000) | $1,496,347 | $1,676,003 | $1,599,963 | $1,074,788 | $643,483 |
| Gross Loans & Leases ($000s) | $1,535,516 | $1,591,138 | $1,607,464 | $1,049,353 | $615,056 |
| Net Income ($000s) | ($98,040) | ($11,340) | $11,842 | $14,549 | $7,571 |

Source: OIG analysis of Uniform Bank Performance Reports (UBPR) and Consolidated Reports of Condition and Income (Call Report) for New Frontier.

## Causes of Failure and Material Loss

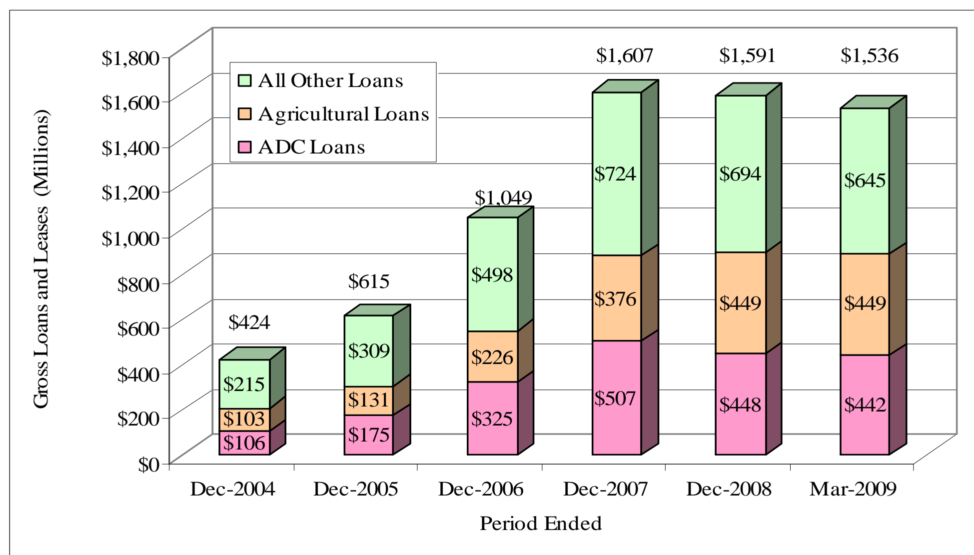
New Frontier failed because its Board and management did not implement adequate risk management practices pertaining to (1) rapid growth and significant concentrations of ADC and agricultural loans, (2) loan underwriting and credit administration, and (3) heavy reliance on non-core funding sources. Examiners expressed concern about New Frontier's risk management practices in the years preceding the institution's failure and

made a number of recommendations for improvement. However, the actions taken by New Frontier's Board and management to address these concerns and recommendations were not timely or adequate. Also contributing to New Frontier's losses was an incentive compensation program that paid a commission to a senior lending official based on the volume of loans and fees that the official originated. When the institution's primary real estate and agricultural lending markets began to deteriorate in 2007 and 2008, respectively, weaknesses in New Frontier's risk management practices translated into a decline in the quality of the institution's ADC and agricultural loans. The losses and provisions associated with this decline quickly depleted the institution's capital and earnings, and significantly impaired its liquidity position. CDB closed New Frontier based on a determination that the institution did not have adequate capital, its business was being conducted in an unlawful or unsound manner, and it was unable to continue normal operations.

### Rapid Growth and Loan Concentrations

Following its establishment in 1998, New Frontier embarked on a business strategy of rapid asset growth. Much of this growth was fueled through the institution's loan portfolio and included risky ADC and agricultural lending. New Frontier's growth was particularly pronounced during 2005 through 2007, when the institution's growth rate for net loans and leases was in the 94th percentile or higher for its peer institutions. Examiners noted that New Frontier's growth during this period was well in excess of the institution's internal growth plans. In addition, the sophistication of New Frontier's risk identification and monitoring systems did not keep pace with this growth, limiting the institution's ability to effectively identify, measure, monitor, and control risks in its operations. Figure 1 illustrates the general composition and growth of New Frontier's loan portfolio in the years preceding the institution's failure. As reflected in the figure, concentrations in ADC and agricultural loans existed in each of these years.

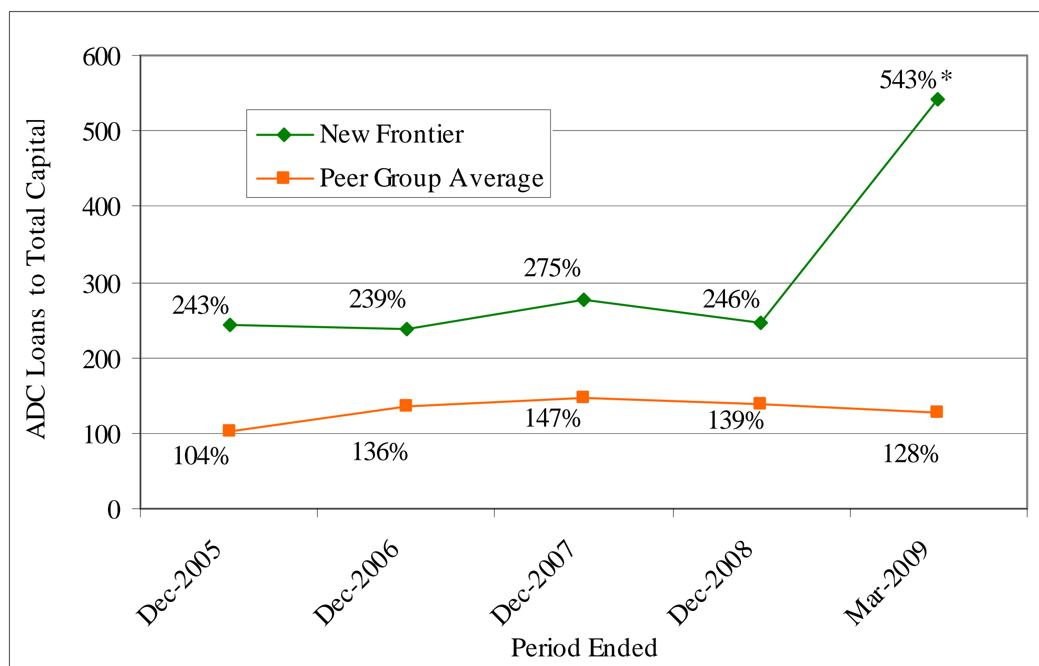
**Figure 1: Composition and Growth of New Frontier's Loan Portfolio**




Source: OIG analysis of UBPRs and Call Reports for New Frontier.

The FDIC's December 2006 guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, recognizes that ADC concentrations pose substantial risks. Such risks include unanticipated earnings and capital volatility during a sustained downturn in the real estate market. The December 2006 guidance defines institutions with significant concentrations, in part, as those institutions reporting loans for construction, land development, and other land (i.e., ADC) representing 100 percent or more of total capital. Due to the risks associated with ADC lending, regulators consider institutions with significant ADC concentrations to be of greater supervisory concern. As reflected in Figure 2, New Frontier maintained a concentration in ADC loans that was significantly higher than its peer averages and above the criteria for ADC concentrations warranting greater supervisory concern in the years preceding the institution's failure.

**Figure 2: New Frontier's ADC Loan Concentration Relative to Peers**




Source: OIG analysis of UBPRs for New Frontier.
* The sharp increase in the ADC loan concentration in 2009 resulted from a decline in New Frontier's capital rather than growth in ADC lending.

In addition to an ADC loan concentration, New Frontier also maintained a concentration in agricultural loans. From December 2005 to March 2009, New Frontier's agricultural loan concentration ranged from a low of 166 percent to a high of 542 percent of total capital. Similar to the ADC loan concentration, New Frontier experienced a sharp increase in its agricultural loan concentration in 2009 caused by a decline in capital rather than growth in agricultural lending.

In each Report of Examination (ROE) issued from 2004 through 2006, examiners expressed concern regarding the aggressive growth of New Frontier's loan portfolio, the burden that this growth was placing on the institution's lending staff, and the institution's

concentration in ADC and agricultural lending. In the November 2006 ROE, New Frontier's management was reminded of the importance of sound loan underwriting and credit administration to the continued satisfactory credit quality of its loan portfolio, given the institution's aggressive growth and credit concentrations. At that time, New Frontier's total adversely classified assets to Tier 1 Capital and the Allowance for Loans and Lease Losses (ALLL) was a manageable 27 percent, up slightly from the 24 percent reported in the November 2005 ROE. Although New Frontier's target real estate lending market began to decline in 2007, the institution continued to focus on ADC lending. At the time of the October 2007 examination, New Frontier's total adversely classified assets to Tier 1 Capital and ALLL had jumped to 85 percent, with much of the increase due to poorly underwritten ADC loans.

By the September 2008 examination, New Frontier's asset quality had become critically deficient, with approximately $265 million in adversely classified assets representing 134 percent of Tier 1 Capital and ALLL. Further, loans designated special mention had jumped from approximately $3.6 million in the prior examination to approximately $258 million. Much of the increase in special mention loans was attributed to poor underwriting and administration of agricultural loans. A final site visitation of New Frontier in March 2009 found that adversely classified assets totaled over 260 percent of Tier 1 Capital and ALLL and that assets classified as loss totaled over $40 million. The majority of these adversely classified assets consisted of ADC and agricultural loans. Between December 2005 and March 2009, New Frontier's net loan charge-offs (i.e., losses) totaled $82 million, of which $37 million pertained to ADC loans and $23 million pertained to agricultural loans.

### Loan Underwriting, Credit Administration, and Risk Analysis and Recognition Practices

Weaknesses in New Frontier's loan underwriting, credit administration, and risk analysis and recognition practices were a contributing factor in the asset quality problems that developed when the institution's real estate and agricultural lending markets began to deteriorate in 2007 and 2008, respectively. Although examiners noted some weaknesses in these areas during the October 2004 and November 2005 examinations, examiners determined that the institution's controls were generally satisfactory. During the November 2006 examination, examiners identified additional and repeat weaknesses in loan underwriting and credit administration and commented that the institution's management needed to be more aggressive in identifying credit weaknesses, given the extraordinary growth of the institution's loan portfolio. Examiners further commented that the institution's high level of past due and non-accrual loans, above peer average loan losses, and largely unseasoned and growing loan portfolio underscored the importance of sound lending standards to limit further deterioration in loan quality.

A significant number of loan underwriting, credit administration, and risk analysis and recognition weaknesses, particularly in the areas of ADC and agricultural lending, were identified in each of the examinations and visitations that followed the November 2006 examination. Such weaknesses included:

Loan Underwriting

- Rapid loan growth that relied on a continuing expansion in real estate values and sales, rather than on prudent underwriting and monitoring practices.
- Routine and significant contraventions of internal loan policies.
- Insufficient financial analysis (i.e., global cash flow and collateral analysis) of complex loans involving multiple parties to ensure repayment sources and collateral coverage were adequate.
- Liberal and high-risk loan structures.
    - Land development loans originated at 100 percent of the land's value.
    - ADC loans originated with principal and interest due at maturity (i.e., no interest service required during construction), no interest expense factored into the project's construction budget, no interest reserves considered in loan-to-value calculations, and optimistic collateral valuations.
- Liberal loan extensions and renewal practices.
    - Extending additional credit to problem borrowers without documenting a supporting rationale.
    - Delaying the reversal of uncollected accrued interest by extending loans and capitalizing unpaid interest, renewing loans without payment of interest, and granting loans to cover accrued interest.
    - Using administrative extensions to extend past-due credits without obtaining the borrower's signature when the extension was granted.

Credit Administration

- Failure to adequately supervise and control the disbursement of construction proceeds, resulting in over-advancing construction credits with collateral shortfalls, delinquencies, and defaults.
    - Performing no and/or infrequent collateral inspections.
    - Over-advancing loan funds.
    - Allowing significant cost overruns.
- Allowing borrowers to operate outside of established limitations.
- Failure to obtain accurate and current financial statements, appraisals and/or evaluations, and collateral perfection for loans.
- Growing a loan portfolio to a size that could not be reasonably managed by the institution's lending staff.
- Failure to ensure that agricultural loans had appropriate inspections, cash flow projections, supporting documentation, and verifiable collateral.

Risk Analysis and Recognition Practices

- Insufficient level of credit expertise within the institution.
- Inadequate ALLL methodology and/or ALLL position.
- Failure to properly report nonaccrual loans and downgrade credits when appropriate.
- Failure to perform portfolio-level stress testing or sensitivity analysis.

### Reliance on Non-Core Funding

In the years preceding its failure, New Frontier became increasingly dependent on non-core funding sources, particularly brokered deposits, to fund rapid growth in its loan portfolio and maintain adequate liquidity. Table 2 below provides detailed information regarding New Frontier's non-core funding sources during the years prior to its failure. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags behind planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. According to the *DSC Risk Management Manual of Examination Policies*, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

**Table 2: New Frontier's Non-Core Funding Sources**

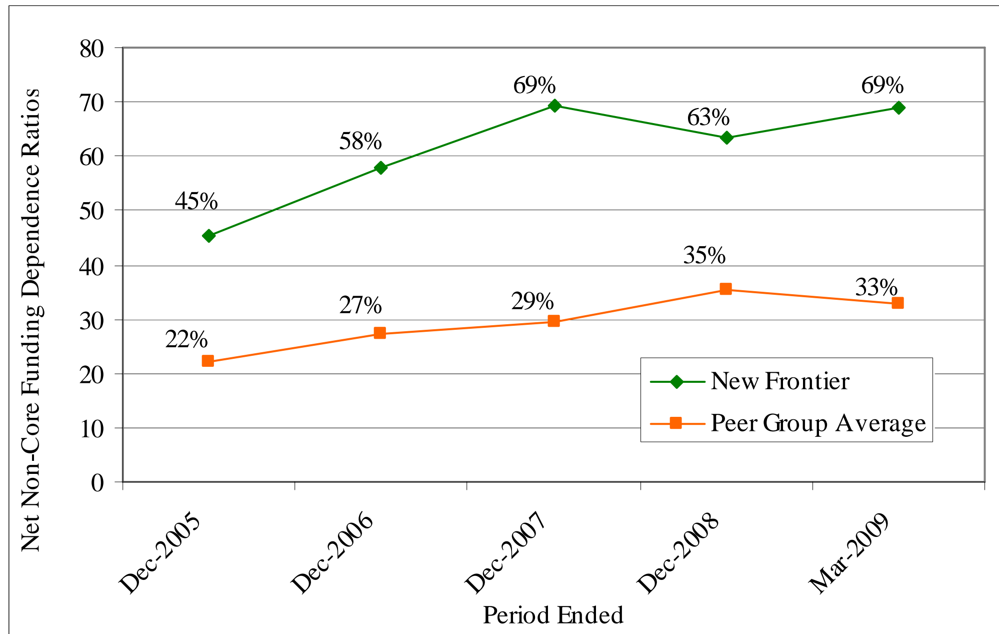
| Period Ended | Time Deposits of $100,000 or More ($000s) | Brokered Deposits ($000s) | Federal Home Loan Bank Borrowings ($000s) |
|---|---|---|---|
| **Mar-09** | $267,447 | $698,594 | $199,374 |
| **Dec-08** | $290,688 | $723,032 | $156,538 |
| **Dec-07** | $399,883 | $727,994 | $184,973 |
| **Dec-06** | $635,147 | $327,481 | $105,458 |
| **Dec-05** | $324,069 | $120,583 | $78,241 |

Source: OIG Analysis of UBPRs for New Frontier.

Figure 3 illustrates New Frontier's net non-core funding dependence ratio[3] between December 2005 and the institution's failure. During this period, New Frontier's net non-core funding dependence ratio was in the 92$^{nd}$ to 97$^{th}$ percentile for its peer group. Such rankings indicate that the institution's potential volatile funding dependence was higher than almost all of the other institutions in New Frontier's peer group.

[3] The net non-core funding dependence ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources that may not be available in times of financial stress.

**Figure 3: New Frontier's Net Non-Core Funding Dependence Compared to Peers**




Source: OIG analysis of the UBPRs for New Frontier.

During the November 2005 and November 2006 examinations, examiners noted that the local market for core deposits was highly competitive and that New Frontier was increasingly turning to non-core funding sources to support loan growth. At that time, examiners concluded that the risk of New Frontier's heavy dependence on non-core funding sources was mitigated, in part, by a well-developed funds management process and an Asset Liability Management Committee that was actively engaged in monitoring and measuring liquidity. By the October 2007 examination, however, the FDIC had determined that New Frontier's liquidity was less than satisfactory. At that time, 39 percent of the institution's deposit base consisted of brokered deposits (up from 30 percent at the prior examination). Examiners concluded that although New Frontier had adequate systems to measure, monitor, and report liquidity, management's continued strategy of relying on brokered deposits to fund tremendous loan growth (which had resulted in asset quality problems) was risky. In addition, examiners identified the following asset liability management weaknesses:

- New Frontier's Contingency Liquidity Plan did not assess the possible impact of high-stress events, such as deteriorating asset quality.

- The institution's Asset Liability Management policy did not assess the potential impact of brokered deposit restrictions on the bank's liability structure.

- Management routinely expanded the institution's volatile liability dependence policy guidelines to accommodate significant loan growth.

Based on the results of the September 2008 examination, the FDIC determined that New Frontier's liquidity position had become critically deficient. By that time, the

institution’s access to external funding sources was limited and its earnings were not sufficient to augment capital, straining liquidity. In addition, New Frontier was not able to sell its loan portfolio without incurring additional losses. Prior to the completion of the examination, New Frontier stipulated to a Cease and Desist Order (C&D) containing a capital provision. Pursuant to the FDIC’s Rules and Regulations, the C&D lowered New Frontier’s PCA capital category from well capitalized to adequately capitalized. As a result, the institution was restricted from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. On February 13, 2009, the FDIC approved a $50 million brokered deposit waiver that expired on March 31, 2009. However, the institution was not successful in raising needed capital and negative media attention associated with New Frontier’s public disclosure of the C&D on January 30, 2009, resulted in a deposit run-off, further straining liquidity.

#### Implementation of Examiner and Auditor Recommendations

In the years preceding New Frontier’s failure, FDIC and CDB examiners expressed repeated concern about the institution’s risk management practices and made a number of recommendations for improvement. However, the actions taken by New Frontier’s Board and management to address these concerns and recommendations were not timely or adequate. A brief summary of key concerns and recommendations raised by examiners in ROEs issued between 2004 and the institution’s failure follows.

- **Rapid Growth.** From 2004 to 2007, examiners repeatedly expressed concern about New Frontier’s rapid asset growth and the strain that this growth was placing on the institution’s lending function. In 2004, examiners recommended that New Frontier modify its strategic business plan to reflect realistic growth projections. By 2006, examiners noted that the institution’s rapid growth was negatively affecting loan underwriting and credit administration, and in 2007, examiners strongly encouraged New Frontier to slow its growth due to increasing asset quality problems. Based on the results of the October 2008 examination, New Frontier stipulated to a C&D in December 2008 that included a provision to develop a strategic plan containing goals for asset growth.

- **Loan Concentrations.** From 2004 until the institution’s failure, examiners raised continued concern about the levels of concentrations in New Frontier’s loan portfolio. In 2005, examiners recommended that New Frontier establish concentration limits by industry, and in 2006, examiners made additional recommendations to establish certain limits on the institution’s loan concentrations. In 2007, examiners criticized New Frontier’s continued focus on ADC lending, given the decline in the residential real estate market, and recommended that management reduce its exposure to residential real estate. New Frontier had not significantly reduced its concentrations by the October 2008 examination, and in the December 2008 C&D, a provision was included for New Frontier to reduce its loan concentrations.

- **Underwriting and Credit Administration.** Between 2004 and the institution’s failure, examiners raised repeated concerns about New Frontier’s lending function

and made a number of recommendations for improvement. These concerns and recommendations focused on correcting deficiencies in New Frontier's loan underwriting and credit administration practices and hiring additional staff to support loan growth. Following the October 2007 examination, New Frontier entered into a Memorandum of Understanding (MOU) with the FDIC that required, among other things, action to address the underwriting and credit administration deficiencies identified by examiners. The December 2008 C&D also required New Frontier to take specific actions to improve its loan underwriting and credit administration practices.

- **Reliance on Non-Core Funding.** From 2004 until the institution's failure, examiners expressed repeated concern about New Frontier's increasing reliance on non-core funding sources, particularly brokered deposits. In 2004, examiners recommended that New Frontier closely monitor and reduce its dependence on non-core funding sources. In 2005, examiners recommended that New Frontier establish guidelines for its net non-core funding dependence ratio. Further, the FDIC's MOU with New Frontier required, among other things, that the institution minimize its dependence on volatile funding. Finally, the December 2008 C&D required New Frontier to reduce its dependence on volatile funding, including brokered deposits.

In addition to examiner concerns and recommendations, New Frontier's external auditors brought a number of internal control issues to the attention of New Frontier's Board and management that were not adequately addressed. For example, during a December 2007 external audit of New Frontier, the institution's audit firm identified a material weakness related to the institution's ability to measure and maintain an appropriate ALLL. Examiners noted in a subsequent examination and visitation in 2008 and 2009, respectively, that New Frontier's ALLL methodology and position were not adequate.

### Incentive Compensation Program and Institution Culture

A contributing factor in New Frontier's losses was an incentive compensation program that paid a commission to a senior lending official based on the volume of loans and fees that the official originated. The compensation program did not take into consideration the quality of the loans that the senior lending official originated. During the October 2007 examination, examiners noted that more than half of the identified adverse loan classifications were originated by the same senior lending official who benefited from the incentive compensation program. Examiners also noted that the senior lending official received $200,000 in commissions under the program during 2006 in addition to an annual salary. Further, based on our analysis of examination documentation, we noted that this same lending official had responsibility for both originating and managing commercial loans as well as serving as a member of the institution's loan approval committee. Having both responsibilities presented an apparent conflict of interest.

Based on concerns raised in the October 2007 examination, New Frontier discontinued its incentive compensation program. New Frontier also had an independent study performed of its lending program to determine whether the size and qualifications of its lending staff

were appropriate for the size, composition, and nature of the institution's loan portfolio. The study concluded, in part, that "the culture of the bank in July 2007 and prior did not promote a conservative approach to lending. Lenders' concerns about keeping their job or falling out of favor with management unless aggressive loan growth occurred overwhelmed most lenders' discipline with underwriting, analysis, and asset quality." Examiners commented during the September 2008 examination that the actions taken by the institution in response to the study were not adequate, that the lending culture appeared to be unchanged, and that weak underwriting and administrative practices persisted.

## The FDIC's Supervision of New Frontier

Through its supervisory efforts, the FDIC identified key risks in New Frontier's management practices and operations and brought these risks to the attention of the institution's Board and management through regular discussions and correspondence, ROEs, and visitation reports. Key risks identified by examiners included weak risk management practices pertaining to the institution's rapid loan growth, ADC and agricultural loan concentrations, loan underwriting and credit administration practices, and reliance on non-core funding sources. The FDIC increased the level of its supervisory attention through visitations in 2006 and 2007 based on the increasing risk profile of New Frontier. Additional visitations were conducted in 2008 and 2009 based on the deteriorating financial condition of the institution.

As discussed in a prior section of this report, the FDIC relied principally on recommendations to address risks identified by examiners and did not impose enforcement actions until early 2008. In retrospect, a stronger supervisory response at earlier examinations may have been prudent in light of the extent and nature of the risks and the institution's lack of adequate or timely corrective action. Stronger supervisory action may have influenced New Frontier's Board and management to constrain their excessive risk taking during the institution's rapid growth period. It may also have prompted the Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

### Supervisory History

The FDIC, in conjunction with CDB, provided ongoing supervision of New Frontier through regular on-site risk management examinations, periodic on-site visitations, and quarterly off-site reviews. In addition, examiners placed New Frontier on the Dallas Regional Office's supervisory watch list in February 2007 and performed daily monitoring of the institution's liquidity position beginning in November 2008. Table 3 summarizes key information pertaining to the on-site risk management examinations and visitations that the FDIC and CDB conducted of New Frontier from October 2004 until the institution failed.

**Table 3: On-site Examinations and Visitations of New Frontier**

| Date | On-site Supervisory Effort | Supervisory Ratings (UFIRS)* | Informal or Formal Action** Taken |
|---|---|---|---|
| 03/03/2009 | Visitation | 555555/5 | Institution Closed 4/10/2009 |
| 09/22/2008 | Joint Examination | 455554/5 | C&D 12/2/2008 |
| 06/09/2008 | Visitation | No Ratings | None |
| 10/09/2007 | FDIC Examination | 333232/3 | MOU 2/28/2008 |
| 04/09/2007 | Visitation | No Ratings | None |
| 11/27/2006 | Visitation | No Ratings | None |
| 11/27/2006 | State Examination | 222222/2 | None |
| 05/22/2006 | Visitation | 222222/2 | None |
| 11/07/2005 | FDIC Examination | 222222/2 | None |
| 10/04/2004 | State Examination | 212232/2 | None |

Source: ROEs for New Frontier.
*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.
** Informal enforcement actions often take the form of Bank Board Resolutions or MOUs. Formal enforcement actions often take the form of C&Ds, but under severe circumstances can also take the form of insurance termination proceedings.

As shown in Table 3, five visitations were conducted at New Frontier from 2006 to 2009 in addition to the required risk management examinations. The purpose of the visitations conducted during 2006 and 2007 was to assess New Frontier's risky business practices, such as its rapid growth, loan concentrations, and dependence on non-core funding. The purpose of the visitations conducted during 2008 and 2009 was to assess and monitor New Frontier's deteriorating financial condition. The FDIC and CDB issued one informal enforcement action and one formal enforcement action between 2005 and the institution's failure. A brief description of these enforcement actions follows.

- **February 2008 MOU.** The FDIC and CDB entered into an MOU based on the results of the October 2007 FDIC examination. The MOU contained 15 provisions addressing such areas as capital, dividend payments, asset quality, loan policies, bank staffing, ALLL, volatile liability dependence, and violations. Among other things, the MOU required New Frontier to establish appropriate limits to minimize the institution's dependence on volatile liabilities and conduct an independent study of the adequacy of the institution's lending function.

- **December 2008 C&D.** New Frontier stipulated to a C&D based on the results of the September 2008 joint examination. The C&D ordered New Frontier to have and retain qualified management, including a new chief executive officer and new senior lending officer. The C&D also ordered the institution to, among other things, submit written plans for (a) increasing and maintaining an appropriate

level of capital, (b) eliminating the institution's reliance on brokered deposits, (c) maintaining an appropriate level of liquidity, and (d) reducing the institution's loan concentrations.

### Supervisory Response to Key Risks

A stronger supervisory response at earlier examinations may have been prudent in light of New Frontier's risk profile and the institution's lack of adequate or timely action to address its weak risk management practices. For example, the FDIC could have imposed an enforcement action requiring that New Frontier commit to a written plan and timeline for addressing key risks identified by examiners and monitored New Frontier's performance relative to the plan. Among other things, the plan could have required New Frontier to:

- Establish reasonable growth projections and parameters for ensuring that loan growth was appropriately constrained.

- Reduce credit concentrations in its loan portfolio.

- Address deficiencies in its loan underwriting, credit administration, and credit risk analysis, recognition, and monitoring practices.

- Reduce its dependence on non-core funding sources, particularly brokered deposits.

We recognize that the February 2008 MOU and December 2008 C&D collectively addressed the points described above. However, at the time these actions were taken, the majority of New Frontier's growth had already occurred, and weak loan underwriting and credit administration practices were already negatively affecting the quality of the institution's loan portfolio. Further, the deteriorating economic environment, coupled with the institution's declining credit profile, was seriously limiting the institution's contingency funding alternatives. Based on the results of the October 2008 examination, the probability of New Frontier's failure was high.

### Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC's Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken with respect to New Frontier, the FDIC properly implemented applicable PCA provisions of section 38. However, PCA's effectiveness in mitigating losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure.

In the case of New Frontier, capital was a lagging indicator of the institution's financial health. At the time of the September 2008 examination, New Frontier was considered well capitalized for PCA purposes. However, examiners concluded during the examination that the overall financial condition of the institution was unsound and that the probability of its failure was high. Based on the results of the September 2008 examination, the FDIC and CDB issued a joint C&D on December 2, 2008, that included, among other things, a capital provision. The capital provision directed New Frontier to increase and maintain a Tier 1 Leverage Capital ratio of 8 percent and a Total Risk-Based Capital ratio of 12 percent—amounts that are greater than required by PCA for well capitalized institutions (see Table 4 below). As a result of stipulating to the C&D, the institution became subject to certain restrictions defined in PCA, including the prohibition on the acceptance, renewal, or roll-over of brokered deposits without a waiver from the FDIC.

On December 10, 2008, New Frontier submitted a brokered deposit waiver application to the FDIC. At that time, almost one half of New Frontier's deposit base consisted of brokered deposits. On February 13, 2009, the FDIC's Washington Office approved a limited brokered deposit waiver totaling $50 million and expiring on March 31, 2009. The waiver was approved in order to address the bank's immediate liquidity concerns while the FDIC's Division of Resolutions and Receiverships (DRR) completed its asset valuation and marketing plans and the institution finalized its recapitalization and sale efforts. Based on the FDIC's analysis of New Frontier's Call Report for the quarter ending December 31, 2008, and the results of the March 2009 visitation, the FDIC and CDB determined that the quality of New Frontier's assets had deteriorated to the point that the institution was significantly undercapitalized for PCA purposes. Table 4 illustrates New Frontier's capital levels relative to the PCA thresholds for well capitalized institutions as of the September 2008 examination and March 2009 visitation.

**Table 4: New Frontier's Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions**

| Capital Ratio | Well Capitalized Threshold | September 2008 Examination | March 2009 Visitation |
|---|---|---|---|
| Tier 1 Leverage Capital | 5% or more | 8.18% | 3.40% |
| Tier 1 Risk-Based Capital | 6% or more | 9.36% | 4.10% |
| Total Risk Based Capital | 10% or more | 10.25% | 5.40% |

Source: OIG Analysis of UBPRs, the September 2008 ROE, and the results of the March 2009 visitation for New Frontier, as well as Section 38 of the FDI Act and 57 Federal Register 44866-01.

On March 20, 2009, the FDIC provided New Frontier's Board with a PCA Notification of Capital Category letter notifying the institution that its capital category for PCA purposes had dropped to significantly undercapitalized. The letter directed New Frontier's management to submit a capital restoration plan and reminded the institution that it was subject to certain mandatory restrictions.

## Corporation Comments

We issued a draft of this report on October 5, 2009. We subsequently met with representatives of DSC to discuss the results of our review. Based on our discussion, we made certain changes to the report that we deemed appropriate. On October 20, 2009, the Director, DSC, provided a written response to the draft report. The response is provided in its entirety as Appendix 4 of this report.

In its response, DSC reiterated the OIG's conclusions regarding the causes of New Frontier's failure. Regarding our assessment of the FDIC's supervision of New Frontier, DSC cited several supervisory activities, discussed in our report, that were undertaken to address key risks at the institution prior to its failure. In its response, DSC also recognized that strong supervisory attention is necessary for institutions like New Frontier that have high CRE and ADC concentrations supported by volatile funding sources. Accordingly, DSC has issued updated guidance reminding examiners to take appropriate action when such risks are imprudently managed.

# Objectives, Scope, and Methodology

## Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

The audit objectives were to: (1) determine the causes of New Frontier's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of New Frontier, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from April 2009 to September 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 assessment of New Frontier's operations from September 30, 2002 until the institution's failure on April 10, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution during the same period.

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

- Analyzed examination and visitation reports prepared by the FDIC and the CDB from 2002 to 2009.

- Analyzed available examination work papers prepared by the FDIC and the CDB from 2005 to 2009.

- Reviewed the following:

    - Institution data contained in UBPRs and Call Reports.
    - Correspondence maintained at the DSC's Dallas Regional Office and Denver Field Office.
    - Reports prepared by DRR and DSC relating to the institution's closure.

- Reports and selected working papers from the institution's external auditors, Fortner, Bayens, Levkulich, P.C., Denver, Colorado, for the years ended 2005 through 2007.
- Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC managers in Washington, D.C.; Dallas, Texas; and Denver, Colorado.

  - FDIC examiners from the DSC Denver Field Office who participated in New Frontier examinations.

- Interviewed officials from the CDB of Denver, Colorado, to discuss their historical perspective of the institution, its examinations, and other activities regarding the CDB's supervision of the institution.

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

Consistent with our audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC's systems, reports, ROEs, and interviews of examiners to obtain an understanding of New Frontier's management controls pertaining to the causes of failure and material loss as discussed in the body of this report. Although we obtained information from various FDIC systems, we determined that the controls pertaining to these systems were not significant to the audit objectives, and therefore, did not evaluate the effectiveness of information system controls. We relied on 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 was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG program audits of DSC operations.

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

# 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. |
| **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. |
| **Prompt Corrective Action (PCA)** | The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for taking prompt supervisory actions against insured non-member 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.<br><br>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 are potentially weak loans or assets which present an unwarranted credit risk, but are less risky than substandard assets. These loans are classified as special mention assets when the lender fails to supervise a loan properly or maintain sufficient documentation, or otherwise has deviated from acceptable and prudent lending practices. |
| **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. |

# Acronyms

| | |
|---|---|
| ADC | Acquisition, Development, and Construction |
| ALLL | Allowance for Loan and Lease Losses |
| C&D | Cease and Desist Order |
| CAMELS | **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk |
| CDB | Banking Board of the Colorado Division of Banking |
| DIF | Deposit Insurance Fund |
| DRR | Division of Resolutions and Receiverships |
| DSC | Division of Supervision and Consumer Protection |
| FDI | Federal Deposit Insurance |
| OIG | Office of Inspector General |
| PCA | Prompt Corrective Action |
| ROE | Report of Examination |
| UBPR | Uniform Bank Performance Report |
| UFIRS | Uniform Financial Institutions Rating System |

# Corporation Comments

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

October 20, 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 New Frontier Bank, Greeley, Colorado
(Assignment No. 2009-040)

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 New Frontier Bank (New Frontier) which failed on April 10, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on October 2, 2009.

The Report concludes that New Frontier's failure was due primarily to the pursuit of rapid asset growth, particularly from 2005 through 2007, significantly concentrated in commercial real estate (CRE), acquisition, development, and construction (ADC) projects and agriculture lending. The growth was funded through wholesale or non-core funding sources. Weaknesses in loan underwriting, credit administration, and risk analysis and recognition practices were prevalent and contributed to the overall decline of the institution.

FDIC examinations during 2004 through 2006 reported growing concern over New Frontier's risk profile and their management practices and operations. These risks were brought to the attention of the Board and management through the supervisory process. Supervisory attention of New Frontier increased with on-site visitations in both 2006 and 2007. In early 2007, New Frontier was placed on the supervisory watch list, and examiners took increasingly stronger enforcement actions to address weak risk management practices, culminating in daily liquidity monitoring beginning in November 2008.

In recognition that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, DSC has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

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