Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-025

Material Loss Review of Affinity Bank, Ventura, California

March 2010

Office of Inspector General

Executive Summary

Material Loss Review of Affinity Bank, Ventura, California

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Why We Did The Audit

On August 28, 2009, the California Department of Financial Institutions (CDFI) closed Affinity Bank (Affinity) and named the FDIC as receiver. On September 25, 2009, the FDIC notified the Office of Inspector General (OIG) that Affinity's total assets at closing were $1.2 billion and the estimated material loss to the Deposit Insurance Fund (DIF) was $251.7 million. As of December 31, 2009, the loss had increased to $261.6 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 Affinity.

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

Background

Affinity was incorporated in 1982 as a state-chartered industrial loan company (ILC) and changed ownership and names several times before converting its charter, on May 20, 2004, from an ILC to a state nonmember bank. Affinity operated 10 full-service retail branches. Predominantly a commercial real estate (CRE) lender, Affinity also provided asset-based loans, financing for healthcare organizations, and consumer and business loans in California. Affinity's assets included, but were not limited to, CRE and acquisition, development, and construction (ADC) loans and collateralized mortgage obligation (CMO) investment securities.

In 2004, bank management recognized Affinity's high CRE concentration as an increased risk to the institution. As a result, Affinity converted from an ILC to a state nonmember bank, which enabled Affinity to offer demand deposit products to businesses. Affinity's business plan was to reduce its high CRE concentrations, diversify into business banking and lending, and lower the bank's cost of funds by adding business transaction accounts to its deposit portfolio. However, the bank's efforts to achieve those goals were impacted by increased competition during growing economic weaknesses and the collapse of the secondary market for loan sales. The bank was wholly-owned by a one-bank holding company, Affinity Bank Holdings, Inc. The holding company had four subsidiaries that issued trust preferred securities, with the proceeds being used to support Affinity's capital position. In addition, Affinity had four subsidiaries established to hold other real estate owned. One principal shareholder owned and controlled 95.1 percent of the holding company and the remaining 4.9 percent was owned by Affinity's president.

Audit Results

Causes of Failure and Material Loss

Affinity failed because its Board and management did not effectively manage the risk associated with strategic decisions to concentrate the bank's loan portfolio in CRE and ADC loans and heavily invest in CMOs. The high concentration in CRE lending, in conjunction with a downturn in the bank's real estate market, resulted in severe loan losses, particularly in ADC loans. Affinity also relied heavily on wholesale funding to support the bank's CRE and ADC concentrations, which increased the institution's risk profile.

As the real estate market declined, Affinity experienced increasing levels of adversely classified assets and associated losses and significant increases in the Allowance for Loan and Lease Losses (ALLL). Affinity's liquidity became deficient and access to certain funding sources became restricted. Losses and provisions associated with the CRE and ADC concentrations eliminated earnings and severely eroded the bank's capital. While the bank had not yet experienced losses on the CMOs at the time it failed, a moderate portion of those investments were considered substandard and the bank did not have sufficient capital to absorb potential losses. Ultimately, CDFI closed Affinity due to the bank's *Critically Undercapitalized* position.

The FDIC's Supervision of Affinity

From 2005 to 2009, the FDIC and the CDFI provided ongoing supervision of Affinity through on-site risk management examinations and visitations. The FDIC also conducted offsite monitoring activities. Through their supervisory efforts, the FDIC and the CDFI identified and brought key risks to the attention of the bank's Board and management, including the high levels of CRE and ADC concentrations and associated weak risk management practices. With respect to Affinity's heavy reliance on wholesale funding sources, examiners expressed concern over the bank's (1) need to improve its liquidity position and address risks associated with its high net non-core dependence ratios and (2) high cost of funding that was negatively impacting the bank's earnings. Examiners also noted the risks associated with Affinity's CMO concentration and insufficient capital in relation to the bank's risk profile.

The FDIC and the CDFI initiated supervisory or enforcement actions in 2008 and 2009 to address identified deficiencies related to capital, asset quality, management, earnings, liquidity, concentrations, and the ALLL. Notwithstanding these efforts, earlier and greater supervisory attention to Affinity may have been warranted, given the elevated risks associated with CRE and ADC concentrations and Affinity's less than satisfactory financial condition, especially after the August 2007 examination.

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

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 22, 2010, the Director, DSC, provided a written response to the draft report. That 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 Affinity's failure. With respect to our assessment of supervision, DSC stated that based on the results of the August 2007 examination, DSC deliberated and proposed an informal enforcement action and that Affinity's Board adopted a Bank Board Resolution in February 2008 that required the bank to augment its capital position commensurate with its risk profile. DSC agreed, however, that a stronger regulatory response could have been taken to address the weak practices identified at that examination. Further, DSC stated that it has issued updated guidance reminding examiners to take appropriate action when concentration and funding risks are imprudently managed.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: March 25, 2010

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

/Signed/

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

SUBJECT: *Material Loss Review of Affinity Bank, Ventura, California* (Report No. MLR-10-025)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Affinity Bank (Affinity), Ventura, California. The California Department of Financial Institutions (CDFI) closed the institution on August 28, 2009 and named the FDIC as receiver. On September 25, 2009, the FDIC notified the OIG that Affinity's total assets at closing were $1.2 billion and the estimated material loss to the Deposit Insurance Fund (DIF) was $251.7 million. As of December 31, 2009, the loss had increased to $261.6 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 audit objectives were to (1) determine the causes of Affinity's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of Affinity, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Affinity's failure and the FDIC's efforts to ensure that Affinity's Board of Directors (Board) and management operated the institution in a safe and sound manner.

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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.

The report does not contain formal recommendations. Instead, as major causes, trends, and common 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

Affinity was incorporated in 1982 as a state-chartered industrial loan company (ILC)[3] and changed ownership and names several times before converting its charter, on May 20, 2004, from an ILC to a state nonmember bank. Affinity operated 10 full-service retail branches. Predominantly a commercial real estate (CRE) lender, Affinity also provided asset-based loans, financing for healthcare organizations, and consumer and business loans in California. Affinity's assets included, but were not limited to, CRE and acquisition, development, and construction (ADC) loans and collateralized mortgage obligation (CMO) investment securities.

In 2004, bank management recognized Affinity's high CRE concentration as an increased risk to the institution.[4] As a result, Affinity converted from an ILC to a state nonmember bank, which enabled Affinity to offer demand deposit products to businesses. Affinity's business plan was to reduce its high CRE concentrations, diversify into business banking and lending, and lower the bank's cost of funds by adding business transaction accounts to its deposit portfolio. However, the bank's efforts to achieve those goals were impacted by increased competition during growing economic weaknesses and the collapse of the secondary market for loan sales. The bank was wholly-owned by a one-bank holding company, Affinity Bank Holdings, Inc. The holding company had four subsidiaries that issued trust preferred securities, with the proceeds being used to support Affinity's capital position. In addition, Affinity had four subsidiaries established to hold other real estate owned. One principal shareholder owned and controlled 95.1 percent of the holding company, and the remaining 4.9 percent was owned by Affinity's president.

Table 1 summarizes Affinity's financial condition for the quarter ending June 2009, and for the 4 preceding calendar years.

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[3] ILCs are state-chartered, FDIC-supervised financial institutions that may be owned by commercial firms that are not regulated by a federal banking agency. In the case of ILCs, the chartering authority is the respective state regulatory agency. Approvals must be granted by the FDIC and the chartering state authority for an ILC to accept insured deposits. The FDIC is the primary federal regulator of ILCs. However, the chartering state authority also has responsibility to supervise and monitor the ILCs in the respective state.
[4] Affinity Bank Holdings, Inc., *Application and Supporting Documentation for the TARP* [Troubled Asset Relief Program] *Capital Purchase Program*, dated February 12, 2009.

Table 1: Selected Financial Information for Affinity

Financial Measure	Jun-09	Dec-08	Dec-07	Dec-06	Dec-05
	(Dollars in Thousands)				
Total Assets	1,211,431	1,231,605	1,181,061	1,096,821	1,035,815
Total Loans	830,647	917,611	830,929	791,459	804,109
Total Deposits	905,593	867,329	688,467	660,844	616,393
Net Income (Loss)	(41,284)	(38,190)	238	9,034	16,255

Source: Uniform Bank Performance Reports (UBPR) for Affinity.

Causes of Failure and Material Loss

Affinity failed because its Board and management did not effectively manage the risk associated with strategic decisions to concentrate the bank's loan portfolio in CRE and ADC loans and heavily invest in CMOs. The high concentration in CRE lending, in conjunction with a downturn in the bank's real estate market, resulted in severe loan losses, particularly in ADC loans. Affinity also relied heavily on wholesale funding to support the bank's CRE and ADC concentrations, which increased the institution's risk profile.

As the real estate market declined, Affinity experienced increasing levels of adversely classified assets and associated losses and significant increases in the Allowance for Loan and Lease Losses (ALLL). Affinity's liquidity became deficient and access to certain funding sources became restricted. Losses and provisions associated with the CRE and ADC concentrations eliminated earnings and severely eroded the bank's capital. While the bank had not yet experienced losses on the CMOs at the time it failed, a moderate portion of those investments were considered substandard and the bank did not have sufficient capital to absorb potential losses. Ultimately, CDFI closed Affinity due to the bank's *Critically Undercapitalized* position.

Board of Directors and Management Oversight

According to DSC's *Risk Management Manual of Examination Policies* (Examination Manual), the quality of management is probably the single most important element in the successful operation of a bank. The Board formulates sound policies and objectives and provides for the effective supervision of its affairs and promotion of a bank's welfare. The primary responsibility of senior management is to implement the Board's policies and objectives into the bank's day-to-day operations.

The FDIC concluded that Affinity's Board and management's strategic lending and investment decisions concerning CRE and CMOs, decreased earnings, capital, and liquidity, and increased the bank's sensitivity to market risk. In addition, the Board did not ensure that (1) bank management controlled the risk of growth and level of concentrations in the CRE loan portfolio and implemented risk management practices commensurate with the inherent risks in that portfolio; (2) capital levels were commensurate with Affinity's risk profile; and (3) an adequate ALLL was maintained.

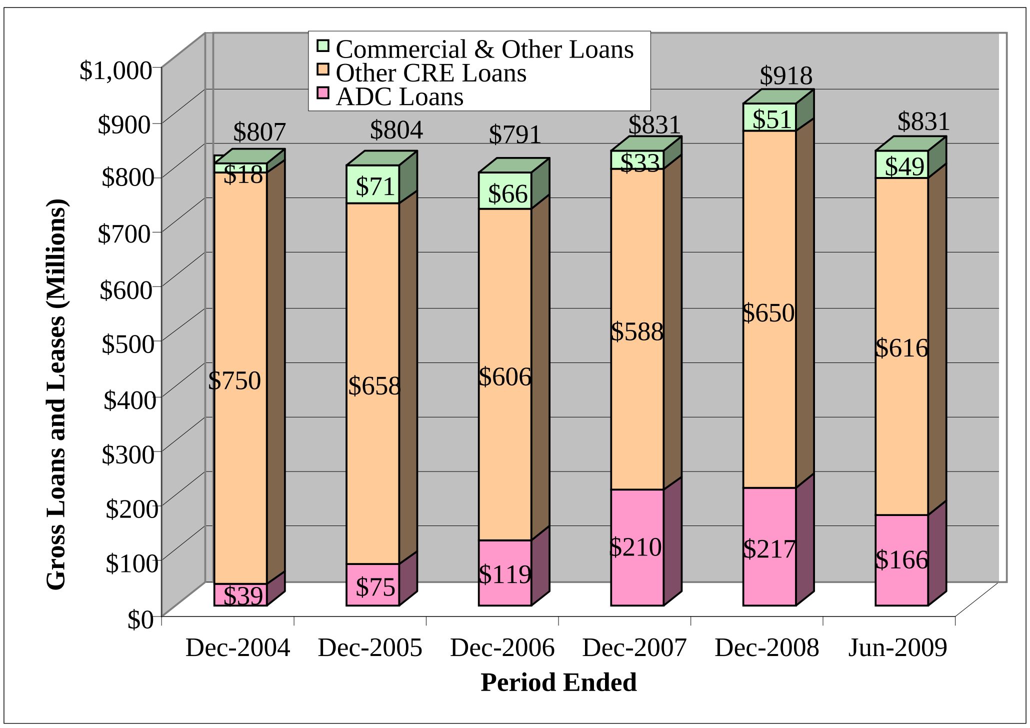
High-Risk Business Strategy

As discussed more fully in subsequent sections of this report, the strategic decisions by Affinity's Board and management to (1) concentrate the loan portfolio in CRE and ADC loans, (2) maintain and increase those concentrations during a severe economic downturn without ensuring consistent and adequate risk monitoring and reporting, and (3) develop and maintain a CMO concentration proved detrimental to the bank's viability. According to examiners, Affinity's Board and management attempted to reduce its CRE concentration level and adequately responded to concerns identified during an August 2007 examination. Notwithstanding those efforts, examiners determined that the Board and management's performance steadily and significantly declined during 2008 as the bank's risk profile increased and its financial condition worsened. Ultimately, examiners considered Affinity's management practices to be critically deficient just prior to the bank's failure.

CRE and ADC Loan Growth and Concentrations

The majority of Affinity's loan growth occurred when the bank was an ILC, with total loan growth rates ranging from 18.38 percent to 38.21 percent between December 2000 and December 2004, respectively. Figure 1 shows Affinity's loan portfolio composition, including the extent of Affinity's CRE and ADC loans.

Figure 1: Composition and Growth of Affinity's Loan Portfolio



Source: Reports of Condition and Income (Call Report).

While the rate of Affinity's overall loan growth slowed between December 2005 and June 2009, the composition of the loan portfolio became more oriented towards CRE and, in particular, ADC loans, as indicated in Figure 1. Of note was the growth in CRE and ADC loans between December 2006 and December 2008. More specifically, during that timeframe, although Affinity's total CRE loans had increased by only 19.6 percent, the growth in the more risky ADC loans for that same period increased by 82.4 percent.

The risks that CRE and ADC concentrations pose to financial institutions' earnings and capital have been evident to supervisory agencies, which have provided guidance on managing these risks to financial institutions as far back as 1998 and more recently in December 2006. Specifically, Financial Institution Letter (FIL) 110-98, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, dated October 8, 1998, states that ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that the activity remains profitable.

December 2006 guidance issued by the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) does not establish specific CRE lending limits. However, the Joint Guidance defines criteria to identify institutions potentially exposed to significant CRE concentration risk. According to the guidance, a bank that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

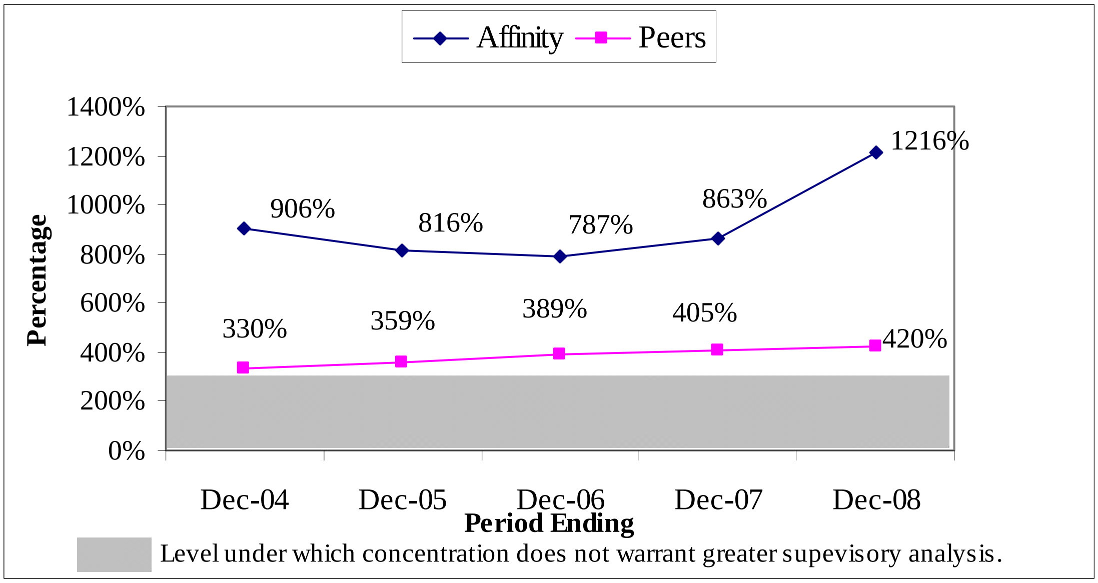
- Total reported loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of Total Capital; or

- Total CRE loans representing 300 percent or more of Total Capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

As shown in Figure 2, Affinity's CRE loan concentration ranged from 906 percent of Total Capital in December 2004 to 1,216 percent in December 2008, significantly exceeding the averages for the bank's peers.[5]

[5] Commercial banks are assigned to one of 25 peer groups based on asset size, number of branches, and whether the bank is located in a metropolitan or non-metropolitan area. Affinity's peer group was that of all insured commercial banks with assets between $1 billion and $3 billion.

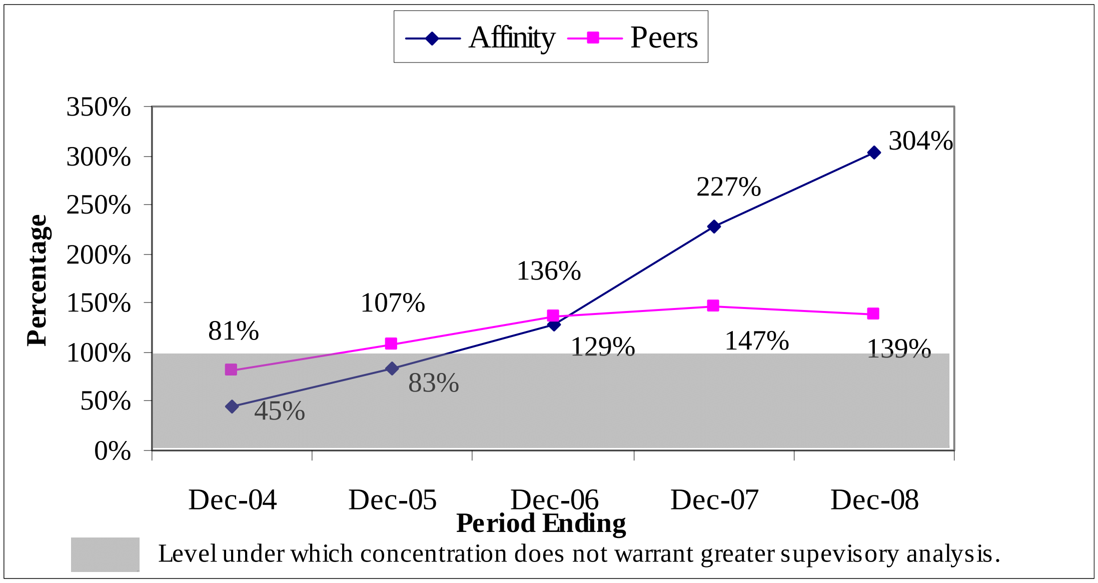
Figure 2: Affinity's CRE Loan Concentration to Total Capital Compared to Peers



Source: UBPRs for Affinity.

Figure 3 illustrates the growth in Affinity's ADC loan concentration that eventually substantially exceeded the average of its peers beginning in December 2006.

Figure 3: Affinity's ADC Loan Concentration to Total Capital Compared to Peers



Source: UBPRs for Affinity.

Examiners consistently reported Affinity's significant CRE and ADC concentrations, but bank management failed to take timely and effective action to reduce the concentrations or adequately manage the associated risks. As far back as 2004, Affinity's CRE loans to Total Capital exceeded the 300 percent parameter that may warrant further supervisory analysis established later in the Joint Guidance. From 2006 through 2009, Affinity's

ADC loans also exceeded the supervisory criteria for identifying an institution potentially exposed to concentration risk.

Risk Management Practices

While examiners generally concluded that Affinity adequately monitored the risk associated with the bank's CRE and ADC concentrations, they also reported deficiencies and made recommendations related to the bank's credit risk identification and monitoring. Examiners observed that while Affinity had established individual limits for construction loans by property types, which totaled 1,000 percent of Tier 1 Capital, the bank had not established an appropriate limit that considered the bank's total exposure in construction loans. Accordingly, examiners made recommendations related to the need for Affinity to establish such a limit and:

- report aggregate totals to the Board when geographically stratifying the bank's California market area,

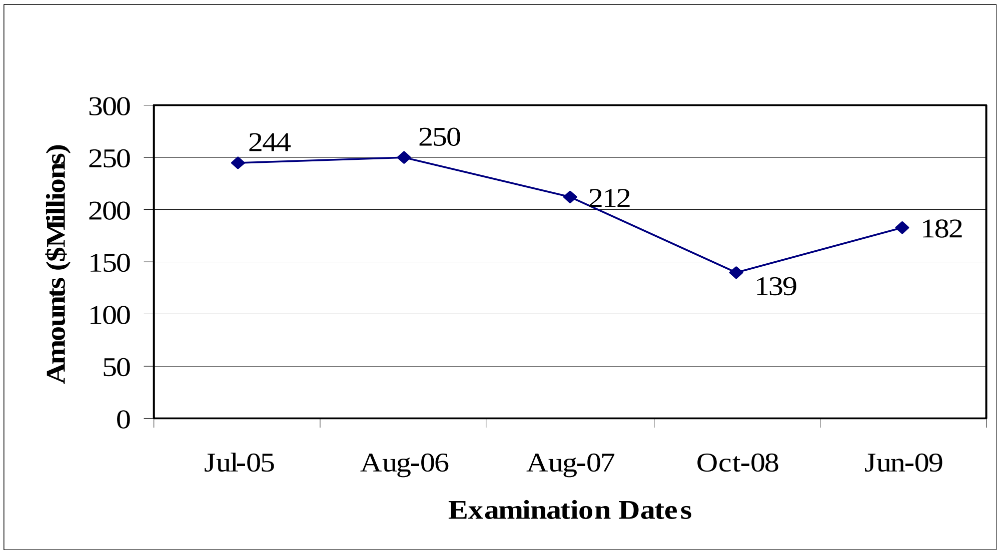
- review Board limits on construction loans to assure reasonableness as they appeared excessive and out of line with the business plan, and

- enhance the Loan Concentration Monitoring Reports to include undisbursed loan commitment amounts.

Collateralized Mortgage-Backed Obligation (CMO) Bond Holdings

Following the acquisition of a savings and loan (S&L) in 2001, Affinity continued the S&L's strategy of investing in discounted Z-tranche CMOs to capitalize on inefficiencies in the mortgage-backed securities market. Figure 4 shows the dollar volume of Affinity's CMO concentration by examination dates.

Figure 4: Affinity's CMO Concentration Amounts by Examination Dates



Source: Examination Reports for Affinity.

Affinity's CMO portfolio had declined by about 25 percent by the time the bank failed in 2009, but it nonetheless increased the bank's risk profile due to the specific characteristics of the CMOs.

A CMO is a mortgage derivative security consisting of several classes (tranches) secured by mortgage pass-through securities or whole mortgage loans. Principal and interest payments from the underlying collateral are divided into separate payment streams that repay investors in the various tranches at different rates. In the case of Affinity, it owned AAA-rated, Z-tranche CMOs. The AAA rating signifies the highest investment grade and means that there is very low credit risk. However, holders of a Z-tranche CMO do not receive any cash (principal or interest) while all prior tranches are outstanding. Instead, the Z-tranche accrues interest as principal until all prior tranches are retired. Therefore, its principal balance increases during the accrual period. Once all prior tranches are retired, the holder of the security receives principal and interest payments based on its new higher principal balance.

As far back as the July 2005 examination, examiners expressed concern regarding the interest rate risk (IRR) exposure from the CMO concentration, which contributed to their decision to downgrade Affinity's sensitivity to market risk supervisory CAMELS rating.[6] Although the CMOs did not directly contribute to the bank's failure, the following are some of the concerns examiners expressed in examination reports:

- The 2006 examination noted that income from the CMO portfolio continued to diminish due to an increase in interest rates, and examiners concluded that the CMO portfolio was subject to risk during a period of increasing interest rates.

- The 2007 examination concluded that Affinity's decision to invest in high-risk Z-tranche CMOs was negatively impacting the bank. The CMOs had been impacted by rising interest rates, which had contributed to the narrowed net interest margin for Affinity, and uncertainty regarding market value of the CMO portfolio generated concerns about the bank's capital adequacy.

- By the October 2008 examination, examiners expected that the CMO portfolio would perform well but acknowledged that the depth of the mortgage market downturn might change that assessment.

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[6] The Uniform Financial Institutions Rating System (UFIRS) is an internal supervisory tool, used by the federal supervisory agencies of the Federal Financial Institutions Examination Council (FFIEC) for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern. Each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations, CAMELS (**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk). Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and, therefore, the highest degree of supervisory concern.

As a result of the June 2009 visitation, examiners adversely classified $42 million of the CMOs as Substandard, representing 23 percent of the CMO portfolio and 17 percent of the total adversely classified items.

Sufficiency of Capital Relative to Affinity's Risk Profile

Affinity's Board and management failed to maintain capital commensurate with the bank's risk profile. Examiners concluded that Affinity needed to maintain capital levels above the minimal levels for *Well Capitalized* financial institution due to:

- the inherent risk associated with the CRE and ADC concentrations,
- the interest rate risk exposure and associated market value uncertainty related to the bank's CMOs, and
- Affinity's low and declining earnings.

As shown in Table 2, at each of Affinity's examinations, the three concentrations, when considered together, significantly and consistently represented substantial percentages of the bank's Tier 1 Capital.

Table 2: Affinity's CRE, ADC, and CMO Concentrations as a Percentage of Tier 1 Capital at Examination Dates

Concentration	July-05	Aug-06	Aug-07	Oct -08
CRE	893%	1,009%	984%	1,191%
ADC	176%	186%	209%	395%
CMO	303%	300%	255%	168%

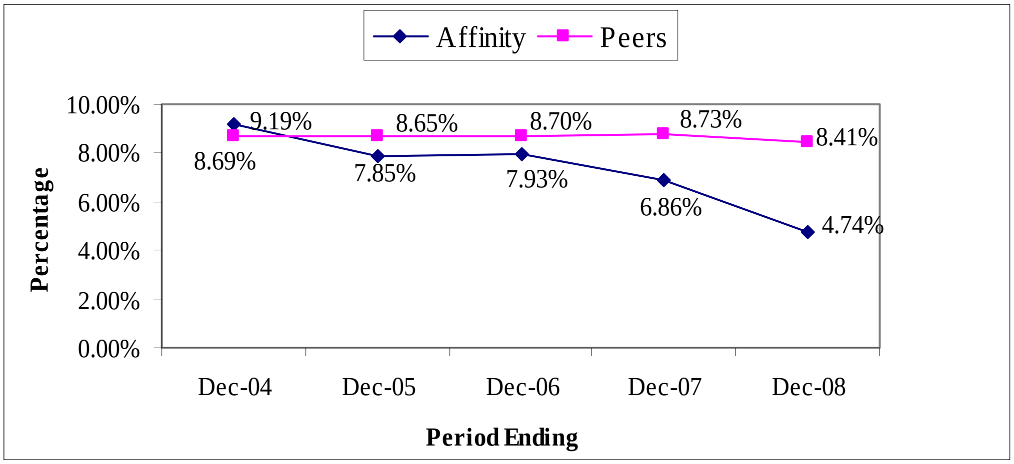
Source: Examination reports for Affinity.

According to the Examination Manual, a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

The need for sufficient capital was reinforced in the Joint Guidance, which noted that an institution should hold capital commensurate with the level and nature of the risks to which it is exposed, including the risk profile of their CRE portfolios. An institution with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentration or for maintaining capital appropriate to the level and nature of its CRE concentration risk.

Although Affinity's CRE concentration levels were significantly above peer levels as shown in Figure 2, Affinity's Tier 1 Leverage Capital ratios were well below peer ratios for year-end 2005 through 2008, as reflected in Figure 5.

Figure 5: Affinity's Tier 1 Leverage Capital Compared to Peers



Source: UBPRs for Affinity.

Affinity attempted to increase the bank's capital during 2008 and, according to the December 31, 2008 Call Report, received $16 million in capital from the bank's holding company and/or principal shareholder. However, those efforts did not have a significant and lasting impact on the bank's capital position because of significant deterioration in asset quality and loan losses. Affinity's capital ratios continued to decline and remained below both the bank's peers and levels outlined in the capital plans submitted in response to a February 2008 Bank Board Resolution (BBR).[7]

The October 2008 examination concluded that it was imperative that Affinity obtain additional capital to support the bank's risk profile. By June 2009, examiners determined that Affinity's capital had been depleted to a level that threatened the bank's viability. After making adjustments for classified assets and provision expense to replenish the ALLL, the bank was determined to be *Critically Undercapitalized*. On July 1, 2009, the CDFI informed Affinity's Board that $66 million was needed to increase the bank's capital to a satisfactory level.

Adverse Classifications and ALLL

The July 2005 through August 2007 examinations did not identify a need for the bank to increase its ALLL. However, by the March 2008 visitation, Affinity's adversely classified assets totaled $65.7 million, or 70.6 percent of Tier 1 Capital and reserves, representing a significant increase over the $20 million, or 21.9 percent of capital and reserves at the August 2007 examination. The majority of the classifications were residential ADC loans. Internally listed "Special Mention" loans totaling $40.5 million were also reported, most of which were also ADC loans. Examiners attributed the

[7] See the *Supervisory History* section of this report for discussion of the BBR.

deterioration in asset quality to the downturn in the residential real estate market and concluded, at the time, that Affinity's management was properly and timely identifying problem loans and aggressively addressing loan-related problems. However, both examiners and bank management acknowledged that conditions in the real estate market would impact the bank throughout 2008 and anticipated that the deterioration in the bank's loan portfolio would persist into 2009. Accordingly, management budgeted an additional $1 million in loan loss provisions for both the second and third quarters of 2008.

As indicated in Table 3, the examiners and Affinity's management were proven correct, as the deterioration in the bank's loan portfolio continued. Although management increased the ALLL each year, examiners recommended even higher provisions, beginning with the October 2008 examination. At both the March 2008 and June 2009 visitations, examiners reported significant increases in adversely classified assets and related loan loss provisions, which required substantial increases in the ALLL.

Table 3: Affinity's Adverse Classifications and ALLL

Examination Dates	Classifications Coverage Ratio	Adverse Classifications	Affinity's Funding for ALLL	Examiner Recommended Increase
		(Dollars in Thousands)		
Aug-07	21.9%	20,086	8,600	0
Oct-08	120.5%	120,669	12,500*	5,400
Jun-09	318.8%	243,055	20,480	26,000

Source: Examination reports and UBPRs for Affinity.
* The "as of" financial date for this examination was June 30, 2008, at which time the ALLL totaled $17.3 million. However, as of September 30, 2008, the ALLL totaled $12.5 million, which examiners concluded was not appropriate and recommended a $5.4 million increase.

The joint FDIC and CDFI October 2008 examination reported that Affinity continued to have a significant level of credit risk concentration. Examiners concluded that the continuing downturn in the real estate market, deteriorating economic conditions, and management's business strategy to concentrate in CRE lending, particularly residential ADC loans, contributed to the substantially high volume of adversely classified assets. Specifically, the October 2008 examination reported that:

- Poor asset quality required large provision expenses due to heavy loan losses.
- Management needed to reverse the deterioration in the loan portfolio and reduce problem assets.
- The credit risk exposure was heightened and remained a regulatory concern in view of the magnitude of classified assets and adverse conditions in the real estate market.

- Management had failed to recognize certain credit weaknesses and assign appropriate loan grades in a timely and accurate manner and needed to further enhance the bank's credit risk rating system.

By the June 2009 visitation, examiners concluded that:

- Affinity's Board and management lacked the ability to correct and/or control the bank's financial condition due to the volume and severity of problem loans.

- Asset quality deterioration was concentrated in CRE, particularly construction and land development loans, which represented 77 percent of total adverse classifications and 94 percent of loss classifications.

- CMO securities totaling $42 million were classified Substandard, representing 17 percent of total adverse classifications.

Reliance on Wholesale Funding Sources

Typically, limited-charter depository institutions can engage in most activities permitted for other insured depository institutions but cannot accept demand deposits, except in limited circumstances. Affinity's former status as an ILC prevented it from accepting demand deposits, and bank management was unsuccessful in obtaining a sufficient amount of core deposits after Affinity's conversion to a commercial bank in October 2004. As a result, for several years, Affinity supplemented core deposits with high levels of non-core wholesale funds to support the bank's asset growth.

The pre-examination planning (PEP) memorandum for the August 2007 examination noted that core deposits represented 69 percent of the bank's total deposits, while brokered deposits and other non-core funding sources comprised 31 percent. Between the August 2007 and October 2008 examinations, Affinity's level of brokered deposits tripled from $21.4 million to $67.3 million, although those deposits represented only 9 percent of the bank's total deposits at the time. Contrary to the examiners' recommendation at the August 2007 examination that management decrease or limit its heavy reliance on expensive, non-core funding sources, Affinity's reliance on wholesale funding continued through June 2009.

Table 4 illustrates Affinity's primary sources of non-core funding from December 2004 through June 2009. The bank's use of such high-cost funding contributed to the decrease in Affinity's earnings for several years.

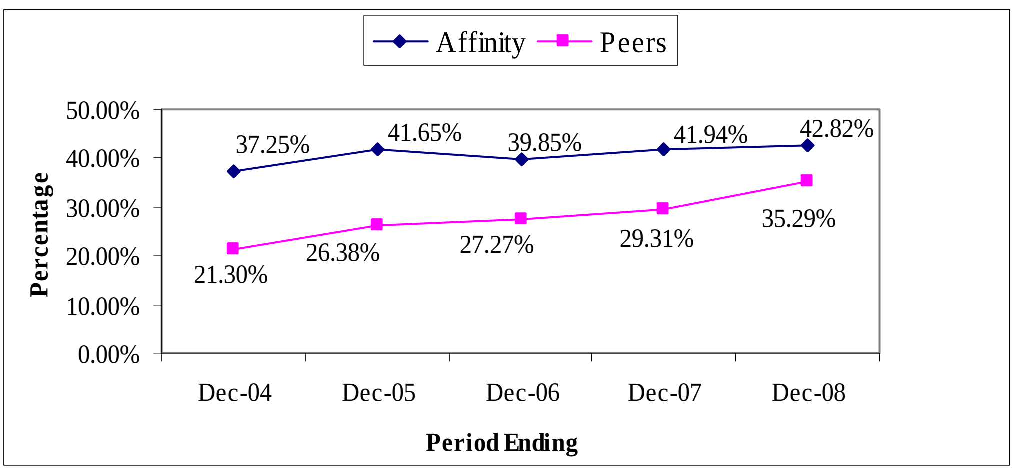
Table 4: Affinity's Non-Core Funding Sources

Non-Core Funding Sources	Dec 04	Dec 05	Dec 06	Dec 07	Dec 08	Jun 09
	(Dollars in Thousands)					
Time Deposits $100,000 or more	165,997	163,039	177,513	191,616	242,414	261,011
Federal Funds Purchases and Resale	0	0	0	45,000	15,000	15,000
Federal Home Loan Bank Borrowings	288,432	330,426	347,019	361,484	294,447	274,427
Brokered Deposits	40,070	5,059	199	30,114	85,920	50,166

Source: UBPRs for Affinity.

The Examination Manual states that the net non-core funding dependence ratio is a key measure of the degree to which a bank relies on potentially volatile liabilities to fund long-term earning assets. Generally, the lower the dependence ratio, the less risk exposure there is for the bank. As indicated in Figure 6, Affinity's net non-core funding dependence ratios remained high and consistently exceeded those of the bank's peers for the period December 2004 through December 2008.

Figure 6: Affinity's Non-Core Funding Dependence Ratios



Source: UBPRs for Affinity.

The increase in Affinity's non-core funding dependence ratio from 2006 to 2008, during the period in which the bank also significantly increased its CRE and ADC concentrations, provides further evidence of the role these funds likely played in the bank's growth. According to the Examination Manual, a bank's fund management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. As Affinity's loan portfolio and overall financial condition deteriorated, the availability of some of the bank's non-core funding sources became strained. For example, the bank's (1) FHLB borrowing line, which was a primary funding tool for Affinity, was reduced from 40 percent to 25 percent of total assets in 2008, and by the June 2009 visitation, the FHLB had further limited the bank's line of credit; (2) lines of credit with other financial institutions were not renewed; and

(3) access to brokered deposits became restricted when Affinity's PCA capital category fell from *Well Capitalized* to *Adequately Capitalized*.[8]

Further, the FDIC has provided extensive guidance to financial institutions regarding the need for, and the suggested components of, a comprehensive contingency liquidity plan (CLP). In that regard, examiners at the June 2009 visitation, determined that Affinity had not adequately addressed prior recommendations for the bank to develop an adequate CLP to (1) assess the potential for triggering restrictions on the bank's access to brokered and high-cost deposits and the effect on its liability structure and (2) identify and assess the adequacy of Affinity's contingent funding sources.

The FDIC's Supervision of Affinity

From 2005 to 2009, the FDIC and the CDFI provided ongoing supervision of Affinity through on-site risk management examinations and visitations. The FDIC also conducted offsite monitoring activities. Through their supervisory efforts, the FDIC and the CDFI identified and brought key risks to the attention of the bank's Board and management, including the high levels of CRE and ADC concentrations and associated weak risk management practices. With respect to Affinity's heavy reliance on wholesale funding sources, examiners expressed concern over the bank's (1) need to improve its liquidity position and address risks associated with its high net non-core dependence ratios and (2) high cost of funding that was negatively impacting the bank's earnings. Examiners also noted the risks associated with Affinity's CMO concentration and insufficient capital in relation to the bank's risk profile.

The FDIC and the CDFI initiated supervisory or enforcement actions in 2008 and 2009 to address identified deficiencies related to capital, asset quality, management, earnings, liquidity, concentrations, and the ALLL. Notwithstanding these efforts, earlier and greater supervisory attention to Affinity may have been warranted, given the elevated risks associated with CRE and ADC concentrations and Affinity's less than satisfactory financial condition, especially after the August 2007 examination.

Supervisory History

The FDIC and the CDFI performed four examinations and one visitation of Affinity from July 2005 until the bank was closed in August 2009. The FDIC also independently

[8] Section 29 of the FDI Act prohibits an insured depository institution that is *Adequately Capitalized* from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts, but permits the FDIC to grant a waiver from the prohibition. Banks that are *Undercapitalized* (including *Significantly Undercapitalized*) under PCA provisions are subject to the prohibition but may not obtain a waiver. On May 29, 2009, the FDIC issued guidance regarding revisions to the interest rate restrictions under Part 337.6 of the FDIC Rules and Regulations. When evaluating the Part 337.6 compliance of an institution that is less than *Well Capitalized*, the FDIC will deem the national rate to be the prevailing rate in all market areas, unless it agrees with evidence provided by the institution that it is operating in an area where prevailing deposit interest rates are higher. The final rule became effective January 1, 2010.

conducted one visitation in March 2008. Table 5 summarizes key examination and visitation information, including the PCA Directive effective July 31, 2009.

Table 5: Affinity's Supervisory History From 2005 to 2009

Examination or Visitation Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory or Enforcement Actions
07/25/2005	06/30/2005	Joint	222223/2	None
08/14/2006	06/30/2006	Joint	222323/2	None
08/13/2007	06/30/2007	Joint	323333/3	BBR – Effective 02/28/2008.
03/24/2008*	12/31/2007	FDIC	Not Rated	None
10/06/2008	06/30/2008	Joint	444444/4	Cease and Desist Order (C&D) – Effective 04/22/2009.
06/15/2009*	03/31/2009	Joint	555544/5	PCA Directive – Effective 07/31/2009.

Source: Examination reports and visitations for Affinity.
* Denotes Report of Visitation dates.

July 2005 and August 2006 Examinations. The FDIC and the CDFI focused their concerns on improvements needed in risk management practices for interest rate risk and Affinity's high cost of funds due to its reliance on wholesale funds. Earnings performance declined to less than satisfactory at the August 2006 examination due to unprofitable investments in the bank's asset-based lending division and additional branches that were established as Affinity transitioned from an ILC to a commercial bank. Additionally, income from Affinity's CMO portfolio had decreased.

Examiners made recommendations regarding risk exposure limits for significant CRE and CMO concentrations. The level of adversely classified assets increased significantly, from 10.5 percent of Tier 1 Capital and reserves at the July 2005 examination, to 40.4 percent of Tier 1 Capital and reserves at the August 2006 examination. Nevertheless, examiners reported that the classification level was manageable and asset quality was satisfactory.

August 2007 Examination Through June 2009 Visitation. Examinations and visitations conducted by the FDIC and the CDFI from 2007 through 2009 identified continued and pronounced deterioration in Affinity's financial condition, with the decline centered in the CRE and ADC concentrations.

- The August 2007 examination concluded that the bank's overall condition was less than satisfactory and examiners expressed concerns regarding Affinity's capital, management, earnings, liquidity, and sensitivity to market risk. To address those concerns, examiners recommended an informal action, after which Affinity's Board adopted a BBR. The BBR is discussed in more detail in the next section of this report.

- The March 2008 visitation concluded that the overall condition of Affinity was less than satisfactory and noted, among other concerns, the negative impact of the economic decline on the bank and the deterioration in asset quality.

- The October 2008 examination noted that Affinity's condition had significantly deteriorated and was unsatisfactory, and reported specific concerns regarding the bank's high loan concentrations, capital, earnings, liquidity, and sensitivity to market risk. Examiners also noted continued deterioration in the Board and management's performance and concluded that such performance was critically deficient.

By June 2009, examiners concluded that the bank's condition had deteriorated to the point where Affinity's viability was threatened. Asset quality was critically deficient, with adverse classifications totaling more than 318 percent of capital and reserves. As of June 30, 2009, $26 million in loan loss provisions were required. The overall condition of Affinity was downgraded to "5", indicating extremely unsafe and unsound practices or conditions, critically deficient performance, and great supervisory concern. The FDIC and the CDFI issued a C&D on April 22, 2009, to address Affinity's unsafe and unsound practices and a PCA Directive in July 2009 to address the bank's inadequate capital. Board and management's efforts to improve the bank's condition and attempts to sell the bank and increase capital were unsuccessful, resulting in the CDFI closing Affinity on August 28, 2009.

Supervisory Approach to CRE, ADC, and CMO Concentrations

As discussed earlier in this report, examiners in 2005 and 2006 identified the risks associated with Affinity's CRE, ADC, and CMO concentrations and made recommendations to enhance the risk management practices for the CRE and ADC concentrations. In addition, examiners expressed concern regarding the impact that the CMO concentration was having on the bank's interest rate risk, capital, and earnings. Subsequent supervisory activities identified additional risk to Affinity, as discussed below.

August 2007 Examination. The PEP for the August 2007 examination noted that Affinity had significant levels of CRE loans and a Real Estate Stress Test (REST) score of 4.99 percent.[9] Such a score indicated a high exposure to a potential economic downturn. In addition, the August 2007 examination determined that Affinity continued to have a significant concentration risk, with the CRE concentration totaling 984 percent of Tier 1 Capital. However, examiners concluded that the concentration risk was partly mitigated by the fact that management had been implementing practices consistent with the Joint Guidance. In addition, examiners concluded that bank management had diversified the CRE loans and generally received adequate monitoring reports. Examiners acknowledged, however, that if specific or overall markets deteriorated, the

[9] REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. The primary risk factor is the ratio of construction and development loans to total assets. Other risk factors include the percentage of CRE loans, percentage of multifamily loans, percentage of commercial and industrial loans, and high non-core funding and rapid asset growth. A bank with a high concentration in construction and development loans, coupled with rapid asset growth, would appear to be riskier than a bank with similar concentrations but low asset growth. REST uses statistical techniques and Call Report data to forecast an institution's condition over a 3- to 5- year period and provides a single rating from 1 to 5 in descending order of performance quality.

bank's loan quality could experience significant deterioration and negatively impact Affinity's capital and earnings.

Examiners concluded that Affinity's overall condition was less than satisfactory and expressed considerable concern regarding the bank's CMO concentration and the associated risks, and reflected those concerns in the bank's CAMELS ratings. Capital levels had declined and were considered to be less than satisfactory and insufficient to support the interest rate risk exposure and CRE concentration. The CMOs had been negatively impacted by rising interest rates that had contributed to a narrowed net interest margin. The CMO, CRE, and ADC concentrations were 255 percent, 984 percent, and 209 percent of Tier 1 Capital, respectively, at that time.

To address concerns related to Affinity's (1) elevated risk profile, (2) deteriorated overall earnings performance, (3) decreased capital ratios, and (4) increased reliance on non-core funding, examiners recommended that the FDIC impose an informal action in the form of a Memorandum of Understanding. After consideration of various factors, including the bank's commitment to addressing supervisory concerns, the DSC San Francisco Regional Office concluded that a BBR would be an effective tool to strengthen and monitor the institution's progress. Accordingly, Affinity adopted a BBR in February 2008, which focused on the bank's less-than-satisfactory capital position and required Affinity to submit a capital plan more commensurate with its current and anticipated risk profile. In addition, the capital plan was to (1) address the deterioration in the bank's financial condition associated with insufficient capital to support the continued IRR exposure caused by CMOs and (2) assess and quantify specific risk characteristics, including earnings, liquidity, growth and branching activities, and the CRE concentration. The BBR did not, however, address the need to reduce the risk associated with the bank's CRE and ADC concentrations.

March 2008 Visitation. This visitation was initiated to review bank management's actions to correct weaknesses identified at the August 2007 examination and to comply with the February 2008 BBR. In addition, examiners placed significant emphasis on loan review at this visitation due to concerns related to increases in past-due and non-performing loans in the ADC portfolio.

Examiners identified significant deterioration in the bank's asset quality since the August 2007 examination. ADC loans represented 82 percent of adverse classifications, which had increased significantly from 21.9 percent of Tier 1 Capital at the August 2007 examination, to more than 70 percent of Tier 1 Capital. Examiners attributed the deterioration in Affinity's asset quality to the downturn in the residential real estate market. In addition, examiners identified a substantial increase in Special Mention loans and highlighted the potential for further asset quality deterioration should real estate market conditions worsen. The FDIC's *Transmittal of Safety and Soundness Report of Visitation*, dated May 27, 2008, expressed concerns regarding Affinity's overall condition and stated that the bank's condition was less than satisfactory, with notable deterioration in asset quality.

However, supervisory action to address concerns identified at this visitation was limited to recommending that Affinity continue efforts to improve asset quality and provide details on plans to reduce the level of problem assets and improve earnings. Further, examiners did not assign CAMELS component or composite ratings reflecting the deteriorated condition of the institution at the time, as allowed by the Examination Manual. Rather, at the conclusion of the visitation, examiners advised management that, if ratings were assigned, they would recommend a downgrade in the asset quality rating from "2" to "3", given the level of adversely classified items, with all other ratings remaining the same. A "3" rating would have indicated, in part, that (1) asset quality or credit administration practices were less than satisfactory; (2) trends may have indicated deterioration in asset quality or an increase in risk exposure; and (3) the level and severity of classified assets and risks required an elevated level of supervisory concern.

October 2008 Examination. During the 6 months following the March 2008 visitation, Affinity's deterioration and trends identified at the March 2008 visitation continued and became more pronounced. Examiners concluded that the bank's CRE concentration well exceeded safe and sound levels. In addition, based on the level of the bank's CRE concentration, Affinity ranked in the 98th percentile among its peers. Further, examiners noted that since the August 2007 examination:

- the non-owner occupied CRE concentration had increased from 830 percent to 897 percent of Total Risk-Based Capital and that Affinity had the fifth highest CRE concentration in the San Francisco Region; and

- the bank's non-farm nonresidential properties represented the largest CRE concentration, at 358 percent of Total Risk-Based Capital, followed by multifamily residential properties at 340 percent.

In addition, examiners identified substantial deterioration in the bank's CRE and ADC concentrations, heightened volume of classifications, and increased severity of problem assets. Adverse classifications had increased from $20.1 million to $120.7 million and the ALLL increased from $8.6 million to $12.5 million. Examiners also recommended a $5.4 million increase in the ALLL. The bank's high-risk profile was further heightened by the fact that Affinity's capital ratios had decreased.

Affinity's actions to address the previously identified deterioration in asset quality had proven to be ineffective. In addition, Affinity's risk management processes were not adequate in relation to economic conditions and asset concentrations. Examiners noted that bank management had improved its monitoring, but Affinity continued to have a significant level of credit risk concentration that contributed to the high volume of adversely classified assets. As a result of the October 2008 examination, the FDIC and the CDFI issued a C&D, effective April 22, 2009, that included a provision to diversify the bank's loan portfolio and reduce concentrations in CRE and ADC loans.

June 2009 Visitation. The FDIC and the CDFI performed a targeted on-site visitation to assess Affinity's financial condition in June 2009. Examiners downgraded Affinity's capital, asset quality, management, and earnings component and composite ratings each to “5”, or critically deficient. Asset classifications were 318 percent of capital and reserves. The need to increase loan loss provisions prevented improvement in the bank’s capital and earnings. The FDIC and the CDFI reported that management was aggressively working to identify and address problem loans. However, examiners also concluded that Affinity was overwhelmed by the magnitude of real estate market conditions due to the heavy concentration in CRE lending, specifically ADC loans. In addition, examiners concluded that the deterioration in Affinity’s financial condition was beyond management’s ability to correct and control.

Earlier and More Aggressive Supervisory Action May Have Been Prudent

Although Affinity adopted a BBR as a result of the August 2007 examination, the resolution did not address the need to reduce the bank’s high CRE and ADC concentrations and the risks that those loans presented to the institution. A lesson learned with respect to CRE and ADC loan concentrations, like those at Affinity, is that early and aggressive supervisory intervention is prudent. At the time of the August 2007 examination, Affinity’s CRE and ADC concentrations, coupled with the CMO concentration, resulted in an extremely high risk profile for the bank. Examiners identified and took action to address the risks that the CMO concentration presented to Affinity. However, examiners did not similarly address the CRE and ADC concentrations which, at that time, significantly exceeded the levels that the Joint Guidance states may be identified for further supervisory analysis.

Specific supervisory action regarding the need to reduce the CRE and ADC concentrations was not taken until after the October 2008 examination, when the FDIC and the CDFI issued a C&D to Affinity in April 2009. With the benefit of hindsight, earlier supervisory steps may have been prudent. Such steps could have included (1) requiring the institution, at the August 2007 examination, to provide a written plan to address and reduce its level of concentrations and the associated risks; (2) taking additional action after the March 2008 visitation, which identified continued high CRE and ADC concentrations and substantial deterioration in the bank’s asset quality, centered in ADC loans, in the form of increased adversely classified assets; and/or (3) assigning new ratings for the CAMELS component and composite elements, including asset quality, at the March 2008 visitation, to reflect the deterioration identified since the August 2007 examination.

DSC officials agreed that, in general, earlier and more aggressive supervisory action related to the CRE and ADC concentration risk at Affinity may have been prudent. DSC officials specifically noted that, as previously discussed, examiners relied on Affinity’s Board and management’s commitment to take appropriate action to address supervisory concerns identified at the August 2007 examination. Examiners also considered Affinity’s Board and management's previous record of correcting deficiencies when deciding upon a course of supervisory action. With respect to steps taken as a result of the March 2008 visitation, DSC officials acknowledged that, looking back, issuing new ratings may have been commensurate with the institution’s financial deterioration and risk profile.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized. Table 6 provides Affinity Bank's capital ratios as of December 31, 2008 and March 31, 2009.

Table 6: Affinity's Capital Ratios Relative to PCA Thresholds for Well Capitalized Banks

	PCA Thresholds	Affinity's Capital Category and Ratios	
		December 31, 2008	March 31, 2009
Capital Category	***Well Capitalized***	***Adequately Capitalized***	***Undercapitalized***
Tier 1 Leverage Capital	5% or more	4.74%	4.44%
Tier 1 Risk-Based Capital	6% or more	6.42%	6.11%
Total Risk-Based Capital	10% or more	7.68%	7.38%

Source: Examination reports and UBPRs for Affinity.

We concluded that the FDIC properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for Affinity. At the October 2008 examination, Affinity was determined to be *Adequately Capitalized*, and, as such, access to brokered deposits became restricted based on section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations. Affinity and Affinity Bank Holding Company, Inc. submitted a Troubled Asset Relief Program (TARP) application to the FDIC, which was subsequently withdrawn.

Other significant steps taken by the FDIC, the CDFI or Affinity to address the bank's capital during 2009 included the following:

April 22, 2009. The FDIC and the CDFI issued a C&D to Affinity that included provisions requiring the bank to (1) submit a capital plan and (2) substantially increase the bank's Tier 1 Capital incrementally so that within 180 days the level would equal or exceed 10 percent of the bank's total assets, and maintain that level for the period during which the C&D was in effect.

May 19, 2009. The FDIC informed Affinity that based on the March 31, 2009 Call Report the bank was considered to be *Undercapitalized*. Accordingly, Affinity became subject to the mandatory requirements of section 38, including submission of a capital restoration plan, and restrictions on asset growth, acquisitions, new activities, and new branches. Further restrictions applied to the payment of dividends or management fees, or making any other capital distributions.

June 18, 2009. The FDIC informed Affinity that the capital plan the bank submitted was unacceptable and needed to be revised to specifically detail (1) the levels of capital to be attained during each year the plan would be in effect, (2) how the bank would comply with PCA restrictions, and (3) the types and levels of activities in which Affinity would engage.

June 30, 2009. The FDIC notified the bank that its PCA category was *Significantly Undercapitalized* based on the bank's May 31, 2009 general ledger.

July 1, 2009. The CDFI notified Affinity that because of its critical condition, the bank had to promptly increase its capital or merge with or sell its business to another depository institution. In addition, the notification advised Affinity that, on or before August 20, 2009, the bank had to increase its tangible shareholders' equity by the greater of $66 million or the amount necessary to make tangible shareholders' equity equal to at least 8 percent of total tangible assets of the bank.

July 7, 2009. The FDIC notified the bank that it was *Critically Undercapitalized* based on the results of the June 15, 2009 visitation. The notification also required Affinity to file a written capital restoration plan with the San Francisco Regional Office by July 14, 2009.

July 31, 2009. The FDIC issued a Supervisory PCA Directive that required Affinity to, among other things:

- sell or take action to be acquired by another depository institution holding company or combine with another insured depository institution,

- restrict the use of brokered deposits based on provisions of section 38 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations,

- restrict the interest rates the bank paid on deposits to comply with Part 337.6 of the FDIC Rules and Regulations, or

- pay no bonuses to, or increase the compensation of, bank directors or officers without prior written FDIC approval.

August 28, 2009. Affinity's attempts to sell the bank and/or substantially increase capital were unsuccessful. Accordingly, the CDFI closed Affinity and named the FDIC as receiver.

Corporation Comments

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 22, 2010, the Director, DSC, provided a written response to the draft report. That 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 Affinity's failure. With respect to our assessment of supervision, DSC stated that based on the results of the August 2007 examination, DSC deliberated and proposed an informal enforcement action and that Affinity's Board adopted a BBR in February 2008 that required the bank to augment its capital position commensurate with its risk profile. DSC agreed, however, that a stronger regulatory response could have been taken to address the weak practices identified at that examination. Further, DSC stated that it has issued updated guidance reminding examiners to take appropriate action when concentration and funding 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.

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

We conducted this performance audit from September 2009 to March 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of Affinity's operations from June 2005 until its failure in August 2009. Our review also entailed an evaluation of the regulatory supervision of Affinity over the same period.

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

- Analyzed examination reports and supporting workpapers prepared jointly by FDIC and CDFI examiners for the July 2005 through June 2009 examinations and visitations.

- Reviewed the following:

  - Documentation for offsite monitoring activities performed by the FDIC.

  - Bank data and correspondence maintained at the DSC's San Francisco Regional Office and Los Angeles West Field Office.

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

  - Pertinent DSC policies and procedures.

Objectives, Scope, and Methodology

- Audit reports of the bank's external auditors, Crowe Horwath LLP and Crowe Chizek and Company LLP.

- Actions that DSC implemented to comply with (1) provisions of section 29 of the FDI Act and FDIC Rules and Regulations, Part 337, *Unsafe and Unsound Banking Practices* restricting Affinity's use of brokered deposits; and (2) section 38 of the FDI Act, including, but not limited to, issuing PCA notification letters and a PCA Directive, and restricting Affinity's growth and payment of dividends, when applicable, based on the bank's capital category.

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C. and the San Francisco Regional Office.

  - FDIC examiners from the DSC Los Angeles West Field Office who conducted examinations and visitations of Affinity.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand Affinity's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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

Objectives, Scope, and Methodology

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A 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.
Collateralized Mortgage Obligations (CMOs)	Collateralized Mortgage Obligations (CMOs) are debt obligations collateralized by various types of mortgage loans or mortgage-backed securities.
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.

Glossary of Terms

Term	Definition
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. 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 determining capital adequacy and taking supervisory action against depository institutions that are in an unsafe or unsound condition. 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 undercapitalized categories.
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Treasury Department to purchase assets and equity from financial institutions to strengthen the financial sector.
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.
Wholesale Funding Sources	Wholesale funding sources include, but are not limited to, federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Acronyms

ADC	Acquisition, Development, and Construction Loans
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CDFI	California Department of Financial Institutions
CLP	Contingency Liquidity Plan
CMO	Collateralized Mortgage Obligations
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
ILC	Industrial Loan Company
IRR	Interest Rate Risk
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PEP	Pre-Examination Planning
REST	Real Estate Stress Test
ROE	Report of Examination
S&L	Savings and Loan
SFRO	San Francisco Regional Office
TARP	Troubled Asset Relief Program
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

March 22, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Affinity Bank, Ventura**,** California (Assignment 2010-010)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Affinity Bank, Ventura, California (Affinity), which failed on August 28, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on March 5, 2010.

Affinity failed due to its Board of Directors (Board) and management not implementing adequate controls to identify, measure, monitor, and control the risks associated with Affinity's growth and concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans. Affinity also relied heavily on wholesale funding to support its growth in the CRE and ADC concentrations. Due to the downturn in Affinity's real estate market, losses associated with deterioration in Affinity's loan portfolio, particularly the ADC loans, far exceeded earnings and eroded capital. Ultimately, the California Department of Financial Institutions closed Affinity due to its Critically Undercapitalized position.

The Report concludes that earlier and greater supervisory attention to Affinity may have been warranted given the elevated risks associated with CRE and ADC concentrations in a declining real estate market and Affinity's less than satisfactory financial condition, especially after the August 2007 examination. At the August 2007 examination, examiners concluded that loan quality, capital, and earnings could be negatively impacted if specific or overall markets deteriorated, due to Affinity's concentrations in CRE and ADC. Based upon the results of the August 2007 examination, DSC deliberated and proposed an informal enforcement action. Affinity's Board adopted a Bank Board Resolution (BBR) in February 2008 that contained provisions requiring Affinity to augment its capital position commensurate with its risk profile.

We agree that a stronger regulatory response could have been taken to address the weak practices identified at the August 2007 examination. 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 Report.