

Office of Inspector General



Office of Audits and Evaluations
Report No. AUD-12-006

**Material Loss Review of Colorado Capital
Bank, Castle Rock, Colorado**

February 2012



Executive Summary

Material Loss Review of Colorado Capital Bank, Castle Rock, Colorado

Report No. AUD-12-006
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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance (FDI) Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the Deposit Insurance Fund (DIF) 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 Financial Reform Act amends section 38(k) by increasing the Material Loss Review (MLR) threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

On July 8, 2011, the Colorado Division of Banking (CDB) closed Colorado Capital Bank (CCB), and the FDIC was appointed receiver. On August 17, 2011, the FDIC notified the Office of Inspector General (OIG) that CCB's total assets at closing were \$681.8 million and that the estimated loss to the DIF was \$283.8 million. The FDIC OIG engaged KPMG LLP (KPMG) to conduct an MLR of CCB. The audit objectives were to (1) determine the causes of CCB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of CCB, including implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

CCB was established in 1998 under the name of Bank West, which was a subsidiary of Bank West Holdings Inc., Castle Rock, Colorado (BW Holdings). In August 2003, a newly formed holding company, BankVest Inc. (BankVest), took control of BW Holdings. BankVest was the surviving entity and had a 100-percent ownership interest in the bank. On May 15, 2005, the bank changed its name to Colorado Capital Bank. The change in control resulted in significant changes to the composition of the bank's Board of Directors (Board) and senior management team. The change also resulted in a new business strategy focused on aggressive growth through commercial real estate (CRE) lending, especially acquisition, development, and construction (ADC) lending, in Colorado.

Audit Results

Causes of Failure and Material Loss

CCB failed primarily because its Board and management did not effectively manage the risks associated with the institution's aggressive loan growth and resulting heavy concentrations in CRE and ADC loans. Notably, the bank did not implement adequate concentration risk management controls, such as prudent ADC loan limits or portfolio-level stress testing. CCB also failed to maintain capital at levels that were commensurate with its risk profile, reducing the bank's ability to absorb losses in the event of a sustained downturn in the real estate market. CCB relied extensively on non-core funds, especially brokered deposits, Internet deposits, Federal Home Loan Bank advances, and capital injections from its parent holding company, to support its loan growth. Access to non-core funding became limited when the bank's financial condition deteriorated, straining the institution's liquidity position. Finally, lax lending practices, particularly when the institution's lending markets declined, contributed to CCB's problems.

Specifically, the Board and management failed to promptly recognize deterioration in the bank's loan portfolio and took certain actions that further elevated CCB's risk profile.

During 2007, economic conditions in CCB's primary lending markets began to decline. By year-end 2009, the quality of CCB's loan portfolio had deteriorated significantly, with the majority of problems centered in ADC loans. Further deterioration occurred in 2010 and 2011. The associated provisions for loan losses depleted CCB's earnings, eroded its capital, and strained its liquidity. The CDB closed CCB on July 8, 2011 because the institution was unable to raise sufficient capital to support its operations.

The FDIC's Supervision of CCB

The FDIC, in coordination with the CDB, provided ongoing supervisory oversight of CCB through regular onsite examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and supervisory actions. Such risks included concerns with Board and management oversight, the bank's heavy concentrations in CRE and ADC loans, less than satisfactory earnings, reliance on non-core funding sources, and weak loan underwriting and credit administration practices.

Like many institutions that failed in recent years, CCB developed a significant exposure to CRE and ADC loans at a time when the bank's financial condition and lending markets were generally favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market. In retrospect, a more forward-looking supervisory approach to the risk profile and weak risk management practices identified by examiners during earlier examinations may have been warranted, considering CCB's significant exposure to CRE and ADC loans and their associated vulnerability to economic cycles, rapid loan growth supported by non-core funds, lack of concentration risk management practices, and capital levels in relation to its risk profile. Examiners made a number of suggestions and recommendations to address CCB's risk management practices during the 2004-2008 examinations. However, the actions taken by the Board and management to address the suggestions and recommendations were not adequate. In addition, the FDIC and CDB issued a Memorandum of Understanding in July 2009 and a Consent Order in September 2010. However, by that time, the institution's lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.

Based on the supervisory actions taken with respect to CCB, the FDIC properly implemented the applicable PCA provisions of section 38.

Management Response

Subsequent to the issuance of KPMG's draft report, officials in the FDIC's Division of Risk Management Supervision (RMS) provided additional information for KPMG's consideration, and KPMG revised its report to reflect this information, as appropriate. On February 16, 2012, the RMS Director provided a

written response to a draft of this report. In the response, the RMS Director reiterated the causes of failure and the supervisory activities described in the report. Further, RMS stated that it has recognized the threat that institutions with high-risk profiles, such as CCB, pose to the DIF and issued to FDIC-supervised institutions a 2008 Financial Institution Letter (FIL), entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued a 2009 FIL, entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*. According to RMS, this FIL heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.



DATE: February 17, 2012

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

FROM: */Signed/*
Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

SUBJECT: *Material Loss Review of Colorado Capital Bank,
Castle Rock, Colorado (Report No. AUD-12-006)*

The subject final report is provided for your information and use. The report does not contain recommendations, thus a response was not required. However, the Division of Risk Management Supervision provided a written response on February 16, 2012. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mark Mulholland, Assistant Inspector General for Audits, at (703) 562-6316. We appreciate the courtesies extended to the audit and contractor staff.

Attachment

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Part I

Report by KPMG LLP

**Material Loss Review
Colorado Capital Bank
Castle Rock, Colorado**

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP
1676 International Drive
McLean, VA 22102

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KPMG LLP
1676 International Drive
McLean, VA 22102

February 17, 2012

Executive Summary

Stephen M. Beard
Deputy Inspector General for Audits and Evaluations
Federal Deposit Insurance Corporation
3501 Fairfax Drive
Arlington, VA 22226

Material Loss Review Report on the Failure of Colorado Capital Bank, Castle Rock, Colorado

Dear Mr. Beard:

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review (MLR) of Colorado Capital Bank (CCB), Castle Rock, Colorado. This performance audit report details the results of our review. The objectives of this performance audit were to (1) determine the causes of CCB's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of CCB, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the Federal Deposit Insurance Act (FDI Act).

Our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG communicates those to FDIC management for its consideration. As resources allow, the FDIC OIG conducts more comprehensive reviews of specific aspects of the FDIC's supervision program and makes recommendations as warranted. A brief summary of the results of our review of CCB follows.

Causes of Failure

CCB failed primarily because the bank's Board of Directors (Board) and management did not effectively manage the risks associated with the institution's aggressive loan growth and resulting heavy concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans. Notably, the bank did not implement adequate concentration risk management controls, such as prudent ADC loan limits or portfolio-level stress testing. CCB also failed to maintain capital at levels that were commensurate with its risk profile, reducing the bank's ability to absorb losses in the event of a downturn in the real estate market. CCB relied extensively on non-core funds, especially brokered deposits, Internet deposits, Federal Home Loan Bank (FHLB) advances, and capital injections from its parent holding company to support its loan growth. Access to non-core funding became limited when the bank's financial condition



deteriorated, straining the institution's liquidity position. Finally, lax lending practices, particularly when the institution's lending markets declined, contributed to CCB's problems. Specifically, the Board and management failed to promptly recognize deterioration in the bank's loan portfolio and took certain actions that further elevated CCB's risk profile.

Evaluation of Supervision

The FDIC, in coordination with the CDB, provided ongoing supervisory oversight of CCB through regular onsite examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and supervisory actions. Such risks included concerns with Board and management oversight, the bank's heavy concentrations in CRE and ADC loans, less than satisfactory earnings, reliance on non-core funding sources, and weak loan underwriting and credit administration practices.

Like many other institutions that failed in recent years, CCB developed a significant exposure to CRE and ADC loans at a time when the bank's financial condition and lending market were generally favorable. This exposure made CCB vulnerable to a sustained downturn in the real estate market. As described in the report, a more forward-looking assessment of CCB's risk profile and management practices during the 2006 and 2008 examinations may have been prudent. In addition, it is our view that while earlier examination ratings reflected the financial condition of the bank, the ratings assigned at these earlier examinations did not appear to fully reflect the risks present at that time.

A general lesson learned with respect to weak risk management practices is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has a relatively low or moderate level of classified assets. A stronger supervisory tenor may have influenced CCB to curb its ADC lending, strengthen its risk management controls, and hold more capital before its lending markets deteriorated.

Examiners made a number of suggestions and recommendations to address CCB's risk management practices during earlier examinations. However, the actions taken by the Board and management to address the suggestions and recommendations were not adequate. In addition, the FDIC and CDB issued a Memorandum of Understanding (MOU) in July 2009 and a Consent Order in September 2010. However, by that time, the institution's lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC informed us that it has taken a number of actions to increase its supervisory attention to banks with risk profiles similar to CCB. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.



Prompt Corrective Action

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository institutions. Based on the supervisory actions taken with respect to CCB, the FDIC properly implemented the applicable PCA provisions of section 38.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). These standards require that we plan and conduct the performance audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The information included in this report was obtained during our fieldwork, which occurred during the period October 2011 through January 2012.

Very truly yours,

KPMG LLP

Why We Did the Audit

Section 38(k) of the FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the DIF 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 Financial Reform Act amends section 38(k) by increasing the MLR threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

On July 8, 2011, the CDB closed CCB, and the FDIC was appointed receiver. The FDIC's Division of Finance notified the OIG on August 17, 2011 that CCB's total assets at closing were \$681.8 million and that the estimated loss to the DIF was \$283.8 million, (or 41.6 percent of CCB's total assets). The FDIC OIG engaged KPMG to conduct an MLR of CCB. The performance audit objectives were to (1) determine the causes of CCB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of CCB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. Appendix 1, Objectives, Scope, and Methodology, describes the procedures used by KPMG to conduct this performance audit.¹ In addition, Appendix 2 provides a glossary of terms, and Appendix 3 contains a list of acronyms used in this report.

Background

CCB was established in 1998 under the name of Bank West, which was a subsidiary of Bank West Holdings Inc., Castle Rock, Colorado (BW Holdings). In August 2003, a newly formed holding company named BankVest Inc., Castle Rock, Colorado (BankVest), took control of BW Holdings. The individual who led the BankVest investor group assumed the role of President and Chief Executive Officer (CEO) for the bank. On January 1, 2004, BankVest merged with BW Holdings. BankVest was the surviving entity and had a 100-percent ownership interest in the bank. On May 15, 2005, the bank changed its name to CCB.

The change in control resulted in significant changes to the composition of the bank's Board of Directors (Board) and senior management team. The change also resulted in a new business strategy that focused on aggressive growth through CRE lending, especially ADC lending, in Colorado. When the bank's financial condition deteriorated, several executive officers and Board members resigned. Most notably, the President and CEO, who also served as a Board member, resigned effective November 1, 2010. The individual selected to replace the outgoing President and CEO subsequently resigned effective April 7, 2011. From April 2011 to July 8, 2011, an executive team consisting of the Chief Credit Officer, Chief Operations Officer, and a consultant assumed the responsibilities of

¹ In conducting this performance audit and preparing the report, KPMG relied primarily on information provided by the OIG and the FDIC's Division of Risk Management Supervision (RMS).

the President and CEO. Table 1 provides details on CCB's financial condition as of December 31, 2010 and for the 4 preceding years.

Table 1: Selected Financial Information for CCB, 2006-2010

Financial Data (\$000s)	12/31/2010	12/31/2009	12/31/2008	12/31/2007	12/31/2006
Total Assets	\$909,251	\$848,406	\$825,494	\$635,593	\$370,628
Total Loans	\$657,701	\$732,852	\$756,322	\$565,823	\$330,436
Total Deposits	\$856,628	\$761,849	\$648,996	\$516,824	\$324,895
Brokered Deposits/Total Liabilities	25.64%	42.05%	34.44%	27.86%	38.55%
FHLB Advances	\$15,000	\$15,000	\$84,692	\$45,948	\$10,505
Past Due Ratio	15.70%	1.49%	0.84%	0.01%	0.02%
ADC Loans/Total Capital	1103%	485%	525%	552%	474%
CRE Loans/Total Capital	1340%	605%	639%	607%	565%
Net Interest Margin	3.40%	4.25%	4.15%	5.49%	6.10%
Return on Average Assets	(5.39%)	(1.81%)	0.45%	0.56%	0.80%
Tier 1 Leverage Capital	2.29%	8.01%	9.37%	8.72%	8.67%
Total Risk-Based Capital	4.83%	10.72%	11.13%	10.03%	10.59%

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

Causes of Failure and Material Loss

CCB failed primarily because its Board and management did not effectively manage the risks associated with the institution's aggressive loan growth and resulting heavy concentrations in CRE and ADC loans. Notably, the bank did not implement adequate concentration risk management controls, such as prudent ADC loan limits or portfolio-level stress testing. CCB also failed to maintain capital at levels that were commensurate with its risk profile, reducing the bank's ability to absorb losses in the event of a sustained downturn in the real estate market. CCB relied extensively on non-core funds, especially brokered deposits, Internet deposits, FHLB advances, and capital injections from its parent holding company to support its loan growth. Access to non-core funding became limited when the bank's financial condition deteriorated, straining the institution's liquidity position. Finally, lax lending practices, particularly when the institution's lending markets declined, contributed to CCB's problems. Specifically, the Board and management failed to promptly recognize deterioration in the bank's loan portfolio and took certain actions that further elevated CCB's risk profile.

During 2007, economic conditions in CCB's primary lending markets began to decline. By year-end 2009, the quality of CCB's loan portfolio had deteriorated significantly, with the majority of problems centered in ADC loans. Further deterioration occurred in 2010 and 2011. The associated provisions for loan losses depleted CCB's earnings, eroded its capital, and strained its liquidity. The CDB closed CCB on July 8, 2011 because the institution was unable to raise sufficient capital to support its operations.

Board and Management Oversight

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), the Board has overall responsibility and authority for formulating sound policies and objectives for the institution and for effectively supervising the institution's affairs. Executive officers, such as the President and CEO, have primary responsibility for managing the day-to-day operations and affairs of the bank. Further, ensuring appropriate corrective actions to regulatory concerns is a key responsibility of the Board.

Following the 2003 change in control, CCB's Board and executive management team implemented a business strategy that exposed the bank to considerable risk and ultimately led to its failure. As discussed in the *Aggressive Growth and CRE and ADC Loan Concentrations* section of the report, CCB's Board and management implemented a rapid growth strategy centered in ADC lending without adequate concentration risk management controls, such as prudent loan exposure limits and loan portfolio stress testing. The significant costs associated with CCB's aggressive expansion resulted in earnings that were insufficient to support the bank's operations and augment capital. As a result, CCB relied extensively on its parent holding company for capital injections to support loan growth. Notwithstanding these capital injections, the Board and management did not maintain capital levels commensurate with the bank's growing risk profile.

As discussed in the *Funding Strategies* section of the report, the Board and management placed considerable reliance on potentially volatile non-core funding sources, such as brokered deposits, to fuel loan growth. Further, as discussed in the *Loan Underwriting, Credit Administration, and Related Monitoring* section of the report, the Board and management did not ensure adequate lending practices when the real estate market declined or recognize deterioration in the loan portfolio in a timely manner. In addition, the Board and management took certain actions during this period that further elevated CCB's risk profile, such as implementing the Asset Repositioning Program (described later).

Further, during examinations conducted from 2004 to 2011, the regulators noted several apparent violations of banking laws and contraventions with policy. For example:

- At the 2004, 2008, 2009, and 2010 examinations, examiners noted a combined total of 10 appraisal violations of Part 323 of the FDIC Rules and Regulations.
- The 2010 joint examination noted an apparent conflict of interest concerning one of the bank's approved real estate appraisers. Specifically, the approved appraiser was the husband of CCB's President of the mortgage department.
- At the 2010 joint examination, examiners noted that the bank was in apparent violation of the Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL).

Overall, the extent and repetition of some of these violations and contraventions provide further evidence of CCB's inadequate management and Board oversight that led to the failure of the bank.

In addition, according to the April 2010 joint examination report, CCB's internal controls, audit procedures, and compliance with laws and regulations were inadequate, and a "culture of non-compliance" was pervasive throughout the institution.

Aggressive Growth and CRE and ADC Loan Concentrations

Following the change in control that took place in August 2003, CCB embarked on an aggressive growth strategy centered in CRE (and particularly ADC) loans. However, CCB's Board and management did not effectively manage the risks associated with the rapid growth and ensuing CRE and ADC loan concentrations. A description of the institution's strategy and risk management practices in this area follows.

Aggressive Loan Growth

During the 4-year period ended December 31, 2008, CCB grew its loan portfolio from \$186.2 million to \$756.3 million (or more than 300 percent). Contributing to the growth during this period was an increase in ADC loans from \$75.1 million (or 40 percent of the loan portfolio) to \$435.3 million (or 57 percent of the loan portfolio). CCB's ADC lending included residential speculative construction,² residential pre-sold construction, non-owner occupied commercial construction, and residential land development in Colorado. The elevated exposure to ADC loans made the bank vulnerable to a sustained downturn in the real estate market. Figure 1 illustrates the composition and growth of the loan portfolio in the years preceding the bank's failure.

² Speculative construction lending involves the financing of projects for which a buyer has not yet been identified.

Figure 1: Composition and Growth of CCB's Loan Portfolio, 2005-2010



Source: KPMG analysis of Reports of Condition and Income (Call Reports) for CCB.

CRE and ADC Loan Concentrations

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The purpose of the Joint Guidance was to reinforce existing regulations and guidelines for real estate lending and safety and soundness. The Joint Guidance states that the federal banking agencies have observed an increasing trend in the number of institutions with concentrations in CRE loans and noted that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. The Joint Guidance defines criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk, but it does not establish specific CRE lending limits. According to the Joint Guidance, an institution 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:

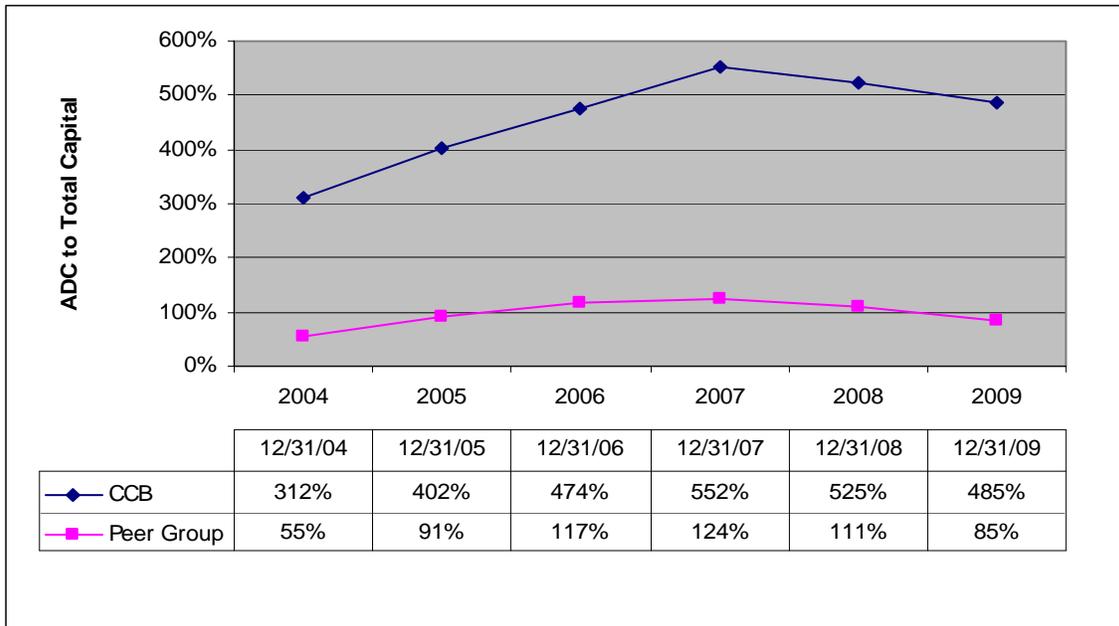
- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

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

In addition, in March 2008, the FDIC issued Financial Institution Letter (FIL)-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risks associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices.

Figure 2 illustrates the trend in CCB’s ADC loans relative to total capital as compared to the bank’s peer group average.³ As reflected in the figure, CCB’s ADC loan concentration significantly exceeded the levels defined in the Joint Guidance as warranting additional supervisory analysis. In addition, the banks’ CRE and ADC loan concentrations as a percentage of total capital substantially exceeded peer group averages. Further, according to the FDIC’s September 2008 visitation report, CCB had the largest concentration in construction and development loans and the second largest concentration in CRE loans among insured institutions in the state of Colorado as of March 31, 2008.

Figure 2: CCB’s ADC Concentration as a Percentage of Total Capital Compared to Peer Group



Source: KPMG analysis of UBPRs for CCB.

ADC lending generally involves a greater degree of risk than permanent financing for finished residences or commercial buildings. Associated risks include adverse changes in

³ Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. From 2006 to 2009, CCB’s peer group consisted of insured commercial banks having assets between \$300 million and \$1 billion. For 2005, CCB’s peer group consisted of insured commercial banks having assets between \$100 million and \$300 million. For 2004, CCB’s peer group consisted of insured commercial banks having assets between \$50 million and \$100 million.

market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans.

A key reason why CCB developed a significant exposure to CRE and ADC loans was that the Board and management had not established CRE and ADC loan limits until after the September 2008 visitation (when real estate market conditions were continuing to decline). The April 2010 joint examination report stated that the bank's loan policy allowed up to 425 percent of the capital to be invested in land and construction loans, of which 175 percent was allowed for land credits. The report noted that these parameters were excessive. In addition, CCB did not stress test its CRE and ADC loan portfolios as described in the Joint Guidance (to assess the impact that various economic scenarios might have on the institution's asset quality, capital, earnings, and liquidity) until after the September 2008 visitation. Further, the bank had not developed a viable contingency plan or management strategies to mitigate the risks associated with its ADC loan concentration in the event of adverse market conditions.⁴ Lending limits, stress testing, and contingency plans are key concentration risk management controls intended to mitigate risks associated with potential adverse market conditions.

Capital Levels Relative to CRE and ADC Loan Growth

The Joint Guidance states that institutions with CRE concentrations should hold capital exceeding regulatory minimums and commensurate with the level of risk in their CRE lending portfolios. In addition, the Examination Manual states that institutions should maintain capital commensurate with the level and nature of risk to which the institutions are exposed. The Examination Manual adds that the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for PCA purposes.

Due to the significant costs associated with the bank's expansion⁵ and the large provision expenses that were needed following the downturn in the real estate market, CCB's earnings were not sufficient to support the bank's operations and augment capital. In fact, examiners determined that the quality of the bank's earnings were less than satisfactory at every examination conducted from 2004 until the bank's failure. As a result, CCB relied extensively on its parent holding company and shareholders for capital injections to support loan growth. Notwithstanding these injections, the bank's capital levels were not commensurate with the growing risk in the loan portfolio. For example, CCB's Total

⁴ The Joint Guidance recommends that institutions develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse market conditions. Such strategies could include, for example, loan participations, loan sales, and securitizations to mitigate concentration risk. Contingency plans facilitate a proactive (rather than reactive) approach to dealing with adverse market conditions.

⁵ CCB's expansion costs pertained to such things as opening new branch offices, establishing loan production offices, developing new departments such as the Wealth Management and Real Estate Mortgage Departments, and hiring new personnel.

Risk-based Capital ratio as of December 31, 2007 was just 3 basis points above the PCA threshold for *Well Capitalized* institutions. In addition, the bank's capital ratios were consistently below peer group averages, despite CRE and ADC loan concentrations that were significantly higher than peer group averages. Table 2 illustrates the trend in CCB's Total Risk-based Capital ratios relative to its peer group during the years preceding the bank's failure.

Table 2: Total Risk-Based Capital Ratios Compared to Peer Group

Period Ended	Bank Ratio	Peer Group Ratio	Bank Percentile
Dec-06	10.59	12.89	14
Dec-07	10.03	12.73	2
Dec-08	11.13	12.60	34
Dec-09	10.72	13.17	14
Dec-10	4.83	14.28	1

Source: UBPRs for CCB.

Note: Data under the percentile column represent the percentile ranking or percentage position of the bank relative to other banks in the peer group.

Had CCB maintained higher capital ratios commensurate with its risk profile, the institution's loan growth may have been constrained, and losses to the DIF may have been mitigated to some extent.

ADC Loan Losses

At the time of the April 2010 joint examination, CCB's adversely classified assets were \$225.4 million (or 253 percent of Tier 1 Capital plus the ALLL), up from \$56.3 million (or 68 percent of Tier 1 Capital plus the ALLL) at the prior examination. ADC loans accounted for about \$206 million of the \$225.4 million in total classifications. By the May 2011 joint examination, adversely classified assets had increased to \$354.1 million (or 804 percent of Tier 1 Capital plus the ALLL), with the majority of classifications consisting of ADC loans. After charging off losses and other assets during the 2011 examination and accounting for an additional provision of \$75 million, examiners determined that the bank would have negative equity capital of about \$63 million, rendering the institution insolvent.

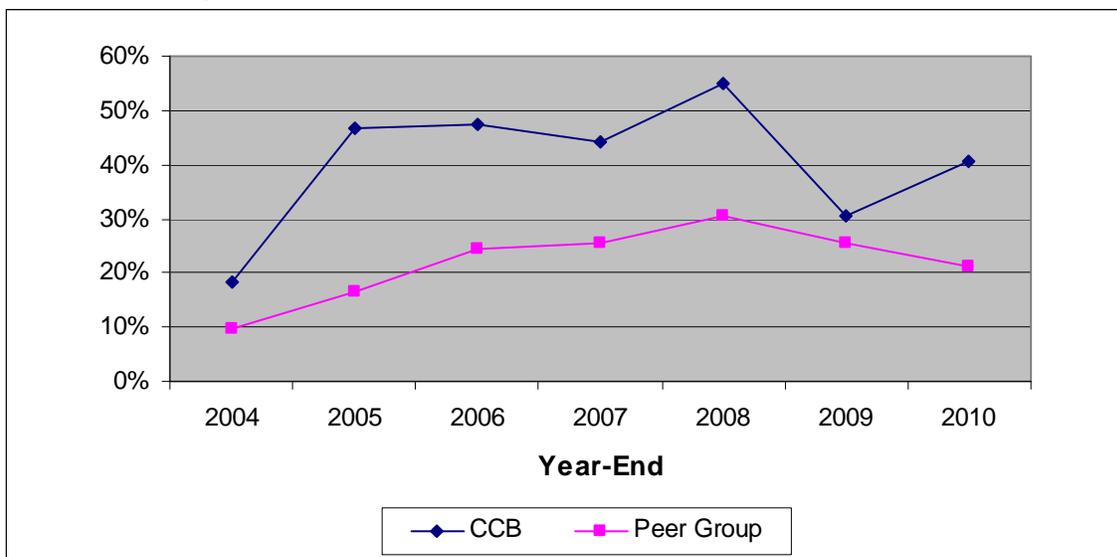
Funding Strategies

In the years preceding its failure, CCB relied extensively on non-core funding sources, particularly brokered deposits, Internet deposits, and FHLB advances, to fund its loan growth and maintain liquidity. When properly managed, non-core funding sources offer a number of important benefits, such as ready access to funds in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as increased volatility when interest rates change and difficulty accessing funding sources when the financial condition of an institution deteriorates. In addition, institutions become subject to limitations on the use of brokered deposits and the interest rates they can offer on deposits when the institutions fall below

Well Capitalized. Under distressed financial or economic conditions, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

According to the Examination Manual, the net non-core funding dependence ratio is a measure of the degree to which the bank relies on potentially volatile liabilities, such as, but not limited to, certificates of deposit over \$100,000 and brokered deposits, to fund long-term earning assets (such as loans that mature in more than 1 year). Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher ratios reflect reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. CCB's net non-core funding dependence ratio increased from about 18 percent to about 49 percent from December 31, 2004 to June 30, 2006. Contributing to this trend was an increase in brokered deposits during the same period from \$5.2 million (or 7 percent of total deposits) to \$101.8 million (or 42 percent of total deposits). Figure 3 illustrates the trend in CCB's net non-core funding dependence ratio relative to its peer group during the period 2004 to 2010.

Figure 3: CCB's Net Non-Core Funding Dependence Ratio Compared to Peer Group



Source: KPMG analysis of UBPRs for CCB.

Adding to the bank's liquidity risk profile was management's decision to establish a \$173 million depository relationship with a trust company during the fourth quarter of 2009 that resulted in a single funding concentration of 23 percent of the bank's deposits. The deposits pertaining to this relationship were used to replace higher-cost brokered deposits as they matured. On May 14, 2010, the FDIC determined that these funds were considered brokered deposits based on the definition of a "deposit broker" in the FDIC Rules and Regulations.⁶ The potential volatility associated with this depository relationship increased CCB's liquidity risk profile.

⁶ See FDIC Rules and Regulations, 12 Code of Federal Regulations 337.6(a)(2) and 337.6(a)(5)(ii)(I).

Following the issuance of a Consent Order in September 2010, CCB became subject to the brokered deposit and interest rate restrictions in the FDIC Rules and Regulations. As a result, the bank turned to Internet deposits to replace its maturing brokered deposits and customer deposit withdrawals and, to a lesser extent, to fund advances on required loan commitments. By May 27, 2011, Internet deposits totaled \$461 million (or 65 percent of total deposits), up from \$27 million (or 3.5 percent of total deposits) during the April 2010 joint examination. By the time of the May 2011 joint examination, the bank's unsecured lines of credit had been cancelled, and borrowing availability was contingent upon the pledging of qualified collateral. Examiners considered the bank's liquidity position to be critically deficient.

Loan Underwriting, Credit Administration, and Related Monitoring

Examination and visitation reports issued from 2005 to 2008 identified various aspects of CCB's loan underwriting, credit administration, and related monitoring practices that needed improvement, but controls in these areas were determined to be generally satisfactory as reflected in the "2" ratings that were assigned for Asset Quality. The April 2009 joint examination assigned a "3" to the Asset Quality component. The April 2010 joint examination assigned a "5" to Asset Quality, and the examination report described significant weaknesses in CCB's loan underwriting, credit administration, and related monitoring. Among other things, the report noted that:

- The internal loan review program and watch list were significantly deficient, resulting in a material difference between examiner loan classifications and the bank's watch list.
- The loan policy did not address the appropriate or inappropriate use of interest reserves. According to the examination report, the bank placed heavy reliance on interest reserves for many loans. However, there was often a lack of adequate documentation of the borrower's capacity to service the debt after the interest reserves were depleted. In other instances, the bank made loans to cover the interest when the borrower did not have the capacity to service the debt. Such practices effectively masked the loan portfolio's true delinquency level.
- The bank needed to implement prudent guidelines for renewals, extensions, and refinancing for all loans, especially problem loans. Examiners determined that the bank's loan workout programs were ineffective and that loan extensions were made on liberal terms.
- The real estate appraisal process was deficient, requiring that the bank review its appraisal policies and procedures and implement effective oversight procedures to ensure that loan officers adhered to such procedures. Prior examination reports noted apparent violations pertaining to appraisals.
- The ALLL level and methodology were critically deficient. Examiners determined that the ALLL was underfunded by at least \$16 million. An

underfunded ALLL has the effect of delaying the recognition of problems in the loan portfolio.

The April 2010 joint examination report also described an Asset Repositioning Program implemented by the Board and management that further elevated CCB's risk profile. The bank did not seek the FDIC's advice or consent before implementing this program. A summary of the program follows.

Asset Repositioning Program

In September 2009, a large volume of CCB's borrowers began to experience significant financial stress due to the economic downturn. The borrowers could no longer fund interest payments and complete real estate projects associated with ADC loans, and many borrowers were facing foreclosure and bankruptcy. The bank's executive management, in consultation with the Board, initiated several loan workout programs. One of these workout programs was referred to as the Asset Repositioning Program, whereby new investors assumed the outstanding balances or executed new notes for these troubled loans.

Although the terms of each repositioning agreement varied, the original borrowers generally agreed to execute non-recourse notes and transfer property pledged as collateral to new entities or individuals for a nominal amount. In return, the bank released many of the original borrowers from liability, obtained non-recourse notes from new investors, and subordinated its collateral position to enable continued outside financing of projects, including interest carry, through escrow notes provided by the new investors. Further, the bank regularly committed to purchase escrow notes senior to the bank's lien if projects were not sold or completed by the maturity date.

The April 2010 joint examination report stated that, in general, these loans were granted with significant underwriting concessions such as subordinated lien positions, high loan-to-value ratios, non-recourse terms, a lack of financial information, and no equity at risk for the new investors. Accordingly, examiners adversely classified loans totaling approximately \$68 million under the program during the April 2010 joint examination and listed an \$8.3 million loan relationship under the program as Special Mention.

Other Loan Underwriting and Administration Weaknesses

The May 2011 joint examination report stated that weak loan underwriting and credit administration practices had contributed to CCB's losses. Among other things, the report indicated that management was relying on outdated and inflated appraisals and expressed concern about the after-effects of the Asset Repositioning Program. At this examination, adversely classified loans under the program were listed at \$14.3 million. Further, examiners anticipated that more deterioration would surface as new appraisals were obtained and interest reserves were depleted. The report noted that management's optimistic estimate of current losses in the loan portfolio (which was criticized at the prior examination) would necessitate significant charge-offs, a minimum provision of

\$75 million to the ALLL, and a restatement of the bank's Call Report filing for the quarter ended March 31, 2011.

The FDIC's Supervision of Colorado Capital Bank

The FDIC, in coordination with the CDB, provided ongoing supervisory oversight of CCB through regular onsite examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and supervisory actions. Such risks included concerns with Board and management oversight, the bank's heavy concentrations in CRE and ADC loans, less than satisfactory earnings, reliance on non-core funding sources, and weak loan underwriting and credit administration practices.

The following sections detail our analysis of the bank's supervisory history, supervisory and enforcement actions, offsite monitoring, PCA activities, and supervisory lessons learned.

Supervisory History

From February 2004 until CCB's closing in July 2011, the FDIC and the CDB conducted seven onsite examinations and three visitations of CCB. The frequency of this onsite examination activity was consistent with relevant statutory and regulatory requirements.⁷ Table 3 summarizes key supervisory information pertaining to CCB's examinations and visitations.

⁷ Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, on-site examinations of every state non-member bank at least once every 12-month period and allows for 18-month intervals for certain small institutions (i.e., total assets of less than \$500 million) if certain conditions are satisfied.

Table 3: Examinations and Visitations for CCB

Examination or Visitation Start Date	Examination or Visitation	Regulator(s)	Supervisory Ratings (UFIRS)*	Informal or Formal Action Taken**
2/9/2004	Examination	CDB	222422/2	None
9/12/2005	Examination	FDIC	222422/2	None
12/11/2006	Examination	CDB	222322/2	None
2/19/2008	Examination	FDIC	222322/2	None
9/15/2008	CRE Visitation	FDIC	No rating changes	None
4/13/2009	Examination	FDIC/CDB	333332/3	MOU - July 21, 2009
12/7/2009	Visitation	FDIC	No rating changes	MOU – still in effect
4/5/2010	Examination	FDIC/CDB	555555/5	Consent Order - September 9, 2010
11/29/2010	Visitation	FDIC	No rating changes	Consent Order - still in effect
5/31/2011	Examination	FDIC/CDB	555555/5	Consent Order - still in effect

Source: KPMG analysis of examination and visitation reports and information in the Virtual Supervisory Information On the Net system (ViSION) for CCB.

* See the report Glossary for a definition of UFIRS, which establishes the CAMELS rating system.

** Informal actions often take the form of a Bank Board Resolution or MOU. Formal enforcement actions often take the form of a Consent Order or a Supervisory Directive.

Supervisory and Enforcement Actions

Based on the results of the April 2009 joint examination, the FDIC and CDB entered into an MOU with CCB's Board on July 21, 2009 to address a number of risk management issues. Under the terms of the MOU, the Board agreed to (among other things):

- Submit a written plan to the FDIC and CDB to improve the bank's credit position through repayment, amortization, liquidation, additional collateral, improved documentation, or other means for each loan or other asset in excess of \$200,000 that was past due more than 90 days, was adversely classified on the bank's watch list, or was adversely classified during the examination.
- Submit to the FDIC and CDB revised loan and credit administration policies and procedures that address the deficiencies identified during the examination.
- Eliminate from the bank's books, by charge-off or collection, all assets or portions of assets classified as "loss" during the examination that had not been previously collected in full or charged off.
- Maintain an adequate ALLL level in accordance with generally acceptable accounting principles (GAAP).
- Conduct an assessment of the bank's capital needs to ensure that capital is maintained at a level commensurate with the level of risk in the bank's activities.

- Develop and submit to the FDIC and CDB a Capital Plan that (among other things) incorporates the capital assessment, addresses the capital adequacy guidelines defined in the FDIC Rules and Regulations, meets certain capital ratio requirements, and includes procedures for notifying the FDIC and CDB of capital ratios that fail to meet required minimum levels.
- Submit to the FDIC and CDB a written plan to improve the bank's liquidity position by reducing reliance on volatile funding sources, including a sound Contingency Funding Plan.
- Ensure that (1) the bank's total assets would not increase more than 5 percent during any consecutive 3-month period without first submitting a growth plan to the FDIC and CDB and obtaining their prior consent and (2) total assets would not increase by more than 10 percent annually.
- Provide the FDIC and CDB with quarterly written progress reports detailing the actions taken to comply with each provision of the agreement and the corresponding results.

Although the MOU addressed key risks at CCB, it did not specifically address the bank's CRE and ADC loan concentrations. During the April 2010 joint examination, examiners determined that bank management had taken a number of actions to address the provisions of the MOU. However, actions taken in some areas were not adequate. For example, examiners found that:

- numerous loan policy and credit administration weaknesses remained, especially in the areas of CRE lending, appraisals, the Asset Repositioning Program, and the ALLL level and methodology;
- the bank's capital ratios were below the levels required by the MOU; and
- the Contingency Funding Plan was general in nature and not considered adequate.

Based on the results of the April 2010 joint examination, which identified all areas of the bank to be critically deficient, the FDIC and CDB entered into a Consent Order with CCB's Board on September 9, 2010. The Order remained in effect until the bank was closed in July 2011. Among other things, the Order required CCB to:

- Submit a comprehensive written Capital Plan to the FDIC and CDB that included a requirement for the bank to achieve and maintain a Tier 1 Leverage Capital ratio and Total Risk-based Capital ratio equal to or greater than 10 percent and 13 percent, respectively.
- Ensure that the bank's total assets would not increase more than 5 percent during any consecutive 12-month period commencing June 30, 2010 without first submitting a growth plan to the FDIC and CDB and obtaining their prior consent.

- Prepare and adopt a comprehensive Strategic Plan.
- Make (to the extent not previously done so) provisions to the ALLL in an amount of at least \$16 million and maintain a reasonable ALLL thereafter.
- Submit to the FDIC and CDB a Classified Asset Reduction Plan to reduce any remaining assets with a balance of \$100,000 or more that were classified as Doubtful and Substandard as of April 5, 2010.
- Formulate and submit to the FDIC and CDB a written plan for the reduction and collection of delinquent loans.
- Correct all deficiencies with regard to the loans listed as Special Mention during the April 2010 joint examination.
- Formulate and submit to the FDIC and CDB a written plan to reduce each of the loan concentrations identified during the examination.
- Establish a Loan Review Committee to periodically review the loan portfolio and identify and categorize problem credits.
- Establish (after review and comment by the FDIC and CDB) loan policies and procedures specifically relating to the Asset Repositioning Program that comply with the reporting requirements for troubled debt restructurings and GAAP.
- Increase the Board's participation in the affairs of the bank by assuming full responsibility for the approval of the bank's policies and objectives and for the supervision of the bank's management, including all of the bank's activities.
- Develop and submit to the FDIC and CDB for review and comment a written liquidity plan.
- Provide the FDIC and CDB with quarterly written progress reports detailing the actions taken to comply with each provision of the order and the corresponding results.

At the May 2011 joint examination, examiners determined that the overall financial condition of the bank had deteriorated with unprecedented speed and was unsound. Furthermore, due to the rapid deterioration in the bank's condition, compliance was not achieved with key provisions of the Order, including those pertaining to meeting minimum capital requirements, funding the ALLL, and reducing adversely classified assets, delinquency levels, and concentrations.

Offsite Monitoring

The FDIC has established an offsite review program that is designed to identify emerging supervisory concerns and potential problems so that bank supervisory strategies can be adjusted appropriately. Under the program, offsite reviews are performed quarterly for each bank that appears on the Offsite Review List (ORL).⁸ Regional RMS management is responsible for implementing procedures to ensure that offsite review findings are considered when establishing examination schedules and other supervisory activities. Offsite reviews must be completed 3½ months after each quarterly Call Report date. This schedule generally provides 45 days to complete the offsite reviews once Call Report data are finalized.

The FDIC uses various offsite monitoring tools to help assess the financial condition of banks. These tools use statistical techniques, Call Report data, and other information to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources. Table 4 identifies the key offsite monitoring tools that identified risk flags for CCB.

⁸ The ORL identifies institutions warranting heightened supervisory oversight. Since the offsite review program is intended to identify potential emerging problems, the ORL includes only those institutions with a composite rating of a “1” or “2.”

Table 4: CCB's Offsite Review History

Offsite Review Date	Statistical CAMELS Offsite Rating System (SCOR) ^A	SCOR-Lag ^B	Real Estate Stress Test (REST) ^C	Growth Monitoring System (GMS) ^D	Consistent Grower ^E	Young Institution ^F	Multiflag ^G
3/31/2005			x	x	x	x	x
9/30/2005		x	x	x	x	x	x
12/31/2005			x	x	x	x	x
9/30/2006			x	x	x		
3/31/2008			x	x	x		
6/30/2008			x	x	x		x
9/30/2008			x	x	x		x
12/31/2008			x	x	x		x
3/31/2009	x	x	x	x	x		x

Source: KPMG analysis of offsite reviews for CCB.

^A SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.

^B SCOR-lag is a derivation of SCOR that assesses the financial condition of rapidly growing banks. SCOR ratios used to measure asset quality are likely to be understated at a rapidly growing bank since few loans are non-performing at origination. A common technique to avoid such an understatement is the use of a lag-ratio. SCOR-lag uses current period SCOR data and then adjusts the asset quality ratios on a 1-year lag basis.

^C REST measures exposures to real estate lending.

^D GMS identifies institutions experiencing rapid growth and/or with a funding structure highly dependent on non-core funding sources.

^E Consistent Grower is a cumulative growth score for an institution using up to 20 quarters of GMS scores.

^F Young Institution identifies institutions that are less than 8 years old.

^G Multiflag is determined by combining multiple risk measures from various offsite review models.

From March 2005 to March 2009, the FDIC's offsite review program identified CCB for offsite review for nine periods. The offsite review documentation explained why the bank was appearing on the ORL and briefly discussed completed or planned examination activity. Examiners made some of the following comments during these offsite reviews:

- **March 2005.** Growth in non-core funding is a factor, and the level of brokered deposits increased from zero to \$11 million in 6 months.
- **September 2005.** Risk is considered to be increasing in view of the bank's continued high growth.
- **December 2005.** Risk levels are considered to be increasing in view of the bank's continued high growth rate and reliance on volatile funds to at least partially fuel that growth.

- **September 2006 and March 2008.** The Board continues to implement an aggressive growth strategy with emphasis on CRE lending funded by brokered deposits.
- **September 2005, June 2008, September 2008, and December 2008.** Reliance on brokered deposits and FHLB advances as a funding source is considered high.
- **March 2009.** An MOU will be pursued to address deficiencies noted during the April 2009 joint examination.

The offsite reviews were conducted in accordance with FDIC policy and, as such, focused on numerical measures of risk with less emphasis on risk management practices to mitigate the corresponding risk, such as high ADC and CRE loan concentrations. As a result, the offsite reviews do not appear to have significantly changed the FDIC’s approach to supervising and monitoring the bank because when offsite reviews were triggered, onsite examinations were either recently completed or scheduled to begin relatively soon thereafter at CCB.

Supervisory Response to CCB’s Board and Management Oversight

While examination reports issued from 2004 to 2008 noted concerns with respect to CCB’s Board and management oversight and contained recommendations for improvement, these reports considered Board and management to be generally satisfactory. Beginning with the April 2009 joint examination report, examiners became increasingly critical of CCB’s Board and management. Table 5 summarizes comments in examination reports issued from 2004 to 2009 that pertain to CCB’s Board and management and their responsibilities.

Table 5: Examiner Comments Pertaining to Board and Management Oversight

Examination Start Date	Examiner Comments
2/9/2004	<ul style="list-style-type: none"> ▪ Although there were significant changes in the bank’s management team and structure, management remains satisfactory. The new management members are tenured and appear capable of operating the bank in a safe and sound manner. ▪ While overall Board and management oversight remains satisfactory, overall policies and practices have been in transition since the change in control. There were several instances where the bank’s actual practices were not consistent with policies. ▪ Although the Funds Management Committee was named in September 2003, the committee did not meet until February 2004. ▪ Management and the Board were not monitoring compliance with Asset Liability Management (ALM) policy guidelines. ▪ Five apparent violations of laws or regulations or contraventions of policy were noted.
9/12/2005	<ul style="list-style-type: none"> ▪ Overall Board and management supervision is satisfactory, although continued diligence is warranted in view of the bank’s rapid growth and continued operating losses. ▪ Management has effectively controlled the risks to the bank, including those pertaining to Liquidity, Asset Quality, and Sensitivity to Market Risk. Capital is maintained at satisfactory levels through stock offerings at the holding company level. Earnings are negative; however, improvement is anticipated.

Examination Start Date	Examiner Comments
	<ul style="list-style-type: none"> ▪ Sound underwriting and strong credit administration must be maintained in view of the bank's high loan growth and credit concentrations. Liquidity must also be closely monitored as the bank's level of volatile funding sources is very high. ▪ It is imperative that a current, detailed strategic plan be in place in view of the bank's significant growth strategy and need for external capital augmentation. ▪ Management has not established guidelines to identify, limit, and monitor loan concentrations. Due to the risks inherent with this type of lending, management is encouraged to set parameters and monitor its volume. ▪ The Board should establish a policy parameter to limit the level of brokered deposits in relation to total deposits.
12/11/2006	<ul style="list-style-type: none"> ▪ The directorate and management continue to provide competent administrative oversight, remain proactive, and closely monitor primary risk areas in accordance with operating policies and procedures. ▪ While the overall level of asset classifications is considered low, the loan portfolio remains relatively unseasoned. ▪ Loan growth continued at a significant pace funded by brokered deposits and FHLB advances. ▪ The high level of loan documentation exceptions and the bank's tightening liquidity position presented concern. ▪ Three apparent violations of laws and regulations were cited.
2/19/2008	<ul style="list-style-type: none"> ▪ Management and Board supervision of the bank are satisfactory. The Board is actively involved in the affairs of the bank, and management provides quality leadership over the lending function as evidenced by the bank's sound asset quality and overall satisfactory condition. ▪ While management has implemented sound lending policies and procedures, the Board has implemented an aggressive growth strategy with emphasis on CRE loans funded largely by brokered deposits. The result is an aggressive and risky profile, especially considering recent weaknesses in the housing and construction and development markets at the local, regional, and national levels. The level of CRE loans and reliance on brokered deposits ranks this bank at the highest percentiles nationally and at the state level in comparison to other insured banks. The Board is strongly encouraged to implement strategies which reduce the bank's exposure to the real estate market and lessen its reliance on brokered deposits. ▪ Continued diligence by the Board and management regarding sound underwriting and strong credit administration practices must be maintained in view of the high loan growth and elevated credit concentrations. Examiners stressed that this was essential and warranted emphasis in light of the overall risk profile of the bank and general economic conditions. ▪ The Board should establish a well-defined process to identify and monitor the real estate industry concentrations. ▪ The Board had not formulated a Residential Mortgage Department Policy, and it was imperative for them to provide guidance to the mortgage department. ▪ Capital protection is marginally satisfactory. It was suggested that management perform a capital assessment to determine the appropriate level of capital and allowance adequacy after considering the volume of its CRE loans. ▪ Examiners made recommendations to improve the bank's risk management practices.
4/13/2009	<ul style="list-style-type: none"> ▪ The Board and management's ability to operate in a safe and sound manner and in accordance with acceptable practices has weakened and requires strengthening. ▪ Management is proactive in identifying problem loans and in working with borrowers regarding resolution strategies. ▪ The Board and management have established a comprehensive loan policy. ▪ Overall, credit administration and practices are adequate. ▪ The Board and management should immediately reduce the bank's reliance on non-

Examination Start Date	Examiner Comments
	<p>core funding sources and enhance liquidity contingency planning.</p> <ul style="list-style-type: none"> ▪ It is imperative for the Board and management to enhance and strengthen its ALLL methodology. ▪ Improvement is still required in monitoring compliance with CRE parameters established in the loan policy. ▪ Examiners made several recommendations to management to strengthen credit administration practices, including appraisal program enhancements. ▪ Five apparent violations of laws and regulations or contraventions of policy were identified.

Source: KPMG analysis of examination reports for CCB.

The April 2010 and May 2011 joint examination reports were sharply critical of Board and management oversight and assigned Management component and composite ratings of “5.” The significant financial deterioration noted by examiners during those examinations was a significant factor in determining the ratings. The April 2010 joint examination report stated that the Board had permitted a high-risk lending strategy in ADC credits without establishing appropriate limits, adequate controls, or effective policies and procedures. The report also noted that management had failed to maintain strong capital and reserves or implement adequate loan underwriting, credit administration, or liquidity risk management practices. As previously discussed, the September 2010 Consent Order included a provision requiring increased Board participation in the affairs of the bank. The May 2011 joint examination report noted that while the bank’s executive management team had been replaced following the prior examination, the new management and Board were unable to stem the deterioration in the bank’s condition or implement corrective measures outlined in the September 2010 Consent Order.

Supervisory Response to CCB’s Aggressive Growth and CRE and ADC Loan Concentrations

Examination reports issued from 2004 to 2008 identified risks pertaining to CCB’s rapid loan growth strategy and ensuing concentrations in CRE and, particularly, ADC loans. These reports contained a number of suggestions and recommendations designed to improve CCB’s concentration risk management practices. Notwithstanding the risks identified, examiners determined that CCB’s concentration risk management practices were generally satisfactory during this period due to various mitigating factors, such as adequate loan underwriting and credit administration. Accordingly, examiners assigned Asset Quality component ratings of “2” until the April 2009 joint examination, at which time, losses in the portfolio became apparent. Table 6 summarizes examiner comments pertaining to CCB’s aggressive growth and loan concentrations in examination reports issued from 2004 to 2010.

Table 6: Examiner Comments Pertaining to Loan Growth and Concentrations

Examination Start Date	CRE / ADC Concentration as a Percentage of Total Capital	Examiner Comments
2/9/2004	345% / 236% as of 9/30/2003	<ul style="list-style-type: none"> ▪ The bank’s 2004 budget projected a doubling of loan volume. ▪ Examiners recommended that the bank monitor concentrations and report them to the Board at least quarterly.
9/12/2005	494% / 366% as of 6/30/2005	<ul style="list-style-type: none"> ▪ Continued due diligence is warranted in view of the bank’s rapid growth and continued operating losses. ▪ Management projects substantial loan growth to continue in 2006. ▪ Monitoring and reporting of concentrations of credits is not evident. Reasonable limits for industry concentrations need to be established and monitored.
12/11/2006	609% / 500% as of 9/30/2006	<ul style="list-style-type: none"> ▪ The loan portfolio grew 89 percent during the past 12 months, and continued growth is projected for 2007. ▪ As the majority of expected growth in 2006 was in construction lending, examiners noted that it was important for management to have good construction loan policies, procedures, and Board reports in place to maintain and monitor the credit quality of the loan portfolio.
2/19/2008	607% / 552% as of 12/31/2007	<ul style="list-style-type: none"> ▪ The heightened level of CRE concentrations warrants increased management and Board supervision. The Board should promptly address recommendations in the report to improve risk management practices in this area. Such recommendations included establishing limits and sub-limits on ADC loans relative to capital and stress testing the loan portfolio. ▪ The highest volume in CRE lending is the speculative residential construction portfolio. ▪ Overall, the CRE concentration is mitigated by good monitoring procedures, adequate underwriting standards, and satisfactory credit administration procedures that identify and track the financial ability of borrowers.
4/13/2009	639% / 525% as of 12/31/2008	<ul style="list-style-type: none"> ▪ Loan portfolio risk is heightened by the bank’s high level of loans concentrated in CRE. ▪ Management has addressed many of the concentration risk management program enhancements requested by examiners, including the establishment of policy limits, the implementation of stress testing, and Board reporting.
4/5/2010	605% / 485% as of 12/31/2009	<ul style="list-style-type: none"> ▪ The Board and management actively pursued a rapid CRE growth strategy and failed to establish reasonable risk limits and sub-limits for CRE loans, especially for higher-risk ADC credits. ▪ Adversely classified loans are almost entirely comprised of ADC loans.

Source: KPMG analysis of examination reports and UBPRs for CCB.

The May 2011 joint examination report was sharply critical of the bank’s extensive exposure to CRE and ADC loans and lack of associated risks management practices.

In early 2008, the FDIC conducted an analysis to identify institutions that were at risk due to their significant exposure to CRE and ADC loans. The analysis was performed in response to the adverse effect that the downturn in the housing market was having on construction and real estate development activity at that time. Recognizing that banks

with large exposures to CRE loans, especially ADC loans, may be negatively affected, the FDIC analyzed Call Report information to identify banks with concentrated exposures in CRE and ADC loans that were operating in markets that the FDIC designated as “distressed” or “at risk.” One of the institutions identified was CCB.

As a result of the analysis, the FDIC conducted a visitation in September 2008 to assess the current and prospective risks posed by CCB’s CRE concentrations, as well as to assess the bank’s compliance with the Joint Guidance and FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*. As a result of the visitation, examiners informed the Board and management that they should take action to address (among other things) policy, procedural and control weaknesses in Board and management oversight, portfolio management, credit underwriting standards, and credit risk review functions. At the joint examination that followed in April 2009, examiners noted that risk in the loan portfolio was heightened by the bank’s high CRE concentration.

The Examination Manual states that examiners should consider the existence of asset concentrations, as well as the level and trend of classified, nonaccrual, and delinquent assets when assessing the Asset Quality component. The Examination Manual further states that management’s ability to identify, measure, monitor, and control credit risk should be reflected in the Asset Quality component rating.

The Asset Quality component was rated a “2” from 2004 to 2008. At the April 2009 joint examination, the Asset Quality rating was downgraded to a “3” and then further downgraded to a “5” at the April 2010 joint examination.

Supervisory Response to CCB’s Funding Strategies

As noted earlier in this report, the 2003 change in control resulted in a new business strategy. This new strategy included increasing the bank’s reliance on non-core funding sources, such as brokered deposits and FHLB advances, to fund its lending and operations. While this change in funding strategy elevated the bank’s overall liquidity profile, examiners considered the bank’s liquidity position to be satisfactory until the April 2009 joint examination. As reflected in Table 7, CCB increased its reliance on brokered deposits from \$5.2 million in 2004 to \$328 million in 2009, while FHLB advances increased from \$0 in 2004 to \$85 million in 2008.

Table 7: CCB's Funding Sources

At Year End	Core Deposits (\$000s)*	Brokered Deposits (\$000s)	Time Deposits Above Insurance Limit (\$000s)	FHLB Advances (\$000s)
December 2004	\$51,863	\$5,247	\$16,507	\$0
December 2005	\$32,507	\$55,429	\$71,909	\$0
December 2006	\$38,976	\$130,172	\$155,747	\$10,505
December 2007	\$144,233	\$162,001	\$210,590	\$45,948
December 2008	\$83,451	\$256,684	\$328,116	\$84,692
December 2009	\$216,246	\$328,052	\$256,420	\$15,000
December 2010	\$549,353	\$227,644	\$123,315	\$15,000

Source: UBPRs for CCB.

*Core deposits may include some deposits of less than \$100,000 obtained through the bank's use of an Internet listing service and brokered deposits representing time deposits of less than \$100,000.

The Examination Manual states that examiners should consider the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. Table 5 (presented earlier) summarizes examiner comments in examination reports pertaining to CCB's funds management practices. From 2004 to 2008, examiners assigned a rating of "2" to the Liquidity component. The Liquidity rating was first downgraded to a "3" at the April 2009 joint examination. By the April 2010 joint examination, examiners downgraded the Liquidity rating to a "5" and noted that liquidity and funds management practices were critically deficient, as excessive reliance on brokered deposits threatened the viability of the bank.

Supervisory Response to Loan Underwriting, Credit Administration, and Related Monitoring

Although examination reports issued from 2004 to 2008 identified aspects of CCB's loan underwriting, credit administration, and related monitoring that could be enhanced, examiners considered risk management practices in these areas to be generally adequate. Examiners became sharply critical of CCB's loan underwriting, credit administration, and related monitoring during the April 2010 joint examination. Among other things, examiners noted during that examination that CCB failed to promptly recognize deterioration in the loan portfolio due to weaknesses in such areas as appraisals, ADC loan administration, and the ALLL. Both the April 2010 and May 2011 joint examination reports contained numerous recommendations to improve loan underwriting, credit administration, and related monitoring. In addition, as previously discussed, the July 2009 MOU and September 2010 Consent Order included provisions addressing these areas.

A brief summary of the FDIC's and CDB's responses to the significant risks associated with the Asset Repositioning Program follows.

Asset Repositioning Program

The FDIC first learned of the Asset Repositioning Program at the April 2010 joint examination, at which time examiners were critical of the program. The examination report stated that loans under the program possessed higher than normal credit risk as management made significant underwriting concessions, such as subordinated lien positions, high loan-to-values ratios, non-recourse terms, a lack of financial information, and no equity at risk for new investors. Examiners adversely classified loans totaling approximately \$68 million under the program during the examination and listed an \$8.3 million loan relationship as Special Mention. Examiners recommended that management take the following actions with respect to the program:

- engage a qualified third party to perform a fair value analysis on all credits under the program and recognize any loss impairment;
- obtain a written accounting opinion from a qualified third party to ensure that accounting entries pertaining to the program conform with GAAP and regulatory accounting standards;
- obtain and review financial information, tax returns, and credit reports for all borrowers under the program as a prudent banking practice; and
- reconsider risk factors in the program's credits and update all policies and procedures to reflect changes in the program.

As previously discussed, the FDIC and CDB included a provision in the September 2010 Consent Order requiring that CCB strengthen its controls pertaining to the Asset Repositioning Program. According to examiners, the bank ceased making any new loans under the program following the April 2010 joint examination. Examiners noted that the Asset Repositioning Program had the effect of deferring losses in the optimistic belief by bank management that the local real estate market would recover in the short term.

Implementation of PCA

Based on the supervisory actions taken with respect to CCB, the FDIC properly implemented applicable PCA provisions of section 38.

Table 8 summarizes CCB's PCA status and any informal or formal actions taken from 2006 through 2011. A chronological description of the changes in the bank's capital categories and the FDIC's implementation of PCA follow the table.

Table 8: CCB's Capital Levels

Examination or Event Date	Total Risk-Based	Tier 1 Risk-Based	Leverage	PCA Capital Category
<i>Well Capitalized Threshold</i>	≥10%	≥6%	≥5%	
12/11/2006 Examination	10.40	9.40	8.89	<i>Well Capitalized</i>
2/19/2008 Examination	10.01	9.17	8.72	<i>Well Capitalized</i>
4/13/2009 Examination	11.04	10.23	9.37	<i>Well Capitalized</i>
4/5/2010 Examination	10.20	8.93	7.74	<i>Well Capitalized</i>
9/9/2010 Consent Order	N/A	N/A	N/A	<i>Adequately Capitalized*</i>
2/21/2011 PCA Notification	6.92	5.61	3.73	<i>Undercapitalized</i>
3/29/2011 PCA Notification	3.50	4.83	2.29	<i>Significantly Undercapitalized**</i>
5/4/2011 PCA Directive	4.00	2.71	1.90	<i>Critically Undercapitalized</i>

Source: KPMG analysis of examination reports and PCA activities for CCB.

*CCB fell to *Adequately Capitalized* as a result of the Consent Order issued on September 9, 2010.

**CCB fell to *Significantly Undercapitalized* as a result of amended Call Report Data as of December 31, 2010 and as a result of its failure to submit an acceptable Capital Restoration Plan.

At the time of the September 2010 Order, CCB's capital ratios exceeded the levels for *Well Capitalized* banks. However, Part 325 Subpart B, *Prompt Corrective Action*, of the FDIC Rules and Regulations states that the *Well Capitalized* status indicates a bank (1) meets the capital ratios and (2) is not subject to any written agreement, Order, capital directive, or PCA Directive to meet and maintain a specific capital level. Accordingly, issuance of the September 2010 Order had the effect of lowering the bank's PCA capital category from *Well Capitalized* to *Adequately Capitalized*.

Under the Order, effective September 9, 2010, the bank was required to submit a written Capital Plan (Plan) within 60 days of the Order. The due date for the Plan was November 9, 2010. The bank requested, and the FDIC Regional Director and CDB Commissioner approved, a 15-day extension to November 24, 2010. The bank submitted the Plan within the extended deadline. The bank's Plan to increase capital included reducing assets, improving income, and raising capital through a stock offering. A contingency plan⁹ within the Capital Plan required the bank to seek an acquirer for the holding company and/or bank if the requirements of the Order were not met.

In a letter dated February 21, 2011, the FDIC notified CCB's Board that the bank was *Undercapitalized* based on the December 31, 2010 Call Report. Within the timeframe set

⁹ As required by the Order, the Capital Plan included a contingency plan in the event that the bank (1) failed to maintain the minimum capital ratios required by the Order, (2) failed to submit an acceptable capital plan, or (3) failed to implement or adhere to a capital plan to which no written objection was provided by the Supervisory Authorities.

forth in the notice, the bank submitted a Capital Restoration Plan on March 15, 2011. On March 29, 2011, the FDIC notified the bank that its Capital Restoration Plan did not comply with section 38 and was not acceptable. As the bank failed to submit an acceptable Capital Restoration Plan, the provisions applicable to a *Significantly Undercapitalized* institution applied to the bank. In the same communication, the FDIC issued a Notice of Intent to Issue a Supervisory PCA Directive. Further, during the week of March 18, 2011, the bank became aware of an accounting adjustment that required an amendment to its year-end 2010 Call Report, causing the bank's capital level to drop to *Significantly Undercapitalized* as of December 31, 2010.

On April 21, 2011, CCB provided the FDIC with an Amended Capital Restoration Plan. On April 27, 2011, the FDIC notified the bank that the Amended Capital Restoration Plan was essentially the same as what was submitted on March 15, 2011 and remained unacceptable. On May 4, 2011, the FDIC sent the bank a Supervisory PCA Directive and notified the bank of its *Critically Undercapitalized* status based on the March 31, 2011 Call Report. The Tier 1 Capital and Total Risk-Based Capital ratios after the May 2011 joint examination were negative 8.60 and negative 12.86 percent, respectively, and the bank had not been successful in implementing the Amended Capital Restoration Plan. Following the May 31, 2011 joint examination, the institution continued to be *Critically Undercapitalized* for PCA purposes, and the bank failed on July 8, 2011.

Supervisory Lessons Learned

The perspectives gained from the failure of CCB are not unique. Like many other institutions that failed in recent years, CCB developed a significant exposure to CRE and ADC loans at a time when the bank's financial condition and lending markets were generally favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market. In retrospect, a more forward-looking supervisory approach to the risk profile and weak risk management practices identified by examiners during earlier examinations may have been warranted, considering CCB's:

- significant exposure to CRE and ADC loans and their associated vulnerability to economic cycles;
- lack of concentration risk management practices;
- rapid loan growth supported by non-core funds, such as brokered deposits; and
- capital levels in relation to its risk profile.

A stronger supervisory tenor during earlier examinations may have influenced CCB to establish and maintain stronger risk management practices, such as prudent limits on its ADC loan concentration and non-core funds and higher levels of capital, which could have better positioned CCB to work through the loan deterioration that developed as the Colorado real estate market deteriorated. In addition, it is our view that while earlier composite and component ratings in the areas of Management, Asset Quality, Liquidity,

and Capital reflected the financial condition of CCB, the ratings did not appear to fully reflect the risks present at that time.

Examiners made a number of suggestions and recommendations to address CCB's risk management practices at examinations conducted from 2004 to 2008. However, the actions taken by the Board and management to address the suggestions and recommendations were not adequate. In addition, the FDIC and CDB issued an MOU in July 2009 and a Consent Order in September 2010, but by that time, the institution's lending markets were rapidly deteriorating, making remedial efforts difficult.

In December 2010, the OIG issued an audit report, entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (OIG Audit Report No. MLR-11-010) for the purpose of identifying trends in recent bank failures and determining the FDIC's actions to enhance its supervision program. The audit report notes that the CAMELS ratings for failed institutions reflected greater emphasis on a bank's financial condition and levels of capital and earnings, rather than the bank's ability to successfully mitigate identified risks. The audit report further states that risky behaviors that do not seem to have had a sufficient impact on CAMELS ratings included, but were not limited to: (1) pursuit of aggressive growth in CRE and ADC loans, (2) excessive levels of asset concentration with little risk mitigation, and (3) reliance on wholesale funding to fund asset growth. Such findings are consistent with the results of our assessment of the supervisory approach for CCB.

The FDIC informed us that it has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, issued FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices. The FDIC has also issued FIL-84-2008, entitled, *Liquidity Risk Management*, which highlights the importance of (among other things) contingency funding plans in addressing relevant stress events. Further, the FDIC issued FIL-13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*, which heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

Additionally, the FDIC completed a training initiative in 2010 for its entire supervisory workforce that emphasized the need to assess a bank's risk profile using forward-looking supervision. The training addressed the importance of considering management practices as well as current financial performance or trends when assigning ratings, consistent with existing examination guidance. Further, on January 26, 2010, the FDIC issued guidance to its examiners that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed.¹⁰

¹⁰ RMS Regional Directors Memorandum, entitled, *Matters Requiring Board Attention* (Transmittal No. 2010-003).

Objectives, Scope, and Methodology

Objectives

We performed this performance audit to satisfy the requirements of section 38(k) of the FDI Act as amended by the Financial Reform Act, which provides, in general, that if the DIF 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 Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Consistent with the Financial Reform and FDI Act provisions described above, the objectives of this MLR were to (1) determine the causes of CCB's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of CCB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

Our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG communicates those to FDIC management for its consideration. As resources allow, the FDIC OIG conducts more comprehensive reviews of specific aspects of the FDIC's supervision program and makes recommendations as warranted.

We conducted this performance audit from October 2011 to January 2012 in accordance with GAGAS. 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 CCB from February 2004 until its failure on July 8, 2011. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by FDIC and CDB examiners from 2004 to 2011.
- Reviewed the following documentation:

Appendix 1

- Financial institution data and correspondence maintained at the RMS Dallas Regional Office and Denver Field Office, as provided to KPMG by RMS.
- Reports prepared by the Division of Resolutions and Receiverships and RMS relating to CCB's closure.
- Pertinent RMS policies and procedures.
- Interviewed relevant FDIC officials who had supervisory responsibilities pertaining to CCB, which included RMS regional officials from the Dallas Regional Office and examination staff in the Denver Field Office.
- Interviewed appropriate CDB officials in Denver, Colorado, to discuss the historical perspective of the institution, its examinations, and other activities regarding CDB's supervision of the bank.
- Researched various banking laws and regulations.

KPMG relied primarily upon the materials provided by the FDIC OIG and RMS, including information and other data collected during interviews. KPMG did not perform specific audit procedures to ensure the information and data were complete and accurate. KPMG is, however, aware that Circular 12000.1, *Cooperation with the Office of Inspector General*, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in examination reports and other relevant supervisory correspondence between the FDIC, CDB, and the bank. KPMG relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

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

Consistent with the audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in the FDIC's systems, reports, and interviews of examiners to understand CCB's management controls pertaining to the 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 examination and visitation reports, 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 MLR, we did not assess the strengths and weaknesses of RMS's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. RMS compliance with the Results Act is reviewed in OIG's program audits of RMS operations.

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

Related Coverage of Financial Institution Failures

The FDIC provided us with a memorandum issued by the OIG on May 1, 2009. The memorandum outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. As discussed earlier in this report, the OIG issued an audit report, entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

Further, with respect to more in-depth coverage of specific issues, the OIGs of the FDIC, the Department of the Treasury, and the Board of Governors of the Federal Reserve System issued an evaluation report in September 2011, entitled, *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which assessed the role and Federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA*, and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Additionally, the FDIC OIG has informed us that it began an evaluation in July 2011 to study the characteristics and related supervisory approaches that may have prevented FDIC-supervised institutions with significant ADC loan concentrations from being designated as problem banks or failing during the recent financial crisis. Most recently, in January 2012, the President signed Public Law 112-88 (H.R. 2056, as amended), which requires the Inspector General of the FDIC to conduct a comprehensive study on the impact of the failure of insured depository institutions. Among the reviews initiated in response to this law, the FDIC OIG has initiated reviews in the following areas of bank supervision:

- evaluation and use of appraisals,
- implementation of FDIC policy statement on CRE loan workouts,
- risk management enforcement actions, and
- examiner assessment of capital.

The Inspector General is required to submit a report on the results of the study and any related recommendations to Congress by January 3, 2013.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction, and that provide interim financing for constructing residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Call Report	Consolidated Reports of Condition and Income (also known as Call Reports) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the FDI 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.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
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.
Consent Order	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A Consent Order may be terminated by the regulators when they have determined that the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

Term	Definition
Federal Home Loan Bank (FHLB)	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community and financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss to the DIF in excess of \$200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify a bank's emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the ORL. Regional management is responsible for implementing procedures to ensure that offsite review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to one of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Prompt Corrective Action (PCA)	<p>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, <i>Prompt Corrective Action</i>, of the FDI Act, 12 United States Code, Section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) <i>Well Capitalized</i>, (2) <i>Adequately Capitalized</i>, (3) <i>Undercapitalized</i>, (4) <i>Significantly Undercapitalized</i>, and (5) <i>Critically Undercapitalized</i>.</p> <p>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.</p>

Term	Definition
Risk-Based Capital	A “supplemental” capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based capital framework, a bank’s qualifying total capital base consists of two types of capital elements, “core capital” (Tier 1) and “supplementary capital” (Tier 2).
Risk-Based Capital Rules	Part 325 Appendix A— <i>Statement of Policy on Risk-Based Capital</i> —defines the FDIC’s risk-based capital rules. Appendix A states an institution’s balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together, and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution’s qualifying total capital base is the numerator of the ratio.
Special Mention Assets	A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institutions credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
Tier 1 Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.2(v), as The sum of: <ul style="list-style-type: none"> • Common stockholder’s equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; Minus: <ul style="list-style-type: none"> • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Appendix 2

Term	Definition
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component, and an overall composite, is assigned a rating of "1" through "5," with "1" having the least regulatory concern and "5" having the greatest concern.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ALM	Asset Liability Management
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CCB	Colorado Capital Bank
CDB	Colorado Division of Banking
CEO	Chief Executive Officer
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GAAP	Generally Accepted Accounting Principles
GAGAS	Generally Accepted Government Auditing Standards
GMS	Growth Monitoring System
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
ORL	Offsite Review List
PCA	Prompt Corrective Action
REST	Real Estate Stress Test
RMS	Division of Risk Management Supervision
SCOR	Statistical CAMELS Offsite Rating
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

OIG Evaluation of Management Response

OIG Evaluation of Management Response

Subsequent to the issuance of KPMG's draft report, RMS officials provided additional information for KPMG's consideration, and KPMG revised its report to reflect this information, as appropriate. On February 16, 2012, the RMS Director provided a written response to a draft of this report. That response is provided in its entirety on page II-2 of this report.

In the response, the RMS Director reiterated the causes of CCB's failure and the supervisory activities described in the report. Further, RMS stated that it has recognized the threat that institutions with high-risk profiles, such as CCB, pose to the DIF and issued to FDIC-supervised institutions a 2008 FIL, entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued a 2009 FIL, entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*. According to RMS, this FIL heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation

550 17th Street NW, Washington, D.C. 20429-9990

Division of Risk Management Supervision

February 16, 2012

TO: Stephen Beard
Assistant Inspector General for Audits

FROM: /Signed/
Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Colorado Capital Bank, Castle Rock, Colorado

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of Colorado Capital Bank (CCB), which failed on July 8, 2011. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on January 20, 2012.

CCB failed primarily because its Board and management did not effectively manage the risks associated with loan growth and concentrations in commercial real estate (CRE) and acquisition, development and construction (ADC) loans. Lax oversight contributed to asset quality problems that developed when CCB's lending markets declined. In addition, CCB did not maintain capital at levels that were commensurate with the increasing risk profile. CCB relied on noncore funding sources that included brokered deposits, Internet deposits, and Federal Home Loan Bank advances, in addition to capital injections from the holding company to support loan growth. By April 2009, CCB's loan portfolio had significantly deteriorated, requiring increases in provisions for loan losses that depleted earnings, eroded capital, and strained liquidity. CCB was unable to raise additional capital to sustain safe and sound operations.

From 2004 to 2011, the FDIC and the Colorado Division of Banking (CDB) conducted seven onsite risk management examinations, onsite visitations, and offsite monitoring. Examiners identified key risks in CCB's operations, brought these to the attention of the Board and management, and made recommendations for improvement. However, CCB's Board and management did not take adequate steps to address the weaknesses and in 2009, examiners downgraded CCB and issued a Memorandum of Understanding. The 2010 joint examination noted that all areas were critically deficient; and examiners further downgraded CCB and issued a Consent Order.

RMS has recognized the threat that institutions with high risk profiles, such as CCB, pose to the Deposit Insurance Fund and issued to FDIC-supervised institutions a Financial Institution Letter (FIL) in 2008 entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued a FIL in 2009 entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*. This FIL heightened our supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

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