



Audit Report



OIG-09-013

SAFETY AND SOUNDNESS: Material Loss Review of ANB
Financial, National Association

November 25, 2008

Office of
Inspector General

Department of the Treasury

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Abbreviations

ANB	ANB Financial, National Association
CRE	commercial real estate
CRP	capital restoration plan
FDIC	Federal Deposit Insurance Corporation

Federal Reserve	Board of Governors of the Federal Reserve System
FHLB	Federal Home Loan Bank
FMFIA	Federal Managers' Financial Integrity Act
IT	information technology
JAMES	Joint Audit Management Enterprise System
LPO	loan production office
OCC	Office of the Comptroller of the Currency
OIG	Department of the Treasury Office of Inspector General
PCA	prompt corrective action
ROE	report of examination

*The Department of the Treasury
Office of Inspector General*

November 25, 2008

Mr. John C. Dugan
Comptroller of the Currency

This report presents the results of our review of the failure of ANB Financial, National Association (ANB), of Bentonville, Arkansas, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. Our review was mandated under section 38(k) of the Federal Deposit Insurance Act, as amended. OCC closed ANB and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on May 9, 2008. At that time, FDIC estimated that ANB's failure would cost the Deposit Insurance Fund \$214 million.

Section 38(k) requires that we determine why ANB's problems resulted in a material loss to the insurance fund; review OCC's supervision of ANB, including implementation of the prompt corrective action (PCA) provisions of section 38(k); and make recommendations for preventing any such loss in the future. We reviewed the supervisory files and interviewed key officials involved in the regulatory enforcement matters. We conducted our fieldwork from May through October 2008 at OCC's headquarters in Washington, D.C.; OCC's district office in Denver, Colorado; OCC's field office in Kansas City, Kansas; and FDIC's Division of Supervision and Consumer Protection and Division of Resolutions and Receiverships in Dallas, Texas.

Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains background information on ANB and OCC's bank supervision processes. We also provide a glossary as Appendix 3. The terms are underlined and hyperlinked to the glossary where first used in the report. A chronology of significant events related to ANB and supervision of the bank is provided in Appendix 4.

Results in Brief

The primary causes of ANB's failure were the bank's strategy of aggressive growth without adequate controls; heavy reliance on wholesale funding, including brokered deposits; inadequate risk management of credit concentrations in commercial real estate, and unsound underwriting practices. These deficiencies were exacerbated by unfavorable economic conditions.

OCC conducted timely and regular examinations of ANB and provided oversight through its off-site monitoring. In addition, OCC appropriately used its authority under PCA. Also, OCC's Special Supervision Division took appropriate supervisory actions after oversight of ANB was transferred to it. However, as discussed below, we believe that OCC did not issue a formal enforcement action in a timely manner, and was not aggressive enough in the supervision of ANB in light of the bank's rapid growth, high concentrations in commercial real estate (CRE) loans, reliance on brokered deposits, and weak credit risk management practices. OCC identified most of ANB's problems in 2005; however, it took no forceful action until 2007.

In addition, we noted that OCC's guidance and examination procedures related to bank use of wholesale funding, including brokered deposits and other non-retail deposit funding sources, is general. According to OCC officials, OCC initiated a lessons-learned review of the ANB failure. While it had done such reviews in the past, OCC did not have a formal policy for conducting lessons-learned reviews of bank failures when conditions warrant.

We are recommending that OCC (1) re-emphasize to examiners that examiners must investigate closely an institution's circumstances and alter supervisory plans, if certain circumstances exist as specified in OCC guidance, (2) re-emphasize to examiners that formal enforcement action is presumed warranted when certain circumstances exist and to document the reason for not taking formal enforcement action, (3) reassess guidance and examination procedures in the Comptroller's Handbook related to bank use of wholesale funding with a focus on heavy reliance on brokered deposits and other non-retail deposit funding sources for

growth, and (4) establish in policy a “lessons-learned” process to assess the causes of bank failures and the supervision exercised over the institution and to take appropriate action to address any significant weaknesses or concerns identified.

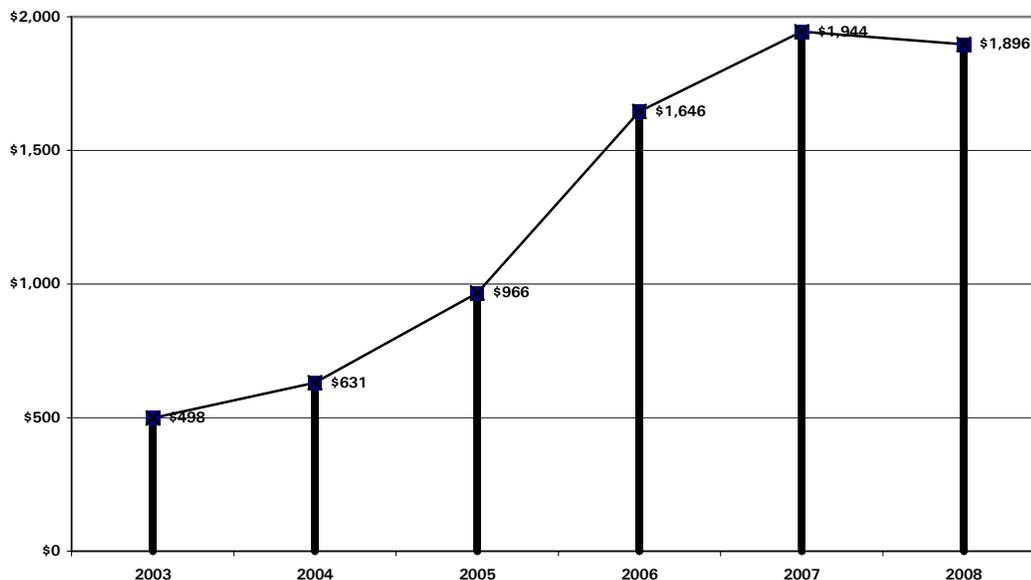
In a written response, OCC agreed that, in the case of ANB, there were shortcomings in its execution of its supervisory process and that it was appropriate to take additional measures to reinforce these principles to OCC examining staff. The steps taken and planned as outlined in OCC’s response are generally responsive to our recommendations, although we believe additional action is needed to institutionalize the lessons-learned process. The response also did not identify estimated dates for completing planned actions, which OCC will need to develop and record in the Joint Audit Management Enterprise System (JAMES), the Department of the Treasury’s audit recommendation tracking system. OCC’s response and our evaluation are discussed in more detail in the Recommendations section of this report. The response is provided as Appendix 6.

Causes of ANB’s Failure

Aggressive Growth

Beginning in 2004, ANB embarked on a strategy of aggressive growth. From the end of 2003 to the end of 2007, the bank’s total assets grew fourfold from about \$500 million to nearly \$1.95 billion. Management achieved this asset growth principally through originations of CRE loans, including loans originated through out-of-state loan production offices (LPOs) located in Utah, Wyoming, and Idaho. This aggressive growth strategy resulted in a 27 percent increase in its total assets in 2004, a 53 percent increase in 2005, a 70 percent increase in 2006, and an 18 percent increase in 2007. The following chart illustrates ANB’s asset growth from December 31, 2003, through March 31, 2008:

Chart 1. ANB Asset Growth, 2003 to 2008 (in millions)*



Asset amounts as of December 31 of each year, except 2008, which is as of March 31
Source: OIG analysis

Although ANB had projected an 8 percent growth rate for 2004, the actual rate—27 percent—strained staffing levels and caused controls to lapse. As discussed further below, such lapses included, but were not limited to, the lack of uniform or centralized loan processing procedures, no senior loan officer with sufficient authority to ensure the safe and sound operation of the bank, and inadequate strategic and capital plans. Inadequate controls led to the bank's failure to obtain appraisals before funding one real estate transaction in the amount of \$6.2 million as required by federal banking regulations,¹ failure to document evaluations by an independent bank officer for real estate transactions below \$250,000, and issuance of real estate loans with no initial borrower equity.

¹ 12 C.F.R. 34.43 requires an appraisal by a state certified or licensed appraiser for all real estate transactions greater than \$250,000. For transactions less than \$250,000, an evaluation by an internal officer independent of the transaction is sufficient. The examiners noted appraisals were not obtained for the purchase of various tracks of land under one real estate transaction during the 2005 examination. The violation was corrected during the examination—ANB obtained the necessary appraisals.

For 2005, ANB management projected an asset growth rate of 15 percent. The actual rate, however, was 53 percent, which reflected management's focus on increasing issuances of CRE loans, including loans issued through out-of-state LPOs. ANB opened its first LPO in St. George, Utah, in January 2005, and its second in Jackson, Wyoming, in May 2005. ANB opened a third LPO in Idaho Falls, Idaho, in May 2007. From January 2005 to December 2007, the bank's real estate loan portfolio increased from \$440 million to \$1.6 billion and its construction and development loans increased from 22 percent to 73 percent of gross loans during the same time period. By March 2008, approximately 63 percent of ANB's loan portfolio was originated through the Utah, Idaho, and Wyoming LPOs.

Beginning in 2005 and throughout the remainder of its existence, ANB experienced continuous deterioration in asset quality because its credit risk management systems did not keep pace with its rapid growth. For example, loan losses recognized in 2005 were the highest in the bank's history and nonperforming loans were twice the national average for banks of ANB's size and characteristics. In addition, by June 2007 adversely classified assets represented 109 percent of capital, and ANB's 2007, net after-tax losses amounted to \$120.4 million.

ANB's volume of problem assets continued to increase significantly as ANB's board and management pursued aggressive growth that increased the bank's concentration in CRE loans without adequate systems and controls for managing credit risk, safe and sound loan underwriting, and adequate staffing. The board took these actions despite being told by OCC examiners in the 2006 examination that the board needed to refocus its attention on ANB's risk management program, including compensation practices, and reinforce risk controls and monitoring.²

² ANB's compensation practices included compensating officers based on the volume of new loans presented for approval regardless of the loans' quality. OCC, in its February 2007 report of examination (ROE), highlighted ANB's need to ensure that compensation practices consider loan quality, prudent underwriting, and ongoing supervision of an officer's loan portfolio.

Inadequate Controls

As it aggressively grew, ANB did not implement commensurate internal controls. As OCC identified and reported deficiencies, the bank did not correct them in a timely manner. These deficiencies are described below.

Lack of Uniform Loan Processing Procedures for LPOs

ANB had no uniform or centralized loan processing procedures to be followed by its LPOs. The lack of standardized procedures resulted in inconsistent application of loan approval and loan administration standards. For example, according to internal ANB documents, there were instances where construction and development loan disbursements were made at one of the LPOs based on draw requests with overstated completion percentages.³ In these instances, the loan officer did not conduct an on-site inspection of the development project before the disbursements were made.

No Senior Loan Officer Until 2007

Despite the growth of its assets to more than \$1.6 billion by the end of 2006, ANB did not hire a senior loan officer until after OCC required it in a formal agreement issued in June 2007. By then, the adverse effects of ANB's previous unsound credit risk management practices could not be overcome. A qualified senior loan officer typically supervises the loan portfolio and installs systems to control credit risk.

Inadequate Strategic and Capital Plans

ANB management failed to adopt long-range/comprehensive strategic and capital plans. Although ANB had a strategic planning process, the plans produced were inadequate given the bank's risk profile and growth. ANB's strategic planning process did not establish objectives based on such factors as the bank's overall risk profile, earnings performance, growth, capital adequacy, and

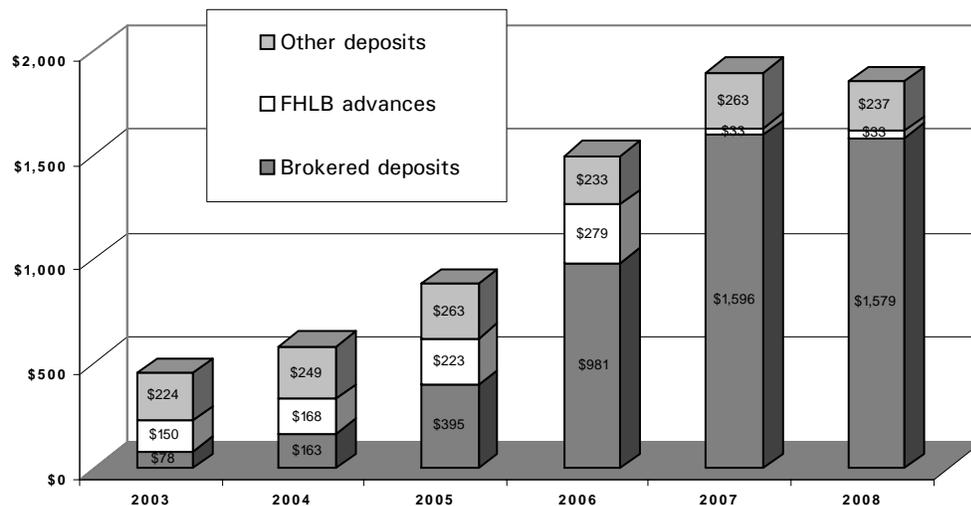
³ After a bank approves a construction and development loan, it disburses funds incrementally. A borrower submits a draw request (an application requesting a disbursement of funds) that indicates, as a percentage, the completion status of the project.

balance sheet mix. It also did not include detailed action plans, timetables for accomplishment, and assignment of key responsibilities. Further, ANB lacked an adequate capital plan that included projections for asset growth, primary sources to rely on to strengthen its capital structure, and alternatives to the primary sources.

Heavy Reliance on Wholesale Funding to Fuel Growth

Due to a highly competitive local banking environment for attracting deposits, ANB relied extensively on wholesale funding sources, primarily brokered deposits and borrowings from the Dallas Federal Home Loan Bank (FHLB) to fuel its growth. The following chart shows a comparison of ANB’s brokered deposits to its other funding sources.

Chart 2. ANB Funding Sources, December 31, 2003, to March 31, 2008 (in millions)



Source: OIG analysis of OCC reports of examination (ROEs) of ANB.

ANB’s liquidity sources were heavily concentrated in brokered deposits, which management acquired from several different brokers. Brokered deposits are generally highly interest-rate sensitive and therefore less stable as a deposit source than retail deposits. ANB mitigated this risk somewhat through such measures as obtaining the longest terms possible, requiring brokers to bid against one another for brokered certificates of deposit contracts, and obtaining options to call the funding in a declining rate

environment. ANB's brokered deposits reached \$981 million in 2006. This amount made up 65 percent of ANB's funding base in 2006, an increase from 45 percent in 2005. OCC examiners determined that ANB's liquidity was adequate but that its liquidity risk was high. The examiners projected that reduced loan growth, as promised by ANB's management, would likely stabilize the liquidity risk. In the 2006 examination, the examiners concluded that ANB's management had the expertise to monitor and control ANB's wholesale funding and put in place a process for adequate short- and medium-term liquidity.

During the 2007 examination, OCC examiners found that a funding strategy that relied heavily on brokered deposits had been reasonable when ANB had satisfactory credit quality but that such reliance was no longer appropriate, especially as it deployed brokered deposits into a high-risk CRE concentration. The examiners also determined that ANB's capital levels were not satisfactory in light of ANB's overall deteriorating conditions. Although ANB's capital ratios reflected the well-capitalized category for PCA purposes, OCC downgraded ANB's capital level to adequately capitalized as a result of the formal agreement issued in June 2007.

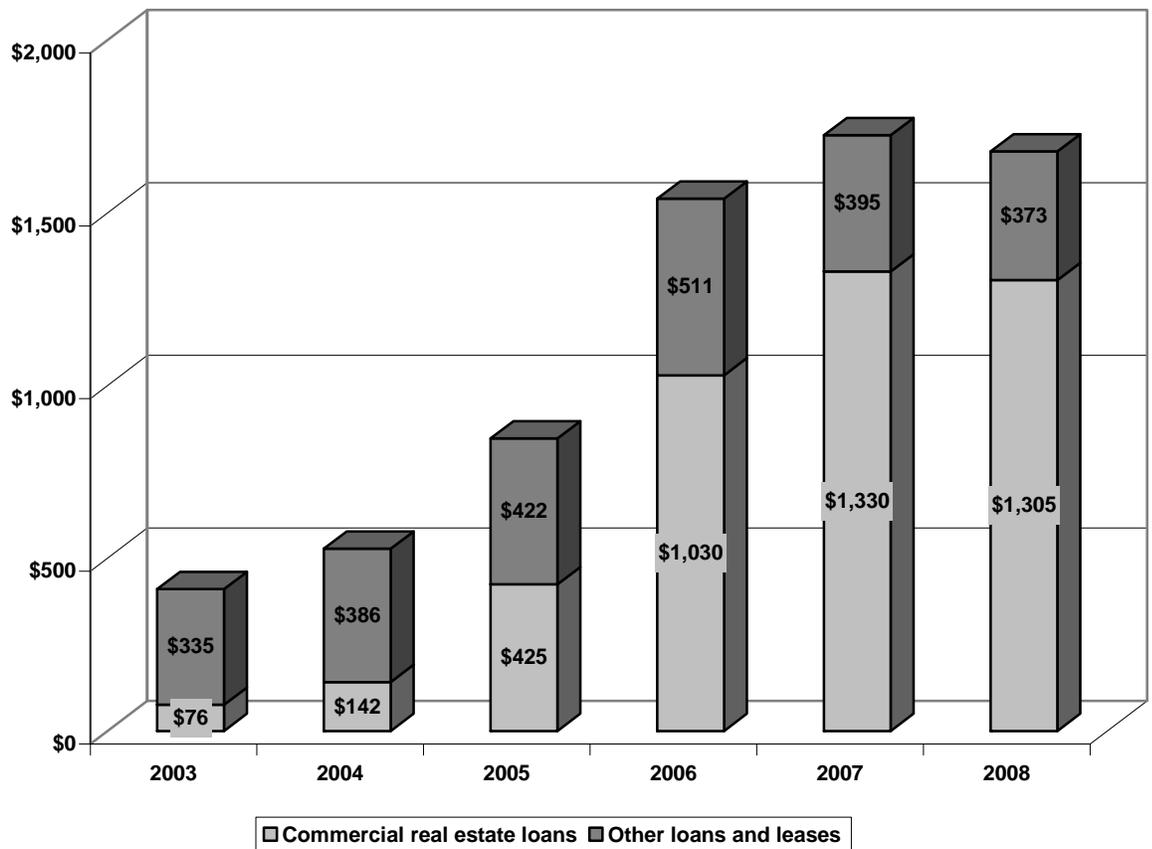
The Federal Deposit Insurance Corporation Improvement Act requires that acceptance of brokered deposits can only be made by well-capitalized institutions that exceed the minimum PCA requirements. Therefore, when ANB fell below the well-capitalized threshold additional brokered deposits were no longer available to it as a funding source. ANB's contingency funding plan failed to identify alternatives to brokered deposits, and FHLB restricted its borrowings in September 2007 because of the bank's worsening financial condition.

By March 31, 2008, ANB's brokered deposits totaled about \$1.58 billion, or 87 percent of total deposits. Using brokered deposits as a funding source may have been a reasonable strategy had ANB maintained satisfactory credit quality. However, by 2007, the bank's increasing problems with risk management control, asset quality, and deteriorating capital levels made brokered deposits inappropriate as a continuing funding source for ANB.

High Concentration of CRE Loans

ANB's increased issuance of CRE loans led to its rapid growth in assets. These loans included construction and development loans issued through LPOs in Utah, Idaho, and Wyoming. By March 2008, loans issued by the three LPOs accounted for approximately 63 percent of ANB's loan portfolio. Chart 3 details the growth in the share of ANB's CRE loans, compared to its other loans.

Chart 3. Distribution of ANB Loans and Leases, 2003-2008 (in millions)



Source: OIG analysis of OCC ROEs of ANB.

Note: Amounts shown for 2008 are as of March 31, 2008. All other amounts are as of December 31.

Financial institutions with high concentrations of CRE loans require strong concentration risk management practices.⁴ However, while ANB's board and management established general limits for concentrations for raw land, land development, and home construction lending, they did not develop adequate policies, procedures, and reporting to ensure effective measurement, monitoring, and control of concentration risk. Without clear guidance regarding the level of concentration risk exposure acceptable to the board, management took undue risks and did not respond in an appropriate manner to changes in the market, economy, or borrowers' circumstances. The board and management were deficient in ensuring ongoing identification of significant concentrations. In this regard, OCC examiners reported in the 2007 ROE that ANB's CRE portfolio exceeded board-approved concentration limits in Utah and that it reflected management's lack of adequate control.⁵ ANB also lacked a uniform, centralized process necessary to support ongoing monitoring of CRE loans.

The examiners required, among other things, ANB's board and management ensure ongoing evaluation of CRE concentrations, formalize support for established concentration limits (including a synopsis of management's market analysis), aggregate the results of stress testing individual borrowers into the concentration risk summary report, and address underwriting limitations within the loan policy when concentrations approach or exceed limits established by the board.

The downturns in the real estate market increased the effects of ANB's poor concentration risk management of the loan portfolio. As of January 31, 2008, nearly \$1.25 billion, or 71 percent, of

⁴ OCC Bulletin 2006-46, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, December 6, 2006, states that strong risk management practices and appropriate levels of capital are essential elements of a sound CRE lending program. The guidance sets forth sound risk management practices that an institution should employ when it has CRE concentration risk. Credit concentrations are broadly defined as groups or classes of credit exposures that share common risk characteristics or sensitivities to economic, financial, or business developments. CRE loans are loans with risk profiles sensitive to the condition of the general CRE market. The guidance describes sound risk management practices that will enable institutions to pursue CRE lending in a safe and sound manner.

⁵ ANB's board approved concentration limit for Utah was 1 percent of total risk-based capital. ANB's Concentration of Credit Report dated June 30, 2006, reports the actual concentration as 1.5 percent.

ANB's \$1.75 billion in loans were CRE loans, including land development loans, undeveloped land loans, and residential construction loans. Of these CRE loans, 39 percent were secured by properties in Utah; 32 percent by properties in Arkansas; 18 percent by properties in Idaho, Nevada, and California; and the remaining 11 percent elsewhere. As growth slowed in previously expanding markets where ANB operated, such as Arkansas and Utah, demand for housing in those markets decreased. As a result, by January 31, 2008, ANB had over \$827 million in problem loans, or 445 percent of capital. Of the \$827 million in problem loans 92 percent were CRE loans.

Unsound Credit Underwriting and Administration

Deficiencies in ANB's credit underwriting and administration process also contributed to its failure. For example, loan presentation memoranda that OCC reviewed did not formally document an analysis of risks and mitigating factors inherent in a credit relationship because loan presentations did not consistently include sufficient detail of the project plan. In addition, loan files did not contain periodic updates on the status of development loans, including whether the development was progressing as scheduled, any changes in market fundamentals, or whether sufficient interest carry remained in the budget to complete the project.

By 2006, the combination of CRE loan concentrations, the softening of the residential real estate market, and weaknesses in ANB's credit risk management practices resulted in deterioration of ANB's asset quality and an increase in the volume of adversely classified and criticized assets. ANB's need for capital injections in 2005 and its plan to infuse additional capital in 2006 reflected the inability of earnings to directly support the capital levels necessary for its growth.

On June 25, 2007, OCC entered into a formal written agreement with ANB's board of directors. The agreement addressed deficiencies identified during the 2007 examination and required ANB to improve its management, asset quality, and capital levels. On January 29, 2008, ANB's holding company and the Board of Governors of the Federal Reserve System (Federal Reserve) also

entered into a formal agreement due to the unsatisfactory condition of the bank. The agreement required the holding company—ANB Bancshares, Inc.—to submit an acceptable written consolidated capital plan to the Federal Reserve within 45 days of the agreement. The holding company was also required to submit an acceptable written plan for servicing its outstanding debt and other obligations (for 2008 and 2009) without incurring additional debt. This formal agreement followed an inspection of ANB Bancshares, Inc., by the Federal Reserve in September 2007. Based on the inspection, the Federal Reserve concluded that ANB’s holding company was highly leveraged, had strained cash flow and liquidity, and was unable to serve as a source of strength to the bank during this time of deteriorating asset quality.

As things continued to deteriorate, OCC issued a notice under PCA that required ANB to submit a capital restoration plan (CRP) by March 6, 2008. The bank submitted a CRP on that date and later submitted a supplement to the CRP that proposed the sale of ANB in its entirety through an investment bank on or before May 5, 2008. However, OCC deemed the CRP unacceptable because it lacked detailed information about the bank’s proposals, financial analyses of the proposals, information about the risks to the bank, and required guarantees from the bank’s holding company.

On May 1, 2008, the bank submitted a partial divestiture plan to OCC. The plan proposed the sale of eight branches, most of the branches’ performing loans, and most of ANB’s core retail deposits. OCC also considered this plan unacceptable because it did not meet minimum CRP requirements, was not based on realistic assumptions, was unlikely to succeed in restoring capital, would likely increase the risks to the bank, and failed to contain an appropriate guarantee by ANB’s holding company.

With ANB’s earnings and capital continuing to decline and its failure to sell all or part of the bank, OCC exercised its authority on May 9, 2008, to close the institution and appointed FDIC as receiver. At the time of its closure, the estimated loss to the Deposit Insurance Fund was \$214 million.

OCC's Supervision of ANB

OCC conducted timely and regular examinations of ANB and provided oversight through its off-site monitoring. In addition, OCC appropriately implemented PCA in reclassifying ANB's capital levels and restricting ANB activities. Also, OCC's Special Supervision Division took appropriate supervisory actions after oversight of ANB was transferred to it. However, as discussed below, we believe that OCC did not issue a formal enforcement action in a timely manner, and was not aggressive enough in the supervision of ANB when problems first arose in light of the bank's rapid growth, high concentrations in CRE loans, reliance on brokered deposits, and weak credit risk management practices. OCC identified most of ANB's problems in 2005; however, it took no forceful action until 2007.

In addition, we noted that OCC's guidance and examination procedures related to bank use of wholesale funding, including brokered deposits and other non-retail deposit funding sources, is general. According to OCC officials, OCC initiated a lessons-learned review of the ANB failure. While it had done such reviews in the past, OCC did not have a formal policy for conducting lessons-learned reviews of bank failures when conditions warrant.

Table 1 summarizes the results of OCC's annual safety and soundness examinations from the ROEs starting with the 2004 examination cycle. Appendix 5 provides details of matters requiring attention and other recommended actions in the ROEs.

Table 1. Summary of OCC ANB Examinations and Enforcement Actions

Date started	Assets (in millions)	CAMELS rating	Examination Results		
			Number of matters requiring attention ⁶	Number of other recommended actions	Formal enforcement actions
1/5/2004	\$498	1/211121	0	2	None
3/9/2005	\$631	1/212121	2	5	None
2/1/2006	\$966	2/222221	0	6	None
2/23/2007	\$1,646	3/233221	5	1	Formal agreement issued 6/25/2007
10/1/2007	\$1,944	4/344342	7	1	Formal agreement issued 6/25/2007
2/5/2008	NA	PCA notice	-	-	Notice of undercapitalization issued
2/27/2008	NA	PCA notice	-	-	Notice of significant undercapitalization issued
4/29/2008	NA	PCA notice	-	-	Notice of critical undercapitalization issued

Source: OCC ROEs and ANB [call reports](#)

Forceful Action Not Taken in a Timely Manner to Address ANB's Problems

2005 Examination Identified Significant Problems at ANB But the Bank Received Highest Rating

ANB's problems first surfaced in 2005 with its pursuit of aggressive loan growth without commensurate controls and risk management practices. OCC reported in the 2005 ROE that management was pursuing an aggressive growth strategy, as evidenced by a 27 percent increase in total assets from year-end 2003 to year-end 2004.⁷ In particular, examiners noted that ANB significantly increased its total outstanding loans through CRE loans originated at its LPO office in Utah. The examiners also noted

⁶ Matters requiring attention identified in OCC ROEs are not enforcement actions. However, failure by a bank's board and management to address the matters could lead to an enforcement action.

⁷ Financial information in the 2005 ROE was as of December 31, 2004.

that the aggressive growth strained ANB's capital base and increased ANB's reliance on wholesale funding for liquidity.

Furthermore, OCC reported in the 2005 ROE that ANB's credit risk was increasing because of its aggressive growth strategy, increases in competitive pressures, and the complexity of its operations. OCC further reported that while overall credit risk management remained strong, management needed to address certain practices and credit administration issues that exposed ANB to increased risk and indicated a potential erosion of underwriting standards. OCC also reported increased policy exceptions and specific deficiencies in audit and information technology (IT). In reviewing the documentation of the examiners' work for this examination, we could not determine how OCC reached these conclusions. Specifically, the examination documentation was insufficient to determine what examination procedures were completed and what support the examiners had for their conclusions.⁸

On June 14, 2005, OCC's Western District placed ANB on the district's watch list because of concerns about the bank's rapid, uncontrolled growth.⁹ Despite the risky conditions mentioned above and being added to the district's watch list, OCC's 2005 ROE contained only two matters requiring attention by ANB. One matter requiring attention advised ANB to strengthen internal controls and oversight to ensure adherence to board-approved policies and prevent violations of federal regulations. The other matter requiring attention advised the bank that during periods of growth it was imperative for the board to ensure that adequate credit administration and IT policies and practices remain in place to minimize potential risk.

Despite these concerns and OCC's downgrading of ANB's management rating from 1 to 2 due to deficiencies in the audit

⁸ In contrast to the 2005 examination, documentation of procedures performed and support for conclusions reached was much more extensive for the 2004, 2006, and 2007 ROEs.

⁹ Each OCC district maintains a watch list of banks that deserve close attention. The weaknesses of watch list banks are not pervasive enough for them to be designated as problem banks, and watch list banks are not adversely rated (i.e., their CAMELS composite rating is 1 or 2).

function and credit administration,¹⁰ it gave the bank a CAMELS composite rating of 1 (the highest rating possible). When we asked the OCC examiner-in-charge for the 2005 examination about why a composite rating of 1 was issued given these conditions, he stated the composite rating of 1 was justified because asset quality and earnings were good and interest rate risk (sensitivity to market risk) was low.¹¹ In this regard, these components of the CAMELS components received a rating of 1 in the 2005 examination.

In its watch list dated December 9, 2005, OCC's Western District again noted its concerns about ANB's increasing credit risk, given the CRE concentration and increased volume and complexity of ANB's loan portfolio.

2006 Examination Identifies Continuing and Additional Problems But Forceful Action Still Not Taken

The combination of the concentration of CRE loans in ANB's portfolio, the softening of the residential real estate market, and weaknesses in ANB's credit risk management practices resulted in further problems for ANB in 2006. Based on concerns reported in the 2005 ROE, OCC expanded the scope of its supervisory activities for ANB which included a review of asset quality and expansion of procedures performed in the areas of credit, IT, and compliance. This expansion of scope did not include site visits to the LPOs; however, OCC officials stated that such visits are an option for the examiners. OCC reiterated its concerns about ANB's rapid growth in the 2006 ROE and reported that while ANB's capital remained adequate in relation to the risk profile, the bank's asset quality had deteriorated. ANB's loan portfolio grew 60 percent in 2005, and its total assets as of year-end 2005 were \$966 million, a 53 percent increase over year-end 2004.¹² OCC examiners also noted that earnings declined in 2005 and by themselves were insufficient to maintain adequate capital levels.

¹⁰ OCC reported that the board's efforts to comply with the requirements of 12 C.F.R. §363 needed improvement, as the board had not formed an independent audit committee. In addition, some 2003 external audit IT recommendations had not been resolved, the disaster recovery plan needed updating, and additional enhancements were recommended to the information security risk assessment process.

¹¹ The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital.

¹² Financial information in the 2006 ROE was as of December 31, 2005.

The examiners commented that the need for capital injections in 2005 and ANB's plans for an additional injection in 2006 reflected the inability of ANB's current earnings to provide for adequate capital through retained earnings.

Although OCC examiners deemed ANB's overall condition and supervision by the board satisfactory, they noted that the bank's significant concentrations in land development, construction, and raw land loans increased its asset quality risk. By 2005, half of ANB's loan portfolio was concentrated in construction and land development loans, a 300 percent increase from 2004. In addition, the examiners found a high level of real estate loans that exceeded ANB's supervisory loan-to-value guidelines. Furthermore, OCC examiners noted that 1.03 percent of ANB's total loans were nonperforming—twice the national average; the volumes of identified problem assets and criticized loans had increased from \$11 million to \$15 million and from \$3.6 million to \$11.3 million, respectively, since the 2005 ROE; and the more than \$4.8 million in loan losses recognized by ANB in 2005 were the highest in the bank's history.

ANB remained on OCC's Western District watch list because of OCC's continued concerns about the bank's rapid, uncontrolled growth. However, despite downgrading ANB's composite, asset quality, and earnings ratings from 1s to 2s and its concerns about the bank's aggressive growth, concentration in CRE loans, and insufficient earnings retention to maintain adequate capital levels, OCC did not, as a result of the 2006 examination, take formal enforcement action, or include any matters requiring attention in the 2006 ROE.

When asked about this, the OCC examiner-in-charge who conducted the 2006 examination commented that in his opinion more aggressive action was not taken because the overall condition of the bank was still considered okay. Additionally, he stated that in his opinion ANB's management was committed to correcting the problems, OCC did not have a basis to support a recommendation to stop growth, and ANB's earnings were still good.¹³

¹³ This examiner was in charge of the examinations of ANB conducted in 2003 through 2006. A different examiner was put in charge of the 2007 examination.

According to *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* (OCC Examiner's Guide), when performing supervisory activities at a bank experiencing rapid growth, examiners must investigate closely the institution's circumstances and alter supervisory plans if one or more of the following conditions exist:

- Growth varies significantly from the bank's budget or strategic plan.
- The risk profile is higher than anticipated.
- Bank underwriting and risk selection standards have been revised.
- Minimal or no changes have been made to the bank's internal control structures.
- Capital levels are declining rapidly.
- Funding sources are unstable or short-term.
- New products and activities are being pursued with little or no expertise or with inadequate risk management controls.
- Growth is influenced heavily by brokered or agent transactions.¹⁴

Four of these eight conditions clearly existed when OCC conducted the 2006 examination. According to OCC's 2006 ROE, (1) ANB's asset growth exceeded original budget projections, (2) its credit risk profile was increasing, (3) the opening of another LPO left ANB's credit risk management controls in need of enhancement, and (4) its growth was being influenced heavily by the use of brokered deposits.

In addition, according to the OCC Policies and Procedures Manual, "Bank Supervision Operations—Enforcement Action Policy," there is a presumption in favor of formal enforcement action when a bank is experiencing serious problems or weaknesses in its systems, controls, internal audit program, operating policies, methods of operations, or management information systems, even if the problems have not yet resulted in a change of rating or have not been reflected in the bank's financial performance or condition.¹⁵ Nevertheless, OCC did not elevate its supervision of

¹⁴ OCC, *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* (January 2001), p. 5.

¹⁵ OCC Policies and Procedures Manual (PPM) 5310-3.

the bank until June 25, 2007, when the formal agreement was issued.

On another matter, examiners first expressed concern in 2005 with credit risk management practices that exposed ANB to increased risk and potential erosion of underwriting standards. OCC again advised ANB in the 2006 ROE to strengthen its policies. The credit risk profile of ANB increased to high in 2006 due to the deterioration in the quality of the loan portfolio since the 2005 examination. However, as noted earlier, the 2006 ROE contained no matter requiring attention that directed ANB to address weaknesses in its credit risk management policies. Subsequently, in 2007, ANB continued to have a credit risk rating of high. OCC examiners wrote, "The lack of robust concentration risk management and credit risk management systems, and an insufficient control structure in advance of aggressive loan growth, reflect weak credit risk management and expose the bank to undue risk."

Given the increasingly deteriorating conditions noted beginning with the 2005 ROE, along with OCC guidance concerning banks experiencing rapid growth,¹⁶ and OCC's enforcement action policy,¹⁷ more aggressive supervision and more timely formal enforcement action by OCC were warranted. If OCC had acted more aggressively and sooner, ANB might have acted earlier or differently to address its problems.

OCC Took Formal Action Against ANB When 2007 Examination Found Further Deterioration

As a result of the 2007 examination, OCC downgraded ANB's CAMELS composite, asset quality, and management ratings from 2s to 3s because of increased credit risk, weaknesses in credit administration and risk controls, aggressive growth (a 70 percent increase in total assets from the prior year), and an increasing concentration in CRE loans (77 percent of ANB's loan portfolio). OCC's 2007 ROE for ANB contained the following five matters requiring attention. Specifically, OCC recommended ANB:

¹⁶ OCC Examiner's Guide, Appendix A, Guidance for Supervising Banks Experiencing Rapid Growth.

¹⁷ OCC Policies and Procedures Manual (PPM) 5310-3.

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1. Hire a senior loan officer.
 2. Ensure that all underwriting and credit administration practices are commensurate with the level of risk in the loan portfolio.
 3. Enhance the independence of the real estate appraisal ordering and review process.
 4. Enhance the bank's concentration management practices.
 5. Adopt and implement a strategic plan for all areas of the bank covering at least a 3-year period.

In addition, OCC designated ANB in "troubled condition"¹⁸ on April 26, 2007, and, as previously noted, entered into a formal agreement with ANB on June 25, 2007, to address ANB's deficiencies and improve ANB's management, asset quality, and capital levels. The formal agreement required that ANB appoint a senior loan officer to improve ANB's overall management; develop a 3-year written action plan for its strategic goals; achieve and maintain certain capital ratios; establish contingency plans; and improve its credit and concentration risk management systems, particularly in connection with CRE loans and appraisals. The formal agreement also limited the financial conditions under which ANB could declare a dividend.

On October 1, 2007, OCC began an on-site examination to assess compliance with the formal agreement. OCC expanded the review to a full-scope examination as a result of finding a significant increase in ANB's credit risk. Examiners found that ANB did not identify problem loans in a timely manner, and that there was a significant increase in the number of problem assets with inaccurate risk ratings. Examiners concluded that ANB had not complied with four of the five requirements in the formal agreement. The examiners also reported that the board's actions did not reflect sound risk management processes; ANB's risk management practices in credit, liquidity, and strategic risks were inadequate; and ANB's system for rating loan risk and reviewing loans was ineffective.

¹⁸ A bank that is designated in "troubled condition" is required to obtain approval from OCC for the addition or employment of all senior officers and directors.

OCC Officials Recognized Supervision of ANB Should Have Been More Aggressive

OCC's Western District officials acknowledged by 2007 that supervision of ANB had not been effective. As part of OCC's Federal Managers' Financial Integrity Act (FMFIA) process, senior officials provide annual assurance statements to the Comptroller on whether the management controls for their area of responsibility are achieving the intended results, consistent with OCC's mission and following rules and regulations, and that timely and reliable information is used for decision making.¹⁹ In this regard, the Deputy Comptroller of the Western District stated in her fiscal year 2007 assurance statement that although OCC had identified ANB's growth as a concern, it had not addressed risk management deficiencies aggressively enough. The statement also said that supervision of the bank had been elevated, a formal enforcement action had been issued, and the supervisory strategy had been revised. In an interview, the OCC Assistant Deputy Comptroller at the OCC field office responsible for supervision of ANB agreed with this assessment.

In an interview, the Deputy Comptroller of the Western District expanded on the 2007 FMFIA Annual Certification Statement by acknowledging that the examiners could have more aggressively supervised ANB during 2005 and 2006. She believed that more matters requiring attention and recommendations, along with a stronger tone, could have been used in the ROEs during those years. She also said if OCC had been more aggressive and ANB management had responded to OCC recommendations, it might have made a difference.

Subsequent to the issuance of the certification statement, the OCC Western District: (1) reemphasized to the Assistant Deputy Comptrollers and the staff the importance of aggressively following up on matters requiring attention and ensuring that the banks have strong risk management systems to support high levels of concentrations and/or rapid growth; (2) initiated a review of 13 banks in the Western District with significant CRE concentrations to gather information about the quality and trend of underwriting,

¹⁹ FMFIA requires agencies to perform regular evaluations of management controls and financial management systems to protect against fraud, waste and abuse.

accuracy of risk ratings, and quality of ongoing monitoring, as well as to form some conclusions about the overall health of several CRE markets across the district; and (3) performed a quality assurance review to determine whether the examiners followed up on prior matters requiring attention.

In the review of banks with significant CRE concentrations, OCC's Western District found (1) asset quality deterioration of varying degrees, (2) initial underwriting and risk selection were generally satisfactory but some underwriting practices caused concern, and (3) CRE risk management systems and processes still needed improvement. According to the Deputy Comptroller of the Western District, the OCC Western District is performing a number of targeted reviews to better quantify the CRE risk, as well as the impact of the slowdown in housing in many markets. In the quality assurance review, OCC Western District found matters requiring attention were (1) usually developed for significant issues, with some exceptions, (2) consistent between the ROE and the OCC examination database, (3) documented with current status for outstanding matters requiring attention, (4) adequately documented in the OCC examination database, and (5) consistent with OCC guidance with some exceptions. The results of this quality assurance review were shared with Western District personnel.

We asked the examiner-in-charge during the 2003 through 2006 examinations whether there should have been more aggressive action taken by OCC sooner. He stated that by looking back, examiners needed a stronger tool to address concentration limits. In his opinion, concentration limits should be set to 25 percent of capital and that examiners should be given more authority to encourage and set limits. He further stated that an interagency guideline on concentration was issued in December 2006 that gave examiners more authority to provide guidance to the bank regarding concentration limits.²⁰

²⁰ OCC, Federal Reserve and FDIC issued joint guidance on concentrations in CRE lending in December 2006 – *Guidance on Concentrations in Commercial Real Estate Lending - Sound Risk Management Practices*. The guidance was issued to address institutions' increased concentrations of CRE loans and reinforces and enhances the existing regulations and guidelines for real estate lending and loan portfolio management. The guidance does not establish specific CRE lending limits; rather, it promotes sound risk management practices and appropriate levels of capital that will enable institutions to continue to pursue CRE lending in a safe and sound manner.

Based on the 2007 OCC Western District FMFIA Annual Certification statement, the results of the 2006 examination, and interviews with OCC officials and examiners, we believe that OCC should have taken formal enforcement action after its 2006 examination of the bank when OCC restated its concerns about the bank's growth, credit risk management, and concentration in CRE loans and downgraded ANB's CAMELS composite, assets, and earnings ratings.

Prompt Corrective Action Used Appropriately

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund.²¹ PCA provides federal banking agencies with the authority to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility to discipline institutions based on criteria other than capital to help reduce deposit insurance losses caused by unsafe and unsound practices. For example, OCC's Enforcement Action Policy allows for the imposing of more severe limitations than a bank's PCA capital category would otherwise permit or require if it is determined that the bank is in an unsafe or unsound condition or engaging in unsafe or unsound practices.

OCC took supervisory action under PCA to reclassify ANB's capital level during 2007. Specifically, as a result of the February 2007 examination and issuance of the formal agreement, OCC designated ANB's capital level as adequately capitalized even though ANB's capital level met the definition of well-capitalized. Because it was designated adequately capitalized, ANB was prohibited from accepting or renewing brokered deposits unless it obtained a waiver from FDIC. ANB did request a brokered deposit waiver from FDIC in July 2007 but withdrew the request in December 2007.

As ANB's capital levels fell in 2008, OCC designated the bank as undercapitalized on February 5, 2008, significantly undercapitalized on February 27, 2008, and critically undercapitalized on April 29,

²¹ 12 U.S.C. § 1831o and 12 C.F.R. § 6.

2008. We believe OCC appropriately implemented PCA in reclassifying ANB's capital to these levels.

OCC's Guidance on Brokered Deposits Was General

OCC's Comptroller's Handbook provides examiners guidance on liquidity risk management and examination procedures to assess a bank's liquidity condition including the use of wholesale funding sources such as brokered deposits. The examination procedures include determining the bank's degree of reliance on credit sensitive wholesale funds providers, evaluating the level of risk in wholesale funding activities including reviewing concentrations in funding sources, and determining compliance with requirement that brokered deposits can only be accepted by well-capitalized institutions. The guidance, however, did not provide benchmarks or more specific guidance as to when examiners should start to raise concerns with bank management about the use of brokered deposits and other non-retail deposit funding sources.

As discussed above, brokered deposits were used by ANB to fuel its rapid growth and ANB's liquidity sources became heavily concentrated in brokered deposits, as shown in Chart 2. In 2007, brokered deposits became unavailable to ANB when its capital level was downgraded to adequately capitalized and ANB's contingency funding plan failed to identify alternative funding sources which left ANB in a weak liquidity position. Prior to ANB's failure, OCC did identify ANB's reliance on brokered deposits as an unsafe and unsound practice.

Based on the following, we believe OCC should reassess its guidance and examination procedures related to brokered deposits.

- OCC acknowledged that ANB's reliance on brokered deposits was an unsafe and unsound practice.²²
- It has been reported that two other recent bank failures, IndyMac Bank, F.S.B. and Columbian Bank and Trust Co., have

²² May 7, 2008, memorandum from Special Supervision Division to Senior Deputy Comptroller, Midsize/Community Bank Supervision. Memorandum details the reasons Special Supervision Division recommended that OCC appoint the FDIC as receiver of ANB.

been blamed in part on a high concentration of brokered deposits.²³

- Recently issued guidance from FDIC on liquidity risk management recognizes the increased risk of the use of brokered deposits and describes FDIC's expectations for insured institutions for managing liquidity risk.²⁴

After Supervision of ANB Transferred to OCC's Special Supervision Division, Actions Taken Were Appropriate But Ultimately Unable to Prevent ANB's Failure

In December 2007, OCC's Western District reviewed a sample of CRE loans that, for the most part, it had not previously reviewed. The review revealed continued deterioration in loan quality and an increase of classified assets to 235 percent of Tier 1 capital and allowance for loan and lease losses. Based on this review, OCC notified ANB in a letter dated December 17, 2007 that the bank's composite CAMELS rating was downgraded to 5 and supervision of the bank was transferred to the Special Supervision Division.²⁵ The transfer of supervision to the Special Supervision Division at this time was appropriate as OCC's *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* states that supervisory responsibility transfers automatically once a bank is downgraded to a 5.

The Special Supervision Division directed the overall supervision of ANB from December 17, 2007, until ANB was closed on May 9, 2008. The Special Supervision Division supervisory actions included reviewing and commenting on required CRPs from ANB, working with FDIC and Federal Reserve personnel, and issuing PCA notices to ANB. These actions are detailed in Appendix 4 Chronology of Significant Events. We concluded that the Special Supervision Division did what it could, but with the rapidly deteriorating conditions at ANB, there was little that could be done

²³ American Banker, article "Guidance Offered on Brokered Funds" dated August 27, 2008.

²⁴ FDIC Financial Institution Letter "Liquidity Risk Management" dated August 26, 2008.

²⁵ The Special Supervision Division of the Mid-Size/Community Bank Supervision division supervises critical problem banks through rehabilitation or through other resolution processes such as orderly failure management or the sale, merger, or liquidation of such institutions. The Special Supervision Division is located at OCC Headquarters.

to rehabilitate the bank after the transfer of supervisory responsibility.

Other Matter – Lessons-Learned Reviews

Following the failure in 1999 of First National Bank of Keystone, OCC developed a plan to include performing a formal lessons-learned review when a bank fails. After Hamilton Bank failed in January 2002, the OCC Hamilton lessons-learned review project team conducted a review and issued its report in July 2002. The Hamilton lessons-learned review report documented several key issues, a description of action that OCC had taken, and recommendations for additional action. In our material loss review report on the Hamilton failure, we concluded that the lessons-learned review process provided OCC useful information to improve its supervisory process.²⁶

OCC has not completed a lessons-learned review on ANB. OCC officials informed us that a review was started in September 2008. Current OCC policy does not require a lessons-learned review be performed when a bank fails.

As noted with the Hamilton failure, lessons-learned reviews can produce useful information to improve OCC's supervisory process outside and in advance of material loss reviews by our office. The performance of lessons-learned reviews also represents an important internal control, defined in the Government Accountability Office's *Standards for Internal Control in the Federal Government* as the plans, methods, and procedures used to meet missions, goals, and objectives.²⁷ Accordingly, we believe OCC should revisit and formalize in policy a process for conducting lessons-learned reviews of bank failures when conditions warrant.

²⁶ OIG, *Material Loss Review of Hamilton Bank, NA*, OIG-03-032 (Dec. 17, 2002).

²⁷ GAO/AIMD-00-21.3.1 (November 1999).

Recommendations

We recommend that the Comptroller of the Currency do the following:

1. Re-emphasize to examiners that examiners must closely investigate an institution's circumstances and alter its supervisory plan if certain conditions exist as specified in OCC's Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution.

Management Response

OCC plans to leverage the findings of this report and its lessons-learned review by communicating them to field staff to reinforce its expectations of examiners in the execution of its supervisory process. In addition to numerous policies and processes currently in place to ensure timely recognition and response to increasing risks in banks, including formal enforcement action if warranted, OCC provided guidance to examiners on assessing commercial real estate portfolios and discussed this guidance in April and October conference calls with examiners.

OIG Comment

OCC's actions, both taken and planned, meet the intent of our recommendation. OCC will need to establish an estimated completion date for its planned action to communicate the results of our review and its lessons learned review of the ANB failure, and record that date in JAMES.

2. Re-emphasize to examiners that formal enforcement action is presumed warranted when certain circumstances specified in OCC's Enforcement Action Policy (PPM 5310-3) exist. Examiners should also be directed to document in the examination files the reason for not taking formal enforcement action if those circumstances do exist.

Management Response

OCC plans on sharing the results of this report and its lessons-learned review with examiners to emphasize the importance of taking formal enforcement action when appropriate and consistent with policy and also of documenting the decision. OCC refreshed examiner awareness of OCC's Enforcement Action Policy and promoted consistency in the application of the policy in three ways: in a written document, through discussions at district management meetings, and during an all-examiner conference call in October 2008. The central message was, "In general, enforcement actions should be taken at an early stage, while problems are still manageable and the prospects for rehabilitation or, alternatively, sale or merger of the institution, are still good."

OIG Comment

OCC's actions, both taken and planned, meet the intent of our recommendation. OCC will need to establish an estimated completion date for its planned action to communicate the results of our review and its lessons-learned review of the ANB failure, and record that date in JAMES.

3. Reassess guidance and examination procedures in the Comptroller's Handbook related to bank use of wholesale funding with a focus on heavy reliance on brokered deposits and other non-retail deposit funding sources for growth.

Management Response

OCC agreed that the guidance and examination procedures in the Comptroller's Handbook should be refreshed with respect to wholesale funding, brokered deposits, and other liquidity related topics. The Office of the Chief National Bank Examiner has made updating this portion of the Handbook a priority. In the interim, OCC developed updated guidance, which was distributed to all examiners and discussed during an October 2008 all-examiner conference call.

OIG Comment

OCC's commitment to update the Comptroller's Handbook meets the intent of our recommendation. OCC will need to establish a planned completion date for this action in JAMES.

4. Establish in policy a "lessons-learned" process to assess the causes of bank failures and the supervision exercised over the institution and to take appropriate action to address any significant weaknesses or concerns identified.

Management Response

OCC will incorporate "lessons-learned" reviews of failed banks or other significant events into the quality assurance activities of Mid-size and Community Bank supervision, typically enumerated in annual business plans. OCC also noted its intent to share the results of its lessons-learned review of the ANB failure with examiners in an instructive manner.

OIG Comment

OCC's commitment to incorporate lessons-learned reviews into quality assurance activities of mid-size and community bank supervision is an important step to meet the intent of our recommendation. OCC's response, however, does not specifically state that the commitment will be incorporated in policy. We believe it should so that the lessons-learned review process is institutionalized. Also, such a process should not be limited to mid-size and community banks. Accordingly, while we consider this recommendation to be resolved, further action is needed for its implementation.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-5776 or Jeff Dye, Audit Manager, at (202) 927-0384. Major contributors to this report are listed in Appendix 7.

Susan L. Barron
Audit Director

We conducted this material loss review of ANB Financial, National Association, (ANB) in response to our mandate under section 38(k) of the Federal Deposit Insurance Act, as amended.²⁸ This section provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency, which shall

- ascertain why the institution's problems resulted in a material loss to the insurance fund,
- review the agency's supervision of the institution, including its implementation of the prompt corrective actions provisions of section 38, and
- make recommendations for preventing any such loss in the future.

Section 38(k) defines a loss as material if it exceeds the greater of \$25 million or 2 percent of the institution's total assets. The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

We initiated a material loss review of ANB based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of May 9, 2008, FDIC's Deposit Insurance Fund had recorded an estimated loss of \$214 million.

To accomplish our review, we conducted fieldwork at the Office of the Comptroller of the Currency's (OCC) headquarters in Washington, D.C.; its district office in Denver, Colorado; and its field office in Kansas City, Kansas. We also met with officials of FDIC's Division of Supervision and Consumer Protection and Division of Resolutions and Receiverships in Dallas, Texas.

To assess the adequacy of OCC's supervision of ANB, we performed interviews and reviews to determine (1) when OCC first identified ANB's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OCC took to get the bank to correct the problems. We also performed interviews

²⁸ 12 U.S.C. § 1831(k).

and reviews to determine whether OCC (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we did the following:

- Based on reviews of all the reports of examinations, we determined that ANB's problems began in 2005. Therefore, we determined the scope of our audit would be from 2003, two years prior to problems being noted, through 2008. We reviewed OCC supervisory files and records for ANB from 2003 through 2008. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the regulatory action used by OCC to compel bank management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.
- We interviewed and discussed various aspects of the supervision of ANB with OCC officials, examiners, and attorneys to obtain their perspective on the bank's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring ANB for federal deposit insurance purposes.
- We interviewed FDIC Division of Resolutions and Receiverships personnel who were involved in the receivership process, which was conducted before and after ANB's closure and appointment of receiver.
- Assessed OCC actions based on its internal guidance and legislative guidance provided by Federal Deposit Insurance Act, 12 U.S.C. § 1820(d).

Our review covered the period from 2003 until ANB's failure on May 9, 2008. We conducted our fieldwork from May 2008 through

October 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

ANB History

ANB was established in 1994 as Arkansas National Bank, National Association, and renamed ANB Financial, National Association, in 2005. ANB was headquartered in Bentonville, Arkansas, and had eight full-service branches in northwestern Arkansas and LPOs in Utah, Wyoming, and Idaho. ANB also had two mortgage offices, in Arkansas and in Texas, and three subsidiaries—ANB Financial Group, LLC, which provided brokerage services, ANB Financial Services, LLC, which was an insurance agency, and ANB Title, LLC, which provided title insurance.

The bank was wholly owned by ANB Bancshares, Inc., a one-bank holding company. ANB Bancshares, Inc. was regulated by the Board of Governors of the Federal Reserve System (Federal Reserve), and ANB was regulated by OCC. ANB's board of directors and employee stock option plan controlled approximately 64 percent of the holding company's common stock and 65 percent of the outstanding preferred stock. The bank elected Subchapter S status in 2003.²⁹

Appendix 4 contains a chronology of significant events regarding ANB.

Types of Examinations Conducted by OCC

National banks must receive a full-scope, on-site examination at least once during each 12-month period.³⁰ A full-scope examination is examination activities that are sufficient in scope to assign or confirm a bank's CAMELS composite and component ratings. It also results in conclusions about a bank's risk profile, includes on-site supervisory activities, and generally conclude with the issuance of a ROE. OCC generally conducts examinations of specialty areas like IT and compliance activities as part of the full-scope, on-site examination. The IT examination evaluates the overall performance of IT within the institution and the institution's ability to identify,

²⁹ A Subchapter S corporation is treated as a pass-through entity, similar to a partnership, for federal income tax purposes. It is generally not subject to federal income tax at the corporate level. Its taxable income flows through to its shareholders in proportion to their stock ownership, and the shareholders generally pay federal income tax on their share of this taxable income.

³⁰ 12 U.S.C. 1820(d).

measure, monitor and control technology-related risks. The compliance examination evaluates whether the bank was in compliance with various laws and regulations such as anti-money laundering, Office of Foreign Asset Control, and the Bank Secrecy Act. A targeted examination is any examination that does not fulfill all the statutory requirements of a full-scope examination.

The OCC may extend the cycle for full-scope examinations to 18 months if the following conditions are satisfied: (1) the bank has total assets of less than \$500 million; (2) the bank is well-capitalized as defined in 12 C.F.R. 6; (3) at its most recent examination, the OCC assigned the bank composite and management ratings of 1 or 2; (4) the bank currently is not subject to a formal enforcement proceeding or order by the FDIC, OCC, or Federal Reserve System; and (5) no person acquired control of the bank during the preceding 12-month period in which a full-scope, on-site examination would have been required. ANB did not meet these criteria during the scope of our review and was therefore examined annually by OCC.

The results of full-scope examinations are used to assign ratings to the banks. OCC, like other bank regulatory agencies, uses the Uniform Financial Institutions Rating System, commonly called CAMELS ratings. A bank's composite rating under CAMELS integrates ratings from six component areas: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. OCC may also assign ratings based on activities other than full-scope examinations, such as targeted reviews.

A bank assigned a composite rating of 1 is sound in every respect, generally has components rated 1 or 2, and gives no cause for supervisory concern. A composite rating of 2 indicates the bank is fundamentally sound, generally no component is rated more severe than a 3, and there are no material supervisory concerns. Banks with a composite rating of 3 exhibit some degree of supervisory concern in one or more component areas, the deficiencies generally will not cause a component to be rated more severe than a 4, and require more than normal supervision, which may include formal or informal enforcement actions. A composite rating of 4 indicates the bank exhibits unsafe and unsound practices, problems range from

severe to critically deficient, and the problems are not being satisfactorily addressed by management. Banks with a composite rating of 5 exhibit extremely unsafe and unsound practices or conditions, exhibit a critically deficient performance, and are of the greatest supervisory concern.

Types of Enforcement Actions Available to OCC

OCC uses formal and informal enforcement actions in response to violations of law, rules, regulations, final agency orders, and/or unsafe and unsound practices or conditions.

Informal Enforcement Actions

When a bank's overall condition is sound, but it is necessary to obtain written commitments from a bank's board of directors to ensure that identified problems and weaknesses will be corrected, OCC may use informal enforcement actions. Informal enforcement actions provide a bank with more explicit guidance and direction than a ROE normally contains, but are generally not legally binding. Informal enforcement actions include commitment letters, memoranda of understanding, and safety and soundness plans.

Formal Enforcement Actions

Unlike most informal actions, formal enforcement actions are authorized by statute, are generally more severe, and are public. Formal actions are also enforceable through the assessment of civil money penalties and, with the exception of formal agreements, through the federal court system. Formal enforcement actions available to OCC include consent orders, cease and desist orders, formal written agreements, and PCA directives.

OCC Enforcement Guidelines³¹

Determining the appropriate enforcement action, whether informal or formal, depends on the following:

- the overall condition of the bank;

³¹ OCC Policies and Procedures Manual (PPM) 5310-3 (REV),

- the nature, extent, and severity of the bank's problems and weaknesses;
- the commitment and ability of bank management to correct the identified deficiencies; and
- the existence of previously identified but unaddressed problems or weaknesses.

Adversely Classified Assets

Assets rated as substandard, doubtful, and loss. Substandard assets are inadequately protected by the current worth and paying capacity of the obligor or of the collateral pledged, if any. A doubtful asset has all the weaknesses of a substandard asset with the added characteristic that the weaknesses make collection or liquidation in full questionable and improbable. A loss asset is considered uncollectible and of such little value that continuation as a bankable asset is not warranted.

Allowance for Loan and Lease Losses

A valuation reserve established and maintained by charges against a bank's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. Valuation allowances established to absorb unidentified losses inherent in an institution's overall loan and lease portfolio are referred to as the allowance for loan and lease losses.

Brokered Deposits

Brokered deposits include any deposit that is obtained, directly or indirectly, from a deposit broker. When a bank is less than well-capitalized according to the "prompt corrective action" provisions of 12 C.F.R. 6, the term "brokered deposits" may apply to any deposits it solicits by offering rates of interest that are significantly higher than the rates offered by other insured depository institutions in its normal market area. Under 12 U.S.C. 1831f and 12 C.F.R. 337.6, the use of brokered deposits is limited to well-capitalized insured depository institutions and, with a waiver from the FDIC, to adequately capitalized institutions. Undercapitalized institutions are not permitted to accept brokered deposits

Call Reports

The contents of call reports include consolidated detailed financial information on assets, liabilities, capital, and loans to executive officers, as well as income, expenses, and changes in capital accounts.

CAMELS

CAMELS is an acronym for the performance rating components: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the highest rating and 5 representing the worst-rated banks.

Capital Restoration Plan

A capital restoration plan is submitted to the appropriate federal banking agency by any undercapitalized insured depository institution. A CRP specifies the steps the insured depository institution will take to become adequately capitalized, the levels of capital to be attained during each year in which the plan will be in effect, how the institution will comply with the statutory restrictions against asset growth and acquisitions, the types and levels of activities in which the institution will engage, and any other information that the federal banking agency may require.

Concentration Risk

Risk in a loan portfolio that arises when a disproportionate number of an institution's loans are concentrated in one or a small number of financial sectors, geographical areas, or borrowers. If loans are more broadly distributed, weaknesses confined to one or a small number of sectors, areas, or borrowers would pose a smaller risk to the institution's financial health.

Criticized Assets

Criticized assets include assets rated as special mention. Special mention assets have potential weaknesses that deserve management's close attention.

Federal Home Loan Bank

The Federal Home Loan Bank (FHLB) System was established by Congress in 1932. FHLBs are government-sponsored enterprises chartered by Congress. Their purpose is to support residential mortgage lending and community investment at the local level by providing primary liquidity loans to its more than 8,000 member financial institutions

(primarily banks and thrift institutions). Each member is a shareholder in its regional FHLB, which is a privately capitalized, independently managed cooperative. The bank's Office of Finance is its centralized debt issuance facility. The funds obtained through debt issuance are used to support FHLB activities.

Formal Agreement

A formal agreement is a type of formal enforcement action authorized by statute. Formal agreements are generally more severe than informal actions and are disclosed to the public. Formal actions are also enforceable through the assessment of civil money penalties.

Interest Carry

The portion of a construction line of credit that is set aside to advance interest expense until the construction project is completed. Interest carry is considered part of the cost of the construction project until it is completed.

Loan Presentation Memo

Loan presentation memos are approval memos that loan officers prepare for a loan committee (mainly comprised of the president and/or senior leaders of the bank) when a loan is initially approved, extended, or renewed. There are no required elements of a good approval memo but an informative loan approval memo would generally contain the purpose of the credit, primary and secondary source of repayment (collateral generally), terms of the note, a description of the project, strength and weaknesses of the credit, and importantly, an analysis of the project/guarantor and when do they expect repayment.

Loan Production Offices

Banking offices that take loan applications and arrange financing for corporations and small businesses, but they do not accept deposits. Loan applications are subject to approval by the lending institution.

Matter Requiring Attention

A bank practice noted during an examination that deviates from sound governance, internal control, and

risk management principles, which may adversely impact the bank's earnings or capital, risk profile, or reputation, if not addressed; or result in substantive noncompliance with laws and regulations, internal policies or processes, OCC supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by a bank. A matter requiring attention is not an enforcement action.

Prompt Corrective Action

Prompt Corrective Action is a framework of supervisory actions, set forth in 12 U.S.C. §1831o, for insured banks that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to minimize resulting losses. These actions become increasingly severe as a bank falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

Tier 1 Capital

Tier 1 capital consists of common shareholders equity, perpetual preferred shareholders equity with noncumulative dividends, retained earnings, and minority interests in the equity accounts of consolidated subsidiaries.

Well-Capitalized

An insured depository institution is well-capitalized if it significantly exceeds the required minimum level for each relevant capital measure.

Wholesale Funding

Wholesale funding sources include federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or certificate of deposit listing services.

Appendix 4
Chronology of Significant Events

The following chronology describes significant events in the history of ANB Financial, National Association, including examinations conducted and enforcement actions taken by the Office of the Comptroller of the Currency (OCC).

- 6/1/1994 Institution is established under original name, Arkansas National Bank.
- 11/1994 OCC performs a safety and soundness exam. The exam resulted in composite and CAMEL ratings of 2/12242.
- 8/1995 OCC performs a safety and soundness exam. The exam resulted in composite and CAMEL ratings of 2/22233.
- 2/20/1996 Arkansas National Bancshares, Inc., is established as the holding company for National Bank of Arkansas, National Association.
- 9/1996 OCC performs a safety and soundness exam. The exam resulted in composite and CAMEL ratings of 2/22222.
- 11/1997 OCC performs a safety and soundness exam. The exam resulted in composite and CAMELS ratings of 2/222323.
- 12/1998 OCC performs a safety and soundness exam. The exam resulted in composite and CAMELS ratings of 2/222323.
- 10/18/1999 OCC performs a safety and soundness exam. The exam resulted in composite and CAMELS ratings of 3/223333. The bank is rated a 3 due to high interest rate and liquidity risk, ineffective board oversight, inadequate interest rate measurement tools, and weaknesses in risk management systems. Problems noted were corrected by the next examination.
- 12/28/2000 OCC performs a full-scope exam. The exam resulted in composite and CAMELS ratings of 2/222232.
- 1/7/2002 OCC performs a full-scope exam. The exam resulted in composite and CAMELS ratings of 2/221222.
- 1/2003 The bank elects to be a Sub-Chapter S Corporation.

Appendix 4
Chronology of Significant Events

- 2/24/2003 OCC performs a full-scope exam. The exam resulted in composite and CAMELS ratings of 2/221121.
- 1/5/2004 OCC performs a full-scope exam. The exam resulted in composite and CAMELS ratings of 1/211121.
- 1/2005 The bank opens a loan production office in St. George, Utah.
- 1/17/2005 Arkansas National Bancshares, Inc is renamed ANB Bancshares, Inc.
- 1/26/2005 The bank changes its name to ANB Financial, National Association (ANB).
- 3/9/2005 OCC performs a full-scope exam. The exam resulted in composite and CAMELS ratings of 1/212121.
- 6/14/2005 OCC Western District adds ANB to its watch List because of concern over ANB's rapid growth.
- 2/1/2006 OCC performs a full-scope exam. The exam resulted in composite and CAMELS ratings of 2/222221.
- 5/1/2006 ANB opens a loan production office in Jackson, Wyoming.
- 12/2006 A new Portfolio Manager/Examiner-In-Charge for ANB transitions into the position in preparation for the examination to be conducted in 2007. The prior Portfolio Manager/Examiner-In-Charge had been in the position since the examination conducted in 2003.
- 2/23/2007 OCC performs a full-scope exam. The exam resulted in composite and CAMELS ratings of 3/233221.
- 4/26/2007 OCC designates the bank as in "troubled condition" based on the results of the 2/23/07 exam.
- 5/2007 ANB opens a loan production office in Idaho Falls, Idaho.
- 5/9/2007 The OCC Western District Supervisory Review Committee decides to initiate a formal agreement to address ANB's issues.
- 6/25/2007 OCC enters into a formal agreement with ANB that requires ANB to achieve increased total risk-based capital thresholds to 10.75 percent of

risk-weighted assets in September 2007 and 11 percent of risk-weighted assets in December 2007. The formal agreement also addresses strategic planning, credit risk management and concentration risk.

- 7/5/2007 The ANB board approves payment of dividends. The payment complies with the formal agreement between ANB and OCC which stated a dividend payment could not exceed 42 percent of the bank's earnings.
- 7/26/2007 FDIC received a brokered deposit waiver request from ANB that would allow the bank to accept new or renew brokered deposits.
- 9/24/2007 The Dallas Federal Home Loan Bank (FHLB) notifies ANB that it is restricting ANB's access to FHLB's credit products and services because of the bank's condition, increasing nonperforming loan levels, and high concentrations in softening markets.
- 10/1/2007 OCC conducts an on-site exam to assess ANB's compliance with the formal agreement. OCC expands the review to a full-scope exam as a result of finding a significant increase in the bank's credit risk. The exam resulted in ANB receiving composite and CAMELS ratings of 4/344342.
- 10/4/2007 The ANB board approves a dividend to the shareholders for \$5.6 million, which is promptly paid. The dividend initially creates a capital shortfall for the bank when its increased loan loss provisions decreases its earnings. ANB's holding company injects \$6.5 million into ANB to achieve the capital minimum requirement.
- 10/25/2007 OCC requires ANB to hire an external loan review consultant because of concerns about the bank's asset quality.
- 12/2007 OCC, along with FDIC, reviews a sample of commercial real estate loans. The review reveals continued deterioration in loan quality and an increase of classified assets.
- 12/13/2007 Supervision of ANB is transferred within OCC to the Special Supervision Division at OCC Headquarters due to the serious problems that developed at ANB.
- 12/17/2007 OCC notifies ANB by letter, that its composite CAMELS rating has been downgraded to a 5 and that OCC's Special Supervision Division is now the bank's supervisory office. The letter also directs ANB's board to

develop a preliminary capital plan as well as a contingency plan to sell, merge, or liquidate the bank.

12/19/2007 ANB withdraws its request to FDIC for the brokered deposit waiver.

12/31/2007 ANB submits an unacceptable capital and contingency plan to OCC.

1/28/2008 To gain a better understanding of ANB's capital needs, OCC and FDIC planned a targeted exam of ANB that consists of validation of the external loan review results to date.

1/29/2008 ANB's holding company, ANB Bancshares Inc., and the Board of Governors of the Federal Reserve System (Federal Reserve) enter into a formal agreement. The agreement requires the holding company to: (1) submit an acceptable written consolidated capital plan; (2) submit an acceptable written plan to service its outstanding debt and other obligations without incurring additional debt; (3) not incur, increase, or guarantee any debt, without prior approval; (4) not take dividends from ANB or declare or pay any dividends without prior approval; (5) not increase any salaries, bonuses, or directors' fees to any directors or executive officers without prior approval; (6) provide notification of in the appointment of new directors and the hiring of officers prior to hiring; and (7) submit acceptable written plans.

1/30/2008 ANB files its initial year-end 2007 call report, which reports ANB as undercapitalized for Prompt Corrective Action (PCA) purposes.

2/5/2008 OCC issues a PCA notice, categorizing the bank as undercapitalized, due to its Tier 1 capital to adjusted total assets of 4.66 percent. The bank is required to submit a capital restoration plan (CRP) by March 6, 2008.

2/22/2008 ANB updates its allowance for loan and lease losses and capital analysis.

2/27/2008 OCC, FDIC, and the Federal Reserve meet with ANB's board of directors and OCC delivers a second PCA notice categorizing the bank as significantly undercapitalized. Its Tier 1 capital ration was now 2.5 percent. The bank is informed that it needs to restore capital and that the FDIC's Division of Resolutions and Receiverships personnel will be on-site to put together a bid package for potential purchasers of ANB.

- 3/6/2008 ANB submits a CRP and the bank engages an institutional brokerage and investment banking firm to market the bank.
- 3/14/2008 ANB submits a supplement to the CRP proposing the sale of ANB in its entirety through an investment bank on or before May 5, 2008. The CRP notes that ANB has received two expressions of interest in purchasing ANB's branches in northwestern Arkansas, and ANB plans to move forward with those proposals.
- 3/20/2008 OCC informs ANB that the CRP is unacceptable because the CRP lacked detailed information about the bank's proposals, lacked financial analyses of the proposals, lacked information about the risks to the bank, and lacked the required guarantee from ANB's holding company.
- 4/25/2008 ANB becomes critically undercapitalized (Tangible equity capital as a percentage of assets was 1.865 percent).
- 4/29/2008 OCC notifies ANB that its tangible equity ratio puts it in the critically undercapitalized category for PCA purposes.
- 4/30/2008 ANB files a second amendment to the year-end 2007 call report at the request of its external auditor. The external auditor identifies significant allowance for loan and lease losses provisions recognized in 2008 that should have been recognized in 2007.
- 5/1/2008 After failing to find a buyer or investor, ANB develops and submits a partial divestiture plan in order to inject a portion of the needed capital into ANB. The plan, among other things, proposes the sale of eight branches, most of the associated performing loans, and most of ANB's core retail deposits. OCC considers the plan unacceptable because it did not meet minimum CRP requirements, was not based on realistic assumptions, was unlikely to succeed in restoring capital, would likely increase the risks to the bank, and failed to contain an appropriate guarantee by ANB's holding company.
- 5/2/2008 ANB's earnings and capital continues to decline steadily. However, ANB's leverage and tangible equity ratios increase to 2.02 percent, shifting ANB back to the significantly undercapitalized category.
- 5/9/2008 OCC closes the bank and appoints FDIC as receiver.

Appendix 4
Chronology of Significant Events

5/9/2008 FDIC approves the assumption of ANB's insured deposits by Pulaski Bank and Trust Company, Little Rock, Arkansas.

Appendix 5
OCC ANB Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring attention, other recommended actions, and other issues cited in Reports of Examination 2004 – 2007	Formal enforcement action
1/5/2004	1/211121	\$498	<p><u>Matters requiring ANB Financial, National Association (ANB) board attention</u></p> <ul style="list-style-type: none"> • <u>None identified</u> <p><u>Other recommended actions made to ANB</u></p> <ul style="list-style-type: none"> • Improve the risk assessment process by identifying threats to individual information systems and ranking systems by overall risk. • Ensure the information security risk assessment includes a formal process for identifying threats, vulnerabilities, and controls in new information technology (IT) initiatives prior to implementation. 	None
3/9/2005	1/212121	\$631	<p><u>Matters requiring ANB board attention</u></p> <ul style="list-style-type: none"> • Strengthen internal controls and oversight to ensure adherence to board approved policies and prevent violations of federal regulations (refers to a violation of 12 C.F.R. §34 which requires an appraisal for all real estate-related financial transactions where transaction value if \$250,000 or more). • Ensure that adequate credit administration and IT policies and practices remain in place to minimize potential risk during times of growth. <p><u>Other recommended actions made to ANB</u></p> <ul style="list-style-type: none"> • Form an independent audit committee to conform to the requirements of 12 C.F.R. §363, which requires depository institutions establish an audit committee. • Ensure controls are in place to ensure certain practices and credit administration issues are avoided in the future. • Adjust the security risk assessment in a timely manner as changes are made to the bank’s systems or environment. • Use the security risk assessment to establish the scope of the IT audit. • Establish priorities for addressing outstanding IT issues and new initiatives, and provide additional staffing if necessary. <p><u>Other issues</u></p> <ul style="list-style-type: none"> • While liquidity is satisfactory, liquidity risk remains high and is increasing due to the aggressive asset growth and a greater reliance on wholesale funding sources. • ANB’s risk profile is increasing in 5 of 7 risk categories. 	None

Appendix 5
OCC ANB Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring attention, other recommended actions, and other issues cited in Reports of Examination 2004 – 2007	Formal enforcement action
2/1/2006	2/222221	\$966	<p><u>Matters requiring ANB board attention</u></p> <ul style="list-style-type: none"> • <u>None identified</u> <p><u>Other recommended actions made to ANB</u></p> <ul style="list-style-type: none"> • Expand the loan sample size when specific credit administration weaknesses or noncompliance with policy are noted to determine the overall depth, severity, and impact on credit quality. The loan review report should identify the cause of the weakness and document the corrective action implemented in response, with follow-up testing to ensure compliance. • Ensure that individual account officers are proactive in the early and accurate risk rating of loans and establish tolerance levels for inaccuracy as verified by the independent reviews performed by the Credit Risk Department. • Implement procedures to reduce the high level of credit and collateral documentation exceptions as noted by the independent loan review, particularly at the St. George, Utah location. In addition, enhance the tracking report by segregating documentation exceptions by type and severity. • Strengthen the compliance audit function by performing an interim follow-up audit on previous violations to ensure implementation of corrective action. The follow-up audit should be documented with results reported to the board on a timely basis. • Revise customer identification documentation policy to ensure compliance with USA Patriot Act. • Ensure dividends are paid no more frequently than once a quarter (refers to violation of 12 U.S.C. §60.³²) <p><u>Other issues</u></p> <ul style="list-style-type: none"> • ANB’s risk profile remains increasing in 5 of 8 risk categories. (1 risk category added since last exam). • Earnings retention has not been sufficient to maintain adequate capital levels. The need for capital injections in 2005 and plans for additional capital in 2006 reflect the inability of current income to directly support the capital base. • Increased risk is evident by the significant concentrations in land development, construction, and raw land loans. 	None

³² The directors of any national banking association may, quarterly, semiannually or annually, declare a dividend.

Appendix 5
OCC ANB Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring attention, other recommended actions, and other issues cited in Reports of Examination 2004 – 2007	Formal enforcement action
			<ul style="list-style-type: none"> Auditor’s Note: No matters requiring ANB board attention reported in ROE though earnings, asset quality and the composite rating were all downgraded. 	
2/23/2007	3/233221	\$1,646	<p data-bbox="633 552 1015 573"><u>Matters requiring ANB board attention</u></p> <ul style="list-style-type: none"> Hire a senior loan officer to ensure improvements are made to credit risk systems and to properly administer the higher level of problem assets. Ensure that all underwriting and credit administration practices are commensurate with the level of risk in the loan portfolio. Specifically, require expanded loan presentations and analysis and quarterly reports to senior management and the loan committee on project status. Enhance the independence of the real estate appraisal ordering and review process by clearly separating it from the loan approval process. The individual granting the loan request should not have the responsibility for reviewing the appraisals and evaluations. Enhance the bank’s concentration management practices and policy. Ensure ongoing evaluation of commercial real estate concentrations in submarkets of each of the bank’s loan production offices, formalize support for established concentration limits that include a synopsis of management’s market analysis as part of the concentration report provided to the board, aggregate the results of stress testing individual borrowers into the concentration risk summary report and address underwriting limitations within the loan policy when concentrations approach or exceed limits established by the board. Adopt and implement a strategic plan that is commensurate with the bank’s risk profile and future growth plans for all areas of the bank covering at least a 3- year period. <p data-bbox="633 1518 1015 1539"><u>Other recommendations made to ANB</u></p> <ul style="list-style-type: none"> Monitor the redevelopment of its internet banking application software and ensure that appropriate security is built into the application prior to releasing it to the public. Validation of the security built into the application should be performed by a qualified independent third party that will test security of the application and database and inter-functionality of the application, database, and multi-factor authentication. <p data-bbox="633 1833 755 1854"><u>Other Issues</u></p> <ul style="list-style-type: none"> ANB is designated as in “troubled condition” which means 	<p data-bbox="1282 552 1437 636">Formal agreement issued</p> <p data-bbox="1282 657 1437 678">6/25/2007</p>

Appendix 5
OCC ANB Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring attention, other recommended actions, and other issues cited in Reports of Examination 2004 – 2007	Formal enforcement action
			the bank must notify the Office of the Comptroller of the Currency before adding or replacing a member of the board, and employing or changing the duties and responsibilities of any senior executive officer.	
10/1/2007	4/344342	\$1,944 As of 6/30/07	<p><u>Matters requiring ANB board attention</u></p> <ul style="list-style-type: none"> • Develop, ensure, and adhere to a written program designed to improve and strengthen problem loan collection efforts. Problem loan workout plans must incorporate specific workout objectives, target dates, and performance criteria to measure progress toward problem resolution and to reinforce accountability in the workout process. • Develop, implement, and ensure adherence to a written program designed to improve and strengthen the loan risk rating function. • Develop and adopt a comprehensive loan review program that ensures prompt corrective action of identified credit system weaknesses and accurate risk rating of loans. • Develop, implement, and ensure strong lending controls that conform to the bank’s lending policy and approval process. Also, hold loan officers accountable for complying with loan approval requirements. • Establish a loan workout function for the purpose of restoring and reclaiming classified assets and ensure prompt intervention in problem loans by qualified personnel. Also, identify and employ a qualified officer with sufficient staff to manage the loan workout function. • Ensure sufficient liquidity to sustain the bank’s current operations and to withstand any unanticipated or extraordinary demand against its funding base. Also, develop a long-term business plan that focuses on diversification of funding sources. • Develop and adhere to documented policies and procedures that sufficiently address regulatory and generally accepted accounting principles requirements and limit the bank’s risk exposure from mortgage banking activities to an acceptable level. <p><u>Other recommended actions made to ANB</u></p> <ul style="list-style-type: none"> • Improve support, documented analysis, and policy guidance for stronger concentration risk management systems and greater risk controls. 	Formal agreement issued 6/25/07

Appendix 5
 OCC ANB Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring attention, other recommended actions, and other issues cited in Reports of Examination 2004 – 2007	Formal enforcement action
<u>Other Issues</u>				
<ul style="list-style-type: none"> • All future dividends require prior OCC approval. 				

Source: OIG analysis from OCC ROEs on ANB.



MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Susan L. Barron, Director, Banking Audits

From: John C. Dugan, Comptroller of the Currency *JCD*

Date: November 24, 2008

Subject: Comments on Draft Audit Report

We have received and reviewed your draft report titled "Material Loss Review of ANB Financial, National Association." Your overall objectives were to determine why ANB's problems resulted in a material loss to the FDIC insurance fund, review OCC's supervision of ANB, and make recommendations for preventing any such loss in the future.

You concluded that ANB failed due to a strategy of aggressive growth without adequate controls, heavy reliance on wholesale funding, and inadequate risk management of credit concentrations and underwriting standards – all exacerbated by unfavorable economic conditions. We agree that, in the case of ANB, there were shortcomings in our execution of our supervisory process and that it is appropriate to take additional measures to reinforce these principles to our examining staff. The paragraphs below outline the steps that we have taken and plan to take to address your recommendations.

Altering Supervisory Strategy

A primary element of OCC's risk based approach to supervision is the continual process of identifying supervisory concerns and monitoring their correction throughout the supervisory cycle. We currently have numerous policies and processes in place to ensure timely recognition and response to increasing risk in our banks, including formal enforcement action if warranted.

In addition to examiners' direct contact with institutions, other resources, including independently prepared outlier reports and filters, provide early warning information to be used in identifying emerging risks and altering supervisory strategies, *e.g.*, changing planned activities, when appropriate.

We use a variety of communication methods to remind and re-emphasize our expectations to examiners. For example, to be sure that examiners understand how to assess commercial real estate portfolios and do so consistently, we provide guidance in the form of a summary document that clarifies expectations and references existing policies and procedures. We discussed this guidance in conference calls with examiners in April and October of this year.

We also plan to leverage the findings of the OIG Material Loss Review and our internal “lessons learned” by communicating them to field staff as further reinforcement of our expectations.

Taking Formal Enforcement Action

To refresh examiner awareness of the OCC’s Enforcement Action Policy (Policy) and to promote consistency in the application of the policy, OCC senior management communicated its philosophy and expectations in three ways: in a written document, through discussions at district management meetings, and during an all-examiner conference call in October 2008. The central message was, “In general, enforcement actions should be taken at an early stage, while problems are still manageable and the prospects for rehabilitation or, alternatively, sale or merger of the institution, are still good.”

Again, we believe that sharing the results of our respective reviews of the ANB failure will serve to emphasize to examiners the importance of taking formal enforcement action when appropriate and consistent with policy, and also of documenting such decisions, just as they document all other substantive conclusions.

Use of Wholesale Funding

We agree that the guidance and examination procedures in the Comptroller’s Handbook should be refreshed with respect to wholesale funding, brokered deposits, and other liquidity related topics. The Office of the Chief National Bank Examiner has made updating this portion of the Handbook a priority. In the interim, however, OCC developed updated guidance, which was distributed to all examiners and discussed during an October 2008 all-examiner conference call.

Lessons Learned

As noted in your report, we are currently conducting our own internal “lessons learned” review of the circumstances surrounding the ANB failure. Highly qualified and independent supervision staff are performing this review, with the intent of sharing the results with examiners in an instructive manner. Going forward, “lessons learned” reviews of failed banks or other significant events will be incorporated into the quality assurance activities of Mid-size and Community Bank Supervision, typically enumerated in annual business plans.

Thank you for the opportunity to review and comment on your draft report. If you have questions or need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Mid-size and Community Bank Supervision, at 202-874-5020.

Appendix 7
Major Contributors to This Report

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Department of the Treasury

Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control

Office of the Comptroller of the Currency

Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

Federal Deposit Insurance Corporation

Chairman

United States Senate

Chairman and Ranking Member
Committee on Banking, Housing, and Urban Affairs

Chairman and Ranking Member
Committee on Finance

U.S. House of Representatives

Chairman and Ranking Member
Committee on Financial Services

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Acting Comptroller General of the United States