



# Audit Report



OIG-09-033

SAFETY AND SOUNDNESS: Material Loss Review of First National Bank of Nevada and First Heritage Bank, National Association

February 27, 2009

Office of  
Inspector General

Department of the Treasury



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## Abbreviations

CRE	Commercial Real Estate
FDIC	Federal Deposit Insurance Corporation
MRA	Matter Requiring Attention
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

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*The Department of the Treasury  
Office of Inspector General*

February 27, 2009

Mr. John C. Dugan  
Comptroller of the Currency

This report presents the results of our review of the failures of First National Bank of Nevada (FNB Nevada), of Reno, Nevada, and First Heritage Bank, National Association (First Heritage Bank), of Newport Beach, California, and supervision of the institutions by the Office of the Comptroller of the Currency (OCC). Both banks were owned by the First National Bank Holding Company of Scottsdale, Arizona. Accordingly, we performed a single review of the failures. Also included in this review is information about a third OCC-supervised bank, First National Bank of Arizona (FNB Arizona), that was also owned by First National Bank Holding Company. FNB Arizona merged into FNB Nevada on June 30, 2008, 1 month before the banks failed.

Our review was mandated under section 38(k) of the Federal Deposit Insurance Act, as amended. OCC closed FNB Nevada and First Heritage Bank and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on July 25, 2008. As of December 31, 2008, FDIC's Deposit Insurance Fund had recorded an estimated loss of \$706 million for FNB Nevada and \$33 million for First Heritage Bank. FNB Arizona was no longer a separate institution at the time of the failures and did not incur a distinct, separate loss to the Deposit Insurance Fund.

Section 38(k) requires that we determine why FNB Nevada's and First Heritage Bank's problems resulted in a material loss to the Deposit Insurance Fund; review OCC's supervision of both banks, including implementation of the Prompt Corrective Action (PCA) provisions of section 38; and make recommendations for preventing any such loss in the future. We reviewed the

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supervisory files and interviewed key officials involved in the regulatory matters. Because FNB Arizona operated independently from FNB Nevada and First Heritage Bank until 1 month before the banks failed, we reviewed OCC's supervision of FNB Arizona as a separate institution. We conducted our fieldwork from August through December 2008 at OCC's headquarters in Washington, D.C., its Western District office in Denver, Colorado, and its field office in Phoenix, Arizona. We also met with officials from FDIC's 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 FNB Nevada and First Heritage Bank, as well as OCC's bank supervision processes. We also provide a glossary of terms as appendix 3 (various terms when first used throughout the report are underlined and hyperlinked to the glossary). A chronology of significant events related to FNB Nevada and First Heritage Bank and OCC's supervision of the banks is provided in appendix 4.

## Results in Brief

The primary cause of the failure of FNB Nevada was the significant losses within its commercial real estate loan portfolio as well as the losses from the residential mortgage division operations of the previously independent FNB Arizona. These losses resulted from inadequate management controls over credit underwriting and administrative practices, and inadequate risk management. The control deficiencies were exacerbated by unfavorable economic conditions. The primary cause of the failure of First Heritage Bank was FNB Nevada's inability to repay, at the time OCC closed the banks, a \$74.4 million loan from First Heritage Bank. The resulting loss depleted all of First Heritage Bank's capital.

OCC conducted timely and regular examinations of FNB Nevada, the former FNB Arizona prior to its merger with FNB Nevada, and First Heritage Bank and provided oversight through its off-site monitoring. The scope of the examinations appeared comprehensive as indicated by the ROEs, although workpaper evidence supporting the examination procedures performed was

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generally limited. OCC also used its authority under the PCA provisions of the Federal Deposit Insurance Act. However, as discussed below, we believe that OCC did not issue formal enforcement action for any of the banks in a timely manner, and was not aggressive enough in its supervision of the banks in light of their weak management practices. OCC identified problems at FNB Nevada and the former FNB Arizona as early as 2002. OCC identified additional problems at FNB Nevada in 2005, 2006, and 2007. (First Heritage Bank was not established until 2005.) That said, OCC took no forceful action to remediate unsafe and unsound practices by the banks found through its examinations until the second quarter of 2008. In December 2007, OCC concluded that a formal enforcement action was needed against both FNB Arizona and FNB Nevada but held off issuing the enforcement action to allow time for an investor to determine whether to make an equity injection. OCC's enforcement policy allows for such discretion and we conclude it was properly used in this instance.

In an internal assessment, OCC acknowledged it did not effectively supervise FNB Arizona in that while risks were identified, follow-up to ensure that bank management took corrective action was not as aggressive as it should have been.

In this report, we recommend that OCC re-emphasize to examiners the need to ensure banks take swift corrective actions in response to examination findings and reiterate to examiners its policy that supervision workpapers are to be clear, concise, and readily understood by other examiners and reviewers.

In a written response, OCC concurred that FNB Nevada failed due to significant losses within its commercial real estate portfolio as well as the losses from the residential mortgage division operations of the former First National Bank of Arizona, and that the cause of First Heritage's failure was FNB Nevada's inability to repay Federal Funds purchased from First Heritage Bank. OCC also agreed that, based on their experience with these two banks, it was appropriate to take additional measures to reinforce certain expectations and requirements to OCC examining staff. The actions taken and planned by OCC meet the intent of our recommendations. The full text of OCC's response is provided as appendix 6.

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## Causes of FNB Nevada and First Heritage Bank Failures

### **Inadequate Controls Over Residential Mortgage and Commercial Real Estate Lending**

FNB Nevada, FNB Arizona (before its merger with FNB Nevada), and First Heritage Bank were controlled by First National Bank Holding Company. Management of all three banks, dominated by the owner of the holding company, failed to ensure that the residential mortgage<sup>1</sup> and commercial real estate divisions at each bank had adequate controls over credit underwriting and administrative practices, and risk management. Management also did not address repeated OCC examiner criticisms concerning accounting, underwriting, and loan concentration.

### FNB Arizona's Unsound Credit Underwriting and Administration

Between 2002 and early 2005, the real estate mortgage market had grown nationally due to relatively low interest rates and demand for Alt-A loans and residential mortgage-backed securities issued by investment firms. After mid-2005, with rising interest rates and increased competition, the mortgage business became less profitable and the secondary market for Alt-A mortgages slowed, as part of a national trend, and then ceased altogether in 2007.

To deal with market deterioration, FNB Arizona's residential mortgage division in late 2006 began selling mortgages at reduced prices to attract investors. Management also amended investor contract agreements to make the loans easier to sell and to increase bank profit margins. The amended contracts provided investors with easier recourse terms when the loans did not meet the representations and warranties made to the investors. The new recourse provisions increased the bank's risk exposure by forcing the bank to repurchase loans from investors for various reasons, such as overstated borrower income and other fraud. Additionally,

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<sup>1</sup> The residential mortgage division was operated as part of FNB Arizona. Mortgages were originated from retail channels, correspondent channels, and wholesale channels, with the wholesale channels being the leading producer of mortgages for the division.



management amended agreements with mortgage brokers it bought loans from to improve the bank's margins when it later sold the mortgages to investors. The amended mortgage broker agreements increased the bank's risk by waiving the bank's ability to force mortgage brokers to repurchase loans returned by investors. The effect was that FNB Arizona assumed all the risk with these purchased mortgages.

At the same time it was taking on these additional risks, FNB Arizona failed to improve its underwriting standards or drop riskier mortgage products. As a result, it sustained considerable losses in its residential mortgage division because of repurchase demands by mortgage investors because the losses could no longer be passed back to mortgage brokers.

From 2002 through 2007, OCC examiners repeatedly expressed the need for stronger controls over FNB Arizona's residential mortgage division's origination of the high-risk non-traditional and Alt-A loans. Bank management, however, did not adequately address these concerns. As a result, the bank found itself repurchasing tens of millions of dollars in loans. As illustrated in table 1, FNB Arizona's residential mortgage division repurchased approximately \$372.7 million in loans from 2003 through 2007.

**Table 1: Mortgage Loans Sold and Repurchased by FNB Arizona's Residential Mortgage Division**

<b>Year sold</b>	<b>Amount sold to investors (millions)</b>	<b>Amount Repurchased (millions)</b>
2003	\$4,351	\$61
2004	\$5,900	\$104
2005	\$6,447	\$39
2006	\$6,922	\$104
2007	\$3,514	\$64
<b>Totals</b>	<b>\$27,134</b>	<b>\$373</b>

Source: OIG analysis of bank documentation.

Note: FNB Arizona closed the mortgage division in August 2007.

As shown in the table, in 2007 the residential mortgage division repurchased about \$64 million of non-performing mortgage loans. Additionally, in that year, the division recorded \$29.6 million in loss

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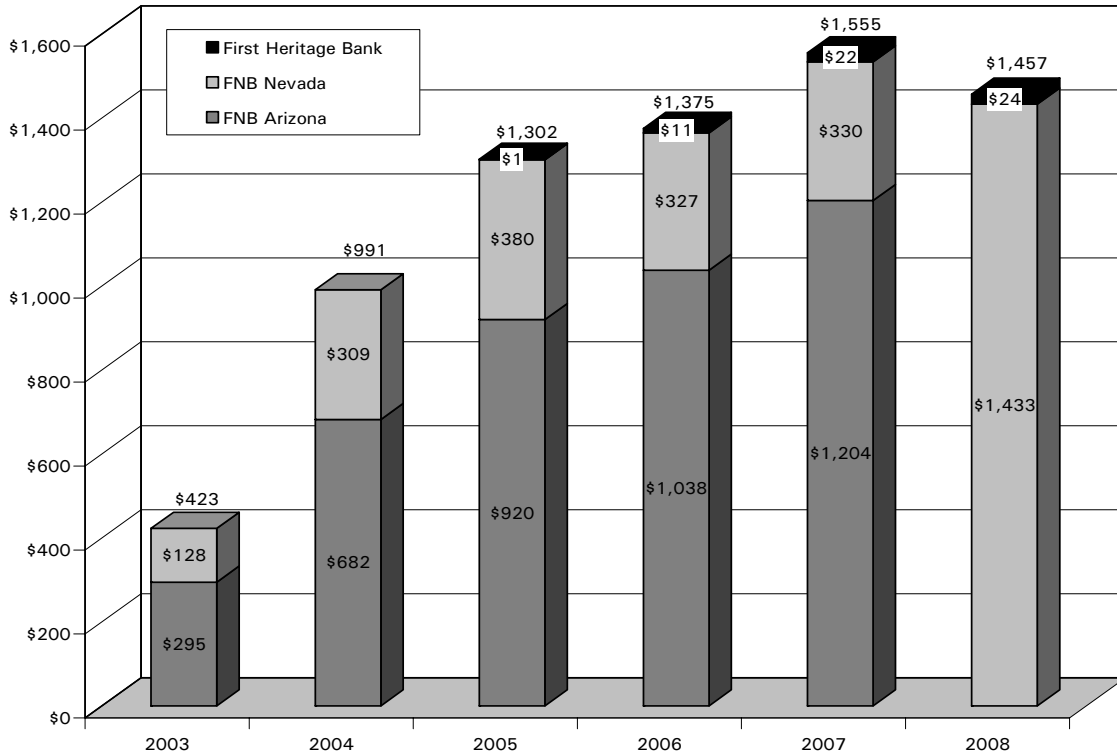
provisions linked to those repurchases because the loans did not meet the representations and warranties made to the investors. Skeptical of the underwriting standards, investors also shied away from purchasing loans in the quantities they had purchased previously. An OCC examiner stated that the banks were caught holding a large amount of poor quality mortgages and the mortgages had to be sold at deep discounts. Those mortgages which could not be sold had to be written down. The bank was not able to sell approximately \$683 million worth of mortgages that it had originated. Although FNB Arizona closed the residential mortgage division in August 2007, the losses continued. In the 10 months following the division's closure—September 2007 to June 2008—residential mortgage losses totaled approximately \$205.7 million, which was primarily attributable to loan repurchases, the writing down of the loan values on the bank's books, and the reselling of loans to the secondary market at a discount.

Because FNB Arizona and, through loan participation, FNB Nevada, could not sell these nontraditional loans to generate cash, the liquidity of both banks were strained. As a result, both banks relied on First Heritage Bank for liquidity to support their funding needs.

#### High Concentration of CRE Loans

FNB Arizona, FNB Nevada, and First Heritage Bank originated and retained commercial real estate (CRE) loans for the acquisition and development of land, and for residential construction. From 2003 to 2008, the three banks collectively increased their CRE loan portfolios from \$423 million to \$1.5 billion. Chart 1 shows the banks' combined growth in CRE loans from 2003 through June 2008.

**Chart 1: Banks' Combined CRE Loan Growth 2003 Through June 2008 (millions)**



Source: OIG analysis of the banks' Reports of Condition and Income (call reports).

Notes: (1) FNB Arizona's CRE loans were combined with FNB Nevada's in 2008 because of the banks' merger.

(2) Totals do not add due to rounding.

As a result of the commercial real estate market deterioration, a large volume of CRE loans originated and retained by the banks declined in quality and the banks experienced significant losses in their CRE portfolios. From 2003 to 2008, the banks had losses totaling approximately \$53 million. As of June 30, 2008, the banks had recorded about \$374 million of CRE loans as being over 90 days past due, representing about 25 percent of their collective CRE loan portfolio as of that date. The losses incurred from the high concentration of CRE loans were a significant factor in the banks' failures.

The reacquisition and retention of poor-quality residential mortgage loans and the CRE loans increased FNB Arizona's and FNB Nevada's levels of adversely classified assets. The increasing levels of adversely classified assets triggered an increase in the

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Allowance for Loan and Lease Losses (ALLL), which diminished capital and earnings.

Table 2 illustrates the three banks' CRE loans as a percentage of total capital.

**Table 2: CRE Loans as a Percentage of Total Capital**

<b>Year</b>	<b>FNB Arizona</b>	<b>FNB Nevada</b>	<b>Peer banks</b>	<b>First Heritage Bank</b>	<b>Peer banks</b>
2004	613%	446%	333%	n/a	n/a
2005	577%	510%	359%	15%	74%
2006	555%	445%	389%	109%	232%
2007	659%	579%	405%	175%	341%
2008	n/a	985%	285%	344%	379%

Source: OIG analysis of bank documentation.

Notes: (1) First Heritage Bank opened in 2005.

(2) FNB Arizona merged with FNB Nevada on June 30, 2008.

As early as 2004, OCC examiners voiced concern to the banks about the growing loan concentration problem and repeatedly encouraged establishing concentration limits. Bank management, however, ignored OCC's recommendations. OCC expressed the following additional concentration concerns through 2007:

- In OCC's 2004 Reports of Examination (ROE) for FNB Arizona and FNB Nevada, examiners wrote that credit risk was high and increasing due to large concentrations of credit in real estate construction and land development, and that these concerns were exacerbated by the lack of internal concentration limits.
- In the 2005 ROEs for FNB Arizona and FNB Nevada, examiners wrote that the real estate concentrations of credit were of heightened supervisory concern primarily related to the need to improve identification and monitoring of risk associated with these concentrations on an individual loan and a portfolio basis.
- In the 2006 ROEs for FNB Arizona and FNB Nevada, examiners again criticized the banks' CRE and large lending relationship concentrations. The examiners recognized that the banks operated in strong real estate markets but cautioned that there was an inherent risk associated with concentrations, especially

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in the context of the softening real estate markets. In the ROEs, the examiners recommended that management establish limits for the amount of risk that the banks were willing to accept for each large lending relationship.

- In the 2007 ROEs, examiners once again criticized the banks' high concentrations, this time as a Matter Requiring Attention (MRA). The MRA directed the banks' board of directors to establish reasonable concentration limits and strategies to conform to the limits.

#### Accounting Practices Not Compliant With GAAP

Management failed to implement adequate controls over the banks' accounting practices. Beginning with the 2004 examination of FNB Arizona and FNB Nevada, OCC examiners repeatedly raised concerns about the adequacy of controls over the accounting processes to ensure compliance with generally accepted accounting principles (GAAP).

- The repurchase reserve methodology never fully conformed with GAAP. For example, FNB Arizona's reserve analysis did not consider external factors such as the economic environment, industry data, underwriting changes, or other factors for the types of loans being sold.
- Processes to consistently recognize impairments and charge-offs in a timely manner and in accordance with GAAP were lacking. The examiners noted that the ALLL procedures needed to include a discussion of the methodology employed when determining and measuring loan impairment.
- Comprehensive accounting policies needed to be developed, implemented, and followed.

In the 2005 ROEs for FNB Arizona and FNB Nevada, examiners found that the banks still had not established comprehensive accounting policies and procedures to ensure compliance with complex accounting rules, such as the standards for recognizing mortgage sales. OCC also noticed that each bank's repurchase reserve was comparatively lower than several other large banks

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and found that the banks did not adjust their repurchase reserves to reflect external factors in accordance with GAAP. In addition, OCC found that there was a lack of support for general ledger adjustments made to the amount of the repurchase reserves. The ROEs for the 2006 and 2007 examinations communicated that the ALLL was adequate but the methodology still required enhancements to meet federal banking interagency policy.

Despite repeated examiner criticisms from 2004 to 2007, management never implemented proper controls over the banks' accounting processes and the residential mortgage division's repurchase reserve methodology. The examiners warned in the 2007 ROEs that these accounting inadequacies would materially misstate the banks' financial statements and understate the potential losses from repurchased mortgages.

#### Ineffectiveness of the Banks' Board and Management

FNB Arizona, FNB Nevada, First Heritage Bank, and the First National Bank Holding Company shared common boards and some centralized functions. OCC examiners were concerned that the boards lacked independence because they were comprised of the same individuals, bank employees, and friends of the banks' owner.

Management of the three banks was dominated by the board's chairman, who was also the sole owner of the holding company. In FDIC documentation we reviewed, bank officials described the individual as being very dominant and influential in making decisions and setting direction. According to OCC, the owner created a culture within the banks that they considered to be high-risk and one that emphasized growth and profits over appropriate risk management.<sup>2</sup>

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<sup>2</sup> In September 2005, the First National Bank Holding Company voluntarily dissolved its New Mexico thrift, chartered by the Office of Thrift Supervision (OTS) just 11 months prior, after OTS had threatened to revoke the thrift's charter for deviating from its originally approved business plan. At that time, the thrift's key executives, including the owner of the holding company, also signed confidential letters certifying that they would not participate as an institution-affiliated party of any OTS-supervised thrift. OCC reviewed OTS's documentation and actions and did not find sufficient grounds to support action against First National Bank Holding Company management.

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Furthermore, the owner's son managed the residential mortgage division, becoming president of the division in 2004 without any previous mortgage experience. The banks' chief financial officer told FDIC that the owner's son ran the mortgage division as a closed, separate operation and wanted no intervention from anyone.

As mentioned above, the banks' management failed to address repeated OCC examiners criticisms concerning underwriting, loan concentrations, and accounting. In the 2007 and 2008 ROEs, the examiners discussed their significant concerns about the banks' board of directors and management. The examiners wrote that the ineffectiveness of the board and management directly caused the banks' significant problems. Examiners found the board and management to be critically deficient, as they had implemented high-risk business strategies that allowed the significant concentrations in high-risk residential mortgage and CRE loans without adequate risk management practices and without appropriate accounting policies and procedures. In addition, management failed to correct weak underwriting practices within the CRE and mortgage portfolios and was slow to react to market changes within these areas.

### **First Heritage Bank's Selling (Lending) of Federal Funds to Affiliates**

As normal practice, banks are required to maintain a certain amount of funds in reserve at a Federal Reserve Bank. Federal funds are overnight borrowings by banks to maintain their bank reserves with the Federal Reserve. Specifically, banks are required to maintain a certain level of reserves with the Federal Reserve to satisfy withdrawal demands and to clear financial transactions. Banks with reserves in excess of the required minimum amount can earn interest on the excess reserves by lending, or "selling" as it is called by market participants, the excess funds to other banks, usually on an overnight basis. Federal funds transactions neither increase nor decrease total bank reserves. Instead, they redistribute reserves and enable otherwise idle funds to yield a return. Banks may borrow these funds to avoid an overdraft (that is, the balance going below zero) of their reserve account, or in order to meet the reserves required to back their deposits.

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FNB Nevada, FNB Arizona, and First Heritage Bank had long standing funding interrelationships with each other. For example, according to OCC officials, First Heritage had a loan participation with FNB Arizona in the amount of \$150 million until December 2007. Additionally, until September 2007, First Heritage Bank purchased federal funds from FNB Arizona on a regular basis.

In December 2007, First Heritage Bank began selling federal funds to FNB Arizona and later to FNB Nevada, and this activity contributed to First Heritage Bank's failure. In this regard, the amounts sold to FNB Arizona varied on a daily basis and reached as high as \$89 million a day in May 2008. FNB Arizona became heavily dependent upon the funds to meet its daily reserve requirements, as well as to help it maintain liquidity and stability.

First Heritage Bank continued to sell federal funds to FNB Arizona until June 30, 2008, when FNB Arizona merged into FNB Nevada. Following the merger, First Heritage Bank sold federal funds to FNB Nevada to help it maintain liquidity and stability while it attempted to address losses arising from residential mortgage and CRE lending.

The selling of federal funds represented a significant risk to the viability of First Heritage Bank. At the peak, the federal funds sold to FNB Nevada (and to FNB Arizona pre-merger) amounted to approximately four times First Heritage Bank's capital and approximately one-half of its assets. Accordingly, if the affiliated banks were at anytime unable to repay the loans, this would cause First Heritage Bank to become critically undercapitalized. Ultimately, First Heritage Bank's capital was in fact depleted, leaving it critically undercapitalized and forcing OCC to close it as FNB Nevada, at the time of its failure, owed First Heritage Bank approximately \$74.4 million for the federal funds it had borrowed but could not repay.



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## OCC's Supervision of FNB Nevada and First Heritage Bank

OCC conducted timely and regular examinations of FNB Nevada (including FNB Arizona, before it merged with FNB Nevada) and First Heritage Bank and provided oversight through its off-site monitoring. The scope of the examinations appeared comprehensive as indicated by the ROEs, although workpaper evidence supporting the examination procedures performed was generally limited. In addition, as their financial condition deteriorated, OCC used PCA in reclassifying the FNB Arizona, FNB Nevada, and First Heritage Bank capital levels and restricting the banks' activities.

However, as discussed below, we believe that OCC should have taken formal enforcement action much sooner, and was not aggressive enough in the supervision of the banks when problems first arose. OCC identified problems in the mortgage operation of FNB Arizona and FNB Nevada as early as 2002 and found worsening conditions during subsequent exams into 2008; however, OCC took no forceful action until it issued Part 30 informal (non-public) enforcement actions to FNB Arizona and FNB Nevada in April 2008 and formal (public) consent orders to the three banks in June 2008.

Table 3 summarizes the results of OCC's annual safety and soundness examinations and enforcement actions for FNB Arizona, FNB Nevada, and First Heritage Bank. Appendix 5 provides details of MRAs and other recommended actions.

**Table 3: Summary of OCC's Safety and Soundness Examinations and Enforcement Actions for FNB Arizona, FNB Nevada, and First Heritage Bank**

Date started	Assets (\$Millions)	CAMELS rating	Examination Results		
			Number of matters requiring attention	Number of recommendations or other issues	Enforcement actions
<b>FNB Arizona</b>					
10/15/2002	\$443	2/222123	4	10	None
10/6/2003	\$814	2/222122	1	6	None
9/20/2004	\$1,517	2/222222	1	8	None
9/19/2005	\$2,145	2/222322	5	9	None
9/11/2006	\$2,325	2/212222	6	9	None
10/15/2007	\$2,940	4/444532	13	4	Part 30 issued 4/8/2008
5/12/2008	\$2,836	5/555553	0	18	Consent order Issued 6/4/2008
<b>FNB Nevada</b>					
10/15/2002	\$280	2/222123	4	10	None
10/6/2003	\$663	2/222122	1	6	None
9/20/2004	\$1,068	2/222122	1	6	None
9/19/2005	\$1,325	2/222122	4	6	None
9/11/2006	\$1,511	2/212122	2	6	None
10/15/2007	\$1,433	3/333232	12	3	Part 30 issued 4/8/2008
5/08/2008	\$1,634	5/555553	0	19	Consent order Issued 6/4/2008
<b>First Heritage Bank</b>					
1/23/2006	\$129	2/112322	0	8	None
10/2/2006	\$226	2/212322	2	4	None
10/15/2007	\$232	2/222322	5	4	None
5/12/2008	\$159	5/553553	0	7	Consent order Issued 6/4/2008

Source: OCC ROEs and Reports of Condition and Income (call reports).

Note: OCC issued no MRAs in the 2008 ROEs. The purpose of the 2008 ROEs was to downgrade the banks' CAMELS ratings. FNB Arizona merged into FNB Nevada on June 30, 2008.

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## **Forceful Action Not Taken in a Timely Manner to Address the Banks' Problems**

### Problems Found in the 2002 Examinations Were Repeated Through the 2006 Examinations

OCC first identified problems at FNB Arizona and FNB Nevada in 2002 when OCC performed a targeted review of their mortgage operations. OCC found that the condition of FNB Arizona and FNB Nevada was adversely impacted by the significant concentration in high-risk mortgage products and weak risk management controls. The examiners wrote that the viability of the banks could be impacted if senior bank management did not take immediate action to address the deficiencies. As it turned out, the examiners were correct.

OCC examiners found the following management inadequacies during their targeted review of the banks' mortgage operations:

- The boards of directors did not require bank management to conduct mortgage-banking activities in a safe and sound manner, as evidenced by the lack of concentration limits, weak risk management controls, and risky lending policies.
- Bank capital was strained by the large volumes of high-risk mortgage product originated and sold on a monthly basis.
- Liquidity was inadequate. Although earnings had increased, the banks were heavily dependent on volatile mortgage profits.
- Mortgage underwriting and credit risk management deficiencies, along with a concentration in high-risk mortgage lending activities, would likely adversely impact asset quality.

Despite these concerns, OCC assigned both FNB Arizona and FNB Nevada a CAMELS composite rating of 2—the same rating as in 2001 when relatively few problems were noted.

In the ROEs for the 2003 examinations, OCC reported that the two banks had addressed the deficiencies with their controls over mortgage operations. While this may have been the case, the

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examinations conducted from 2004 to 2006 found continuing and additional problems, and over time these conditions worsened. These problems included, for example, underwriting weaknesses in the origination and later the administration of loans, inadequate accounting policies, an inadequate ALLL methodology, large CRE concentrations, and weak contingency funding planning. During these years, OCC examiners assigned the banks composite CAMELS ratings of 2.

### 2007 Examination Resulted in an Elevated Response by OCC

OCC concluded in the 2007 examination that the condition of FNB Arizona and FNB Nevada had deteriorated to the point where the banks had become a supervisory concern. A major issue at FNB Arizona, which ultimately affected its sister banks, was the significant losses incurred by the residential mortgage division. OCC reported that the division's projected loss at year-end would be \$168 million. The mortgage losses threatened the viability of FNB Arizona by eroding its capital, and OCC expected that those losses would affect FNB Nevada because the bank would need to support FNB Arizona.

OCC also found CRE risk management weak at FNB Arizona and FNB Nevada. Further, the examiners found that First Heritage Bank's loan portfolio contained CRE concentrations and weaknesses in its credit administration similar to those found at FNB Arizona and FNB Nevada.

It also became increasingly apparent to OCC that the banks' management was slow to respond to prior supervisory recommendations. OCC blamed the ineffective and insufficient board oversight for the failures to correct repeated issues and the declining conditions of FNB Arizona and FNB Nevada. Both the board and management failed to ensure that accounting policies, staffing levels, and expertise were commensurate with the complexities of bank operations. OCC stated in its ROEs that these issues had been ongoing despite recommendations and MRAs dating back to the 2004 examinations.

Based on the examination findings, OCC concluded in December 2007 that a formal enforcement action needed to be taken with

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respect to FNB Arizona. As discussed below, OCC held off on taking formal action until June 4, 2008.

The decision in December 2007 to pursue a formal enforcement action was made by OCC's Western District office based on its review of the OCC's field office draft ROE for the 2007 examination. We noted that there were disagreements between the district officials and the field office examiners as to the severity of the examination findings on various matters such as liquidity risk. The Western District office and the field office also had differences as to the CAMELS ratings that should be assigned to FNB Nevada. In December 2007, the district downgraded FNB Nevada's 2007 ROE CAMELS composite rating to a 3 from the 2 recommended by the field office. The Western District office also decided that a formal enforcement action was needed for FNB Nevada. In January 2008, the district office also added two MRAs to the ROE that addressed FNB Nevada's liquidity problems and accounting issues, and downgraded the bank's liquidity component of the risk assessment profile to weak from satisfactory.

On April 8, 2008, OCC finally issued the 2007 ROEs and downgraded the CAMELS composite ratings for FNB Arizona and FNB Nevada to 4 and 3, respectively. OCC had approved the ratings on December 6, 2007, and communicated the ratings to the banks on December 10, 2007. OCC retained First Heritage Bank's 2007 CAMELS composite rating at 2, despite the significant impact that the deterioration of FNB Arizona and FNB Nevada had on its financial condition.

Because the deteriorating conditions of FNB Arizona and FNB Nevada necessitated the CAMELS ratings downgrades and implementation of the informal enforcement actions, we believe OCC should also have downgraded First Heritage Bank's composite rating following the 2007 exam. First Heritage Bank's CAMELS composite rating of 2, issued April 8, 2008, clearly did not reflect the bank's actual condition given the significant deterioration of its sister banks and the risk posed by its selling of federal funds. OCC had to significantly downgrade First Heritage Bank's composite rating to a 5 from a 2 on June 23, 2008, just 3 months later.

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## Enforcement Action Delayed While a Potential Investor Considered Making an Equity Injection in the Banks

As stated above, OCC concluded in December 2007 that formal (public) enforcement action should be taken against both FNB Arizona and FNB Nevada. It was not until April 8, 2008, that enforcement actions were taken, when OCC issued FNB Arizona and FNB Nevada a "Notification of Failure to Meet Safety and Soundness Standards and Request for Compliance Plan." Referred to as a Part 30, this was an informal (non-public) enforcement action. Concurrent with the Part 30, OCC notified bank management that its minimum capital requirements were increased.

*OCC's Bank Supervision Operations—Enforcement Action Policy* states that there is a strong presumption that banks with a composite rating of 4 or 5 warrant a formal action because they are more likely to fail. The policy, which provides for some management discretion, also states that there is a presumption of issuing either informal or formal enforcement action for 3 rated banks, depending on the management's ability to take appropriate corrective measures.<sup>3</sup> With respect to the timeframes for taking enforcement actions, the policy states that they should be done as soon as practical once the need for the action has been identified. It further states that the decision whether to initiate an enforcement action should be made within 15 days following a decision to assign or retain a composite CAMELS rating of 3, 4, or 5. The same policy states that notice of the Part 30 Safety and Soundness Plan should be served to the board of directors within 15 days following the final decision to take an enforcement action, and that a consent order (a formal public enforcement action) should be executed within 3 weeks of the final decision to take such action.

The main reason OCC delayed action was that an investment firm had expressed interest in making a substantial equity injection into the banks. Bank management informed OCC that the investment firm was likely to inject capital of at least \$158 million into FNB Arizona and \$32 million into Nevada. The Deputy Comptroller of

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<sup>3</sup> Discretion is superseded when actions are required by statute or other legal source, such as monetary transaction record keeping and reporting required by the Bank Secrecy Act.

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the OCC's Western District told us that OCC met with the investment firm in December 2007. The investment firm informed OCC that it would not pursue investing in the banks if OCC issued a formal enforcement action. While OCC had made a decision to issue a formal enforcement action in December 2007, OCC officials concluded in January 2008 that the informal Part 30 action, coupled with the capital injection, would help address the weaknesses at FNB Arizona and FNB Nevada and assist in obtaining adequate capital.

OCC expected that the investment firm's due diligence process would be completed by February 2008. However, the process continued past February and the investment firm communicated to OCC its continued interest in pursuing the investment. By this time, the required amount of the capital needed for the banks to remain viable had more than doubled. As time went on, the amount of investment needed to sustain the banks increased and the losses widened. Ultimately, in May 2008, the investment firm concluded that the projected losses were too high for them to receive the rate of return necessary to make the deal tenable. OCC's Senior Deputy Comptroller for Midsize/Community Bank Supervision told us that he was more comfortable in January 2008 than in March 2008 that the investor would make the investment.

In its Part 30 action, OCC directed the banks to file acceptable safety and soundness compliance plans by May 8, 2008. OCC provided specific criteria that the compliance plans should address. OCC required that FNB Arizona and FNB Nevada appoint two external/independent board members, refrain from making new Alt-A or other non-traditional mortgages without OCC approval, develop a contingency funding plan, restore accounting records to comply with GAAP, and ensure appropriate underwriting standards are used for new CRE loans.

In response, FNB Arizona and FNB Nevada filed the safety and soundness compliance plans required by the Part 30 action on May 8, 2008. OCC's Western District Office approved the plans on May 16, 2008, and immediately required both institutions to implement and adhere to the plans.

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On April 8, 2008, OCC also notified all three banks of its intent to establish higher individual minimum capital ratios by May 30, 2008.<sup>4</sup> On May 16, 2008, the Western District Office issued letters notifying all three banks that OCC had decided to establish the higher minimum capital ratios. According to OCC documents of verbal interactions with bank management, FNB Arizona and FNB Nevada had been informed earlier in the year that OCC would immediately issue formal enforcement actions should the banks fail to find investors willing to invest capital in the banks and complete the proposed investment by May 31, 2008. When the banks failed to meet that deadline, OCC issued consent orders on June 4, 2008. OCC also issued a consent order to First Heritage Bank because of the significant volume of assets it had tied up in its sister banks.

OCC's Western District Deputy Comptroller as well as Special Counsel for the Western District told us that OCC initially drafted and planned to issue a consent order to FNB Arizona and a formal action on FNB Nevada in December 2007. However, we were told that there was a lot of discussion within OCC as to whether to issue the order because the would-be investor had expressed interest in providing the banks with the needed capital. At that time, the investment firm informed OCC that it was very interested in the banks, but that the firm would be unwilling to make the investment if OCC took a formal enforcement action against the banks. The Deputy Comptroller told us that the situation with the banks was unique because of the investor's involvement.

According to OCC officials, OCC was in a position to issue the informal Part 30 actions to FNB Arizona and FNB Nevada immediately after the Senior Deputy Comptroller agreed with the action in January 2008. However, as a prudent measure, the Senior Deputy Comptroller presented the case and the recommendation to issue the Part 30 actions to OCC's Washington Supervision Review Committee (WSRC). This presentation occurred on March 20, 2008. During the presentation, the Senior Deputy Controller said he verbally communicated to WSRC that it would be appropriate to have a Part 30 action in place during investor

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<sup>4</sup> OCC's authority to require such action is found at 12 USC. § 3907(a)(2) and 12 CFR Part 3, Subpart C.



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negotiation and possible sale of the bank. WSRC concurred with the recommended action but only if the investor had a definitive agreement with the banks to make the investment and if bank control issues were resolved favorably. If such an agreement was not in place, WSRC recommended that OCC should move immediately to impose the formal actions on the banks.

OCC, however, issued the informal Part 30 action on April 8, 2008, with no definitive investment agreement in place. The Senior Deputy Comptroller told us that he recognized that the circumstances called for a consent order. However, the ultimate decision to issue the informal Part 30 action rather than the formal consent order was his. He said his decision was made in accordance with OCC policy that provides the Senior Deputy Comptroller with authority to use informal enforcement action in this manner.

While it could be argued that OCC allowed the investor too much time to consider the capital injection before OCC started taking enforcement action, we recognized the dilemma facing OCC in this matter. It is also important to note that OCC policy allows for discretion in the taking of enforcement actions with authorization by senior management. In this case, the enforcement approach toward FNB Nevada and First Heritage Bank was approved at the senior OCC management level in accordance with policy. While the timing of the various enforcement actions was somewhat delayed, in the end we conclude that OCC senior management used its enforcement discretion in an appropriate manner. That said, OCC needs to be careful when exercising such enforcement discretion that it can later defend its actions when an ailing institution cannot ultimately be saved.

#### OCC Acknowledged It Did Not Effectively Supervise FNB Arizona

As part of the process to meet the internal control requirements of the Federal Managers' Financial Integrity Act (FMFIA), OCC executive committee members submit FMFIA certification to the Comptroller in which management attest that programs under their areas of responsibility are achieving the intended results, consistent

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with OCC's mission and following rules and regulations, and that timely and reliable information was used for decision-making.<sup>5</sup>

The Deputy Comptroller for the Western District wrote in her fiscal year 2008 assurance statement to the Comptroller that OCC had not effectively supervised FNB Arizona and although OCC appropriately identified many of the risks in the bank, OCC did not require corrective action from bank management as aggressively as it should have. The assurance statement also noted that issues at FNB Arizona spilled into FNB Nevada and First Heritage Bank.

Examination Workpapers Generally Lacked Specificity and the Basis for Conclusions Were Not Always Clear

OCC polices and procedures applicable to supervision workpapers require that examiners prepare clear and concise workpapers that other examiners and reviewers can readily understand.<sup>6</sup> While workpapers are not required to include all of the data reviewed, examiners should generate and retain documents necessary to support the scope of the supervisory activity, significant conclusions, rating changes, or changes in risk profiles.

We found that the workpapers supporting the examinations of FNB Arizona, FNB Nevada, and First Heritage Bank generally lacked clarity, specificity, and support for many of the conclusions reached and what examination procedures were performed.

A 2006 internal OCC quality assurance review of the supervisory activities performed on FNB Arizona also found problems with the examination workpapers. The reviewers noted that (1) the examiners' follow-up on issues identified in a prior exam was not properly documented and (2) an OCC supervisory letter to the bank referenced in the ROE could not be found.

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<sup>5</sup> The Federal Managers' Financial Integrity Act (31 USC § 3512), as implemented by the Office of Management and Budget, requires agencies to perform regular evaluations of management controls and financial management systems to protect against fraud, waste, and abuse.

<sup>6</sup> OCC PPM 5400-8, section: Bank Supervision, Subject Supervision Work Papers, Revised October 23, 2002.

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Based on the above, we believe adequacy of examination workpapers is an area that requires continuous OCC management attention.

### **OCC Used Prompt Corrective Action Appropriately**

The purpose of PCA is to resolve the problems of insured depository institutions at the point at which there is the least possible long-term loss to the Deposit Insurance Fund.<sup>7</sup> 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 *Bank Supervision Operations—Enforcement Action Policy* allows for imposing 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 used the mandatory and discretionary PCA provisions against FNB Arizona, FNB Nevada, and First Heritage Bank, as prescribed in its enforcement action policy, as follows:

- OCC notified FNB Arizona that the bank was downgraded to the adequately capitalized category on February 11, 2008, and that because it was categorized as adequately capitalized, it no longer could receive or renew brokered deposits unless specifically authorized by FDIC. OCC notified FNB Arizona that the bank was downgraded to the undercapitalized category on May 14, 2008, and significantly undercapitalized category on June 23, 2008. On May 14, 2008, OCC required the bank to submit an acceptable capital restoration plan to become adequately capitalized and required a guaranty and pledge of assets from the holding company. FNB Arizona submitted a capital restoration plan but OCC deemed it unacceptable on June 27, 2008.

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<sup>7</sup> 12 USC § 1831o and 12 CFR § 6.

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- OCC likewise notified FNB Nevada that the bank was adequately capitalized on May 14, 2008, and that it could not receive or renew brokered deposits unless authorized by FDIC. Following the merger with FNB Arizona, FNB Nevada's capital ratios declined to the undercapitalized category. OCC notified the bank of this change in a letter dated July 2, 2008.
  - Although First Heritage Bank's capital ratios reflected the well-capitalized category for PCA purposes, as a result of the consent order issued on June 4, 2008, First Heritage Bank was no longer considered well-capitalized. First Heritage Bank became critically undercapitalized when OCC closed FNB Nevada on July 25, 2008. At that time, First Heritage Bank had a capital position of negative \$58.7 million as a result of having to record a loss of \$74.4 million in federal funds that it had sold to but could not collect from FNB Nevada. OCC immediately placed First Heritage Bank in receivership with FDIC.

We also found that in May 2008, First Heritage Bank began accepting brokered deposits after this source of funds was no longer available to FNB Arizona and FNB Nevada. The brokered deposits obtained by First Heritage Bank were used to finance the sale of federal funds to FNB Arizona and FNB Nevada. We asked the Western District's Deputy Comptroller why First Heritage Bank was allowed to accept brokered deposits when its affiliates were prohibited from doing so. The OCC official told us that the impact of the brokered deposits was considered as part of the daily onsite liquidity monitoring but OCC's main concern was the stability of the overall consolidated company. She said that OCC did not have the legal authority to immediately prevent First Heritage Bank from accepting brokered deposits in May 2008 because First Heritage Bank was still well-capitalized. However, about a month later, by virtue of the June 4, 2008, consent order, First Heritage Bank was also prohibited from accepting brokered deposits.

### **OCC Transferred Supervision of the Banks to its Special Supervision Division to Facilitate Closings**

On June 23, 2008, OCC notified FNB Arizona, FNB Nevada, and First Heritage Bank that they were in critical condition and their failure was highly probable without an immediate injection of

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capital. OCC downgraded the banks to a CAMELS composite rating of 5 and transferred supervision to its Special Supervision Division in Washington, D.C., in accordance with OCC's *Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution*. The role of the Special Supervision Division is to supervise problem banks through rehabilitation or through other resolution processes such as the sale, merger, or liquidation of such institutions. The guide states that supervisory responsibility transfers automatically once a bank is downgraded to a 5.

The Special Supervision Division directed the overall supervision of the banks until their closure on July 25, 2008. The Special Supervision Division supervisory actions in the case of these banks included reviewing required capital restoration plans, working with FDIC and Federal Reserve personnel, and issuing PCA notices. By the time of the transfer to Special Supervision Division, the financial condition of the banks had deteriorated rapidly and they had no viable plan to restore capital and achieve profitability. As a result, OCC exercised its authority to close the banks and appointed FDIC as receiver on July 25, 2008.

## Recommendations

1. OCC acknowledged that it had not effectively supervised FNB Arizona and that issues at FNB Arizona later spilled into FNB Nevada and First Heritage Bank. While we did not find weaknesses in OCC's supervisory policy and procedures in this regard, we do recommend that the Comptroller of the Currency re-emphasize to examiners the need to ensure banks take swift corrective actions in response to examination findings.

### Management Response

OCC plans to reinforce the requirements of its Enforcement Action Policies and emphasize to examiners the need to ensure banks take swift corrective actions in response to examination findings. OCC also plans to include follow-up on outstanding concerns in the supervisory strategies for individual banks, and to track that follow-up. In addition, follow-up on supervisory concerns will remain in the scope of OCC's quality assurance

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processes, and OCC will make certain that, if appropriate, communication of quality assurance results includes observations about examiner efforts to ensure banks promptly address supervisory concerns. In this regard, subsequent to the failure of FNB Nevada and First Heritage Bank, OCC's Enterprise Governance unit conducted a special review to confirm that all community bank quality assurance programs contain specific quality management elements pertaining to corrective action, follow-up, and enforcement. OCC also plans to reiterate to examiners in an upcoming conference call the importance of ensuring that banks take timely actions to address examination findings.

2. To address the issue related to examination workpapers, we further recommend that the Comptroller of the Currency re-emphasize to examiners OCC's policy on the preparation of supervision workpapers (e.g., workpapers are to be clear, concise, and readily understood by other examiners and reviewers).

#### Management Response

OCC plans to ensure that observations about the quality of workpapers identified as part of its quality assurance processes involving regular reviews of samples of supervision workpapers, and recommendations for improving documentation, are included in the communication of quality assurance results to examiners. OCC also plans to address the importance of workpaper quality and completeness in an upcoming conference call with examiners.

#### OIG Comment

OCC's actions, both taken and planned, meet the intent of our recommendations. These are matters that require continued OCC management attention and monitoring.

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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 (617) 223-8640 or Mark Ossinger, Audit Manager, at (617) 223-8643. Major contributors to this report are listed in Appendix 7.

Donald P. Benson  
Audit Director

We conducted this material loss review of First National Bank of Nevada (FNB Nevada) and First Heritage Bank, N.A. (First Heritage Bank) in response to our mandate under section 38(k) of the Federal Deposit Insurance Act, as amended. 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 implementation of the Prompt Corrective Action (PCA) 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 FNB Nevada and First Heritage Bank based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of December 31, 2008, FDIC's Deposit Insurance Fund had recorded an estimated loss of \$706 million for FNB Nevada and \$33 million for First Heritage Bank. We also included in this review information from a third OCC bank, First National Bank of Arizona (FNB Arizona), which merged into FNB Nevada on June 30, 2008, 1 month before the banks failed.

To accomplish our review, we conducted fieldwork at Office of the Comptroller of the Currency's (OCC) headquarters in Washington, D.C., its Western District office in Denver, Colorado, and its field office in Phoenix, Arizona. We also met with officials from FDIC's Division of Resolutions and Receiverships in Dallas, Texas. Our specific activities consisted of the following:



- We reviewed OCC supervisory records for FNB Arizona, FNB Nevada, and First Heritage Bank from 2002 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 FNB Arizona, FNB Nevada, and First Heritage Bank with OCC officials, attorneys, and examination staff to obtain their perspective on why the banks failed. We also interviewed an FDIC supervisory examiner who was responsible for monitoring the daily liquidity of the banks prior to their closing.
- We interviewed FDIC Division of Resolutions and Receiverships personnel involved in the closings and receivership of FNB Nevada and First Heritage Bank.

In reviewing OCC's supervision of the banks, we assessed (1) the timeliness of OCC's discovery of the banks' safety and soundness problems; (2) the types and gravity of the problems, and OCC's reporting of such; and (3) the adequacy of OCC's supervisory response to get the banks to correct the problems.

We did not assess OCC's overall management control structure because of the limited audit objectives. Regarding compliance with laws and regulations, we determined OCC's compliance with and use of the provisions of Prompt Corrective Actions (PCA).

We did not assess the validity and reliability of computer-processed data from OCC or FDIC because such data were not significant to the objectives of the audit and did not affect the results. Instead, we relied on interviews, correspondence, and other evidence to support the result of our audit.

Our review covered the period from 2002 until the failures of FNB Nevada and First Heritage Bank on July 25, 2008. We conducted our fieldwork from August 2008 through December 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.

### **History of FNB Nevada and First Heritage Bank**

First National Bank of Nevada (FNB Nevada) was established in 1987 as Laughlin National Bank and changed to its current name in 1998. On June 30, 2008, First National Bank of Arizona (FNB Arizona) merged with FNB Nevada. The post-merge FNB Nevada had \$3.4 billion in assets and, in addition to its main office, 24 branch locations.

Prior to the merger, First National Bank Holding Company owned 95 percent of FNB Arizona and all of FNB Nevada. The holding company owned 100 percent of the combined bank.

First National Bank Holding Company also owned First Heritage Bank, which was established in 2005 as a community bank specializing in commercial banking. As of June 30, 2008, First Heritage Bank had \$254 million in assets and three offices in California. The holding company managed FNB Arizona, FNB Nevada, and First Heritage Bank jointly, with common management and similar boards and some centralized functions.

Appendix 4 presents a chronology of significant events concerning FNB Nevada and First Heritage Bank.

### **Types of Examinations Conducted by OCC**

OCC conducts various types of bank examinations, including full-scope examinations. A full-scope examination is a combined examination of the institution's safety and soundness, compliance with various rules and regulations, and information technology (IT) systems. The safety and soundness portion of the examination includes a review and evaluation of capital adequacy, asset quality, management effectiveness, earnings performance, liquidity and asset/liability management, and sensitivity to market risk. The IT portion of the full-scope examination evaluates the overall performance of IT within the institution and the institution's ability to identify, measure, monitor, and control technology-related risks. The compliance portion of the examination includes an assessment of how well the bank manages compliance with various consumer protection regulations, such as Truth in Lending, Truth in Savings, and the Bank Secrecy Act. A targeted examination is any

examination that does not fulfill all the statutory requirements of a full-scope examination.<sup>8</sup>

The results of full-scope examinations are used to assign ratings to 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 assigns each banking organization individual CAMELS component ratings and a composite rating that indicates the institution's overall condition. CAMELS composite and component ratings are on a five-point scale, with 1 being the best score and 5 being the worst score. 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. Banks with a composite rating of 2 are fundamentally sound, generally have no component rated 4 or 5, and exhibit no material supervisory concerns. Banks with a composite rating of 3 exhibit some degree of supervisory concern in one or more component areas, generally have no component with a rating of 5, and require more than normal supervision, which may include formal or informal enforcement actions. Banks with a composite rating of 4 exhibit unsafe and unsound practices and have problems ranging from severe to critically deficient that are not being satisfactorily addressed by management. Banks with a composite rating of 5 exhibit extremely unsafe and unsound practices or conditions, have critically deficient performance, and present the greatest supervisory concern.

### **Types of Enforcement Actions Available to OCC**

OCC uses informal and formal enforcement actions to address violations of laws, rules, regulations, and unsafe and unsound practices or conditions.

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<sup>8</sup> 12 USC § 1820(d), generally requires that the appropriate federal banking agency, conduct a full-scope, on-site examination of each insured depository institution at least once during each 12-month period. However, the 12-month period may be extended to 18 months depending on the size and other circumstances of the affected institution.

### Informal Enforcement Actions

When a bank's overall condition is sound but it is necessary to obtain written commitments from its 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 Report of Examination (ROE) normally contains but are generally not legally binding.

Informal enforcement actions include commitment letters, memoranda of understanding (MOU), and Part 30 safety and soundness plans. A commitment letter and MOU contain specific bank commitments to take corrective actions in response to problems or concerns identified by OCC in its supervision of the bank. A Part 30 informal enforcement action requires the bank to submit a compliance plan for OCC approval that outlines the steps the bank will take and timeframes to correct identified deficiencies. Unlike formal enforcement actions, informal actions are not disclosed to the public.

### Formal Enforcement Actions

Formal enforcement actions are authorized by statute, generally more severe, and disclosed to the 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 Guidelines**

OCC policy specifies that determining the appropriate enforcement action, whether informal or formal, depends on the following:

- the overall condition of the bank;
- 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.<sup>9</sup>

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<sup>9</sup> *Bank Supervision Operations—Enforcement Action Policy* (PPM 5310-3).

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.
Alt-A loan	A mortgage made to a borrower that typically does not involve income verification or documentation of income, assets, or employment. Instead, the approval of the loan is based primarily on an individual applicant's FICO score.
Brokered deposits	Any deposit that is obtained, directly or indirectly, from a deposit broker. The bank solicits deposits 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 USC § 1831(f) and 12 CFR § 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 report	A quarterly report of income and financial condition that banks file with their regulatory agency. The

contents of a call report 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 following 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 best rating and 5 being the worst rating.

Capital restoration plan

A plan submitted to the appropriate federal banking agency by any undercapitalized insured depository institution. The plan 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 is in effect, how the institution will comply with the restrictions or requirements then in effect, the types and levels of activities in which the institution will engage, and any other information that the federal banking agency may require.

Commercial real estate loans

Loans secured by raw land, land development, and construction. Commercial real estate includes one-to four-family residential construction, multifamily property, and nonfarm nonresidential property where the primary or a significant source of repayment is from rental income associated with the property (i.e., loans for which 50 percent or more of the source of repayment comes from third-party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

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.
Consent order	The title given by OCC to an Order to Cease and Desist, which is entered into and becomes final through the board of directors' execution on behalf of the bank of a stipulation and consent document. Its provisions are set out in article-by-article form and prescribe restrictions and corrective and remedial measures necessary to correct deficiencies or violations in the bank and return it to a safe and sound condition.
Correspondent channel	The selling of loans whereby a correspondent lender not only takes the application and processes the loan, but also funds the loan. The correspondent then sells the loan to a wholesale lender, usually under a previous commitment of the wholesaler to purchase a certain amount of loans at an agreed-upon interest rate.
De novo bank	A newly chartered bank opened less than 3 years.
District Supervision Review Committee	An OCC committee that ensures that OCC bank supervision and enforcement policies are applied effectively and consistently. The committee advises the deputy comptrollers on bank supervision and enforcement cases by providing recommendations on supervisory strategies and enforcement actions.
Formal agreement	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.
Generally accepted accounting principles	A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board.

Individual minimum capital ratio	Established under OCC authority, a minimum level of capital for a banking institution that OCC considers to be necessary or appropriate in light of the particular circumstances of the institution.
Loan participation	The sharing of a loan by a group of banks that join together to make a loan too large for any one of the banks to handle. Loan participation is a convenient way for smaller banks to book loans that would otherwise exceed their legal lending limits.
Matter requiring attention	A bank practice noted during an examination that deviates from sound governance, internal control, and risk management principles, which may adversely affect the bank's earnings or capital, risk profile, or reputation if not addressed or which may 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. Matters requiring attention are not enforcement actions, but failure by a bank's board and management to address a matter requiring attention could lead to an enforcement action.
Part 30 Safety and Soundness Plan	An informal, nonpublic enforcement action. It informs the recipient of OCC's conclusion that the bank failed to meet established safety and soundness standards and requires the bank to submit a compliance plan to describe the steps the institution will take to correct the deficiencies and establish the time period for when the actions will be taken.
Prompt Corrective Action	A framework of supervisory actions, set forth in 12 USC § 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 prevent a failure or 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.
Relationship concentrations	Concentration of loans and/or other obligations to one borrower or related group of borrowers.
Repurchase reserve	Funds earmarked by a bank from its retained earnings for potential future repurchase of nonperforming or nonconforming loans sold to investors.
Retail channel	The selling of loans whereby the lender offers mortgage loans directly to borrowers through a sales force of loan officers.
Risk Assessment Profile	A measure of the quantity and quality of risk management that OCC assigns to each of the following 9 risk categories for bank supervision purposes: credit, interest rate, liquidity, price, foreign currency translation, transaction, compliance, strategic, and reputation. Quantity of risk represents the level or volume of risk that currently exists and is assessed as low, moderate, or high. Quality of risk management is how well risks are identified, measured, controlled, and monitored, and is assessed as strong, satisfactory, or weak.
Tier 1 capital	Common shareholder's equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.
Washington Supervision Review Committee	An OCC committee that advises senior deputy comptrollers on bank supervision and enforcement cases by providing recommendations on supervisory strategies and enforcement actions. The committee is chaired by the deputy comptroller for Special Supervision.
Well-capitalized	An insured depository institution that significantly exceeds the required minimum level for each relevant capital measure.

Wholesale channel	The selling of loans whereby the lender does not deal directly with the consumer to acquire loans. Instead, the lender and consumer work through an intermediary, such as a mortgage broker.
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Appendix 4  
Chronology of Significant Events

This chronology describes significant events in the history of First National Bank of Nevada (FNB Nevada) and First Heritage Bank, National Association (First Heritage Bank), including examinations conducted and enforcement actions taken by the Office of the Comptroller of the Currency (OCC).

Date	Event
07/23/1987	Laughlin National Bank is established.
09/02/1998	Laughlin National Bank is renamed FNB Nevada.
01/31/2001	Rocky Mountain Bank changes its name to FNB Arizona and is reorganized as a national bank. OCC becomes the bank's primary regulator.
06/01/2001	FNB Arizona acquires First Bank of Arizona, National Association. FNB Arizona moves its headquarters to Scottsdale, Arizona.
06/27/2001	OCC examines FNB Arizona's and FNB Nevada's risk management practices and financial condition. OCC assigns both banks a CAMELS composite rating of 2.
08/08/2002	FNB Nevada reorganizes and moves its headquarters from Laughlin, Nevada, to Reno, Nevada.
10/15/2002 to 11/25/2002	OCC examines FNB Arizona's and FNB Nevada's risk management processes, financial condition, and mortgage operations. OCC assigns both banks a CAMELS composite rating of 2.
10/06/2003 to 10/31/2003	OCC examines FNB Arizona's and FNB Nevada's financial condition and risk profile and evaluates compliance management and information technology functions. OCC assigns both banks a CAMELS composite rating of 2.
09/20/2004 to 10/28/2004	OCC begins a safety and soundness exam of the FNB Arizona and FNB Nevada. OCC assigns both FNB Arizona and FNB Nevada a CAMELS composite rating of 2.
02/15/2005	First Heritage Bank is established.
06/28/2005	OCC issues a letter to First Heritage Bank with results of its <i>de novo</i> site visit. OCC makes six recommendations to the board of directors and does not require a formal response.
09/19/2005 to 11/08/2005	OCC conducts a safety and soundness exam of FNB Arizona and FNB Nevada. OCC assigns both FNB Arizona and FNB Nevada a CAMELS composite rating of 2.
01/23/2006 to 2/02/2006	OCC conducts a safety and soundness exam of First Heritage Bank. OCC assigns a CAMELS composite rating of 2.
09/11/2006 to 11/16/2006	OCC conducts a safety and soundness exam of FNB Arizona and FNB Nevada. OCC assigns both FNB Arizona and FNB Nevada a CAMELS composite rating of 2.
10/02/2006 to 11/16/2006	OCC conducts a safety and soundness exam of First Heritage Bank. OCC assigns the bank a CAMELS composite rating of 2.
05/08/2007	OCC approves the merger of FNB Arizona into FNB Nevada. The banks are given 1 year to complete the merger before the approval expires.
08/21/2007	FNB Arizona closes its residential mortgage division.
09/30/2007	The president (the owner's son) of the residential mortgage division resigns.
10/15/2007 to 11/23/2007	OCC conducts a safety and soundness exam of FNB Arizona, FNB Nevada, and First Heritage Bank. OCC assigns FNB Arizona, FNB Nevada, and First Heritage Bank CAMELS composite ratings of 4, 3, and 2, respectively.

Appendix 4  
Chronology of Significant Events

Date	Event
12/06/2007	OCC's Western District Supervision Review Committee approves a CAMELS composite rating of 4 and a consent order for FNB Arizona and a CAMELS composite rating of 3 and the institution of a formal agreement for FNB Nevada.
12/19/2007	OCC meets with an investment firm interested in providing the banks with capital. The firm informs OCC that it will not make the investment if FNB Arizona is under a public enforcement action.
12/31/2007	Bank data indicate that as of year-end 2007, First Heritage Bank had sold a \$60 million of federal funds to FNB Arizona.
01/10/2008	OCC informs FNB Arizona and FNB Nevada that they are in "troubled condition" for purposes of section 914 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 12 USC § 1831(i), and as defined in OCC's implementing regulation and 12 CFR § 5.51.
01/14/2008	OCC conducts a horizontal review of commercial real estate loans of FNB Arizona, FNB Nevada, and First Heritage Bank.
02/11/2008	OCC informs FNB Arizona that the bank cannot receive or renew brokered deposits unless specifically authorized by FDIC because the bank is in the adequately capitalized PCA category.
03/20/2008	OCC's Washington Supervision Review Committee concurs with the Western District to issue 12 CFR Part 30 Safety and Soundness Plans (Part 30) to FNB Arizona and FNB Nevada instead of cease and desist orders. The Senior Deputy Comptroller for Midsize/Community Bank Supervision approves the Part 30.
03/31/2008	First Heritage Bank sells \$41.9 million of federal funds to FNB Arizona and FNB Nevada.
04/08/2008	OCC requires that FNB Arizona and FNB Nevada submit a Part 30 plan. Additionally, OCC requests that FNB Arizona, FNB Nevada, and First Heritage Bank establish a minimum capital ratio of 8 percent pursuant to 12 CFR Part 3 (individual minimum capital ratio). The banks accept the new minimum capital ratios requirements.
05/05/2008	OCC begins to conduct daily liquidity monitoring at FNB Arizona.
05/07/2008	The individual serving as president, vice chairman, and chief executive officer of FNB Arizona and FNB Nevada and director of First Heritage Bank resigns.
05/08/2008	OCC extends the merger application of FNB Arizona and FNB Nevada. FNB Arizona and FNB Nevada provide OCC with the Part 30 Safety and Soundness Plan, which OCC accepts on May 16, 2008.
05/14/2008	OCC requires FNB Arizona to submit an acceptable capital restoration plan because its PCA capital category is at undercapitalized status. OCC notifies FNB Nevada that its PCA capital category is at adequate capitalized status, which prevents the bank from accepting or renewing brokered deposits without FDIC approval.

Appendix 4  
Chronology of Significant Events

<b>Date</b>	<b>Event</b>
05/16/2008	OCC notifies FNB Arizona and FNB Nevada of its decision, under the Part 3 enforcement action, to establish and maintain the minimum capital ratio of 8 percent. FNB Arizona and FNB Nevada are to submit plans and to achieve the updated leverage ratios by May 30, 2008. OCC also notifies FNB Arizona and FNB Nevada that the compliance plans the banks submitted under Part 30 have been approved and that they are to immediately implement and adhere to the approved plans.
06/04/2008	OCC issues a consent order to FNB Arizona, FNB Nevada, and First Heritage Bank, which replaces the Part 30 Safety and Soundness Plan and the individual minimum capital ratio. OCC requires the banks to achieve and maintain a Tier 1 leverage ratio of 8 percent by June 30, 2008.
06/09/2008	FNB Arizona submits its capital restoration plan.
06/16/2008	The Board of Governors of the Federal Reserve System enters into a consent order with First National Bank Holding Company that requires the holding company to provide financial strength to its banks.
06/23/2008	OCC informs FNB Arizona that the bank is significantly undercapitalized. OCC downgrades FNB Arizona's CAMELS composite rating to a 5 from a 4. OCC also downgrades FNB Nevada's CAMELS composite rating to a 5 from a 3 and First Heritage Bank's CAMELS composite rating to a 5 from a 2. OCC transfers supervision of the banks to its Special Supervision Division in Washington, D.C.
06/27/2008	OCC informs FNB Arizona that its overall capital restoration plan is unacceptable.
06/30/2008	FNB Arizona merges into FNB Nevada.
07/02/2008	FNB Nevada's capital category is at undercapitalized status following the merger.
07/03/2008	OCC's terminates FNB Arizona's consent order because of the merger.
07/25/2008	OCC closes FNB Nevada and First Heritage Bank and appoints FDIC as receiver.
07/28/2008	Mutual of Omaha Bank acquires all of the deposits and certain assets of FNB Nevada and the First Heritage Bank and reopens 28 of the banks' offices.

Source: OIG analysis of OCC, FDIC, FNB Arizona, FNB Nevada, and First Heritage Bank data.

Appendix 5  
OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
<b>FNB Arizona and FNB Nevada</b>				
09/20/2004	2/222222 (FNB Arizona)	\$1,517	<u>Matters requiring the attention of the board of directors</u>	None
	2/222122 (FNB Nevada)	\$1,068	<ul style="list-style-type: none"> <li>• Evaluation of the corporate governance and organizational structure is needed. Assessment is to include <ul style="list-style-type: none"> <li>○ reviewing the adequacy of audit committee membership;</li> <li>○ determining the appropriate level for corporate processes such as risk management, internal audit, internal loan review, and compliance management (repeat issue);</li> <li>○ ensuring clear expense and profit allocation for affiliates and/or related organizations;</li> <li>○ establishing and implementing a balanced incentive compensation program that achieves an appropriate balance between production and loan quality and loan administration across the organization.</li> </ul> </li> </ul> <p><u>Other issue/recommendation</u></p> <ul style="list-style-type: none"> <li>• Policies and internal controls over the use of appraisers need strengthening to prevent violations regarding hiring of appraisers.</li> <li>• Certain accounting processes need to be brought into full conformance with generally accepted accounting principles.</li> <li>• ALLL methodology needs enhancement.</li> <li>• Procedures to reduce underwriting exceptions need development (FNB Arizona only).</li> <li>• Significant loan concentrations of supervisory concern.</li> <li>• Methodology for maintaining adequate repurchase reserve in development (FNB Arizona only).</li> <li>• <u>Concentration risk</u> limits not established.</li> <li>• Generalized contingency funding plan needs enhancement.</li> </ul>	
09/19/2005	2/222322 (FNB Arizona)	\$2,145	<u>Matters requiring the attention of the board of directors</u> <ul style="list-style-type: none"> <li>• Credit underwriting and administration</li> </ul>	None



Appendix 5  
 OCC Examination and Enforcement Actions Concerning First National Bank of  
 Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
	2/222122 (FNB Nevada)	\$1,325	<p>need improvement. The quickness of loan production has had priority over quality. Issues include</p> <ul style="list-style-type: none"> <li>○ loan appraisal violations (repeat issue) and</li> <li>○ inadequate practices over standby letters of credit.</li> </ul> <ul style="list-style-type: none"> <li>● Accounting issues identified resulted in the following recommendations:               <ul style="list-style-type: none"> <li>○ Develop and implement comprehensive accounting policies and procedures that comply with generally accepted accounting principles (GAAP) (repeat issue).</li> <li>○ Document rationale used to determine that impact of auditor findings or accounting pronouncements is immaterial (repeat issue).</li> <li>○ Improve internal controls over financial reporting (repeat issue). Implement proper segregation of duties.</li> <li>○ Expand repurchase reserve analysis to include external factors (repeat issue).</li> <li>○ Implement lower cost or market accounting for warehouse loans.</li> <li>○ Ensure that impairment and charge-offs are timely recognized (repeat issue for ALLL methodology).</li> <li>○ Assess staffing levels in accounting for adequacy.</li> </ul> </li> <li>● Liquidity risk management practices need improvement, including               <ul style="list-style-type: none"> <li>○ development of more robust contingency funding plan (repeat issue) and</li> <li>○ update of funds management policy.</li> </ul> </li> <li>● Management of interest risk rate needs improvement:               <ul style="list-style-type: none"> <li>○ Continue to develop, test, and validate a holistic simulation model (repeat issue).</li> <li>○ Re-evaluate earnings-at-risk limits by changing target account, including basis and yield curve risk.</li> <li>○ Adjust holistic model for core deposit rate and balance sensitivity.</li> </ul> </li> </ul>	

Appendix 5  
OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
			<ul style="list-style-type: none"> <li>• FNB Arizona only: Mortgage division losses totaled about \$5.5 million. Recommended actions for the bank include the following: <ul style="list-style-type: none"> <li>○ Benchmark origination costs and establish expense management targets.</li> <li>○ Develop and implement procedures and accountability that are effective in reducing the high level of underwriting exceptions (repeat issue).</li> <li>○ Enhance mortgage division's monthly "risk book."</li> <li>○ Develop contingency strategies to restructure or exit the business if a return to profitability was not successful.</li> </ul> </li> </ul> <p><u>Other issues/recommendations</u></p> <ul style="list-style-type: none"> <li>• Violation of 12 CFR § 34.43(a)— appraisal required prior to loan approval.</li> <li>• Violation of 12 CFR § 34.45(b)(2)— need for appraisal independence (repeat issue).</li> <li>• Violation of 12 CFR § 22.9(c)— notification of borrower before completion of transaction about flood hazard before completing the transaction (FNB Nevada only).</li> <li>• Succession planning process in need of completion.</li> <li>• Viability of mortgage division business model in doubt (FNB Arizona only).</li> <li>• Repurchase rate estimates for relatively new products not well established (FNB Arizona only).</li> <li>• Quality of loan production in need of significant improvement due to employee or vendor error and need to improve accountability (FNB Arizona only).</li> <li>• Internal control and reconciliation issues disclosed by internal audit reviews and external audits (FNB Arizona only).</li> <li>• Significant loan concentrations (repeat issue).</li> <li>• Loan portfolio diversification parameters (concentration risk limits) not established</li> </ul>	

Appendix 5  
 OCC Examination and Enforcement Actions Concerning First National Bank of  
 Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)  (repeat issue).	Enforcement action
09/11/2006	2/212222 (FNB Arizona)	\$2,325	<u>Matters requiring the attention of the board of directors</u>	None
	2/212122 (FNB Nevada)	\$1,511	<ul style="list-style-type: none"> <li>• Effective procedures and processes to reduce the level and number of underwriting exceptions have not been implemented (FNB Arizona only, repeat issue).</li> <li>• Documentation supporting compliance with underwriting processes for reduced documentation loans is inadequate—need to demonstrate repayment capacity (FNB Arizona only).</li> <li>• Comprehensive accounting policies in compliance with GAAP have not been developed (repeat issue).</li> <li>• Repurchase reserve analyses are inadequate (FNB Arizona only, repeat issue).</li> <li>• Documentation to meet GAAP hedge fund accounting requirements have not been developed (FNB Arizona only).</li> <li>• Contingency funding plan is not fully developed (repeat issue).</li> </ul> <u>Other issues/recommendations</u> <ul style="list-style-type: none"> <li>• Violation 12 CFR § 22.3(a)—Modified flood insurance policy requirements have not been properly implemented.</li> <li>• Succession planning process needs to be completed (repeat issue).</li> <li>• Appraisal review checklists for mortgage loans are often missing or incomplete. (FNB Arizona only)</li> <li>• Outsourced servicing of loans needs quality control reviews and audits. (FNB Arizona only)</li> <li>• Policies and procedures over outsourcing of servicing need to be formalized. (FNB Arizona only)</li> <li>• Allowance for loan and lease losses (ALLL) methodology need enhancement (repeat issue).</li> <li>• Procedures for tracking due dates for receipt of borrower annual financial statements are inadequate.</li> </ul>	

Appendix 5  
OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
10/15/2007	4/444532 (FNB Arizona)	\$2,940	<ul style="list-style-type: none"> <li>• Commercial real estate and large relationship concentrations are of supervisory concern (repeat issue).</li> <li>• Concentration risk limits not established (repeat issue).</li> </ul>	Part 30 Safety and Soundness Plan requirement issued 04/08/2008 (Informal Action)
10/15/2007	3/333232 (FNB Nevada)	\$1,433	<p>The banks' conditions have deteriorated and are a supervisory concern. OCC initiates an informal enforcement action because of the significance of the problems and the poor/fair financial condition of the banks.</p> <p><u>Matters requiring the attention of the board of directors</u></p> <ul style="list-style-type: none"> <li>• The banks lack a current comprehensive capital plan. Such a plan should address, at a minimum, the following:               <ul style="list-style-type: none"> <li>○ capital structure;</li> <li>○ growth plans;</li> <li>○ dividend plans;</li> <li>○ quality and strength of earnings, and capital support from earnings retention;</li> <li>○ quality and depth of management;</li> <li>○ quality of asset-liability management;</li> <li>○ asset quality;</li> <li>○ risk concentrations, such as concentrations of credit (repeat issues);</li> <li>○ overall risk profile for each risk assessment factor;</li> <li>○ maintaining adequate loss reserves;</li> <li>○ strategic plans regarding new products and services;</li> <li>○ adequacy of operating procedures (repeat issues); and</li> <li>○ adequacy of internal controls (repeat issues).</li> </ul> </li> <li>• Senior management and loan officers are not identifying problem assets in a timely manner. This is causing criticized and classified assets to be understated, and efforts to mitigate risk may be delayed.</li> <li>• The internal loan review function lacks independence due to executive management influences that affect the final ratings assigned to credits.</li> </ul>	Individual minimum capital ratio requirement implemented 05/16/08 (informal action)

Appendix 5  
 OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
			<ul style="list-style-type: none"> <li>• Internal loan review is understaffed.</li> <li>• Credit analysis for real estate development lacks global monitoring of the entire borrowing relationship, including all of the borrower’s projects and indebtedness. Borrowers are generally monitored on an individual project basis. Guarantor financial analysis also is incomplete.</li> <li>• Credit file documentation does not indicate adequate monitoring of loan covenants or project performance on acquisition and development and construction loans.</li> <li>• Concentration risk limits have not been established (repeat issue).</li> <li>• The bank’s ALLL methodology does not completely conform to regulatory guidelines as outlined by OCC guidance (repeat issue).</li> <li>• Management does not have a process to consistently recognize loss and record charge-offs in a timely manner and in accordance with accounting principles.</li> <li>• The residential mortgage loan repurchase reserve analysis does not fully conform to the requirements of Statements of Financial Accounting Standards Nos. 5 and 140 (FNB Arizona only, repeat issue).</li> <li>• The board and management have not ensured that accounting policies, staffing levels, and expertise are commensurate with the complexities of bank operations (repeat issue).</li> <li>• A subsidiary is incorrectly consolidated on the books of FNB Arizona.</li> <li>• The board and management continue to rely on purchased funds for managing liquidity. Funds management practices have not changed to reflect the bank’s poor condition and increased risk profile.</li> </ul>	
			<p><u>Other issues</u></p>	
			<ul style="list-style-type: none"> <li>• Board and management supervision and risk management practices have been inadequate for the scope of operations. Board composition needs to be enhanced</li> </ul>	

Appendix 5  
OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
			<p>with additional outside directors to allow for greater independence and improved corporate governance. Concerns exist about board and management ability to restore the bank to a sound condition.</p> <ul style="list-style-type: none"> <li>• Procedures to reduce underwriting exceptions need improvements (FNB Arizona only—repeat issue).</li> <li>• Significant loan concentrations (repeat issue).</li> <li>• Contingency funding plan is not fully developed (repeat issue).</li> </ul>	
05/12/2008	5/555553 (FNB Arizona)	\$2,836	OCC initiates a formal enforcement action because the banks have failed to achieve the required individual minimum capital ratio.	Consent order issued on 06/04/2008 (formal action)
05/08/2008	5/555553 (FNB Nevada)	\$1,634	<p><u>Matters requiring the attention of the board of directors</u></p> <ul style="list-style-type: none"> <li>• No matters are identified. OCC issues a letter to downgrade the institution’s CAMELS composite rating to a 5.</li> </ul> <p><u>Other issues</u></p> <ul style="list-style-type: none"> <li>• The bank is in critical condition, experiencing substantial and ongoing deterioration that is negatively affecting earnings, capital, and liquidity with a high probability of failure.</li> <li>• The bank is engaged in statutorily unsafe and unsound practices.</li> <li>• The board and management are critically deficient because of their implementation of business strategies that allowed significant concentrations in high-risk commercial real estate and residential lending without adequate risk management and appropriate accounting policies and procedures.</li> <li>• With the selling of federal funds to FNB Arizona, despite its deteriorating condition, management has threatened the viability of FNB Nevada. (FNB Nevada only)</li> <li>• Bank management was slow to adjust to safety and soundness concerns and deterioration in investor and real estate</li> </ul>	

Appendix 5  
 OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
			<p>markets.</p> <ul style="list-style-type: none"> <li>• The ability of the management team to address deficiencies is unknown.</li> <li>• Management was unsuccessful in adding external members to the board of directors to address corporate governance concerns.</li> <li>• Asset quality is critically deficient, with significant increases in classified and special mention assets.</li> <li>• Loan losses, problem loans, and non-performing asset volumes have significantly increased.</li> <li>• The board of directors has failed to               <ul style="list-style-type: none"> <li>○ correct weak underwriting practices within the CRE portfolio and high-risk mortgage loans;</li> <li>○ stop unfavorable changes in sales agreements; and</li> <li>○ was slow to react to changes in CRE markets and residential mortgage investor markets.</li> </ul> </li> <li>• The banks' capital is critically deficient and undercapitalized at levels that threaten the viability of the institutions.</li> <li>• The banks' liquidity levels are critically deficient, threatening the viability of the institutions.</li> <li>• Wholesale external funding resources have been reduced or are no longer available.</li> <li>• The banks can no longer issue or renew brokered deposits.</li> <li>• The stability of homeowners association account deposits is unclear due to the issuance of a public enforcement action by OCC.</li> <li>• Earnings are critically deficient, with large losses contributing to the erosion of capital.</li> <li>• Management budgeting and forecasting processes are weak and have not demonstrated the ability to accurately forecast realistic earnings.</li> <li>• Management's ability to reliably measure</li> </ul>	

Appendix 5  
OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
<div style="display: flex; justify-content: space-between;"> <div style="width: 30%;"></div> <div style="width: 40%; text-align: center;"> <p>interest rate risk is questionable.</p> <ul style="list-style-type: none"> <li>• Level of earnings and capital do not provide adequate support for the amount of market risk inherent in the company.</li> </ul> </div> <div style="width: 25%;"></div> </div>				
<b>First Heritage Bank</b>				
01/23/2006	2/112322	\$129	<p><u>Matters requiring the attention of the board of directors</u></p> <ul style="list-style-type: none"> <li>• No matters are identified.</li> </ul> <p><u>Other issues/recommendations</u></p> <ul style="list-style-type: none"> <li>• Loan participation certificates should be accurate and complete and loans should be booked according to terms.</li> <li>• The bank's earnings need improvement.</li> <li>• Listing of high-risk customers was not complete or accurate.</li> <li>• Customer service representatives did not have sufficient access to customer due diligence policies.</li> <li>• Management should document review of reports on liquidity and interest rate risk.</li> <li>• Comprehensive accounting policies and procedures that comply with generally accepted accounting principles (GAAP) not developed. (Issue noted for affiliate banks and in First Heritage Bank's 2006 ROE).</li> <li>• Contingency funding plan is not fully developed (repeat issue). (Issue noted for affiliate banks and in First Heritage Bank's 2006 ROE).</li> <li>• Concentration risk limits not established (Issue noted for affiliate banks and in First Heritage Bank's 2006 ROE).</li> </ul>	None
10/02/2006	2/212322	\$226	<p><u>Matters requiring the attention of the board of directors</u></p> <ul style="list-style-type: none"> <li>• Comprehensive accounting policies in compliance with GAAP have not been fully developed.</li> <li>• Contingency funding plan has not been fully developed (repeat issue).</li> </ul> <p><u>Other issues/recommendations</u></p> <ul style="list-style-type: none"> <li>• Violation of 12 CFR § 22.3(a) - Modified flood insurance policy requirements have not been properly implemented.</li> <li>• Capital ratios and net interest margin are</li> </ul>	None



Appendix 5  
 OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
10/15/2007	2/222322	\$232	<p data-bbox="760 401 1276 464">well below levels for peer institutions due to negative earnings.</p> <ul data-bbox="727 468 1276 621" style="list-style-type: none"> <li data-bbox="727 468 1195 531">• Succession planning process is not complete.</li> <li data-bbox="727 535 1276 621">• Progress made on credit risk and concentration project (concentration risk limits still not established—repeat issue).</li> </ul> <p data-bbox="727 627 1276 690"><u>Matters requiring the attention of the board of directors</u></p> <ul data-bbox="727 695 1276 1178" style="list-style-type: none"> <li data-bbox="727 695 1276 848">• Credit analysis for real estate development is weak, monitoring of borrowing relationships is lacking, and financial analysis of guarantors is incomplete.</li> <li data-bbox="727 852 1276 947">• Monitoring of loan covenants and project performance for development and construction loans is inadequate.</li> <li data-bbox="727 951 1276 1014">• Concentration risk limits have not been established (repeat issue).</li> <li data-bbox="727 1018 1276 1081">• ALLL methodology does not conform to regulatory guidelines.</li> <li data-bbox="727 1085 1276 1178">• Funds management practices have not yet changed to reflect the bank’s poor condition and increased risk.</li> </ul> <p data-bbox="727 1182 1276 1213"><u>Other issues/recommendations</u></p> <ul data-bbox="727 1218 1276 1724" style="list-style-type: none"> <li data-bbox="727 1218 1276 1339">• Significant credit administration weaknesses and deterioration in loan portfolios at affiliates could affect First Heritage Bank’s viability.</li> <li data-bbox="727 1344 1276 1407">• Earnings have improved but remain less than satisfactory.</li> <li data-bbox="727 1411 1276 1598">• The board and management have not ensured that accounting policies, staffing levels, and expertise are commensurate with the complexities of bank operations (repeat issue from prior ROEs and in affiliate ROEs for 2007).</li> <li data-bbox="727 1602 1276 1724">• Contingency funding plan in need of enhancement (repeat issue-centralized issue noted for affiliate banks for 2007 and prior First Heritage Bank’s ROE).</li> </ul>	

Appendix 5  
 OCC Examination and Enforcement Actions Concerning First National Bank of Nevada and First Heritage Bank, N.A.

Date examination started	CAMELS rating	Assets (\$Millions)	Significant safety and soundness corrective actions and other issues cited in reports of examination (ROE)	Enforcement action
05/12/2008	5/553553	\$159	<p>OCC initiates a formal enforcement action because of First Heritage Bank's sale of a significant volume of federal funds to its affiliated banks.</p> <p><u>Matters requiring the attention of the board of directors</u></p> <ul style="list-style-type: none"> <li>• No matters are identified. OCC issues a letter to downgrade the institution's CAMELS composite rating to 5.</li> </ul> <p><u>Other issues/recommendations</u></p> <ul style="list-style-type: none"> <li>• The bank is considered to be in critical condition, experiencing substantial and ongoing deterioration due to conditions at affiliate banks FNB Arizona and FNB Nevada.</li> <li>• The bank is experiencing deterioration in its credit portfolio, affecting earnings, capital, and liquidity.</li> <li>• Asset quality has significantly deteriorated due to the daily sale of federal funds, up to four times its capital, to affiliate FNB Arizona.</li> <li>• Classified and special mention assets have increased significantly.</li> <li>• Earnings are critically deficient due to unsafe and unsound practices.</li> <li>• Budget and forecasting processes are weak.</li> <li>• Management's ability to measure interest risk rate is questionable.</li> </ul>	<p>Consent order issued on 06/04/2008 (formal action)</p>

Source: OIG analysis of OCC Reports of Examination.



## MEMORANDUM

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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

To: Donald Benson, Audit Director, Office of Inspector General

From: John C. Dugan, Comptroller of the Currency /S/

Date: February 25, 2009

Subject: Comments on Draft Audit Report

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We have received and reviewed your draft report titled "Material Loss Review of First National Bank of Nevada (FNB Nevada) and First Heritage Bank, National Association (First Heritage)." Your overall objectives were to determine why the banks' problems resulted in material loss to the FDIC insurance fund, review OCC's supervision of FNB Nevada and First Heritage, and make recommendations for preventing such losses in the future.

We concur with your conclusion that FNB Nevada failed due to significant losses within its commercial real estate portfolio as well as the losses from the residential mortgage division operations of the former First National Bank of Arizona. Your report also correctly reflects that the cause of First Heritage's failure was FNB Nevada's inability to repay Federal Funds Purchased from First Heritage.

We agree that, based on our experience with these two banks, it is appropriate to take additional measures to reinforce certain expectations and requirements to our examining staff. The paragraphs below outline the steps that we have taken, or plan to take, to address your recommendations.

### **Ensuring Banks Take Swift Corrective Actions in Response To Examination Findings**

Matters Requiring Attention (MRAs) cited in Reports of Examination are OCC's most common tool for communicating to bank management issues that require corrective action. On July 5, 2005, Senior Deputy Comptroller Tim Long issued a memorandum to all community bank examiners outlining OCC philosophy and practices with respect to MRAs. The memorandum directed examiners to "impress upon the Board that it is their responsibility to ensure management implements remedial actions within a reasonable period of time and that they need to ensure actions are effective." In the case of corrective actions required by enforcement actions, OCC's Enforcement Action Policy, PPM 5310-3 (REV), contains a detailed description of efforts examiners should take to ensure bank management achieves timely compliance with enforcement actions. The section *OCC Responsibilities Following Completion of all*

## Appendix 6 Management Comments

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*Enforcement Actions* emphasizes the importance of early assessment and feedback, and, if appropriate, more severe enforcement action.

To reinforce the requirements of these policies and emphasize to examiners the need to ensure banks take swift corrective actions in response to examination findings, we have taken, or will take, the following measures:

- We will continue to include follow-up on outstanding concerns in the supervisory strategies for individual banks, and will track that follow-up in Examiner View, our automated record of examination activities.
- Follow-up on supervisory concerns will remain an important element in the scope of our established quality assurance (QA) processes. To assure this, subsequent to the failure of FNB Nevada and First Heritage, OCC's Enterprise Governance unit conducted a special review to confirm that all community bank QA programs contain specific quality management elements pertaining to corrective action, follow-up, and enforcement. We will make certain that, if appropriate, communication of QA results includes observations about examiner efforts to ensure banks promptly address supervisory concerns.
- OCC senior management holds regular conference calls during which important messages are communicated to all community bank examiners. We will utilize an upcoming call to reiterate the importance of ensuring that banks take timely actions to address examination findings.

### **Workpaper Documentation**

We agree that it is important that examiners ensure supervision workpapers are clear, concise and readily understood by other examiners and reviewers. OCC's Supervision Work Papers Policy, PPM 5400-8 (Rev) dated October 23, 2002, outlines in detail the agency's standards for workpaper documentation. Your report recommends that we reiterate these expectations for workpaper quality to examiners, which we plan to do through the following measures:

- As a part of our QA processes, we regularly review a representative sample of supervision workpapers, and the results of these QA reviews are shared with examining staff. We will ensure that any observations about the quality of workpapers and recommendations for improving documentation are included in the communication of QA results to examiners.
- We have found that the examiner conference calls mentioned above are an effective way to communicate important messages to all examiners. We will address the importance of workpaper quality and completeness in an upcoming call.

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.

**Boston Audit Office**

Mark Ossinger, Audit Manager  
Kenneth Dion, Audit Manager  
Jenny Hu, Auditor-in-Charge  
Kenneth O'Loughlin, Auditor  
Alex Taubinger, Auditor

**Washington, DC**

Asha Mede, Referencer

**Department of the Treasury**

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

**Office of the Comptroller of the Currency**

Office of the Comptroller of the Currency  
Liaison Officer

**Office of Management and Budget**

OIG Budget Examiner

**United States Senate**

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

Chairman and Ranking Member  
Committee on Finance

**United States House of Representatives**

Chairman and Ranking Member  
Committee on Financial Services

**Federal Deposit Insurance Corporation**

Chairman

**Comptroller General of the United States**

Acting Comptroller General