FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D.C.

In the Matter of WASHITA STATE BANK BURNS FLAT, OKLAHOMA (Insured State Nonmember Bank)	))))))))))	NOTICE OF CHARGES AND OF HEARING FDIC-08-248b

The Federal Deposit Insurance Corporation ("FDIC") having determined that Washita State Bank, Burns Flat, Oklahoma ("Bank") has engaged in unsafe or unsound banking practices institutes this proceeding to determine whether an appropriate order should be issued against the Bank under the provisions of section 8(b)(1) of the Federal Deposit Insurance Act ("Act"), 12 U.S.C. § 1818(b)(1). The FDIC hereby issues this NOTICE OF CHARGES AND OF HEARING ("NOTICE") pursuant to the provisions of the Act, 12 U.S.C. §§ 1811-1831aa, and the FDIC Rules of Practice and Procedures, 12 C.F.R. Part 308, and alleges as follows:

JURISDICTION

1. The Bank is a corporation existing and doing business under the laws of the State of Oklahoma and has its principal place of business in Burns Flat, Oklahoma. At all times pertinent to the charges herein, the Bank is and has been a State nonmember bank within the meaning of section 3(e)(2) of the Act, 12 U.S.C. § 1813(e)(2), an insured depository institution

within the meaning of section 3(c)(2) of the Act, 12 U.S.C. 1813(c)(2), and subject to the Act, 12 U.S.C. §§ 1811-1831aa, the Rules and Regulations of the FDIC, 12 C.F.R. Chapter III ("Rules"), and the laws of the State of Oklahoma ("State").

2. The FDIC has jurisdiction over the Bank, institution-affiliated parties of the Bank, and the subject matter of this proceeding.

3. The Bank utilizes a leveraged investment program funding its long-term assets with short-term liabilities ("Leverage Program").

4. Under the Leverage Program, the Bank invests funds in long–term collateralized mortgage obligations ("CMOs") issued by government agencies; CMOs issued by non-government agencies secured by mortgage loans that do not conform to the underwriting standards of the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation ("non-agency CMOs"); and callable debentures, using short-term rate sensitive borrowings from the Federal Home Loan Bank, Topeka, Kansas ("FHLB"), the State of Oklahoma Treasurer's public funds, brokered deposits, and other non-brokered certificates of deposit over $100,000 ("Investment Portfolio").

5. In addition to short-term borrowings, the Bank utilizes convertible advances from the FHLB, characterized by ten-year maturities and embedded options that allow the FHLB to convert the advances, on a quarterly basis, to an adjustable rate, after a lockout period, to fund the Investment Portfolio.

2008 EXAMINATION

6. The FDIC and the State examined the Bank with a start date of December 8, 2008 ("2008 Examination"), and utilized financial information as of September 30, 2008, (or later, if indicated herein), that detailed the following:

(a) Total Equity Capital equaled $16,260,000;

(b) Tier 1 Capital equaled $19,293,000;

(c) Total Capital equaled $19,485,000;

(d) Tier 1 Leverage Capital equaled 8.25 percent;

(e) Peer group Tier 1 Leverage Capital equaled 10.36 percent;

(f) Net Non-Core Funding Dependence Ratio (a measure of the extent to which a bank relies upon volatile liabilities to fund longer term earning assets) ("Dependence Ratio") equaled 85.60 percent;

(g) Peer group Dependence Ratio equaled 21.76 percent;

(h) Net Interest Income to Average Earning Assets (commonly known as Net Interest Margin ("NIM")) equaled 2.37 percent;

(i) Peer group NIM equaled 3.86 percent;

(j) Subchapter S Adjusted Net Income equaled 1.21 percent;

(k) Peer group Subchapter S Adjusted Net Income equaled 1.06 percent;

(l) Total Assets, as defined in section 325.2(x) of the Rules, equaled $242,511,000, up from $211,825,000 as of December 31, 2007;

(m) Asset growth rate equaled 11.69 percent;

(n) Peer group asset growth rate equaled 7.43 percent;

(o) Total deposits equaled $145,182,000;

(p) Brokered deposits equaled 41.52 percent of total liabilities;

(q) Brokered deposits to total deposits equaled 64.70 percent;

(r) Peer group brokered deposits to total deposits equaled 1.95 percent;

(s) Net loans and leases to assets equaled 3.86 percent;

(t) Peer group net loans and leases to assets equaled 61.06 percent;

(u) Adversely classified assets totaled $22,272,000;

(v) Adversely classified item coverage ratio equaled 114.30 percent of Total Capital, up from 1.97 percent as of June 30, 2007;

(w) Total adversely classified assets increased to 9.18 percent of total assets;

(x) Total Risk-Based Capital Ratio decreased to 8.19 percent as of December 31, 2008 from 27.82 percent as of September 30, 2008;

(y) Twelve of the Bank's twenty non-agency CMOs, totaling $21,928,000 were classified as Substandard;

(z) Four additional non-agency CMOs, totaling $7,442,000 were downgraded to sub-investment grade by a Nationally Recognized Securities Rating Organization ("NRSRO") as of February, 2009; and

(aa) Two additional non-agency CMOs had not been externally rated for at least twelve months.

7. In 2007, the Bank acquired use of two FHLB convertible advances totaling $54,000,000 to help fund the Investment Portfolio ("Convertible Advances").

8. The Convertible Advances contain a provision which allows the FHLB to convert the interest rate on the advance to an adjustable rate each quarter after expiration of the rate lock.

UNSAFE OR UNSOUND PRACTICES

Inadequate Asset Quality

9. The Bank has engaged in unsafe and unsound practices by operating with inadequate asset quality as demonstrated by the following:

(a) Adversely classified assets total $22,272,000;

(b) Adversely classified items coverage ratio is excessive and equaled 114.30 percent of Total Capital;

(c) The Bank's non-agency CMOs are collateralized by mortgage loans secured by real property located in areas of the country that have experienced significant losses in housing values as well as by loans written with less than full documentation and loans experiencing high levels of default;

(d) The Bank's non-agency CMOs exhibit interest rate risk because of significant pre-payment, and extension risks as well as credit risk because the underlying mortgage loans do not have any agency guarantee and the mortgage loans are the sole source of payment;

(e) The credit quality in the Bank's non-agency CMOs is deteriorating and causing ratings downgrades and significant depreciation of asset value;

(f) The matrix scoring system used by the Bank to assess the appropriate purchase price of non-agency CMOs is inadequate, ineffective and unsupported by any analysis to test or validate assumptions utilized in the analysis;

(g) The Bank's Investment Management Policy concerning non-agency CMOs contains no quantitative or qualitative limits on non-agency CMOs and contains no criteria for proper credit risk analysis;

(h) The Bank's on-going monitoring of non-agency CMOs lacks any effective testing and proper analysis;

(i) Beginning in March 2008, the Bank has purchased twenty non-agency CMOs, twelve of which are classified substandard totaling $21,928,000 according to the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (attached hereto as Exhibit A and incorporated herein);

(j) Four additional non-agency CMOs totaling $7,442,000 have been downgraded to sub-investment quality by a NRSRO since January 2009;

(k) The Bank has no written policies that address "Other Than Temporary Impairment" ("OTTI") for securities; and

(l) The Bank does not assess whether impairment in the Investment Portfolio is OTTI as required in conjunction with filing Call Reports.

10. The Bank received a less than satisfactory Asset Quality rating in the 2008 Examination Report.

11. The Bank has not corrected the deficiencies noted in the Asset Quality section of the 2008 Examination Report.

Inadequate Capital

12. The Bank has engaged in unsafe or unsound practices by operating with an inadequate level of capital protection for the inherent market and credit risk in the assets and liabilities held by the Bank as demonstrated by the following:

(a) Purchasing non-agency CMOs without an appropriate understanding of the risk based capital implications of holding these securities;

(b) Twelve non-agency CMOs with an amortized cost of $21,928,000 are adversely classified as of the November 28, 2008 asset review date based on ratings assigned by a NRSRO;

(c) Incorrectly assigning risk weights to non-agency CMOs in the Bank's December 31, 2008 Call Report;

(d) Tier 1 Leverage Capital Ratio equaled 8.25 percent as of September 30, 2008, which is inadequate because of excessive market, price, credit, and extension risk in the Investment Portfolio as evidenced by:

(i) The weighted average life of the Investment Portfolio and the level of depreciation of the Investment Portfolio are extremely volatile; and

(ii) Internal Bank models utilizing Bloomberg default ratios continue to indicate the potential for massive depreciation in the Investment Portfolio under a 200 basis point increasing interest rate stressed scenario;

(e) Total Risk-Based Capital Ratio equaled 8.19 percent as of December 31, 2008, down from 27.82 percent as of September 30, 2008; and

(f) Based on the Bank's June 30, 2009 Call Report, the FDIC notified the Bank in a letter dated July 7, 2009 that the Bank is "Significantly Undercapitalized," subject to the provisions and restrictions of 12 C.F.R. § 325, Subpart B, 12 U.S.C. § 1831o(d)(e) and (f), Prompt Corrective Action ("PCA") and a PCA Directive was issued by the FDIC on September 18, 2009.

Inadequate Liquidity

13. The Bank has engaged in unsafe or unsound practices by operating with inadequate liquidity in light of the Bank's asset and liability mix as demonstrated by the following:

(a) The Bank is highly reliant on short-term non-core funding to support its leverage strategy;

(b) Non-core funding is concentrated in four credit sensitive sources and exposes the Bank to a high degree of funding risk;

(c) Dependence Ratio is 85.60 percent which exceeds the FDIC Guidance of 45 percent;

(d) Understating the level of funding by using imprudent internal calculations to measure the Bank's Dependence Ratio;

(e) Core deposits as a percentage of total assets equaled 48.38 percent;

(f) Non-core funding represents 90 percent of total liabilities;

(g) Brokered deposits of $93,937,000 equaled 41.52 percent of total liabilities;

(h) Failing to adopt a comprehensive Contingency Funding Plan as addressed in Financial Institution Letter 84-2008 (August 26, 2008), "Liquidity Risk Management" and the FDIC's Risk Management Manual of Examination Policies;

(i) Failing to perform pro-forma cash flow projections as discussed in Financial Institution Letter 84-2008, Liquidity Risk Management;

(j) Failing to adequately plan for the contingency of a change in the Bank's capital category under PCA and the consequences thereof; and

(k) Operating with an inadequate asset growth plan.

14. The Bank received a less than satisfactory Liquidity rating in the 2008 Examination Report.

15. The Bank has not corrected the deficiencies noted in the Liquidity section of the 2008 Examination Report.

Sensitivity to Market Risk

Excessive Interest Rate Risk Exposure

16. The Bank has engaged in unsafe or unsound practices by operating with an excessive level of interest rate risk exposure as demonstrated by the following:

(a) Utilizing interest rate risk measurement tools that are ineffective, overly simplistic, inconsistent, and/or unable to quantify, accurately, the market risk inherent in the Investment Program;

(b) Relying on reports produced by interest rate risk measurement tools that significantly understate the market risk of the Investment Portfolio;

(c) Failing to effectively measure interest rate risk for specific assets and liabilities of the Bank;

(d) Purchasing non-agency CMOs that are subject to extreme price sensitivity and extension risk during periods of rising interest rates, thereby exposing the Bank to cash flow volatility;

(e) Operating with a high level of market risk as a result of the level of non-agency CMOs purchased;

(f) Operating outside the parameters of the 1996 Joint Agency Policy Statement on Interest Rate Risk (attached hereto as Exhibit B and incorporated herein) as demonstrated by the following:

(i) The Bank does not effectively control the interest rate risk management process;

(ii) The Bank's interest rate risk parameters are imprudent;

(iii) The limits established by the Bank for both economic and earnings risk allow the Bank to act with excessive and unacceptable amounts of interest rate risk in both NIM and Economic Value of Equity ("EVE");

(iv) Utilizing an EVE model provided by ALX Consulting, Inc. ("ALX"), that is wholly inadequate and consequently does not accurately measure the large volume of complex assets and liabilities in the Bank's balance sheet;

(v) Utilizing an internal spreadsheet model to measure earnings at risk that does not accurately measure earnings at risk, does not provide

(vi) The Bank's interest rate risk models identify excessive and unacceptable interest rate risk, for example the Bank's analysis of a 200 basis points increase in interest rates shows that EVE would decline 123.8 percent and for a 200 basis points decrease, shows EVE would decline 79.1 percent;

(vii) Failing to conduct a comprehensive independent review of the interest rate risk management process;

(viii) Exposing the Bank to earnings volatility from interest rate swings;

(ix) Failing to adequately measure risk to Net Interest Income and Net Income;

(x) Operating with imprudent and excessive EVE risk limits; and

(xi) Utilizing Convertible Advances from the FHLB that fail to benefit the Bank as interest rates decline.

(g) Operating outside the parameters of the 1998 Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (attached hereto as Exhibit C and incorporated herein) as demonstrated by the following:

(i) The Bank's Investment Management Policy is not sufficient to manage adequately the complex market risk inherent in the Bank's Investment Portfolio;

(ii) The overall market risk in the Investment Portfolio is excessive and contains a significant level of complex embedded options;

(iii) Inadequate procedures to assess the degree of credit risk created by the pre-purchase analysis of non-agency CMOs; and

(iv) There are no stated Investment Portfolio-wide limitations on price volatility and weighted average life extensions.

Inadequate Earnings

17. The Bank has engaged in unsafe or unsound practices by operating with volatile or inadequate earnings in light of the interest rate risk inherent in the Bank's leverage strategy as demonstrated by the following:

(a) NIM equals 2.37 percent, an amount significantly less than peer group average of 3.86 percent;

(b) Utilizing higher cost funding such as FHLB and brokered deposits which negatively impacts the Bank's NIM;

(c) Purchasing twenty non-agency CMOs in 2008, twelve of which were considered sub-investment quality as of November 28, 2008 and adversely classified Substandard in the 2008 Examination, and an additional four of which were classified sub-investment quality as of February, 2009; and

(d) Operating with an inadequate and inaccurate Budget.

18. The Bank received a less than satisfactory Earnings rating in the 2008 Examination Report.

19. The Bank has not corrected the deficiencies noted in the Earnings section of the 2008 Examination Report.

Inadequate Management

20. The Bank received a less than satisfactory Management rating in the 2008 Examination Report.

21. The Bank has not corrected the deficiencies noted in the Management section of the 2008 Examination Report.

22. By reason of the allegations in paragraphs 9 through 21, the Bank has engaged in unsafe or unsound practices by operating with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits.

23. By reason of the allegations in paragraphs 9 through 21, the Bank's board of directors has engaged in unsafe or unsound practices by failing to adequately supervise management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits.

AUGUST 31, 2009 VISITATION

24. The Bank was examined by FDIC examiners commencing August 31, 2009, ("2009 Visitation"). The scope of the 2009 Visitation was, among other concerns, to assess the progress the Bank was making in correcting deficiencies noted in the 2008 Examination.

25. The Bank has received a copy of the FDIC's Report of Visitation for the 2009 Visitation.

26. The Visitation Report concluded that the deficiencies noted in the 2008 Examination Report have not been corrected relating to:

(a) Capital;

(b) Asset Quality;

(c) Management;

(d) Earnings;

(e) Liquidity; and

(f) Sensitivity.

UNSAFE AND UNSOUND PRACTICES

Inadequate Asset Quality

27. The Bank continues to engage in unsafe and unsound practices by operating with inadequate asset quality as demonstrated by the following:

(a) The Bank has continued to purchase non-agency CMOs since the 2008 Examination;

(b) As of the 2009 Visitation date of August 31, 2009, the Bank owned 25 non-agency CMOs , 22 of which are classified Substandard, because they are rated in the fifth or lower rating band by a NRSRO;

(c) Two of the non-agency CMOs purchased in 2009 have been downgraded to the fifth or lower rating band; and

(d) The Bank has failed to formulate any written policies that address OTTI present in the Bank's assets held as capital.

Inadequate Liquidity

28. The Bank continues to engage in unsafe and unsound practices by operating with inadequate liquidity in light of the Bank's assets and liability mix as demonstrated by the following:

(a) The Bank's dependence ratio increased to 93.25 percent;

(b) Brokered deposits increased to 53.02 percent of total liabilities;

(c) Brokered deposits exceeded the Bank's internal policy limit of 50 percent;

(d) The Bank has been unable to accept, renew or roll over any brokered deposits when it became "significantly undercapitalized" pursuant to 12 C.F.R. § 325.103(b)(3) as of the June 30, 2009 Call Report, thereby depriving the Bank of a major source of funding;

(e) Funding liabilities remain concentrated in brokered deposits, State of Oklahoma deposits, FHLB advances and certificates of deposit in excess of $100,000;

(f) The Bank has not made substantial revision to the Asset/Liability Management Policy reviewed at the 2008 examination;

(g) The Bank has not adopted a comprehensive Contingency Funding Plan; and

(h) The Bank continues to calculate its Dependence Ratio imprudently.

Inadequate Capital

29. The Bank continues to engage in unsafe and unsound practices in that it has maintained inadequate capital in relation to the Bank's risk profiles as demonstrated by the following:

(a) As of June 30, 2009, the Bank's Tier 1 Risk-based Capital declined to 3.82 percent;

(b) As of June 30, 2009, the Bank's Total Risk-Based Capital declined to 3.86;

(c) As of the Bank's June 30, 2009, Call Report, the Bank became "Significantly Undercapitalized" pursuant to PCA; and

(d) The Bank has not submitted an accepted capital restoration plan under PCA.

Excessive Sensitivity To Market Risk

30. The Bank continues to engage in unsafe and unsound practices by operating with an excessive level of interest rate risk exposure as demonstrated by the following:

(a) The Bank's Asset/Liability Management Policy remains substantively unchanged from the 2008 Examination;

(b) The Bank's Investment Management Policy remains substantively unchanged from the 2008 Examination;

(c) The Bank continues to operate outside the parameters of the 1996 Joint Agency Policy Statement on Interest Rate Risk as detailed in the 2008 Examination;

(d) The Bank continues to operate outside the parameters of the 1998 Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities as detailed in the 2008 Examination;

(e) Deficiencies noted in the 2008 Examination for the ALX and Internal Earnings models have not been corrected and do not accurately measure the level of interest rate risk;

(f) Risk limits for EVE and earnings are unchanged from the 2008 Examination; and

(g) The scope of the Bank's independent, outside review of the interest rate risk management process has not changed, is considered inadequate and does not fully address the requirements of the 1996 Joint Agency Policy Statement on Interest Rate Risk.

Inadequate Earnings

31. The Bank continues to engage in unsafe and unsound practices by operating with volatile and inadequate earnings as demonstrated by the following:

(a) Earnings continue to be driven by high interest rate risk in the Investment Portfolio;

(b) Although NIM has increased to 5.34 percent from 2.37 percent as of the 2008 Examination, the improvement is attributable in large part to increasing interest income from the non-agency CMOs which continue to deteriorate, a majority of which are below investment grade quality; and

(c) Earnings are overstated because of a lack of an OTTI analysis.

Inadequate Management

32. The Bank continues to engage in unsafe and unsound practices by operating with management who policies and practices are detrimental to the Bank and jeopardize the safety of the Bank's deposits as described in paragraphs 9 through 31.

33. The Bank's board of directors continues to engage in unsafe and unsound practices by failing to adequately supervise management whose policies and practices are detrimental to the Bank jeopardize the safety of the Bank's deposits as described in paragraphs 9 through 31.

OPPORTUNITY FOR HEARING

34. Notice is hereby given that a hearing will be held in Oklahoma City, Oklahoma, within 60 days from the date of service of this NOTICE on the Bank, or on such date as may be set by the Administrative Law Judge appointed to hear this matter, for the purpose of taking evidence on the above-mentioned charges in order to determine whether an Order should be issued under the Act requiring the Bank:

(a) To cease and desist from the unsafe or unsound banking practices herein specified; and/or

(b) To take affirmative action to correct the conditions resulting from such practices.

35. The hearing is to be held before an Administrative Law Judge to be appointed by the Office of Financial Institution Adjudication pursuant to 5 U.S.C. § 3105. The hearing will be open to the public, unless the FDIC shall determine that an open hearing would be contrary to the

public interest, and in all respects will be conducted in compliance with the provisions of the Act and the FDIC Rules of Practice and Procedures.

36. The Respondent Bank is directed to file an answer to this NOTICE with the Office of Financial Institution Adjudication, 3501 N. Fairfax Drive, Suite VS-D8113, Arlington, VA 22226-3500, the Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, N.W., F-1058 Washington, D.C. 20429, A. T. Dill, Assistant General Counsel, Enforcement Section, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429 and Stephen C. Zachary, Regional Counsel (Supervision), Federal Deposit Insurance Corporation, Dallas Regional Office, 1601 Bryan Street, 37th Floor, Dallas, Texas 75201, within twenty days from the date of service of this NOTICE, in accordance with 12 C.F.R. § 308.19. Respondent Bank is encouraged to file any answer electronically with the Office of Financial Institution Adjudication at ofia@fdic.gov. Failure to answer within this time period shall constitute a waiver of the right to appear and contest the allegations contained in this NOTICE and shall, upon the FDIC's motion, cause the Administrative Law Judge or the FDIC to find the facts in this Notice to be as alleged and to issue an appropriate order.

Pursuant to delegated authority.

Dated at Dallas, Texas this __12th__ day of _November, 2009.

/s/

Thomas J. Dujenski
Regional Director
Dallas Region
Dallas, Texas
Federal Deposit Insurance Corporation