The Bank of Anytown illustrates the application of ROE instructions when presenting examination findings. The Bank of Anytown does not cover all possible examination circumstances and should not be used as boilerplate language. The Bank of Anytown is not intended to inhibit examiner judgment in situations that require other presentation methods due to unique situations.

BANK OF ANYTOWN

ANYTOWN	**ANYCOUNTY**	**ANYSTATE**
Region:	Any Region	Certificate Number: 99999
Examiner-In-Charge:	Sandra E. Smart	
Examination Start Date:	August 01, 20x6	
Examination As Of Date:	June 30, 20x6	

Table of Contents	**99999**

All dollar amounts are reported in thousands, unless otherwise indicated.

Abbreviations within the report are included inside the back cover and can also be found at https://www.fdic.gov/regulations/safety/manual/section16-1.pdf

The following practices or financial conditions or operations require Board attention and corrective actions. Unsatisfactory conditions and practices identified during this examination, and recommendations from the previous examination that were not satisfactorily addressed, are described more fully throughout this Report of Examination (ROE).

MEMORANDUM OF UNDERSTANDING (MOU)

The MOU provisions relating to the Allowance for Loan and Lease Losses (ALLL), Reports of Condition and Income (Call Report), and credit extensions to borrowers with charged-off loans remain outstanding and uncorrected. Failure to satisfactorily address the Memorandum of Understanding (MOU) provisions will likely impede progress in returning the bank to a satisfactory condition. The Board should take additional action to ensure full remediation of the unsatisfactory conditions addressed by the MOU.

ALLOWANCE FOR LOAN AND LEASE LOSSES

The ALLL is at an insufficient level requiring an estimated allocation of $325M due to elevated loan losses and deficiencies in the methodology for establishing the ALLL. The Board's attention is needed to ensure a sound process for maintaining an appropriate ALLL is developed and implemented to protect the institution and accurately report earnings and capital.

INTERAGENCY GUIDELINES ESTABLISHING SAFETY AND SOUNDNESS STANDARDS - APPENDIX A OF PART 364 OF THE FDIC RULES AND REGULATIONS

The institution is not in conformance with established safety and soundness standards contained in Appendix A of Part 364, in the areas of internal controls and information systems, internal audit system, loan documentation, credit underwriting, and asset quality. Failure to appropriately address these deficiencies and improve risk management practices may result in further deterioration in the bank's financial condition. In particular, the Board's attention is necessary to ensure the following inadequate risk management practices are corrected to prevent future financial deterioration:

- <u>Asset Quality, Credit Administration, and Loan Underwriting:</u> Inaccurately graded credits contributed to the insufficient ALLL level. In addition, poor credit administration practices (relating to weak participation loan underwriting, the lack of construction loan inspections, and lack of on-going cash-flow analysis for commercial real estate loans) inhibit management's ability to make sound credit decisions, hamper collection efforts, and could lead to further loan losses. Also, procedures to identify and monitor asset concentrations are inadequate. Poor controls over concentrated asset positions can lead to disproportionately higher losses in the event of problems.

- <u>Internal Controls and Internal Audit:</u> Internal controls have not been sufficient to provide for operations in compliance with rules and regulations. For example, the Board approved loans in apparent violation of the Federal Reserve Board's Regulation O, and senior management purchased investments above its Board-approved investment authority. Moreover, the internal audit function lacks independence, as the internal auditor reports directly to the bank's president. Weak internal controls prevent the Board and management from adequately identifying, monitoring, and controlling risks, potentially exposing earnings and capital.

STRATEGIC PLANNING

Despite the continued decline of the local fishing industry and the increase of local financial service providers, the bank's strategic plan does not adequately address regional economic conditions or local competition. Therefore, the plan may not provide the Board or management with adequate information to assess business opportunities or to adjust strategies and practices in light of changing conditions. The Board should direct correction of the deficiencies in the strategic plan and ensure supporting data is current and comprehensive.

SUMMARY

The Board should address the weaknesses and recommendations highlighted above. The FDIC and Any State will monitor the remediation of these matters between examinations.

For additional details, including management's responses to these matters, refer to related comments included in this ROE.

Examination Conclusions and Comments	99999

Uniform Financial Institutions Rating System

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Examination As Of Date	06/30/20x6	09/30/20x5	09/30/20x4
Composite Rating	**3**	**3**	**3**
Component Ratings:			
Capital	**3**	**2**	**2**
Asset Quality	**4**	**4**	**3**
Management	**3**	**3**	**3**
Earnings	**4**	**4**	**3**
Liquidity	**2**	**2**	**2**
Sensitivity to Market Risk	**2**	**2**	**2**
Information Technology	**2**	**1**	**2**
Trust	**2**	**2**	**2**
Compliance[1]	**2**		
Community Reinvestment Act[1]	**S**		

1 Examination dated xx/xx/xxxx

OVERALL CONDITION AND RISK PROFILE

This $80 million community bank is a locally owned, full-service commercial bank offering traditional deposit and credit products with particular focus on customers directly and indirectly reliant upon maritime-related businesses. The trade area is centered in a regional economic area heavily dependent upon a depressed fishing industry. Assets consist primarily of commercial and real estate loans to small, local businesses. Similarly, the bank's depositors are mostly business loan clients and local retail customers. In efforts to diversify from maritime-related businesses, management has purchased commercial loan participations, primarily from Other Bank, Othertown, Other State. In addition, the bank has a trust department that manages approximately $3.3 million in assets, most of which is in non-discretionary accounts.

The bank remains in less than satisfactory condition due to the lingering effects of poor risk selection and underwriting during an aggressive growth campaign in commercial real estate (CRE) and particularly acquisition development and construction (ADC) loans identified at the previous examination. Significant and increasing weaknesses in the local economy have further exacerbated credit risk problems. Numerous workout credits and further deterioration in CRE due to poor credit administration have resulted in an insufficient ALLL level and have negatively impacted earnings. Capital levels are less than satisfactory in relation to the heightened risk profile. Management needs to make additional efforts to comply with the outstanding Memorandum of Understanding (MOU). Information Technology, Trust, and Bank Secrecy Act (BSA)/Anti-Money Laundering programs are adequately managed as findings identified during the examination are limited and correctable in the normal course of business. Compliance and Community Reinvestment Act programs are also satisfactory.

MEMORANDUM OF UNDERSTANDING

The bank entered into a MOU on January 21, 20x5, based on the October 21, 20x4, FDIC examination findings. Management and the Board have not fully addressed three MOU provisions, relating to the appropriateness of the ALLL, accuracy of the Reports of Condition and Income, and documentation for credit extensions to previously classified borrowers. Refer to the Compliance with Enforcement Actions page for additional details.

ASSET QUALITY – 4

Asset quality remains weak and is the primary impediment to improving the bank's overall financial condition. As reflected on the Examination Data and Ratios page, the volume of adversely classified items (ACI) has decreased by 12 percent since the prior examination, with the volume of adversely classified loans dropping by 24 percent. Despite these improvements, adverse classifications still represent 84 percent of Tier 1 Capital and the ALLL. Additionally, the volume of Loss classifications increased from $194M at the 20x4 examination to $1,015M at the current examination. (Asset Review Date: 6/30/20x6.)

Loans

Examination classifications are centered in the CRE portfolio. Loans adversely classified Loss (portions of three relationships totaling $890M) are CRE loans that were adversely classified Substandard at the prior examination. Most troubled credits reflect liberal lending practices exacerbated by the depressed regional economy, particularly the local fishing industry. In response to past regulatory criticisms, management has taken affirmative steps to strengthen credit administration by tightening overall underwriting standards, strengthening collection efforts, decreasing CRE advance rates from 90 percent to 75 percent, and avoiding financing for speculative real estate acquisition and development projects. These actions have longer-term positive implications, but present credit quality remains hindered by numerous workout situations and the deterioration of existing credits not previously subject to adverse classification. Moreover, underwriting weaknesses are evident in participations purchased, and credit administration weaknesses were noted in the areas of construction loan inspections and cash-flow analysis. Additional details regarding trends in the level of adversely classified loans are included on the Analysis of Loans Subject to Adverse Classification page.

Loan Review and Internal Grading System

The institution's internal loan review and grading program is not producing timely or accurate information about the condition of the loan portfolio. Management has been unable to comply with internal review frequency standards due to elevated personnel demands associated with problem asset workouts. Assigned credit grades for several larger credits were inaccurate, as exemplified by examiner identification of the partial Loss classification of the Irma Deat, Ltd. and Last Chance Motel credits. In both cases, the credits were internally rated Substandard. Additionally, several credits adversely classified Substandard by examiners were internally rated Watch. Failure to accurately grade credits on a timely basis has resulted in an insufficient ALLL level, and may hinder management's ability to take appropriate and timely corrective action. To address this issue, management needs to provide additional resources to improve performance of this function.

President Allie C. Lincoln stated that management would add staff by year-end 20x6, and meet review frequency standards by mid-20x7.

Allowance for Loan and Lease Losses

The ALLL is at an insufficient level requiring an estimated allocation of $325M, primarily due to inaccurate internal credit grading. Additionally, the ALLL allocation for non-watch list credits is inappropriate based upon recent loan loss experience on non-watch list loans. Specifically, the institution's average loss rate on non-watch list loans since 20x4 is 0.75 percent; however, management only allocates 0.1 percent for residential mortgages and 0.5 percent for all other non-watch list loans.

Institutions are expected to maintain an ALLL methodology in accordance with Generally Accepted Accounting Principles (GAAP), which reflects consideration of the risk profile of the loan portfolio. Moreover, due to the deficiencies in the loan grading system, earnings and capital could be exposed should future loan and lease loss provisions prove insufficient. Refer to the Risk Management Assessment page for additional details.

President Lincoln indicated management intends to file amended June 30, 20x6, Reports of Condition and Income to address reporting issues (see comments below) and will include a $325M loan loss provision in the amended filings. President Lincoln also initiated a review of the loan grading system during the examination and stated that all existing loss-rate percentages would be reviewed and updated to ensure full conformance with GAAP.

Credit Underwriting and Administration

Credit underwriting and administration, although improving, requires further attention. The Robert Rain, LLC., credit is representative of deficiencies in the monitoring of construction loans and performing cash flow (CF) analysis; refer to the Items Listed as Special Mention for further details. As detailed on the Assets with Credit Data or Collateral Documentation Exceptions pages, the number of loans possessing potential weaknesses and documentation exceptions remains high. In particular, the following underwriting and credit administration weaknesses should be promptly addressed:

- *Credit Analysis on Participations Purchased* - The bank does not perform pre-purchase credit analysis on participations purchased. Pre-purchase analysis is necessary for management to assess the repayment capacity of the borrower(s) and assign an appropriate loan grade. An institution purchasing all or part of a loan should perform the same degree of independent credit analysis as if it were the originator.

- *Financial Statements (FSs)* - Loan officers have not obtained updated FSs from all repayment sources to perform global CF analysis and verify assets of guarantors. Obtaining current FSs allows a loan officer to analyze and document a guarantor's source of strength to a loan or borrowing relationship.

- *Inspections and Lien Waivers* - The bank does not perform inspections or obtain mechanic's lien waivers prior to making construction loan advances. Timely inspections and lien waivers protect the institution's collateral and lien positions and allow management to make informed decisions regarding the ALLL.

- *Rent Rolls* - Loan officers do not obtain rent rolls and vacancy figures on an ongoing basis for loans secured by CRE. Rent rolls and vacancy information allow management to properly monitor these types of loans if conditions are changing, understand any changes in the condition, and make informed and timely credit decisions.

- *Lien Perfection* - The bank periodically allows perfected interests in collateral to lapse by not filing timely Uniform Commercial Code (UCC-1) continuation statements. Use of a system to assist in keeping filings current protects collateral positions determined to be appropriate in original loan underwriting.

President Lincoln stated loan officers would immediately begin performing pre-purchase analyses on participations purchased. She also stated that the volume of documentation deficiencies is primarily due to understaffing and indicated management is in the process of hiring an additional loan clerk to assist in this area.

Other Real Estate (ORE)

Management maintains appropriate policies and procedures for acquiring, holding, and disposing of ORE. However, due to deterioration in existing credits, the dollar volume of adversely classified ORE increased $535M, or 78 percent, since the previous examination. The ORE portfolio primarily consists of CRE previously written down to fair value. The $100M ORE Loss classification reflected in this Report is based on the recently obtained (August 3, 20x6), appraised value of the Rolly property.

Concentrations

Several asset concentrations, including a fishing industry concentration, are listed on the Concentrations page. Management does not currently have procedures in place to adequately identify and monitor such concentrations. Concentrations that are not monitored and managed through sound risk management practices can expose a bank's capital and earnings to disproportionately higher losses in the event of a borrower's financial problems or an industry downturn, such as is currently being experienced by the local fishing industry. Given the potential for increased risk posed by asset concentrations, appropriate policies and procedures should be established to ensure these risks are properly identified, monitored, and managed.

President Lincoln indicated that management will develop procedures for identifying, monitoring, and managing the risk of concentrations and present them to the Board for its review and approval by year-end 20x6.

Disposition of Assets Classified Loss

President Lincoln stated that assets classified Loss totaling $1,015M will be charged off by September 30, 20x6.

EARNINGS – 4

Earnings performance remains poor. As detailed on the Analysis of Earnings page of this Report, the bank experienced significant operating losses in 20x4 and 20x5. Although the bank shows net operating income of $103M for the first six months of 20x6, profits are substantially overstated due to insufficient provisions for loan losses. As reflected in the footnote on the Examination Data and Ratios page, the bank will show a negative 0.58 percent Return on Average Assets, based on a net operating loss of $222M, after amending the June 30, 20x6 Call Report for the additional $325M provision to the ALLL.

The poor earnings performance is a direct result of persistent poor asset quality and increasing ORE levels. Although improving, the high level of nonperforming assets has required high ALLL provisions and increased overhead expenses. In spite of the volume of nonaccruals and other nonearning assets remaining high, the net interest margin for the first six months of 20x6 improved to 4.74 percent from 4.37 percent at year-end 20x5. This improvement is primarily the result of management's ability to maintain average interest rates in the loan portfolio above 8 percent, while reducing the average cost of funds to below 3 percent.

Total Noninterest Expense as a percentage of Average Assets has steadily increased over the last three years and reached 3.82 percent as of June 30, 20x6. Overhead expenses are nearly 100 basis points above comparable institutions, primarily due to expenses associated with ORE. Given the composition and level of problem assets, management does not expect ORE-related expenses to diminish in the near future. Overhead expenses will also increase due to the planned hiring of additional credit administration personnel. However, in an effort to reduce overhead, management plans to close the institution's only branch office on September 30, 20x6.

The 20x6 budget forecasts net income of $226M. With the exception of inaccurate assumptions related to the level of provision expense, the budgeting process is adequate and the assumptions used are reasonable. Future profitability is primarily dependent on improved asset quality and controlled overhead expenses.

Chairman of the Board Roger White stated that the directorate and senior management would revise the budget to depict provision expense levels more accurately. He directed President Lincoln to have the revised budget ready for Board review and approval at the November 20x6 Board meeting.

MANAGEMENT – 3

The overall performance of senior management and the Board of Directors remains less than satisfactory. The bank's weak financial condition is primarily the result of liberal lending policies and poor credit administration practices. As documented in prior examination reports, the present management team aggressively pursued loan growth without regard for prudent lending standards and, ultimately, asset quality. Although initial signs of more prudent loan underwriting and improved credit administration are evident, asset quality remains weak and significant aspects of the credit function remain deficient.

<u>Board Supervision</u>

A director's duty to oversee the conduct of a bank's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Directors need to critically evaluate the issues before them, rather than routinely deferring to management. However, Board minutes lack evidence to demonstrate that directors are exercising their independent judgment. Instead, Board minutes indicate that Chairman White and President Lincoln dominate policy discussions and decisions. Moreover, Director Michael D. Brown attended only 5 of the 12 Board meetings held since the previous examination. Regular attendance at Board and committee meetings is a prerequisite to fulfilling the duty to oversee the conduct of the bank's business, and directors who are unable to meet this obligation should consider resignation. Weaknesses in the strategic planning process and the inadequacy of certain written policies are additional indicators that the Board needs to improve its oversight of the bank's operations and management's actions.

Chairman of the Board White indicated that directors are more engaged in discussions regarding the bank's business than is reflected in the minutes and that future minutes will be more descriptive regarding the input from various directors. Director Brown stated that he frequently travels out of town on business; however, he committed to attending Board meetings on a more regular basis.

Apparent Violations of Laws and Regulations

Examiners cited apparent violations of the Treasury Department's BSA regulations for late currency transaction report (CTR) filings, the Federal Reserve Board's Regulation O for two insider loans that did not receive full Board approval, and exceeding the state's legal lending limit statute. An apparent violation of the BSA was also cited at the last FDIC examination, and although the number of late filings of currency transaction reports (CTRs) has declined, repeat infractions reflect unfavorably on the Board and management. The Board of Directors should implement improved controls and procedures to ensure timely CTR filings, appropriate Regulation O loan approvals, and identification of concentrations of loans to one borrower. Additionally, the institution is in nonconformance with multiple parts of the Interagency Guidelines Establishing Standards for Safety and Soundness, Appendix A to Part 364 of the FDIC Rules and Regulations.

Chairman of the Board White committed to improve BSA and Regulation O controls and promised future conformance with all Safety and Soundness standards detailed in Appendix A to Part 364.

Strategic Planning

The 20x4 five-year strategic plan has not been updated, and is therefore inconsistent with the present condition of the bank, the regional economy, and the local competitive environment. Specifically, the plan's assumptions do not consider the continuing decline of the local fishing industry, the potential impact of a new commercial bank in town, or the recent merger of two local savings and loan associations. Based on these factors, many of the goals and strategies in the plan may be unrealistic. Setting a bank's strategic focus, in conjunction with executive management, is one of the key responsibilities of a bank's Board. An effective strategic planning process provides for regular reviews to determine whether assumptions and strategies remain valid or should be revised. The Board and management should update the strategic plan to reflect current conditions and should adopt a process to periodically review the plan going forward.

Chairman of the Board White stated that the strategic plan would be reviewed and updated before the end of 20x6 and annually thereafter.

Audit and Internal Control

The audit and internal control functions lack independence. While the scope and frequency of the internal audit program are adequate, Internal Auditor Mary Jackson reports directly to President Lincoln. Since President Lincoln is ultimately responsible for most of the day-to-day operations reviewed by the internal auditor, this situation compromises the independence of the internal audit program. The internal auditor should report directly to the Board of Directors or the Audit Committee of the Board to ensure the independence and effectiveness of the audit function. President Lincoln is also a member of the Audit Committee, which oversees the external audit function. Her presence on the committee further limits audit independence. Lack of independence in the internal control structure exposes the institution to operational and financial risks and could impact management and the Board's ability to appropriately control risks. Several outside directors are qualified to serve on the Audit Committee, and it is recommended that the Board strengthen the audit function by limiting committee membership to outside directors.

Several internal control deficiencies are detailed under Item 5 of the Risk Management Assessment section of this Report. While these deficiencies are relatively minor, management incorrectly reported that two of these items were corrected in the response to the last internal audit. Failure to accurately monitor and track corrective actions of audit findings decreases the Board's ability to fulfill their oversight responsibilities.

Chairman of the Board White stated that the Board would consider these recommendations at its next meeting. He also stated the internal control deficiencies would be addressed by the end of 20x6.

Reports of Condition and Income (Call Report)

Material errors were noted in the last three quarterly Reports of Condition and Income. In numerous cases, examiners were unable to reconcile bank records with the quarterly filings. The most significant errors relate to inaccurately reported interest and fee income on loans, the inappropriate inclusion of gains on the sale of repossessed assets in interest and fee income, and the shortfall in the ALLL. These errors misrepresent financial performance and negatively affect management's ability to make informed decisions. Management should investigate these errors and amend prior Reports of Condition and Income as appropriate.

Executive Vice President/Cashier John M. Gutierrez stated he will file amended June 30, 20x6, Reports of Condition and Income, prior to September 30, 20x6, to address these issues.

Bank Secrecy Act (BSA)

The BSA program is generally satisfactory; however, examiners cited apparent violations of Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's BSA regulations. The apparent violations relate to CTRs that were not filed within prescribed periods; refer to the Violations of Laws and Regulations page for additional details. Management should establish procedures to ensure CTRs are filed within prescribed timeframes.

President Lincoln indicated procedures would be implemented within 90 days to ensure CTRs are submitted in a timely manner.

Office of Foreign Assets Control (OFAC)

Effective policies, procedures, and controls are in place to ensure satisfactory compliance with OFAC regulations.

CAPITAL - 3

Capital is less than satisfactory in relation to the bank's risk profile. The ACI Coverage Ratio remains high at approximately 84 percent. In addition, after adjustments for provisions to fund the ALLL appropriately, the bank has had net operating losses over the past two and a half years. The existing concentration in fishing industry loans, considering the industry's current depressed condition and anticipated continuing decline, adds to capital concerns. The Leverage Capital ratio of 7.44 percent, detailed on the Examination Data and Ratios page, reflects current examination adjustments for assets classified Loss and the provision expense needed to fund the ALLL appropriately.

President Lincoln stated that dividends have not been paid for five years. She further stated that no dividends would be paid until the Tier 1 Leverage Capital ratio exceeds eight percent and earnings become positive and stable.

LIQUIDITY - 2

The bank's liquidity position is satisfactory. Asset growth has been minimal since the prior examination and the loan portfolio is shrinking. Management has increased the volume of investments in mortgage-backed securities, with the portfolio maintaining slight appreciation. Non-core funding has increased slightly but management is using these funds appropriately. Management could further strengthen funds management practices by developing a written funds management policy and a contingency funding plan (CFP) commensurate with the bank's risk profile. Clearly articulated policies reflective of the bank's characteristics help ensure that the institution is operating within Board-approved risk tolerances, which can mitigate the negative impact of overreliance on volatile funding sources in an adverse economic environment. Off-balance sheet commitments are minimal.

President Lincoln stated a written funds management policy and a CFP would be developed by year-end 20x6.

SENSITIVITY TO MARKET RISK - 2

Sensitivity to market risk is moderate and risk management practices are satisfactory. Funding sources reasonably match the bank's asset repricing structure, and the loan portfolio includes a high volume of adjustable-rate commercial loans. Over the past two years, depositors have moved funds out of maturing time deposits and into money market demand accounts. Management actively manages rates on these deposits, as the local market is very competitive. The bank does not engage in off-balance sheet derivative activity.

Management regularly monitors the bank's rate sensitivity position using income simulations and an economic value of equity model, and presents detailed quarterly reports to the Board. However, the Board and management should establish interest rate risk (IRR) policy limits. If not properly controlled, IRR can impact an institution's earnings, capital, and its underlying economic value. Setting policy limits helps control this risk by establishing a baseline for the institution's tolerance for interest risk. Monitoring compliance with these limits ensures that the level of IRR is maintained at prudent levels and in accordance with the Board's expectations. Refer to the Risk Management Assessment page for additional details.

For additional information on prudent IRR management principles, refer to the Joint Agency Policy Statement on Interest Rate Risk.

Chairman of the Board White stated that management and the Board would establish IRR policy limits by year-end 20x6.

TRUST - 2

The Board and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Account administration is generally in compliance with governing documents. Oversight of the asset management function is satisfactory. Operations, internal controls, and audit are generally satisfactory in relation to the trust business model. The earnings component was not rated due to the department's size. Only moderate weaknesses are present and within management's ability to correct. Recommendations and management responses are noted below and further detailed on the Fiduciary Activities Assessment pages.

Account administration is generally in compliance with originating documents. However, potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hannah Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys. Appropriate policies, procedures, and practices should be developed and implemented to effectively control conflicts of interest and manage own-bank deposits and stock holdings. Without proper policies, procedures, and practices, the bank is exposed to potential litigation risk, which could negatively affect earnings and capital.

Trust Officer Hancock stated she would maintain documentation of comparable rates in the future.

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. However, management should annually document its needs assessment for each applicable account and/or beneficiary, and indicate whether the account's investment mix is meeting those needs. Failure to adequately document needs assessments, evaluate the mix, and document the review exposes the bank to litigation risks.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account.

INFORMATION TECHNOLOGY - 2

Overall, IT operations, risk management practices, and cybersecurity are satisfactory. The IT audit program is generally adequate. Management and Board oversight of IT programs are generally satisfactory as demonstrated by adequate policies and risk management practices. The bank is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards. Management adequately assesses its cybersecurity risk exposure including its inherent risks, and cyber maturity levels.

While the overall IT department is satisfactory, exceptions were noted related to:

- Audit reporting lines and scoping,
- Patch Management,
- Financial and audit review of critical vendors,
- Control assessments on third party providers,
- Detail in project documentation, and
- Business Continuity Plan parameters.

Management attention to the aforementioned areas will strengthen the institution's IT security, operating and control environment, and better prepare the institution to respond to business disruptions. These areas are further discussed on the Information Technology and Operations Risk Assessment pages.

Findings of the IT examination were discussed in detail on August 27, 20x6, with Information Technology Manager William Robbins and President Lincoln, during which they indicated agreement with all findings. Refer to the Information Technology and Operations Risk Assessment pages for details on the exceptions and management commitment and timeframes for corrective action.

MEETING WITH THE DIRECTORATE

A Board of Directors meeting was held on September 18, 20x6. All directors were present with the exception of Director Henry P. Black. William E. Smith, partner in the bank's auditing firm, was also present. Deputy Commissioner of Banking Cynthia B. Jones represented the State Department of Banking. Field Supervisor James D. Gilmore, Examiner-in-Charge Sandra E. Smart, and Financial Institution Examiner Monica D. Powers represented the FDIC. All matters listed above were discussed with the Board. Most of the discussion concerned the increase in severity of adverse classifications, the need to improve the ALLL methodology, and management's efforts to improve loan administration procedures. The Directorate and management's commitments for corrective action are noted within this report. Chairman of the Board White asserted that due to the improvement in the bank's overall condition, the MOU should be removed.

DIRECTORATE RESPONSIBILITY

Each member of the Board of Directors is responsible for reviewing this Report of Examination. Each Director must sign the Signatures of Directors page, which affirms that he or she reviewed the Report in its entirety.

Examiner (Signature)	Reviewing Official (Signature) and Title
Sandra E. Smart	Dale K. Watson, Assistant Regional Director

A Memorandum of Understanding (MOU) between the FDIC and the bank became effective on January 21, 20x5. Provisions of the MOU that require further efforts or are of a continuing nature are detailed below.

2(b). The bank shall maintain an Allowance for Loan and Lease Losses at an appropriate level.

Based on this examination's findings, the ALLL is at an insufficient level requiring an estimated allocation of at least $325M.

3(a). The bank shall maintain a Leverage Capital ratio equal to or greater than 7 percent.

As of June 30, 20x5, the Leverage Capital ratio, adjusted for the additional $325M provision for loan and lease loss expense, approximates 7.44 percent.

3(d). The bank shall maintain a Total Capital ratio equal to or greater than 10 percent.

As of June 30, 20x6, the Total Capital ratio, adjusted for the additional $325M provision for loan and lease loss expense is 11.75 percent.

4. The bank shall file accurate Call Reports.

Examiners noted significant errors in the December 31, 20x5, March 31, and June 30, 20x6, Call Reports which require amendments.

5. The bank shall not extend or renew, directly or indirectly, credit to, or for the benefit of, any borrower who has a loan or other extension of credit with the bank that has been charged off or classified, in whole or in part, Loss, Doubtful, or Substandard, unless rationale for the extension is noted in the official Board minutes and the appropriate credit file.

On January 30, 20x6, the bank extended a $50M loan to U. R. Worth. The borrower was adversely classified Loss at the previous examination. The Board did not specifically document the reason(s) for the extension in the official Board minutes or in the appropriate credit file.

6. The bank shall not declare or pay any dividends without the written consent of the FDIC.

No dividends have been declared or paid since the previous examination.

1. **Are risk management processes adequate in relation to economic conditions and asset concentration levels?**

   No. As discussed on the Examination Conclusions and Comments (ECC) pages, the Board's strategic plan is outdated and does not reflect the institution's current condition or operating environment. In addition, management does not adequately identify, evaluate and monitor asset concentrations as exemplified by the deficiencies noted in managing the correspondent bank, fishing industry, and individual borrower concentrations identified in this report. Establishment of appropriate concentration risk policies and procedures would enhance management's ability to identify and control risks and avoid potential violations of law. Refer to the Concentrations pages for additional details.

   President Lincoln stated that management will develop procedures to identify, evaluate, and monitor concentrations.

2. **Are risk management policies and practices for the credit function adequate**?

   No. Internal credit review and grading procedures are weak, and credit administration practices are deficient. Recommendations for improvement are included under Asset Quality on the ECC page.

   Due to the deficiencies noted in the institution's internal credit grading system and the use of inaccurate loan loss rates, the ALLL is at an insufficient level. In addition, management utilized an inappropriate loan loss experience to establish a reserve rate for its non-watch list loans, which contributed to the insufficient ALLL level. Management should ensure controls are in place to consistently determine the ALLL is maintained in accordance with GAAP and should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans and the resulting estimated credit losses. For additional information, refer to the Interagency Policy Statement on the Allowance for Loan and Lease Losses.

   President Lincoln committed to filing Call Report amendments prior to the September 30, 20x6 submission and to reviewing the loan grading system.

   Additionally, although the bank's loan policy is generally adequate, it does not address the following matters:

   <u>*Participation Loans*</u> - The bank regularly purchases loans or portions of loans from other institutions. These specialized lending activities are not covered in the loan policy.

   <u>*Construction Loans*</u> - The bank finances the construction of 1- to 4-family residences and mixed use commercial property. While practices are generally adequate, a large construction loan listed for Special Mention reflects several weaknesses in construction lending. The policy lacks specific guidelines pertaining to construction lending.

   Development of comprehensive loan policy guidance provides management and staff with clear expectations for administering the lending function and facilitates sound risk management practices.

   President Lincoln stated that management would develop guidelines for purchased loans and construction lending and revise the loan policy by December 31, 20x6.

3. Are risk management policies and practices for asset/liability management and the investment function adequate?

Generally, yes. Management's liquidity management practices are generally adequate; but could be improved by implementing a formal funds management policy or a contingency funding plan. Overall practices for Sensitivity to Market Risk are generally adequate; however, policy parameters should be established that reflect the Board's tolerance for interest rate risk (IRR). The Board should establish and guide the bank's tolerance for IRR, including approving relevant risk limits and other key policies, identifying lines of authority and responsibility for managing risk, and ensuring adequate resources are devoted to IRR management. Implementing appropriate limits strengthens management's ability to manage IRR and monitor actual risk taking activity.

President Lincoln stated that IRR policy limits would be established by year-end 20x6.

Investment policy guidelines are adequate; however, management's adherence to its written investment policy is inconsistent. On at least three occasions since the previous examination, President Lincoln exceeded her purchasing authority when she purchased securities over $250M without prior Board approval. Failure to adhere to Board approved purchasing authority could increase the risk profile of the institution above Board approved risk tolerances.

The Board should ensure management purchases investments in conformance with existing policy standards or determine if it would be prudent to revise the standards to meet purchasing needs.

President Lincoln stated that she was presented with the opportunity to purchase these securities at a good price and could not wait for Board approval. She further stated she would comply with the policy in the future or discuss modifying the policy with the Board at the next Board meeting.

4. Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?

No. As discussed on the ECC pages, risk management practices regarding the credit portfolio are insufficient for the institution's business model and risk profile.

5. Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?

No. As indicated on the ECC page, apparent violations of BSA regulations, Regulation O, and the state legal lending limit were cited during this examination. Additionally, the bank is not in conformance with the Interagency Guidelines Establishing Safety and Soundness Standards. Full details of these citations can be found on the Violations of Laws and Regulations pages. In addition, the audit and internal control functions lack independence.

<u>Internal Controls</u>

Examiners noted the weaknesses below in the bank's system of internal controls. Maintaining strong internal controls helps ensure the integrity of operations and discourages potential insider abuse.

- *Vacation Policy* – The bank's vacation policy requires employees to be absent from their normal duties for an uninterrupted period of two weeks each calendar year. Executive Vice President Leslie S. Cook did not remain absent during her two-week vacation in 20x5 as she returned daily to reconcile the Federal funds sold account. Management should enforce the policy, particularly for employees who are responsible for sensitive transactions.

- *Reconcilement of Correspondent Bank Accounts* - Management has not reconciled the correspondent bank accounts for the past three months. While personnel reconciled these accounts during the examination, they should be reconciled at least monthly

President Lincoln stated she would take action to address these deficiencies before year-end 20x6.

6. **Is Board supervision adequate, and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?**

No. Board supervision is less than satisfactory. Numerous underwriting weaknesses and credit administration deficiencies remain uncorrected from prior examinations, and the Board has not established an effective independent internal audit function. Refer to comments under Management on the ECC page for more details. Additionally, examiners cited two loans as apparent violations of the Federal Reserve Board's Regulation O because management did not obtain the prior approval of the Board on loans to the related interests of President Lincoln and Director Larry G. Green. Refer to the Violations of Laws and Regulations page of this Report for details.

APPARENT VIOLATIONS OF LAWS AND REGULATIONS

BANK SECRECY ACT

Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's Bank Secrecy Act regulations requires a covered financial institution to file a CTR (FinCEN Form 104) within the prescribed period.

Examiners identified numerous instances where CTRs were not filed within the required 15-day period. This infraction was also cited at the previous FDIC examination. Between October 20x5 and July 20x6, 289 of 944 CTRs (31 percent) were filed late. In many cases, CTRs were signed by the approving official more than 15 days after the transaction date. The time between the transaction date and receipt by the Treasury Department on these late filings was generally around 20 to 25 days, with a few exceeding 70 days.

BSA Officer Donna Ludlow stated that some of the late CTRs were filed after an internal audit noted that the forms had not been submitted; however, she could offer no explanation as to why the remaining CTRs were filed late. President Lincoln stated that new procedures would be implemented within 90 days to ensure all CTRs are submitted in a timely manner in the future.

REGULATION O

The Federal Reserve Board's Regulation O, which implements Section 22(h) of the Federal Reserve Act and is made applicable to insured nonmember institutions by Section 18(j)(2) of the Federal Deposit Insurance Act, covers transactions with bank insiders. Section 215.4(b)(1) of Regulation O requires extensions of credit by an institution to a director or related interest exceeding the greater of $25M or five percent of unimpaired capital and surplus to have prior approval by a majority of the institution's board of directors.

The bank is in apparent violation of this section for extending the following loans with the prior approval of the Executive Loan Committee, which is composed of only three Board members, rather than prior approval by a majority of the Board.

Borrower	Date of Note	Original Amount
Lincoln, Allie C.	12/11/20x5	$500M
Any Body, Inc.	12/28/20x5	$250M
(A related interest of President Lincoln and Director Green.)		

President Lincoln stated that these exceptions were the result of oversight. She further indicated that bank policy requires that all insider loans receive the prior approval of the full Board. Examiners noted that all other insider loans received prior Board approval. President Lincoln and the Board of Directors promised future compliance.

LEGAL LENDING LIMIT

Section 1127 of the State Banking Code provides that the total direct or indirect loans and extension of credit or lease by a bank to one obligor or guarantor at no time shall exceed 15 percent of "statutory capital" (equivalent to total capital) of the bank, except upon approval by two-third vote of its board of directors, the limit may be increased up to 25 percent of the statutory capital of the bank. On January 2, 20x6, the bank extended an additional $650M to J&M Realty Trust, guaranteed by John and Mary Smith, which increased total outstanding debt to the Smiths and their companies to $1,950M, or 31 percent of statutory capital. The extension of additional credit was made without approval by the board of directors, and represents an apparent violation of Section 1127.

President Lincoln stated that the extension of credit over the lending limit was the result of oversight.

NONCONFORMANCE WITH GUIDELINES INCORPORATED INTO REGULATIONS

INTERAGENCY GUIDELINES ESTABLISHING STANDARDS FOR SAFETY AND SOUNDNESS APPENDIX A TO PART 364 OF THE FDIC's RULES AND REGULATIONS (APPENDIX A)

Appendix A sets out the safety and soundness standards that the FDIC uses to identify and address problems at insured depository institutions before capital becomes impaired. The institution is in nonconformance with the following sections of the Operational and Managerial Standards of Appendix A to Part 364.

A. Internal controls and information systems. An institution should have internal controls and information systems that, in part, are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for timely and accurate financial, operational, and regulatory reports and compliance with applicable laws and regulations.

Material errors were noted in the institution's quarterly Call Report filings over the last three quarters, which necessitates restatement of the institution's most recent Call Report. Additionally, three apparent violations of laws and regulations were noted, including a repeat violation regarding untimely CTR filings.

B. Internal audit system. An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for, in part: independence and objectivity; adequate testing and review of information systems; and adequate documentation of tests and findings and any corrective actions.

The audit and internal control functions lack independence, which jeopardizes the effectiveness of the internal audit program. Further, the lack of independence coupled with inadequate monitoring of audit findings status reports resulted in previously identified deficiencies being inaccurately reported as corrected.

C. Loan documentation. An institution should establish and maintain loan documentation practices that, in part: enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis; identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner; ensure that any claim against a borrower is legally enforceable; and demonstrate appropriate administration and monitoring of loans.

Credit administration, although improving, remains deficient. Noted weaknesses include lapses in UCC-1 filings, absence of inspections or mechanic's lien waivers prior to construction advances, and absence of rent roll information. As noted on the Assets with Credit Data or Collateral Documentation Exceptions page, one-third of the dollar volume of loans reviewed had documentation exceptions that impaired management's ability to make an informed lending decision and to assess risk, as necessary on an ongoing basis.

D. Credit underwriting. An institution should establish and maintain prudent credit underwriting practices that: are commensurate with the types of loans the institution will make and, in part, provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed; establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors; and take adequate account of concentration of credit risk.

Management does not conduct pre-purchase credit analysis for participations purchased, which precludes its ability to evaluate the underlying creditworthiness of these credits and the borrower’s ability to repay. Additionally, inadequate staffing of the credit review function contributed to inaccurate loan grading for several large credits. Moreover, management does not have adequate procedures in place to identify and monitor concentrations.

E. Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should, in part, estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses.

As detailed on the ECC page, inaccurate internal loan grading resulted in an insufficient ALLL level.

President Lincoln stated that all noted deficiencies will be added to the Audit Findings Tracking Report and that applicable executive officers would begin action to address deficiencies immediately.

Uniform Rating System for Information Technology

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Composite Rating	**2**	**1**	**2**
Component Ratings:			
Audit	**2**		
Management	**2**		
Development & Acquisition	**2**		
Support & Delivery	**2**		

Overall, IT, operations, risk management, and security are generally satisfactory. Management's attention is directed to the items below.

Audit - 2

The IT audit program is generally adequate, and internal auditors promptly identify and report deficiencies and risks. Identified issues are formally tracked and resolved in a timely fashion, and the IT audit plan is based on a thorough risk assessment of IT assets and internal and external threats.

The majority of critical IT areas were reviewed in recent IT audits; however, examiners identified a concern with the current audit scope. Specifically, patch management and cybersecurity are not included in the bank's IT audits. Management should ensure all critical IT areas are included in the scope of IT audits, with the frequency being based on the audit risk assessment. Including all critical IT areas in the internal audits may have reduced the number of items noted in the recent external vulnerability assessment and will help ensure operations continue functioning as needed going forward.

Examiners also noted a concern with the audit reporting structure. At present, internal auditors report to President Lincoln rather than the Board's Audit Committee. In order to increase the auditors' independence and help ensure the Board is able to fulfill its oversight responsibilities, the internal auditors should report directly to the Board's Audit Committee.

President Lincoln stated that the omission of patch management and cybersecurity from the recent IT General Controls audit was an oversight and agreed to include the areas in future audits. President Lincoln also stated that she would recommend to the Board that they modify the IT audit reporting structure so auditors report directly to the Board's Audit Committee.

Management - 2

Overall IT management provides adequate guidance and direction. The oversight and supervision of the information security program and related practices are supported by adequate Board approved policies and risk management practices. Managers are well qualified and tenured for their respective positions.

<u>Vendor Management</u>

Overall, management monitors service providers to confirm they satisfied their contractual obligations; however, management did not review the financial statements or the Statement on Standards for Attestation Engagements (SSAE 16) reports of two critical service providers. To help ensure all service providers are appropriately monitored and to improve the effectiveness of management's monitoring activities, management should formally document all required reviews.

President Lincoln indicated the missing reviews were an oversight and stated that a tickler system would be developed to remind the vendor -review officer of upcoming vendor reviews.

Conformance with Information Security Standards

Management is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards of the FDIC Rules and Regulations. Management identified the location of all non-public personal information, both electronic and hard copy. Threats to each type of information were identified, adequate controls are in place, and an annual report of the program is presented to the Board. While the overall program is adequate, management did not conduct control assessments on all third-party providers that obtain, use, or process non-public personal information. Management should expand the scope of the control assessments to include all applicable third-party providers. Including all applicable third parties in the assessments will help ensure the providers are appropriately identified and risk rated, and will help confirm third parties have adequate internal controls to protect non-public information.

President Lincoln stated that the vendor management program would be updated to identify all vendors with access to non-public personal information and that control assessments would be conducted on all identified vendors before March 31, 20x7.

Cybersecurity Preparedness

Management's assessment of the bank's cybersecurity risk exposure appropriately identifies inherent risks; however, cybersecurity preparedness could be strengthened by determining whether cyber-related controls are sufficient. By identifying cyber-related controls and determining whether they mitigate the identified inherent risks to an acceptable level, management will be better able to identify cybersecurity weaknesses and implement appropriate controls.

President Lincoln indicated that the assessment process would be expanded to include targeted maturity levels by June 30, 20x7.

Development and Acquisition - 2

Development and acquisition practices, which include hardware and software implementation and change-management practices, are appropriate for the institution's size and complexity. Overall, project management processes are adequate and provide sufficient guidance to manage projects. Currently, any project exceeding $20M is rated as a major project and requires specific project documentation. However, not all project documentation complies with the internal bank guidelines. For example, the documentation of three recent projects did not include reviews of alternative project solutions or explanations of why the solutions recommended in the project proposals were the most appropriate solutions. Management should comply with internal bank guidelines to ensure project requirements are met and consistent project documentation is in place.

President Lincoln indicated the project management program was relatively new and that project requirements were being introduced in a phased approach to not overwhelm employees. However, she agreed to follow internal project guidelines on future projects.

Support and Delivery - 2

Overall computer operations and information security practices are adequate, and management has improved its business continuity and disaster recovery plans. Management established an information security group to set standards, monitor trends, and review system logs and alerts. Although overall operations are adequate, examiners identified areas that require management's attention such as system-log monitoring, vulnerability assessments, patch management, and business continuity planning.

<u>Logging and Monitoring</u>

Management uses different logging platforms for firewalls, internal servers, and routers, and data are not shared or correlated among the logging systems. While servers and base operating systems are logged, logging is not enabled for virtual operating system environments. Management should review its current logging program to ensure all critical systems are included and that there is sufficient data correlation between the systems. Improving the logging program will help ensure all necessary information is obtained and provide the information security group with data in a more effective, centralized format.

<u>Vulnerability Assessments</u>

Management contracts an outside third party to conduct annual, internal vulnerability assessments as part of an overall security review. The scope of the vulnerability assessment is adequate; however, having only one assessment per year could result in vulnerabilities not being promptly identified. Management should review the frequency of its vulnerability assessment to ensure the frequency of the assessments is based on appropriate risk analysis.

President Lincoln committed to revisiting the logging and monitoring program to ensure that all needed information is logged and, to the extent possible, centralized. Additionally, she stated that management would review the frequency of the vulnerability assessments and conduct more frequent assessments based on appropriate risk analysis. President Lincoln stated the reviews would be completed by the end of 20x6, and appropriate corrective actions would be implemented by March 31, 20x7.

<u>Business Continuity Planning (BCP)</u>

Management changed the structure of its BCP this year. Most elements of the new program are adequate, but some should be improved. The areas of business impact analysis (BIA) and disaster recovery (DR) testing require further refinement.

The BIA and risk assessments are out-of-date, but are being updated to include new recovery time objectives (RTO) and to identify reasonably foreseeable threats, including cybersecurity threats. Currently, the shortest RTO is 24 hours. The 24-hour RTO may be too extended for the application, and there are several systems that may benefit from RTOs of four hours or less. The current extended RTOs may significantly affect multiple business lines and the institution's ability to restore critical systems after a disaster. Management should ensure RTOs are appropriate so that critical operations can be restored promptly after a disaster or business interruption. While some disaster recovery (DR) testing has occurred, management has not sufficiently tested a few critical systems. Management should review its testing universe and implement a risk-based testing approach to ensure all necessary testing is completed in a timely manner. Failure to conduct appropriate tests could result in material delays in restoring critical systems if a disaster occurs.

President Lincoln agreed to conduct the BIA and risk assessments, review RTOs, and implement risk-based DR testing by March 31, 20x7.

Uniform Interagency Trust Rating System

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	**08/01/20x6**	**11/13/20x5 / S**	**10/21/20x4**
Composite Rating:	2	2	2
Management	2	2	2
Operations, Internal Controls and Auditing	2	2	2
Earnings Compliance	0	0	0
Asset Management	2	2	2
Management	2	2	2

A Trust Department Rating of "2" is assigned. Overall risk management practices are satisfactory relative to the institution's size and complexity. There are no material supervisory concerns. Fiduciary activities are conducted in substantial compliance with laws and regulations. Examination recommendations and management's responses are detailed below.

Compliance – 2

Account administration is generally in compliance with originating documents. Potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys. Appropriate policies, procedures, and practices should be in place to effectively control conflicts of interest and manage own-bank deposits and stock holdings. Without proper policies, procedures, and practices, the bank is exposed to potential litigation risk, which could negatively affect earnings and capital.

Trust Officer Hancock stated she would maintain documentation of comparable rates beginning immediately.

Regarding the trust account with holding company and affiliate stock, the party in interest of that account is informed of the trust officer's proxy vote and attends annual stockholder meetings; however, these facts are not documented in the trust files. Failure to adequately document voting rights could be viewed as a breach of trust and expose the bank to a potential conflict of interest.

Trust Officer Hancock indicated that since the party in interest to that account is a member of the Lincoln family, and stockholder meeting minutes of the holding company and the affiliate could be produced should the need arise, the risk is minimal.

Asset Management – 2

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. However, management should document in the annual account reviews an assessment of the needs of each applicable account and/or beneficiary, and whether the account's investment mix is meeting those needs. In addition, three trust accounts use fixed income and/or equity mutual funds. Qualified staff should annually review each mutual fund's investment mix, performance relative to competing mutual funds, and any other related criteria. These mutual fund reviews should also consider the ongoing needs and objectives of the respective trust accounts. Failure to adequately document needs assessments, evaluate the mix, and document the review exposes the bank to litigation risks.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account, as well as annual mutual fund reviews going forward.

Management – 2

The Board's and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Only moderate weaknesses are present and are within management's capabilities and willingness to correct. The full Board acts as the Trust Committee and reviews department activity reports monthly. Trust Officer Hancock is the primary administrator and record keeper for personal trust accounts, while President Lincoln administers the farm management agency account.

The Board has adopted a general Trust Policy. The Directorate should consider adding policy criteria regarding environmental reviews of real estate that may be held in current or future trust accounts. Such policy guidance would help ensure that department management can identify and take mitigating action on potential environmental concerns on real estate held in managed accounts.

Trust Officer Hancock agreed to develop such guidance for the Board's consideration at its next meeting.

Operations, Internal Controls and Auditing – 2

Operations, internal controls, and audit are satisfactory in relation to the volume and character of trust business. Moderate weaknesses exist, but in general are effectively identified and monitored. The bank's audit program includes an annual review of trust department activity, including the verification of trust assets.

Trust department records are maintained manually, which limits internal control capability. Trust Officer Hancock is implementing a computerized trust record keeping system as time permits. The computerized system has the capacity to allow for the separation of record keeping and data entry functions from the account administration function. Limited staff restricts full segregation of duties. Despite this, check writing and account reconciliation procedures should be separated to reduce the risk of error or inappropriate activity going undetected.

Trust Officer Hancock stated she would enhance the deposit account reconcilement procedures by the end of the third quarter.

Earnings – 0

This small department is operating primarily as a service to current customers rather than as a profit center. Due to this aspect of the trust department's operations, and the limited volume of $3.3 million assets under management, the earnings component is not rated.

Meeting With Management

A meeting was held on September 8, 20x6, with President Lincoln and Trust Officer Hancock to discuss examination findings in detail. An overview of these findings was also presented to the bank's Board of Directors at its meeting on September 18, 20x6.

ASSET QUALITY		ADVERSELY CLASSIFIED			
		Substandard	Doubtful	Loss	Total
Loans and Leases		4,290	140	890	5,320
Securities		45			45
Other Real Estate Owned		1,125		100	1,225
Other Assets				25	25
Other Transfer Risk					
Subtotal		5,460	140	1,015	6,615
Contingent Liabilities		230			230
Totals at Exam Date	06/30/20x6	5,690	140	1,015	6,845
Totals at Prior Exam	09/30/20x5	7,345	220	194	7,759
Totals at Prior Exam	09/30/20x4	6,655	177	67	6,899

	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Total Special Mention	854	515	
Adversely Classified Items Coverage Ratio	84.41	102.71	94.92
Total Adversely Classified Assets/Total Assets	8.21	9.93	8.20
Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases	6.74	8.42	9.12
Adversely Classified Loans and Leases/Total Loans	9.86	12.68	11.30
ALLL/Total Loans and Leases	3.67	3.15	2.50

CAPITAL	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Tier 1 Capital/Average Total Assets	7.44	7.55	7.67
Common Equity Tier 1 Capital/Risk-Weighted Assets(1)	10.48		
Tier 1 Capital/Risk-Weighted Assets(1)	10.48	9.88	9.90
Total Capital/Risk-Weighted Assets(1)	11.75	8.42	11.40
Prompt Corrective Action Capital Category	W	W	W

PCA Categories: W – Well-capitalized, A – Adequately capitalized,
U – Undercapitalized, S – Significantly undercapitalized,
C – Critically undercapitalized

	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Retained Earnings(1)/Average Total Equity	3.37	9.32	(2.05)	(3.86)
Asset Growth Rate	2.66	6.78	0.42	0.20
Cash Dividends/Net Income		32.65		

EARNINGS	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Income (After Tax)/Average Assets (*)	0.27	1.03	(0.15)	(0.30)
Net Interest Income (TE)/Average Earning Assets	4.74	4.64	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	2.90	3.62	3.54

LIQUIDITY	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Non-Core Funding Dependence	14.71	1.02	8.69	6.66
Net Loans and Leases/Assets	64.45	66.20	68.79	69.24

(1) Institutions under the CBLR framework do not calculate Risk-Weighted Assets or Tier 2 Capital. For such institutions, Tier 1 Capital equals Total Capital under Part 324.
(*) After management's planned $325M adjustment to the ALLL, the 6/30/20x6 Ratio will drop to (0.58)%.

Comparative Statements of Financial Condition | 99999

ASSETS	6/30/20x6	12/31/20x5
Total Loans and Leases	53,931	55,545
Less: Allowance for Loan & Lease Losses	1,979	1,748
Loans and Leases (net)	51,952	53,797
Interest-Bearing Balances	20	
Federal Funds Sold and Securities Purchased Under Agreements to Resell	4,000	9,100
Trading Account Assets		
Securities: Held-to-Maturity (at Amortized Cost)	2,787	5,993
Available-for-Sale (at Fair Value)	10,888	
Equity Securities with readily determinable fair values not held for trading		
Total Earning Assets	**69,647**	**68,890**
Cash and Noninterest-Bearing Balances	5,895	4,754
Premises and Fixed Assets	2,530	2,709
Other Real Estate Owned	1,225	690
Intangible Assets		
Other Assets	1,307	1,175
TOTAL ASSETS	**80,604**	**78,207**

LIABILITIES		
Deposits	67,815	66,221
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	441	516
Other Borrowed Money	5,857	5,136
Other Liabilities	301	307
Subordinated Notes and Debentures		
Total Liabilities	**74,414**	**72,180**
EQUITY CAPITAL		
Perpetual Preferred Stock		
Common Equity Capital	6,190	6,027
Includes net unrealized holding gains (losses) on available-for-sale securities.		
Other Equity Capital		
Total Bank Equity Capital	**6,190**	**6,027**
Minority Interest in Consolidated Subsidiaries		
Total Equity Capital	**6,190**	**6,027**
TOTAL LIABILITIES AND EQUITY CAPITAL	**80,604**	**78,207**

DERIVATIVES AND OFF-BALANCE SHEET ITEMS		
Unused Commitments	4,333	5,893
Letters of Credit	209	824
Other Off-Balance Sheet Items		
Notional Amount of Derivative Contracts		
Appreciation (Depreciation) in Held-to-Maturity Securities	56	

Footnotes:

Loans and Lease Financing Receivables | 99999

Date: 06/30/20x6

Category:	Amount	Percent
Real Estate Loans	21,938	40.53
Installment Loans	7,058	13.04
Credit Card and Related Plans	90	0.17
Commercial Loans	22,292	41.18
All Other Loans and Leases	2,753	5.09
Gross Loans and Leases	54,121	100.00

PAST DUE AND NONACCRUAL LOANS AND LEASES

Date: 06/30/20x6

Category	Past Due 30 through 89 Days and Accruing	Past Due 90 Days or More and Accruing	Total Past Due and Accruing	Percent of Category	Nonaccrual	Nonaccrual Percent of Category
Real Estate Loans	800	44	844	3.85	1,402	6.39
Installment Loans	125		125	1.77	107	1.52
Credit Card and Related Plans	3		3	3.33		
Commercial and All Other Loans and Leases	626		626	2.50	554	2.21
Totals	1,554	44	1,598	2.95	2,063	3.81
Memorandum Restructured Loans and Leases Included in the Above Totals						

Footnotes:

Recapitulation of Securities

99999

Description	HELD-TO-MATURITY		AVAILABLE-FOR-SALE	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. Treasury securities	1,537	1,593		
U.S. Government agency obligations			2,550	2,554
Securities issued by U.S. states & political subdivisions	250	250		
Mortgage-backed securities (MBS)				
Residential pass-through securities:				
Issued or guaranteed by FNMA, FHLMC, or GNMA			7,322	7,415
Other residential MBS (inc. CMOs, REMICs, & stripped MBS):				
Issued or guaranteed by U.S. Government agencies or sponsored agencies				
Collateralized by MBS issued or guaranteed by U.S. Government agencies or sponsored agencies				
All other residential MBS				
Commercial MBS				
Commercial mortgage pass-through securities:				
Issued or guaranteed by FNMA, FHLMC, or GNMA				
Other pass-through securities				
Other Commercial MBS:				
Issued or guaranteed by U.S. Government agencies or sponsored agencies				
All other commercial MBS				
Asset-backed Securities (ABS) and structured financial products				
Asset-backed securities				
Structured financial products:				
Other Debt Securities				
Other Domestic Debt Securities				
Foreign Debt Securities	1,000	1,000		
Equity Securities				
Investments in mutual funds & other equity securities with readily determinable fair values not held for trading[1]			919	919
Totals:	2,787	2,843	10,791	10,888

SECURITIES APPRECIATION (DEPRECIATION)

Description	Held-to-Maturity	Available-for-Sale	Total
Securities Appreciation (Depreciation)	56	97	153
As a Percent of Amortized Cost	2.01	0.90	1.13

Footnotes:

(1) Not applicable for institutions that have adopted ASU 2016-01, which governs the accounting for equity securities.

Items Subject to Adverse Classification	**99999**

Includes assets and off-balance sheet items which are detailed in the following categories:
Substandard Assets - A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
Doubtful Assets - An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
Loss Assets - An asset classified Loss is considered uncollectible and of such little value that continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

		CATEGORY	
AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss

These sample write-ups do not reflect required or preferred formats, but simply illustrate various ways to present the required analytical elements.

LOANS

500	(1)	Nonaccrual	96 Days Past Due	
<u>250</u>	(2)	Nonaccrual	96 Days Past Due	
750				750

AMHILL TOOL & DIE, INC.
By: Robert E. Hill, President
Gty: Roger S. Barrett

Amhill Tool & Die, Inc. manufactures custom plastic-forming dies and provides injection-molding services.

(1) Note originated 1/7/20x2 at $500M to refinance a $450M mortgage on the obligor's manufacturing plant and provide $50M working capital. The note matures 1/7/20x9 and requires interest-only payments, with principal due on demand. (2) Term note originated 6/10/20x3 at $280M, matures 6/11/20x0, and was extended to refinance a working capital note at another financial institution. The primary source of repayment for both notes is operating CF.

The loans are cross-collateralized by a first mortgage on the manufacturing plant, located in Anytown, Anystate, and a first security interest in all business assets. A 12/7/20x1 appraisal reflects a property value of $625M; however, the valuation appears stale given downward trends in local RE values. As of 12/31/20x5, management estimated the value of account receivables and inventory at $100M and assigned an estimated liquidation value of $125M to machinery and equipment. Reliance on the machinery and equipment as a secondary repayment source is restricted by their highly specialized nature and limited marketability.

Amhill Tool & Die, Inc. has been negatively impacted by cancelled contracts and high employee turnover. Weak CFs have caused on-going delinquency problems and management placed the notes on nonaccrual on 3/31/20x6. The obligor's 12/31/20x5 income statement reported gross income of $800M and a NOI of $100M. Gross sale revenues declined steadily since year-end 2012 and operating losses of $123M and $234M were reported as of 12/31/20x3 and 12/31/20x4, respectively. NW declined to $125M at year-end 20x5, and DSC was calculated at 0.91 as of 12/31/20x5. The guarantor's 12/31/20x4 personal FS reflects liquid assets of $30M, a NW of $375M, and TA of $890M centered in his ownership interest in Amhill Tool & Die, Inc.

EVP/SLO Leslie S. Cook indicated managerial conflicts contributed to the loss of several lucrative contracts and numerous highly trained employees; however, he stated production output is increasing due to the addition of two knowledgeable managers and improved employee training. He also stated management intends to obtain a new

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss

property appraisal, restructure the notes to better match the corporation's cash flows, and to require principal and interest payments on the modified mortgage note.

Debts classified Substandard based on inadequate cash flows, continuing delinquencies, and marginal collateral protection.

Internal Rating: 6 (Watch)
Originating/Servicing Officer: Cook
Examiner: T. Hinojosa

AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss
340 BROOKS, JAMES	200	140	
1,250 IRMA DEAT, LTD.	750		500
290 KING, CHRISTOPHER Gty: Sam King, Inc.	290		
865 LAST CHANCE MOTEL, INC.	500		365
275 RAMIREZ, PETER	250		25
1,550 EIGHT LOANS LESS THAN $250,000 List left with management.	1,550		
TOTAL ADVERSELY CLASSIFIED LOANS	4,290	140	890
SECURITIES			
45 ANYCOUNTY MUNICIPAL GENERAL OBLIGATION	45		
TOTAL ADVERSELY CLASSIFIED SECURITIES	45		

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss
OTHER REAL ESTATE OWNED			
550 ONE WAY HOME, INC. PROPERTY	550		
675 ROLLY PROPERTY	575		100
TOTAL ADVERSELY CLASSIFIED ORE	1,125		100
OTHER ASSETS			
25 SUN, RAYMOND Repossessed Heavy Equipment			25
TOTAL ADVERSELY CLASSIFIED OTHER ASSETS			25
CONTINGENT LIABILITIES			
230 KING, CHRISTOPHER Amount represents unfunded portion of loan commitment for construction of a single-family residence.	230		
TOTAL ADVERSELY CLASSIFIED CONTINGENT LIABILITIES	230		
TOTAL ADVERSELY CLASSIFIED ITEMS	5,690	140	1,015

Items Listed for Special Mention	99999

Includes assets and off-balance sheet items which are detailed as follows:
Special Mention Assets – A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

DESCRIPTION	AMOUNT

LOANS

854 | 854
RAIN, ROBERT, L.L.C.
GTY: Robert Rain

Debt represents the balance outstanding on a $1,600M construction/permanent facility, dated 3/7/20x6, to refinance an existing $1,200M loan at subject bank granted 1/5/20x5. The original loan was granted to develop a 3-story mixed-use commercial and apartment building in Neighboring Town. The new loan provided the borrower with an additional $400M in funds to accommodate a revised construction budget stemming from plan modifications. Loan terms require interest-only payments at 4.375% for a 10-month period. Principal and interest payments of $8,231 based on a 25-year amortization are to commence on 1/7/20x7, with the loan to mature in 20x1. Collateral consists of a first mortgage on the property under construction appraised at $1,000M "as is" and $2,000M "as complete."

The following credit concerns are associated with the indebtedness:

- The project encountered numerous delays due to difficulty in obtaining permits resulting from the changes in construction plans and due to the need for additional financing.
- Guarantor analysis is inadequate, as liquid assets were not verified and a global CF analysis was not prepared.
- Monitoring of the project has been weak. As a result, the loan has been 53 percent funded, but the project is only 40 percent completed, with the difference representing construction funds used for soft costs.
- No feasibility analysis was performed to support the 20x5 origination.
- The guarantor's experience as a construction manager is questionable considering the delays, revisions, and cost overruns.
- The appraised value may need to be updated, as it is based on the project being completed within the revised budget and assumes that projected operating results will materialize.

Given the concerns noted above and weaknesses associated with this indebtedness, a Special Mention designation is warranted. To strengthen the credit, close management oversight and monitoring is required, along with the following actions:

- Monitor construction progress and compare to budget to ensure percentage completion is brought in line with funding.
- Verify the guarantor's liquid assets and obtain financial information to perform a global CF analysis.
- Obtain an updated appraisal if actual rental rates significantly diverge from the appraisal's projections, if project costs outstrip the revised budget, or if further delays ensue.

Internal Rating: 3
Originating/Servicing Officer: Cook
Examiner: V. Stewart

TOTAL LOANS LISTED FOR SPECIAL MENTION | 854

Analysis of Loans Subject to Adverse Classification | 99999

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	6,641	220	176	7,037
Reductions:				
Payments	1,030	58		1,088
Not Now Adversely Classified	955	162		1,117
Now Classified Substandard				
Now Classified Doubtful	140			140
Now Classified Loss	890			890
To Other Real Estate or Other Assets				
Charged-Off	209		176	385
TOTAL REDUCTIONS	3,224	220	176	3,620
Additions:				
Not Adversely Classified Previously	873			873
Further Advances – Loans				
Not Adversely Classified Previously				
Further Advances – Loans				
Adversely Classified Previously				
Credits Newly Extended				
Previously Classified Substandard		140	890	1,030
Previously Classified Doubtful				
Previously Classified Loss				
TOTAL ADDITIONS	873	140	890	1,903
Book Value at This Examination: 06/30/20x6	4,290	140	890	5,320

Analysis of Other Real Estate Owned Subject to Adverse Classification	99999

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	672		18	690
Reductions:				
Not Now Adversely Classified				
Sales With Outside Financing				
Sales With Financing				
Provided By Subject Institution				
Now Classified Substandard				
Now Classified Doubtful				
Now Classified Loss	100			100
Charged-Off			18	18
TOTAL REDUCTIONS	100		18	118
Additions:				
Not Adversely Classified Previously	550			550
Further Advances - ORE or Loans Not Adversely Classified Previously				
Transferred from Previously Adversely Classified Loans				
Further Advances - ORE or Loans Adversely Classified Previously	3			3
ORE From Credits Newly Extended				
Previously Classified Substandard ORE			100	100
Previously Classified Doubtful ORE				
Previously Classified Loss ORE				
TOTAL ADDITIONS	553		100	653
Book Value at This Examination: 06/30/20x6	1,125		100	1,225

Assets with Credit Data or Collateral Documentation Exceptions	99999

This Page includes assets with technical defects not corrected during the examination. The appropriate number or description is noted in the "Deficiency Description" column.

1 - Appraisal
2 - Title Search or Legal Opinion
3 - Borrowing Authorization
4 - Recordation
5 - Insurance
6 - Collateral Assignment
7 - Financial Statement
8 - Inadequate Income/Cash Flow Information
9 - Livestock Inspection
10 - Crop Inspection

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description
LOANS			
AMHERST, MARY	400	None	7
BODY, CHARLES	1,932	12/31/2014	7
C&C MARINA	1,973	6/30/2014	7
GOETZ, MICHAEL	1,538	None	1
IRMA DEAT, LTD.	750		4, 6
JENNINGS, JENNIFER	1,906		5, 6
KING, CHRISTOPHER	290		4, 5, 6
Gty: Sam King		None	7
LAST CHANCE MOTEL, INC.	500		3, 4, 6
TOTAL	9,289		

Total represents 33 percent of the dollar volume of loans reviewed.

OTHER REAL ESTATE OWNED			
ONE WAY HOME, INC. PROPERTY	550		5
TOTAL	550		

Total represents 45 percent of the dollar volume of ORE reviewed.

DESCRIPTION	DETAIL	AMOUNT EXTENDED

CORRESPONDENT BANK CONCENTRATIONS

FIRST NATIONAL BANK
Anothercity, Anotherstate

Due From Account	4,025	
Federal Funds Sold	5,000	
		9,025

- Concentration to First National Bank (FNB) represents 111 percent of Tier 1 Capital plus the allowance for loan and lease losses.
- Aggregate monthly balances have averaged over $9 million for the past six quarters.
- Management does not formally measure or track the level of this concentration.
- Management does not perform formal financial analysis of FNB.
- Management stays abreast of the FNB's financial condition through routine business contacts and review of publicly available financial data.
- The overall health of regional banks is satisfactory.
- Credit risk is relatively low due to FNB’s current financial strength.
- Concentration risk is moderate due to a lack of formal monitoring procedures.
- Deterioration in FNB’s financial position could negatively affect daily operations as the Bank of Anytown uses the Due From FNB account to clear transactions and the federal funds sold account is a primary liquidity source.
- Policies and procedures for ensuring compliance with the Federal Reserve’s Regulation F are satisfactory; however, management has not established formal guidelines for identifying or limiting overall correspondent concentrations.

<u>Summary</u>

This correspondent bank concentration presents moderate risk to the institution and is generally adequately managed, though President Lincoln indicated that more formal correspondent bank risk management guidelines would be developed. See Question 1 on the Risk Management Assessment Page.

INDIVIDUAL BORROWER CONCENTRATION

John and Mary Smith Relationship

John and Mary Smith		
RE mortgage	500	
JMS Corporation		
JM: John and Mary Smith		
Secured commercial loans (3)	785	
Commercial letters of credit (2)	315	
J&M Realty Trust		
Gty: John and Mary Smith		
Commercial RE mortgage	750	
		2,350

The Smiths own JMS Corporation (JMS), which repairs and resells used wood pallets, and J&M Realty Trust, which holds their commercial property. This credit concentration represents 29 percent of Tier 1 Capital plus the allowance for loan and lease losses.

The wood pallet industry is facing increased competition from the plastic pallet industry. However, JMS's recycling of scrap wood has allowed it to maintain solid sales and profitability levels to offset the effect of the increased competition. The borrowers have had a very positive, long-term credit relationship with the bank, the notes are well collateralized by diverse and marketable collateral, and the concentration poses limited risk to the bank.

The Loan Policy includes appropriate credit limits to one borrower, and management reports large credit relationships to the Board each month. However, the Smith's residential mortgage was not identified in the bank's relationship analysis and the Smith relationship has not been reported to the Board as a concentration. The most recent annual loan review for this credit relationship included adequate analysis of the economic and competitive factors that may affect this concentration's risk profile, and the internal risk rating is appropriate. However, the origination of the J&M Realty Trust mortgage on 1/2/20x6, caused the outstanding balances for this relationship to exceed the Anystate legal lending limit statute, as discussed previously on the Violations of Laws and Regulations page for further discussion.

<u>Summary</u>

The concentration poses limited risk to the institution. However, concentration identification and reporting practices need improvement. See Question 1 on the Risk Management Assessment Page.

INDUSTRY CONCENTRATION

Shellfish Fishing Industry (NAICS Code 114112) 8,694

Identification - This credit concentration consists of loans to borrowers who specialize in shell fishing or the sale of customized fishing vessels and equipment. Although loans to the shell fishing industry represent 107 percent of Tier 1 Capital plus the allowance for loan and lease losses, management does not measure or track the credits as a concentration of risk.

Economic and Competitive Factors - Management stays abreast of general factors and economic trends relating to the industry through local news reports and discussions with borrowers. However, management does not maintain a formal process for obtaining and disseminating economic, competitive, or regulatory information to the Board or loan staff. Given the informality of the process, management was unaware of some key factors adversely affecting the industry, such as federal efforts to reduce overfishing through lower fuel subsidies and State proposals to reduce daily catch limits and shorten permissible fishing hours.

Risk Stratification and Vulnerability Assessment - Most of the borrowers are fishermen that share the same fishing grounds, as there are no alternative grounds readily available. The collateral consists of specialized fishing vessels and equipment that are not easily converted to other purposes, thereby limiting their marketability.

Borrower CF is heavily influenced by catch volumes, market price, and operating costs. Although sustained demand has contributed to higher per-pound prices, lower catch volumes and higher fuel costs have reduced profitability levels and increased repayment risk associated with this industry.

Underwriting standards are heavily reliant on collateral values, with limited analysis of projected CFs. Delinquencies remain relatively low, but have been increasing. Internal risk ratings, which appear to accurately reflect the characteristics of individual loans, have not been aggregated for analysis of the fishing portfolio. Additionally, as management does not formally monitor industry risks, there has been no analysis of the potential impact to the institution's asset quality, earnings, or capital if adverse trends continue.

Risk Management and Control Processes - Management relies on general loan delinquency reports and periodic discussions with borrowers to monitor loans to the fishing industry. Although the strategic plan identifies fishing as an important factor in the local economy, it does not address any of the unique risks or mitigating risk management practices associated with lending to this industry. Also, as noted above, management has not established formal procedures to identify, aggregate, or track loans to the fishing industry, and the loan policy does not address portfolio concentration limits.

<u>Summary</u>

Monitoring of this concentration has been relatively informal, given management’s long term experience in lending to this industry, but given the size of the concentration and vulnerabilities in the industry, risk management should be more robust. President Lincoln stated that plans are to continue to lend in this industry at the current levels; however, she stated that oversight and administration of the concentration would be strengthened. See Question 1 on the Risk Management Assessment Page.

Capital Calculations		99999
COMMON EQUITY TIER 1 CAPITAL (CET1)		
Common Stock and Surplus net of Treasury Stock and unearned ESOP shares	6,027	
Retained Earnings	103	
Accumulated Other Comprehensive Income	60	
Common Equity Tier 1 Minority Interest includable in Common Equity Tier 1		
Subtotal: Common Equity Tier 1 Capital Before Adjustments and Deductions		6190
Adjustments and Deductions to CET1		
Less: Goodwill net of Associated Deferred Tax Liabilities		
- Intangible Assets (other than Goodwill and Mortgage Servicing Assets), net of associated deferred tax liabilities		
- Deferred Tax Assets that arise from net operating loss and tax credit carryforwards, net of any related valuation allowances and net of deferred tax liabilities		
- AOCI-related Adjustments(1)	60	
- Unrealized net gain (loss) related to changes in the fair value of liabilities that are due to changes in own credit risk		
- All other deductions from (additions to) CET1 capital before threshold-based deductions		
- Investments in the capital of unconsolidated financial institutions in the form of common stock that exceeds the 25 percent CET1 Capital deduction threshold		
- MSAs, net of associated DTLs that exceed the 25 percent CET1 capital deduction threshold		
- DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs that exceed the 25 percent CET1 deduction threshold(3)		
- Deductions for insufficient amounts of Additional Tier 1 and Tier 2 capital to cover deductions		
Subtotal: Adjustments and Deductions to CET1		60
Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss	125	
- Additional Provision (to be Transferred to Tier 2 Capital, if applicable)(2)	325	
- Other Adjustments to and Deductions from Common Equity Tier 1 Capital(3)		
Subtotal: Other Adjustments and Deductions to CET1		450
Common Equity Tier 1 Capital		5,680
ADDITIONAL TIER 1 CAPITAL		
Noncumulative Perpetual Preferred Stock and related Surplus		
Non-qualifying capital instruments subject to phase-out from Additional Tier 1 capital		
Tier 1 Minority Interest not included in CET1 Capital		
Subtotal: Additional Tier 1 Capital before Deductions		
Less: Additional Tier 1 Capital Deductions		
Additional Tier 1 Capital		
Tier 1 Capital		5,680

TIER 2 CAPITAL (2)

Tier 2 Capital instruments and related surplus		
Non-qualifying capital instruments subject to phase-out from Tier 2 Capital		
Total capital minority interest that is not included in Tier 1 capital		
Allowance for Loan and Lease Losses	1,979	
Less: Held-for-Investment Loans and Leases Classified Loss	890	
Add: Additional Provision Transferred from Common Equity Tier 1 Capital	325	
Examination Adjusted Allowance for Loan and Lease Losses	1,414	
Less: Excess Allowance for Loan and Lease Losses (If Applicable)	728	
Allowance for Loan and Lease Losses Includable in Tier 2 Capital	686	
Unrealized Gains on Available-For-Sale Equity Securities Includable in Tier 2 Capital		
Subtotal: Tier 2 Capital Before Deductions	686	
Less: Tier 2 Capital Deductions		
Tier 2 Capital		686
TOTAL CAPITAL(2)		6,366

RISK-WEIGHTED ASSETS AND AVERAGE TOTAL ASSETS CALCULATIONS(2)

Risk-Weighted Assets Before Deductions for Excess Allowance for Loan and Lease Losses and Allocated Transfer Risk Reserve	55,920	
Less: Excess Allowance for Loan and Lease Losses	728	
Less: Allocated Transfer Risk Reserve		
Less: Risk-Weighted Asset Amounts Deducted from Capital	1,015	
Total Risk-Weighted Assets		54,177
Average Total Assets	76,803	
Less: Deductions from Common Equity Tier 1 Capital and Additional Tier 1 Capital(3)	450	
Average Total Assets for the Leverage Ratio		76,353

MEMORANDA

Capital Conservation Buffer(2)		N/A
Securities Appreciation (Depreciation)		1,126
Contingent Liabilities/Potential Loss	130,787 / 0	

Footnotes:

(1) Includes AOCI adjustments by banks making the AOCI opt-out election and the adjustment for certain accumulated gains (losses) on cash flow hedges by banks not making the AOCI opt-out election as outlined in Part 324.

(2) Institutions under the CBLR framework do not calculate Tier 2 Capital. For such institutions, Tier 1 Capital equals Total Capital under Part 324. In addition, these institutions do not calculate Risk-Weighted Assets or the Capital Conservation Buffer.

(3) Includes adjustment for financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999, if applicable.

Analysis of Earnings	99999

Comparative Statement of Income

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Interest Income	2,519	5,582	7,329
Interest Expense	894	2,452	3,850
Net Interest Income	1,625	3,130	3,479
Noninterest Income	304	589	643
Noninterest Expense	1,467	2,902	2,904
Provision for Loan and Lease Losses	300	1,025	1,580
Securities Gains (Losses)	15	48	
Net Operating Income (Pre-Tax)	177	(160)	(362)
Applicable Income Taxes	74	(36)	(117)
Net Operating Income (After-Tax)	103	(124)	(245)
Discontinued Operations Net of Applicable Income Taxes			
Net Income (Loss) Attributable to Noncontrolling (Minority) Interests			
Net Income	103	(124)	(245)
Other Increases/Decreases	60		
Includes changes in the net unrealized holding gains (losses) on Available-For-Sale Securities			
Cash Dividends			
Net Change in Equity Accounts	163	(124)	(245)

Reconcilement of Allowance for Loan and Lease Losses

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Beginning Balance	1,748	1,407	950
Gross Loan and Lease Losses	181	884	1274
Recoveries	112	200	151
Provision for Loan and Lease Losses	300	1025	1580
Other Increases (Decreases)			
Ending Balance	1,979	1,748	1,407

Other Component Ratios and Trends

<u>Ratio</u>	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Interest Income (TE)/Average Earning Assets	4.74	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	3.62	3.54
Net Income/Average Total Equity	3.39	-2.05	-3.87
Net Losses/Average Total Loans and Leases	0.025	1.24	1.88
Earnings Coverage of Net Losses (X)	6.7	-1.19	-1.08
ALLL/Total Loans and Leases	3.67	3.15	2.5
Noncurrent Loans and Leases/ALLL	106.47	143.88	100.64

Footnotes:

Comparative Statements of Income and Changes in Equity Capital Accounts | 99999

ITEMS	06/30/20x6	12/31/20x5	12/31/20x4
INTEREST INCOME:			
Interest and fee income on loans	2,185	4,826	6,305
Income from lease financing			
Interest on balances with depository institutions			
Income on Federal funds sold and repos	66	350	512
Interest from assets held in trading accounts			
Interest and dividends on securities	268	406	512
Other Interest Income			
TOTAL INTEREST INCOME	2519	5582	7,329
INTEREST EXPENSE:			
Interest on deposits	858	2,434	3,832
Expense on Federal funds purchased and repos	5	18	18
Other interest expense	31		
TOTAL INTEREST EXPENSE	894	2,452	3,850
NET INTEREST INCOME	1,625	3,130	3,479
NONINTEREST INCOME:			
Services charges on deposit accounts	234	461	415
All other noninterest income	70	128	228
TOTAL NONINTEREST INCOME	304	589	643
NONINTEREST EXPENSE:			
Salaries and employee benefits	750	1,422	1,342
Premises and fixed assets expense (net of rental income)	271	549	584
Amortization expense of intangible assets (including goodwill)			
Other noninterest expense	446	931	978
TOTAL NONINTEREST EXPENSE	1,467	2,902	2,904
Provision for loan and lease losses	300	1,025	1,580
Securities gains (losses)	15	48	
NET OPERATING INCOME (PRETAX)	177	(160)	(362)
Applicable income taxes	74	(36)	(117)
NET OPERATING INCOME (AFTERTAX)	103	(124)	(245)
Discontinued operations net of applicable income taxes			
Net income (loss) attributable to noncontrolling (minority) interests			
NET INCOME	103	(124)	(245)
Other increases in equity capital accounts	60		
Other decreases in equity capital accounts			
Cash dividends declared on common stock			
Net change in equity capital accounts for the period	163	(124)	(245)
Equity capital accounts at beginning of the period	6,027	6,151	6,396
Equity capital accounts at end of the period	6,190	6,027	6,151

Footnotes:

HOLDING COMPANY RATIOS AND TRENDS

CONSOLIDATED HOLDING COMPANY	HOLDING COMPANY		
	(Date)	(Date)	(Date)
Net Operating Income to Average Assets			
Total Risk-Based Capital Ratio			
Leverage Capital Ratio			
This Institution's Assets to Consolidated Holding Company Assets			
PARENT ONLY			
Pre-Tax Operating Income and Interest Expense to Interest Expense (X) (Fixed Charge Coverage)			
Operating Income - Tax + Non-Cash Items to Total Operating Expense and Dividends Paid (Cash Flow Match)			
Total Liabilities to Equity			
Equity Investments in Subsidiaries to Equity (Double Leverage)			
Equity Investment in Subsidiaries - Equity Capital/Net Income - Dividends (Double Leverage Payback in Years)			

EXTENSIONS OF CREDIT TO AFFILIATED ORGANIZATIONS

DESCRIPTION	DIRECT	INDIRECT	TOTAL
A. Affiliated organizations including securities issued by affiliated organizations.	250		250
B. Indebtedness of others, or portions of such indebtedness, collateralized by securities issued by affiliated organizations.			0
Total	250	0	250
Less duplications within and between groups			0
Net Total	250	0	250

Comments:

HOLDING COMPANY

Any Company, Inc.
Anytown, Anystate

SUBSIDIARY

Any Time, Inc.
Anytown, Anystate

OTHER AFFILIATES

Any Body, Inc.
Anytown, Anystate

Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests	99999

Description	Total
A. Executive Officers and their related interests	1,200
B. Directors/Trustees and Principal Shareholders and their related interests	250
TOTAL	1,450
Less duplications within and between groups	250
NET TOTAL	1,200
Capital and unimpaired surplus as of last Call Report date (Per Regulation "O")	7,094
Net total insider borrowing as a percentage of unimpaired capital and surplus	16.92%

NAME AND COMMENTS (Designate all duplications with a "D")	Detail	% of Unimpaired Capital & Surplus
Group A		
LINCOLN, ALLIE C. Director and President	500	7.05%
GUTIERREZ, JOHN M. Executive Vice President and Cashier	450	6.34%
ANY BODY, INC. Duplication debt guaranteed by President Lincoln and Director Green.	250 D	3.52%
TOTAL	1,200	
Group B		
ANY BODY, INC. A related interest of President Lincoln and Director Green. Both individuals guarantee the debt.	250 D	3.52%

Safety and Soundness

Composite 3. Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Information Technology

Composite 2. Financial institutions and service providers rated composite "2" exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. The financial condition of the service provider is acceptable and while internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Trust

Composite 2. Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Compliance

Composite 2. An institution in this category is in a generally strong compliance position. Management is capable of administering an effective compliance program. Although a system of internal operating procedures and controls has been established to ensure compliance, violations have nonetheless occurred. These violations, however, involve technical aspects of the law or result from oversight on the part of operating personnel. Modification in the bank's compliance program and/or the establishment of additional review/audit procedures may eliminate many of the violations. Compliance training is satisfactory. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.

Community Reinvestment Act (CRA)

A CRA rating of "Satisfactory" is assigned. An institution in this group has a satisfactory record of helping to meet the credit needs of its assessment area, including low- and moderate income neighborhoods, in a manner consistent with its resources and capabilities.

Refer to http://www.fdic.gov/regulations/examinations/ratings/index.html for definitions of all composite ratings.

Signatures of Directors/Trustees	99999

We the undersigned directors/trustees of Bank of Anytown, Anytown, Anystate, have personally reviewed the contents of the Report of Examination dated June 30, 20x6

Signatures of Directors/Trustees	**Date**
Henry P. Black	
Michael D. Brown	
Larry G. Green	
Kerry A. Jones	
Allie C. Lincoln	
Jaime S. Martin	
John D. Scott	
Roger White	

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations. The signatures of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

CONTROL AND RELATIONSHIPS

Any Company, Inc., a one-bank holding company, continues to own 100 percent of the bank's common stock. Bank directors own or control a combined 908,584 shares or 56 percent of holding company stock. President Lincoln is the largest individual stockholder, controlling 500,326 shares or 31 percent of the outstanding stock. Any Time, Inc. is a subsidiary of the bank and holds title to ORE. Any Body, Inc., is an on-premise insurance agency owned by President Lincoln and Director Green that sells credit life, auto, fire, and disability insurance but does not utilize bank employees or equipment. President Lincoln stated that no ownership or management changes are planned. President Lincoln notified the bonding company of the nonbank activity being conducted on the premises and received an acknowledgement letter from the bonding company dated November 9, 20x5. On January 20, 20x6, the board of directors of Any Company reviewed the operations of Any Body, Inc., and approved its continued operations and lease of bank space for another year.

DIRECTOR INVOLVEMENT

One of the bank's directors contacted the EIC during the examination to discuss his concerns with the current committee structure of the bank. Director John Scott indicated that he felt the Loan Committee membership should be expanded and that the committees were dominated by Chairman White and President Lincoln.

DOMINANT MANAGEMENT

Chairman of the Board Roger White and President Allie Lincoln exhibit a dominant influence over the bank's affairs. Their dominance over policy discussion and decisions has negatively impacted the condition of the institution as noted throughout the report of examination. Both Chairman White and President Lincoln were responsive to regulatory concerns and promised prompt corrective actions to implement the current exam recommendations and outstanding MOU.

EXAMINATION SCOPE

Examination Number 12345

The examination scope was expanded from the pre-exam planning (EP) memo in the following areas:

- Construction Lending – Expanded due to administrative problems identified in the original loan sample. Ten additional construction loans serviced by the two construction lenders and originated in 20x6 were reviewed.
- BSA Review – Expanded to include a review of all Currency Transaction Reports filed in 20x6 due to indications that they were being filed late.
- Call Report Review – Expanded to include year-end 20x5 in response to the volume of errors noted with the original review.

As a result, examination hours, totaling 760, are 150 over budget (25 percent). Other examination procedures were not modified from those identified in the EP memo and no significant variances between projected and actual examination hours, scope, or procedures were noted in the BSA/AML (Exam #12346), Trust (Exam #12347), or IT (Exam #12348) reviews.

SUGGESTIONS FOR FUTURE EXAMINATIONS

There is sufficient working space for seven examiners.
Management accommodated working hours of 7:30am to 5:30pm.
The examination crew should contain at least one examiner with experience in construction loan analysis.

List alphabetically all directors/trustees, senior officers, and principal stockholders. Also indicate their titles. Number of shares owned is not rounded. (J – indicates stock jointly owned; P – indicates preferred stock owned; H – indicates holding company stock owned; C – indicates stock controlled but not owned)

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					

Biographical and background information on directors, officers, and other key management officials listed on this page should be prepared in accordance with the Report of Examination Instructions.

Names and Comments	Amount	Date of Statement	Year Joined Bank	Year of Birth	Attendance	Number of Shares Owned	Salary and Bonus (B)
DIRECTORS/TRUSTEES							
BLACK, HENRY P. Attorney *Address*	501	3/1/20x5	1980	1961	12	50,992 (H)	
BROWN, MICHAEL D. Commercial RE Consultant (1) *Address*	7,890	6/1/20x5	1983	1959	5	5,005 (H)	
GREEN, LARRY G. Automobile Dealership Owner (1) *Address* *Estimated by President Lincoln.	10,000	8/1/20x6*	1981	1955	12	200,150 (H)	
JONES, KERRY A. Retired Doctor *Address*	2,500	6/1/20x5	1979	1933	12	1,010 (H)	
LINCOLN, ALLIE C. President (1)(2) *Address*	1,357	2/1/20x5	1982	1951	12	500,326 (H)	100 25(B)
MARTIN, JAIME S. Economist *Address*	3,565	3/1/20x5	1981	1950	11	150,500 (H)	
SCOTT, JOHN D. Certified Public Accountant (2) *Address*	7,234	8/7/20x5	1982	1954	11	101 (H)	
WHITE, ROGER Chairman of the Board (1)(2) *Address* *Estimated by Money Magazine.	5,000	6/24/20x6*	1980	1960	12	500 (H)	24(B)
OFFICERS, NOT DIRECTORS/TRUSTEES							
COOK, LESLIE S. Executive Vice President - Commercial Lending (1)			1983	1960			85

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					
GUTIERREZ, JOHN M. Executive Vice President / Cashier (2)			1983	1958			70

PRINCIPAL SHAREHOLDERS, NOT DIRECTORS/TRUSTEES OR OFFICERS

ANY COMPANY, INC. Anytown, Anystate						162,247	

(1) Loan Committee
(2) Investment Committee

Total Holding Company shares owned by the Directorate: 908,584
Percentage Holding Company ownership by the Directorate: 56 percent

There have been 12 regular Board meetings since the last regulatory examination.
Director fees are $250 per Board meeting attended.
Committee fees are $100 per committee attended.