FIRST STATE BANK

ANYTOWN ANYCOUNTY ANYSTATE

Region:	Anyregion	Certificate Number:	12345
Examiner-In-Charge:	John A. Doe (State) Jane Smith (FDIC)		
Examination Start Date:	February 28, 2005		
Examination As Of Date:	December 31, 2004		

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Uniform Financial Institutions Rating System	Current Exam	Prior Exam	Prior Exam
Examination Start Date	02/28/2005	12/14/2003 / S	02/24/2003
Examination As Of Date	12/31/2004	09/30/2003 / S	12/31/2002
Composite Rating		2	2
Component Ratings:			
Capital	___	2	2
Asset Quality	___	2	2
Management	___	2	2
Earnings	___	2	1
Liquidity	___	2	2
Sensitivity to Market Risk	___	2	1

SUMMARY

The overall financial condition of the bank has deteriorated since the last regulatory examination. This deterioration is mainly due to rapid asset growth and the lack of adequate risk management. Asset quality has declined due to inadequate underwriting practices, credit administration weaknesses, and high concentrations in commercial real estate and construction loans. Capital levels have declined and are strained due to rapid asset growth and the bank's increasing risk profile. Earnings have declined due to the need for increased provisions for loan losses and a moderate increase in personnel expense. While liquidity and sensitivity to market risk are currently satisfactory, they could be adversely impacted if steps are not taken to remedy asset quality and capital adequacy concerns. An increased level of supervisory concern is warranted.

MANAGEMENT SUPERVISION

The institution's risk profile has risen to a level of concern due to ineffective board supervision. Policies are not being enforced by the board or followed by management, and the Loan Policy is not adequate for the bank's needs. Additionally, this examination cites several apparent violations of laws and regulations.

Board Oversight

The board of directors has not demonstrated active participation in the oversight of the institution. Board and committee meeting minutes reflect minimal discussion and show that two directors have had unsatisfactory attendance (less than 70% of meetings attended). Furthermore, board packages do not contain sufficient information to allow directors to make independent decisions and assessments. President Apple appears to be exerting a dominant influence over board members as he chairs every committee and prepares all of the information for the meetings. Information that he provides to the board does not reflect the numerous policy exceptions noted during this examination.

Internal Audit

The bank's internal audit program is inadequate. The internal audit schedule has not been completed in over two years, and the Audit Committee meets infrequently. Additionally, the internal audit function is not independent. Audit reports, when produced, are presented to President Apple rather than directly to the Audit Committee, and President Apple chairs the committee. Furthermore, there are no formal procedures in place for responding to audit criticisms/recommendations, and there is no documentation of corrective actions taken by management.

Policies and Procedures

Although the bank's policies are generally adequate, they are not being enforced by the board. Management is operating outside of policy guidelines and board awareness and approval of policy exceptions is not evident. Furthermore, the board does not review and approve bank policies annually, bringing into question the board's knowledge of these policies. Additionally, the Loan Policy is not adequate and should be revised to strengthen loan underwriting guidelines, establish prudent limits for loan concentrations, and develop an effective methodology for monitoring concentrations.

Strategic Plan

The board has not established a realistic strategic plan. The current strategic plan is general in nature and has not been updated for nearly three years. Led by President Apple, the bank's actual growth has far outpaced the strategic plan's growth targets. He has also changed the bank's strategic focus to that of a real estate lender. This was done without board approval and without consideration to the lending expertise required to properly underwrite and administer such loans.

Apparent Violations

Several apparent violations of law were noted during the examination and are summarized below:

- Part 323 of the FDIC Rules and Regulations - missing or inadequate appraisals and appraisal reviews
- The Federal Reserve Board's Regulation O - exceeding limits on loans to executive officers
- The Bank Secrecy Act - inadequate written compliance program, and
- Part 365 of the FDIC Rules and Regulations - inadequate real estate lending guidelines and monitoring procedures

Details are provided in the Violations of Laws and Regulations pages of this report.

ASSET QUALITY

Asset quality has deteriorated. Adversely classified items to Tier 1 Leverage Capital and the Allowance for Loan and Lease Losses (ALLL) now total 37%, up from 23% at the prior examination. The severity of adversely classified items has also increased as assets classified Doubtful and Loss total $1.2 million, or 26% of total adverse classifications - up from $177,000 at the prior examination.

The increase in classifications is a direct result of more liberal credit practices and lax loan documentation, particularly within the commercial real estate and construction loan portfolios. Management has aggressively pursued these loans despite the economic downturn in its trade area. The bank now has significant concentrations of credit in commercial real estate and construction loans, aggregating 480% and 530% of Tier 1 Capital, respectively. These figures exceed policy maximums, and rather than control these risks, the board opted to increase policy risk limits. Furthermore, management has exceeded the loan-to-value guidelines contained in Part 365 of the FDIC's Rules and Regulations on many loans, and an excessive 62% of loans reviewed contained documentation exceptions.

Management's monitoring of loan concentrations is deficient. Concentration reports show only the bank's aggregate exposure to commercial real estate and construction loans rather than segmenting the portfolios by loan type/collateral, etc. These reports do not allow management to adequately identify, manage, and monitor concentration risk. Refer to the Concentrations page for further details.

Loan Policy

The Loan Policy does not establish prudent guidelines for loan concentrations and provides inadequate guidance for commercial real estate and construction lending. As a result, loan concentrations are excessive and are not being properly monitored or controlled. Additionally, asset quality has deteriorated due to weak loan underwriting and credit administration practices. The Loan Policy is again criticized for its lack of sufficient guidance for underwriting commercial real estate and construction loans. The policy does not:

- Establish prudent credit concentration guidelines
- Establish effective concentration monitoring and reporting procedures
- Require comprehensive analysis of cash flow and repayment ability
- Specify the type of financial information and other documentation necessary for each loan type
- Require property inspections on commercial real estate and construction loans

Loan Underwriting Weaknesses

- Credit memos do not provide a clear assessment of repayment capacity - many real estate credits are approved based solely on collateral values with no cash flow analysis performed
- Loan documentation weaknesses are again noted at this examination – an excessive 62% of the credits reviewed contained documentation exceptions
- Property inspections are not being prepared for all commercial properties

Credit Administration Weaknesses

- Ongoing loan documentation is poor as updated financial statements are not being acquired
- Management's internal credit review is based solely on delinquency
- The watch list is inadequate - many of the credits classified in this examination were not classified internally

Allowance for Loan and Lease Losses (ALLL)

The ALLL methodology is inadequate and a provision of at least $500M is needed to replenish the ALLL following the credit losses identified during the examination. The methodology needs to be revised to include the following items from the Interagency Policy Statement on ALLL Methodologies and Documentation:

- The performing portion of the loan portfolio should be stratified into groups with similar characteristics
- Reserves should be assigned based on the risk present in each group
- Factors such as changes in economic trends, underwriting standards, and portfolio growth should be considered in determining an adequate reserve level

CAPITAL

Capital ratios have declined substantially due to significant asset growth that has outpaced equity formation. The Tier 1 Leverage Capital ratio and the Tier 1 and Total Risk Based Capital ratios have declined to 8.08%, 9.11%, and 10.31% compared to 9.61%, 12.87%, and 14.03% at the previous examination. Although "Well Capitalized" for Prompt Corrective Action purposes, these ratios are not adequate when considering the bank's elevated risk profile. The bank's risk profile has increased due to:

- Lack of adequate board and management oversight
- Declining asset quality
- Aggressive and non-diversified loan growth
  - Commercial real estate loans = 480% of Tier 1 Capital, up from 275%
  - Real estate construction loans = 530% of Tier 1 Capital, up from 290%.
- Weaknesses in management's loan underwriting and credit administration, and
- Poor loan concentration monitoring
  - Management has routinely exceeded board-established loan concentration limits
  - Policy risk tolerances for loan concentrations were raised to reflect the actual exposure rather than establishing prudent risk limits

EARNINGS

The bank's historically strong earnings performance has been impacted by deterioration in the loan portfolio and rising overhead expenses. Net income is overstated by $500,000 due to an inadequate Allowance for Loan and Lease Losses, which has not increased despite significant loan growth. After making the required provision, Return on Assets (ROA) declines to 0.87% from 1.14% as reported on the December 31, 2004, UBPR. This is well below the peer group ratio of 1.26%.

Rising overhead expenses are also impacting earnings. Overhead costs as a percentage of average assets increased 25 basis points over the past year. The majority of this increase is the result of the new loan officer incentive program introduced to facilitate the bank's rapid loan growth.

Net Interest Income

Despite the bank's dramatic growth in higher risk loans, net interest income has increased only slightly. This is because of the higher cost of funds and aggressive loan pricing associated with the bank's rapid growth objectives. Also, deteriorating loan performance has hampered loan yields.

Future Earnings Prospects

The outlook for improved earnings performance is uncertain at this time given the bank's increasing risk profile. Although the budget projects a 1.2% ROA for the current year, it does not address the bank's deteriorating asset quality, including:

- The increasing volume of non-performing loans
- The need for additional provisions for loan losses
- The likely need for additional personnel expenses to address deficiencies in the lending function

Management must address these issues to prevent further earnings deterioration and restore earnings to historical levels.

LIQUIDITY

Liquidity levels and funds management practices are satisfactory; however, the position is weakening as increased competition has caused deterioration in core deposit levels, requiring loan growth to be funded with increased borrowings. As a result, the net non-core funding exposure has increased to a notable, yet still manageable 21.76%. Excessive liquidity concerns are tempered somewhat, however, by management's commitment to discontinue asset growth until core deposit levels increase. Furthermore, the bank has ample and diverse secondary funding sources including $20 million in unpledged available-for-sale (AFS) securities and $30 million in available Federal Home Loan Bank (FHLB) borrowings.

SENSITIVITY TO MARKET RISK

Sensitivity to market risk is limited to interest rate risk (IRR) and is considered satisfactory. Exposure to IRR is moderate and management of the IRR function continues to be effective. As of our examination date, the bank's interest rate risk model indicated that a +/-200 basis point change in market interest rates would have a modest +/-21 basis point impact on the net interest margin. This remains well within board-approved policy parameters; however, the lower levels of earnings and capital require that management remain in a reasonably well-balanced position.

DIRECTORATE RESPONSIBILITY

It is the responsibility of each member of the board of directors to thoroughly review the Report of Examination. Each director must sign the Signatures of Directors page to affirm that each director has reviewed the Report in its entirety.

Examiner (Signature)	Regional Director (Signature)