



# SR003\_7: Failed Bank Report

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## Westsound Bank

607 Pacific Avenue  
Bremerton, WA 98337

(3/12/1999 – 5/8/2009)

# Report Objective

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This report has **two** objectives, using the bank's **data**\*:

1. To examine the bank finances in the quarters prior to its failure.
2. To analyze the bank finances using our Key Performance Indicator (KPI) scoring approach to determine if the bank's failure is something we could have predicted.

\*Data source: FDIC and company filings.

# Bank Background

<b>FDIC Certificate #</b>	<b>34843</b>
<b>Parent Holding Company</b>	WSB FINANCIAL GROUP, INC.
<b>Bank Charter Class</b>	Federal Reserve Non-member
<b>Asset Concentration</b>	Commercial Lending Specialization
<b>Product Specialty</b>	Commercial Banking Services, Commercial and Residential Real Estate Loans, Constructions and Land development Loans
<b>Number of Branches</b>	9 (as of March 31, 2009)
<b>Number of Employees</b>	92 (as of March 31, 2009)
<b>Executives</b>	
<b>CEO/President</b>	Terry Peterson
<b>CFO</b>	Janet Hobson

# What took place?

**W**estsound Bank, Bremerton, WA was closed by the Washington Department of Financial Institutions on May 8<sup>th</sup>, 2009. The Federal Deposit Insurance Corporation (FDIC) was named Receiver. The estimated cost to the FDIC Deposit Insurance Fund is \$108,000,000, compared to the average cost of \$389,206,944. Kitsap Bank of Washington will acquire all deposits.

# Bank Financial Snapshot

Financial Data Overlay (thousands)			
	2008 Q1	2009 Q1	Percentage Change
<b>Assets</b>	\$ 502,789	\$ 334,608	↓ 33.4%
<b>Liabilities</b>	\$ 445,034	\$ 306,334	↓ 31.2%
<b>Net Income</b>	-\$ 5,682	-\$ 4,320	↑ 24.0%

- The average net income change for all FDIC banks was -59.6% in the same period.
- The average net income change for all the commercial lending specialization banks was -107.5% in the same period.
- Compared with the whole industry and other commercial lending specialization banks, Westsound Bank's change from net income is positive, and its net loss in 2009 is less than the net loss in 2008.

# Key Performance Indicators

KPI Summary for 2009 Q1	
Normalized Income Rating	Very Poor
Delinquent Asset Rating	Moderate
Asset: Liability Rating	Poor
Real Estate Asset Rating*	Poor
Bankability Composite Score	35.17** (Poor)

Possible ratings: *Excellent, Good, Moderate, Poor, Very Poor.*

\*This rating is relevant to the current “financial crisis” fueled by mortgage security backed loans.

\*\*This is out of 100.

# Normalized Income Analysis

	2007Q4	2008Q1 	2008Q2	2008Q3	2008Q4	2009Q1
Normalized Income	0.10%	-1.13%	-2.49%	-0.80%	-3.12%	-1.29%
SD's from Average*	0.0370	-2.48	-3.88	-0.904	-2.82	-2.21
Ranking	Moderate	Very Poor	Very Poor	Moderate	Very Poor	Very Poor


- Westsound Bank had a normalized income of -1.29% in the first quarter of 2009, the quarter before it failed.
- Banks of the same asset concentration hierarchy (commercial lending specialization) had an average normalized income of -0.01%. The standard deviation of the normalized incomes was 0.58%, which means that Westsound Bank was 2.21 SD's below the average.

\*Average of banks of the same asset concentration hierarchy



Indicates sign of bank in financial distress

# Delinquent Asset Analysis

	2007Q4 	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1
Delinquent Asset	9.4337%	9.8021%	8.8681%	9.4602%	3.5143%	3.3104%
SD's from Average*	4.77	4.37	4.02	4.16	0.83	0.59
Ranking	Very Poor	Very Poor	Very Poor	Very Poor	Moderate	Moderate

- Westsound Bank had a delinquent assets out of total assets ratio 3.3% in the first quarter of 2009, the quarter before it failed.
- Banks of the same asset concentration hierarchy (commercial lending specialization) had an average delinquent asset of 1.9142%. The standard deviation of the delinquent assets was 2.37%, which means that Westsound Bank was about 0.6 SD's above the average.
- Since the fourth quarter of 2007, Westsound Bank's delinquent assets ratio has been very poor and way above the average. However, right before the bank fails, its delinquent asset ratio suddenly dropped to normal level, which provides no signs of the bank's failure.

\*Average of banks of the same asset concentration hierarchy



Indicates sign of bank in financial distress

# Real Estate Loan Asset Analysis

	2007Q4 	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1
Real Estate Loan Asset Ratio	77.47%	70.33%	72.05%	70.74%	67.14%	66.41%
SD from Average*	1.43	0.97	1.04	0.94	0.71	0.71
Ranking	Very Poor	Poor	Poor	Poor	Poor	Poor

- Westsound Bank had a 66.41% of R/A ratio in 09 Q1, the quarter before it failed.
- In 09 Q1, banks of the same asset concentration hierarchy (commercial lending specialization) had an average R/A ratio of 56.23%. The standard deviation of the R/A ratio was 14.37%, which means that Westsound Bank was 0.71 SD's above the average.

\* Average of banks of the same asset concentration hierarchy



Indicates sign of bank in financial distress

# Asset: Liability Analysis

	2007Q4	2008Q1	2008Q2	2008Q3	2008Q4 	2009Q1
Asset: Liability Ratio	114.89%	112.98%	112.30%	112.41%	109.81%	109.23%
Median A/L Ratio*	110.95%	110.93%	110.69%	110.65%	110.52%	110.57%
Ranking	Good	Moderate	Moderate	Moderate	Moderate	Poor

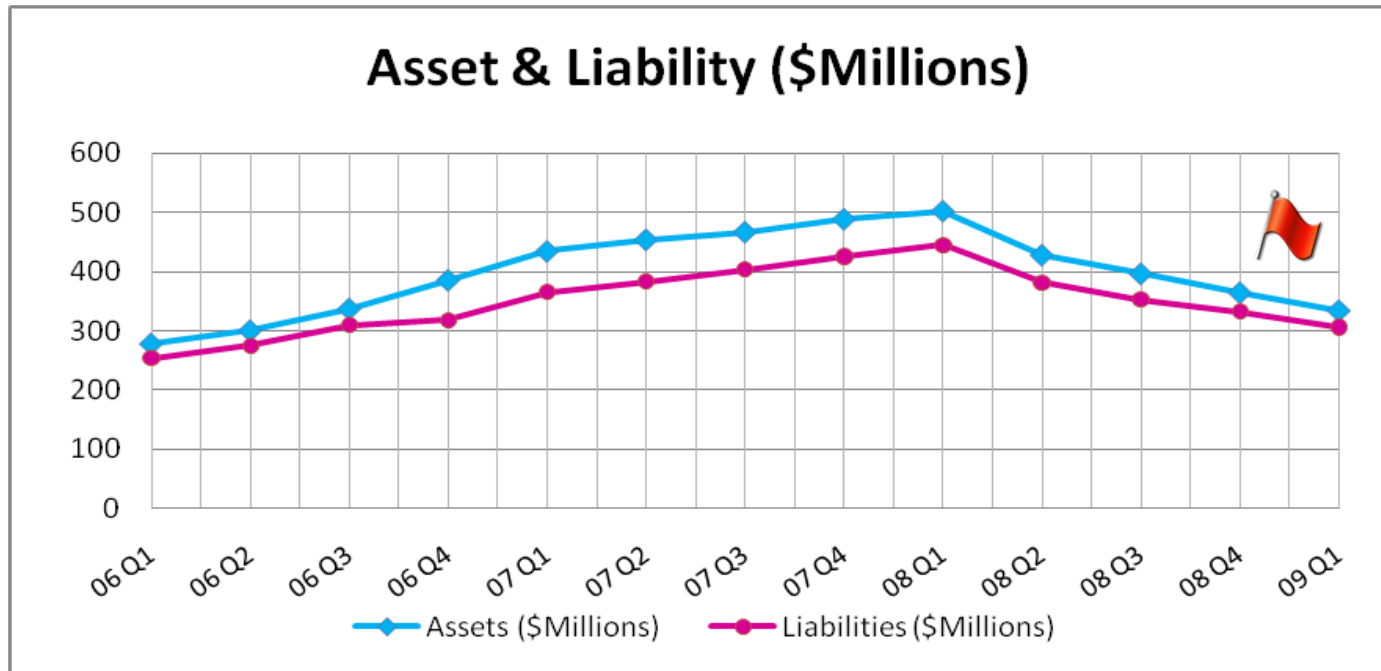
- Westsound Bank experienced decreasing A/L ratio since 08 Q3.
- The bank's A/L ratio dropped below average in 08 Q4.

\*Median of banks of the same asset concentration hierarchy



Indicates sign of bank in financial distress

# Asset & Liability History

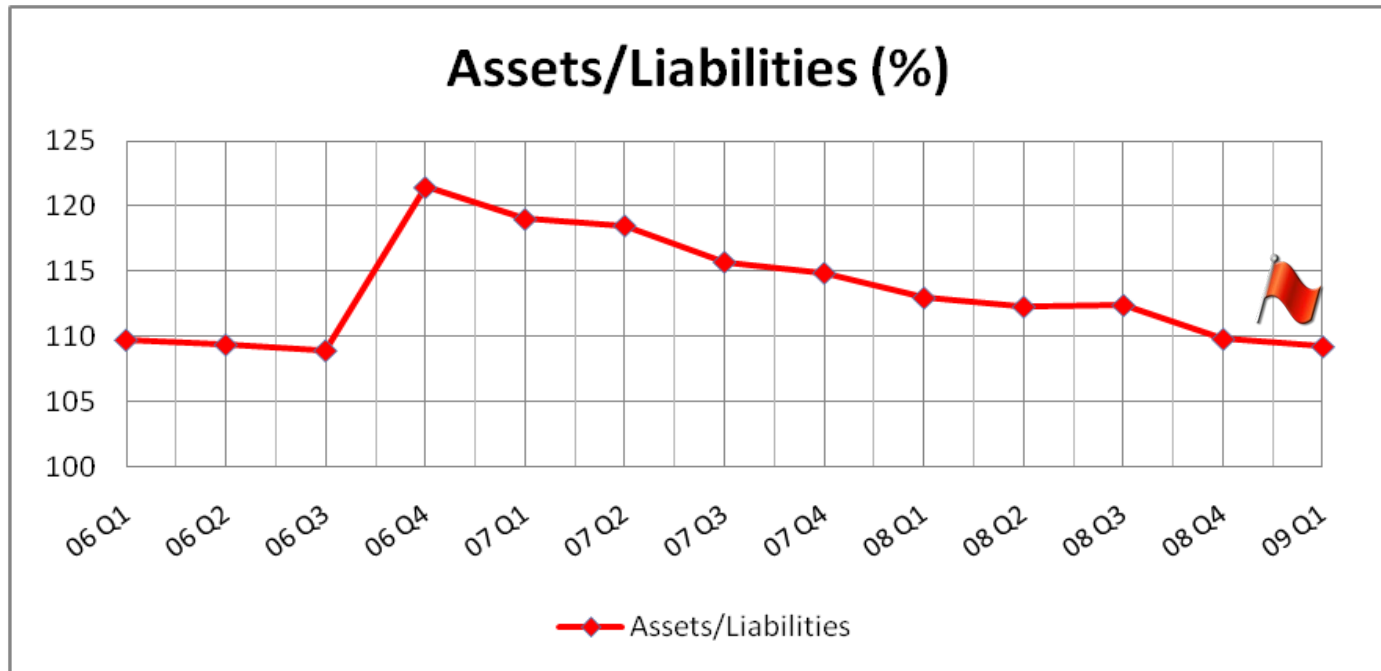


- The difference between asset and liability was getting closer in 08 Q3.



Indicates sign of bank in financial distress

# Asset/Liability History

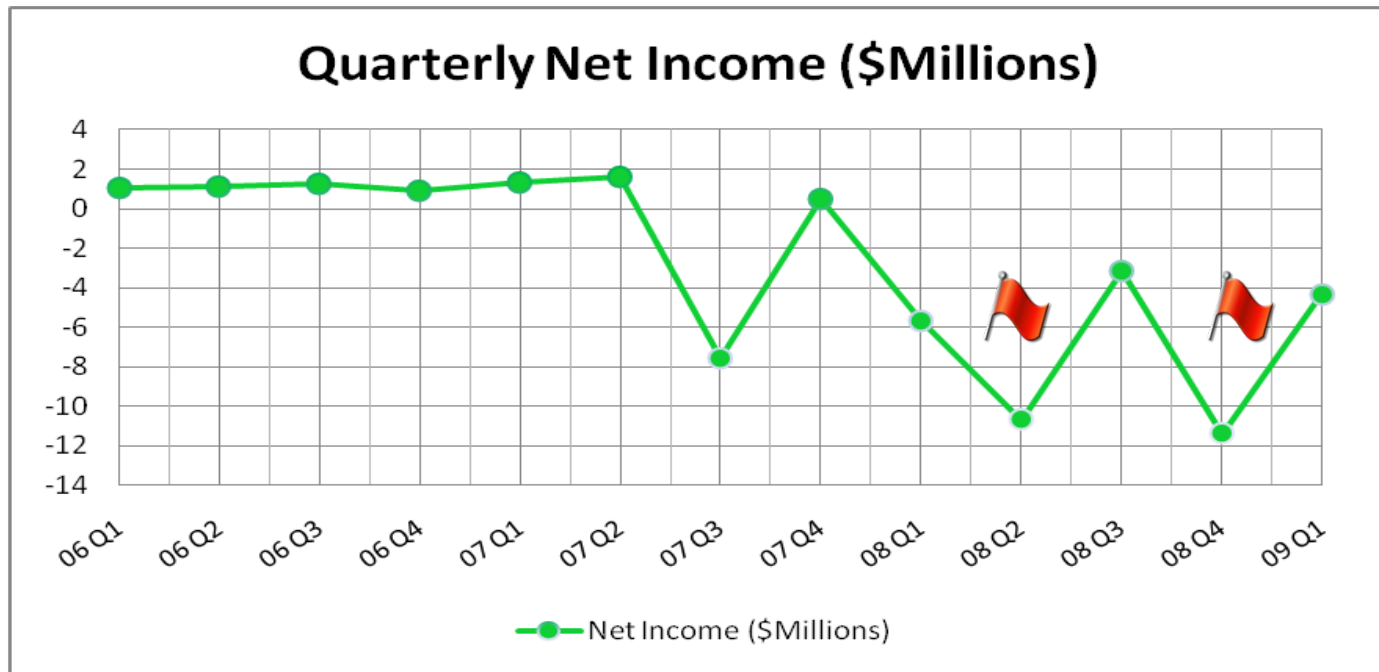


- The A/L ratio was decreasing from 06 Q4 to 08 Q2.



Indicates sign of bank in financial distress

# Net Income History

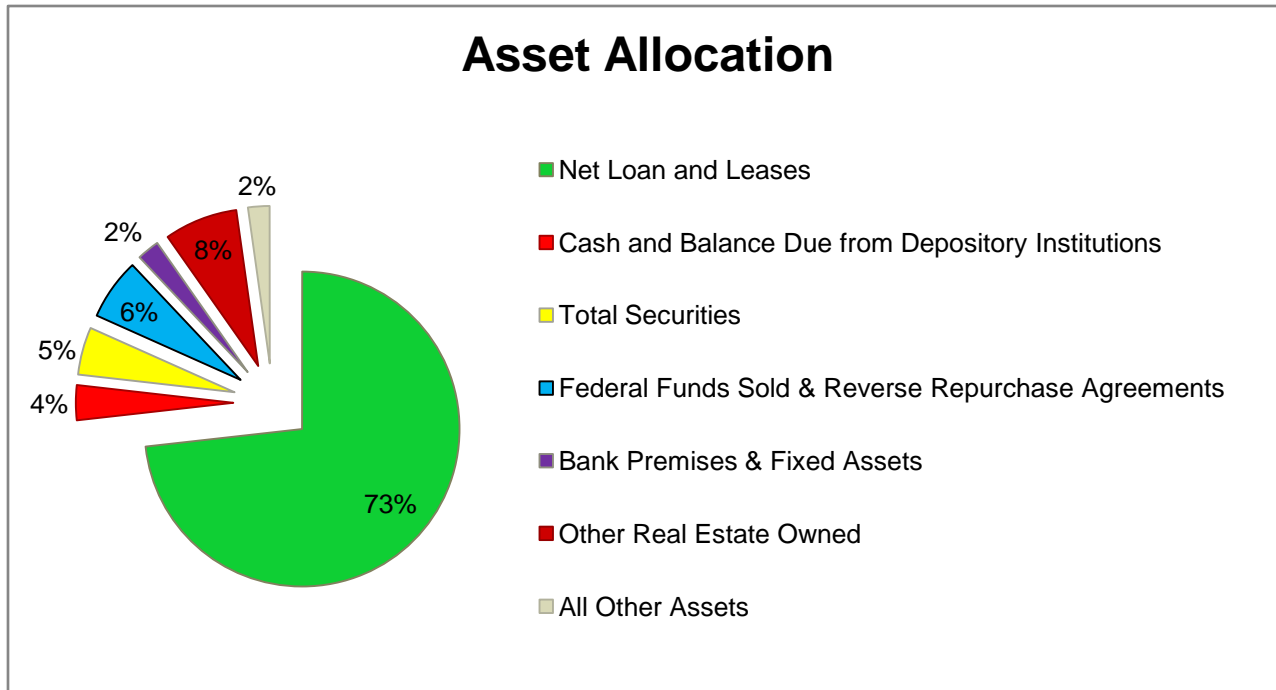


- The bank recorded big losses in 08 Q2 and Q4.
- The bank started reporting losses since 08 Q1.



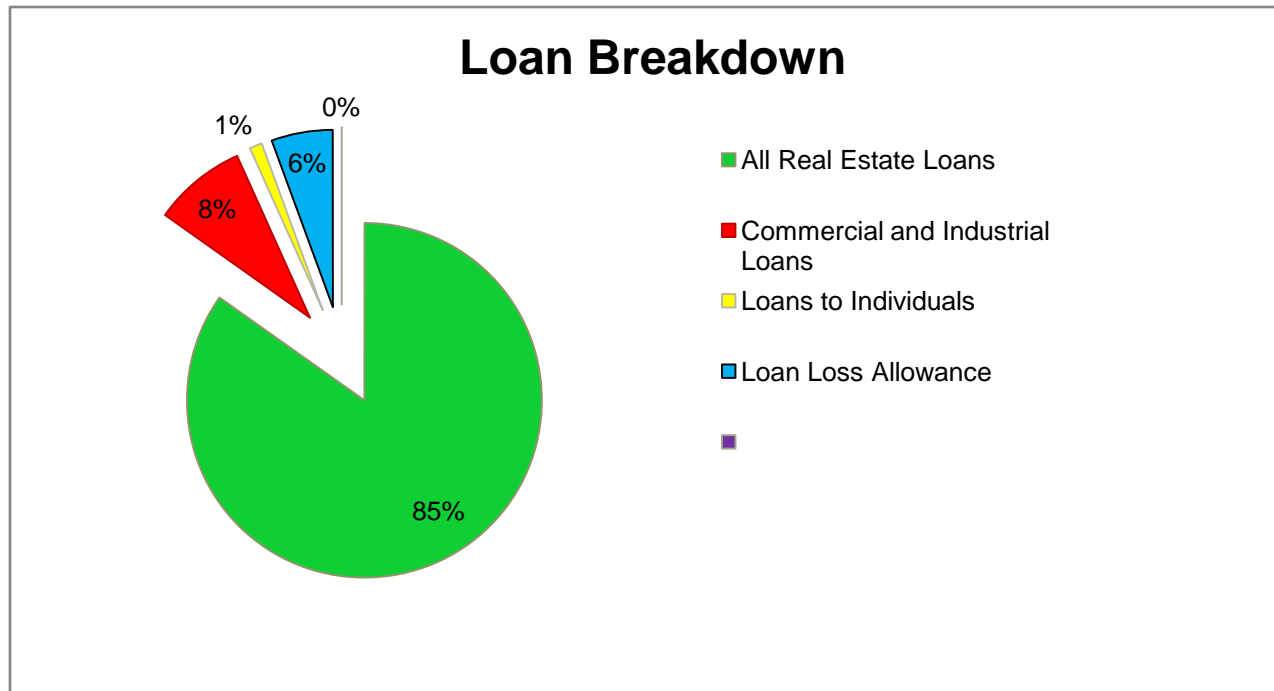
Indicates sign of bank in financial distress

# Asset Allocation



- The average percentage of Net Loans for banks of the same Asset Concentration Hierarchy in the first quarter of 2009 was 71.42%.
- The average Net Loan percentage of all banks in the first quarter of 2009 was 64.89%.

# Loan Breakdown



- The average percentage of Real Estate Loans for banks of the same Asset Concentration Hierarchy in the first quarter of 2009 was 76.90%.
- The average percentage for all banks in the first quarter of 2009 was 71.75%.

# Events Timeline

- Sept. 21, 07** - Westsound Bank laid off 33 people in its mortgage division.
- Sept. 25, 07** - Westsound reported \$33 million in revenues and \$3.9 million in net income for 2006.
- Oct. 24, 07** - Regulators are examining the mortgage lending practices and construction loan portfolio of Westsound Bank.
- Oct. 24, 07** - Westsound reported 3Q Net earnings of \$1.3 million, or 21 cents a share.
- Oct. 24, 07** - Shares of the parent company of Westsound Bank tumbled 35%.
- Dec. 17, 07** - The allowance for loan losses was \$19.5 million or 4.7%.
- Feb. 1, 08** - The parent of Westsound Bank reported a loss for 3Q.
- Feb. 1, 08** - Dave Johnson, president and CEO of Westsound Bank, will resign from his post.
- Mar. 4, 08** - SEC voted to disclose information for the secondary market ETF investors in Form N-1A.
- Mar. 7, 08** - The Fed will initiate a series of term repurchase transactions that are expected to cumulate to \$100 billion.
- Mar. 12, 08** - Westsound under the term of the FDIC order.
- Mar. 19, 08** - Fannie Mae and Freddie Mac is expected to provide support to the U.S. mortgage market, up to \$200 billion immediate liquidity.
- May 1, 08** - The parent company of Westsound Bank reported 1Q net loss of \$5,8 million, or a loss of \$1.04 per share.
- May 29, 08** - U.S.-Canada mutual recognition arrangement: U.S. Securities markets and certain U.S. financial service firms could gain greater freedom to operate in Canada under SEC.

# Events Timeline

- June 10, 08** - FDIC releases a supervisory letter to all banks on interest reserves that examines the risks that this underwriting practice presents.
- June 11, 08** - SEC voted on a comprehensive series of credit rating agency reforms to bring increased transparency to credit rating process.
- June 17, 08** - New HOPE NOW guidelines to deal with issues surrounding second mortgages and short sales.
- June 26, 08** - FDIC adopts Basel II-Based Standardized Approach as an alternative risk-based capital framework available to all banks except the largest and most complex banks
- June 26, 08** - FRS, FDIC, and OCC issued the host state loan-to-deposit ratios, which help indicate branches outside of the home state that were established or acquired for the purpose of deposit production.
- June 30, 08** - The allowance for loan losses was \$28.1 million or 8.3%.
- Jul. 2, 08** – About 43% of Westsound Bank’s construction and land loans in 1Q were delinquent.
- Jul. 13, 08** - Paulson Announces a three-part plan for GSEs: a temporary increase in the line of credit, a temporary authority for Treasury to purchase equity, and an advisory role is given to the Fed.
- Jul. 30, 08** - Westsound Bank parent reported a sharp increase in bad loans and a loss of \$11 million in 2Q.
- Aug. 20, 08** - FDIC's implementation in Loan Modification Program will help to modify troubled IndyMac mortgages loans.

# Events Timeline

- Sept. 17, 08** - SEC clarified that bank support of money market mutual funds generally are not required to present the fund on-balance sheet, but disclosure of the nature of the support provided is expected.
- Sept. 18, 08** - SEC requires that certain institutional money managers report their new short sales of certain publicly traded securities.
- Sept. 19, 08** - SEC prohibited short selling in 779 financial institutions.
- Sept. 20, 08** - Treasury Secretary Hank Paulson releases \$700 billion proposal to purchase troubled mortgage-related assets.
- Sept. 30, 08** - The allowance for loan losses was \$24.5 million, or 7.6% of total loans.
- Sept. 30, 08** - Non-performing loans increased to \$119.1 million from 101.4 million at 6/30/08.
- Oct. 7, 08** - Emergency Economic Stabilization Act of 2008 Temporarily Increases Basic FDIC Insurance Coverage from \$100,000 to \$250,000 per Depositor.
- Oct. 14, 08** - FDIC creates new program to guarantee bank debts and fully insure non-interest bearing deposit transaction accounts.
- Oct. 14, 08** - The Treasury Department will invest up to \$250 billion in the nation's banks via the Capital Purchase Program.
- Oct. 14, 08** - Westsound Bank parent will settle a class-action suit with stockholders for \$4.85 million.
- Nov. 20, 08** - FDIC announces the availability of IndyMac Loan Modification Model.
- Nov. 25, 08** - Created the Term Asset-Backed Securities Loan Facility to support the issuance of asset-backed securities collateralized by loans.

# Events Timeline

- Dec. 3, 08** - SEC approved measures to strengthen oversight of credit rating agencies.
- Dec. 16, 08** - Troubled banks have to provide certain position level and counterparty level data and QFC counterparty and portfolio identifiers to FDIC in a timely manner.
- Dec. 23, 08** - Treasury provides TARP funds to focal Banks by purchasing \$2.8 billion investment from 49 banks.
- Dec. 30, 08** - The Fed announced that it will purchase mortgage-backed securities.
- Dec. 31, 08** – Westsound Bank parent files extension for 2008 Form 10-K.
- Jan. 15, 09** - The Senate voted to allow access to the remaining bailout funds of \$350 billion.
- Jan. 27, 09** - As part of the Capital Purchase Program, Treasury announced investments of \$386 million in 23 healthy banks.
- Feb. 3, 09** – Westsound Bank parent lost \$11.6 million in 4Q.
- Feb. 10, 09** - Geithner rolls out the Financial Stability Plan, promises to perform “stress tests” on big banks, and commit \$100 billion to boost the TALF.
- Feb. 10, 09** - A Capital Assistance Program to help ensure banks hold sufficient capital, produce a more consistent and forward-looking assessment of risks on banks' balance and their potential capital needs.
- Feb. 10, 09** - A Public-Private Investment Fund will combine public and private capital with government financing to help free up capital to support new lending.
- Feb. 10, 09** - Treasury and Fed expended the Term Asset-Backed Securities Lending facility up to \$1 trillion.

# Events Timeline

- Feb. 18, 09** - President Obama signs the American Recovery and Reinvestment Act of 2009, which limits bonuses of the highest earning executives.
- Mar. 4, 09** - Treasury announced loan modification guidelines under the Administration's Homeowner Affordability and Stability Plan.
- Mar. 23, 09** - Using TARP capital and capital from private investors, the Public-Private Investment Program will generate \$500 billion in purchasing power to buy legacy assets.
- May 8, 09** - Westsound Bank was closed by the Washington Department of Financial Institutions. Kitsap Bank assumed all of the deposits.
- May 29, 09** - FDIC tightens the deposit interest rates paid by banks that are less than well capitalized. Generally, such banks will be permitted to offer to "national rate" plus 75 basis points.
- June 9, 09** - 10 Of the largest U.S financial institutions are expected to make CPP repayments to Treasury.
- Jul. 2, 09** - FDIC proposed guidelines require private equity firms to hold bank purchases for 3yrs and maintain capital levels.

# Report Summary – *Surprise?*

Based on the methods with which we analyzed, Westsound Bank, its failure was **not a surprise**.

Although Westsound Bank's delinquent asset analysis was relatively typical of banks with the same asset concentration hierarchy, there are other indications that Westsound Bank should fail:

- 1) **Westsound Bank's normalized income fell into very poor conditions two quarters prior to the bank's failure.**
- 2) **Westsound Bank's real estate loan ratio has always been too high since 2007 Q4.**
- 3) **Westsound Bank's asset: liability ratio has worsened two quarters prior to the bank's failure.**
- 4) **Its Bankability Composite Score was 35.17 before its failure, which was considered to be poor.**

The combination of these four measures being very poor shows that the bank could fail anytime.

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