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Material Loss Review of Freedom Bank, Bradenton, Florida

AUDIT REPORT

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Federal Deposit Insurance Corporation

Material Loss Review of Freedom Bank, Bradenton, Florida

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Freedom Bank (FB), Bradenton, Florida. On October 31, 2008, the State of Florida, Office of Financial Regulation (OFR), closed FB and named the FDIC as receiver. On November 10, 2008, the FDIC notified the OIG that FB's total assets at closing were $276 million, and the estimated loss to the Deposit Insurance Fund (DIF) was $92 million.

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

FB was a state-chartered nonmember bank insured on May 17, 2005. As a de novo bank for its first 3 years in operation, FB was subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency. FB engaged principally in traditional banking activities within its local marketplace, which experienced a significant economic downturn starting in 2006. FB had no holding company, subsidiaries, or affiliates.

FB's assets consisted principally of commercial real estate (CRE) loans, including a significant concentration in residential acquisition, development, and construction (ADC) loans.

FDIC guidance issued to financial institutions describes a risk management framework to effectively identify, measure, monitor, and control CRE concentration risk. That framework includes effective oversight by bank management, including the board of directors (BOD) and senior executives, and sound loan underwriting, administration, and portfolio management practices.

Audit Results

FB failed primarily due to bank management's aggressive pursuit of asset growth concentrated in high-risk CRE loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls. In addition, FB had a lending incentive compensation program without substantive credit quality controls that contributed to the bank's rapid loan portfolio growth and rewarded loan officers without consideration of actual loan performance. Resulting losses severely eroded FB's earnings and capital and negatively impacted liquidity, leading to the bank's failure and a material loss to the DIF.

Management. FB's BOD did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. In addition, the BOD did not implement corrective actions in response to bank examiner and audit recommendations. FB revised its business plan to incorporate aggressive asset growth in CRE lending without implementing commensurate risk management controls. This aggressive growth strategy continued during and after the significant downturn in the economy, beginning in 2006, and resulted in a high level of problem assets and overall deterioration in the bank's financial condition. Further, FB's president/chief executive officer (CEO)—a dominant official—had a history of rapidly growing banks without establishing adequate risk management controls.

Asset Quality. Examiners noted concerns about FB's asset quality at each examination and visitation. FB's loan portfolio, with CRE/ADC loan concentrations, included high-risk terms, such as collateral dependency, interest-only provisions with balloon payments, and interest reserves. Due to FB's unsound loan underwriting and administration practices, FB did not (1) effectively identify loan portfolio risk; (2) obtain adequate financial information on borrowers and guarantors; (3) ensure appropriate use, control, and reporting of interest reserves; and (4) appropriately report to the BOD. Further, FB's allowance for loan and lease losses was not adequate.

Liquidity. The bank's liquidity position was affected by FB's increasing dependence on non-core/volatile sources of funding, such as large time deposits and brokered deposits, to fund its significant loan growth. FB also used Federal Home Loan Bank advances. At the 2008 examination, FB's liquidity position was inadequate considering declining earnings, capital, potential deposit withdrawals, and insufficient access to secondary and emergency funds.

Supervision. The FDIC and OFR conducted timely examinations of FB, and the FDIC conducted visitations and off-site monitoring. The OFR and FDIC examinations and visitations conducted in October 2005 and May 2006, respectively, identified the weaknesses in management and asset quality that ultimately led to FB's failure, but supervisory action was not taken commensurate with the risks these weaknesses posed to the de novo institution. Rather, the FDIC did not take supervisory action until it issued a joint Memorandum of Understanding with OFR after the OFR's March 2007 examination. More timely supervisory action, directed at the performance of FB's president/CEO, high-risk lending, weak credit underwriting and administration practices, and the bank's increasing risk should have been taken as a result of the FDIC's 2006 examination. The FDIC has taken steps to improve its supervisory review of de novo business plans, contingency liquidity plans, and oversight of financial institutions that have CRE loan concentrations and use interest reserves.

In May 2008, the FDIC required FB to submit a capital restoration plan. In September 2008, the FDIC issued a Cease and Desist Order requiring the bank to take various actions, including increasing capital and improving management and asset quality. The FDIC notified FB of applicable restrictions under PCA in May and August 2008 after the bank became less than well capitalized but did not issue a PCA Directive. The FDIC has authority to take a wide range of supervisory actions. In the case of FB, however, supervisory actions were not timely and effective in addressing the bank's most significant problems.

The FDIC OIG plans to issue a series of summary reports on the material loss reviews it is conducting and will make appropriate recommendations related to the failure of FB and other FDIC-supervised banks at that time, including with regard to implementation of PCA provisions.

Management Response

DSC provided a written response to the draft report and stated that the rapid and pronounced decline in real estate values within FB's local market area was an important contributing factor to FB's ultimate failure and a material loss to the DIF. DSC agreed with the OIG's assessment that FB failed primarily due to management's aggressive pursuit of asset growth concentrated in high-risk CRE loans, including ADC loans, with inadequate loan underwriting and other loan portfolio and risk management controls. Further, DSC concluded that additional action directed at FB's management performance, lending practices, and high growth was needed to better control and limit the bank's risks. DSC stated that it continues to monitor risks to the DIF and proactively adjust its supervisory programs in light of the changing economic landscape.

To view the full report, go to www.fdicig.gov/2009reports.asp

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Freedom Bank's Key CAMELS Ratings 3

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits
Office of Inspector General

DATE: May 8, 2009

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/Signed/

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Freedom Bank, Bradenton, Florida* (Report No. AUD-09-011)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Freedom Bank (FB), Bradenton, Florida. On October 31, 2008, the State of Florida, Office of Financial Regulation (OFR), closed FB and named the FDIC as receiver. On November 10, 2008, the FDIC notified the OIG that FB's total assets at closing were $276.2 million, and the estimated loss to the Deposit Insurance Fund (DIF) was $91.8 million. As of December 31, 2008, the estimated loss to the DIF increased to $92.9 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act, section 38, *Prompt Corrective Action* (PCA); ascertains why the institution's problems resulted in a material loss to the DIF; and makes recommendations for preventing such loss in the future.

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38.

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[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices, including internal control systems; and compliance with applicable laws and regulations; and (2) issues related guidance to institutions and examiners.

Appendix 1 contains details on our objectives, scope, and methodology; and Appendix 2 contains a glossary of terms. Acronyms used in the report are listed in Appendix 4.

This report presents the FDIC OIG's analysis of FB's failure and the FDIC's efforts to ensure FB's management operated the bank in a safe and sound manner. The FDIC OIG plans to issue a series of summary reports on our observations on the major causes, trends, and common characteristics of financial institution failures resulting in a material loss to the DIF. Recommendations in the summary reports will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

FB, a state-chartered nonmember bank, opened for business and was insured by the FDIC effective May 17, 2005.[3] FB, which was headquartered in Bradenton, Florida:

- had four branches in Bradenton and Sarasota, Florida;
- provided traditional banking activities within its marketplace;
- specialized in commercial lending, with concentrations in commercial real estate (CRE), including acquisition, development, and construction (ADC) loans; and
- used certificates of deposit (CD), brokered deposits, Internet deposits, and Federal Home Loan Bank (FHLB) advances as funding sources, in addition to core deposits, to fund asset growth.

FB's loan portfolio did not include subprime loans or non-traditional mortgage products. In addition, FB did not have a holding company, subsidiaries, or affiliates. At one time, FB's local marketplace was characterized by rapidly appreciating real estate values. However, real estate values experienced a significant downturn, contributing to the severe deterioration in FB's asset value, excessive operating losses, and severely eroded capital, and the real estate construction industry was negatively impacted.

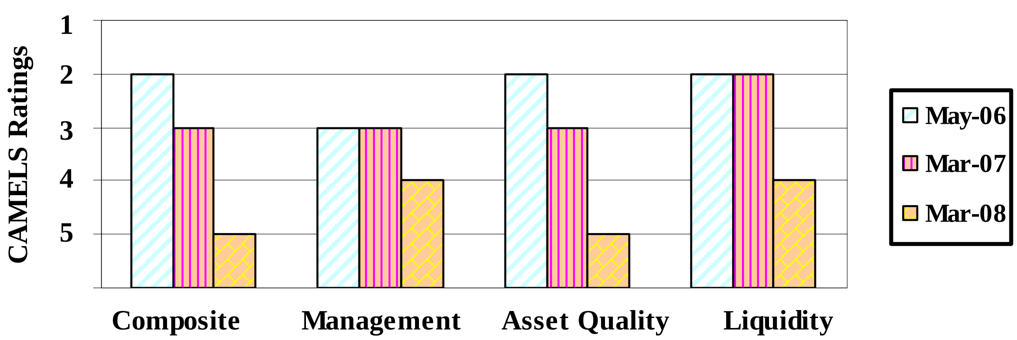
DSC's Atlanta Regional Office (ARO) and OFR alternated safety and soundness examinations of FB, conducting four full-scope examinations from October 2005 through

[3] The OFR Final Order, dated January 6, 2005, and the FDIC's Final Order for Deposit Insurance, dated April 4, 2005, included conditions applicable to FB during the first 3 years of operations. Those conditions included requirements related, but not limited to: (1) reassessing the bank's initial business plan after 6 months; (2) operating within the parameters of the bank's business plan, with notification to the FDIC of major deviations from the plan within 60 days; and (3) maintaining Tier 1 Capital at not less than 8 percent and an adequate allowance for loan and lease losses (ALLL). In addition, the OFR Final Order required FB to (1) revise its business plan if the bank exceeded projected total assets during the first 3 years of operation by more than 20 percent and (2) adopt a board resolution restricting asset growth within 30-days of the end of the quarter in which such increase occurs.

March 2008.[4] Additionally, DSC conducted a visitation concurrently with the October 2005 and March 2007 OFR examinations and in October 2008. At the March 2007 examination, as indicated in the figure that follows, FB's composite rating was downgraded to 3,[5] indicating some level of supervisory concern in one or more of the component areas. One year later, at FB's March 2008 examination, the bank's composite rating was downgraded to 5, indicating extremely unsafe and unsound practices or conditions, a high probability of failure, and significant risk to the DIF.

Further, with respect to selected component ratings, as indicated in the figure below, FB's management, which had been rated 2 at the OFR 2005 examination, was downgraded to 3 at the FDIC's 2006 examination. At the subsequent OFR March 2007 examination, management and asset quality were both rated 3, and liquidity was rated 2. As indicated below, the ratings for management, asset quality, and liquidity were downgraded at the March 2008 examination.

Freedom Bank's Key CAMELS Ratings



Source: Reports of Examination (ROE) for Freedom Bank.

Details on FB's financial condition as of September 2008 and for the 3 preceding calendar years and CAMELS ratings follow in Table 1 on the next page.

[4] Additionally, OFR conducted a pre-opening examination on May 9, 2005. As a result of that examination, the OFR recommended, among other things, that examiners closely monitor FB by conducting quarterly visitations.

[5] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Table 1: Financial Condition of FB

	30-Sept-08	31-Dec-07	31-Dec-06	31-Dec-05
Total Assets ($000s)	$270,842	$291,586	$215,839	$89,991
Total Deposits ($000)	$256,793	$257,132	$182,733	$73,907
Total Loans ($000s)	$211,900	$239,073	$170,905	$66,518
Net Loans and Leases Growth Rate	15.41%	36.35%	156.81 %	NA
Net Income (Loss) ($000)	($18,023)	($5,876)	($1,014)	($987)
Loan Mix (% of Loans)				
All Loans Secured by Real Estate	**83.72%**	**83.22%**	**81.59%**	**81.08%**
Construction and Development	34.00%	29.35%	20.87%	11.94%
CRE - Nonfarm/nonresidential	29.13%	30.37%	33.49%	48.82%
Multifamily Residential Real Estate	6.60%	8.12%	7.35%	3.94%
1-4 Family Residential - excluding Home Equity Lines of Credit	8.75%	11.09%	15.89%	13.45%
Home Equity Loans	4.48%	3.88%	4.00%	2.93%
Commercial and Industrial Loans	15.14%	15.63%	16.63%	16.32%
Funding				
Net Non-Core Dependence Ratio	22.98%	19.98%	28.13%	-2.86%
Adverse Classifications Ratio	201%	36.53%	2.70%	NA

Source: OIG's analysis of FB's Uniform Bank Performance Reports (UBPR) and ROEs.

RESULTS IN BRIEF

FB failed primarily due to bank management's aggressive pursuit of asset growth concentrated in high-risk CRE loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls. In addition, FB had a lending incentive compensation program without substantive credit quality controls that contributed to the bank's rapid loan portfolio growth and rewarded loan officers without consideration of actual loan performance. Resulting losses severely eroded FB's earnings and capital and negatively impacted liquidity, leading to the bank's failure and a material loss to the DIF.

Management. FB's Board of Directors (BOD) did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. In addition, the BOD did not implement corrective actions in response to bank examiner and audit recommendations. FB revised its business plan to incorporate aggressive asset growth in CRE lending without implementing commensurate risk management controls. This aggressive growth strategy continued during and after the significant downturn in the economy, beginning in 2006, and resulted in a high level of problem assets and overall deterioration in the bank's financial condition. Rapid asset growth, declining asset quality, and poor earnings further increased liquidity risk, but bank management did not put into place the necessary controls for liquidity management, including an adequate contingency liquidity plan (CLP). Additionally, without implementing adequate provisions to mitigate credit quality risks, management established a loan incentive compensation plan that encouraged loan officers to rapidly grow the bank's loan portfolio. Further, FB's president/chief executive officer (CEO)—a dominant official—had a history of rapidly growing banks without establishing adequate risk management controls.

Asset Quality. Examiners noted concerns about FB's asset quality at each examination and visitation. FB's loan portfolio, with CRE/ADC loan concentrations, included high-risk terms, such as collateral dependency, interest-only provisions with balloon payments, and interest reserves. Due to FB's unsound loan underwriting and administration practices, FB did not (1) effectively identify loan portfolio risk; (2) obtain adequate financial information on borrowers and guarantors; (3) ensure appropriate use, control, and reporting of interest reserves; and (4) appropriately report to the BOD. Further, FB's allowance for loan and lease losses (ALLL) was not adequate. As asset quality declined and losses were recognized, FB's liquidity position became deficient, and earnings and capital were eroded.

Liquidity. The bank's liquidity position was affected by FB's increasing dependence on non-core/volatile sources of funding, such as large time and brokered deposits, to fund its significant loan growth. FB also used FHLB advances. At the 2008 examination, FB's liquidity position was inadequate considering FB's declining financial condition and declining capital, potential deposit withdrawals, and insufficient access to secondary and emergency funds.

Supervision. The FDIC and OFR conducted timely examinations of FB, and the FDIC conducted visitations and off-site monitoring. The FDIC's investigation that was conducted for the approval of FB's deposit insurance noted concerns regarding FB's president/CEO, and the OFR and FDIC examinations and visitations conducted in October 2005 and May 2006, respectively, identified the weaknesses in management and asset quality that ultimately led to FB's failure. However, supervisory action was not taken commensurate with the risks these weaknesses posed to the de novo[6] institution. Rather, the FDIC did not take supervisory action until it issued a joint MOU with OFR after the OFR's March 2007 examination. More timely supervisory action, directed at the performance of FB's president/CEO, high-risk lending, weak credit underwriting and administration practices, and the bank's increasing risk should have been taken as a result of the FDIC's 2006 examination. The FDIC has taken steps to improve its supervisory review of de novo business plans, CLPs, and oversight of financial institutions that have CRE loan concentrations and use interest reserves.

The joint FDIC/OFR MOU addressed asset quality deficiencies and requested a revised FB business plan that addressed growth expectations and steps to improve earnings. In May 2008, the FDIC required FB to submit a capital restoration plan (CRP). In September 2008, the FDIC issued a Cease and Desist Order (C&D) requiring the bank to take various actions, including increasing capital and improving management and asset quality. The FDIC notified FB of applicable restrictions under PCA in May and August 2008 after the bank became less than well capitalized but did not issue a PCA Directive.

[6] De novo institutions are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency.

The FDIC has authority to take a wide range of supervisory actions. In the case of FB, however, supervisory actions were not timely and effective in addressing the bank's most significant problems.

MANAGEMENT

The OFR's 2005 examination resulted in a 2 rating for FB management, which was the only CAMELS component rated at this examination.[7] At subsequent examinations, the management rating for this de novo bank was progressively downgraded due to deficient BOD and management performance, risk management practices that were inadequate, and excessive risk exposure. In 2006, about 1 year after the bank opened, the FDIC's examination concluded that management was less than satisfactory. The BOD and management had not established appropriate policies, procedures, controls, or underwriting to adequately address the risks associated with the rapid growth experienced and planned for the de novo institution. In addition, in 2006 and 2007, FB rapidly expanded the bank's branch operations and continued to pursue its aggressive growth strategy in CRE/ADC lending, without regard to ensuring sound underwriting, credit administration, and other risk management controls were implemented and followed.

Ineffective BOD and Management

Examiner concerns with FB's BOD and management were noted at the bank's first OFR full-scope examination and the FDIC's visitation in October 2005—5 months after the bank opened—and continued through the 2006, 2007, and 2008 examinations and visitations. FB's BOD permitted an environment that included a high-risk business strategy; operations controlled by a dominant president/CEO who was known by DSC to rapidly grow banks and price loans below peer banks; and weak risk management practices. Furthermore, FB's management routinely failed to effectively implement audit and examination recommendations and to ensure that adequate risk management controls were implemented and followed to effectively identify, measure, monitor, and control bank operations and risks. At times, management was argumentative and not receptive to examiner recommendations and comments. Table 2, which follows, provides examples of examiner comments and recommendations related to FB's BOD and management.

[7] During the time that the OFR concluded FB's initial full-scope examination, the OFR's policy was to assign a rating for the Management component only. The other components were reviewed during the examination and comments were included in the ROE. Since that time, the OFR has changed its policy to assign ratings to all components reviewed during examinations.

Table 2: Examples of Examiner Comments and Recommendations Regarding FB's BOD and Management Performance

Examiner Comments	Examination and Visitation Dates			
	Oct 2005*	May 2006	Mar 2007*	Mar 2008
Overall conclusion on BOD and management performance				
• Management was experienced and appeared capable of operating the bank in a safe and sound manner	✓			
• BOD was very involved in directing the affairs of the bank	✓			
• Management was less than satisfactory		✓		
• BOD and management failed to establish appropriate policies, practices, and procedures		✓		
• BOD was responsible for the institution's deterioration				✓
Compliance with laws and regulations and interagency policies				
• Apparent violations and/or repeat apparent violations		✓	✓	✓
• Noncompliance with the OFR Final Order or FDIC Final Order of Approval for Deposit Insurance	✓			✓
• Contraventions of interagency policy statements		✓	✓	✓
Growth of FB operations				
• Growth far exceeded earlier projections, and projections in the most recent business plan were significantly more aggressive than any previously proposed	✓			
• Growth in loan volume had resulted in management aggressively soliciting high-priced deposits		✓		✓
• Rapid loan production apparently contributed to a pattern of weaknesses in underwriting documentation and loan structure	✓			
• Loan growth had not been accompanied by sound underwriting		✓		
• Continued growth should be accompanied by measurable policy limits on CRE exposure		✓		
• Loan growth was aggressive, significant, or faster than anticipated				✓
• Loan portfolio was concentrated in CRE/ADC high-risk loans			✓	✓
• Growth plans were ambitious and included aggressively pursuing branching opportunities	✓			✓
• Loan growth had resulted in deficiencies in managing the growth and a substantial increase in adversely classified assets			✓	
• Aggressive growth strategy was hampering the bank's ability to control the deposit mix			✓	
• Significant loan growth had been funded by high-cost money market accounts and/or brokered and wholesale CDs			✓	✓
Loan underwriting and administration				
• Limits of prudent credit risk and structure had been stretched by bank management	✓			
• Necessary resources for loan underwriting and credit administration had not been deployed by bank management	✓			
• Risk management practices needed improvement to control loan growth	✓			
• Inadequate reporting and policies on concentration by collateral types, industry, and geographic locations		✓		✓
• Inadequate documentation of appraisal reviews and/or approval of loans, and/or inconsistent documentation included in loan files		✓	✓	✓
• Significant/excessive loan underwriting and credit administration deficiencies		✓	✓	✓
• Inadequate financial information on borrowers and documentation of real estate liens	✓		✓	

Examiner Comments	Examination and Visitation Dates			
	Oct 2005*	May 2006	Mar 2007*	Mar 2008
• Inadequate risk management controls, including appraisal review, consumer credit parameters, methodology for loan loss allowance, and loan-to-value exceptions		✓		✓
• High growth strategy without developing and implementing adequate risk management systems to identify, measure, monitor, and control the increased risk				✓
• Deficient or weak underwriting practices, loan policy, and credit administration, including incomplete/missing cash flow credit analysis, justification of the use of interest reserves, and updated borrower and/or guarantor financial information	✓	✓	✓	
• Deficient asset quality given the extremely high level of adversely classified assets				✓
• Inadequate methodology for determining the ALLL and inadequate ALLL				✓
• Inadequate attention to, and timely implementation of, examiner and/or auditor recommendations		✓		✓
• Inadequate/potentially inadequate staffing of loan department or management succession plan	✓	✓		✓
• Negative effect on asset quality by economic downturn or potential adverse effect identified		✓	✓	
• Prudent monitoring of the economic downturn and establishment of risk limits for the portfolio as previously recommended could have prevented a substantial amount of the bank's financial deterioration				✓
Examiner recommendations				
• Perform and maintain a written risk assessment to identify those areas of the bank's operations that are high risk	✓			
• Improve practices and procedures in loan underwriting, administration, and internal routines and controls or increase loan staff	✓		✓	✓
• Improve loan underwriting, loan presentation, and loan portfolio administration			✓	
• Establish appropriate practices, procedures, controls, and underwriting to adequately address risks associated with rapid growth		✓		
• Improve policies, reporting, and monitoring on concentrations, speculative lending, and/or interest reserves			✓	✓
• Improve policies and reporting practices related to CRE exposure		✓		
• Implement a process for identifying and limiting credit concentrations and/or establish and implement a CRE monitoring program				✓
• Improve the ALLL methodology and record an appropriate provision before filing the Consolidated Report of Condition and Income (Call Report)				✓
• Improve the reporting of loan-to-value exceptions to the BOD				✓
• Implement appropriate review, reporting, and monitoring programs to ensure compliance with laws and regulations		✓		

Source: ROEs issued by the OFR and FDIC and the FDIC's October 2005 and March 2007 visitation results.
In October 2005 and March 2007, the FDIC conducted visitations concurrent with the OFR examinations. The FDIC also conducted a visitation in October 2008.

Risk Management. FB's BOD and management used an aggressive, high-risk business strategy for FB, which was evident in three primary areas—high-risk lending in CRE/ADC loans, new branch offices to obtain core deposits, and use of high-cost/volatile liquidity sources to fund asset growth. The BOD and bank management primarily focused on growth and did not ensure that adequate risk management controls were implemented and followed and did not implement corrective actions in a timely and effective manner to adequately address deficiencies identified by examiners and auditors. DSC's *Supervisory History Memorandum*, dated September 10, 2008, concluded that FB's BOD and management ignored warnings, criticisms, and recommendations of regulators and auditors regarding loan underwriting, oversight, administration, and economic conditions and projections. In just over 3 years, the bank failed.

After the bank opened in May 2005, FB's management immediately implemented an aggressive, rapid growth strategy. Total assets from December 2005 through September 2008 grew, on a cumulative basis, over 200 percent from $89.9 million to over $270.8 million. Despite such growth and an increased risk profile resulting from CRE/ADC lending, the bank did not adequately identify, measure, monitor, and report regularly to the BOD on these concentrations, speculative lending, and the use of interest reserves.

The October 2005 FDIC visitation concluded that FB's risk management practices needed improvement to control loan growth. The May 2006 examination noted that risk management practices related to real estate or economic conditions, overreliance on particular industry sectors, and individual asset concentrations needed to be enhanced. In addition, examiners concluded that the BOD and management had not established appropriate risk management practices, procedures, controls, or loan underwriting to adequately address the risk associated with the rapid growth experienced since FB's opening on May 17, 2005. Rapid growth was also noted at the May 2006 examination, which concluded that total assets from the October 2005 examination to the May 2006 examination had grown about 200 percent. The examiners also concluded that exposure to all sectors of CRE constituted only 190 percent of Tier 1 Capital that and the ADC exposure constituted less than 100 percent, as of March 31, 2006. However, the examiners also noted that the bank's plans for continued growth should be accompanied by measurable policy limits on CRE exposure, with periodic reports to the BOD that measured the exposure against the established limits.

The ROEs for the March 2007 and March 2008 examinations also identified deficiencies in the bank's risk management practices. During the OFR's exit meeting for the March 2007 examination, examiners expressed concern regarding FB's growth. In response, FB's BOD and management rejected examiner concerns about a possible downturn in the market or potential for further credit deterioration within the bank's loan portfolio. FB's president/CEO maintained that continued growth was imperative to sufficiently cover fixed operating costs. In addition, the March 2008 examination concluded that the bank's financial condition had substantially deteriorated and that the BOD was responsible for the institution's deterioration. Examiners' primary concern was that FB's management had not appropriately monitored credit concentration in light of the weakening economic market conditions. Because the bank's risk management and loan administration practices were inadequate, the BOD was slow to recognize the increasing risk in FB's loan portfolio and lending program and continued to make risky loans, increasing the bank's exposure, as residential real estate values started to decline.

FB's branching activities were also a high-cost approach since the strategy increased operating expenses. The branching activities allowed FB to compete for core deposits in a highly-competitive market. Thus, the cost of these deposits increased the interest paid, cost of branch operations, and loss of income, which was problematic to FB.

To fund its rapid growth, FB employed a high-risk funding structure, centered on branching, to attract core deposits and high-cost/volatile, non-core deposits. FB's core deposits grew from $27 million in September 2005 to $211 million in September 2008 (a growth rate of 681 percent), and non-core funding grew from $9 million in September 2005 to $99 million in September 2007, FB's highest level of non-core funding (a growth rate of 1,000 percent in 2 years). A heavy reliance on non-core deposits to fund asset growth is a risky business strategy because such deposits are high-cost/volatile sources of funding that may be restricted as an institution's financial condition deteriorates. (These issues are more fully discussed in the *Liquidity* section of this report.)

Deviations from FB's Business Plan. FB significantly deviated from its initial and subsequent business plans by quickly exceeding financial projections and budgets and realizing significantly high net losses during its de novo period. In addition, FB did not implement risk management controls that were outlined in its business plan, contributing to the ineffective management of the bank's high risk lending. FB's business plan indicated that the bank would make commercial, residential, and construction loans and projected those loans to account for 61 percent of total loans for each of the first 3 years. However, the original business plan did not provide information on the significant growth and concentration of its loan portfolio in CRE/ADC loans, which presented high risk for the bank and undue risk to the DIF. Within 6 months of opening and having substantially more capital than originally planned, FB submitted an amended business plan and financial projections reflecting significantly higher growth in its first 3 years due to growth opportunities in the market.

FB's initial business plan did not include specific plans for branch expansion. The plan stated that FB would consider opening a branch office if conditions allowed within the first 3 years of operation in compliance with safety and soundness factors, as dictated by the regulatory authorities. However, after receiving deposit insurance, revised business plans indicated that the bank would open at least eight branch offices by 2008. Further, FB's initial business plan stated that the bank would not solicit brokered deposits as a source of funding. Nevertheless, the bank started obtaining brokered deposits during the last quarter of 2006, garnering more than $21 million in such deposits by December 31, 2006, and became increasingly reliant on this non-core funding source. FB submitted revised business plans in August 2005, January 2006, and September 2007, which addressed revised financial data, plans to open branch offices, and/or use brokered deposits. As a result of the deposit insurance application process, conducted January 26, 2005 through March 2, 2005, DSC concluded that the overall risk tolerance level for FB's proposed operations would be reasonably conservative. However, FB's actual operations, aggressive business strategy, and associated risk after receiving deposit insurance proved not to be conservative.

Examiners reported concerns with FB's revised business plan in 2005, 2006, 2007, and 2008. For example, in May 2006, examiners concluded that although FB had not materially departed from the types of activities in the business plan that had been approved with the bank's application, FB's growth and branching materially exceeded projected plans. The initial business plan projected $53.3 million in total assets at the end of the first year, but actual total assets as of March 31, 2006, about 10 months after FB opened, totaled $125.8 million—representing more than a 136 percent increase. In addition, the original business plan projected total deposits of $40 million, $57.5 million, and $67.5 million, respectively, in the first 3 years of operation. However, as of March 31, 2006—less than 1 year after FB opened—deposits totaled $93.7 million and exceeded FB's initial projection for the bank's first 3 years of operation by over $26 million.

Along with the submission of initial applications for federal deposit insurance, proposed financial institutions are expected to submit business plans that include information on a bank's business strategy and financial data for a 3-year period. According to the *FDIC Statement of Policy on Applications for Deposit Insurance*, and in compliance with sections 5 and 6 of the FDI Act, the FDIC must be assured that the proposed institution does not present an undue risk to the DIF. The FDIC expects that proposed institutions will submit a business plan commensurate with management's capabilities and financial commitment of the incorporators. Business plans that rely on high-risk lending or significant funding from sources other than core deposits require specific documentation as to the suitability of the proposed activities for an insured institution. Similarly, additional documentation of a business plan is required where markets to be entered are intensely competitive or economic conditions are marginal. We consider significant deviations from business plans to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Dominant Bank Official. Before the FDIC approved FB's application for deposit insurance, the FDIC's Report of Investigation (ROI), dated March 2, 2005, reported that FB's president/CEO was known to have rapidly grown banks in the past by paying above-market rates on deposits and pricing loans below peer banks. In addition, the president/CEO was associated with soft earnings and limited liquidity. The investigating examiner was aware of the marginal performance of the president/CEO at two other financial institutions—where he was the founding president/CEO—and concluded that appropriate supervision and BOD oversight at FB, together with a seasoned executive management team, should mitigate that concern. According to section 21 of the DSC *Case Managers Procedures Manual*, the FDIC can include standard and nonstandard conditions[8] in its Final Order for Deposit Insurance. Despite the concerns reported in the

[8] The FDIC can impose standard conditions and may include nonstandard conditions, as deemed appropriate, in the Final Order for Deposit Insurance.

ROI regarding FB's president/CEO, the FDIC's Final Order for Deposit Insurance did not include conditions related to the dominant president/CEO and rapid growth of the bank or ensure that FB implemented adequate risk management controls to mitigate rapid growth.

The president/CEO acknowledged problems with his past performance and committed to avoiding similar occurrences and ensuring that FB was operated in a safe and sound manner. However, the president/CEO did not achieve his commitments. FB's president/CEO controlled the bank's lending operations and funding decisions, was the chairman of the loan committee; and, according to the March 2008 ROE, led the bank's executive management and oversaw FB's focus on aggressive growth. According to examiners:

- BOD members did not challenge the president/CEO concerning the reasonableness and risk of bank practices.

- The president/CEO encouraged the senior lending officer to aggressively originate loans without appropriate lending guidance.

- The president/CEO and the BOD were responsible for FB's excessive asset growth by promoting an aggressive lending strategy and concentrations in CRE/ADC loans.

Certain ROEs issued by the FDIC for other institutions that had been associated with the FB's proposed president/CEO documented how, under his management, the institutions' aggressive pursuit for rapid asset growth negatively affected overall bank performance and precipitated additional supervisory monitoring. Nevertheless, DSC approved FB's application for deposit insurance with the consideration that the remaining members of the bank's management team would exhibit sufficient conservatism and independence in order to ensure the success of FB's proposed business plan. During FB's existence, however, the FDIC identified similar risk factors and practices at FB—rapid growth, non-existent earnings, and limited liquidity, indicating that management by the president/CEO was characteristic of his prior management techniques and that the remaining members of management had not exhibited sufficient independence to ensure FB's success. Ultimately, the president/CEO failed to operate FB in a safe and sound manner.

DSC officials stated that FB's BOD and management did not fully comprehend the seriousness of the bank's problems and take necessary actions to correct deficiencies. Under management by the president/CEO, FB failed in a little over 3 years, with a resultant $92.9 million loss to the DIF.

Incentive Compensation Plan. According to the FDIC's March 2008 ROE, FB's loan incentive compensation plan encouraged loan officers to rapidly grow the bank's loan portfolio. The incentive program focused on rewarding a loan officer for originating loans based on a percentage of estimated first-year loan income minus expenses. Since FB utilized interest reserves extensively for its ADC loans; therefore, first-year loan performance was usually based on capitalized interest income. Accordingly, loan officers may have been compensated based on the bank's ability to use interest reserves in order to mask actual loan performance. Further, the plan did not contain sufficient compensating controls to mitigate credit quality risks, except when loan officers may have been on probation for reasons that may have included, excessive past-due loans, poor loan quality, insufficient underwriting, or excessive loan documentation exceptions. The use of this compensation program and lack of mitigating controls encouraged loan production without appropriate emphasis on initial loan quality.

We could not determine when FB's loan incentive program actually began. The program was discussed in the March 2007 and March 2008 examination results but was not mentioned in the October 2005 or May 2006 ROEs. The FDIC's March 2007 visitation concluded that the incentive program allowed residential lenders to receive production-based commissions for both secondary and in-house loans with no adjustment for subsequent performance quality (such as past-due loans, nonaccruals, or credit losses). The FDIC's March 2008 ROE recommended that FB management develop controls to address credit quality, such as longer-term payouts based on the establishment of loan credit quality criteria. Examiners stated that FB's management should also consider whether loans underwritten with a high loan-to-value ratio or other policy exceptions would also be eligible for the incentive plan. The March 2008 examination work papers indicated that the bank's incentive program had been suspended.

The DSC *Risk Management Manual of Examination Policies* (Examination Manual) states that the reasonableness of compensation policies is one of many factors examiners use to rate BOD and management's performance. In addition, the standard *Risk Management Examination Request List* (Request List) asks the bank to summarize loan officer and management incentive programs, if any.

On November 12, 2008 the FDIC, along with the other federal regulatory agencies, issued an interagency statement,[9] which states that poorly-designed management compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization. The statement emphasizes that banking organizations are expected to regularly review their management compensation policies to ensure they are consistent with the long-run objectives of the organization and sound lending and risk management practices. FB had failed before the interagency statement was issued.

We consider incentive compensation plans without sufficient controls to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Management

According to the Examination Manual, the quality of management is probably the single most important element in the successful operation of a bank. The BOD is responsible for formulating sound policies and objectives for the bank, effective supervision of its

[9] *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, dated November 12, 2008.

affairs, and promotion of its welfare, while the primary responsibility of senior management is implementing the BOD's policies and objectives in the bank's day-to-day operations. Also according to the manual, the capability and performance of management and the BOD is rated based upon, but not limited to, an assessment of compliance with laws and regulations.

Need for Increased Supervisory Monitoring. Based on the information brought forth during the application process about FB's president/CEO, in the early stages of FB's existence, both the OFR and FDIC concluded that FB needed to be monitored closely. In its pre-opening examination conducted May 9, 2005, the OFR concluded that FB's president/CEO had been known to rapidly grow banks in the past by paying above-market rates on deposits and pricing loans below peer banks and that FB should be monitored by quarterly visitations. In October 2005, a DSC official decided during October 2005 against special monitoring of FB and stated that no additional monitoring of FB appeared necessary at that time and that consideration of supervision other than a standard examination program would be based on the October 2005 visitation results. In a work paper for the FDIC May 2006 examination, the examiner recommended that increased supervisory monitoring and visitations more frequent than the standard examinations might be appropriate to assess credit underwriting and administration and reporting trends. The OFR and FDIC, however, did not conduct quarterly visitations but the FDIC conducted visitations in October 2005, March 2007, and October 2008. DSC's relationship manager contacted FB in August 2006 and in June, November, and December 2007 and developed supervisory plans for the bank.

Concern for Asset and Funding Growth. The ROEs by the OFR and FDIC expressed concern regarding FB's rapid growth. The October 2005 OFR examination concluded that FB's growth plans, with aggressive branching, were ambitious and expressed concern about FB's accelerated growth and plans for continued growth. The OFR required FB to develop a Bank Growth Resolution, which outlined FB's growth target for the following 2-½ years. Based on that plan, FB expected total assets to reach $200 million, $300 million, and $400 million for 2006, 2007, and 2008, respectively. These amounts were significantly higher than the bank's original projections.

On February 10, 2006, the FDIC informed FB that although the bank's revised business plan did not present material departures from activities presented in the initial business plan (included in the deposit insurance application), the plan did present significantly higher asset and funding growth and accelerated expansion plans not presented with the application. DSC officials also stated in ROEs that the asset and funding growth would require two significant future capital injections to maintain the 8 percent Tier 1 Leverage Capital. Further, the FDIC informed FB of the following:

- The FDIC generally does not favorably consider business plan projections that require capital injections to maintain Tier 1 Capital at 8 percent in the first 3 years of business. FB's application generally would not have been approved with such a plan.

- With each branch application, FB would be expected to (1) support the convenience and needs factor for the new market; (2) have capital in place to support the projected asset growth while maintaining an 8 percent Tier 1 Leverage Capital ratio; and (3) have an appropriate level of personnel to provide for and maintain adequate credit and underwriting standards. The FDIC's October 31, 2005 visitation noted the lack of sufficient staffing as a weakness in relation to accelerated loan growth.

As indicated above, although the FDIC established the expectation that FB would have an appropriate level of personnel to support its growth and expansion plans, at the FDIC's examination conducted in May 2006, examiners determined that significant weaknesses related to inadequate loan underwriting might have been indicative of insufficient staffing levels to fully support the level of growth experienced during the first year of FB's operations. The March 2007 examination concluded that sufficient staff was in place. However, at the March 2008 examination, examiners concluded that in order to stay abreast of deterioration in FB's loan portfolio, bank management should determine whether additional staff might be necessary. Regardless of examiner concerns about FB's branching activities, FB continued to expand its operations, opening one branch office in July 2006 and three branch offices in January 2007.

The FDIC's 2005 Visitation and 2006 Examination Results. The FDIC's 2005 visitation focused on management's ability to manage all risks arising from its proposed high growth plan. The visitation noted concerns with the bank's ability to control growth, stating that the bank's rapid loan growth had contributed to a pattern of weaknesses in underwriting documentation and loan structure. The FDIC's May 2006 examination identified significant issues regarding FB's management; emphasis on bank and loan portfolio growth; inadequate attention to loan underwriting and credit administration; increasing risk to the bank; and numerous apparent violations of laws and regulations. The FDIC's May 2006 examination was further evidence that FB's BOD and management, including the bank's president/CEO, had continued the types of management practices reported in the FDIC's ROI that presented risk to FB. Under the president/CEO's dominance, the BOD and bank management had failed to establish appropriate risk management practices, procedures, controls, or loan underwriting to adequately address the risks associated with FB's rapid growth experienced since its opening on May 17, 2005. The FDIC's May 2006 examination concluded that the bank's rapid growth, in the absence of sound underwriting and credit administration practices presented undue risk to the institution and recommended increased supervision; however, the FDIC did not take supervisory action to address those deficiencies and exposure to the bank.

DSC officials discussed the May 2006 FDIC examination results and the management and earnings components that received a 3 rating. DSC officials stated that FB's management was rated 3 and was considered to be less than satisfactory largely because of weaknesses in loan underwriting and administration. According to DSC, concerns regarding FB's deficiencies were mitigated by the corrective action promised by FB's BOD and management. Examiners for the May 2006 examination did not recommend an enforcement action. DSC's regional and field office officials considered taking informal action after the May 2006 examination and concluded that such action was not necessary because the 2006 examination was the first full-scope FDIC examination, which had been completed prior to visible deterioration in FB's local ADC market. FDIC officials concluded that FB management's efforts to address issues identified during the May 2006 examination and bank management's promise to take corrective actions were considered a good-faith effort by FB to correct noted deficiencies. Despite being the FDIC's first full-scope examination, the May 2006 examination results showed a continued pattern of inadequate risk management controls and increased risk to the bank.

In September 2006, FB submitted two branch applications and provided assurances that improvements were being made to support future growth and that examination weaknesses were being corrected as the bases for the applications. Although improvements in earnings had been noted in March and June 2006, the high cost of funds from FB's reliance on CDs and time deposits negatively impacted the bank's net interest margin. Abundant capital obtained through stock issuances supported the growth reflected in FB's revised financials, and the FDIC approved the branch applications.

DSC's concerns regarding FB's expansion and risk management control weaknesses and FB's promises to take corrective action did not result in FB taking timely and effective action to strengthen loan underwriting and credit administration deficiencies, including establishing appropriate practices, procedures, and controls to adequately address risks, avoid further deterioration in asset quality, and ensure compliance with laws and regulations.

Supervisory and Enforcement Actions. The OFR's March 2007 examination retained the 3 rating for management and earnings due to OFR's conclusion that management had done little, if anything, to improve the underwriting deficiencies identified at the FDIC's May 2006 examination and the bank's unsatisfactory earnings. In addition, the OFR downgraded FB's composite rating to 3 because of the bank's excessive CRE exposure, lax credit administration procedures, continuing operating losses, and poor risk management practices.

The FDIC conducted a visitation concurrently with the OFR's March 2007 examination, expanding the scope of the visitation significantly in light of the deteriorating condition of the bank, and joined the OFR in issuing the MOU—14 months after the FDIC's May 2006 examination. The MOU required FB to develop and submit a revised business plan and budget for 2007, 2008, and 2009 to include FB's expectations for asset growth, plans for improving earnings, projected times to meet profitability, and assumptions used for the financial projections. In addition, the MOU required FB to notify the OFR and FDIC when the annualized rate of asset growth exceeded 20 percent. This requirement was also included in the OFR's conditions for approval of FB's state charter. FB submitted progress reports in response to the MOU, indicating corrective actions that bank management was taking or planned to take for the loan underwriting and administration deficiencies. However repeat and additional deficiencies in the bank's loan documentation and administration were reported in the March 2008 ROE.

The FDIC's March 2008 ROE concluded that shortly after FB opened for business, the BOD changed the approved business plan from a conservative strategy to an aggressive one, pursuing rapid asset growth and branch development. FB's BOD and management remained committed to its aggressive growth strategy during a slowdown in the local economy, allowing significant unrecognized credit concentrations to develop, and planned to fund the growth with time deposits. The FDIC approved the following branch applications for FB (see Table 3).

Table 3: FB's Branch Application History

FB Branch	Application Status			
	Received from FB	**Accepted by the FDIC**	**Approved by the FDIC**	**Branch Opened**
1	10/6/2005	10/6/2005	11/8/2005	3/1/2006
2	5/4/2006*	5/4/2006	6/1/2006	7/26/2006
3	5/30/2006	6/30/2006	7/28/2006	1/8/2007
4	9/1/2006	9/1/2006	9/29/2006	1/8/2007
5	9/5/2006	9/5/2006	10/5/2006	1/22/2007

Source: DSC *Supervisory History Memorandum* and ROEs for FB.
* Limited-service drive-through branch.

In the interim between FB's submitted applications for branch offices and the FDIC's approval of the applications, examiners expressed significant concerns regarding FB's growth and management. For example, the ROEs for the OFR's 2005 examination and the FDIC's May 2006 examination indicated:

- excessive actual and planned growth,
- significant deviation from the original business plan for branch expansion,
- weaknesses in loan administration and documentation,
- less than satisfactory BOD and management performance,
- apparent violations of laws and regulations, and
- significant loan underwriting and credit administration deficiencies.

The March 2008 ROE concluded that (1) FB's growth strategy might have been the single most important risk management deficiency evident in the bank, as it clearly resulted in a high level of problem assets and overall deterioration in the bank's financial condition; (2) net losses that exceeded the bank's projections primarily because of the increased ALLL associated with the declining asset quality and increased expenses related to foreclosures; and (3) noncompliance with the FDIC's Final Order for Deposit Insurance, which required FB to provide notification to the regulatory agencies within 60 days when the bank deviated from the approved plan and budget. FB did not provide the required notification related to total asset growth levels, loan growth, and projected net income.

As a result of the March 2008 examination and FB's continued deterioration, in September 2008, the FDIC and OFR jointly issued a C&D that included provisions related to the bank's capital, management, concentrations, asset quality, ALLL, apparent violations of laws and regulations, loan policy, budget, liquidity, brokered deposits, and internal audit.

At the October 2008 visitation, the FDIC found that FB's efforts to comply with both the MOU and C&D were not effective. FB had failed to maintain an adequate ALLL, and due to the required provisions for the ALLL, the bank's Tier 1 Capital ratio would be reduced to 2 percent. The bank's operating losses continued, averaging $450,000 per month, and without additional capital, the future viability of FB was highly doubtful.

The FDIC also concluded that permitting the bank to continue to operate in this critically undercapitalized position significantly increased the risk to the DIF.

ASSET QUALITY

The FDIC rated FB's asset quality a 2 at the 2006 examination, indicating satisfactory asset quality and credit administration practices and, according to DSC's Examination Manual, the level and severity of classifications and other weaknesses warranted limited supervisory attention. The OFR 2007 examination and FDIC 2008 examination downgraded FB's asset quality to 3 and 5, respectively. The 3 rating indicated that the bank's level and severity of classified assets, other weaknesses, and risks required an elevated level of supervisory concern. In addition, there was a general need to improve credit administration and risk management practices. The March 2008 FDIC examination concluded that FB's asset quality and credit administration practices were critically deficient and presented an imminent threat to the institution's viability.

Indications of FB's asset quality deterioration began in 2006 and continued in 2007 and 2008. In particular, asset classifications significantly increased, from $850,000 in 2006 to $61 million in 2008. At the May 2006 examination, adversely classified assets represented only 2.70 percent of capital, and by March 2008, adversely classified assets totaled more than 200 percent of capital. Increases in the bank's ALLL were required at the March 2007 and March 2008 examinations (see Table 4, which follows).

Table 4: FB's Asset Classifications and ALLL

	Asset Quality (Dollars in Thousands)						
	Asset Classifications					Analysis of ALLL	
Examination Date	Substandard	Doubtful	Loss	Total Classified Asset		ALLL Computed by FB	Increase in ALLL Required by Examiners
				Total	Percent		
Oct 05	0	0	0	0	0	$460	0
May 06	$850	0	0	$850	2.70	$1,013	0
Mar 07	$11,423	$200	$113	$11,736	36.53	$2,014	$875
Mar 08	$47,656	$11,752	$1,646	$61,054	200.77	$8,796	$7,000

Source: ROEs for FB.

Examiner Concerns and Recommendations Regarding Asset Quality

Examiner concerns regarding FB's asset quality related to its concentration in high-risk CRE/ADC loans, the extensive use of interest reserve loans without appropriate guidance and risk consideration; an inadequate ALLL methodology and underfunded ALLL; and inadequate loan underwriting and credit administration (see Table 5, which follows, for examples).

Table 5: Examples of Examiner Comments and Recommendations Regarding FB's Asset Quality

Examiner Comments	Examination and Visitation			
	Oct 2005*	May 2006	Mar 2007*	Mar 2008
Overall conclusion on FB's asset quality				
• Strong, satisfactory, or adequate	✓	✓		
• Less than satisfactory or deficient			✓	✓
• BOD and management failed to identify, measure, monitor, and control risk				✓
• Loan incentive program had no substantive credit quality controls				✓
Asset growth rate				
• Far exceeded initial projections or was rapid or significant	✓	✓	✓	✓
• Continued focus on rapid growth continues to result in inconsistency in structuring credits and created undue risk	✓	✓	✓	
Adverse classifications				
• Adversely classified assets during the first year of operations reflects negatively on asset quality and management		✓		
• Level of classifications were excessive and extremely unusual for a de novo bank			✓	
• Extremely high level of adversely classified items				✓
• Past-due and nonaccrual loans could be understated due to extensive inappropriate use of interest reserves for non-construction loans				✓
Assessment of risk management practices				
• Appropriate practices, procedures, controls or underwriting had not been established to adequately address the risks associated with the rapid growth		✓		
• Inappropriate repayment terms, deficiencies in financial analysis, or several interest-only loans	✓	✓		

Examiner Comments	Examination and Visitation			
	Oct 2005*	May 2006	Mar 2007*	Mar 2008
• Weak appraisal ordering, review process, or review practices		✓		✓
• Significant portion of loans had bank-funded interest reserves or extensive use of interest reserves or no tracking of interest reserves		✓	✓	✓
• Weaknesses in loan administration, credit administration, and loan documentation and/or insufficient/inadequate staffing	✓	✓		✓
• Rapid loan growth contributed to, or resulted in, loan underwriting and credit administration weaknesses or deterioration in asset quality	✓	✓		
• Deficient underwriting and credit administration or important elements omitted		✓	✓	✓
• Inadequate loan policy and procedures	✓			✓
Adequacy of ALLL				
• ALLL methodology was inadequate or did not recognize the elevated risk associated with the declining asset quality and CRE risks		✓	✓	✓
• ALLL was underfunded			✓	✓
Examiner recommendations				
• Risk management practices need improvement to control loan growth	✓			
• Establish an independent credit department and/or perform independent loan review	✓		✓	
• Interest reserve policy should be revised or expanded			✓	
• Assets adversely classified as loss should be charged off or eliminated from the bank's books upon receipt of the ROE			✓	✓
• Recommendations made relative to underwriting, loan presentations, portfolio administration, and loan policy enhancements			✓	✓

Source: ROEs for FB.
* The FDIC conducted visitations concurrently with the OFR's October 2005 and March 2007 examinations.

Concentration in CRE and ADC Loans

FB focused and concentrated its loan portfolio in CRE/ADC loans, which increased its level of risk, and failed to ensure that adequate risk management controls were developed and implemented. A significant portion of the CRE/ADC loan portfolio included high-risk terms, such as high loan-to-value ratios, collateral dependency, an interest-only provision with balloon payments, and interest reserves used to capitalize interest expense. FB's concentration in CRE loans at the OFR's October 2005 examination comprised about 83 percent of the loan portfolio. The ROEs and examination work papers documented significant and rapid increases in CRE-related exposure, with significant risk management deficiencies. In addition, FB's exposure in CRE/ADC lending always exceeded its peer group[10] average (see Table 6, which follows).

[10] FB's peer group consisted of financial institutions established in 2005, with assets less than $750 million.

Table 6: FB's CRE/ADC Concentration Exposure Compared to Peer*

	Dec 2005		Dec 2006		Dec 2007		Sept 2008	
	FB	**Peer**	**FB**	**Peer**	**FB**	**Peer**	**FB**	**Peer**
CRE	270.42%	70.18%	343.51%	207.09%	676.71%	323.47%	1722.71%	384.86%
ADC	65.12%	27.22%	139.76%	86.14%	330.61%	130.65%	787.21%	133.23%

Source: UBPRs for FB.
* Ratios for the level of exposure are a percentage of total capital.

On December 12, 2006, the federal banking agencies issued joint guidance on CRE lending entitled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* The guidance was issued after the economic downturn in FB's local market began but acknowledged that a concentration in CRE loans, coupled with weak loan underwriting and depressed CRE markets, has contributed to significant loan losses.[11] Examiners recommended several actions to mitigate the bank's CRE risk, but FB's management failed to implement sound risk management practices to adequately address those recommendations, and asset quality continued to decline as FB's management continued with its aggressive growth strategy.

Further, beginning with the March 2007 examination, and continuing through the March 2008 examination and October 2008 visitation, examiners identified a high level of adverse classifications, with significant downgrades of classified loans, and significant increases in the ALLL. As asset quality declined and appropriate provisions were made for impaired loans, FB's earnings and capital were eroded, and liquidity was negatively impacted.

We consider loan concentrations without adequate risk management controls to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Interest Reserves. FB did not have appropriate controls related to the use and reporting of interest reserves. Additionally, FB did not maintain complete records on the number of loans funded with interest reserves, including those that had been funded multiple times, or the total amount of interest reserves. FB's April 2005 loan policy did not contain specific guidance on the use of interest reserves; however, the policy did state that loan officers were not authorized to extend credit for the payment of interest on existing loans at the bank or renew loans without the full collection of interest due. Although interest reserves can be appropriately used for construction lending, FB used the reserves extensively and inappropriately and without adequate guidance, justification, or tracking and monitoring as indicated in Table 7, which follows. The use of interest reserves helped to mask the deterioration of the bank's loan portfolio, resulting in an underfunded ALLL and overstated capital and earnings. Examiners reported concerns

[11] The FDIC also issued Financial Institution Letter (FIL) 22-2008 on March 17, 2008, entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, which re-emphasized the importance of strong capital and ALLL and loan risk-management practices for state nonmember institutions with significant CRE and construction and development loan concentrations. FIL-22-2008 also articulated the FDIC's concern about the use of interest reserves for ADC loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

with the bank's use of interest reserves in many of the examinations and visitations (see Table 7 for examples).

Table 7: Examiner Comments Regarding Interest Reserves

Significant Date	Examiner Comments
May 2006 examination	Due to bank-funded interest reserves for a significant volume of loans, the ability of borrowers to service the debt with recurrent cash flow had not been tested.
March 2007 examination and visitation	Development loans were frequently structured as interest-only or facilitated through interest reserves with inadequate information in the files to support borrower repayment abilities and cash flow sources. Interest reserve funding was commonly provided by the bank for commercial construction projects that did not have pre-sale and/or pre-lease arrangements, and numerous development loans were originated with no amortization or principal pay-down requirements until the sale of collateral. Loans or commitments to advance funds that were facilitated through interest reserve funding approximated $47.8 million, or nearly 149 percent of total regulatory capital. The justification for using interest reserves for the speculative aspects behind borrower construction and development projects was frequently not supported in loan presentations; and loan policies and procedures did not include guidance on interest reserve funding and interest-only credits. The bank president stated that overly restrictive loan policies could have adverse consequences for bank management's "well known" clientele. Examiners recommended that the loan policy address parameters for the use of interest reserves, including the specific types of loans where such reserves were permissible, require verification of the borrower's ability to service the debt when the interest reserve became depleted, and require presales, or pre-leases, for construction/development loans with interest reserves.
March 2008 examination	Interest reserve credits were underwritten based on significantly appreciated collateral values to borrowers who were unable to service the debt from other means because of insufficient cash flow, indicating bank management continued to underwrite loans with interest reserves without conforming to loan policy. FB management still could not provide a detailed listing of all loans with interest reserves, and loan policies and procedures still lacked guidance on interest reserve funding and interest-only credits.

Source: ROEs and examination work papers for FB.

The lack of specific tracking and/or reporting to the BOD and lack of a requirement for such reporting by the BOD on the extent of the bank's use of interest reserves and associated risk represented a significant breakdown in the bank's risk management controls.

We consider inadequate controls over the use and reporting of interest reserves to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Allowance for Loan and Lease Losses. FB's methodology for determining the ALLL did not comply with interagency policy. According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (FIL-105-2006), dated December 13, 2006, each institution must analyze the collectibility of its loans and maintain an ALLL at a level that is appropriate and determined to be in accordance with Generally Accepted Accounting Principles (GAAP).[12] An appropriate ALLL covers estimated loan losses on individually evaluated loans that are determined to be impaired as well as estimated loan losses inherent in the remainder of the loan and lease portfolio. In addition, examiners assessed and made recommendations related to FB's ALLL methodology and the adequacy of its funding.

May 2006. The examiners concluded that FB's ALLL methodology was generally adequate and recommended that FB expand the policy guidelines for estimating an appropriate ALLL.

March 2007. Adversely classified items totaled $11.7 million, representing 36.53 percent of Tier 1 Capital and ALLL—$8 million represented adversely classified loans that were not downgraded from FB's internal watch list until immediately before the start of the examination. The examiners recommended an increase of $875,000 to the ALLL.

March 2008. The examiners cited a contravention to the interagency policy due to FB's failure to maintain the ALLL at an adequate level. The examiners recommended that (1) FB establish an effective loan review/credit grading system and controls to identify, monitor, and address asset quality problems and (2) increase the ALLL by $7 million.

October 2008. The examiners concluded that the ALLL needed to be increased by $812,000.

As FB's assets deteriorated and ALLL was increased, earnings and capital were significantly impacted. FB's net losses significantly increased each year (see Table 8).

Table 8: FB's Net Income or Loss (Dollars in Thousands)

2005	**2006**	**2007**	**Sept 2008**
($987)	($1,014)	($5,876)	($18,023)

Source: UBPR annual data for FB as of December 31st each year, except for September 2008.

We consider an inadequate methodology for determining the ALLL to be a significant concern, which we will address in our summary reports covering multiple bank failures.

[12] The interagency policy reiterates key concepts and requirements pertaining to the ALLL included in GAAP and existing supervisory guidance. In addition, it describes the nature and purpose of the ALLL; the responsibilities of BODs, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound loan grading system.

Regulatory Supervision Related to Asset Quality

FB's management issues, de novo status, significant loan portfolio growth from 2005 through 2006, and significant loan administration deficiencies identified at the May 2006 examination should have warranted greater supervisory concern. As reported in DSC's *2004 De novo Bank Study*,[13] de novo institutions frequently exhibit factors that present significant risk to de novo banks, including, but not limited to:

- a dominant BOD member and weak oversight by the BOD,
- inexperienced management,
- departure from the business plan by exceeding projected asset growth,
- rapid asset growth and associated dependence on non-core sources to fund growth in high-risk loans, and
- inadequate staffing, particularly when coupled with rapid asset growth.

Those risk factors for FB were manifested as follows in Table 9.

Table 9: Risk Factors Exhibited at FB

Risk Factors Exhibited at FB	
FB's president/CEO had a history of marginal risk management and operational performance and aggressively growing banks.	Management was less than satisfactory; both the BOD and management failed to establish appropriate policies, practices, and procedures to support growth.
Management's primary focus had been to grow the bank and use the high level of capital raised.	FB far exceeded its original projected growth plans and planned to open several branch offices.
Policies and procedures regarding loan underwriting and credit administration needed enhancing.	The level of adversely classified loans was low, with underwriting and credit administration deficiencies.
FB was dependent on high-cost, non-core funds that comprised over 93 percent of total deposits, and the overall cost on interest-bearing balances exceeded the bank's peer group by 65 basis points.	FB's earnings lagged projections and were insufficient to support operations; losses exceeded those originally projected.

Source: ROEs for FB and the FDIC's ROI.

The FDIC's pre-examination planning memorandum (PEP) for the May 2006 examination noted several areas of concern including: the bank's growth, revisions to initial business plans, and the importance of ensuring that management and the BOD had provided appropriate guidance and oversight for the lending function and that underwriting and credit administration practices were sound. The PEP also indicated the FDIC's increased concern with the bank's expansion efforts and stated that the FDIC would review the bank's future expansion efforts and changes in business activities on a case-by-case basis. Further, the PEP stated that particular attention would be given to the loan review function, including underwriting and credit administration.

[13] The DSC Atlanta Region led an interregional study of de novo financial institutions to review the timing of, and susceptibility to, problems of de novo financial institutions and to determine important factors in the application process for new banks that would aid in the efficient supervision of new banks. The FDIC's Division of Information and Research and Legal Division also participated in the study.

At the May 2006 FDIC examination, examiners assessed the condition of the bank's loan portfolio and, ultimately, concluded in the ROE that asset quality and credit administration practices were satisfactory; however, loan portfolio deterioration had occurred since the prior examination. Loans adversely classified by examiners totaled $850,000, which represented only 2.70 percent of Tier 1 Leverage Capital. Nevertheless, examiners noted that any level of adverse classifications during the first year of operation normally reflects negatively on asset quality and on management as compared to other de novo institutions. However, other examiner comments in the May 2006 ROE and examination work papers seemed to conflict regarding the overall assessment of asset quality, especially related to the underwriting and credit administration. Specifically, the examiner:

- Identified weaknesses in underwriting and credit administration practices and concluded that they should be promptly addressed to avoid further deterioration. The examiner also made recommendations to improve FB's risk management for CRE/ADC loans and underwriting and credit administration practices.

- Concluded that the bank's rapid growth without sound underwriting and credit administration practices presented undue risk to the institution.

- Documented on the CRE Review Worksheet for the FDIC 2006 examination that increased supervisory monitoring was recommended and visitations that are more frequent than the standard examinations might be appropriate to assess credit underwriting, administration, and reporting trends. It is worth noting that during its pre-opening examination, the OFR had made a similar recommendation for increased supervision of FB. However, the FDIC decided not to implement this recommendation.

The examiner's overall assessment of FB's asset quality at the May 2006 examination focused more on the condition of the bank's asset quality and amount of adversely classified loans rather than the risk presented by the BOD and management's rapid growth, plans for continued growth, and absence of sound underwriting and credit administration practices, which the examiner concluded presented undue risk to the bank. The assessment did not give greater weight to the systemic nature of the significant deficiencies in underwriting and credit administration or a qualitative consideration of the bank's elevated CRE risk exposure.

According to the Examination Manual, the asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios and other assets. The ability of management to identify, measure, monitor, and control credit risk and the evaluation of the adequacy of the ALLL are also reflected in the asset quality rating. The Examination Manual provides guidance on which rating is appropriate based on issues identified by examiners. For example, the Examination Manual states that a rating of 3 is assigned for asset quality when:

- Asset quality or credit administration practices are less than satisfactory, and there is a general need to improve those practices.

- The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern.

As stated previously, DSC considered whether to take informal action after the May 2006 examination and determined such action was not necessary. Given the bank's rapid growth strategy and plans for continued growth, significant underwriting and credit administration deficiencies, and the examiner's conclusion that the bank's growth absent sound underwriting and credit administration practices presented undue risk to the bank, additional supervisory action as a result of the 2006 examination was warranted. The underlying problems that contributed to the failure of FB and material loss to the DIF were identified during the 2006 examination and, in retrospect, greater concern during this examination regarding the severity of the underwriting and credit administration deficiencies could have led to elevated supervisory attention and earlier supervisory action.

After the OFR's March 2007 examination and concurrent FDIC visitation identified continued and more severe deficiencies in FB's loan underwriting and credit administration, the FDIC and OFR implemented a supervisory strategy that included a progression of actions to address FB's deficiencies. As a result of that examination:

- The OFR downgraded asset quality to 3.

- On July 23, 2007, the OFR and the FDIC jointly issued an MOU to FB. The MOU, which primarily focused on asset quality issues, required FB actions related, but not limited, to:

    - Submitting plans and proposals to effect the reduction and/or collection of assets.

    - Providing notification when the annualized rate of asset growth exceeded 20 percent.

    - Revising the loan policy to address deficiencies and the use of interest reserves.

    - Developing and implementing a plan to improve credit and loan administration and developing a written plan to monitor concentrations of risk in relation to Tier 1 Capital and identifying appropriate limits for concentrations of credit by industry, product line, type of collateral, and borrower; establishing limits and identifying the risks associated with concentrations of CRE; and providing monthly reports to the BOD on concentrations of risk.

- Reviewing the ALLL for adequacy and correcting all violations of laws and regulations.

- Submitting quarterly progress reports detailing steps taken to comply with the requirements of the MOU.

- The FDIC did not perform a visitation between the 2007 and 2008 examination to determine if the MOU was being followed. Because FB did not adequately address the MOU requirements, resulting in further deterioration of the bank's asset quality and continued loan administration and documentation deficiencies, the OFR and FDIC issued a C&D in September 2008, requiring FB to, among other things, cease and desist unsafe or unsound banking practices and violations of law and/or regulations, including operating with inadequate:

  - capital for the bank's risk profile;
  - supervision by the BOD and management;
  - level of adversely classified assets and ALLL;
  - underwriting and administration practices; and
  - policies and procedures to monitor and control risks in concentrations of credit.

FB's efforts to comply with the MOU and C&D proved unsuccessful, and the bank was closed on October 31, 2008.

LIQUIDITY

Examinations in 2006 and 2007 resulted in a 2 rating for liquidity. At the last full-scope examination in March 2008, the rating was downgraded to a 4, indicating that FB's liquidity levels or funds management practices were deficient or inadequate and that the bank may not have been able to obtain sufficient funds, on reasonable terms, to meet liquidity needs.

A bank's net non-core dependence ratio indicates the degree to which the bank is relying on non-core/volatile liabilities to fund long-term earning assets. Generally, a lower ratio results in less risk exposure for the bank, and higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. FB had various sources of funding, including established credit lines, federal funds, FHLB advances, brokered deposits, and large time deposits. Although FB's net non-core dependence ratio as of March 31, 2006 was -6.85, indicating no net reliance on non-core funding, the bank became increasingly more reliant on high-cost sources, such as brokered deposits and large time deposits, to support its asset growth (see Table 10, which follows). Further, the bank's access to funding sources became restricted as its financial condition deteriorated. The increased interest expense associated with these funding sources reduced FB's earnings.

Table 10: FB's Non-Core Funding Sources

Period Ended	Non-Core Funding Sources (Dollars in Thousands) Time Deposits $100,000 or More[a]	Brokered Deposits	FHLB[b]	Total	Growth Rate
Dec 05	$15,123	0	0	$15,123	Not applicable
Dec 06	$74,303	$21,431	0	$95,734	533.04%
Dec 07	$56,892	$44,699	$2,000	$103,591	8.21%
Sept 08	$46,036	$26,390	$2,000	$74,426	-28.15%

Source: OIG's analysis of FB's UBPRs.
[a] Time deposits of $100,000 or more may include brokered deposits.
[b] FB did not rely on this source to fund the bank's rapid asset growth during 2005 through 2007.

Ultimately, the bank's liquidity position became inadequate as a result of the declining financial condition and access to secondary sources of funds, including FHLB advances and credit facilities. In addition, FB had $22 million in unsecured lines of credit, which were contingent on the bank maintaining a satisfactory financial condition.

Examiner Concerns and Recommendations Regarding Liquidity

From October 2005 to March 2007, examinations consistently determined that the bank's overall liquidity risk management and funding positions were strong or adequate. Accordingly, examiners did not make recommendations related to the bank's liquidity position or funds management. Table 11, which follows, includes examples of examiner comments and recommendations on liquidity.

Table 11: Examples of Examiner Comments and Recommendations Regarding Liquidity

Examiner Comments	Examination Dates Oct 2005*	May 2006	Mar 2007*	Mar 2008
Overall Conclusions on Liquidity				
• Liquidity position was adequate or sufficient or adequately monitored	✓	✓	✓	
• Liquidity position was weak and strained				✓
• Current and future liquidity position was inadequate				✓
Loan to Deposit Ratio				
• High and exceeds the BOD-approved policy limit	✓			
• Off-balance sheet loan commitments could result in increased deposit rates		✓		
• Deposit pricing had stabilized		✓		
Non-core Funding Sources				
• Lack of success in attracting core deposits and expected increased level of core deposits to replace non-core deposits			✓	
• High-cost deposits used as a funding source		✓	✓	
• Brokered deposits or money-market accounts used as a funding source		✓	✓	
• FHLB borrowings used as a funding source				✓
• Certificates of deposit used as a funding source		✓	✓	
• Cost of deposits was higher than peer			✓	

Examiner Comments	Examination Dates			
	Oct 2005*	May 2006	Mar 2007*	Mar 2008
Available Liquidity				
• Possibility of critical liquidity position due to the threat of deposit withdrawals				✓
• Alternate funding sources negatively impacted by the bank's weak financial condition				✓
• Insufficient access to emergency funds on reasonable terms				✓
• Correspondent lines of credit contingent upon financial condition of bank				✓
• Use of brokered deposits as a major funding source created an additional liquidity issue due to the bank's undercapitalized position				✓
• FHLB credit lines were withdrawn				✓
Examiner recommendations				
• Perform an analysis of these uninsured deposits to determine their potential volatility				✓
• Proactively arrange emergency alternative sources of funding				✓
• Consider other proactive measures to avoid a panic reaction from depositors				✓

Source: OIG's review of FB's ROEs and visitation results.
* The FDIC conducted visitations concurrently with the OFR examinations.

The May 2006 examination concluded that FB was maintaining adequate liquidity sources and at that time, FB had three backup correspondence lines, $26 million in federal funds sold, which were primarily associated with the bank's recent stock offering, and $1.5 million available from other sources. Examiners reported that the bank's overall cost of funds was 65 basis points higher than its peer group. Assets grew 140 percent during 2006. As of December 31, 2006, the non-core fund dependence ratio was 28 percent compared to 15 percent for FB's peer group.

The March 2007 examination and visitation reported that (1) the bank had not generated expected levels of demand (core) deposits, even though the bank opened three branch offices in January 2007 and (2) FB still relied on high-cost non-core funding sources. The March 2007 visitation determined that FB's reliance on time deposits to augment deposit growth was increasing. Combined regular and large time deposits represented over 50 percent of average assets at end of 2006, compared to 42 percent at the end of 2005. FB's cost of deposits was significantly higher than its peer group—by 55 basis points.

In March 2008, about 7 months before the bank failed, examiners concluded that the bank's current and projected liquidity position was inadequate, considering the declining financial condition of the bank, which prompted the FHLB and a national bank to withdraw previously extended credit facilities.

When the bank's financial condition began to deteriorate, its access to high-cost funding sources that were dependent on the bank maintaining an acceptable financial condition became reduced; then restricted; and finally, prohibited. For example, although FB's initial application stated that the bank did not plan to solicit brokered deposits, FB started using brokered deposits extensively to fund its aggressive asset growth in the last quarter of 2006—having over $47 million in brokered deposits reported in its UBPR for March 2008—with a gradual decline due to restrictions placed on the bank when it fell below the well capitalized category for PCA purposes. The March 2008 examination concluded that bank management did not have sufficient access to emergency funds on reasonable terms to meet material deposit withdrawals.

Lack of a Comprehensive CLP. FB did not implement sound liquidity risk management controls that included a comprehensive CLP. As a result, when FB's asset quality severely deteriorated, the bank's liquidity position was negatively impacted.

According to the Examination Manual, CLPs should be in force and should include strategies for handling liquidity crises and procedures for addressing cash flow shortfalls in emergency situations. The manual also states that financial institutions should have an adequate CLP in place to manage and monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources.

FB demonstrated warning indicators that should have prompted FB of the need for a comprehensive CLP and increased monitoring of the bank's liquidity position by the bank's BOD and management. For example, FB exhibited indicators such as:

- rapid asset growth funded by potentially volatile liabilities,
- a decline in earnings performance or projections,
- a decline in asset quality, and
- real or perceived negative publicity.

The FDIC issued FIL-59-2003 entitled, *Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management*, dated July 23, 2003, which provides interagency guidance on the need for financial institutions to develop CLPs, in addition to other liquidity risk management controls, and informs depository institutions that a contingency plan should be part of the bank's liquidity management program. The manual also states that financial institutions should have an adequate CLP in place to manage and monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources. FB's BOD and management failed to implement adequate controls to effectively monitor the bank's liquidity risk and as FB's asset quality declined, the bank's liquidity position was negatively impacted.

We consider the lack of a comprehensive CLP to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Liquidity

Examiners assessed liquidity at each examination and made recommendations to address the adequacy of the bank's liquidity and risk management practices. However, the bank's policies, lack of development and implementation of a comprehensive CLP, and reliance on non-core/potentially volatile funding sources should have warranted greater supervisory concern. The Examination Manual states that liquidity is rated based upon, but not limited to, examiner assessment of the following:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.

- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets.

- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and CLPs.

In addition, the manual states that each institution's liquidity policy should have a CLP that addresses alternative funding if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises. Although FB had developed a CLP, it was not comprehensive. Examiners did not recommend that the bank develop a more comprehensive CLP to adequately address elements listed in the Examination Manual. FB had not developed controls that could have identified the specific circumstances related, but not limited, to (1) assessing the potential for triggering legal restrictions on the bank's access to brokered deposits under PCA provisions and the effect on the bank's liability structure, and (2) matching potential sources and uses of funds.

The ROEs did not specifically discuss whether FB needed to have an adequate CLP or policy inadequacies prior to the March 2008 examination, which concluded that management needed to proactively arrange for emergency alternatives of funding to avoid a panic reaction from depositors. On April 29, 2008, the FDIC and OFR began to closely monitor FB's liquidity position. In the September 2008 C&D, the FDIC required FB to implement a written plan to address liquidity, contingency funding, and asset liability management. In addition, the C&D restricted FB from increasing the amount of brokered deposits and required a written plan to eliminate the bank's reliance on those deposits.

The Examination Manual states that examiners should not wait for the PCA-based brokered deposits restrictions to be triggered, or the viability of an institution to be in question, before raising relevant safety and soundness issues with regard to the use of volatile funding sources. If examiners determine that the bank's use of these funding sources is not safe and sound, that risks are excessive, or that risks adversely affect the bank's condition, then appropriate supervisory action should be taken immediately. The manual also describes red flags related to the use of such funding sources. Several red flags should have indicated to examiners that FB needed to ensure that the risks associated with brokered or other rate-sensitive funding sources were managed appropriately before the restrictions on the use of brokered deposits were implemented based on the PCA provisions. The red flags at FB included:

- ineffective management and an aggressive growth strategy,
- inadequate information systems and controls,
- the absence of adequate policy limitations on non-core funding sources,
- a high delinquency rate or deterioration in other asset quality indicators, and
- deterioration in the general financial condition of the bank.

Subsequent to FB's failure, DSC issued additional guidance related to liquidity risk and CLPs. The FDIC's *Liquidity Risk Management* guidance, dated August 26, 2008, (1) urges financial institutions to establish a formal CLP that establishes quantitative liquidity risk guidelines; (2) states that CLPs should identify the institution's liquidity risk profile and the types of stress events that may be faced including, but not limited to, a deterioration in asset quality, becoming less than well capitalized, loss of access to market funding sources, and the impact of negative press coverage; and (3) reiterates several of the elements that FB's CLP did not include.

IMPLEMENTATION OF PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized.

The bank's 2004 application for deposit insurance included projected capital of $7.5 million. FB raised substantial capital before the bank closed in October 2008 and, as of June 2008, FB had raised over $35.9 million. However, as indicated in Table 12, which follows, the bank's capital ratios lagged behind its peer group.

Table 12: Comparison of FB's Capital Ratios to Its Peer Group

Call Report Date	Tier 1 Leverage Capital		Tier 1 Risk-Based Capital		Total Risk-Based Capital	
	FB	Peer	FB	Peer	FB	Peer
September 30, 2005	35.93	64.70	36.00	113.26	37.09	114.00
March 31, 2006	30.36	36.21	31.83	53.30	32.89	54.24
December 31, 2006	15.55	20.37	17.34	25.41	18.50	26.36
June 30, 2007	10.60	16.20	12.22	19.89	13.48	20.92
September 30, 2007	9.84	14.90	11.71	17.97	12.96	19.03
December 31, 2007	7.48	14.08	8.33	16.75	9.61	17.83
March 31, 2008	5.63	13.39	6.46	15.72	7.76	16.81
June 30, 2008	3.00	12.68	3.64	14.54	4.97	15.64
September 30, 2008	2.00	11.83	2.20	13.53	3.45	14.65

Source: UBPRs for FB.

DSC attributed FB's lagging capital ratios on the need for FB to provide substantial increases to the ALLL due to loan losses identified by examiners at the OFR March 2007 examination. In addition, DSC officials stated that FB's BOD seemed to believe that the president/CEO would address regulatory matters and provide additional investor capital infusions to rectify the bank's problems. Further, DSC stated that the FDIC was initially overly-reliant on the capital infusions that FB made to address concerns regarding fast growth, weak underwriting, and asset quality problems.

Although the FDIC did not issue a PCA Directive to FB, other actions taken by the FDIC addressed PCA restrictions. The ARO sent PCA notification letters to FB when the bank's capital category fell below well capitalized. FB's capital category for PCA purposes was well capitalized until FB's submission of its amended December 31, 2007 Call Report, at which time, the bank was reported as adequately capitalized. FB incurred significant provisions for loan losses in the first quarter 2008, which caused the bank to fall to undercapitalized. The FDIC forwarded appropriate PCA notifications to FB and required FB to submit a CRP. For example, on May 23, 2008, the FDIC notified FB of mandatory restrictions applicable to undercapitalized banks, in compliance with section 38 of the FDI Act and the FDIC's implementing regulation, Part 325, subpart B, including the continued prohibition against the use of brokered deposits. In accordance with the notification letters FB was required to, among other things, submit a CRP and restrict its use of brokered deposits.[14] In addition, on August 21, 2008, the FDIC notified FB that the bank was significantly undercapitalized for PCA purposes. Accordingly, the bank was subject to additional provisions of Section 38 that restrict compensation paid to senior executive officers of the institution. Section 38 also requires the appropriate federal banking agency to take one or more of the following actions when an institution becomes significantly undercapitalized:

- require recapitalization;
- restrict transactions with affiliates, interest rates paid on deposits, or activities that pose excessive risk to the institution; or

[14] Section 29 of the FDI Act prohibits an insured depository institution that is not well capitalized from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts.

- improve management.

FB provided the FDIC information that summarized FB's planned actions to recapitalize the bank with $15 to $20 million or find a merger partner, improve management, resolve and reduce nonperforming assets, strengthen loan underwriting and credit policies, reduce expenses, rationalize the branch network, and increase core deposits. Additionally, the CRP indicated that the bank would not accept, renew, or roll over brokered deposits. The FDIC determined the CRP to be unacceptable and on August 15, 2008, the ARO notified FB that the submitted information was incomplete and requested additional information, including details regarding the existing agreement with the private equity company that had committed to invest $5 million. The FDIC also requested a status report on the effort to attract other capital investors to complete the projected $20 million offering. FB forwarded a revised CRP to the ARO on September 5, 2008. In September 2008, the FDIC issued a C&D requiring the bank to take various actions, including increasing capital and improving management and asset quality.

PCA's focus is on capital, which can be a lagging indicator of an institution's financial health. In addition, the use of PCA Directives depends on the accuracy of capital ratios in a financial institution's Call Reports. DSC concluded that the deterioration in FB's asset quality, poor outlook for earning performance, weak liquidity position and asset liability composition, and less than satisfactory supervision by the BOD required a significant capital injection, without which the viability of the bank appeared threatened.

Ultimately, FB's efforts to comply with the MOU and C&D, develop an adequate CRP, and recapitalize the bank proved unsuccessful. Further, by the time FB's capital level fell below the required threshold to implement PCA, the bank's condition had deteriorated to the point at which the institution could not raise the needed capital, estimated to be between $15 to $20 million, through its BOD or find other investors to assist in capitalizing the bank. Accordingly, on October 31, 2008, the OFR closed the bank and named the FDIC as Receiver.

CORPORATION COMMENTS

On May 4, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 3 of this report. In its response, DSC stated that the rapid and pronounced decline in real estate values within FB's local market area was an important contributing factor to FB's ultimate failure and a material loss to the DIF. DSC agreed with the OIG's assessment that FB failed primarily due to management's aggressive pursuit of asset growth concentrated in high-risk CRE loans, including ADC loans, with inadequate loan underwriting and other loan portfolio and risk management controls. Further, DSC concluded that additional action directed at FB's management performance, lending practices, and high growth was needed to better control and limit the bank's risks. DSC stated that it continues to monitor risks to the DIF and proactively adjust its supervisory programs in light of the changing economic landscape.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted the audit from November 2008 to April 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it was not feasible to address certain aspects of the standards, as described on the next page.

Scope and Methodology

The scope of this audit included an analysis of FB's operations, which opened on May 17, 2005, until its failure on October 31, 2008. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the audit objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports and examination work papers prepared by the FDIC and the OFR from 2005 to 2008.

- Reviewed the following:

    - Bank data and correspondence maintained at DSC's Tampa Field Office.

    - Reports prepared by the Division of Resolutions and Receiverships and DSC relating to the bank's closure.

    - Reports from the bank's external auditors, CPA Associates, Bradenton, Florida; Stogniew and Associates, Palm Harbor, Florida; and Mauldin & Jenkins, Albany, Georgia.

    - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C.; Atlanta, Georgia; and Tampa, Florida.

  - FDIC examiners from the DSC Tampa Field Office who participated in FB examinations.

- Interviewed officials from the OFR in Tallahassee and Tampa, Florida, to discuss their historical perspective of the institution, its examinations, and other activities regarding the OFR's supervision of the bank.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance With Laws and Regulations

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of FB's management controls pertaining to its operations as discussed in the finding section of this report. For purposes of the audit, we did not rely on computer-processed data to support our significant findings or conclusions. Our review centered on interviews, ROEs, and correspondence and other evidence to support our audit.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed where appropriate in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

GLOSSARY OF TERMS

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an ROE. Adversely classified assets are allocated on the basis of risk (lowest to highest) to three categories: • Substandard, • Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL level that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of loan.
Cease and Desist Order (C&D)	A formal enforcement action issued by a regulator to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Interest Reserves	The use of interest reserves to fund the initial construction and/or development of real estate is generally an acceptable practice, subject to prudent underwriting standards and the timely completion of construction/development projects in accordance with the original construction loan agreement. Conversely, the use of interest reserves to service loans for any other purpose is often inappropriate and should be closely reviewed.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.

Report of Investigation (ROI)	The ROI contains conclusions and recommendations that present an overview of the application, analyzes and summarizes findings, and concludes with the investigating examiner's recommendation of whether the FDIC should grant federal deposit insurance to proposed financial institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

May 4, 2009

MEMORANDUM TO:	Russell A. Rau Assistant Inspector General for Audits
FROM:	Sandra L. Thompson Director
SUBJECT:	Draft Audit Report Entitled, *Material Loss Review of Freedom Bank, Bradenton, Florida* (Assignment No. 2009-006)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Freedom Bank (Freedom), Bradenton, Florida, which failed on October 31, 2008. This memorandum represents the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received April 17, 2009.

We agree with the OIG's assessment that Freedom failed primarily due to management's aggressive pursuit of asset growth concentrated in high risk Commercial Real Estate (CRE) loans, including Acquisition, Development, and Construction (ADC) loans with inadequate loan underwriting and other loan portfolio and risk management controls. In addition, we believe that the rapid and pronounced decline in real estate values within Freedom's local market area was an important contributing factor to Freedom's ultimate failure and a material loss to the Deposit Insurance Fund.

The Draft Report states that the OIG found that the FDIC and the State of Florida, Office of Financial Regulation conducted timely examinations of Freedom, and notes that examiners identified loan administration and underwriting deficiencies at each examination and visitation of Freedom. We note that as a result of these deficiencies, the Management component was rated 3 at Freedom's initial examination in May 2006, and the Management component and the Composite rating were rated 3 at Freedom's second examination in March 2007 when the FDIC and OFR entered into a joint Memorandum of Understanding with Freedom's Directors.

The Draft Report concludes that more timely supervisory action should have been taken as a result of the 2006 examination. DSC has concluded that additional action directed at Freedom's management performance, lending practices, and high growth was needed to better control and limit these risks. DSC continues to monitor risks to the Deposit Insurance Fund and proactively adjust its supervisory programs in light of the changing economic landscape.

Thank you for the opportunity to review and comment on the Draft Audit Report.

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ARO	Atlanta Regional Office
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
CEO	Chief Executive Officer
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FB	Freedom Bank
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GAAP	Generally Accepted Accounting Principles
MOU	Memorandum of Understanding
OFR	Office of Financial Regulation
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PEP	Pre-Examination Planning
ROE	Report of Examination
ROI	Report of Investigation
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institution Rating System