Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-002

Material Loss Review of Cape Fear Bank, Wilmington, North Carolina

October 2009

Office of Inspector General

Executive Summary

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Why We Did The Audit

On April 10, 2009, the North Carolina Office of the Commissioner of Banks closed Cape Fear Bank (Cape Fear) of Wilmington, North Carolina, and named the FDIC as receiver. On April 23, 2009, the FDIC notified the Office of Inspector General (OIG) that Cape Fear's total assets at closing were $466.8 million and the estimated loss to the Deposit Insurance Fund (DIF) was $131 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Cape Fear.

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

Background

Cape Fear was a state-chartered nonmember institution established on June 22, 1998. The institution was headquartered in Wilmington, North Carolina, and maintained seven other branch locations. Cape Fear was a wholly owned subsidiary of the Cape Fear Bank Corporation, Inc., a one-bank holding company. Cape Fear engaged principally in commercial real estate (CRE) and acquisition, development, and construction (ADC) lending within its local marketplace.

Audit Results

Causes of Failure and Material Loss

Cape Fear failed because its Board and management did not implement effective risk management practices pertaining to (a) rapid growth and significant concentrations of CRE and ADC loans, (b) loan underwriting and credit administration, and (c) heavy reliance on non-core funding sources, particularly brokered deposits. Although examiners expressed concern about Cape Fear's risk management practices in the years preceding the institution's failure, the actions taken by Cape Fear's Board and management to address these concerns were not timely or adequate in preventing the institution's failure.

When the North Carolina real estate market began to deteriorate in 2007, weaknesses in Cape Fear's risk management practices quickly translated into a significant decline in the quality of the institution's loan portfolio. The associated losses and provisions depleted Cape Fear's capital and earnings and significantly impaired the institution's liquidity. Further, in April 2009, Cape Fear's parent company notified the Securities and Exchange Commission that substantial doubt existed regarding the institution's ability to continue as a going concern. The notification generated negative media attention and resulted in substantial depositor withdrawals, placing additional pressure on the institution's liquidity and capital. The North Carolina Commissioner of Banks closed Cape Fear due to its deficient liquidity position.

FDIC's Supervision of Cape Fear

The FDIC, in conjunction with the North Carolina Commissioner of Banks, provided supervision of Cape Fear through regular on-site risk management examinations, periodic visitations, and certain off-site monitoring procedures. The FDIC also pursued three informal enforcement actions and one formal enforcement action to address weak risk management practices identified by examiners. In addition, the FDIC performed daily monitoring of Cape Fear's liquidity position in the days preceding the institution's failure. Through its supervisory efforts, the FDIC identified risks in Cape Fear's operations and brought these risks to the attention of the institution's Board and management. These risks included weak management practices pertaining to the institution's rapid loan growth, credit concentrations, loan underwriting and credit administration, and reliance on non-core funding sources.

In retrospect, the FDIC could have taken stronger supervisory action based on the risks identified during the April 2006 examination. At that time, Cape Fear had a high risk profile. The institution had significant concentrations in CRE and ADC loans (which are historically vulnerable to economic downturns), weak loan underwriting and credit administration practices, and a growing reliance on non-core funding sources. The FDIC could have pursued an informal enforcement action, such as a Memorandum of Understanding, that required Cape Fear's Board and management to commit to a plan and timeline for addressing the key risks identified during the examination. Stronger supervisory action at that time may have influenced Cape Fear's Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

With respect to PCA, we concluded that the FDIC had properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for Cape Fear. However, PCA's effectiveness in mitigating losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure. Based on information contained in Cape Fear's Call Reports, the institution fell from well capitalized to adequately capitalized for PCA purposes on September 30, 2008 and remained adequately capitalized through the end of 2008. However, examiners concluded during the October 2008 examination that, given the high-risk profile of Cape Fear, its capital levels were "critically deficient" and the probability of the institution's failure was high.

Management Response

On October 22, 2009, the Director, DSC, provided a written response to a draft of this report. The response is provided in its entirety as Appendix 4 of this report. In its response, DSC reiterated the OIG's conclusions regarding the causes of Cape Fear's failure. Regarding our assessment of FDIC's supervision of Cape Fear, DSC cited several supervisory activities, discussed in our report, that were taken to address key risks at the institution prior to its failure. In its response, DSC also recognized that strong supervisory attention is necessary for institutions like Cape Fear that have high CRE and ADC concentrations supported by volatile funding sources. Accordingly, DSC has issued updated guidance reminding examiners to take appropriate action when such risks are imprudently managed.

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FDIC

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226 Office of Inspector General

DATE:	October 23, 2009
MEMORANDUM TO:	Sandra L. Thompson, Director Division of Supervision and Consumer Protection
FROM:	**/Signed/** Stephen M. Beard Assistant Inspector General for Material Loss Reviews
SUBJECT:	*Material Loss Review of Cape Fear Bank, Wilmington, North Carolina* (Report Number MLR-10-002)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the FDIC Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Cape Fear Bank (Cape Fear), Wilmington, North Carolina. The North Carolina Office of the Commissioner of Banks (North Carolina Commissioner) closed Cape Fear on April 10, 2009 and named the FDIC as receiver. On April 23, 2009, the FDIC notified the OIG that Cape Fear's total assets at closing were $466.8 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $131 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. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review were to: (1) determine the causes of Cape Fear's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of Cape Fear, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Cape Fear's failure and the FDIC's efforts to ensure that Cape Fear's Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not

[1] As defined by section 38 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.

contain formal recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our material loss reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of DSC's supervision program and make recommendations, as warranted. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of key terms and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

Cape Fear was established in June 1998 as a state-chartered non-member institution.[3] The institution had eight locations, consisting of a main office in Wilmington, North Carolina, and seven full-service branches in the southeast area of North Carolina. The majority of Cape Fear's lending was in real estate, particularly commercial real estate (CRE) and acquisition, development, and construction (ADC), within its local market area. Cape Fear was wholly owned by the Cape Fear Bank Corporation, a publicly traded company. Collectively, the institution's Board controlled approximately 4 percent of the Cape Fear Bank Corporation. Cape Fear had no other affiliates or subsidiaries. Table 1 provides details on Cape Fear's financial condition as of March 31, 2009 and for the 5 preceding calendar years.

Table 1: Financial Condition of Cape Fear

Financial Measure	31-Mar-09	31-Dec-08	31-Dec-07	31-Dec-06	31-Dec-05	31-Dec-04
Total Assets ($000s)	$492,418	$473,112	$463,944	$424,402	$342,725	$201,755
Total Loans ($000s)	$402,820	$401,488	$387,239	$354,616	$284,175	$170,202
Total Deposits ($000s)	$385,039	$390,507	$370,678	$334,409	$278,386	$162,399
Net Loan Growth Rate	1.91%	4.63%	10.62%	20.01%	71.48%	56.57%
Net Income (Loss) ($000s)	($1,851)	($5,175)	$1,946	$2,813	$1,777	$1,148

Source: OIG Analysis of Uniform Bank Performance Reports (UBPR) for Cape Fear.

Causes of Failure and Material Loss

Cape Fear failed because its Board and management did not implement effective risk management practices pertaining to (a) rapid growth and significant concentrations of CRE and ADC loans, (b) loan underwriting and credit administration, and (c) heavy reliance on non-core funding sources, particularly brokered deposits. Examiners expressed concern about Cape Fear's risk management practices in the years preceding the institution's failure. However, the actions taken by Cape Fear's Board and management to address these concerns were not timely or adequate in preventing the institution's failure.

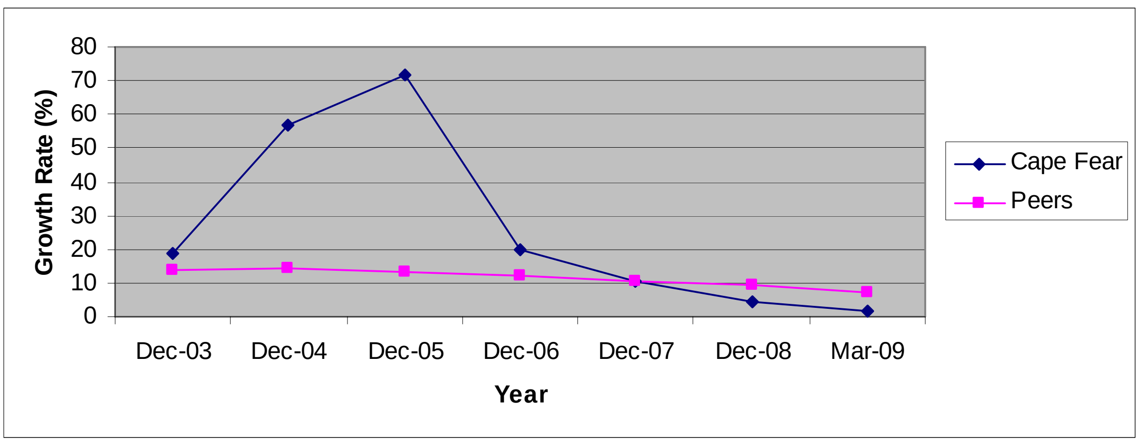
[3] Cape Fear opened as the Bank of Wilmington on June 22, 1998. The institution changed its name to Cape Fear in October 2006.

When the North Carolina real estate market began to deteriorate in 2007, weaknesses in Cape Fear's risk management practices quickly translated into a significant decline in the quality of the institution's loan portfolio. The associated losses and provisions depleted Cape Fear's capital and earnings and significantly impaired the institution's liquidity. Further, in April 2009, Cape Fear's parent company notified the Securities and Exchange Commission that substantial doubt existed regarding the institution's ability to continue as a going concern. The notification generated negative media attention and resulted in substantial depositor withdrawals, placing additional pressure on the institution's liquidity and capital. The North Carolina Commissioner closed Cape Fear on April 10, 2009 due to its deficient liquidity position.

Rapid Loan Growth

During 2004 and 2005, Cape Fear grew its loan portfolio at a pace that significantly exceeded both the institution's peer group and its own internal growth plans. During these years, the institution ranked among the 96th and 97th percentile of its peer group for asset growth. Figure 1 illustrates the rapid growth of Cape Fear's loan portfolio relative to its peer group during these years.

Figure 1: Annual Growth of Cape Fear's Loan Portfolio Relative to Peers



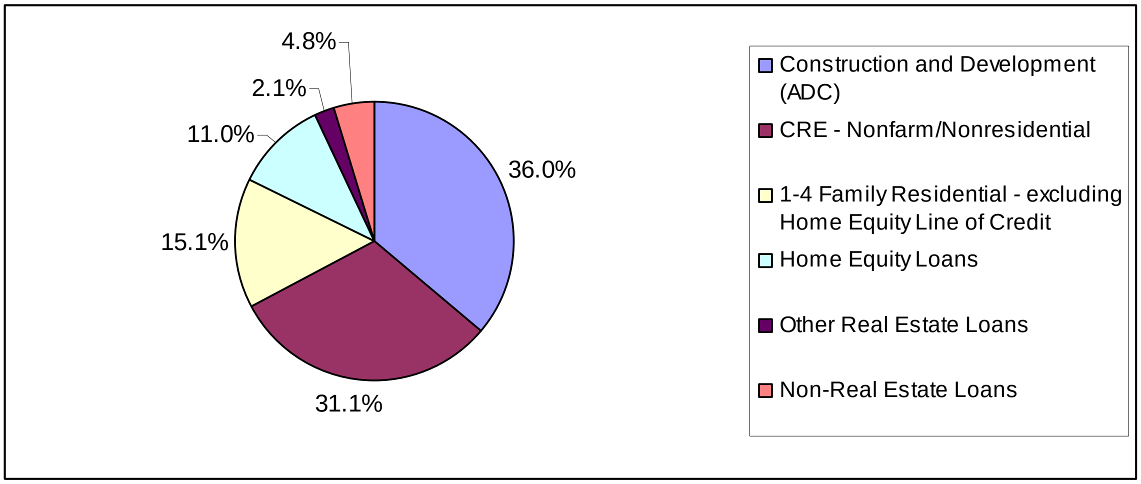
Source: OIG Analysis of UBPRs for Cape Fear.

Examiners noted the rapid growth of Cape Fear's loan portfolio during the February 2005 examination but did not express concern at that time because the institution's risk management policies and practices were considered adequate. During the April 2006 examination, examiners noted that although Cape Fear's financial condition was generally satisfactory, management had not adequately planned for or monitored the growth of its loan portfolio. Among other things, Cape Fear had not developed a written strategic plan to help manage the affairs of the institution. Although management developed a written strategic plan in 2007, the plan was of limited benefit because it was not sufficiently detailed. Additionally, growth in the institution's loan portfolio, principally concentrated in ADC loans, had already occurred. Cape Fear's Board adopted a revised strategic plan on January 31, 2008. However, examiners again concluded during the October 2008 examination that the plan was inadequate.

Controls to Manage Risks Associated with Loan Concentrations

At the time of its failure, approximately 95 percent of Cape Fear's loan portfolio was in real estate. Included within the loan portfolio were significant concentrations of high-risk loans, including CRE and ADC loans. Figure 2 summarizes Cape Fear's loan mix based on its Consolidated Reports of Condition and Income (Call Report) for the quarter ending March 31, 2009.

Figure 2: Cape Fear's Loan Mix as of March 31, 2009



Source: OIG Analysis of UBPRs for Cape Fear.

The FDIC's December 2006 guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, recognizes that there are substantial risks posed by CRE concentrations, and in particular ADC concentrations. Such risks include unanticipated earnings and capital volatility during a sustained downturn in the real estate market. The December 2006 guidance defines institutions with significant CRE concentrations as those institutions reporting loans for construction, land development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. Due to the risks associated with CRE and ADC lending, regulators consider institutions with significant CRE and ADC concentrations to be of greater supervisory concern.

At the close of 2003, Cape Fear's CRE and ADC loans represented 387 and 143 percent of the institution's total capital, respectively. By December 31, 2008, Cape Fear's CRE and ADC loans had swelled to 828 and 436 percent of total capital, respectively.[4] Figure 3 illustrates the rapid growth in Cape Fear's ADC loan concentrations compared to its peers.

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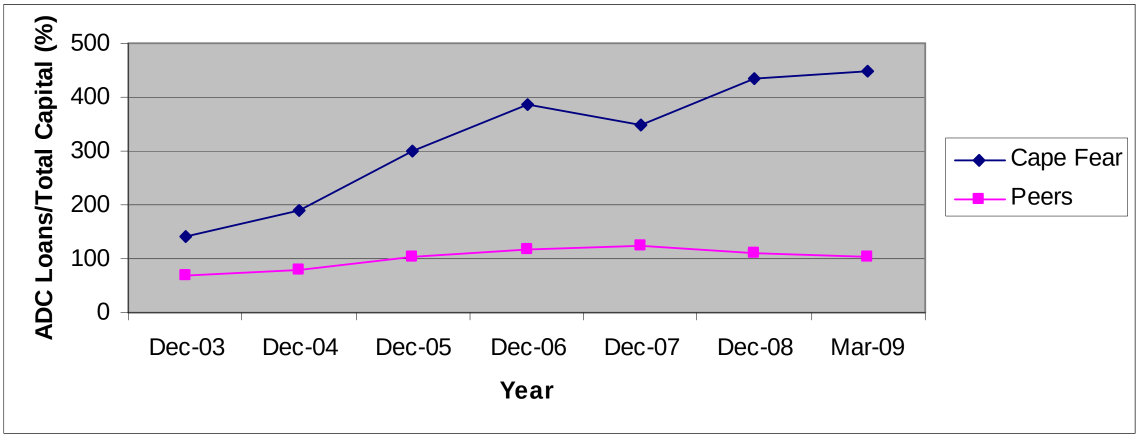
[4] It should be noted that much of the increase in Cape Fear's CRE and ADC loan concentrations during 2007 and beyond was the result of a decline in capital rather than an increase in loans.

Figure 3: Cape Fear's ADC Loan Concentrations Relative to Peers



Source: OIG Analysis of UBPRs for Cape Fear.

Although examiners noted an ADC concentration in Cape Fear's loan portfolio during the 2003 and 2005 examinations, the examiners concluded that the institution's monitoring practices were acceptable at that time. During the 2006 examination, examiners noted that the institution's CRE and ADC concentrations had increased measurably and that Cape Fear did not have appropriate controls to manage the risks associated with the concentrations. Specifically, the institution had not established limits on its loan concentrations; developed goals to diversify its loan portfolio; or developed specific strategies or procedures for assessing, managing, or monitoring its concentrations. The institution had also not established any limits on its other high-risk loan types or practices, such as interest-only loans, speculative land-carry notes, unsecured credits, or loans with multiple renewals or extensions. As of March 31, 2006, almost half of Cape Fear's loan portfolio required interest-only payments. Such loans are considered high-risk because they do not require principal payments and can, therefore, mask a borrower's inability to ultimately repay the loan.

By the October 2008 examination, the financial condition of the institution had deteriorated significantly. At that time, the institution had $48.3 million in adversely classified assets, representing 120 percent of Tier 1 Capital and Reserves. Of the $48.3 million, $39.8 million (or 83 percent) consisted of CRE loans, and the majority of these CRE loans ($34.1 million, or 71 percent) were ADC loans. Following a change in Board membership, Cape Fear established limits on its CRE concentrations on October 30, 2008, to prevent further growth in the institution's CRE concentrations. However, the limits were not particularly beneficial because they reflected the institution's elevated CRE positions and no plans existed to reduce the CRE concentrations. Further, nearly half of Cape Fear's loan portfolio continued to require interest-only payments. Additionally, the risks associated with Cape Fear's loan concentrations were exacerbated by weak loan underwriting and credit administration practices.

Loan Underwriting and Credit Administration

Weaknesses in Cape Fear's loan underwriting and credit administration practices were a contributing factor to the asset quality problems that developed in the institution's loan portfolio when the North Carolina real estate market began to deteriorate in 2007. Examiners began raising concerns about Cape Fear's credit administration practices during the 2006 examination. Among other things, examiners commented that:

- The institution's loan policy did not meet the needs of the institution. For example, the policy provided only general underwriting parameters for unsecured commercial loans and did not address amortization and repayment ability considerations.

- Policies and procedures for interest-only and unsecured lending needed to be reviewed and strengthened.

- Loans originated as exceptions to policy were not being tracked and reported to the Board.

- Management was not monitoring the volume of, or tracking renewal for, high-risk loans, such as interest-only loans and unsecured loans.

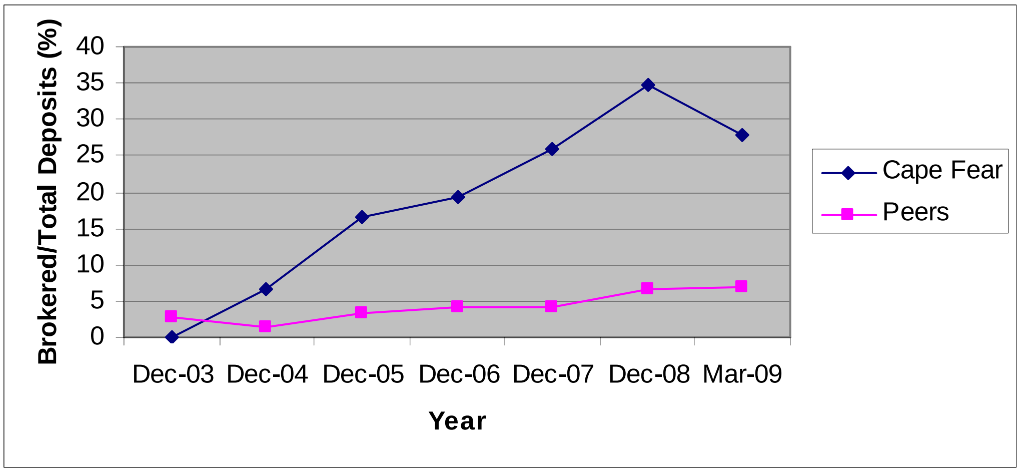
Subsequent examinations of Cape Fear identified weak underwriting practices. Such practices included, but were not limited to, the capitalization of interest for loan renewals, a failure to establish and enforce appropriate loan repayment programs, inadequate analysis of borrower repayment capabilities, liberal renewal and extension practices, inadequate borrower equity in real estate projects, over-reliance on collateral as the primary repayment source, and unsupported real estate appraisals.

Reliance on Non-Core Funding

In the years preceding its failure, Cape Fear became increasingly dependent on non-core funding sources, particularly brokered deposits, to fund its loan growth and maintain adequate liquidity. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags behind planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. According to the *DSC Risk Management Manual of Examination Policies*, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or market conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

Cape Fear's net non-core funding dependence ratio[5] grew steadily in the years preceding its failure. By December 2007, Cape Fear's net non-core funding dependence ratio was in the 94th percentile for its peer group. The elevated ratio was driven, in part, by Cape Fear's decision in 2004 to begin using brokered deposits to grow its loan portfolio. Figure 4 illustrates Cape Fear's use of brokered deposits relative to its peers. By the close of 2008, brokered deposits represented approximately 35 percent of Cape Fear's total deposit base.

Figure 4: Cape Fear's Use of Brokered Deposits Relative to Peers



Source: OIG Analysis of UBPRs for Cape Fear.

During 2006 and 2007, examiners determined that Cape Fear's liquidity position was minimally adequate given the institution's heavy reliance on non-core funding. In addition, Cape Fear's use of non-core funding was increasing the cost of the institution's funds and placing downward pressure on its earnings. As of March 31, 2006, Cape Fear was paying 95 basis points more than its peer average for interest-bearing funds, placing the institution in the 94th percentile of peers for the cost of funds. In an effort to generate growth in local core deposits and help alleviate its growing dependence on non-core funding sources, Cape Fear embarked on an aggressive expansion of its branch locations in 2006 and 2007. However, the new branches did not attract sufficient local deposits to reduce Cape Fear's dependence on non-core funding sources, and the cost of the branch expansion weighed heavily on earnings.

Based on information contained in its Call Report for the quarter ending September 30, 2008, Cape Fear fell from well capitalized to adequately capitalized for PCA purposes. Part 337.6 of the FDIC Rules and Regulations prohibits adequately capitalized institutions from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. Cape Fear submitted a brokered deposit waiver application on

[5] The net non-core funding dependence ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources that may not be available in times of financial stress.

October 31, 2008. At that time, the institution had over $40 million in brokered deposits that were scheduled to mature by March 31, 2009. Cape Fear subsequently withdrew its brokered deposit waiver application on December 23, 2008 because it was determined that other sources of liquidity were available to the institution at that time. Although Cape Fear had a funds management policy describing the factors that management should consider during a liquidity crisis, the institution did not have a well-defined contingency funding plan. As the institution's financial condition deteriorated, Cape Fear's liquidity position became increasingly strained.

The FDIC's Supervision of Cape Fear

Through its supervisory efforts, the FDIC identified risks in Cape Fear's operations and brought these risks to the attention of the institution's Board and management through regular discussions and correspondence, Reports of Examination (ROEs), and informal and formal enforcement actions. Key risks identified by examiners included weak risk management practices pertaining to the institution's rapid loan growth, ADC and CRE loan concentrations, loan underwriting and credit administration functions, and reliance on non-core funding sources. Although the FDIC's actions in this regard were positive, the FDIC could have taken stronger supervisory action based on the risks that it identified during the April 2006 examination. Stronger supervisory action following the April 2006 examination may have influenced Cape Fear's Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the DIF.

Supervisory History

The FDIC, in conjunction with the North Carolina Commissioner, provided supervision of Cape Fear through regular on-site risk management examinations, periodic visitations, and certain off-site monitoring procedures. In addition, the FDIC performed daily monitoring of Cape Fear's liquidity position in the days preceding the institution's failure. Table 2 summarizes key information pertaining to the on-site risk management examinations and visitations that the FDIC and North Carolina Commissioner conducted of Cape Fear from 2002 until the institution failed, including the institution's supervisory ratings.[6]

[6] 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 2: On-site Examinations and Visitations of Cape Fear

Date	On-Site Effort	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken*	Date Action Lifted
07/08/2002	Joint Examination	333332/3	BBR 11/21/02	8/27/03
06/23/2003	Joint Examination	222222/2	None	
02/14/2005	State Examination	122222/2	None	
04/19/2006	FDIC Examination	223322/2	BBR** 9/21/06	12/18/08
12/11/2006	FDIC Visitation	No Rating	N/A	
05/08/2007	FDIC Visitation	No Rating	N/A	
08/06/2007	State Examination	223322/3	BBR 9/26/07	Replaced with C&D 2/24/09
02/05/2008	Joint Visitation	No Rating	N/A	
10/06/2008	Joint Examination	554454/5	C&D 2/24/09	4/10/09
04/07/2009	FDIC Visitation***	No Rating	N/A	

Source: FDIC's Virtual Supervisory Information on the Net system and ROEs for Cape Fear.
* Informal enforcement actions often take the form of Bank Board Resolutions (BBR) or Memorandums of Understanding (MOU). Formal enforcement actions often take the form of Cease and Desist (C&D) Orders, but under severe circumstances can also take the form of insurance termination proceedings.
** As described below, this BBR was limited to Information Technology (IT) security issues.
*** This visitation focused on monitoring the institution's liquidity position.

As shown in Table 2, four visitations were conducted at Cape Fear from 2006 to 2009 in addition to the required risk management examinations. The purposes of these visitations were as follows:

- **December 2006 and May 2007:** Determine the progress that Cape Fear was making in addressing the IT security control deficiencies discussed in the September 2006 BBR. As part of these visitations, FDIC examiners also assessed Cape Fear's efforts to address the concerns raised in the April 2006 examination related to the extent of, and controls over, CRE and ADC concentrations.

- **February 2008:** Follow up on Cape Fear's progress in addressing the weak risk management practices discussed in the September 2007 BBR.

- **April 2009:** Monitor Cape Fear's liquidity position.

The FDIC and North Carolina Commissioner pursued a total of three informal enforcement actions and one formal enforcement action to address weak risk management practices identified by the examiners. A brief description of these actions follows.

- **November 2002 BBR.** In response to the July 2002 joint examination, this BBR required Cape Fear's management to take such actions as strengthening its loan policy to address the acquisition and analysis of financial information on borrowers, documenting credit decisions, performing real estate appraisals, and making ADC loans; improving the institution's loan grading system; and developing a plan to comply with the Interagency Guidelines for Real Estate Lending Policies.

- **September 2006 BBR.** This BBR focused on addressing IT security control deficiencies and did not address financial matters identified in the April 2006 examination.

- **September 2007 BBR.** As a result of the August 2007 examination, this BBR required Cape Fear's management to take various actions, such as developing a comprehensive strategic plan, documenting an acceptable methodology for determining the adequacy of the loan loss reserve, improving the institution's loan grading and review system, setting specific limits for CRE lending, and adopting a formal loan policy to address how the institution would manage all types of loans in its portfolio.

- **February 2009 C&D.** This corrective action was taken in response to the October 2008 examination. Among other things, the C&D directed Cape Fear's Board and management to implement a written funds management policy; discontinue the acceptance, renewal, or roll over of brokered deposits unless a waiver was obtained from the FDIC; reduce undue loan concentrations, including concentrations in CRE; implement written lending and collection policies; and formulate a written strategic plan.

With regard to offsite monitoring, the FDIC's systems did not identify Cape Fear's rapid growth as a supervisory concern because, according to FDIC officials, the systems were designed to flag the top 2 percent of rapidly growing institutions. As discussed earlier, Cape Fear's growth at its height in 2004 and 2005 was in the 96^{th} and 97^{th} percentile of its peer group. However, as detailed below, the FDIC's on-site examinations and numerous visitations identified key risks in Cape Fear's operations years before its failure.

Supervisory Response to Key Risks at Cape Fear

The FDIC could have taken stronger supervisory action based on the risks that examiners identified during the April 2006 examination. The results of that examination indicated that Cape Fear had a high-risk profile. Among other things, the institution had not implemented adequate risk management practices or taken corrective action to effectively manage key risks discussed earlier in the report, including:

- Rapid growth in the loan portfolio.

- Significant concentrations of CRE and ADC loans.

- Weaknesses in loan underwriting and credit administration.

- Heavy reliance on non-core funding sources.

- Weaknesses in the internal risk grading of loans and the Allowance for Loan and Lease Losses (ALLL) methodology.

Stronger supervisory action may have included an informal enforcement action, such as an MOU, requiring Cape Fear's Board and management to commit to a plan and timeline for addressing the key risks identified by examiners. Examiners with whom we spoke indicated that they contemplated pursuing an informal enforcement action based on the results of April 2006 examination. In retrospect, such an action may have been prudent because the actions that the institution took in response to the results of the examination were generally not timely or adequate, as summarized in Table 3.

Table 3: Cape Fear's Actions to Address Selected Key Risks Identified During the April 2006 Examination

Concerns Identified in the April 2006 Examination	Actions Taken by Cape Fear's Board and Management
Management had not adopted a written strategic plan to help manage the institution's rapid growth.	Cape Fear did not develop a written strategic plan until 2007, after its critical growth period. Examiners concluded that the plan was general in nature and of limited value. The Board adopted a revised strategic plan on January 31, 2008. Examiners, however, criticized the plan as flawed during the October 2008 examination. Cape Fear was working to revise its strategic plan at the close of the October 2008 examination.
Management did not have specific limits regarding credit concentrations or goals to diversify the loan portfolio.	The Board did not establish specific CRE concentration limits until October 30, 2008. However, examiners concluded that these limits were of negligible value because they mirrored the institution's elevated CRE positions. Further, the October 2008 ROE indicated that plans did not exist to reduce the institution's CRE positions.
Loan underwriting and credit administration practices needed improvement.	Examiners noted in the August 2007 examination that although management had improved the tracking of its CRE loans, many of the loan underwriting and credit administration weaknesses identified in the April 2006 examination had not been addressed. Although the institution developed comprehensive guidance for its lending function in July 2008, the quality of the loan portfolio was already deteriorating.
Liquidity was minimally adequate due to a growing reliance on non-core funding sources.	Although Cape Fear expanded its branches during 2006 and 2007 in an effort to increase its core deposit base, the effort did not result in a meaningful decline in the institution's reliance on non-core funding sources. Cape Fear's net non-core funding dependence ratio increased in the years following the April 2006 examination. In addition, examiners noted during the October 2008 examination that although management had taken some contingency funding planning measures, it had not developed a well-defined contingency funding plan.
The institution's internal risk grading system and the ALLL methodology did not capture key risk characteristics of the loan portfolio and needed improvement.	Examiners noted in the August 2007 examination that risk grade assignments and the ALLL methodology continued to need improvement. The ALLL was also cited as a material weakness in the March 26, 2008 audit report on the Cape Fear Bank Corporation's 2007 consolidated financial statements. Although Cape Fear updated its loan grading and review system and ALLL methodology in July 2008, examiners noted continued weaknesses in both areas during the October 2008 examination.

Source: OIG Analysis of ROEs for Cape Fear.

To its credit, the FDIC conducted on-site visitations of Cape Fear in December 2006 and May 2007, during which it assessed Cape Fear's progress in addressing examiner concerns raised in the April 2006 examination. Generally, these visitations found that the institution was making progress in addressing prior examiner concerns. Of particular interest, examiners noted that overall supervision of the institution had improved, asset and loan growth had slowed, management had begun reporting more detailed loan information to the Board, the ALLL methodology had been improved, and a full-time internal auditor had been hired. However, examiners noted that, among other things, a new loan policy and strategic plan had been drafted, but not yet finalized. In addition, significant loan concentrations continued to exist and the institution's recently initiated branch expansion was not generating enough core deposits to offset its continued reliance on non-core funding sources, including brokered deposits.

The FDIC also conducted a visitation in February 2008 to assess Cape Fear's progress in addressing the weak risk management practices discussed in the September 2007 BBR. Although not required, it may have been prudent for the FDIC to have requested Cape Fear to provide regular status reports describing the institution's progress in addressing the provisions of the September 2007 BBR. Requiring status reports would have further elevated supervisory attention to key risks in the institution. Finally, we noted that the FDIC issued a C&D on February 24, 2009, based on the results of the October 2008 examination. Although a C&D was appropriate for the risks that were identified during the October 2008 examination, the ultimate viability of the institution was already in serious question by the time the C&D was issued.

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. Part 325 of the FDIC's Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. However, PCA's effectiveness in mitigating losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure.

In the case of Cape Fear, capital was a lagging indicator of the institution's financial health. Based on information contained in Cape Fear's Call Reports, the institution fell from well capitalized to adequately capitalized for PCA purposes on September 30, 2008, and remained adequately capitalized through the end of 2008.[7] Table 4 illustrates Cape Fear's capital levels relative to the PCA thresholds for well capitalized institutions during this period. However, examiners concluded during the October 2008 examination that, given the high-risk profile of Cape Fear, its capital levels were "critically deficient," and the probability of the institution's failure was high.

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[7] Section 38 of the FDI Act and 57 Federal Register 44866-01 defines Adequately Capitalized as Total Risk Based Capital of 8 percent or more, Tier 1 Risk Based Capital of 4 percent or more, and Leverage Capital of 4 percent or more.

Table 4: Cape Fear's Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions

Capital Ratio	PCA Threshold	September 30, 2008	December 31, 2008
Leverage Capital	5% or more	6.76%	5.66%
Tier 1 Risk-Based Capital	6% or more	7.94%	6.74%
Total Risk Based Capital	10% or more	9.21%	8.01%

Source: OIG Analysis of UBPRs for Cape Fear and Section 38 of the FDI Act and 57 Federal Register 44866-01.

Consistent with the PCA provisions of section 38, the FDIC notified Cape Fear on November 20, 2008 that, based on information contained in the institution's Call Report for the quarter ending September 30, 2008, the institution was considered adequately capitalized for purposes of Part 325 of the FDIC Rules and Regulations. The FDIC's notification included a reminder of the requirements that Cape Fear had become subject to based on its PCA capital category. Such requirements included, among other things, a prohibition on the acceptance, renewal, or roll-over of brokered deposits without a waiver from the FDIC. The November 2008 notification also included a reminder that, pursuant to Part 337.6 of the FDIC Rules and Regulations, adequately capitalized institutions are subject to certain restrictions on the interest rates that can be paid on deposits. The FDIC provided Cape Fear with a similar notification that the institution was adequately capitalized on February 12, 2009, based on information contained in the institution's Call Report for the quarter ending December 31, 2008.

Corporation Comments

We issued a draft of this report on October 1, 2009. We subsequently met with representatives of DSC to discuss the results of our review. Based on our discussion, we made certain changes to the report that we deemed appropriate. On October 22, 2009, the Director, DSC, provided a written response to the draft report. The response is provided in its entirety as Appendix 4 of this report.

In its response, DSC reiterated the OIG's conclusions regarding the causes of Cape Fear's failure. Regarding our assessment of the FDIC's supervision of Cape Fear, DSC cited several supervisory activities, discussed in our report, that were undertaken to address key risks at the institution prior to its failure. In its response, DSC also recognized that strong supervisory attention is necessary for institutions like Cape Fear that have high CRE and ADC concentrations supported by volatile funding sources. Accordingly, DSC has issued updated guidance reminding examiners to take appropriate action when such risks are imprudently managed.

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 Cape Fear's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Cape Fear, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from May 2009 to October 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an assessment of Cape Fear's operations from March 31, 2002 until the institution's failure on April 10, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution during the same period.

To accomplish our objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the FDIC and North Carolina Commissioner from July 2002 through April 2009.

- Reviewed the following information:

    - Financial institution data and correspondence maintained in DSC's Atlanta Regional Office (ARO) and Raleigh, North Carolina, Field Office.

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the institution's closure and records maintained by DRR at the bank's former location in Wilmington, North Carolina.

    - Working papers and reports prepared by the institution's external auditor, Dixon Hughes, at its offices in Raleigh, North Carolina.

Objectives, Scope, and Methodology

  - Relevant FDIC policies, procedures, and guidelines.

- Interviewed the FDIC officials having supervisory responsibilities pertaining to Cape Fear, including:

  - DSC examination staff in the Washington, D.C. office, ARO, and Raleigh, North Carolina, Field Office.

  - DRR personnel in the Dallas Regional Office.

- Met with officials from the North Carolina Office of the Commissioner of Banks in Raleigh, North Carolina, to obtain their perspective on the institution's supervision and examinations and to discuss relevant state banking laws and other activities related to the state's supervision of the institution.

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

Consistent with our audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC's systems, reports, ROEs, and interviews of examiners to obtain an understanding of Cape Fear's management controls pertaining to the causes of failure and material loss as discussed in the body of this report. We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that was used to support our audit conclusions.

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 is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests are 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 examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL 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 credit.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A formal enforcement action issued by financial institution regulators 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.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
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 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 1831(o), 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: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of financial institution 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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ARO	Atlanta Regional Office
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
IT	Information Technology
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

FDIC

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

Division of Supervision and Consumer Protection

October 22, 2009

MEMORANDUM TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Cape Fear Bank, Wilmington, North Carolina
(Assignment No. 2009-039)

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 Cape Fear Bank (Cape Fear) which failed on April 10, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on October 1, 2009.

The Report concludes that Cape Fear's failure was due to the ineffective risk management practices of the Board and senior management over its rapid growth in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans and its growing dependence on non-core funding sources, particularly brokered deposits. Examiners expressed concern over Cape Fear's risk management practices; however, the Board and management did not take adequate or timely actions to implement corrective practices that could have prevented the failure.

The Report further states that the North Carolina real estate market began to deteriorate in 2007 and that Cape Fear's weak risk management practices quickly translated into a significant decline in loan portfolio quality. The associated loan losses and provisions depleted Cape Fear's capital and earnings and impaired liquidity. Further, in April 2009, negative media attention and its adverse effect on Cape Fear's capital and liquidity grew when the parent company notified the Securities and Exchange Commission that doubt existed as to the institution's ability to continue as a going concern. The notification resulted in depositor withdrawals placing additional pressure on Cape Fear's capital and liquidity.

As part of our supervisory program, examiners conducted on-site risk management examinations, made periodic visitations, and used certain offsite tools, including personal contact with bank management, to monitor Cape Fear's condition. Additionally, DSC pursued three informal corrective actions and one formal enforcement action against Cape Fear to address its weak risk management practices and performed daily monitoring of its liquidity position in the days preceding failure. In recognition that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as Cape Fear, DSC has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

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