Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-013

Material Loss Review of Cooperative Bank, Wilmington, North Carolina

January 2010

Office of
Inspector General

Executive Summary

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Why We Did The Audit

On June 19, 2009, the North Carolina Office of the Commissioner of Banks (North Carolina Commissioner) closed Cooperative Bank (Cooperative), Wilmington, North Carolina, and named the FDIC as receiver. On July 6, 2009, the FDIC notified the Office of Inspector General (OIG) that Cooperative's total assets at closing were $973.6 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $215.2 million. As of December 11, 2009, the estimated loss to the DIF had increased to $216.1 million. Pursuant to section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Cooperative.

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

Background

Cooperative was chartered in January 1898 as a mutual savings institution under the name of Cooperative Building and Loan Association. The FDIC became Cooperative's primary federal regulator in October 1992, following the institution's conversion to a state-chartered savings bank. Cooperative again changed its charter to that of a state commercial bank effective December 30, 2002. Cooperative's lending activities focused primarily on commercial real estate (CRE) and acquisition, development, and construction (ADC) of residential properties in the coastal and inland areas of eastern North and South Carolina. These lending markets, which were largely dependent on beach and summer tourism, began to experience a decline in residential building activity prior to 2008.

In addition to a main office in Wilmington, North Carolina, Cooperative operated a loan production office and 23 additional branch offices extending from Kill Devil Hills on the Outer Banks of North Carolina to Myrtle Beach, South Carolina. Cooperative also had one subsidiary, the Lumina Mortgage Company, Inc., which originated and sold residential loan mortgage products. Cooperative was wholly-owned by Cooperative Bankshares, Inc. (Bankshares), a publicly-traded, one-bank holding company. Collectively, the institution's directors and officers controlled approximately 34 percent of Bankshares.

Audit Results

Causes of Failure and Material Loss

Cooperative failed because its Board and management did not adequately manage the risk associated with the institution's aggressive real estate lending, particularly in the area of residential ADC. Weak loan underwriting, credit administration, and related monitoring practices were key causes of the loan quality problems that developed when economic conditions in the institution's lending markets deteriorated. In addition, Cooperative did not have adequate contingency funding plans to mitigate the risk associated with its heavy dependence on wholesale funding sources, particularly Federal Home Loan Bank borrowings and brokered deposits. Such funding sources, which were used to support rapid growth in the

institution's loan portfolio, became restricted when Cooperative's credit risk profile deteriorated in the fall of 2008. Also contributing to Cooperative's failure was a weak internal audit program.

By the close of 2008, weaknesses in Cooperative's risk management practices had translated into a significant decline in the quality of the institution's loan portfolio, especially its ADC loans. The provisions and losses associated with this decline depleted the institution's earnings, eroded its capital, and strained its liquidity. The North Carolina Commissioner closed Cooperative in June 2009 due to a lack of sufficient capital and liquidity to support the institution's operations.

The FDIC's Supervision of Cooperative

The FDIC, in conjunction with the North Carolina Commissioner, provided ongoing supervision of Cooperative by conducting regular on-site risk management examinations and performing offsite monitoring procedures. Through these supervisory efforts, the FDIC identified key risks in Cooperative's operations and brought these risks to the attention of the institution's Board and management in examination reports. Such risks included Cooperative's rapid loan growth and credit concentrations; weak loan underwriting, credit administration, and related monitoring practices; an inadequate internal audit program; risky funds management practices; and apparent violations of regulations and policy.

The FDIC determined that Cooperative's overall financial and operational condition was generally satisfactory prior to the November 2008 examination and did not impose an enforcement action until March 2009. The FDIC generally relied on recommendations in examination reports to address the institution's weak risk management practices identified by examiners before November 2008. In retrospect, a stronger supervisory response at earlier examinations, particularly during the July 2006 examination, to address Cooperative's weak risk management practices may have been prudent. Such a response could have included lowering the institution's supervisory rating and/or issuing an enforcement action that required the Board and management to (1) commit to a written plan and timeline for addressing the key risks identified by the examiners and (2) provide the FDIC with written progress reports detailing the institution's actions relative to the plan. Earlier and stronger supervisory action may have influenced Cooperative's Board and management to constrain its excessive risk-taking, 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 Cooperative.

Management Response

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response to a draft of this report on January 6, 2010. The DSC Director's response reiterates key causes of Cooperative's failure discussed in the report and notes that the Board failed to implement risk management recommendations made by regulators. The response also cites supervisory activities, discussed in the report, that were undertaken to assess and address risks at the institution prior to its failure.

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

DATE: January 6, 2010

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

/Signed/
FROM: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of Cooperative Bank, Wilmington, North Carolina* (Report No. MLR-10-013)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Cooperative Bank (Cooperative), Wilmington, North Carolina. The North Carolina Office of the Commissioner of Banks (North Carolina Commissioner) closed the institution on June 19, 2009, and named the FDIC as receiver. On July 6, 2009, the FDIC notified the OIG that Cooperative's total assets at closing were $973.6 million and the estimated loss to the Deposit Insurance Fund (DIF) was $215.2 million. As of December 11, 2009, the estimated loss to the DIF had increased to $216.1 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 Cooperative's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of Cooperative, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Cooperative's failure and the FDIC's efforts to ensure that Cooperative's Board of Directors (Board) and management operated the institution in a safe and sound manner.

[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 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.

The report does not 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 FDIC 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 terms; and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

Cooperative was chartered in January 1898 as a mutual savings institution under the name of Cooperative Building and Loan Association. The FDIC became Cooperative's primary federal regulator in October 1992, following the institution's conversion to a state-chartered savings bank. Cooperative again changed its charter to that of a state commercial bank effective December 30, 2002. Cooperative's lending activities focused primarily on commercial real estate (CRE) and acquisition, development, and construction (ADC) of residential properties in the coastal and inland areas of eastern North and South Carolina. These lending markets, which were largely dependent on beach and summer tourism, began to experience a decline in residential building activity prior to 2008.

In addition to a main office in Wilmington, North Carolina, Cooperative operated a loan production office and 23 additional branch offices extending from Kill Devil Hills on the Outer Banks of North Carolina to Myrtle Beach, South Carolina. Cooperative also had one subsidiary, the Lumina Mortgage Company, Inc., which originated and sold residential loan mortgage products. Cooperative was wholly owned by Cooperative Bankshares, Inc. (Bankshares), a publicly-traded, one-bank holding company. Collectively, the institution's directors and officers controlled approximately 34 percent of Bankshares. Table 1 summarizes selected financial information pertaining to Cooperative for the quarter ended March 31, 2009, and for the 5 preceding calendar years.

Table 1: Selected Financial Information for Cooperative

Financial Measure	Mar-09	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets ($000s)	$966,778	$950,491	$926,359	$859,626	$745,802	$550,107
Gross Loans and Leases ($000s)	$850,109	$890,113	$825,787	$768,057	$650,695	$462,704
Total Deposits ($000s)	$768,479	$696,321	$715,458	$662,404	$570,398	$414,954
Federal Home Loan Bank (FHLB) Borrowings ($000s)	$158,058	$148,059	$123,066	$116,072	$105,077	$78,083
Brokered Deposits ($000s)	$112,340	$137,554	$82,349	$69,657	$20,659	-0-

Source: Uniform Bank Performance Reports (UBPR) and Consolidated Reports of Condition and Income (Call Report) for Cooperative.

Causes of Failure and Material Loss

Cooperative failed because its Board and management did not adequately manage the risk associated with the institution's aggressive real estate lending, particularly in the area of residential ADC. Weak loan underwriting, credit administration, and related monitoring practices were key causes of the loan quality problems that developed when economic conditions in the institution's lending markets deteriorated. In addition, Cooperative did not have adequate contingency funding plans to mitigate the risk associated with its heavy dependence on wholesale funding sources, particularly FHLB borrowings and brokered deposits. Such funding sources, which were used to support rapid growth in the institution's loan portfolio, became restricted when Cooperative's credit risk profile deteriorated in the fall of 2008. Also contributing to Cooperative's failure was a weak internal audit program.

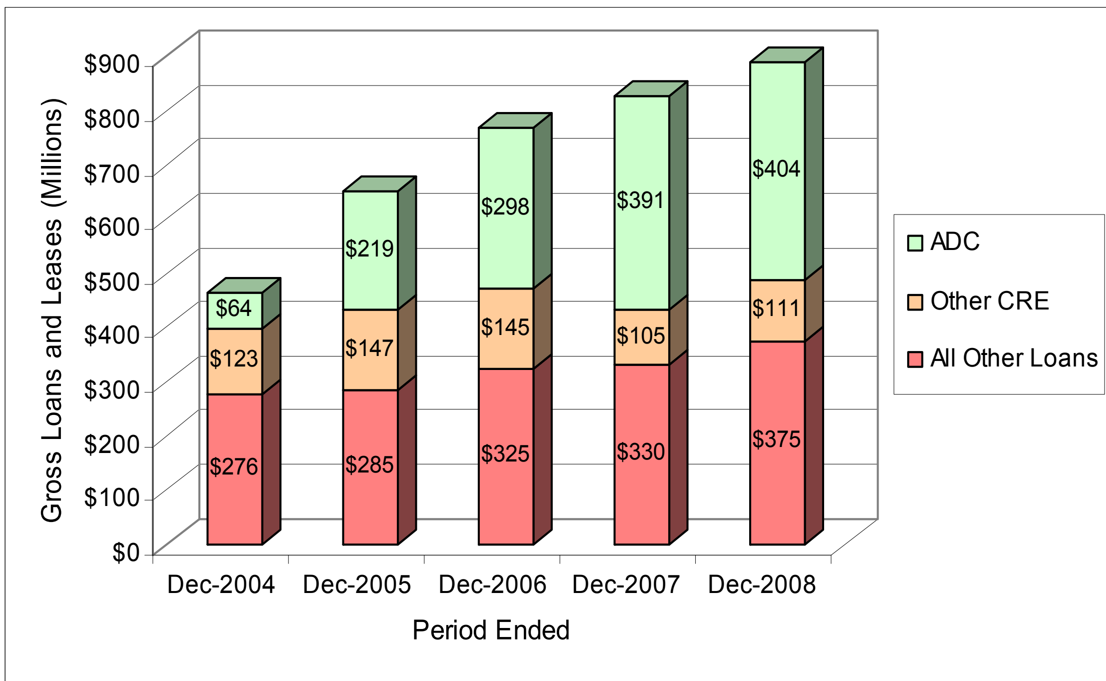
By the close of 2008, weaknesses in Cooperative's risk management practices had translated into a significant decline in the quality of the institution's loan portfolio, especially its ADC loans. The provisions and losses associated with this decline depleted the institution's earnings, eroded its capital, and strained its liquidity. The North Carolina Commissioner closed Cooperative in June 2009 due to a lack of sufficient capital and liquidity to support the institution's operations.

Rapid Growth and ADC Lending

Cooperative's lending activities focused almost exclusively on real estate. Between December 31, 2004 and March 31, 2009, the institution ranked in the 97th percentile or higher relative to its peer group[3] for concentrations in real estate loans based on average gross loans and leases. Cooperative also grew its loan portfolio at a rapid pace during this period, from approximately $463 million at the end of 2004 to $850 million by March 31, 2009. Much of this growth was fueled by ADC lending for residential properties in the coastal and inland areas of eastern North Carolina. Figure 1 illustrates the general composition and growth of Cooperative's loan portfolio in the years preceding the institution's failure. As reflected in the figure, ADC loans grew more than 6-fold during this period, from about $64 million to $404 million.

[3] Financial institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. Cooperative's peer group included institutions with assets between $300 million and $1 billion.

Figure 1: Composition and Growth of Cooperative's Loan Portfolio

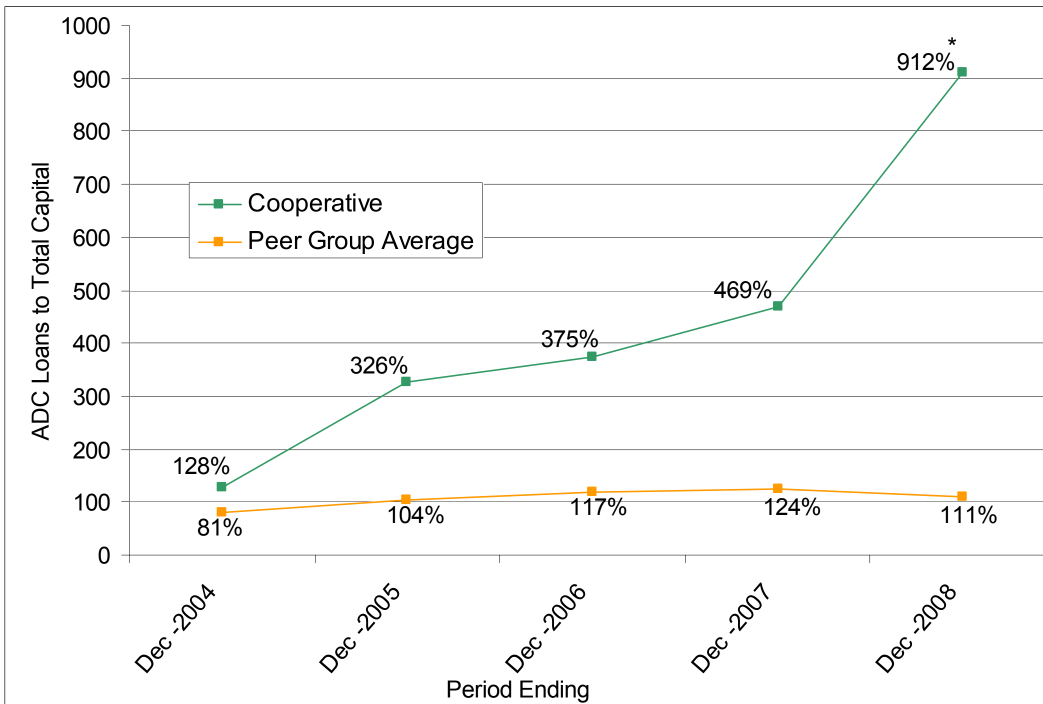


Source: Call Reports for Cooperative.

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, especially 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 (referred to in this report as 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.

As of December 31, 2007, Cooperative's non-owner occupied CRE loans represented 584 percent of the institution's total risk-based capital, well in excess of the level defined in the 2006 guidance as warranting supervisory concern. This level was also well above Cooperative's aggregate CRE lending limit as defined in the institution's loan policy. Further, Cooperative's ADC loan concentrations at year-end 2007 represented 469 percent of total risk-based capital, significantly higher than the level defined in the 2006 guidance as warranting supervisory concern. As of December 31, 2007, Cooperative ranked in the 98th percentile of its peer group for ADC loan concentrations. Figure 2 illustrates the trend in Cooperative's ADC concentration relative to its peer group in the years before its failure.

Figure 2: Cooperative's ADC Concentration Compared to Peer Group



Source: UBPRs for Cooperative.
* The sharp increase in the ADC loan concentration in December 2008 resulted from a decline in Cooperative's capital rather than growth in ADC lending.

In addition to credit concentrations, Cooperative's loan portfolio had other high-risk characteristics. According to an internal management analysis, almost 97 percent of the $432.5 million in CRE loans that Cooperative held on June 14, 2007 was secured by investment properties. Loans for investment property, such as land and vacation rental property, are considered riskier than loans secured by a borrower's permanent residence. This is because loans for investment property are more sensitive to such factors as adverse economic and real estate market conditions. In addition, more than half of Cooperative's CRE loans required interest-only payments. Such loans can be risky because they do not require principal payments and can, therefore, mask a borrower's inability to ultimately repay the loan.

Also contributing to the high-risk nature of Cooperative's loan portfolio was a speculative Residential Lot Loan Program introduced in 2002 that provided borrowers with funding to purchase lots for the purpose of building on them in the near future. In 2007, Cooperative expanded and modified this program to support an incentive that various developers were offering to buyers whereby the developer would pay the interest on the loans for a period of 18-24 months using an interest reserve account at the institution. Many of the loans under the program were approved based on minimal repayment qualifications, required no down payment, and allowed interest-only payments. Cooperative discontinued the Residential Lot Loan Program in August 2008 due to slowing lot sales, declining real estate values, and borrowers not making payments after their interest reserves were exhausted.

At the time of the September 2007 examination report, adversely classified assets totaled approximately $11.3 million, or 13 percent of Cooperative's Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL). By the November 2008 examination, adversely classified assets had jumped to almost $143 million,[4] or 182 percent of Tier 1 Capital plus the ALLL. The majority of the $143 million was comprised of ADC loans, including the entire Residential Lot Loan Program portfolio valued at $32 million (or 22 percent of total classifications). According to its Annual Report on Form 10-K filed with the Securities and Exchange Commission, Cooperative recorded a net loss of $44.5 million for the year ended December 31, 2008.

Loan Underwriting, Credit Administration, and Related Monitoring

Weak loan underwriting, credit administration, and related monitoring practices were key factors in the asset quality problems that developed when Cooperative's real estate lending markets deteriorated. Prior to 2006, examiners raised little concern in this area and considered the institution's asset quality to be strong. However, examiners identified numerous loan underwriting and credit administration weaknesses during the July 2006 examination and advised Cooperative's Board that these weaknesses were increasing the institution's risk profile. Examiners noted that these weaknesses were symptomatic of the institution's rapid loan growth and weak oversight of, and organization within, the lending function. New and repeat loan underwriting, credit administration, and related monitoring weaknesses were also identified in the September 2007 and November 2008 examinations. Examiners reported the following types of weaknesses in this area between 2006 and 2008 based on the loans they reviewed.

Loan Underwriting

- Inadequate analysis of borrower repayment capabilities (e.g., a lack of cash flow analysis, inaccurate computations of cash flow and debt service coverage ratios).
- Little or no borrower equity in real estate loans and reliance on collateral (such as the sale of real estate) as a primary source of repayment.
- Instances in which loans were made for residential lots with little or no documentation or verification of borrower income, employment, or repayment capability.
- Liberal loan renewals and extensions, such as renewing interest-only loans under the Residential Lot Loan Program multiple times for individual borrowers.
- Failure to establish and enforce appropriate loan repayment programs following payment deferrals, including the capitalization of interest on loans or providing a separate loan for the purpose of financing interest.
- Renewing credits without sufficient or current financial information.
- Not ordering, receiving, and analyzing real estate appraisals independent of the lending function.

[4] This figure includes $6.6 million in contingent liabilities.

Credit Administration

- A lack of input and oversight from the institution's Credit Administrator for new loans and credit renewals.
- Untimely updates of the institution's loan policy to reflect changes in business activities; untimely distribution of updates to the loan policy to loan officers resulting in delayed implementation of new policy requirements; and untimely Board review and approval of real estate lending guidelines in the loan policy as prescribed by Appendix A, *Interagency Guidelines for Real Estate Lending Practices,* of Part 365, *Real Estate Lending Standards*, of the FDIC Rules and Regulations.
- Inadequate definitions for internal loan risk grades (i.e., a lack of financial ratios with which to distinguish one loan grade from another).
- Instances in which loan risk grades were not changed until problems with payments occurred or extensions or renewals were requested by the borrower.
- A lack of an annual review of the institution's largest credit relationships independent of the loan origination function, including an analysis of the borrower's and guarantor's repayment capability on a global cash flow basis, an assessment of the current status of the business or project, and an evaluation of secondary sources of repayment.

Monitoring

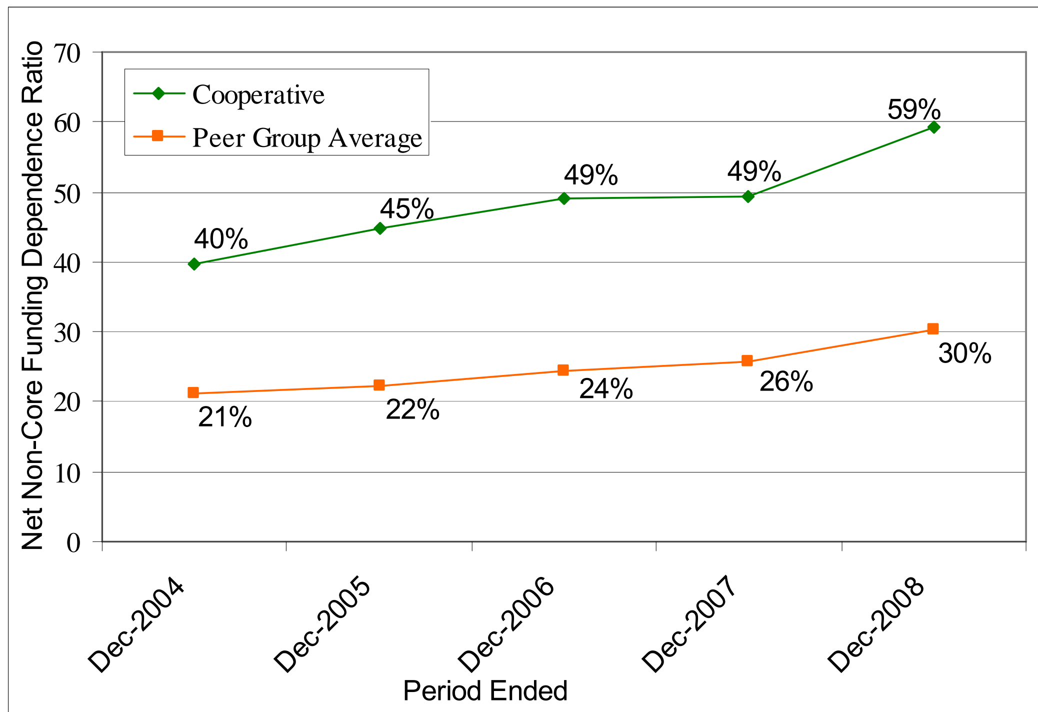
- A lack of a comprehensive monitoring and reporting process to assist the Board in assessing the overall risk of the institution's CRE lending activities and making related policy decisions. Such a process could have provided the Board with regular information on the performance and migration of loans within the portfolio as well as such detailed information as tenant- versus owner-occupied loans, secured versus unsecured loans, and the use of multiple extensions, interest reserves, and interest-only payments.
- A lack of CRE loan portfolio stress testing, such as tracking loss rates by loan category and gradually increasing loss rates to determine the resulting effect on earnings, capital, and liquidity.
- Insufficient market analysis of areas where the institution had large loan concentrations.
- An inadequate ALLL methodology.
- Underlying weaknesses identified by third-party loan reviews not addressed in a timely manner.

Apparent violations or contraventions were also noted in such as areas as (1) extending credit to insiders as prescribed in the Federal Reserve Board Regulation O; (2) conducting real estate appraisals as defined in Part 323, *Appraisals,* of the FDIC Rules and Regulations; (3) reporting loans that exceed supervisory loan-to-value limits as defined in Appendix A to Part 365; and (4) soliciting and accepting brokered deposits as defined in Part 337, *Unsafe and Unsound Banking Practices*, of the FDIC Rules and Regulations.

Reliance on Wholesale Funding Sources

In the years preceding its failure, Cooperative became increasingly dependent on wholesale funding sources, particularly FHLB borrowings and brokered deposits, to fund its loan growth and maintain adequate liquidity. The institution's management determined that borrowing or acquiring funds could be more cost-effective and expeditious than growing deposits through the institution's branch network. Figure 3 illustrates the trend in Cooperative's net non-core funding dependence ratio[5] for the years ended 2004 through 2008. Throughout this period, Cooperative's net non-core funding dependence ratio was approximately two times greater than its peer group. Cooperative also ranked in the 88th to 97th percentile of its peer group for net non-core funding dependence during this period. Such rankings indicate that Cooperative's potential volatile funding dependence was higher than that of almost all of the other institutions in its peer group.

Figure 3: Cooperative's Net Non-Core Funding Dependence Ratio Compared to Peer Group



Source: UBPR data for Cooperative.

When properly managed, wholesale funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, wholesale funding sources also present potential

[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. For purposes of this report, the terms non-core funding and wholesale funding have substantially the same meaning.

risks, such as higher costs and increased volatility. 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 economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

Examiners determined that Cooperative's liquidity and funds management practices were generally satisfactory between 2004 and 2007, as indicated by the supervisory component ratings of "2" assigned for liquidity.[6] However, examiners also expressed concern in the examination reports issued during this period regarding Cooperative's low liquidity levels and heavy reliance on wholesale funding sources. Examiners recommended in these reports that Cooperative strengthen its liquidity risk management policy and practices in a number of areas. Of note, examiners recommended in 2007 that Cooperative develop a contingency plan and incorporate the plan into the institution's liquidity management policy. However, Cooperative's actions to address the risks associated with its heavy and growing reliance on wholesale funding sources were not adequate.

In September 2008, Cooperative recorded an other-than-temporary impairment charge of $9.1 million for the stock it held in the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). As discussed more fully in the *Implementation of PCA* section of this report, the impairment charge was large enough to lower Cooperative's capital category for PCA purposes from *Well Capitalized* to *Adequately Capitalized*. As a result, the institution's access to brokered deposits was restricted, straining its liquidity. By December 2008, Cooperative's weak credit risk profile was impairing the institution's ability to access needed funds from outside sources, and regulators were requiring the institution to submit daily reports on its liquidity position.

Internal Audit Program

Deficiencies in Cooperative's internal audit program contributed to the weak risk management practices that caused the institution to fail. Internal audits are a key control for proactively identifying and remediating internal control weaknesses, including weaknesses related to loan underwriting and credit administration. The March 2004 examination report noted that Cooperative's internal audit program appeared to be understaffed for much of 2003 and, as a result, the 2003 audit schedule had not been completed. The report also noted that although a written risk assessment had been prepared by the institution's internal auditor, the assessment was not presented to the Audit Committee or used in preparing the audit schedule. The June 2005 examination report noted various weaknesses in Cooperative's internal audit program, including a lack

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[6] Pursuant to the Uniform Financial Institutions Rating System (UFIRS), federal and state regulators assign supervisory ratings to financial institutions based on the results of safety and soundness examinations and other supervisory activities. Ratings consist of a "composite" rating reflecting the institution's overall financial condition and operations and six "component" ratings 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. Ratings are assigned on a scale of 1 to 5, with 1 representing the least supervisory concern and 5 representing the greatest supervisory concern.

of proper separation of duties to ensure auditor independence. The July 2006 examination report identified a number of new and repeat deficiencies pertaining to Cooperative's audit program, including the following:

- Internal auditors were charged with both audit and operational responsibilities in several areas and reported administratively to the institution's management, diminishing their independence.
- Auditors lacked the necessary knowledge and training to effectively conduct some audits.
- Audit risk analysis and planning did not ensure that audit coverage was commensurate with risk. For example, a full commercial loan audit had not been performed since 2004 despite extensive growth in this area.
- Several audits were either not performed timely or were deficient in scope.
- Audit reports lacked a description of the scope of work performed, a determination of the underlying causes and significance of findings, and conclusions regarding the severity and pervasiveness of findings.
- The internal audit department did not track exceptions identified by outside entities, including recommendations made by regulators and other third parties, to ensure such exceptions were appropriately corrected. Of note, loan underwriting and administration weaknesses identified through an external loan review were not generally being resolved.

In the November 2008 examination, examiners noted a number of other new and repeat deficiencies pertaining to Cooperative's internal audit program. Among other things, examiners noted that Cooperative needed to develop and implement a comprehensive corporate-wide risk assessment program, enhance its audit exception tracking, better monitor corrective action plans, revise its internal audit policies, and strengthen the oversight of the Audit Committee.

The FDIC's Supervision of Cooperative

Through its supervisory efforts, the FDIC identified key risks in Cooperative's operations and brought these risks to the attention of the institution's Board and management in examination reports. Such risks included Cooperative's rapid loan growth and credit concentrations; weak loan underwriting, credit administration, and related monitoring practices; an inadequate internal audit program; risky funds management practices; and apparent violations of regulations and policy. The examination reports issued in the years preceding Cooperative's failure also contained numerous recommendations to address these and other risks identified by examiners.

As discussed more fully below, the FDIC determined that Cooperative's overall financial and operational condition was generally satisfactory prior to the November 2008 examination and did not impose an enforcement action until March 2009. The FDIC generally relied on recommendations in examination reports to address the institution's weak risk management practices identified by examiners before November 2008. In

retrospect, a stronger supervisory response at earlier examinations may have been prudent in light of the extent and nature of the institution's risk profile. Such a response could have influenced Cooperative's Board and management to constrain its excessive risk-taking during the institution's growth period. Further, it may have prompted the Board and management to take more timely and adequate action to address the concerns raised by examiners, thereby mitigating, to some extent, the losses incurred by the DIF.

Supervisory History

The FDIC, in conjunction with the North Carolina Commissioner, provided ongoing supervision of Cooperative by conducting regular on-site risk management examinations and performing offsite monitoring procedures. Table 2 summarizes key information pertaining to the on-site risk management examinations that the FDIC and North Carolina Commissioner conducted of Cooperative between 2004 until the institution's failure.

Table 2: On-site Examinations of Cooperative

Examination Date	Regulator Conducting the Examination	Supervisory Ratings	Informal or Formal Action* Taken
11/10/08	FDIC and State	555554/5	C&D
09/10/07	State	222222/2	None
07/24/06	FDIC	222222/2	None
06/20/05	State	212221/2	None
03/15/04	FDIC	212222/2	None

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for Cooperative.
* Informal enforcement actions often take the form of Bank Board Resolutions or Memoranda of Understanding. 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.

The FDIC's offsite monitoring procedures generally consisted of contacting the institution's management from time to time to discuss current and emerging business issues and using automated tools[7] to help identify potential supervisory concerns. These procedures did not identify any serious concern at Cooperative until July 2008, when an analysis of the institution's March 31, 2008 Call Report information was completed. The July 2008 analysis noted that a decline in Cooperative's real estate lending markets appeared to be negatively affecting the quality of the institution's loan portfolio. The analysis also found that the risk associated with the institution's reliance on wholesale funding sources was increasing. Because an on-site risk management examination was scheduled for the 4th quarter of 2008, examiners decided to review these risks in greater detail during the examination (versus conducting a visitation in the interim).

[7] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating (SCOR) system and the Growth Monitoring System (GMS). Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

Based on the results of the November 2008 examination, the FDIC determined that Cooperative's financial condition was critically deficient and that the probability of the institution's failure was high. Examiners assigned Cooperative a supervisory composite rating of "5" and prepared a C&D to address the institution's problems. Cooperative entered into a stipulation and consent to the issuance of a C&D on March 10, 2009. Among other things, the C&D required that the institution's Board members obtain appropriate training and increase their participation in the affairs of the institution. The C&D also required Cooperative to have and retain qualified management, reduce its credit concentrations, improve its lending policies and practices, and develop plans to strengthen its capital and funds management practices. The C&D defined specific timeframes for meeting these requirements and directed the institution to submit periodic progress reports describing its compliance.

The North Carolina Commissioner closed Cooperative on June 19, 2009, because the institution was unable to obtain adequate capital to support its operations and lacked sufficient liquidity.

Supervisory Response to Key Risks

At the time of the July 2006 examination, economic conditions in Cooperative's lending markets were favorable and the performance of the institution's assets was satisfactory. According to the July 2006 examination report, total adversely classified assets were a manageable $4 million, or 5.2 percent of Tier 1 Capital and the ALLL. In addition, these classifications were centered in the classification category of *Substandard*. Based on this information and management's agreement to address the weaknesses identified during the examination, examiners determined that the overall financial and operational condition of Cooperative was satisfactory and assigned a supervisory rating of 22222/2.

Notwithstanding the financial condition of Cooperative in 2006, the examination report also described numerous concerns related to the institution's risk management practices, including "material weaknesses" in management's oversight and administration of the institution. Such concerns, several of which are summarized below, are not consistent with the UFIRS definition of a "2" rating, which is generally defined as an institution with satisfactory risk management practices relative to its size, complexity, and risk profile.

- **Rapid growth and loan concentrations.** Examiners noted that Cooperative's loan portfolio had grown almost 60 percent during the prior 18-month period, without the benefit of an effective strategic plan. In addition, the institution had significant concentrations in both construction and land development loans and beach resort property totaling 477 percent and 226 percent of Tier 1 Capital, respectively.

- **Weak loan underwriting and credit administration.** Examiners noted that the institution's underwriting and administration practices for the construction, commercial, and CRE loan portfolios lacked consistency and appropriate

oversight. Administration and analysis were not commensurate with the size, complexity, and level of risk associated with the loans and relationships reviewed by examiners. Examiners determined that weaknesses in this area presented undue risk to the loan portfolio and increased the institution's risk profile. Examiners commented that management needed to establish prudent and standard underwriting and administration guidelines across the entire organization to foster a strong commercial credit culture.

- **Reliance on non-core funding.** Examiners noted that the institution's liquidity was strained and that management needed to adopt a more proactive role in monitoring and managing the institution's liquidity position.

- **Apparent violations or contraventions of regulations and policy.** Examiners noted nine apparent violations or contraventions pertaining to such areas as Regulation O, appraisals, lending practices, and interest rate risk management. Examiners commented that additional efforts were needed to ensure future compliance, particularly with respect to matters involving bank insiders.

- **Weak internal audit program.** Examiners noted that both the scope and quality of the institution's internal audit program needed improvement. Specifically, the institution's internal audit planning, risk analysis, and oversight was weak; the scope, frequency, and content of reports was inadequate; the tracking of exceptions identified during audits was not sufficient; and auditors had both operational and audit responsibilities in several areas, impairing their independence.

The July 2006 examination report contained a total of 64 recommendations to address the weak risk management practices that examiners had identified. Cooperative's management agreed to address the majority of these recommendations by year-end 2006. On March 7, 2007, an FDIC examiner contacted a senior management official at Cooperative to discuss the institution's progress in implementing corrective actions from the July 2006 examination. The management official advised the examiner that all of the recommendations had either been corrected or would be corrected within the timelines defined in the July 2006 report.

Examiners determined during the September 2007 examination that Cooperative had failed to correct a number of the weaknesses identified in the July 2006 report. Of note, the institution's appraisal ordering and review process continued to lack independence; a process for tracking and monitoring loan policy exceptions had not been implemented; loan file maintenance was inadequate; practices for identifying, monitoring, and controlling CRE concentration risk were not adequate; ADC loans continued to be made based on little or no equity; and the internal audit program was deficient in several areas. In addition, Cooperative's ADC loan portfolio increased by almost $75 million following the July 2006 examination, and the institution's dependence on wholesale funding sources remained high. The September 2007 examination report contained additional

recommendations to address the weak risk management practices identified by examiners.

In retrospect, the FDIC could have taken stronger supervisory action at earlier examinations, particularly during the July 2006 examination, to address Cooperative's weak risk management practices. Such action could have included lowering the institution's supervisory rating and/or issuing an enforcement action that required the Board and management to (1) commit to a written plan and timeline for addressing the key risks identified by the examiners and (2) provide the FDIC with written progress reports detailing the institution's actions relative to the plan. Among other things, the plan could have required Cooperative to reduce its ADC loan concentrations and dependence on wholesale funding sources. Had there been an enforcement action in 2006, it is more likely that the FDIC would have conducted a visitation prior to the September 2007 examination to assess Cooperative's progress in addressing examiner recommendations. Based on the results of a visitation, the FDIC may have decided to take stronger supervisory action, if appropriate. Such actions would have further elevated supervisory attention to the key risks at Cooperative.

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, *Capital Maintenance*, of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered based on an institution's capital levels. Based on the supervisory actions taken with respect to Cooperative, the FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act.

Effective September 30, 2008, Cooperative recorded an other-than-temporary impairment charge of $9.1 million for the stock it held in Fannie Mae and Freddie Mac. This charge was taken due to a decline in the market value of the stock. The impairment charge caused a reduction in Cooperative's capital, and, as a result, the institution's capital ratios fell from *Well Capitalized* to *Adequately Capitalized* as defined in Part 325. Section 29, *Brokered Deposits*, of the FDI Act and Part 337 of the FDIC Rules and Regulations prohibit institutions from accepting, renewing, or rolling over brokered deposits, absent a waiver from the FDIC. On October 2, 2008, the FDIC received a substantially complete request from Cooperative for a brokered deposit waiver.

On November 20, 2008, the FDIC formally notified Cooperative's Board that, based on its Call Report for the quarter ended September 30, 2008, the institution was considered *Adequately Capitalized* for purposes of Part 325. The notification included a reminder that Cooperative was subject to certain restrictions, including a prohibition on the acceptance, renewal, or roll-over of brokered deposits without a waiver from the FDIC and limitations on the interest rates that could be paid on deposits. Cooperative made a concerted effort in late 2008 and early 2009 to replace its maturing brokered deposits with Internet deposits. However, examiners noted instances in which the institution had accepted brokered deposits totaling $22.1 million between October 1, 2008 and December 31, 2008, in apparent violation of Part 337. Examiners brought these apparent

violations to the attention of the institution's Board in the November 2008 examination report. On December 19, 2008, Cooperative withdrew its brokered deposit waiver request.

On February 3, 2009, the FDIC notified Cooperative that, based on its Call Report for the quarter ended December 31, 2008, the institution's capital category had fallen to *Undercapitalized*. As a result, Cooperative was prohibited under section 29 and Part 337 from accepting, renewing, or rolling over brokered deposits and was required to provide the FDIC with a capital restoration plan. Table 3 illustrates Cooperative's capital levels relative to the PCA thresholds for *Well Capitalized* institutions at the close of the last 2 quarters of 2008.

Table 3: Cooperative's Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions

Capital Ratio	Well Capitalized Threshold	Sept-08	Dec-08 (Original Filing)	Dec-08 (As Amended)
Tier 1 Leverage Capital	5% or more	6.52%	5.40%	3.48%
Tier 1 Risk-Based Capital	6% or more	7.73%	6.66%	4.41%
Total Risk Based Capital	10% or more	8.99%	7.94%	5.70%

Source: UBPRs for Cooperative and section 38 of the FDI Act.

The March 12, 2009 C&D directed Cooperative to, among other things, develop a detailed capital restoration plan and achieve and maintain a Tier 1 leverage capital ratio of at least 6 percent and a total risk-based capital ratio of at least 10 percent. Cooperative provided the FDIC with a written capital restoration plan on March 24, 2009. In addition, the institution explored a number of alternatives to increase its capital ratios. Such alternatives included soliciting investors for capital, selling assets, and seeking funds from the U.S. Treasury's Troubled Asset Relief Program. However, these efforts were not successful. The FDIC subsequently determined that Cooperative's March 2009 capital restoration plan was not acceptable. The North Carolina Commissioner closed Cooperative on June 19, 2009 due to a lack of sufficient capital and liquidity to support the institution's operations.

Corporation Comments

We issued a draft of this report on December 19, 2009. DSC management subsequently provided us with additional information for our consideration. We made certain changes to the report that we deemed appropriate based on the information that DSC management provided. On January 6, 2010, the Director, DSC, provided a formal, written response to the draft report. The response is provided in its entirety as Appendix 4 of this report.

The DSC Director's response reiterates key causes of Cooperative's failure discussed in this report and notes that the Board failed to implement risk management recommendations made by regulators. The response also cites supervisory activities, discussed in the report, that were undertaken to assess and address risks at the institution prior to its failure.

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

We conducted this performance audit from October 2009 to December 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 focused on Cooperative's business operations between 2004 until its failure on June 19, 2009. Our work also included an evaluation of the regulatory supervision of the institution during this same time period.

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

- Analyzed examination reports prepared by the FDIC and North Carolina Commissioner from 2004 through 2008.

- Reviewed the following:

  - Bank data and correspondence maintained in DSC's Atlanta Regional Office and Raleigh, North Carolina, Field Office.

  - Relevant reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC's Washington, D.C. Office staff relating to the institution's failure.

  - Pertinent FDIC regulations, policies, procedures, and guidance.

    - Relevant records maintained by the institution's external auditor, Dixon Hughes PLLC of Greenville, North Carolina.

- Interviewed the following officials:

    - DSC examination staff in Washington, D.C., the Atlanta Regional Office, and Raleigh Field Office.

    - A DRR official in the Dallas, Texas Regional Office and a DRR contractor working at the institution's Wilmington, North Carolina office.

- Met with examiners of the North Carolina Commissioner's office to discuss their role in the supervision of the institution.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, examination reports, and interviews of examiners to understand Cooperative's management controls pertaining to 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 reports of examination, 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 and the FDIC Rules and Regulations. 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 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.
Annual Report on Form 10-K	An annual report required by the Securities and Exchange Commission that provides a comprehensive summary of a public company's performance. The report includes information such as company history, organizational structure, executive compensation, equity, subsidiaries, and audited financial statements, among other information.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. National banks, state member banks, and insured nonmember banks are required by the Federal Financial Institutions Examination Council to file a Call Report with the FDIC as of the close of business on the last day of each calendar quarter.
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.
Contingency Funding Plan	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency funding plans should be regularly tested and updated to ensure that they are operationally sound. DSC uses the term contingency funding plan and contingency liquidity plan interchangeably.
Federal Home Loan Bank (FHLB)	One of 12 Federal Home Loan Banks from which financial institutions in America borrow funds to finance housing, economic development, infrastructure, and jobs.
Interest Reserve Account	An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. Frequently, ADC loan budgets will include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sell-out or lease-up period.

Glossary of Terms

Term	Definition
Memorandum of Understanding	A written agreement between the FDIC and an FDIC-supervised institution considered to be of supervisory concern, but which has not deteriorated to a point warranting formal action.
Other-than-Temporary Impairment Charge	From an accounting standpoint, an "impairment" of a debt or equity security occurs when the fair value of the security is less than its amortized cost basis, i.e., whenever a security has an unrealized loss. An other than temporary impairment occurs, for example, when it is probable that an institution will be unable to collect all amounts due according to the contractual terms of the debt security not impaired at acquisition.
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 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: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*.
Substandard	One of three types of classifications used by examiners to describe adversely classified assets. The term is generally used to describe an asset that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of 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 data reported in Reports of Condition and Income submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
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
FHLB	Federal Home Loan Bank
GMS	Growth Monitoring System
OIG	Office of Inspector General
PCA	Prompt Corrective Action
SCOR	Statistical CAMELS Offsite Rating
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

Division of Supervision and Consumer Protection

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 Cooperative Bank, Wilmington, North Carolina (Assignment No. 2009-069)

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 Cooperative Bank (Cooperative) which failed on June 19, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on December 14, 2009.

Cooperative failed because its Board and management did not adequately manage the risk associated with its aggressive real estate lending, particularly in the area of residential acquisition, development, and construction (ADC) loans. When economic conditions in North Carolina began to deteriorate in mid-2008, weak loan underwriting, credit administration, and related monitoring practices resulted in a significant decline in the quality of the institution's loan portfolio, especially its ADC loans. The provisions and losses associated with this decline depleted the institution's earnings, eroded its capital and strained its liquidity. The North Carolina Office of the Commissioner of Banks (NCCOB) closed Cooperative in June 2009 because it lacked sufficient capital and liquidity to support its operations.

The Report indicates that DSC and the NCCOB conducted regular on-site examinations of Cooperative consistent with statutory requirements and further analyzed its condition utilizing various offsite monitoring tools. The Report concludes that a stronger supervisory response, particularly at the July 2006 examination, may have constrained Cooperative's excessive risk taking. At that time, FDIC made numerous recommendations to Cooperative's Board and management to improve its risk management practices. When Cooperative's Board and management failed to implement those recommendations, DSC implemented a formal enforcement action more directly supervising Cooperative's Board.

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