Office of Inspector General

February 2009
Report No. AUD-09-003

Material Loss Review of First Priority Bank, Bradenton, Florida

AUDIT REPORT

Office of Audits

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OIG

Federal Deposit Insurance Corporation

Report No. AUD-09-003 **February 2009**

Material Loss Review of First Priority Bank, Bradenton, Florida

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of First Priority Bank (FPB), Bradenton, Florida. On August 1, 2008, the State of Florida, Office of Financial Regulation (OFR), closed FPB and named the FDIC as receiver. On August 19, 2008, the FDIC notified the OIG that FPB's total assets at closing were $241 million, and the estimated loss to the Deposit Insurance Fund (DIF) was $72 million.

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

Background

FPB was a state-chartered nonmember bank insured on December 8, 2003. As a de novo bank for its first 3 years in operation, FPB was subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency. With five branches in Florida, FPB engaged principally in traditional banking activities within its local marketplace, which experienced a significant economic downturn starting in 2006. FPB had no holding company, subsidiaries, or affiliates.

FPB's assets consisted principally of commercial real estate (CRE) loans, including a significant concentration in residential acquisition, development, and construction (ADC) loans. The FDIC has recognized the increased risk that CRE loans present to financial institutions and has issued guidance that describes a risk management framework to effectively identify, measure, monitor, and control CRE concentration risk. That framework includes effective oversight by bank management, including the Board of Directors (BOD) and senior executives, and sound loan underwriting, administration, and portfolio management practices.

Audit Results

FPB failed primarily due to bank management's aggressive pursuit of asset growth concentrated in high-risk CRE loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls. Resulting losses severely eroded FPB's earnings and capital, and negatively impacted liquidity, leading to the bank's failure and a material loss to the DIF.

Management. FPB's Board of Directors (BOD) did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. In addition, the BOD did not ensure that corrective actions were implemented in response to examiner and auditor recommendations. Further, FPB developed a business plan governing its activities; however, the plan was not kept current or followed. Although rapid asset growth, declining asset quality, and poor earnings further increased liquidity risk, bank management did not put into place the necessary controls for liquidity management, including an adequate contingency liquidity plan (CLP).

Asset Quality. FPB's CRE/ADC loans were concentrated in a rapidly growing local marketplace. A significant portion of the loan portfolio included high-risk terms, such as high loan-to-value ratios, interest-only basis with balloon payments, and interest reserves used to capitalize interest expense. However, FPB did not follow sound loan underwriting standards and administration practices, including those pertaining to: (1) effectively identifying loan portfolio risk, (2) obtaining current appraisals and financial statements on borrowers and guarantors, (3) ensuring appropriate use and control over interest reserves, and (4) providing appropriate reports to the BOD on loan concentrations, speculative lending, and interest reserves. Also, FPB did not maintain a sufficient allowance for loan and lease losses (ALLL). As asset quality declined and losses were recognized, FPB's liquidity position became critical, and earnings and capital were eroded.

Supervision. The FDIC and OFR conducted timely examinations of FPB. Additionally, the FDIC provided oversight through its off-site monitoring process and accelerated examinations as a result of identified deficiencies. As a result of the November 2006 examination, the FDIC delayed its approval of three FPB branch applications until FPB provided information on how the bank would address examination concerns. As a result of the September 2007 examination, and after various OFR and FPB discussions regarding the bank's condition and proposed regulatory actions, the FDIC, in conjunction with the OFR, took supervisory action in February 2008 to address management's failure to implement corrective actions in response to audit and/or examiner concerns. Such concerns included, but were not limited to, inadequate management oversight, poor asset quality, the need to increase capital and improve earnings, an inadequate ALLL, noncompliance with laws and regulations, and an outdated liquidity policy. Further, in March and May 2008, the FDIC notified FPB of applicable restrictions under PCA when FPB fell below the well capitalized category, and in June 2008, the FDIC issued a PCA Directive. The FDIC has authority to take a wide range of supervisory actions. In the case of FPB, however, supervisory actions were not always timely and effective in addressing the bank's most significant problems.

The FDIC has taken steps to improve its supervisory review of business plans, oversight of financial institutions that have CRE loan concentrations and use interest reserves, and CLPs. However, FPB's loan documentation and administration deficiencies should have warranted greater concern during the 2006 examination. Specifically, during that examination, FPB was in a de novo status; the loan portfolio had begun to deteriorate and was highly concentrated in high-risk CRE/ADC loans; loan administration issues, identified as early as the FDIC's 2004 examination, were uncorrected or in need of improvement; ALLL was inadequate; and FPB's risk profile was increasing. Greater concern regarding FPB's loan documentation and administration deficiencies could have led to elevated supervisory attention and earlier supervisory action.

The FDIC OIG plans to issue a summary report on the material loss reviews it is conducting and will make appropriate recommendations related to the failure of FPB and other FDIC-supervised banks at that time.

Management Response

DSC provided a written response to the draft report. DSC agreed with the OIG's conclusions regarding the causes of FPB's failure and resulting material loss and the supervisory activities related to FPB. DSC also agreed that the results of the November 2006 examination related to FPB's loan documentation and administration deficiencies should have warranted greater supervisory action.

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

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DATE: February 18, 2009

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

/Signed/
FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of First Priority Bank, Bradenton, Florida* (Report No. AUD-09-003)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of First Priority Bank (FPB), Bradenton, Florida. On August 1, 2008, the State of Florida, Office of Financial Regulation (OFR), closed FPB and named the FDIC as receiver. On August 19, 2008, the FDIC notified the OIG that FPB's total assets at closing were $241 million, and the estimated loss to the Deposit Insurance Fund (DIF) was $72 million.

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

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

[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.

contains a glossary of terms. The FDIC's response to the draft of this report is contained in Appendix 3. Acronyms used in the report are listed in Appendix 4. This report presents the FDIC OIG's analysis of FPB's failure and the FDIC's efforts to require FPB's management to operate the bank in a safe and sound manner. The FDIC OIG is performing similar analyses regarding the failure of other FDIC-supervised financial institutions. A planned capping report will summarize our observations on the major causes, trends, and common characteristics of failures resulting in a material loss to the DIF. Recommendations in the capping report will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

FPB was a state-chartered nonmember bank, which received approval to open for business on March 27, 2003 subject to certain conditions by the OFR. The bank was insured by the FDIC effective December 8, 2003. FPB, which was headquartered in Bradenton, Florida:

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

FPB did not have a holding company, subsidiaries, or affiliates. FPB's local marketplace was, at one time, characterized by rapidly appreciating real estate values. However, real estate values experienced a significant downturn, causing severe deterioration in FPB's asset value, excessive operating losses, and severely eroded capital, and the real estate construction industry was negatively impacted.

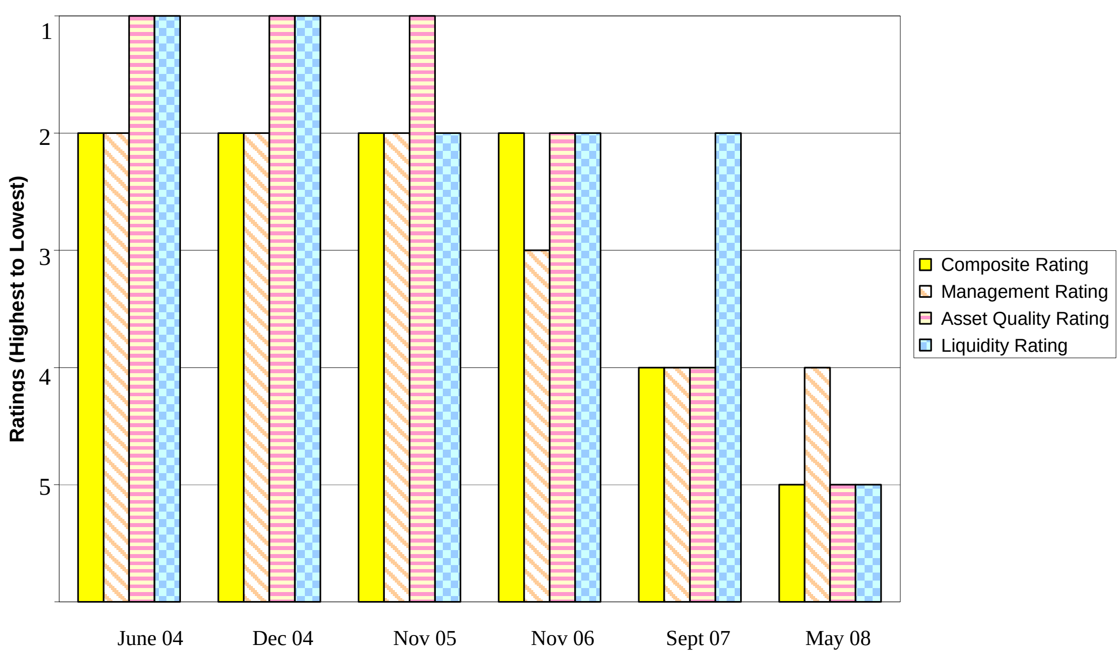
DSC's Atlanta Regional Office (ARO) and OFR alternated safety and soundness examinations of FPB, conducting six examinations from June 2004 through May 2008.[3] DSC also conducted a visitation concurrently with an OFR examination during June 2004 and another visitation during August 2007. At the September 2007 examination, FPB's

[3] The FDIC Report of Examination (ROE) for the May 5, 2008 examination was a draft report and was not officially issued to FPB.

composite rating was downgraded to 4,[4] indicating unsafe and unsound practices or conditions and a distinct possibility of failure if such conditions and practices were not satisfactorily addressed and resolved. As a result of the May 2008 examination, FPB's composite rating was downgraded to 5, indicating extremely unsafe and unsound practices or conditions; critically deficient performance, often with inadequate risk management practices; and great supervisory concern. Institutions in this category pose a significant risk to the DIF and have a high probability of failure.

Further, with respect to selected component ratings, as indicated in the figure below, at the November 2006 examination, FPB's management rating was downgraded to 3, and asset quality was downgraded to 2. At the following September 2007 examination, FPB's asset quality ratings were downgraded to 4. As a result of the May 2008 examination, examiners downgraded FPB's asset quality and liquidity ratings to 5.

FPB's Composite, Management, Asset Quality, and Liquidity Ratings



Source: ROEs for FPB.

To address examination concerns, including apparent violations of laws and regulations, inadequate risk management controls, and other safety and soundness issues, the OFR and the FDIC jointly issued a Memorandum of Understanding (MOU) in February 2008, and the FDIC issued a PCA Directive to FPB in June 2008. Additionally, in February

[4] 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.

2008, the FDIC notified FPB that the Corporation considered the bank to be in "troubled condition" and added the institution to the FDIC's formal problem bank list.

Details on FPB's financial condition, as of June 2008, and for the 5 preceding calendar years follow in Table 1.

Table 1: Financial Condition of FPB

	30-Jun-08	31-Dec-07	31-Dec-06	31-Dec-05	31-Dec-04	31-Dec-03
Total Assets ($000s)	$258,610	$262,563	$245,343	$140,550	$63,165	$11,136
Total Deposits ($000)	$226,698	$231,389	$211,019	$124,566	$55,735	$2,941
Total Loans ($000s)	$189,108	$207,872	$192,699	$122,618	$44,771	$199
Net Loans and Leases Growth Rate	-9.43%	3.61%	55.75%	175.51%	NA	NA
Net Income (Loss) ($000s)	($12,448)	($18,997)	($546)	$19	($961)	($432)
Loan Mix (% of Avg. Gross Loans):						
All Loans Secured by Real Estate	**84.77%**	**82.32%**	**85.90%**	**90.34%**	**86.07%**	**44.22%**
Construction and Development	34.53%	31.11%	22.99%	19.32%	19.06%	0.00%
CRE - Nonfarm/ nonresidential	30.71%	32.28%	44.37%	49.46%	42.74%	0.00%
Multifamily Residential Real Estate	3.04%	2.22%	1.71%	3.01%	5.04%	0.00%
1-4 Family Residential – excluding Home Equity Lines of Credit	8.77%	8.34%	7.05%	6.10%	6.24%	44.22%
Home Equity Loans	7.72%	8.37%	9.78%	12.46%	12.97%	0.00%
Construction and Industrial Loans	11.76%	15.80%	13.17%	8.62%	12.05%	51.76%
Adverse Classifications Ratio	403%	129%	16%	0%	0%	0%

Source: Uniform Bank Performance Report (UBPR) and ROEs for FPB.

RESULTS IN BRIEF

FPB failed primarily due to bank management's aggressive pursuit of asset growth concentrated in high-risk CRE loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls. Resulting losses severely eroded FPB's earnings and capital, and negatively impacted liquidity, leading to the bank's failure and a material loss to the DIF. Specifically:

Management. FPB's Board of Directors (BOD) did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. In addition, the BOD did not ensure that corrective actions were implemented in response to examiner and auditor recommendations. Although FPB developed a business plan governing its activities, the plan was not kept current or followed. Further, FPB rapidly expanded branch and lending operations without sufficient attention to associated risk management controls. Although rapid asset growth, declining asset quality, and poor earnings further increased liquidity risk, bank management did not put into place the necessary controls for liquidity management, including an adequate contingency liquidity plan (CLP).[5]

Asset Quality. FPB's CRE/ADC loans were concentrated in a rapidly growing local marketplace. A significant portion of the loan portfolio included high-risk terms, such as high loan-to-value ratios, interest-only with balloon payments, and interest reserves used to capitalize interest expense. However, FPB did not follow sound loan underwriting standards and administration practices, including those pertaining to: (1) effectively identifying loan portfolio risk; (2) obtaining current appraisals and financial statements on borrowers and guarantors; (3) ensuring appropriate use and control over interest reserves; and (4) providing appropriate reports to the BOD on loan concentrations, speculative lending, and interest reserves. Also, FPB did not maintain a sufficient allowance for loan and lease losses (ALLL). As asset quality declined and losses were recognized, FPB's liquidity position became critical, and earnings and capital were eroded.

Supervision. The FDIC and OFR conducted timely examinations of FPB. Additionally, the FDIC provided oversight through its off-site monitoring process and accelerated examinations as a result of identified deficiencies. As a result of the November 2006 examination, the FDIC delayed its approval of three FPB branch applications until FPB provided information on how the bank would address those examination concerns. As a result of the September 2007 examination, and after various discussions between OFR and FPB regarding the bank's condition and proposed regulatory actions, the FDIC, in conjunction with the OFR, took supervisory action in February 2008 to address management's failure to implement corrective actions in response to audit and examiner concerns. Such concerns included, but were not limited to, inadequate management oversight, poor asset quality, the need to increase capital and improve earnings, an inadequate ALLL, noncompliance with laws and regulations, and an outdated liquidity policy. Further, in March and May 2008, the FDIC notified FPB of applicable restrictions under PCA when FPB fell below the well capitalized category, and in June 2008, the FDIC issued a PCA Directive. The FDIC has authority to take a wide range of supervisory actions. In the case of FPB, however, supervisory actions were not always timely and effective in addressing the bank's most significant problems.

The FDIC has taken steps to improve its supervisory review of business plans, oversight of financial institutions that have CRE loan concentrations and use interest reserves, and CLPs. However, FPB's loan documentation and administration deficiencies should have warranted greater concern as a result of the 2006 examination. Specifically, during that examination, FPB was in a de novo[6] status; the loan portfolio had begun to deteriorate and was highly concentrated in high-risk ADC loans; loan administration issues, identified as early as the FDIC's 2004 examination, were uncorrected or in need of

[5] DSC uses the terms contingency liquidity plan, liquidity contingency plans, and contingency funding plans interchangeably. For purposes of this report, we use the term contingency liquidity plans.
[6] De novo institutions are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency.

improvement; ALLL was inadequate; and FPB's risk profile was increasing. Greater concern regarding FPB's loan documentation and administration deficiencies could have led to elevated supervisory attention and earlier supervisory action.

MANAGEMENT

Examinations in 2004 and 2005 resulted in a 2 rating for FPB management. At subsequent examinations, the rating was progressively downgraded, indicating deficient BOD and management performance, risk management practices that were inadequate, and excessive risk exposure. By 2006, the bank's problems and significant risks had been inadequately identified, measured, monitored, or controlled and required immediate action by FPB's BOD and management to preserve the safety and soundness of the institution. In addition, FPB rapidly expanded the bank's branch operations without regard to loan documentation and administration deficiencies and the inadequacy of other risk management controls.

Ineffective BOD and Management

Examiner concerns with FPB's BOD and management were noted at the bank's examinations conducted in 2004 and 2005, including concerns related to excessive growth; noncompliance with laws and regulations and the OFR and FDIC final orders regarding the bank's charter and deposit insurance approval; and FPB's business plan.[7] Many of those issues continued throughout the bank's existence. FPB examinations showed a continuing pattern of inadequate risk management for the loan portfolio, beginning with the first examination in June 2004; growing severity regarding the lack of loan documentation; inadequate loan administration; and significant loan portfolio deterioration, culminating in an increasing risk profile for the institution. The loan documentation and administration deficiencies were repeated and compounded as noted in the 2005 through 2008 examinations. Table 2, which follows, provides examples of examiner comments and recommendations related to FPB's BOD and management.

[7] The FDIC's amended order granting deposit insurance required that FPB operate within the parameters of the bank's business plan submitted to the FDIC and that FPB notify DSC's Regional Director of proposed major deviations or material changes 60 days before consummation of the change.

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

Examiner Comments	Examination and Visitation Dates						
	June 2004	Dec 2004	Nov 2005	Nov 2006	Aug 2007*	Sept 2007	May 2008
Overall conclusion on BOD and management performance							
• Satisfactory	✓	✓	✓				
• Improvement needed and failure to adequately identify, measure, monitor, and/or control risks				✓	✓	✓	✓
Compliance with laws and regulations							
• Apparent violations	✓	✓	✓	✓	✓	✓	✓
• Noncompliance with the OFR Final Order or FDIC Final Order of Approval for Deposit Insurance	✓	✓					
Growth of FPB operations							
• Loan growth was aggressive, significant, or faster than anticipated	✓	✓		✓	✓	✓	✓
• Loan portfolio was concentrated in CRE/ADC high-risk loans		✓		✓	✓	✓	✓
• Loan growth far exceeded deposit growth			✓				
• Rapid growth in bank operations, including branch operations, with inadequate monitoring				✓	✓	✓	✓
Loan documentation and administration							
• Inadequate reporting on concentration by collateral types, industry, and geographic locations	✓			✓	✓		
• Inadequate documentation of appraisal reviews and approval of loans, and/or inconsistent documentation included in loan files	✓		✓				
• Deficient loan administration, loan portfolio monitoring systems, or concentration policies		✓	✓		✓		✓
• Inadequate financial information on borrowers and documentation of real estate liens		✓					
• Inadequate cash flow analyses for the loan underwriting process			✓				
• Inadequate risk management controls, including inadequate audit oversight				✓	✓	✓	✓
• Inadequate documentation of loan deficiencies and follow-up activities			✓				
• Deterioration of asset quality, including increases in adversely classified items				✓	✓	✓	✓
• Inadequate methodology for determining the ALLL	✓				✓	✓	✓
• Inadequate ALLL				✓	✓	✓	✓
• Inadequate attention to, and implementation of, examiner and/or auditor recommendations				✓	✓	✓	✓
• Inadequate staffing of loan department or management succession plan				✓	✓	✓	
• Asset quality negatively affected by economic downturn or potential adverse effect identified				✓	✓	✓	✓
Earnings							
• Improvement needed	✓			✓	✓	✓	✓
• Significant operating losses identified				✓	✓	✓	✓
Liquidity							
• Strong or satisfactory	✓	✓	✓	✓	✓	✓	
• Adequate reserves or funding sources to address anticipated funding needs	✓	✓		✓			

Examiner Comments	Examination and Visitation Dates						
	June 2004	**Dec 2004**	**Nov 2005**	**Nov 2006**	**Aug 2007***	**Sept 2007**	**May 2008**
• Additional collateral required for lines of credit with national banks and the FHLB due to the bank’s declining financial condition							✓
• Inadequate sources for funding due to the bank’s troubled financial condition, negative publicity, and the potential for a run on deposits							✓
Examiner recommendations							
• Become more familiar with applicable laws and regulations/repeat violations reported	✓	✓	✓	✓			✓
• Revise operating plans, obtain BOD approval and document in BOD minutes	✓						
• Evaluate the increasing risk associated with continued aggressive growth			✓	✓			
• Improve reports on concentrations, speculative lending, and/or interest reserves	✓			✓	✓		
• Develop and implement a comprehensive ADC and investment loan risk management system						✓	
• Improve practices and procedures in loan administration and internal routines and controls			✓	✓		✓	✓

Source: FPB ROEs issued by OFR and the FDIC and the FDIC’s August 2007 visitation results.
* In August 2007, the FDIC conducted a visitation, which accelerated OFR’s 2007 examination and identified substantial deterioration in FPB’s condition.

Risk Management. FPB did not ensure that adequate risk management controls were implemented and followed and did not implement corrective actions in a timely manner to adequately address deficiencies identified by examiners and auditors related to the bank's inadequate risk management controls for loan documentation, administration, and monitoring.

FPB's loan policy stated that the bank would avoid concentrations of credit, defined as loans or certain groups of loans which, when aggregated, exceeded 25 percent of the bank's equity capital and reserves, including combinations of loans secured by types of collateral that were particularly vulnerable to volatile market conditions. However, in contravention of this policy, FPB's BOD and senior management focused on a strategy of aggressively growing the bank's assets, consisting primarily of high-risk CRE loans with a heavy concentration in ADC loans. As early as the December 2004 examination, FPB's CRE loans totaled nearly 65 percent of the loan portfolio. Total assets from June 2004 through June 2008 grew, on a cumulative basis, over 516 percent from $41 million to over $258 million, with the majority of the growth occurring in 2004 through 2006—during FPB's de novo period. However, given such growth and an increased risk profile that resulted from FPB's BOD and management's decision to pursue such lending activity, the bank did not adequately identify, measure, monitor, and report regularly to the BOD on these concentrations, speculative lending, and interest reserves.

The September 2007 ROE noted that while FPB had made some improvement, the bank's overall portfolio risk identification, measuring, monitoring, and reporting practices were ineffective. In fact, inadequate loan documentation and administration were also identified and reported by examiners in the bank's last examination report dated May 2008. Specifically, the FDIC's May 2008 examination concluded that during FPB's brief history, the bank had operated with an aggressive loan growth strategy that included poorly structured and underwritten real-estate-dependent loans in a highly competitive market. The decline in real estate values and construction activity had resulted in many projects being delayed or abandoned. Nevertheless, because the bank's risk management and loan administration practices were inadequate, the BOD was slow to recognize the increasing risk in FPB's loan portfolio and lending program as residential real estate values started to decline.

Inadequate Actions for Apparent Violations of Regulatory Requirements. Beginning with the bank's June 2004 examination, examiners cited FPB for apparent violations of laws and regulations related to loans to directors and officers, appraisals, and minimum capital requirements; contraventions of interagency policies on supervisory loan-to-value limits and ALLL; and noncompliance with regulatory orders. According to the DSC *Risk Management Manual of Examination Policies* (Examination Manual), an institution's BOD and management should implement appropriate policies and procedures to effect compliance, detect instances of noncompliance, institute corrective measures, and provide adequate training and retraining of officers and employees to prevent future infractions. Further, the Examination Manual states that it is important that the correction of all apparent violations of laws and regulations be instituted promptly, regardless of their perceived importance.

With respect to the regulatory orders, FPB did not comply with specific conditions included in the following:

- The FDIC's Final Order of Approval for Deposit Insurance related to significantly deviating from the bank's business plan by exceeding loan growth projections during the first year of operation without prior notification to the FDIC.

- OFR Final Order related to (1) notifying the OFR of FPB's proposed employment of individuals as executive officers or equivalent positions, (2) providing copies of employment agreements or contracts, and (3) submitting a revised business plan and financial projections to OFR within the first 6 months of FPB's operations.

FPB's BOD and management failed to implement adequate controls to ensure compliance with laws, regulations, and other regulatory requirements, even though apparent violations were reported in each of the bank's six examinations.

Deviations from FPB's Business Plan. Contrary to the FDIC's final order approving FPB's deposit insurance, FPB significantly deviated from its business plan by quickly exceeding financial projections and budgets and realizing net losses during its de novo period that were significantly higher than planned losses. In addition, FPB disregarded loan documentation and administration controls that were outlined in its business plan. Further, the bank's business plan indicated that the bank planned to make commercial, residential, and construction loans, including real estate acquisitions and improvements; however, the plan did not provide information regarding FPB's intentions to concentrate its loan operations in CRE/ADC loans, which can present high risks for institutions, and rapidly expand by opening five branch offices. FPB also did not follow certain risk management controls outlined in its business plan that impacted its lending policy and practices.

Proposed financial institutions are expected to submit business plans with their initial applications for federal deposit insurance. According to the *FDIC Statement of Policy on Applications for Deposit Insurance*, and in compliance with sections 5 and 6 of the FDI Act, the FDIC must be assured that the proposed institution does not present an undue risk to the DIF. The FDIC expects that proposed institutions will submit a business plan commensurate with the capabilities of its management and the financial commitment of the incorporators. Any significant deviation from the business plan within the first 3 years of operation—the de novo phase—must be reported by the insured depository institution to the primary federal regulator before consummation of the change. Business plans that rely on high-risk lending, a special-purpose market, or significant funding from sources other than core deposits, or that otherwise diverge from conventional bank-related financial services, require specific documentation as to the suitability of the proposed activities for an insured institution. Similarly, additional documentation of a business plan is required where markets to be entered are intensely competitive or economic conditions are marginal. Business plans also include information on projected financial data for a 3-year period.

Soon after FPB's opening, examiners concluded that the bank had significantly deviated from its business plan and initial financial projections, and FPB's asset growth had quickly exceeded the revised October 2003 projections. FPB's July 2004 revised business plan and financial projections reflected the significant deviations which included, but were not limited to (1) increased asset growth, (2) expanding branch office operations, and (3) an additional capital infusion. In addition, FPB did not follow risk management controls outlined in the bank's business plan related to its loan portfolio (see Table 3 for examples).

Table 3: FPB's Business Plan Compared to FPB's Actions

FPB's Business Plan	FPB's Actions
Follow a conservative lending policy that permitted prudent risks.	FPB pursued a liberal lending strategy and relaxed underwriting practices that included aggressively growing the bank's CRE/ADC loan portfolio and expanding branch operations.
Commit funds to asset products with low loan risk.	FPB aggressively pursued high-risk CRE/ADC loans that significantly increased the bank's risk exposure and ALLL and negatively impacted earnings and capital.
Exercise care and good judgment in underwriting loans (including underwriting loans on the basis of the borrower's ability to repay the loan from the cash flow of the business, obtaining appraisals at the time loans are originated, maintaining an adequate ALLL, and limiting the level of classified assets to less than 1 percent of the assets).	FPB's BOD and management failed to ensure that appropriate loan documentation and administration risk management controls were implemented and followed, took actions that negatively affected the quality of the bank's assets, failed to maintain an adequate ALLL, and allowed adversely classified assets to exceed 400 percent of total capital prior to failure.

Source: FPB's business plan, ROEs, and OIG analysis.

FPB Branch Offices. FPB's original business plan was conservative; however, the bank soon departed from its plan and embarked on an aggressive growth/branching strategy. Of particular note is the bank's decision to rapidly expand branch operations. As indicated in Table 4, applications for three FPB branch offices were submitted, accepted, and approved by the FDIC after its November 2006 examination began, during which significant examiner concerns regarding the bank's compliance with laws and regulations, loan administration and documentation, CRE/ADC concentration, inadequate ALLL, inadequate BOD and management performance, deviations from the banks business plan, and weak earnings were reported.

Table 4: FPB Application History and Examiner Concerns

FPB Branch	Application Status			Branch Office Opened	Significant Examination Concerns
	Submitted	Accepted	Approved		
1	8/4/2004	8/20/2004	8/30/2004	2/23/2006	Violations of laws and regulations. Loan administration and documentation deficiencies. Earnings were weak and resulted in a net loss.
2	10/4/2005	10/6/2005	11/4/2005	7/5/2006	Violations of laws and regulations. Loan administration and documentation deficiencies. Examiners downgraded liquidity.
3	12/27/2006	2/1/2007	3/16/2007	4/30/2007	Violations of laws and regulations. Significant loan documentation and administration deficiencies. Decline in FPB's asset quality, with noticeable loan portfolio deterioration. FPB's rapid growth not adequately monitored or managed by the BOD and management, and the BOD and management needed to improve performance.
4	12/27/2006	2/1/2007	3/16/2007	5/21/2007	
5	3/20/2007	5/3/2007	6/4/2007	7/16/2007	

Source: An FDIC *Supervisory History* memorandum and ROEs for FPB.

During the November 2006 examination, the examiner noted that aggressive branching plans underscored the need to significantly improve the loan review and administration functions. Further, during the examination, the bank's chief loan officer resigned, creating additional loan monitoring challenges. Within its short existence, FPB opened five branch offices and three loan production offices (LPO) without adequate consideration of examiner concerns regarding the bank's loan documentation and administration and other risk management control weaknesses and inadequate monitoring and management of the bank's growth. In addition, FPB's additional branch offices increased the bank's overhead costs; placed additional strain on earnings, which had been historically weak; and contributed to the bank's increasing reliance on non-core deposits to fund its asset growth.

Lack of a Comprehensive CLP. FPB did not implement sound liquidity risk management controls that included a comprehensive CLP. As a result, when FPB's asset quality severely deteriorated, the bank's liquidity position was impacted by negative publicity related to the bank's financial condition. According to the

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

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

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

The FDIC issued Financial Institution Letter—FIL-59-2003—entitled, *Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management*, dated July 23, 2003, which provides interagency guidance on the need for financial institutions to develop CLPs, in addition to other liquidity risk management controls, and informs depository institutions that a contingency plan should be part of the bank's liquidity management program. In addition, the Examination Manual includes 13 suggested elements that should be included in CLPs. However, FPB's CLP included only 3 of those 13 elements. FPB's CLP identified sources of funding but did not identify the conditions related to their use and circumstances where the institution might use them. For example, the CLP did not:

- define responsibilities and decision-making authority,
- include an assessment of the possible liquidity events that an institution might encounter,
- detail how management would monitor for liquidity events, and
- identify and assess the adequacy of contingent funding sources.

Further, FPB's CLP was not diversified to allow consideration of potential providers of funds and the underlying stability, availability, and flexibility of funding sources.

FPB's BOD and management had failed to implement adequate controls to monitor the bank's liquidity risk. The September 2007 examination identified significant deterioration in FPB's loan portfolio, a high level of adverse classifications, significant downgrades in loans from the bank's internal watch list, and an inadequate ALLL. After October 2007, FPB's asset liability committee failed to monitor, strategize, and otherwise plan for FPB's liquidity needs, even though the bank's financial condition was severely deteriorating.

FPB's loan portfolio deterioration became even more critical after the bank's September 2007 examination, which identified significant deterioration in FPB's asset quality. FPB's liquidity position was monitored solely by the chief financial officer, who managed the bank's liquidity by focusing almost exclusively on maintaining sufficient liquidity to avert a crisis. As FPB's financial position continued to deteriorate due to poor asset quality, the bank's liquidity position was adversely affected. Specifically, FPB's net interest margin declined, and earnings and capital positions were adversely affected. In addition, FPB was required to pledge investment securities to secure the bank's lines of credit. Further, the bank lacked adequate controls and potential sources to address liquidity shortfalls and the resultant crises, and negative publicity impacted the bank's liquidity position.

Regulatory Supervision Related to Management

According to the Examination Manual, the quality of management is probably the single most important element in the successful operation of a bank. The BOD is responsible for formulating sound policies and objectives for the bank, effective supervision of its affairs, and promotion of its welfare, while the primary responsibility of senior management is implementing the BOD's policies and objectives in the bank's day-to-day operations. Also according to the manual, the capability and performance of management and the BOD is rated based upon, but not limited to, an assessment of compliance with laws and regulations.

Generally, FPB provided written responses to each examination and promised corrective actions, and examiners generally followed up on any recommendations at the next examination. However, in response to the 2006 examination, the FDIC followed up with FPB between examinations, requiring FPB to provide information on addressing the 2006 examination loan administration and documentation issues and improving earnings (both management and earnings were rated 3 at the 2006 examination). In its response to the FDIC on January 29, 2007, FPB stated it had taken steps to hire new management, including a chief credit officer and commercial loan portfolio manager; increased the loan department staff; and initiated actions to improve loan administration. Although the FDIC accepted FPB's response, FPB failed to implement actions to sufficiently address the 2006 examination results and to prevent the continued deterioration of FPB's financial condition.

In addition, according to the DSC *Case Manager Procedures Manual*, the risk posed by any particular institution is a function of the business plan pursued, management's competency in administering the institution's affairs, and the quality and implementation of risk management programs. Regarding FPB's business plan, examiner concerns seemed to focus on the bank's financial projections and did not include an assessment of FPB's planned business strategy and risk management controls compared to the bank's actual practices. Although DSC required FPB to provide updated financial and budget data, DSC did not require FPB to provide a revised business plan that addressed the bank's concentrations in CRE/ADC loans that presented high risks to the bank and the bank's plan to mitigate such risk through appropriate loan documentation, administration, and lending strategies.

Regarding FPB's branch office activities, examiners downgraded FPB's management and earnings ratings from 2 to 3 and downgraded asset quality from 1 to 2 as a result of the 2006 examination. According to the DSC *Case Manager Procedures Manual*, an application can be removed from expedited processing if DSC determines that the bank's application presents significant supervisory concerns, including a management rating of 3. Accordingly, after the November 2006 examination, the FDIC removed three FPB branch applications (for FPB's third, fourth, and fifth branch offices) from the expedited approval process because the BOD and management had not:

- staffed loan operations and review properly while focusing on rapid growth, which had resulted in numerous administrative deficiencies and inadequate portfolio monitoring systems;

- adequately funded the ALLL;

- provided sufficient internal audit oversight; and

- implemented examiner recommendations in a timely manner.

The FDIC's decision-making process for FPB's branch applications included an assessment of FPB's financial data and branching strategy. In addition, pursuant to sections 5 and 6 of the FDI Act, DSC officials evaluated FPB's applications for branch offices to conclude on the:

- financial history and condition of FPB,
- adequacy of FPB's capital structure,
- future earnings prospects,
- general character and fitness of bank management,
- risk to the DIF, and
- convenience and needs of the community to be served.

DSC officials also evaluated the applications to determine whether FPB's corporate powers were consistent with the purposes of the FDI Act.

Before the FDIC approved FPB's applications for its third and fourth branch offices, the FDIC proactively required FPB to respond to the November 2006 examination deficiencies, submit revised financial projections reflecting the proposed branches, and discuss the bank's earnings improvement plan. In its response, FPB projected net income of $263,000, which DSC considered realistic. In addition, FPB stated that in August 2006, FPB had hired a chief credit officer, who was expected to have a positive impact on credit administration and portfolio monitoring systems, and hired a new senior lender in December 2006. Additionally, the BOD stated its commitment to correct the weaknesses noted in the ROE and provided corrective action plans to address the weaknesses.

Regarding FPB's application for its fifth branch office, the FDIC requested FPB to provide a copy of the bank's strategic/business plans for 2007 and 2008, including assumptions and branching plans; supporting assumptions for the 2007 budget; and copies of CRE loan concentration reports provided to the BOD. The FDIC reviewed FPB's revised financial projections, which included the three branches in 2007 and a conservatively maintained ALLL throughout the 2-year period and reflected a nominal loss of $28,000 in 2007 and net income of $693,000 in 2008. However, from the time FPB responded to the FDIC's concerns related to the third and fourth branch offices to its response for the fifth branch, the bank's net income projections for 2007 had changed from $263,000 to a projected net loss of $28,000—a decrease of $291,000.

Nevertheless, the FDIC concluded that:

- FPB's business plan anticipated that future earnings opportunities would be enhanced by accessing new markets and lowering its cost of funds with new retail deposits generated by the branches;

- the bank's CRE loan report reflected improved monitoring; and

- FPB's capital was sufficient to support the business plan with projected Tier 1 Leverage Capital Ratios of 10.3 percent at the end of 2007 and 8.4 percent at the end of 2008.

Additionally, FPB committed to the FDIC that it had no additional branching plans through 2008. However, soon after FPB's last branch office opened on July 16, 2007, the FDIC's offsite analysis and follow-up visitation conducted in July and August 2007, respectively, identified significant deterioration in FPB's financial condition, earnings, and asset quality; and loan documentation and administration deficiencies, indicating ineffective corrective actions to address prior examiner concerns and FPB's deficient risk management controls. Further, the FDIC assessed FPB's branch applications based on statutory requirements and delayed application approvals; however, the actions taken and promised by FPB ultimately did not resolve examiner concerns, overall operational deficiencies, or earnings performance issues (see Table 2).

Previous guidance related to business plans did not provide a definition of significant deviations; accordingly, in June 2008, DSC's ARO issued guidance for determining what constitutes a major deviation or material change in business plans for de novo institutions during the first 3 years of operation. That guidance states that examiners should consider whether changes have occurred in growth levels, asset and liability mix or products offered, and plans for branch offices or LPOs.

Although FPB had not developed a comprehensive CLP, examiners did not recommend that the bank review and revise its CLP to adequately address the 13 plan elements listed in the Examination Manual. FPB had not developed controls that could have identified the specific circumstances under which secondary sources of funds should be used and the manner in which those funds would be used to provide liquidity for the bank.

Subsequent to FPB's failure, DSC issued additional guidance related to liquidity risk and CLPs. The FDIC's *Liquidity Risk Management* guidance, dated August 26, 2008, urges the financial institution BOD to establish a formal CLP that establishes quantitative liquidity risk guidelines. The guidance also states that CLPs should identify the institution's liquidity risk profile and the types of stress events that may be faced including, but not limited to, a deterioration in asset quality, becoming less than well capitalized, the need to fund unplanned asset growth, loss of access to market funding sources, and the impact of negative press coverage. The guidance also reiterates many of the CLP elements that FPB's CLP did not include, as discussed earlier.

ASSET QUALITY

FPB's asset quality was rated 1 at its 2004 and 2005 examinations. At subsequent examinations, FPB's asset quality rating was progressively downgraded, indicating that the bank's level of risk and problem assets were significant and inadequately controlled and subjected the bank to potential losses that threatened the viability of the institution. By the May 2008 examination, examiners concluded that FPB's asset quality or credit administration practices were critically deficient and presented an imminent threat to the institution's viability.

FPB's asset quality deteriorated as total adversely classified items increased to over $65.7 million in 2008. In particular, loan classifications significantly increased, from $5.7 million in 2006 to over $60.1 million in 2008. Corresponding increases in the FPB's adversely classified loans and ALLL were also significant (see Table 5). At the November 2006 examination, adversely classified loans represented 15.66 percent of capital, and by May 2008, adversely classified loans totaled more than 403 percent of capital.

Table 5: FPB Asset Classifications and ALLL

	Asset Quality (Dollars in Thousands)					
	Asset Classifications				**Analysis of ALLL**	
Examination Date	**Substandard**	**Doubtful**	**Loss**	**Total Classified Items**	**ALLL Computed by FPB**	**Increase in ALLL Required by Examiners**
June 04	0	0	0	0	$80	0
Dec 04	0	0	0	0	$398	0
Nov 05	0	0	0	0	$1,201	0
Nov 06	$4,649	$25	$1,061	$5,735	$2,640	$1,100
Sept 07	$41,474	0	$3,232	$44,706	$3,606	$6,100
May 08	$58,240	$392	$7,086	$65,718	$8,468	$3,400

Source: ROEs for FPB.

In addition to identification of the $5.7 million in adversely classified assets at the 2006 examination, examiners identified another $4.6 million in assets as "Special Mention," referring to loans that had potential weaknesses that deserved management's close attention and, if left uncorrected, could result in deterioration of the status of those assets.

Examiner Concerns and Recommendations Regarding Asset Quality

Examiner concerns regarding FPB's asset quality related to its concentration in high-risk CRE/ADC loans and the bank's lack of adequate loan documentation and administration (see Table 6, which follows). A significant portion of the CRE/ADC loan portfolio included high-risk terms, such as high loan-to-value ratios, an interest-only basis with balloon payments, and interest reserves used to capitalize interest expense.

Table 6: Examples of Examiner Comments and Recommendations Regarding FPB's Asset Quality

Examiner Comments*	Examination Dates					
	June 2004	**Dec 2004**	**Nov 2005**	**Nov 2006**	**Sept 2007**	**May 2008**
Overall conclusion on FPB asset quality						
• Strong or satisfactory	✓	✓	✓	✓		
• BOD and management were slow to identify and manage problem loans					✓	✓
CRE and ADC concentrations						
• Concentration developing or already developed		✓	✓	✓	✓	✓
• Increasing risk profile based on loan portfolio affected by an economic downturn				✓	✓	✓
Adverse classifications						
• Noticeable loan quality deterioration and significant increases in adverse classifications and ALLL				✓	✓	✓
Assessment of risk management practices						
• Risk management, monitoring, and reporting practices ineffective or inadequate				✓	✓	
• Loan documentation and/or underwriting standards needed improvement	✓	✓	✓	✓	✓	✓
• ALLL methodology adequate				✓		
• ALLL methodology inadequate					✓	✓
• ALLL adequately funded		✓	✓			
• ALLL not adequately funded				✓	✓	✓
• Inadequate attention to examiner and auditor recommendations				✓	✓	✓
• Loan policy lacking specific parameters for limiting concentrations and promoting portfolio diversity				✓	✓	
• Inaccurate internal watch list that did not include all adversely classified loans					✓	
Examiner recommendations						
• Document the review of appraisals and/or include appraisal reports in loan files	✓			✓	✓	✓
• Provide comprehensive reports on loan concentration by collateral type, industries, or geographic boundaries or establish concentration limits	✓			✓	✓	
• Document and/or improve the ALLL methodology and allowance	✓			✓	✓	✓
• Improve internal reporting on interest reserves, speculative lending, and loans exceeding supervisory loan-to-value guidelines				✓	✓	
• Ensure real estate loans in excess of the supervisory loan-to-value limits do not exceed total capital		✓		✓	✓	✓

Source: ROEs for FPB.

* Refer to Table 2 for additional examples of examiner comments and recommendations related to FPB's asset quality, including those for the FDIC's August 2007 visitation.

Concentration in CRE and ADC Loans

FPB's concentration in CRE loans was first noted during the FDIC's December 2004 examination when those loans comprised 65 percent of the loan portfolio. DSC ROEs and examination work papers documented that steady and rapid increases in CRE-related exposure followed as indicated below.

- March 2005. CRE loans totaled more than 228 percent of Tier 1 capital.

- September 2006. CRE exposure totaled 127 percent of Tier 1 Leverage Capital. Including multi-family and other non-farm nonresidential loans increased the bank's risk exposure to 342 percent of Tier 1 Leverage Capital. Further, examiners noted that the degree of exposure was likely underreported because the bank recognized that an undetermined amount of loans might need to be reclassified as CRE loans.

- June 2007. CRE loans represented 388 percent of total capital. Of that amount, ADC loans comprised 49 percent of all CRE loans and were equal to 190 percent of total capital—nearly double the benchmark for further supervisory review. Classified assets were 129 percent of Tier 1 Capital and the ALLL, which was deficient by $6.1 million. Additionally, loans totaling a substantial $15.2 million were downgraded and adversely classified, and loans totaling an additional $9 million were not on FPB's internal watch list.

- May 2008. The level of concentration was extremely high given the fact that the bank was critically undercapitalized and the amount of CRE loans was significant.

On December 12, 2006, the federal banking agencies issued joint guidance on CRE lending entitled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* According to the guidance, the FDIC and the other federal banking agencies acknowledged that a concentration in CRE loans, coupled with weak loan underwriting and depressed CRE markets, has contributed to significant loan losses.[8]

However, FPB focused and concentrated its loan portfolio in CRE/ADC loans, which increased its level of risk, and failed to ensure that adequate risk management controls were developed and implemented. Examiners recommended several actions to mitigate the bank's CRE risk. However, bank management failed to implement actions to adequately address those recommendations, and asset quality continued to decline. Further, beginning with the November 2006 examination, and continuing through the May 2008 examination, examiners identified a high level of adverse classifications along with significant downgrades of classified loans, an inadequate ALLL methodology, and

[8] The FDIC also issued FIL 22-2008 on March 17, 2008, entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, which re-emphasized the importance of strong capital and ALLL and loan risk-management practices for state nonmember institutions with significant CRE and construction and development loan concentrations.

inadequately funded ALLL. As asset quality declined and losses were properly recognized, FPB's liquidity position became deficient, and earnings and capital were eroded.

Interest Reserves. FPB did not have appropriate controls related to the use and reporting of interest reserves. FPB's December 8, 2003 loan policy stated the bank should include provisions in the loan agreement that provide for the discontinuation of funding of the interest reserve in the event the project falls behind projected performance goals. However, FPB did not always follow this policy in that management extended or re-funded the interest reserves for many loans. In addition, FPB did not maintain complete records on the extent and number of loans funded with interest reserves or the extent of loans for which interest reserves had been funded multiple times. Through reconstruction of FPB records, the OIG determined that FPB used about $8.9 million in interest reserves to fund loans. Of that amount, $4.5 million (about 51 percent) was associated with FPB's adversely classified loans. The use of interest reserves helped to mask the deterioration of these loans.

DSC has issued guidance on the use of interest reserves. In November 2007, the ARO issued guidance entitled, *Identification and Analysis of Interest Reserves at Risk Management Examinations*. In April 2008, DSC issued examiner guidance reiterating the November 2007 ARO guidance. In addition, in June 2008, DSC issued guidance to examiners and FDIC-supervised financial institutions on the use of interest reserves that describes the use of interest reserves in ADC lending, examines the risk this underwriting practice could present, and identifies "red flags" that should alert lenders to potential problems at each stage of the ADC cycle.

Allowance for Loan and Lease Losses. FPB's methodology for determining the ALLL did not comply with interagency policy. According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (FIL-105-2006), dated December 13, 2006, each institution must analyze the collectibility of its loans and maintain an ALLL at a level that is appropriate and determined to be in accordance with Generally Accepted Accounting Principles (GAAP).[9] An appropriate ALLL covers estimated loan losses on individually evaluated loans that are determined to be impaired as well as estimated loan losses inherent in the remainder of the loan and lease portfolio.

[9] *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (FIL-105-2006), dated December 13, 2006. The federal banking agencies originally issued a 1993 policy statement that described the responsibilities of the BOD and management of banks and savings associations and of examiners regarding the ALLL. The December 2006 policy reiterated that guidance and made the policy applicable to credit unions. Further, the policy provides key concepts and requirements pertaining to the ALLL included in GAAP and existing supervisory guidance and describes the nature and purpose of the ALLL; the responsibilities of BODs, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound loan grading system.

Although the November 2006 examination concluded that FPB's ALLL methodology was adequate, examiners recommended that FPB increase the ALLL by $1.1 million due to adversely classified loans that totaled $5.7 million. However, in subsequent examinations, examiners' conclusions regarding the adequacy of the ALLL methodology changed. Specifically, examiners concluded that FPB's ALLL methodology did not comply with interagency guidance included in FIL-105-2006. Examiners recommended significant increases in FPB's ALLL to compensate for FPB's inaccurate methodology and to provide for the increased amount of adversely classified loans examiners identified.

- At the follow-up visitation in August 2007, adversely classified items totaled $45 million, representing 129 percent of Tier 1 Capital and ALLL. Of the $45 million, $15.2 million represented adversely classified loans that were downgraded from FPB's internal watch list, and $9 million represented adversely classified loans that bank management had not included on the watch list. As a result, the ALLL had a shortfall of $6.1 million.

- The May 2008 examination determined that adversely classified assets, including $60.1 million in loans, had increased to $65.7 million, representing 403 percent of Tier 1 Capital and ALLL, resulting in a shortfall of $3.4 million in ALLL.

Examiners determined that shortages in ALLL could be attributable to the bank's slow identification of problem loans and to an ineffective ALLL methodology that failed to follow the interagency policy on ALLL and GAAP. As FPB's assets deteriorated and the need to substantially increase the ALLL became apparent, earnings and capital were significantly impacted. FPB reported net losses for almost each year of operation (see Table 7).

Table 7: FPB Net Income or Loss (Dollars in Thousands)

2003	2004	2005	2006	2007	2008*
($432)	($961)	$19	($546)	($18,997)	(12,448)

Source: FPB December 31st UBPR data for each year, except as noted for 2008.
* Data is as of June 30, 2008 UBPR Report.

According to the FDIC's documentation on FPB's applications, revised financial projections provided by FPB reflected that FPB expected a nominal loss of $28,000 for 2007 and showed a net income of $693,000 for 2008. However, as indicated in Table 7, the financial projections were grossly inaccurate. Further, during the exit meeting with OFR examiners after the bank's September 2007 examination, FPB officials attributed the bank's earnings problem to the bank's strategy for new branch offices at a time when the real estate market began to decline and stated that the lack of earnings was a "self-inflicted" problem.

Regulatory Supervision Related to Asset Quality

FPB's loan administration deficiencies should have warranted greater supervisory concern during the November 2006 examination when FPB was still in a de novo status and had experienced significant growth in its loan portfolio between 2004 and 2006. In addition, FPB exhibited the following risk factors that DSC has determined to be associated with de novo institutions:

- inexperienced management and/or high turnover,
- weak oversight by the BOD,
- rapid asset growth, and
- a dominant BOD member.

FPB's BOD and management aggressively grew its loan portfolio although the bank had not adequately identified, measured, monitored, or controlled risks; including implementing actions to address examiner concerns related to loan documentation and administration deficiencies. Specifically, as a result of the 2006 examination, DSC concluded that FPB's loan portfolio had begun to deteriorate noticeably and was highly concentrated in CRE/ADC loans, which presented a higher risk for the bank; loan administration issues, which had been identified as early as the 2004 examination and by internal auditors in 2004 and 2005, remained uncorrected or in need of improvement. DSC also concluded that FPB's risk profile was increasing.

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

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

- Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure.

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

At the November 2006 FDIC examination, examiners assessed the condition of the bank's loan portfolio and concluded that asset quality was satisfactory; however, noticeable loan portfolio deterioration had occurred since the prior examination. Adversely classified loans exceeded \$5.7 million, which represented 15.66 percent of Tier 1 Leverage Capital. In addition, loans cited as Special Mention for their underwriting deficiencies exceeded \$4.6 million. Collectively, \$10.3 million in criticized loans represented 28.31 percent of Tier 1 Leverage Capital. Examiners also concluded that, while the level and severity of classified loans was low in relation to capital, noticeable loan portfolio deterioration had occurred since the last examination. Examiners also noted that the emergence of substandard and loss loans in the bank's third year of operations was unusual and reflected increased significance given the elevated and increasing risk profile of the institution and the bank's pattern of weak underwriting practices. As a result, examiners made several recommendations to improve FPB's risk management for CRE/ADC loans (see Tables 2 and 6).

In addition, at the 2006 examination, although examiners concluded that FPB's methodology for determining the adequacy of the ALLL was adequate, examiners also concluded that, based on the significant amount of adversely classified loans, FPB would need to increase the ALLL by up to $1.1 million by December 31, 2006.

Further, at the November 2006 examination, examiners noted that risk management policies and practices for the loan function were not adequate and identified numerous loan administration shortcomings that appeared to be systemic in nature. Despite modest improvements since the prior examination related to loan documentation and administration weaknesses, the examiners emphasized the need for further improvement. For example, the ALLL was inadequate, a significant number of loan files were found to be deficient, and exceptions to supervisory loan-to-value guidelines reported to the BOD each quarter were found to improperly exclude certain loans.

However, the examiners' evaluation of FPB's asset quality at the November 2006 examination was based on the total of adversely classified loans—15.66 percent of Tier 1 Leverage Capital—and did not consider the systemic nature of deficiencies in loan documentation and administration or a qualitative assessment of the bank's elevated CRE risk exposure, which the examiner concluded might adversely impact the bank's financial condition. DSC officials stated that the loan documentation and administration deficiencies identified during the 2006 examination were addressed in the examiners' decision to downgrade FPB's management to 3 and asset quality to 2.

After the November 2006 examination, DSC's offsite monitoring of FPB's condition in July 2007 reflected a significant increase in past due and nonaccrual loans and additional charge-offs based on March 31, 2007 financial data. Although FPB's earnings continued to be weak, the bank was scheduled to open three branch offices in 2007. As a result of these concerns, the DSC regional office requested the DSC field office to conduct a targeted visitation to review the actions taken by FPB management to:

- correct the deficiencies noted in the prior FDIC examination,
- analyze loans charged off and increases in past due loans,
- review earnings, and
- review risk management practices over the bank's significant real estate exposure.

Shortly after the visitation began, the examiner noted significant deterioration in the loan portfolio that prompted the OFR to accelerate its scheduled full-scope examination, which was conducted in September 2007. The FDIC also issued a problem bank memorandum in January 2008.

On February 8, 2008, the OFR and the FDIC jointly issued an MOU[10] to FPB. The MOU, among other things, required FPB to:

- Increase the BOD's participation in the supervision of the bank's operations.
- Obtain qualified management and staffing for the loan department.
- Improve asset quality.
- Amend loan and other policies to establish:
    - stronger, appropriate loan concentration guidelines for all loan types;
    - procedures and criteria for approving loan policy exceptions;
    - guidelines for establishing and monitoring interest reserves, appropriate loan-to-value limits, and determining realistic collateral values;
    - specific criteria for the use of interest-only loans with balloon payments;
    - comprehensive ADC loan risk management systems; and
    - requirements for obtaining current financial statements and/or tax returns for borrowers and guarantors and ensuring insurance coverage on any collateral.
- Develop a written plan to monitor concentrations of risk in relation to total capital that included: appropriate limits for concentrations of credit by industry, product line, type of collateral, and borrower; and establish limits and identify the risks associated with the concentration of CRE loans.

Although the 2008 MOU addressed issues related to FPB's asset quality and loan administration and documentation, greater concern during the 2006 examination, regarding the severity of these deficiencies and FPB's history of not adequately addressing these issues for more than 2 years, could have led to elevated supervisory attention and earlier supervisory action.

IMPLEMENTATION OF PCA

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

The FDIC evaluated FPB's capital position; assigned capital component ratings; included capital-related provisions in informal and formal actions, including a PCA Directive, in

[10] The OFR and FDIC initially considered issuing a Cease and Desist Order (C&D) against FPB. However, in the decision-making process regarding the type of supervisory action to impose, OFR considered actions taken by FPB's new management to address the bank's financial condition and asset quality-related issues and decided to issue an MOU rather than a C&D. The MOU included the same provisions that had been proposed for the C&D.

accordance with regulatory guidelines; and provided PCA notification letters. The FDIC's November 2005 examination concluded that FPB's declining trend in capital ratios was a result of the bank's asset growth and that, in order to remain well capitalized given its significant growth rate, FPB had raised additional capital through a second stock offering. In fact, FPB's rapid growth from 2003 to 2006—the bank's de novo period—was supported by significant stock issuances to raise more than $35 million in capital, as shown in Table 8 below.

Table 8: FPB Capital Stock Issuances

	2003	2004	2005	2006	2007
	($000)				
Common Stock Issued	$8,616	$144	$8,192	$18,345	$0
Cumulative	$8,616	$8,760	$16,952	$35,297	$35,297

Source: An FDIC *Supervisory History* memorandum.

As of December 31, 2007, DSC officials concluded that FPB's capital position had deteriorated and, considering FPB's decline in capital, excessive level of problem assets, significant concentration in CRE loans relative to capital, and questionable earning prospects, the institution's capital was considered to be marginal. On February 8, 2008, the FDIC and OFR jointly issued an MOU. The MOU included provisions related to capital and required FPB to:

- Submit, within 60 days, a capital plan for maintaining a Tier 1 Capital ratio of no less than 8 percent. The plan, at a minimum, was to address FPB's current and future capital requirements, including the maintenance of adequate risk-based and Tier 1 Capital ratios; the volume of FPB's adversely classified and problem assets; the bank's anticipated level of earnings; and the source and timing of additional funds to fulfill future ALLL and capital requirements.

- Develop a written capital plan acceptable to the OFR and FDIC to enable the bank to monitor concentrations of risk in relation to total capital.

In its Consolidated Report of Condition and Income (Call) Report, dated December 31, 2007, FPB reported that it held brokered deposits totaling $13.5 million. On March 14, 2008, the FDIC issued a letter restricting FPB's use of brokered deposits because FPB's capital category fell below the well capitalized category. In response to the FDIC's letter, FPB notified the FDIC that it had not rolled over or renewed any brokered deposits.

On May 1, 2008, the FDIC notified FPB that based on its March 31, 2008 Call Report data, FPB was considered to be significantly undercapitalized for PCA purposes. The FDIC required FPB to develop and submit a capital restoration plan (CRP) within 45 days of April 30, 2008. The plan was to provide information on:

- steps the bank would take to become adequately capitalized;
- levels of capital to be attained during each year in which the plan would be in effect;
- how the bank would comply with the restrictions and requirements related to asset growth restrictions and prior approval of acquisitions, new branches, and new lines of business; and
- types and levels of activities in which the bank would engage.

The bank submitted its CRP on June 6, 2008, which the FDIC reviewed and requested FPB to update. On June 25, 2008, the FDIC issued a PCA Directive. Mandatory actions included the submission of another CRP and restrictions on asset growth, acquisitions, new activities, new branches, payment of dividends or making any other capital distribution, or payment of management fees.

PCA's focus is on capital, and capital can be a lagging indicator of an institution's financial health. In addition, the use of PCA Directives depends on the accuracy of capital ratios in a financial institution's Call Reports. FPB's capital remained in the well capitalized to adequately capitalized range long after its operations had begun to deteriorate because of problems related to management, asset quality, risk management controls, and net losses. In particular, the ALLL was significantly underfunded which overstated capital and underreported the deterioration of the loan portfolio.

FPB's efforts to comply with the MOU to improve the bank's condition and raise additional capital proved unsuccessful. Further, by the time FPB's capital level fell below the required threshold necessary to implement PCA, the bank's condition had deteriorated to the point at which the institution could not raise additional needed capital, estimated to total $30 million, through its BOD or find other investors to assist in capitalizing the bank.

CORPORATION COMMENTS

On February 12, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 3 of this report. In its response, DSC agreed with the OIG's conclusions regarding the causes of FPB's failure and the resulting material loss to the DIF, and DSC's supervisory activities related to FPB. DSC also agreed that the November 2006 examination results related to the loan documentation and administration deficiencies should have warranted greater supervisory action.

DSC also stated that it has undertaken a number of initiatives related to the supervision of financial institutions that have high-risk lending activities, including concentrations in CRE and/or the use of interest reserves. Additionally in December 2008, DSC conducted on-site visitations of certain financial institutions that resulted in downgraded ratings and initiating corrective programs.

It should be noted the OIG did not conclude on specific examination ratings or supervisory actions. Rather, we evaluated the FDIC's overall supervision of the institution. In this regard, we concluded that greater supervisory concern was warranted as a result of the 2006 examination due to the deficiencies identified, the de novo status of the institution, and its increasing risk profile.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

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

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

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

Scope and Methodology

The scope of this audit included an analysis of FPB's operations, which opened on December 8, 2003, until its failure on August 1, 2008. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period and the application process for FPB.

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

- Analyzed examination and visitation reports and examination work papers prepared by the FDIC and the State of Florida's Office of Financial Regulation examiners from 2004 to 2008.

- Reviewed the following:
  - Bank data and correspondence maintained at the DSC's ARO and Tampa Field Office.

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

  - Records of the bank's external auditor at the offices of Hacker, Johnson & Smith, in Tampa, Florida; and CPA Associates in Bradenton, Florida.

    - Bank records maintained by DRR in Dallas, Texas.

    - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:
    - DSC management in Washington, D.C.; Atlanta, Georgia; and Tampa, Florida.

    - DRR officials at the Dallas Regional Office.

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

- Met with officials from the State of Florida's Office of Financial Regulation in Tallahassee, Florida, to discuss their historical perspective of the institution, its examinations, state banking laws, and other activities regarding the state's supervision of the bank.

- Researched various banking laws and regulations, including State of Florida banking laws.

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

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

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

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

GLOSSARY OF TERMS

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an ROE. Adversely classified assets are allocated on the basis of risk (lowest to highest) to three categories: • Substandard, • Doubtful, and • Loss.
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.
Loan Loss Reserve also called Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL level that is adequate to absorb the estimated credit 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.
Memorandum of Understanding (MOU)	An informal corrective administrative action for institutions considered to be of supervisory concern but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, an MOU is to be considered for all institutions rated a composite 3.
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 individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The Federal Financial Institutions Examination Council produces the UBPR quarterly, from Call Report data submitted by banks, for use by banking supervisors, bankers, and the general public.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Supervision and Consumer Protection

February 12, 2009

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, *Material Loss Review of First Priority Bank* (Assignment No. 2008-038)

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 First Priority Bank (FPB), Bradenton, Florida, which failed on August 1, 2008. This memorandum represents the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received January 23, 2009.

We are pleased that the OIG generally agrees with the results of DSC's supervisory processes. The OIG found that the FDIC and the State of Florida, Office of Financial Regulation conducted timely examinations of FPB; the OIG agreed with the ratings assigned at each regulatory examination; and the OIG found that DSC properly exercised its responsibilities under Prompt Corrective Action and followed its internal policies in processing applications for the establishment of branches.

Second, we agree with the OIG's assessment that FPB failed primarily due to management's aggressive pursuit of asset growth concentrated in high-risk Commercial Real Estate (CRE) loans with inadequate loan underwriting and lack of other loan portfolio and risk management controls. The resulting loan losses severely eroded FPB's earnings and capital, leading to the bank's failure and a material loss to the Deposit Insurance Fund.

Lastly, we agree, in hindsight, with the OIG's assessment that credit administration deficiencies identified by examiners should have warranted supervisory action at the 2006 examination. Examiners had identified weaknesses at the prior two examinations and made recommendations for improvements, yet management did not fully implement these recommendations. The identified weaknesses were then exacerbated by rapidly deteriorating economic conditions, most notably in the Construction and Development (C&D) sector.

In light of the economic deterioration and its impact on FPB and other similarly situated institutions, DSC undertook a number of initiatives of which we wish to make OIG aware:

- In May 2007, DSC launched a call program for institutions with significant residential construction, subprime mortgage, or other higher-risk lending activities. A goal of the program was to identify problems early and initiate appropriate supervisory responses.
- DSC examiners authored an article titled *Managing Commercial Real Estate Concentrations* in the Winter 2007 edition of ***Supervisory Insights***. This article was prompted by rapid CRE loan growth in the banking industry and elaborates on the authors' field examination experience with the principles set forth in the 2006 CRE Guidance, issued by the FDIC, the Federal Reserve Board, and the Office of the Comptroller of the Currency on December 6, 2006, titled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (2006 CRE Guidance).

- In January 2008, DSC conducted a horizontal review of CRE lending practices. Outcomes of the review included CRE exposures and performance identifiable from offsite sources, results from onsite file reviews of the largest loans at the most exposed banks, standardized CRE reporting systems, and underwriting trends.

- The FDIC issued a Financial Institution Letter on March 17, 2008, titled *Managing Commercial Real Estate Concentrations in a Challenging Environment* (2008 CRE FIL). The 2008 CRE FIL re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices and recommended several risk management processes to help institutions manage CRE and C&D concentrations. This FIL also articulated the FDIC's concern about interest reserves for C&D loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

- In July 2008, DSC developed a comprehensive CRE guidance repository in a Regional Director memorandum which updates and re-emphasizes CRE loan examination procedures in view of more challenging market conditions, particularly in C&D lending.

- DSC examiners authored an article titled *A Primer on the Use of Interest Reserves* in the Summer 2008 edition of ***Supervisory Insights***.

- In August 2008, DSC issued revised examination instructions to collect information on market conditions and practices at banks potentially exposed to significant CRE concentration risk. These data will provide real-time information relating to CRE markets across the country and FDIC-supervised institutions operating in those markets and will be available for supervisory purposes.

- In September 2008, DSC made available to examiners a resource that provides for more detailed information on commercial and residential real estate markets and transactions. These data, which include estimated property values, comparable sales, leasing rates, capitalization rates, vacancy rates, title/deed documents, and other related information, may aid examiner analysis of market conditions during examinations of banks with significant CRE concentrations.

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- In November and December 2008, examiners conducted on-site visitations of certain banks in Georgia, Florida and California with high C&D concentrations. Ratings were downgraded as appropriate and corrective programs initiated.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ARO	Atlanta Regional Office
BOD	Board of Directors
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
C&D	Cease and Desist
CFO	Chief Financial Officer
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
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
FIL	Financial Institution Letter
FPB	First Priority Bank
GAAP	Generally Accepted Accounting Principles
LPO	Loan Production Office
MOU	Memorandum of Understanding
OFR	Office of Financial Regulation
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institution Rating System