Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-001

Material Loss Review of FirstCity Bank, Stockbridge, Georgia

October 2009

Office of Inspector General

Executive Summary

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Why We Did The Audit

On March 20, 2009, the Georgia Department of Banking and Finance (DBF) closed FirstCity Bank (FirstCity), Stockbridge, Georgia, and named the FDIC as receiver. On April 6, 2009, the FDIC notified the Office of Inspector General (OIG) that FirstCity's total assets at closing were $291.3 million and the estimated loss to the Deposit Insurance Fund (DIF) was $101.8 million. As of August 7, 2009, the estimated loss was decreased to $101.6 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of FirstCity.

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

FirstCity was a state-chartered nonmember bank insured on May 20, 1960. FirstCity was headquartered in Stockbridge, Georgia, and had three other branches in Georgia. FirstCity engaged principally in commercial real estate (CRE) lending activities within its local marketplace, which experienced a significant economic downturn starting in 2007. FirstCity was a wholly owned subsidiary of FirstCity Bancorp, Inc., a one-bank holding company.

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

Audit Results

Causes of Failure and Material Loss

FirstCity failed because its BOD and management pursued a strategy of aggressive growth centered in ADC lending. As part of its strategy, FirstCity sold loan participations to make larger loans and to improve liquidity and earnings. Although FirstCity's high-growth strategy was initially profitable, as the level of concentrations increased, FirstCity failed to develop risk management practices commensurate with the size and complexity of its portfolio. Specifically, the BOD and management failed to establish strong loan underwriting and credit administration practices, had inadequate loan policies and practices, and, at various times, violated laws and regulations, including those related to obtaining adequate appraisals. After 2005, FirstCity also became increasingly reliant on volatile funding sources, which increased its liquidity risk profile. Due to losses in the loan portfolio, the bank's capital eroded and liquidity became strained. Collectively, these factors led to the failure of the bank.

FDIC's Supervision of FirstCity

From April 2001 through January 2009, the FDIC and DBF conducted seven safety and soundness examinations of FirstCity, alternating these examinations except for the last one, which was a joint examination. FirstCity was considered to be fundamentally sound until the 2008 examination.

The BOD's decision to pursue rapid asset growth concentrated in ADC lending created a strategic risk that FirstCity had a responsibility to properly monitor and control. Onsite examinations and offsite review activity identified the increasing concentration and appropriately identified weaknesses; however, the ultimate impact of management's inability to manage and monitor its ADC concentration was not exposed until the real estate market slowed. In hindsight, pursuing stronger supervisory action as a result of the 2007 examination, as was done after the 2002 examination, would have required the BOD to commit to a plan and timeline for correcting deficient practices that were identified and increased supervisory oversight at a critical point in time.

Further, taking into consideration that institutions with high ADC concentrations were historically vulnerable to economic downtowns and that reliance on brokered deposits can increase an institution's liquidity risk profile, earlier and greater emphasis of the risks associated with FirstCity's growth and funding strategy might have been prudent. In that regard, the FDIC's offsite monitoring program did not substantially alter the FDIC's and DBF's supervisory strategy until early 2008. Further, the FDIC's tools for controlling the use of brokered deposits did not prevent FirstCity from obtaining such deposits in the third quarter of 2008, when it was known that FirstCity's financial condition had deteriorated.

With respect to PCA, the FDIC followed PCA guidance, but PCA had little or no impact on minimizing the loss to the DIF. The FDIC informally notified FirstCity that it was adequately capitalized in December 2008. The FDIC sent a formal letter on February 18, 2008, informing the bank it was considered to be adequately capitalized based on its December 31, 2008 capital ratios. FirstCity's capital position continued to decline, and on or about February 24, 2009, the FDIC notified the bank it was undercapitalized and required to submit a capital restoration plan within 45 days. However, FirstCity was unable to raise additional capital and subsequently failed on March 20, 2009.

Management Response

On September 30, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the cause of FirstCity's failure. With regard to our assessment of the FDIC's supervision of FirstCity, DSC's response cites several supervisory activities, discussed in our report, that were taken to address key risks at FirstCity. In the response, management acknowledges that a stronger regulatory response could have been taken to address the weak loan underwriting and credit administration practices identified in the 2007 onsite examination. DSC's response also states that it has provided further guidance to enhance its supervision of institutions with concentrated CRE/ADC lending and reliance on non-core funding.

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

DATE: October 5, 2009

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 FirstCity Bank, Stockbridge, Georgia* (Report No. MLR-10-001)

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 FirstCity Bank (FirstCity), Stockbridge, Georgia. On March 20, 2009, the Georgia Department of Banking and Finance (DBF) closed the institution and named the FDIC as receiver. On April 6, 2009, the FDIC notified the OIG that FirstCity's total assets at closing were $291.3 million and the estimated material loss to the Deposit Insurance Fund (DIF) was $101.8 million. As of August 7, 2009, the loss to the DIF from FirstCity's failure had decreased to $101.6 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 of the FDI Act. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of terms. A list of acronyms used in this report can be found in Appendix 4.

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[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.

[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices, including internal control systems; and compliance with applicable laws and regulations; and (2) issues related guidance to institutions and examiners.

This report presents the FDIC OIG's analysis of FirstCity's failure and the FDIC's efforts to ensure FirstCity's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations, as warranted.

Background

FirstCity was a state-chartered, non-member bank that was insured on May 20, 1960 in Gibson, Georgia under the name Bank of Gibson.[3] The FDIC granted approval for change in control in September 2000, and all of the Bank of Gibson's common stock was acquired by the bank's former chairman and CEO. Subsequently, in October 2001, the name of the bank was officially changed to FirstCity Bank, and the main office was relocated to Stockbridge, Georgia, in May 2004. During its history, FirstCity operated three branches, two in the Stockbridge, Georgia, area and one in Gibson, Georgia, and had an affiliate, FirstCity Mortgage, Inc., that originated and sold residential mortgage loans to FirstCity. FirstCity was wholly owned by FirstCity Bancorp, Inc. (FCBI), a single-bank holding company.

After the change in control in 2000, FirstCity grew at a rapid pace, from $18 million in assets at the end of 2001 to $285 million in assets by the end of 2008. Much of this asset growth occurred in commercial real estate (CRE), with a focus in higher risk acquisition, development, and construction (ADC) lending. To fund its loan growth, FirstCity became increasing reliant on brokered deposits after 2005. FCBI also injected capital into FirstCity, obtained from issuances of common stock and trust-preferred securities, and borrowings from another bank. Table 1 provides details on FirstCity's financial condition, as of December 2008, and for the 3 preceding calendar years.

Table 1: Financial Condition of FirstCity

	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	$285,015	$256,958	$205,844	$159,929
Total Loans ($000s)	$191,088	$214,140	$180,508	$134,102
Total Deposits ($000)	$259,056	$230,536	$179,695	$141,107
Total Brokered Deposits ($000)	$173,629	$100,676	$39,537	$20,567
Brokered Deposits as a % of Total Deposits	67.0%	43.7%	22.0%	14.6%
Net Income (Loss) ($000s)	($8,347)	$3,131	$4,645	$1,827

Source: Uniform Bank Performance Reports (UBPR) for FirstCity.

[3] The Bank of Gibson was originally established November 27, 1905.

Causes of Failure and Material Loss

FirstCity failed because its Board of Directors (BOD) and management pursued a strategy of aggressive growth centered in ADC lending. As part of its strategy, FirstCity sold loan participations to make larger loans and to improve liquidity and earnings. Although FirstCity's high-growth strategy was initially profitable, as the level of concentrations increased, FirstCity failed to develop risk management practices commensurate with the size and complexity of its portfolio. Specifically, the BOD and management failed to establish strong credit underwriting and administration practices, had inadequate loan policies and practices, and, at various times, violated laws and regulations, including those related to obtaining adequate appraisals. After 2005, FirstCity also became increasingly reliant on volatile funding sources, which increased its liquidity risk profile. Due to losses in the loan portfolio, the bank's capital eroded and liquidity became strained. Collectively, these factors led to the failure of the bank.

Aggressive Growth Strategy Centered in ADC Lending

After the change in management control in 2000, FirstCity's assets increased from $18 million at the end of 2001 to $285 million by the end of 2008, most of which was centered in ADC lending. FirstCity developed one of the largest ADC concentration levels in the state of Georgia. Table 2 summarizes FirstCity's ADC concentrations in comparison to peer group. As illustrated, FirstCity's volume of ADC loans as a percentage of total capital increased from 8 percent as of December 31, 2001 to 711 percent as of December 31, 2006, more than seven times greater than its peer group.

Table 2: FirstCity's ADC Concentrations Compared to Peer Group

Date	FirstCity ADC Loans as a Percentage of Total Capital	Peer Group ADC Loans as a Percentage of Total Capital	FirstCity ADC Loans as a Percentage of Average Gross Loans	Peer Group ADC Loans as a Percentage of Average Gross Loans
December 31, 2001	8%	5%	.37%	.94%
December 31, 2002	76%	11%	6.05%	1.54%
December 31, 2003	272%	20%	19.37%	2.75%
December 31, 2004	494%	81%	38.49%	10.44%
December 31, 2005	618%	91%	56.34%	11.72%
December 31, 2006	711%	101%	70.23%	13.43%
December 31, 2007	715%	108%	73.99%	15.00%
December 31, 2008	555%	111%	63.47%	15.26%

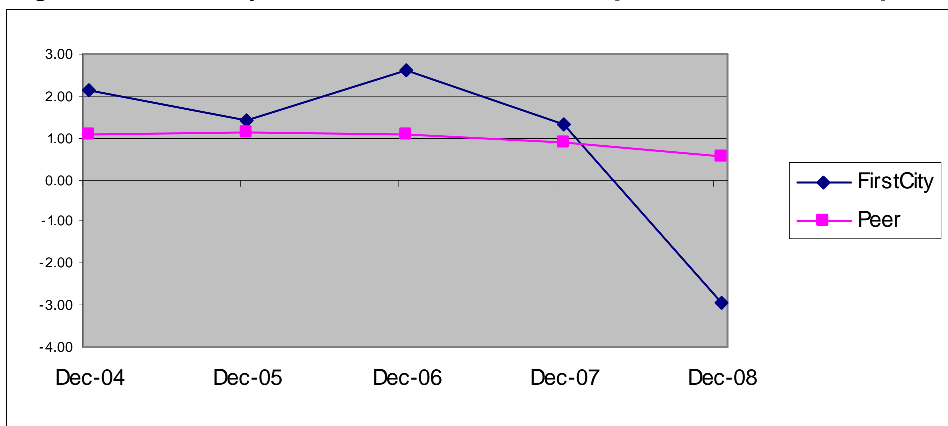
Source: UBPRs for FirstCity.

In response to concerns raised about ADC concentrations, the BOD Chairman stated in the 2007 ROE that bank management would increase risk monitoring and reduce the current concentration level by either selling loans or injecting more capital. Further, the June 2007 BOD minutes indicate that the BOD was also discussing the possible negative effect on the bank's portfolio if the real estate market did not rebound later in the year.

However, FirstCity's ADC loans as a percentage of total capital and average gross loans remained over 700 percent and 70 percent, respectively, from the end of 2006 through the end of 2007, as indicated in Table 2 above.

As indicated in Figure 1, FirstCity's strategy led to high profitability through 2007 in comparison to peers. However, as discussed in Financial Institution Letter 104 -2006 (FIL-104-2006) issued December 12, 2006 titled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,* rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market.[4] Indeed, FirstCity's ADC concentrations left the bank vulnerable to declines in the Atlanta, Georgia, real estate market and ultimately resulted in significant losses in 2008.

Figure 1: FirstCity's Return on Assets Compared to Peer Group



Source: UBPRs for FirstCity.

In 2003, in order to make larger loans and improve liquidity and earnings, the BOD embarked on a parallel strategy of selling loan participations. Generally, selling participations is a quick means for a bank to stay within state lending limits to a single borrower, diversify risk, and earn origination and servicing fees. By January 2007, FirstCity had sold 295 loan participations totaling about $146 million to 20 different financial institutions.[5]

However, in November 2007, FirstCity's BOD's began questioning the bank's reliance on the sale of loan participations because the declining real estate market was creating anxiety and a high level of information requests from participating banks with concentrated real estate portfolios. Three banks were asking FirstCity to buy back

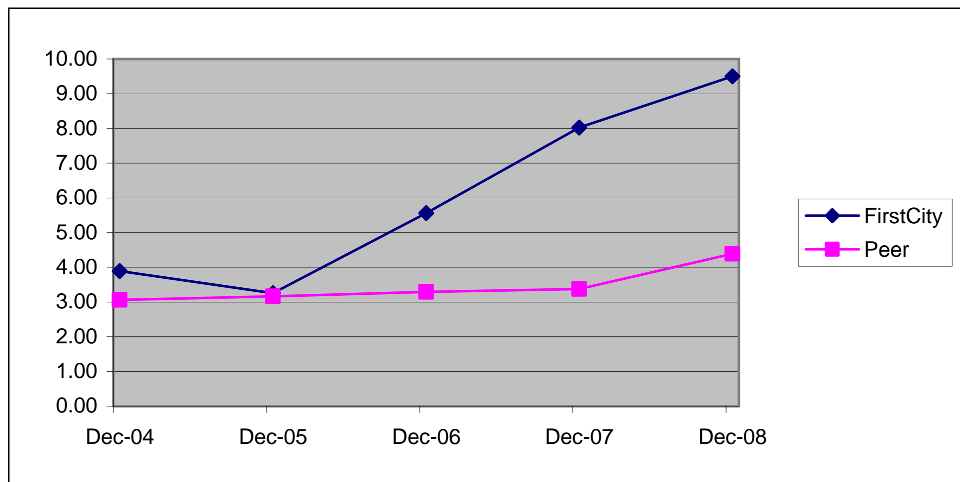
[4] Earlier regulatory guidance issued in 1998, FIL-110-98, Internal and Regulatory Guidelines for *Managing Risks Associated with Acquisition, Development, and Construction Lending*, dated October 1998, states that ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that this activity remains profitable.

[5] FDIC-insured institutions that account for loan participations as sales rather than secured borrowings should generally do so only if the participation agreement is supported by a legal opinion explaining how the agreement satisfies relevant accounting principles associated with treating them in that manner. Examiners found that non-recourse provisions were not always included in all agreements. However, management stated that all agreements were changed to include a non-recourse provision.

participations because of loan quality problems. FirstCity reduced its loan participations sold to approximately $69 million by August 2008. However, about $27 million (39 percent) of these remaining loan participations sold were non-performing loans that had been placed on non-accrual status. Notably, participations sold by FirstCity negatively impacted the financial condition of those banks purchasing the participations, two of which have since failed.[6]

Starting with the 2003 examination, examiners repeatedly reminded the BOD to ensure that the bank had ample staff to oversee and support the operational changes resulting from continued significant asset growth. However, FirstCity's staffing lagged in comparison to its loan growth, especially considering the large volume of loans originated and sold as participations. In 2008, examiners noted that one senior loan officer managed 79 percent of the bank's loan portfolio, which was considered an excessively large span of control. An excessively large portfolio can make it difficult to properly underwrite and administer loans. As noted in Figure 2, FirstCity's assets per employee ratio increased significantly from 2006 through 2008, more than double its peer group by the end of this period.

Figure 2: FirstCity's Assets per Employee Compared to Peer Group (Assets in $ million per Employee)



Source: UBPRs for FirstCity.

Weak Loan Underwriting and Credit Administration

According to FIL-104-2006, risk management practices and capital levels should be commensurate with the level and nature of the bank's CRE concentration risk. FirstCity corrected its weak loan underwriting and credit administration practices that were identified in the 2002 examination. However, as the level of concentrations increased and market conditions changed, FirstCity's risk management practices did not evolve as needed and instead may have weakened. To illustrate, deficiencies were evident in the 2007 ROE that were not apparent in loans reviewed during the 2005 examination. For example, examiners found that the borrower's ability to service debt was not accurately

[6] Neighborhood Community of Newnan, Georgia, and MagnetBank of Salt Lake City, Utah.

summarized. In 2007 and 2008, examiners identified the following deficiencies:

- Errors in cash flow analysis of borrowers.
- Inadequate analysis of the guarantor's ability to support a slow or failed construction project. Also, according to FDIC's Division of Resolutions and Receiverships (DRR) representatives, FirstCity had instances where loans were presented for approval showing guarantors, but guarantor signatures were not obtained on the final loan documents.
- No analysis of possible liquidation values in the event a project did not perform.
- A lack of economic feasibility studies on construction projects.

Further, examiners found that FirstCity's loan underwriting was not sufficiently rigorous to determine which borrowers would be able to service their loans if the project FirstCity was underwriting failed to perform. Additionally, examiners noted that the bank did not establish clear repayment terms on loans and extended construction loans with the timing of construction starts left to the borrower's discretion. Also, examiners identified that FirstCity's loan origination memorandums were generally unsatisfactory in that they did not sufficiently identify loans that had excessive risk or adequately analyze guarantor financial strength. FirstCity's quarterly external loan reviews also consistently noted loan underwriting and credit administration weaknesses, such as loan files with inadequate or outdated financial information and improper loan approvals by the bank.

Inadequate Loan Policies and Practices

Examiners identified that FirstCity's loan policy did not establish appropriate risk limits and monitoring requirements governing the bank's concentration in ADC lending. The bank's loan policy did not require, and management did not obtain, market data concerning ADC lending. Analysis of market data might have prompted management to lower its exposure levels before the market downturn. Additionally, examiners found that the loan policy did not establish standards for the type and quality of financial information to be provided by borrowers. The policy also permitted the waiver of borrower financial statements on certain types of real estate loans. Further, examiners reported that FirstCity's Allowance for Loan and Lease Losses (ALLL) methodology in 2007 did not comply with accounting requirements. Consistent with longstanding supervisory guidance, an institution's ALLL methodology must comply with accounting standards, and the ALLL must be maintained at a level that is appropriate to cover estimated credit losses on individually evaluated loans determined to be impaired as well as estimated credit losses inherent in the remainder of the portfolio.

Violations of Regulatory Requirements

As related to the cause of failure, FirstCity did not comply with requirements designed to ensure that institutions have adequate collateral protection for real estate loans and have sufficient diversification of credit risk. For example, the 2007 ROE indicated that FirstCity used non-market-based time constraints when applying deductions and discounts in the valuation of proposed construction, producing a result that was not market value. The 2008 examination identified 15 loans for which the appraisal did not

include appropriate deductions for holding costs, selling costs, and entrepreneurial profit in accordance with tract real estate lending guidance. In addition, the ROE noted one instance where the appraiser was not independent and two instances where the basis of appraised value was not adequately documented.

Additionally, in 2007 and 2008, examiners determined that FirstCity was in contravention of interagency guidelines on real estate loan-to-value (LTV) limits. The 2007 examination identified three loans totaling $8.1 million that exceeded supervisory LTV limits and were not reported as exceptions to the BOD. The ROE also concluded that loans with exceptions to supervisory LTV limits represented 164 percent of total capital. The 2008 examination identified three additional loans that exceeded supervisory LTV limits and were not included on the bank's internal exception list.

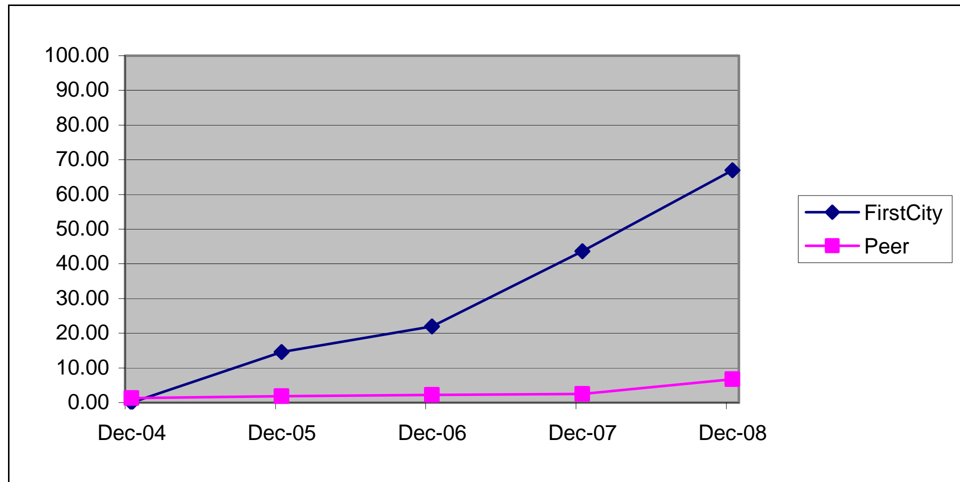
Further, Section 7-1-285 of the Financial Institutions Code of Georgia sets a maximum limitation on loans to one borrower of 25 percent of statutory capital and requires BOD approval of loans to one borrower in excess of 15 percent of statutory capital. The 2008 ROE reported three loans that exceeded the maximum limitation to one borrower and two more loans that exceeded 15 percent of statutory capital and did not have prior BOD approval.

Reliance on Wholesale Funding

Between 2005 and 2007, FirstCity increasingly relied on wholesale funding (Internet certificates of deposit (CDs) and brokered deposits) to fund loan growth, which changed the bank's liquidity risk profile.[7] In 2005, examiners recommended that management more formally monitor the bank's reliance on potentially volatile funding and set appropriate risk levels in the liquidity policy. At that time, FirstCity used a volatile liability dependence ratio as one of its tools to measure liquidity.[8] This ratio reflected the bank's dependence on potentially volatile liabilities to fund longer term earning assets. FirstCity defined volatile liabilities as Qwikrate CDs, Brokered Deposits, and Time Deposits greater than $100,000 that would mature in 1 year or less. The bank's liquidity policy stated that this ratio should not exceed 10 percent, but examiners calculated it to be over 55 percent. FirstCity subsequently revised its liquidity policy in November 2006 and set a target range of 20 to 50 percent for the volatile liability dependence ratio. FDIC officials stated that in 2008, FirstCity acquired brokered deposits to offset maturing deposits in an attempt to avoid a liquidity crisis. As seen in Figure 3, contrary to its own policy, the proportion of FirstCity's brokered deposits to total deposits climbed from about 15 percent as of December 31, 2005, to about 67 percent as of December 31, 2008.

[7] Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services.
[8] Generally, the lower the ratio, the less risk exposure there is for the bank. Higher ratios reflect reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Figure 3: FirstCity's Percentage of Brokered Deposits to Total Deposits Compared to Peer Group



Source: UBPRs for FirstCity.

FDIC's Supervision of FirstCity

The FDIC and DBF provided sustained supervisory attention to FirstCity from April 2001 through January 2009, alternating examinations except for the last one, which was a joint examination. FirstCity was considered to be fundamentally sound until the 2008 examination. The BOD's decision to pursue rapid asset growth in ADC lending created a strategic risk that FirstCity had a responsibility to properly monitor and control. Onsite examinations and offsite review activity identified the increasing concentration and appropriately identified weaknesses; however, the ultimate impact of management's inability to manage and monitor its ADC concentration was not exposed until the real estate market slowed. In hindsight, pursuing stronger supervisory action as a result of the 2007 examination, as was done after the 2002 examination, would have required the BOD to commit to a plan and timeline for correcting deficient practices that were identified and increased supervisory oversight at a critical point in time.

Further, taking into consideration that institutions with high ADC concentrations were historically vulnerable to economic downturns and that reliance on brokered deposits can increase an institution's liquidity risk profile, earlier and greater emphasis of the risks associated with FirstCity's growth and funding strategy might have been prudent. In that regard, the FDIC's offsite monitoring program did not substantially alter the FDIC's and DBF's supervisory strategy until early 2008. Further, the FDIC's tools for controlling the use of brokered deposits did not prevent FirstCity from obtaining such deposits in the third quarter of 2008, when it was known that FirstCity's financial condition had deteriorated.

Supervisory History

From April 2001 through January 2009, the FDIC and DBF conducted seven safety and soundness examinations of FirstCity, alternating these examinations except for the last one, which was a joint examination. From 2001 through 2007, FirstCity consistently received a composite "2" CAMELS rating.[9] As discussed below, based on the 2002 examination, FirstCity was subject to a Bank Board Resolution (BBR).[10] FirstCity was subject to a Cease and Desist Order (C&D) in 2008 when its composite CAMELS rating was downgraded to "4." Table 3 summarizes FirstCity's examination history.

Table 3: FirstCity's Examination History From 2001-2009

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
04/02/2001	12/31/2000	FDIC	222212/2	
12/17/2002	9/30/2002	DBF	223322/2	BBR
12/01/2003	9/30/2003	FDIC	212122/2	Release from BBR
07/15/2005	3/31/2005	DBF	212122/2	
01/22/2007	9/30/2006	FDIC	222121/2	
02/28/2008	12/31/2007	DBF	454534/4	C&D
01/26/2009	12/31/2008	DBF/FDIC	555555/5	

Source: FirstCity's Reports of Examination (ROEs) and DSC Supervisory Documents.

Although the bank had received a composite "2" CAMELS rating, the DBF required the BOD to adopt a BBR, effective in March 2003, to address concerns noted in the 2002 DBF examination. Among other items, the provisions of the Board resolution included steps to address appraisal violations, credit administration weaknesses, and improve the ALLL methodology. The December 2003 FDIC ROE concluded that the bank had taken sufficient steps to address the provisions of the BBR. Subsequently, the bank's examination cycle was extended from 12 to 18 months.[11] FirstCity remained on the 18-month examination cycle until 2008. Moreover, in 2007, the FDIC determined that FirstCity was eligible for review using Maximum Efficiency, Risk-focused, Institution

[9] 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.

[10] A BBR is one type of informal enforcement action and can be used for institutions that receive a composite rating of "2" or a component rating of "3" in order to address risk in a particular area.

[11] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, onsite examinations of every state nonmember bank at least once during each 12-month period and allows for 18-month intervals for certain small institutions (total assets of less than $500 million) if certain conditions are satisfied. FirstCity met these conditions by being well capitalized and being assigned a "1" or "2" management component rating and a "1" or "2" composite rating.

Targeted (MERIT) examination procedures.[12] (The FDIC's use of the MERIT procedures is discussed further in the next section of the report.)

The FDIC December 31, 2007, offsite review indicated that the FDIC identified the increasing risk profile at FirstCity and had contacted DBF regarding an accelerated onsite examination. The 2008 examination confirmed the bank's weakened condition and resulted in the bank's composite CAMELS rating being downgraded to a "4". In September 2008, the DBF, in consultation with the FDIC, issued a C&D to FirstCity. The C&D required the bank, among other things, to:

- submit a revised capital plan and maintain Tier 1 Capital of no less than 8 percent,
- submit a plan detailing appropriate strategies for managing ADC concentration levels, including a contingency plan to reduce or mitigate concentrations given current adverse market conditions; and
- implement an asset liability management policy that establishes an acceptable range for the bank's net non-core funding dependence ratio.

The FDIC began weekly monitoring of FirstCity's liquidity position in August 2008 and performed follow-up after the issuance of the C&D.

The FDIC and DBF began a joint visitation in January 2009, which was subsequently converted into a limited-scope examination due to the bank's continued deterioration. FirstCity's loan quality continued to deteriorate, and the January 2009 ROE reported $76 million in adversely classified assets. Approximately 90 percent of these adverse classifications were related to ADC loans or owned real estate that the bank obtained through foreclosure of ADC loans. The final examination of FirstCity in 2009 resulted in a composite "5" CAMELS rating and concluded that the overall condition of the bank was critically deficient. The ROE reported continued asset quality deterioration, an underfunded ALLL, critically deficient liquidity levels, and a capital ratio that had declined to undercapitalized. The bank was closed 2 months later.

Supervisory Concern Related to ADC Concentrations

The 2002 examination identified a number of management weaknesses associated with the bank's substantial asset growth, resulting in a BBR. However, as discussed previously, the 2003 examination indicated that all issues reported previously had been adequately addressed. The DBF's 2005 examination of FirstCity identified that the bank had an ADC concentration representing 653 percent of Tier 1 Capital and discussed FirstCity's growing ADC concentration but did not identify any significant weaknesses associated with the loan underwriting or credit administration practices. Examiners concluded that management had a reasonable level of expertise in real estate lending, had adequately underwritten loans, and was regularly monitoring the concentration.

[12] In 2002, DSC implemented MERIT guidelines to assist examiners in risk-focusing examination procedures in institutions with lower risk profiles. Under this program, the loan penetration ratio range was guided by the asset quality rating at the last examination. In March 2008, DSC eliminated MERIT examination procedures.

In the 2007 examination, FirstCity's ADC concentration had increased to 802 percent of Tier 1 Capital, one of the largest concentration levels in the State of Georgia. The FDIC examiners expressed concerns related to the risks presented by the bank's ADC concentration and concluded that management had not established a risk management framework to effectively identify, monitor, and control ADC concentration risk to address the more complex features associated with its ADC lending. Examiners identified numerous weaknesses in loan underwriting and credit administration, including:

- The borrower's ability to service bank debt was not accurately summarized on the loan presentation sheet prepared for the Loan Committee.
- Some borrower cash flow calculations included related business entities' income but not related debt.
- Some guarantors' financial capacities were not analyzed or validated to determine if they could service the debt if real estate lots did not sell as anticipated.
- Some appraisals had flaws relating to comparables and financial computations performed by the appraisers.
- The bank did not accurately utilize its internal loan grading system.
- The bank's external loan review program lacked the sophistication necessary to address the construction and land development credits.

As a result of their findings, examiners urged the BOD and management to stratify the ADC portfolio, identify aggregate exposures to a borrower, and establish credit concentration limits. Specifically, the January 2007 ROE recommended that management:

- Identify and quantify the nature and levels of risk presented by the CRE concentrations.
- Address the rationale for its ADC levels in relation to its overall growth objectives, financial targets, and capital plan.
- Establish internal lending guidelines that would reduce the overall risk exposure to levels that illustrate the BOD's risk appetite and protect the bank from a precarious situation should a significant downturn in the real estate market occur.

As discussed previously, MERIT examination procedures were used in the 2007 examination. MERIT examination guidance did not require the same level of loan penetration as a standard examination. The Pre-Examination Planning (PEP) Report for the January 2007 examination stated that, consistent with MERIT examination procedures, the loan review sample would be between 15 and 25 percent. The PEP Report, which was approved the same day the examination started, indicated that this percentage should provide an adequate assessment of the overall credit quality of the portfolio. Accordingly, examiners reviewed 18 percent of the loan portfolio. This percentage was lower than the 37 percent of loans reviewed at the previous 2005 examination and the 50 percent of loans reviewed at the subsequent 2008 examination. Further, the 457 examination hours charged at the 2007 examination was substantially

less than the 776 hours at the previous examination and 1,681 hours at the subsequent examination.

The MERIT guidelines gave Field Supervisors or Supervisory Examiners discretion to remove a bank from the MERIT program. Examiners-in-Charge also had the ability to remove a bank from the MERIT program. The MERIT guidelines stated that a decision to remove a bank was generally based on adverse findings revealed during the planning or examination process. According to FDIC officials, expanding the sample of loans reviewed beyond MERIT guidelines would not have provided additional insights because the weaknesses in loan underwriting and credit administration had not yet manifested into problem loans (i.e., the loans reviewed were performing at the time of the examination).

Despite the numerous weaknesses in loan underwriting and credit administration, examiners assigned asset quality a satisfactory "2" rating and noted that the bank had a moderate level of adversely classified assets, a manageable level of past due and non-accrual loans, and aggressive collection practices. Further, examiners cited the capabilities of the management team, giving management a satisfactory "2" component rating and noted that management's proactive approach to relocate the bank to a developing and growing market had successfully improved earnings and increased total assets of the institution. The examination also concluded that the BOD had demonstrated a willingness to take corrective action as needed. Accordingly, the 2007 ROE transmittal letter to the bank did not request a FirstCity BOD response or action plan related to the examination results. Further, FirstCity was not required to submit progress reports on its corrective actions.

Examiners also referred bank management to the December 12, 2006, Interagency Guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* to assist them with formulating a sound risk management plan. The guidance provides the following supervisory criteria for identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
- total commercial real estate loans that represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

In retrospect, stronger supervisory action in 2007 might have required the BOD and management to take more aggressive action to mitigate risks. Because market conditions were deteriorating rapidly, FirstCity had a limited window of opportunity for addressing weaknesses and, as was discovered in 2008, opted not to take timely action to address the recommendations made.

Indeed, at the 2008 examination, examiners found that management had failed to implement corrective actions recommended in the previous examination. The 2008

examination, initiated 13 months after the start of the 2007 examination, found that the adversely classified items coverage ratio had increased from 23 percent to 309 percent. The majority of the classified assets were in ADC lending. Although the bank's ADC concentration had decreased since the prior examination, the reduction occurred substantially from foreclosures due to asset quality problems. The 2008 ROE also stated that failure to monitor the ADC market caused the bank to extend additional loans in this industry while the market was declining. Examiners noted that the bank's deteriorating condition was characterized by numerous loan underwriting and credit administration weaknesses, 24 apparent violations of laws and regulations, and an overall lack of effective BOD and management oversight. In addition to a composite rating of "4" indicating unsafe and unsound practices, examiners assigned asset quality a "5" rating and management a "4" rating. The ROE was sent to the BOD in August 2008, along with a notification that the DBF was proposing to issue a C&D to address unsafe and unsound banking practices noted at the examination.

Supervisory Concern Related to ALLL

In four of seven examinations completed since 2001, examiners identified an underfunded ALLL due to differences between their assessment of FirstCity's loan quality and grades assigned by FirstCity's internal loan grading system. Further, in the 2007 ROE, the examiner concluded that the bank's ALLL methodology did not comply with regulatory guidance and accounting standards. FirstCity responded that it was revising its ALLL methodology. However, as indicated in the Table 4, the amount that the ALLL was underfunded increased in both the 2008 and 2009 examinations.

Table 4: FirstCity's Adversely Classified Assets and ALLL

Asset Quality (Dollars in Thousands)						
Examination Date	Examiner Adversely Classified Asset Amounts				ALLL Amounts	
	Substandard	Doubtful	Loss	Total Adversely Classified Items	ALLL Computed by FirstCity	Increase in ALLL Computed by Examiners
04/02/01	$339	$0	$27	$366	$192	$0
12/17/02	$693	$10	$34	$737	$183	$280
12/01/03	$592	$0	$0	$592	$496	$0
07/15/05	$787	$0	$7	$794	$992	$0
01/22/07	$3,976	$0	$33	$4,009	$1,899	$123
02/28/08	$68,820	$220	$3,200	$72,240	$3,645	$790
01/26/09	$71,903	$0	$4,276	$76,179	$3,633	$3,800

Source: FDIC and DBF ROEs for FirstCity.

In addition to ALLL concerns identified by examiners, FirstCity's independent public accountant noted in its workpapers for the year-end 2007 financial statement audit that, based on their model of assigning losses for substandard loans, it appeared FirstCity had

underfunded its ALLL by approximately $1.4 million. The dramatic increase in adversely classified assets from 2007 to 2008 shows the importance of having an appropriate ALLL methodology in order to ensure an accurate representation of earnings and capital.

Offsite Review Program

Between 2003 and 2008, FirstCity periodically appeared on the FDIC's offsite review list because of its growth. The FDIC's offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews must be completed and approved 3½ months after each Call Report date for each bank that appears on the offsite review list. Although the FDIC completed required assessments when FirstCity appeared on the offsite review list, the reviews did not substantially alter the supervisory strategy or heighten supervisory oversight until FirstCity's financial condition had significantly deteriorated.

Specifically, FirstCity appeared on the offsite review list based on information in its September 30, 2007, Call Report after the January 2007 examination. The FDIC completed its offsite review in January 2008. During this review, the FDIC noted a dramatic increase in past due loans, with loans 30 to 89 days past due increasing 1,634 percent over the past year. The FDIC contacted bank management who acknowledged the deteriorating condition of the loan portfolio, but FirstCity stated it had scrubbed the entire loan portfolio and initiated aggressive collection efforts. The FDIC concluded that FirstCity would remain on an 18-month examination cycle and that no additional follow-up was necessary at that time.

However, according to FDIC officials, following the completion of its September 30, 2007, offsite review, FDIC officials had several conversations with the DBF examination coordinator to discuss the overall condition of FirstCity and the possibility of accelerating the next scheduled onsite examination. Further, FDIC officials stated that DBF made the decision to accelerate the 2008 examination start date by 6 months (February rather than August) based on analysis of FirstCity's 2007 year-end Call Report data. FDIC officials considered this to be an appropriate supervisory strategy. The FDIC's December 31, 2007, offsite review completed on March 21, 2008, noted FirstCity's increasing risk profile and that DBF was in the process of conducting a full-scope examination. The 2008 onsite examination reported serious deterioration in the bank's condition and led to the issuance of a C&D.

Tools for Limiting Wholesale Funding

Before 2008, FirstCity routinely acquired brokered deposits to fund its growth. FDIC's Rules and Regulations Part 337 states that any well capitalized insured depository institution may solicit and accept, renew, or roll over any brokered deposit without restriction. However, adequately capitalized institutions must receive a waiver from the FDIC before they can accept, renew, or roll over any brokered deposit. The FDIC's tools for limiting FirstCity's acquisition of wholesale funding during 2008 were ineffective

because FirstCity's holding company borrowed funds, injected capital, and kept FirstCity well capitalized.

Although FirstCity's financial condition was rapidly deteriorating and examiners identified in the 2007 ROE that liquidity ratios were repeatedly outside its policy guidelines, FirstCity was able to build its level of brokered deposits to $173 million or 67 percent of its total deposit base by the end of 2008. In fact, FirstCity was able to increase brokered deposits by $77 million in the third quarter of 2008. Of the $77 million, $47 million was obtained before the examination report was issued in August 2008, and the other $30 million was obtained after the report was issued but before the C&D was effective in October 2008. Once the C&D Order became effective, FirstCity was considered to be adequately capitalized.[13] FirstCity's capital ratios subsequently fell to adequately capitalized based on December 31, 2008 Call Report information.

FDIC officials stated that the increase in brokered deposits that occurred in 2008 was not for the purpose of funding growth but rather resulted from FirstCity's attempt to avoid a liquidity crisis. According to FDIC officials, projected maturities of brokered deposits posed a serious threat to liquidity, and bank management officials decided to obtain additional brokered deposits to offset the maturing deposits. FDIC officials told us that they did not endorse this strategy or consider it to be acceptable; however, a brokered deposit waiver was not required during the period these funds were acquired. The FDIC's Problem Bank Memorandum prepared in March 2009 described the impact of these brokered deposits on FirstCity's liquidity, stating that projected maturities of brokered deposits pose some risk of liquidity insolvency.[14]

The same month FirstCity failed, the FDIC took steps to address supervision of institutions that rely extensively on wholesale funding. In March 2009, the FDIC issued Financial Institution Letter 13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*. This guidance, among other things, states that:

- FDIC-supervised institutions, regardless of rating, that engage in aggressive growth strategies or rely excessively on a volatile funding mix are subject to heightened offsite monitoring and on-site examinations.
- Institutions rated "3", "4", or "5" are expected to implement a plan to stabilize or reduce risk exposure and limit growth. This plan should not include the use of volatile liabilities to fund aggressive asset growth or materially increase the institution's risk profile.

[13] According to FDIC Rules and Regulations §325.103, an institution is deemed to be well capitalized if the bank meets certain ratios and is not subject to any written agreement, order, capital directive, or prompt corrective action directive to meet and maintain a specific capital level for any capital measure.
[14] A problem bank memorandum documents the FDIC's concerns with an institution and corrective actions in place or to be implemented.

This guidance should enable the FDIC to subject institutions that engage in aggressive growth strategies or rely excessively on a volatile funding mix to more extensive offsite monitoring, onsite examination, and enforcement to ensure management is taking appropriate steps to stabilize the bank's risk profile and strengthen its financial condition.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. For FirstCity, the FDIC followed PCA guidance, but PCA had little or no impact on minimizing the loss to the DIF.

The FDIC informally notified FirstCity that it was adequately capitalized in an email dated December 23, 2008. The January 2009 joint FDIC/DBF examination found significant deterioration in asset quality and resulted in a recommendation that FirstCity take additional loan and lease loss provisions, which led to a depletion of capital. The FDIC sent a formal letter dated February 18, 2009, notifying the bank that it was adequately capitalized based on the December 31, 2008, Call Report capital ratios. The FDIC subsequently received a letter from the bank dated February 19, 2009, informing the FDIC that the bank's capital ratios had declined to a lower capital category (undercapitalized). Consequently, the FDIC sent a second formal letter on or about February 24, 2009, notifying the bank that its PCA status was now undercapitalized and that the bank was required to submit a capital restoration plan within 45 days. However, FirstCity was unable to raise additional capital and subsequently failed on March 20, 2009.

Corporation Comments

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On September 30, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety as Appendix 3 of this report.

DSC reiterated the OIG's conclusions regarding the cause of FirstCity's failure. With regard to our assessment of the FDIC's supervision of FirstCity, DSC's response cites several supervisory activities, discussed in our report, that were taken to address key risks at FirstCity. In the response, management acknowledges that a stronger regulatory response could have been taken to address the weak loan underwriting and credit administration practices identified in the 2007 onsite examination. DSC's response also states that it has provided further guidance to enhance its supervision of institutions with concentrated CRE/ADC lending and reliance on non-core funding.

Objectives, Scope, and Methodology

Objectives

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

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

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

Scope and Methodology

The scope of this audit included an analysis of FirstCity's operations from April 2, 2001 until its failure on March 20, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed ROEs prepared by the FDIC and the DBF examiners from 2001 to 2009.

- Reviewed the following:

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

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed available FirstCity records maintained by DRR in Dallas, Texas, for information that would provide insight into the bank's failure.

  - Workpapers of the bank's external auditor, Thigpen, Jones, Seaton, & Co., at their offices in Dublin, Georgia.

    - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

    - DSC management in Washington, D.C., and the Atlanta Regional Office, Atlanta, Georgia.

    - DRR officials at the Dallas Regional Office and Stockbridge, Georgia, FirstCity offices.

    - FDIC examiners from the DSC Atlanta Field Office, Atlanta, Georgia, who participated in examinations or reviews of examinations of FirstCity.

- Met with officials from the DBF to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

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

We performed the audit field work at DRR offices in Dallas, Texas, and DSC offices in Atlanta, Georgia.

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, reports, ROEs, and interviews of examiners to understand FirstCity'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 ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that was used to support our audit conclusions.

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

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests 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 loan.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
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. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Corporation Comments

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

Division of Supervision and Consumer Protection

September 30, 2009

TO: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of FirstCity Bank, Stockbridge, Georgia (Assignment No. 2009-033)

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 FirstCity Bank (FirstCity), which failed on March 20, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Audit Report (Report) received on September 11, 2009.

FirstCity failed primarily due to management's pursuit of rapid growth in Commercial Real Estate (CRE) and Acquisition, Development, and Construction (ADC) loans, coupled with the failure to develop risk management practices commensurate with the size and complexity of the loan portfolio. This business strategy, when combined with an increased reliance on volatile sources of funding and the economic downturn throughout 2008, resulted in loan losses, erosion of capital and earnings, and strained liquidity, ultimately causing the failure of the bank.

The Report notes that the FDIC, in conjunction with the Georgia Department of Banking and Finance, provided ongoing supervision of FirstCity and identified key concerns for attention by bank management, including problems that led to FirstCity's failure. Further, the Report notes that the financial deterioration first reflected in the bank's preliminary December 2007 call report resulted in an acceleration of the statutory examination schedule from 18 months to 12 months. OIG concluded, however, that stronger supervisory action following the January 2007 examination may have been warranted.

Beginning in 2003, examiners repeatedly recommended that FirstCity's Board ensure the bank had ample staff to oversee and support the significant asset growth. Loan underwriting and administration showed some improvement in practices for a period of time, but significant weaknesses were again identified at the January 2007 examination. We agree that a stronger regulatory response could have been taken to address the weak practices identified at that examination. DSC has provided further guidance to enhance its supervision of institutions with concentrated CRE/ADC lending and reliance on volatile non-core funding.

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

Acronyms in the Report

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
BOD	Board of Directors
C&D	Cease and Desist Order
CD	Certificates of Deposit
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DBF	Department of Banking and Finance
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FCBI	FirstCity Bancorp, Inc.
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
LTV	Loan-to-Value
MERIT	Maximum Efficiency, Risk-focused, Institution Targeted
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PEP	Pre-Examination Planning
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System