Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-033

Material Loss Review of Hillcrest Bank Florida, Naples, Florida

May 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On October 23, 2009, the Florida Office of Financial Regulation (OFR) closed Hillcrest Bank Florida (Hillcrest), Naples, Florida and named the FDIC as receiver. On November 6, 2009 the FDIC notified the OIG that Hillcrest's total assets at closing were $91.9 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $44.7 million. As of April 27, 2010, the estimated loss to the DIF had decreased to $31.4 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review.

The audit objectives were to (1) determine the causes of Hillcrest's failure and the 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

Hillcrest was a de novo state-chartered nonmember bank that opened for business on August 16, 2006 in Naples, Florida as a traditional full-service community bank. The bank's primary market included Collier and southern Lee counties. In addition to its main office, Hillcrest had a full-service branch in Bonita Springs (north of Naples) and four limited service branches located in retirement communities in and around its local area and also on the east coast of Florida. The bank had no holding company but was affiliated with another out-of-state bank through common ownership of its two principal shareholders.

Audit Results

Causes of Failure and Material Loss

Hillcrest failed because it implemented a lending strategy in its first year of operation that resulted in loan concentrations in commercial real estate (CRE), particularly acquisition, development, and construction (ADC) lending, absent development of adequate risk management practices. The bank's lending strategy constituted a deviation from the bank's original business plan, and this change was not submitted in advance to the FDIC or the OFR for approval as required under the final orders approving the bank's charter and application for deposit insurance. The steep decline in the Florida real estate market during this period factored significantly in the rapid deterioration of the bank's ADC portfolio and, ultimately, loan-related losses eroded capital. The bank's efforts to diversify and shrink its portfolio in 2008 and 2009 to address supervisory concerns and increase capital ratios proved ineffective. The FDIC and the OFR determined that the bank was no longer viable and closed the institution in October 2009.

The FDIC's Supervision of Hillcrest

The FDIC, in conjunction with the OFR, provided ongoing supervisory oversight of Hillcrest consistent with requirements for de novo institutions. Through its supervisory efforts, the FDIC and the OFR identified key risks in Hillcrest's operations and made recommendations to improve weak risk management practices and address areas of concerns, including noted deviations from the bank's original business plan. Enforcement actions were taken in 2008 and 2009; however, Board and management responses to those actions fell short and the financial condition of the bank became critically deficient.

In retrospect, a more critical assessment of Hillcrest during 2007, accompanied by lower supervisory ratings and/or an enforcement action, may have been prudent given the bank's de novo status, the composition of its loan portfolio, and weaknesses identified in its risk management practices. Such an approach would have established a strong supervisory tenor from the onset of the bank's operations and may have (1) been a more effective means of communicating the significance of the risks the bank was assuming and the seriousness of supervisory concerns related to the bank's risk profile and (2) created a more structured supervisory framework to monitor actions the Board and management were taking to address deficiencies. We recognize that the assignment of supervisory ratings and the decisions regarding the pursuit of an enforcement action are matters of judgment based on information known at the time. In that regard, in fairness to the examiners involved, the depth of the economic decline in Florida that factored significantly into Hillcrest's demise was not foreseen in 2007.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. Hillcrest was unsuccessful in raising needed capital and the bank was subsequently closed on October 23, 2009.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from recent failures. For example, in 2009, the FDIC extended the de novo period in recognition that unseasoned institutions may warrant stronger supervisory attention. The FDIC also recently established procedures to better communicate and follow up on risks and deficiencies identified during examinations. Further, the FDIC implemented a training program provided to the FDIC's examination workforce in order to emphasize the need for a more forward-looking approach to examination analysis and ratings.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On April 30, 2010, 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 causes of Hillcrest's failure. With regard to our assessment of the FDIC's supervision of Hillcrest, DSC summarized key aspects of the supervisory history presented in the report. Specifically, DSC stated that from 2007 to 2009, FDIC and OFR examinations identified key risks in operations and made recommendations to improve weak risk management practices. Further, in 2007, the FDIC noted concern about Hillcrest's ADC exposure. During the OFR's August 2008 examination, Hillcrest's weak management practices became evident, resulting in a lower composite rating and the issuance of an enforcement action. DSC's response also highlighted the program changes for de novo institutions in 2009, including extension of the de novo period from 3 to 7 years and emphasis on de novo business plans.

Contents

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

Office of Material Loss Reviews
Office of Inspector General

DATE: May 6, 2010

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

/Signed/

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

SUBJECT: *Material Loss Review of Hillcrest Bank Florida, Naples, Florida* (Report No. MLR-10-033)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Hillcrest Bank Florida (Hillcrest), Naples, Florida. The Florida Office of Financial Regulation (OFR) closed the institution on October 23, 2009, and named the FDIC as receiver. On November 6, 2009 the FDIC notified the OIG that Hillcrest's total assets at closing were $91.9 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $44.7 million. As of April 27, 2010, the estimated loss to the DIF had decreased to $31.4 million.

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

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

[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.

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

Background

Hillcrest was a de novo[3] state-chartered nonmember bank that opened for business on August 16, 2006 in Naples, Florida as a traditional full-service community bank. The bank's primary market included Collier and southern Lee counties. In addition to its main office, Hillcrest had a full-service branch in Bonita Springs (north of Naples) and four limited service branches located in retirement communities in and around its local area and also on the east coast of Florida. The bank had no holding company but was affiliated with another out-of-state bank through common ownership of its two principal shareholders.[4] Table 1 provides details on Hillcrest's financial condition as of September 30, 2009 and for the 3 preceding years.

Table 1: Financial Information for Hillcrest, 2006 to 2009

Financial Measure ($000s)	Sep-2009	Dec-2008	Dec-2007	Dec-2006
Total Assets	$82,774	$104,563	$106,965	$81,572
Total Loans	$72,359	$86,458	$80,509	$43,598
Total Deposits	$83,254	$86,853	$87,681	$64,793
Time Deposits of $100 Million or More	$26,311	$30,417	$33,969	$38,600
Net Income (Loss)	($14,885)	($5,333)	($556)	($1,242)

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

Causes of Failure and Material Loss

Hillcrest failed because it implemented a lending strategy in its first year of operation that resulted in loan concentrations in commercial real estate (CRE), particularly acquisition, development, and construction (ADC) lending, absent development of adequate risk management practices. The bank's lending strategy constituted a deviation from the

[3] Prior to August 2009, de novo banks referred to institutions that were in their first 3 years of operation. On August 28, 2009, the FDIC extended the de novo period from 3 to 7 years in Financial Institution Letter (FIL) 50-2009, entitled, *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*. Hillcrest was considered a de novo institution during its entire existence.

[4] During the FDIC's closing process, the FDIC Legal Division opined that the other bank was not subject to the cross guarantee provisions of section 5 of the FDI Act, meaning, based on the structure of the principals' ownership, the other bank was not liable to the FDIC for any losses caused by the failure of Hillcrest. As defined by Florida state law, Hillcrest was not considered to be a subsidiary or an affiliated bank.

bank's original business plan, and this change was not submitted in advance to the FDIC or the OFR for approval as required under the final orders approving the bank's charter and application for deposit insurance. The steep decline in the Florida real estate market during this period factored significantly in the rapid deterioration of the bank's ADC portfolio and, ultimately, loan-related losses eroded capital. The bank's efforts to diversify and shrink its portfolio in 2008 and 2009 to address supervisory concerns and increase capital ratios proved ineffective. The FDIC and the OFR determined that the bank was no longer viable and closed the institution in October 2009.

ADC Loan Concentration That Deviated from the Business Plan

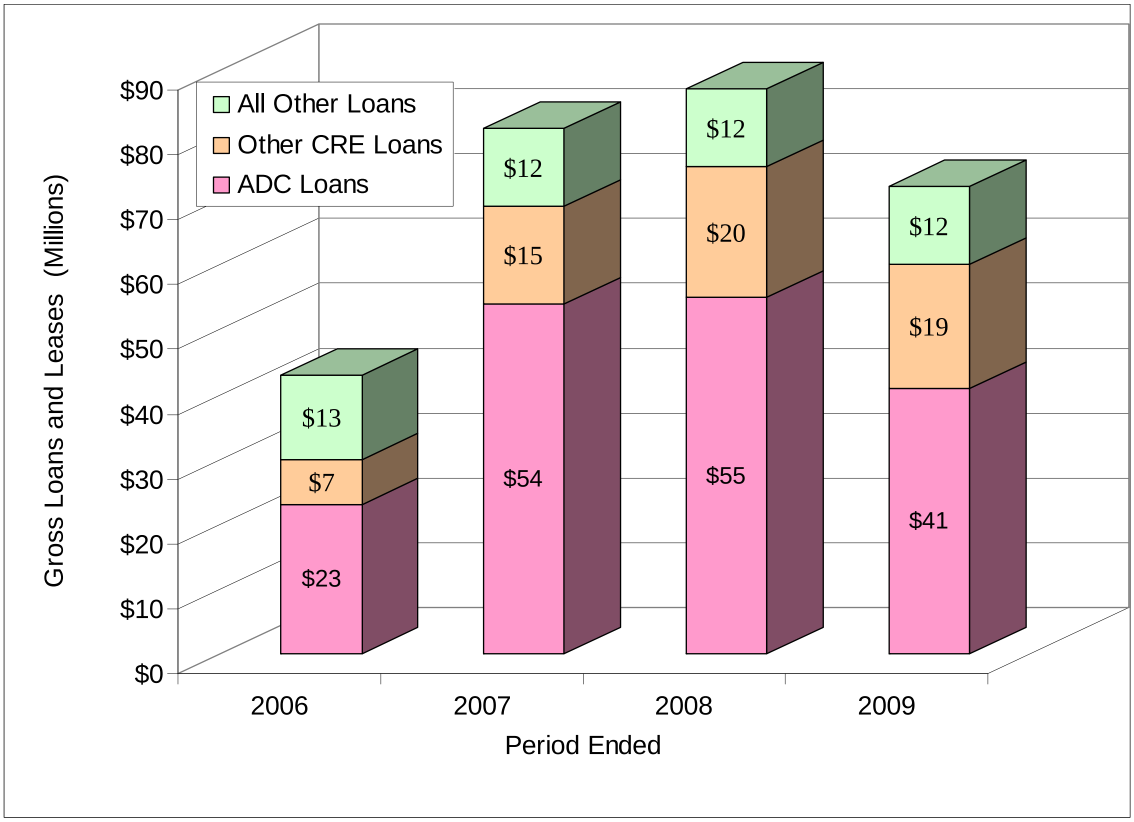
According to the original business plan submitted as part of the chartering and deposit application processes, Hillcrest anticipated a loan mix consisting of commercial and industrial, commercial real estate, consumer, and residential construction loans. However, both the OFR and the FDIC found that, from the beginning, the bank deviated from its original plan as nearly all of Hillcrest's loans were in real estate, including a significant portion in ADC loans. According to the order approving deposit insurance, Hillcrest was required to, among other things, operate within the parameters of the business plan submitted to the FDIC. Furthermore, during the first 3 years of operations, the bank was required to notify the FDIC of any major deviations or material change from the plan 60 days before consummation of the change. The bank did not notify the FDIC or the OFR of changes in advance as required.

Further, the heavy concentration in ADC loans reflected loan participations purchased from the out-of-state bank in which the two principal shareholders were affiliated. The original business plan referenced participations but did not reveal that the level of participations would comprise over 50 percent of total loans or include large, out-of-area ADC loan participations. In response to the OFR's February 2007 examination findings, the bank agreed to cease the purchase of loan participations. In addition, the bank submitted a revised 3-year strategic plan on May 2, 2007 that addressed its planned expansion into retirement facilities and described the level and type of loan participations in its portfolio, and the FDIC reviewed and accepted that revised plan.

However, during its September 2007 examination, the FDIC concluded that the revised business plan did not clearly address the level and type of lending Hillcrest had engaged in and required the bank to submit a progress report detailing its plans to bring the bank into compliance with the original plan or provide an amended business plan by December 15, 2007. Hillcrest submitted a revised plan on December 14, 2007. The FDIC reviewed the plan and provided a response to the bank on February 13, 2008, indicating that it had no objections to the revision. The bank's senior lender, who had resigned in July 2007, was also replaced in February 2008. During 2008, Hillcrest ceased making new loans and began to downsize in order to increase capital ratios.

As of December 31, 2007, Hillcrest's ADC loans represented 66 percent of the loan portfolio and, despite the bank's plans and efforts to diversify, ADC loans accounted for nearly 60 percent of the loan portfolio as of August 2009.[5] Further, according to information provided to us by the Division of Resolutions and Receiverships (DRR), as of August, 14, 2009, Hillcrest had nine purchased loan participations totaling $24.2 million, representing approximately 31 percent of the loan portfolio. Although these participations increased the bank's risk profile, only two of the participations were reported to be in non-accrual status as of August 2009. As discussed below, the bank's Florida-originated lending ultimately proved to be a greater source of loss to the bank. Figure 1 illustrates the general composition and growth pattern of Hillcrest's loan portfolio from 2006 through 2009.

Figure 1: Composition of Hillcrest's Loan Portfolio, 2006 to 2009



Source: Call Reports for Hillcrest.

In December 2006, Federal banking regulatory agencies issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) that reinforces existing regulations and guidelines for real estate lending and safety and soundness.[6] The Joint Guidance points out that there are substantial risks posed by CRE concentrations, especially ADC concentrations. Such risks include unanticipated earnings and capital volatility during a downturn in the real estate market. The Joint Guidance reiterates that concentrations in CRE lending, coupled with weak

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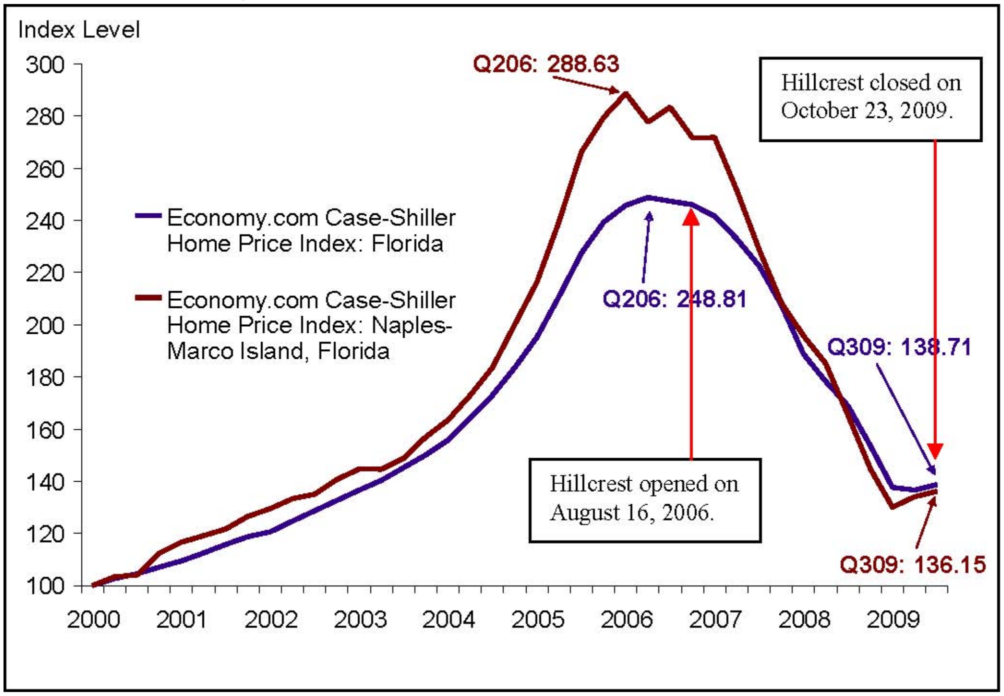
[5] Hillcrest also sold a number of participations. As of August 14, 2009, the general ledger indicated there were 12 participations sold, totaling approximately $16.4 million.
[6] The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).

loan underwriting and depressed CRE markets, contributed to significant credit losses in the past. Figure 2 depicts an indexed snapshot of real estate trends for Florida and Naples relative to Hillcrest opening and closing dates.

Figure 2: Case-Shiller Home Price Index* for Florida and Naples-Marco Island, Florida, 2000 to 2009



Source: FDIC's Division of Insurance.

*Note: The Case-Shiller home price indices measure the residential housing market and track changes in the value of the residential real estate market. Also, note Naples is a city in Collier County, Florida, located at the southern end of Florida's Gulf Coast, bounded by Lee County, Florida to the northwest, and other surrounding counties.

As the figure illustrates, Hillcrest opened as the real estate market was starting to decline. Given that the majority of its ADC portfolio was centered in Florida, the bank was particularly vulnerable when this real estate market collapsed, and by August 2008, Hillcrest's asset quality deteriorated to critically deficient as appraised values in its lending areas plummeted.

Risk Management Practices

An institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk. According to the Joint Guidance, strong risk management practices are an important element of a sound CRE lending program, particularly when an institution has a concentration in CRE loans.

In addition, FIL-22-2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, issued March 17, 2008, provides key risk management processes for institutions with CRE concentrations, including maintaining prudent, time-tested lending policies with a strong credit review and risk rating system to identify deteriorating credit trends early and maintaining updated financial and analytical information for borrowers. For example, institutions should emphasize global financial analyses of obligors, which involves analyzing borrowers' complete financial resources and obligations. The guidance further states that inappropriately adding extra interest reserves on loans where the underlying real estate project is not performing as expected can erode collateral protection and mask loans that would otherwise be reported as delinquent.

As summarized in the 2009 examination report,[7] Hillcrest's Board failed to adequately monitor the risk associated with the loan portfolio and implement sound underwriting and credit risk management practices, which ultimately resulted in an elevated volume of problem loans and credit losses.

Poor Underwriting and Credit Administration

During the bank's short history, examiners identified weaknesses in Hillcrest's underwriting and credit administration practices, including the need for the Board and senior management to:

- Fully address underwriting guidelines and practices in the loan policy.

- Establish standard minimum procedures for loan presentation reviews to ensure consistent analysis. Specifically, examiners recommended that underwriting procedures include global cash flow analyses that consider total debt outstanding with other banks and the assessment of borrowers' outside repayment sources. Examiners reported that Hillcrest's loan files did not adequately document the decision process and the capacity of the borrower to adequately service debt.

- Establish a loan diversification policy and set limits for real estate loans by type and geographic market.

- Establish procedures to make underwriting decisions that consider feasibility of the market; evaluate the marketability of the properties without take-out commitments; and analyze the market levels, trends, and exposure time.

- Establish formal requirements for the appropriate use of interest reserves.

- Establish guidelines for stress testing the portfolio under different interest rates, collateral values, and absorption scenarios.

In addition, the bank failed to conduct proper due diligence and implement prudent underwriting of the loan participation credits. According to the FDIC's *Risk Management Manual of Examination Policies,* institutions purchasing participations must

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[7] As indicated later in this report, the examination was completed but the examination report was never issued to the bank because it was completed near the time the bank was closed.

make a thorough, independent evaluation of the transaction and risks involved before committing any funds. The 2007 OFR examination reported that Hillcrest lacked the personnel, depth, and resources to properly monitor, assess, and manage a large portfolio of complex CRE/ADC loans outside its local market area.

Hillcrest was also cited in the OFR's 2008 examination for being in violation and contravention of regulatory requirements related to its lending activity, another indication of weak risk management practices. The violations cited in the examination report involved the bank's failure to adhere to loan approval requirements outlined in Florida statutes. The bank was also cited to be in contravention of a section of the Florida Administrative Code pertaining to appraisals as well as the *Interagency Appraisal and Evaluation Guidelines* (FIL-74-94 dated November 11, 1994). Further, the 2009 examination noted that Hillcrest was not in compliance with two of the continuing conditions of the order approving the bank's insurance application – capital ratios had fallen below 8 percent as required by the order and the bank was not operating within the parameters of its business plan.

Allowance for Loan and Lease Losses (ALLL)

The December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL Policy Statement) reiterated key concepts and requirements related to generally accepted accounting principles (GAAP)[8] and existing supervisory guidance. According to the ALLL Policy Statement, the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as credit losses inherent in the remainder of the portfolio.

Examiners generally found that Hillcrest's ALLL methodology needed to be improved to ensure that the bank was complying with the ALLL Policy Statement. Specifically, the FDIC's September 2007 examination report stated that Hillcrest's ALLL was appropriately funded but the bank applied a 1.2 percent reserve allocation to the entire loan portfolio. The use of a blanket percentage allocation was considered inadequate. In response to the examination finding, management stated that it performed additional analysis, which considered qualitative factors to ensure the ALLL was appropriate, but the analysis was not documented. Examiners advised Hillcrest that the ALLL methodology, at a minimum, needed to address a number of items, including appropriate qualitative factors such as changes to economic and market conditions.

In 2008, examiners noted that although the bank was trying to comply with ALLL guidance, the bank was in contravention of the ALLL policy statement. Hillcrest's management was determining the amount of impairment on individual loans by applying percentages based on the bank's internal loan grading, but was not determining the credit

[8] Statement of Financial Accounting Standards (FAS) No. 5, *Accounting for Contingencies* and FAS No. 114, *Accounting by Creditors for Impairment of a Loan*.

losses inherent in the remainder of the portfolio as required by generally accepted accounting principles.

The FDIC's Supervision of Hillcrest

The FDIC, in conjunction with the OFR, provided ongoing supervisory oversight of Hillcrest consistent with requirements for de novo institutions.[9] Through its supervisory efforts, the FDIC and the OFR identified key risks in Hillcrest's operations and made recommendations to improve weak risk management practices and address areas of concerns, including noted deviations from the bank's original business plan. Enforcement actions were taken in 2008 and 2009; however, Board and management responses to those actions fell short and the financial condition of the bank became critically deficient.

In retrospect, a more critical assessment of Hillcrest during 2007, accompanied by lower supervisory ratings and/or an enforcement action, may have been prudent given the bank's de novo status, the composition of its loan portfolio, and weaknesses identified in its risk management practices. Such an approach would have established a strong supervisory tenor from the onset of the bank's operations and may have (1) been a more effective means of communicating the significance of the risks the bank was assuming and the seriousness of supervisory concerns related to the bank's risk profile and (2) created a more structured supervisory framework to monitor actions the Board and management were taking to address deficiencies. We recognize that the assignment of supervisory ratings and the decisions regarding the pursuit of an enforcement action are matters of judgment based on information known at the time. In that regard, in fairness to the examiners involved, the depth of the economic decline in Florida that factored significantly into Hillcrest's demise was not foreseen in 2007.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from recent failures. For example, in 2009, the FDIC extended the de novo period in recognition that unseasoned institutions may warrant stronger supervisory attention. The FDIC also recently established procedures to better communicate and follow up on risks and deficiencies identified during examinations. Further, the FDIC implemented a training program provided to the FDIC's examination workforce in order to emphasize the need for a more forward-looking approach to examination analysis and ratings.

Supervisory History

The FDIC completed key steps as required in the deposit insurance application approval process, all of which take into consideration the evaluation of the seven factors included

[9] 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.

in section 6 of FDI Act.[10] The pre-opening examination conducted by the OFR did not indicate any concerns related to the institution's risk management practices and concluded that the institution met all of the requirements to open for business as a state-chartered bank ready to service the public. The bank opened for business on August 16, 2006. Table 2 summarizes key information pertaining to pre-opening and onsite risk management examinations conducted by the FDIC and the OFR, including the (1) supervisory rating, (2) enforcement actions taken in response to concerns identified, and (3) an indication of violations or contraventions of law or policy.

Table 2: Hillcrest's Examination History, 2006 to 2009

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings***	Enforcement Actions	Violation of Law or Contravention of Policy Reported
08/09/2006	08/15/2006	OFR*	N/A	N/A	N/A
02/20/2007	12/31/2006	OFR	132222/2	N/A	N/A
09/24/2007	06/30/2007	FDIC	122322/2	N/A	N/A
08/04/2008	06/30/2008	OFR	353523/4	Memorandum of Understanding (MOU)	✓
07/20/2009	06/30/2009	FDIC**	555555/5	Cease and Desist Order (C&D)	✓

Source: Reports of Examination (ROE) for Hillcrest, ViSION, and problem bank memorandum.
*This was the pre-opening examination to determine compliance with the OFR Final Order of Approval and to confirm the bank's readiness to open for business on August 16, 2006.
**The examination was completed but the ROE was never issued to the bank.
***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.

In addition to onsite examinations, the FDIC's offsite monitoring program generally consists of periodic contact with bank management to discuss current or emerging issues and the use of various offsite monitoring tools, including the offsite review list, to monitor institutions between examinations. In this case, FDIC officials contacted bank officials to follow up on emerging issues or concerns.

Supervisory Response Related to Key Risks

In retrospect, given the examination findings and Hillcrest's risk profile, a more critical assessment and aggressive supervisory approach may have been prudent in 2007. Board and management responses to enforcement actions taken in 2008 fell short, and by the

[10] The seven factors in section 6 of the FDI Act include: (1) the financial history and condition of the depository institution, (2) the adequacy of the depository institution's capital structure, (3) the future earnings prospects of the depository institution, (4) the general character and fitness of the management of the depository institution, (5) the risk presented by such depository institution to the DIF, (6) the convenience and needs of the community to be served by such depository institution, and (7) whether the depository institution's corporate powers are consistent with the purposes of the Act.

time the formal enforcement action taken in 2009 became effective, the bank's financial condition had become critically deficient and it was closed.

2007 Supervisory Activities

As a de novo institution, Hillcrest was subject to two risk management examinations in its first year of its operation. Specifically, the examination guidance requires a limited scope examination to be conducted for newly-chartered and insured institutions within the first 6 months of operation, and a full-scope examination within the first 12 months of operation. In their respective 2007 examinations, the FDIC and the OFR identified a number of risk management practices that needed to be addressed as well as Hillcrest's increased risk profile stemming from the bank's deviations from its original business plan. However, both examinations concluded that the bank's overall condition was satisfactory.

The OFR's February 2007 examination found that management had complied with the conditions contained in the state's final orders approving the bank's charter and deposit insurance. However, the examination report stated that asset quality was less than satisfactory and assigned a "3" rating because of the large volume of loan participations and the high number of technical exceptions related to the participation loan documentation. In response to the examination, a senior bank official stated that the bank would not purchase additional participations in the near term and would work with regulators to determine an appropriate level of loan participations. The OFR's letter transmitting the examination report to the bank requested that Hillcrest's business plan be amended to address the level of loan participations purchased and the bank's expansion into the Florida east coast market. As indicated earlier in this report, the bank submitted a revised plan in May 2007.

As part of the FDIC's broader supervisory efforts to monitor institutions with significant involvement in construction and subprime lending, the FDIC contacted senior management officials at Hillcrest in June 2007 to discuss the bank's ADC exposure, including ADC loans participations. Based on March 31, 2007 Call Report data, the bank's exposure to ADC lending represented approximately 246 percent of Tier 1 Capital. FDIC officials determined through discussions with bank officials that the bank's ADC lending was primarily related to commercial construction loans acquired through participations but noted that the bank was no longer purchasing participations and had established limits with respect to its participation exposure. Bank officials acknowledged that the most significant risk it faced related to the softening of real estate market conditions in southwest Florida and viewed the demand for funding of office and retail construction in Naples to be strong. Overall, the bank anticipated that construction lending would remain a profitable segment of the bank's loan portfolio.

The FDIC performed the second onsite examination in September 2007. Pre-planning efforts targeted key areas, including asset quality, earnings, and management. The overall condition of the bank was again determined to be satisfactory. The FDIC's examination report stated that asset quality and management components were generally satisfactory despite the fact that risk management policies and practices were determined to be inadequate. The examination report outlined a number of elements that needed to be addressed, as described earlier in this report. The level of adversely classified assets at 19.69 percent was considered both moderate and manageable.

The FDIC assigned a “2” to the asset quality component rating, which indicates satisfactory asset quality and credit administration practices, the level and severity of classifications, and other weaknesses warrant a limited level of supervisory concern and risk exposure is commensurate with capital. A “3” rating is assigned when asset quality or credit administration practices are less than satisfactory, trends may be stable or indicate deterioration in asset quality or an increase in risk exposure, and the level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. In our view, assigning asset quality a “3” rating would have been consistent with the 2007 examination findings and communicated a stronger degree of supervisory concern. FDIC officials commented that a lower rating may not have been helpful in ensuring the bank’s viability given that the loans that proved problematic had already been made and the ensuing market decline was rapid and steep.

The FDIC also deemed the performance of senior management and the Board to be satisfactory and assigned the management component a “2” rating, which indicates satisfactory management and Board performance and risk management practices relative to the institution’s size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled. However, the examination report noted that certain aspects of the current business plan were in contravention of the order approving deposit insurance. Further, consistent with comments made in the assessment of asset quality, examiners reported that Board and management oversight of the credit risk management practices needed enhancement, made recommendations to improve the loan policy and ALLL methodology, and concluded that management should be able to correct the deficiencies in the normal course of business.

A “3” management rating indicates management and Board performance need improvement or risk management practices are less than satisfactory given the nature of the institution’s activities. The capabilities of management and the Board may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, and controlled. As with the asset quality rating, the 2007 examination findings related to management appear more consistent with the characteristics of a “3” rating than a “2”.

During this examination, the bank’s earnings performance was found to be marginal but the return on average assets ratio exceeded its peer ratio[11] and exhibited a positive trend, and actual performance exceeded original application projections for the first 12 months

[11] Institutions are assigned to 1 to 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. De novo institutions are compared to other banks that opened in the same period for 5 years. Accordingly, Hillcrest’s peer group included institutions established in 2006 with assets less than $750 million.

of operations. The bank's capital level was determined to be sufficient to support the continued growth of the bank.

In their respective 2007 examinations, the OFR and the FDIC both assigned Hillcrest a composite "2" CAMELS rating, which indicates that an institution is considered to be fundamentally sound and only moderate weaknesses are present and are well within the Board's and management's capabilities and willingness to correct. Further, overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile.

2008 Supervisory Activities

The OFR's August 2008 examination found the bank's overall condition to be marginal and a composite "4" CAMELS rating was assigned to reflect the level of deterioration. Specifically, total adversely classified assets represented approximately 128 percent of Tier 1 Capital and the deterioration in asset quality was attributed to the bank's high concentration in CRE loans coupled with the declining real estate market. Further, the examination report stated that management performance and Board oversight needed improvement and noted significant turnover among senior bank management. Given the condition of the bank, the OFR determined that an enforcement action to correct the bank's deficiencies was needed, and, in conjunction with the FDIC, issued an MOU that became effective on November 7, 2008. Given the bank's condition, a C&D could have been pursued; however, OFR officials concluded that an MOU would be sufficient based on improvement noted under the new management team and corrective measures that had been put in place during the examination. The MOU included 19 provisions primarily related to:

- asset quality and lending,
- capital and earnings,
- management, and
- violations and contraventions cited.

The MOU also required the Board to provide written progress reports within 30 days of each calendar quarter to the OFR and the FDIC. In response to the MOU, the Hillcrest principals injected an additional $2.5 million of capital into the bank in December 2008. Both the state and federal supervisors viewed this action as evidence that Hillcrest was responsive to the capital demands of the MOU and that the owners had the resources to fund the institution through troubled times. This capital injection, along with the institution's response to the MOU, was documented in correspondence and quarterly MOU progress reports submitted to the OFR and the FDIC.

Hillcrest was designated a problem institution in November 2008 and also appeared on the FDIC's offsite review list in the third quarter of 2008 due to the high volume of nonaccrual loans, elevated loan loss provisions, weak earnings performance, and a large volume of CRE loans. The FDIC concluded that further action was not warranted because of ongoing supervisory efforts resulting from the OFR's onsite examination.

The offsite analysis also concluded that concerns were somewhat mitigated by the bank's new management team.

<u>2009 Supervisory Activities</u>

The July 2009 FDIC examination found that the financial condition of the bank had become critically deficient and that the bank was no longer viable. Approximately 50 percent of the bank's loan portfolio was adversely classified and, despite a mandate by the OFR in July 2009 to raise additional capital, the Board failed to do so. Overall, the FDIC examination found the MOU had not been effective in correcting the bank's problems as management had not addressed a number of provisions. The FDIC noted that many of the bank's loan problems originated under prior management and the Board's oversight of those individuals was lacking. Further, the FDIC concluded that the new management team lacked the experience necessary to address the bank's problems and restore the viability of the bank. In addition, since the OFR 2008 examination, three Board members had resigned and only one had been replaced. In 2009, the FDIC assigned Hillcrest a composite "5" CAMELS rating, reaffirmed its status as a problem bank, and initiated the process for a C&D to be put in place. Although the bank stipulated to the C&D in September 2009, the OFR closed Hillcrest on October 23, 2009 and the FDIC terminated the C&D on October 28, 2009.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital levels deteriorate. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38.

Based on the supervisory actions taken with respect to Hillcrest, the FDIC properly implemented applicable PCA provisions of section 38. Notably, as a condition of approval for its deposit insurance application, the bank had to maintain a certain capital ratio for the first 3 years of its operations and did so until December 2008. Further, the 2008 MOU required that the bank submit a capital plan with 60 days and maintain the following ratios, which are higher than those for the *Well Capitalized* thresholds under section 38:

- Tier 1 Capital of no less than 8 percent;
- Tier 1 Risk-Based Capital Ratio at no less than 10 percent, and
- Total Risk-Based Capital at no less than 12 percent.

The MOU required the same Tier 1 Capital levels as the deposit insurance order. Further, the MOU included a provision prohibiting the declaration of any dividends or any other capital distributions without prior regulatory approvals.

The bank developed a capital plan as required under the MOU and did not declare or pay any dividends; however, due to the continuous deterioration of asset quality and inadequate earnings, all capital ratios fell below the required provisions as of June 30, 2009. On June 25, 2009, the FDIC appropriately notified the bank of its capital position and corresponding requirements when it fell to *Adequately Capitalized.* Subsequently, on July 28, 2009, the FDIC notified Hillcrest that it was *Critically Undercapitalized*. In accordance with PCA provisions, the FDIC required the bank's Board to file a written capital restoration plan by August 28, 2009. The bank submitted a capital restoration plan as required but the FDIC determined it to be unacceptable. In the interim, in a letter dated July 14, 2009, the OFR mandated that the Board increase capital by July 31, 2009 in an amount sufficient to increase the Tier 1 Capital ratio to 6 percent. Ultimately, the Board was unsuccessful in raising additional capital and the bank was closed on October 23, 2009. Hillcrest had submitted an application for the Troubled Asset Relief Program on October 24, 2008 for funding of $3 million, however, withdrew the application on February 3, 2009.

Supervisory Lessons Learned

In hindsight, risk factors were present in 2007 that could have triggered a stronger supervisory response in terms of assigning a lower supervisory rating or pursuing some type of enforcement action. In our view, the following factors could have supported lower asset quality and management ratings, a lower CAMELS composite rating, and/or a pursuit of a supervisory action: (1) Hillcrest's de novo status and noted deviations from its original business plan, (2) the assessment in the September 2007 examination that risk management policies and practices for the credit function were not adequate, and (3) the recognition of the bank's elevated risk profile presented by its ADC lending in a weakening real estate market. FDIC officials explained that, at the time, consideration was given to the Board and management's overall experience and general willingness to address concerns, and the expectation that the principals would provide additional capital as necessary.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from recent failures. Specifically, in recognition of the elevated risk that newly-chartered institutions pose to the DIF, the FDIC issued FIL-50-2009, entitled *Enhanced Supervisory Procedures For Newly Insured FDIC-Supervised Depository Institutions*, dated August 28, 2009, which extends the de novo period for newly chartered institutions from 3 to 7 years for purposes of onsite examinations, capital maintenance, and other requirements. In addition, the updated guidance requires that de novo institutions obtain prior approval from the FDIC before making material changes in their business plans.

Further, the FDIC issued guidance in January 2010 that defines a standard approach for communicating matters requiring bank Board attention (e.g., examiner concerns and recommendations) in examination reports. The guidance states that case managers should request a response from the institution regarding the action that it will take to mitigate the risks identified during the examination and correct noted deficiencies. This approach provides examiners with another tool to hold Board and management accountable for improved performance and should also facilitate effective supervisory follow-up.

Finally, the FDIC recently completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as the current financial performance or trends in assigning ratings as allowable under existing examination guidance. The training also covered methods for communicating weak management practices to the Board and management and tools being developed to monitor corrective actions.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On April 30, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Hillcrest's failure. With regard to our assessment of the FDIC's supervision of Hillcrest, DSC summarized key aspects of the supervisory history presented in the report. Specifically, DSC stated that from 2007 to 2009, FDIC and OFR examinations identified key risks in operations and made recommendations to improve weak risk management practices. Further, in 2007, the FDIC noted concern about Hillcrest's ADC exposure. During the OFR's August 2008 examination, Hillcrest's weak management practices became evident, resulting in a lower composite rating and the issuance of an enforcement action. DSC's response also highlighted the program changes for de novo institutions in 2009, including extension of the de novo period from 3 to 7 years and emphasis on de novo business plans.

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 January 2010 to May 2010 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 Hillcrest's operations from 2006 until its failure on October 23, 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 examination reports prepared by FDIC and OFR examiners from 2006 to 2009.

- Reviewed the following:

    - Bank data and correspondence maintained at DSC's Sunrise, Florida Field Office, and Kansas City, Missouri Regional Office.

    - Documents prepared by DRR and DSC relating to the bank's closure. We also reviewed available loan trial balances maintained by DRR for information that would provide insight into the bank's failure.

    - Pertinent DSC policies and procedures and various banking laws and regulations.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:

    - DSC management in Washington, D.C., and the Kansas City Regional Office and Sunrise, Florida Field Office.

    - DRR officials at the Washington Headquarters and the Jacksonville, Florida Field Office.

    - FDIC examiners from the Sunrise, Florida Field Office who participated in examinations or reviews of examinations of Hillcrest.

    - OFR officials to discuss the state's supervision of the bank.

We performed the audit work at the OIG's office in Arlington, Virginia and OFR's office in Tallahassee, Florida.

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, and interviews of examiners to understand Hillcrest'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 examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were 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)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Call Report	The report filed by a bank pursuant to 12 United States Code (U.S.C.) 1817(a)(1), which requires each insured State nonmember bank and each foreign bank having an insured branch which is not a Federal branch to make to the Corporation reports of condition in a form that shall contain such information as the Board of Directors may require. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A 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.
De novo Bank	Prior to the issuance of FIL-50-2009 on August 28, 2009, and for the purposes of FDIC-supervised institutions, this term referred to an institution within its first 3 years of operation. FIL-50-2009 changed the de novo period for newly-chartered FDIC-supervised institutions from 3 years to 7 years. This FIL does not apply to de novo bank subsidiaries of "eligible holding companies", i.e., those with $150 million in consolidated assets, that are 2 rated, and with at least 75 percent of consolidated depository institution assets comprised of eligible depository institutions. Under the new de novo period, institutions must undergo a limited-scope examination within the first 6 months of operation, and a full-scope examination within the first 12 months of operation. Subsequent to the first examination, and through the 7th year of operation, institutions remain on a 12-month examination cycle. Extended examination intervals (i.e., 18-month intervals) do not apply during the de novo period.

Glossary of Terms

Term	Definition
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, this action 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, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations (C.F.R.), section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C. 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.
Tier 1 (Core) Capital	In general, this term is defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in financial subsidiaries subject to section 12 C.F.R. part 362; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.
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 data reported in Reports of Condition and Income submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
MOU	Memorandum of Understanding
OFR	Florida 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 Institutions Rating System

Corporation Comments

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

April 30, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Hillcrest Bank Florida, Naples, FL (Assignment No. 2010-012)

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 Hillcrest Bank Florida (Hillcrest), Naples, Florida, which failed on October 23, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on April 20, 2010.

The Report concludes that Hillcrest failed due to the Board of Directors' (Board) and management's lending strategy concentrated in commercial real estate (CRE) loans, particularly acquisition, development and construction (ADC) loans, coupled with inadequate risk management practices. Hillcrest's strategy, which deviated from the original business plan, did not have approval from the FDIC and the Florida Office of Financial Regulation's (OFR). As of December 31, 2007, Hillcrest's ADC loan portfolio represented 67 percent of the total loan portfolio. Hillcrest opened as the Florida real estate market began a steep decline, leaving Hillcrest vulnerable when the real estate market collapsed.

From 2007 to 2009, FDIC and OFR examinations identified key risks in operations and made recommendations to improve weak risk management practices. In 2007, the FDIC noted Hillcrest's ADC exposure, including the purchased loan participations, and expressed concern regarding the heightened risk posture. During the August 2008 examination, Hillcrest's weak management practices became evident in the significant deterioration in Hillcrest's overall condition resulting in a composite rating of "4" being assigned. Given the condition of Hillcrest, the OFR in conjunction with the FDIC issued an enforcement action that became effective in November 2008.

In recognition that stringent supervisory attention is necessary for de novo institutions, DSC has extended its supervisory program so that these institutions receive a full scope examination every year for seven years, as opposed to three years. De novo business plans are receiving careful analysis prior to an institution's opening and being closely monitored against approved financial projections throughout the seven year period. A Financial Institution Letter issued in August 2009 describes the program changes for de novo institutions and warns that changes in business plans undertaken without required prior notice may subject an institution or its insiders to civil money penalties.

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