Office of Inspector General

Office of Audits and Evaluations
Report No. AUD-12-014

Material Loss Review of Tennessee Commerce Bank, Franklin, Tennessee

September 2012

Office of Inspector General

Executive Summary

Material Loss Review of Tennessee Commerce Bank, Franklin, Tennessee

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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the Deposit Insurance Fund (DIF) 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. Section 38(k), as amended, establishes a material loss review (MLR) threshold of $150 million for losses that occur for the period January 1, 2012 through December 31, 2013.

On January 27, 2012, the Tennessee Department of Financial Institutions (TDFI) closed Tennessee Commerce Bank (TCB), and the FDIC was appointed receiver. The FDIC notified the Office of Inspector General (OIG) on March 13, 2012 that TCB's total assets at closing were $1.0 billion and that the estimated loss to the DIF was $416.8 million (or 42 percent of TCB's total assets). The FDIC OIG engaged KPMG LLP (KPMG) to conduct an MLR of TCB. The performance audit objectives were to (1) determine the causes of TCB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of TCB, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. As part of the audit, KPMG reviewed the application submitted by the Tennessee Commerce Bancorp, Inc. (Bancorp)–TCB's parent holding company–for capital from the United States Department of the Treasury's (Treasury) Troubled Asset Relief Program (TARP) and examiner coverage of the use of those funds at TCB.

Background

TCB commenced operations on January 14, 2000. The institution's corporate and banking offices were located in Franklin, Tennessee, which is about 15 miles south of Nashville. The bank was wholly owned by Bancorp, a publicly traded, one-bank holding company. TCB's assets were centered in its loan portfolio, which totaled $1.17 billion as of December 31, 2009, a point at which loan growth was slowing and the FDIC had determined the bank to be in a "troubled condition." The loan portfolio consisted of 55 percent commercial and industrial (C&I) loans, 38 percent real estate loans (both commercial and consumer), and 7 percent consumer and credit card loans as of that date.

Although TCB offered a full range of banking services and products, its operations focused on a nontraditional "Business Bank" strategy that emphasized banking services for small- to medium-sized businesses, entrepreneurs, and professionals in the bank's local market within a 250 mile radius of the Nashville, TN, metropolitan area. The strategy did not target retail customers or involve competition with other banks based on the traditional definition of "convenience." For example, the bank did not maintain a branch network, a teller line, a drive-through window, or extended banking hours at its main office. TCB's customized business lending consisted of such things as providing lines of credit and term loans secured by accounts receivable, inventory, equipment, and real estate. The bank also made commercial real estate (CRE) loans, including acquisition and construction loans for business properties and term loan financing of CRE.

A large portion of TCB's lending activities included collateral-based financing to national and regional equipment vendors and financing companies through two indirect national market funding programs, one of which focused on large loans and the other on small loans. Under both programs, transactions were originated by third parties, such as equipment vendors or financial services companies, that provided TCB with borrower financial information and arranged for the borrowers' execution of loan documentation. As of December 31, 2009, TCB's indirect national market funding programs accounted for about 25 percent of the bank's $1.17 billion loan portfolio. In addition to its main office in Franklin, TCB operated three loan production offices in Alabama, Minnesota, and Georgia prior to the downturn in its lending markets. By January 2011, all three loan production offices had closed. TCB also originated and sold loan packages and loan participations to increase its earnings and manage its exposure to borrowers.

Audit Results

Causes of Failure and Material Loss

TCB failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the bank's sustained high growth in C&I lending. Notably, TCB had a significant concentration in an economically sensitive and specialized segment of the C&I market pertaining to the transportation industry. The bank's lending in this area included loans to leasing companies and lease brokers for the financing of trucks, buses, and other commercial use vehicles. However, TCB's underwriting, administration, monitoring, and collection procedures for these and other C&I loans was not adequate. Contributing to the bank's credit risk exposure were large and complex borrowing relationships that were not effectively managed. Further, TCB's funding strategy for sustaining loan growth and maintaining liquidity involved heavy reliance on non-core funding sources, such as Internet and brokered deposits, and capital injections from its holding company. Finally, TCB did not maintain capital at levels that were commensurate with its risk profile.

In 2007, TCB began to experience problems with its loans in the transportation industry due to the bank's lax lending practices and a softening economy. The credit quality of TCB's loan portfolio continued to decline in 2008 and accelerated as the economy deteriorated. However, TCB continued its high growth strategy, reporting that it originated over $90 million in new loans during the first quarter of 2009. In total, TCB originated or renewed about $400 million in loans from 2009 until its failure. The bank ultimately charged off about $64 million of the $400 million amount as loss. TCB's Board and management failed to recognize problems and losses in the bank's loan portfolio in a timely manner or to take appropriate action to address problems as they developed. TCB also engaged in unusual lending practices, such as insurance premium financing, and made a number of particularly risky loans to individuals in the banking sector that were secured by the stock of other banks in the years before its failure. These loans contributed to the bank's losses.

TCB's final Consolidated Reports of Condition and Income indicated that the bank lost more than $165 million during 2011 and had negative equity capital. The TDFI closed TCB on January 27, 2012 because the institution was unable to raise sufficient capital to support safe and sound banking operations.

The FDIC's Supervision of TCB

The FDIC, in coordination with the TDFI, provided ongoing supervisory oversight of TCB through regular onsite examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and a formal enforcement action. Such risks related to the Board and management's oversight of the institution, the bank's lending strategy, loan underwriting and credit administration, the decline in the loan portfolio, and TCB's heavy reliance on non-core funding sources. Based on the results of an August 2010 joint examination, TCB's Board stipulated to the issuance of a Consent Order, which became effective on May 25, 2011 and remained in place until the bank was closed.

TCB exhibited a high-risk profile in the years preceding the bank's financial decline. Key risks included:

- Sustained high growth and heavy concentrations in economically sensitive segments of C&I lending, including emphasis on specialized lending to leasing companies and lease brokers in the transportation industry, the nature of which exposed the bank to elevated credit risk.

- Reliance on outside sources of capital to maintain growth and capital ratios that were marginally above the PCA thresholds for *Well Capitalized* institutions.

- Exposure to large and complex borrowing relationships without adequate underwriting and administration.

- Dependence on non-core funding sources, such as Internet and brokered deposits, to support loan growth and liquidity.

Examination reports issued in the years before TCB's financial decline noted that the bank had a relatively high-risk profile and included recommendations to TCB's Board and management to address risks identified during the examinations. During those periods, TCB was profitable, its financial condition was satisfactory, and conditions in its lending markets were generally favorable. Under the FDIC's current approach to supervision, banks with elevated risk profiles, such as TCB, are subject to increased supervisory analysis and a more proactive supervisory response—including accelerated examinations or visitations, lower ratings, and/or supervisory actions—when risks are not properly managed.

In the case of TCB, a more proactive supervisory response to the bank's risky business activities during earlier examinations may have been prudent. Such a response could have included placing greater emphasis on TCB establishing prudent limits on its industry and borrower concentrations, holding higher levels of capital, and implementing stronger risk management practices—particularly with respect to its specialized lending and funds management practices. A more in-depth review of TCB's loan portfolio during the April 2008 TDFI examination also may have been warranted given the risk and complexity of the bank's lending practices, its continued high growth, and management's less-than-satisfactory oversight of the bank. Examiners could have also expressed greater concern within the examination report regarding the risks associated with segments of TCB's C&I loan portfolio, including concentrations of credit pertaining to the transportation industry.

Based on the results of the June 2009 examination, the FDIC pursued a Memorandum of Understanding (MOU) with TCB's Board to address key risk management concerns. Although TCB's Board passed a bank board resolution to address the issues identified during the examination, the FDIC was unable to persuade the bank to execute an MOU. The FDIC performed a visitation of the bank in April 2010. In retrospect, accelerating the next full-scope examination may have resulted in the necessary support to pursue a formal action sooner than the Consent Order that became effective in May 2011.

With respect to Bancorp's receipt of $30 million under the TARP Capital Purchase Program (CPP), in accordance with provisions of the Emergency Economic Stabilization Act of 2008 (EESA), the FDIC recommended that Treasury approve Bancorp for CPP funds after determining that TCB met all of Treasury's eligibility criteria. Examiners obtained documentation during the June 2009 joint examination that addressed TCB's use of the CPP funds and efforts to comply with executive compensation requirements associated with CPP funding. While the June 2009 joint examination report stated that CPP funds were used to fund loan growth, the report did not address TCB's compliance with the CPP securities purchase agreement. The August 2010 joint examination report stated that examiners were unable to determine whether TCB fully complied with the agreement and the requirements of EESA based on limited information provided by the bank. According to RMS officials, examiners made multiple attempts to obtain information from the TCB's Chief Financial Officer and other bank management officials.

Based on the supervisory actions taken with respect to TCB, the FDIC properly implemented the applicable PCA provisions of section 38.

As it relates to the issues and lessons learned discussed in this report, the FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the recent financial crisis. Such actions include instituting a training initiative for examiners on the appropriate supervisory response for banks with elevated risk profiles and issuing additional supervisory guidance on funds management practices and specialty lending areas, including C&I lending and lease financing.

Management Response

Subsequent to the issuance of KPMG's draft report, RMS and TDFI officials provided additional information for KPMG's consideration, and KPMG revised its report to reflect this information, as appropriate. On September 11, 2012, the Director, RMS, provided a written response to the draft report. In the response, the Director reiterated the causes of TCB's failure and the supervisory activities described in the report. Further, RMS has recognized the threat that institutions with high risk profiles, such as TCB, pose to the DIF and issued additional guidance to examiners related to C&I loans and lease financing in 2009 and 2010. RMS also issued a Financial Institution Letter (FIL) to FDIC-supervised institutions in 2009 entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition.* According to RMS, this FIL heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

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

Office of Audits and Evaluations
Office of Inspector General

DATE: September 13, 2012

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

/Signed/

FROM: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

SUBJECT: *Material Loss Review of Tennessee Commerce Bank, Franklin, Tennessee* (Report No. AUD-12-014)

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. The report does not contain recommendations, thus a response was not required. However, the Division of Risk Management Supervision provided a written response on September 11, 2012. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mark Mulholland, Assistant Inspector General for Audits, at (703) 562-6316. We appreciate the courtesies extended to the Office of Inspector General and contractor staff.

Attachment

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Part I

Report by KMPG LLP

Material Loss Review
Tennessee Commerce Bank
Franklin, Tennessee

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP

1676 International Drive
McLean, VA 22102

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KPMG LLP
1676 International Drive
McLean, VA 22102

September 13, 2012

Stephen M. Beard
Deputy Inspector General for Audits and Evaluations
Federal Deposit Insurance Corporation
3501 Fairfax Drive
Arlington, VA 22226

Material Loss Review Report on the Failure of Tennessee Commerce Bank, Franklin, Tennessee

Dear Mr. Beard:

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review (MLR) of the Tennessee Commerce Bank (TCB or the bank), Franklin, Tennessee. This performance audit report details the results of our review. The objectives of this performance audit were to (1) determine the causes of TCB's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of TCB, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the Federal Deposit Insurance Act (FDI Act).

Our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG communicates those to FDIC management for its consideration. As resources allow, the FDIC OIG conducts more comprehensive reviews of specific aspects of the FDIC's supervision program and makes recommendations as warranted.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). These standards require that we plan and conduct the performance 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.

The information included in this report was obtained during our fieldwork, which occurred during the period April 2012 through June 2012.

Very truly yours,

KPMG LLP

Why a Material Loss Review Was Performed

Section 38(k) of the FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the DIF 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. Section 38(k), as amended, establishes an MLR threshold of $150 million for losses that occur for the period January 1, 2012 through December 31, 2013. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

On January 27, 2012, the Tennessee Department of Financial Institutions (TDFI) closed TCB, and the FDIC was appointed receiver. The FDIC's Division of Finance notified the OIG on March 13, 2012 that TCB's total assets at closing were $1.0 billion and that the estimated loss to the DIF was $416.8 million (or 42 percent of TCB's total assets). The FDIC OIG engaged KPMG to conduct an MLR of TCB. The performance audit objectives were to (1) determine the causes of TCB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of TCB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. Appendix 1, *Objectives, Scope, and Methodology*, describes the procedures used by KPMG to conduct this performance audit.[1] In addition, Appendix 2 provides a glossary of terms, and Appendix 3 contains a list of acronyms used in this report.

Background

TCB commenced operations on January 14, 2000. The institution's corporate and banking offices were located in Franklin, Tennessee, which is about 15 miles south of Nashville. The bank was wholly owned by the Tennessee Commerce Bancorp, Inc. (Bancorp), a publicly traded, one-bank holding company. As of December 2011, a single shareholder controlled about 10 percent of Bancorp's outstanding stock and TCB's directorate and officers collectively owned or controlled an additional 9.9 percent of the stock. The remainder of Bancorp's stock was widely held. In addition, TCB owned 27 percent of the stock in Commerce Bancshares, Inc.—the parent holding company of the Peoples State Bank of Commerce (Peoples), Nolensville, Tennessee—and 46 percent of the stock in Farmers Bancorp, Inc.—the parent of the Farmers Bank of Lynchburg (Farmers), Lynchburg, Tennessee, which failed on June 15, 2012. After analyzing the circumstances pertaining to TCB's holdings in Peoples and Farmers, the FDIC

[1] In conducting this performance audit and preparing the report, KPMG relied primarily on TCB records and on information provided by the OIG, the FDIC's Division of Risk Management Supervision (RMS), and the Division of Resolutions and Receiverships (DRR). Within the FDIC, DRR has primary responsibility for resolving failing and failed financial institutions and managing the resulting receiverships.

determined that TCB was not commonly controlled with the institutions and, therefore, did not subject them to cross-guarantee liability when TCB failed.[2]

TCB's assets were centered in its loan portfolio, which totaled $1.17 billion as of December 31, 2009, a point at which loan growth was slowing and the FDIC had determined the bank to be in "troubled condition." The loan portfolio consisted of 55 percent commercial and industrial (C&I) loans, 38 percent real estate loans (both commercial and consumer), and 7 percent consumer and credit card loans as of that date. Although TCB offered a full range of banking services and products, its operations focused on a nontraditional "Business Bank" strategy that emphasized banking services for small- to medium-sized businesses, entrepreneurs, and professionals in the bank's local market of middle Tennessee, which consisted of a 250 mile radius around the Nashville metropolitan area. The strategy did not target retail customers or involve competition with other banks based on the traditional definition of "convenience." For example, the bank did not maintain a branch network, a teller line, a drive-through window, or extended banking hours at its main office. TCB's customized business lending consisted of such things as providing lines of credit and term loans secured by accounts receivable, inventory, equipment, and real estate. The bank also made commercial real estate (CRE) loans, including acquisition and construction loans for business properties and term loan financing of CRE.

A large portion of TCB's lending activities included collateral-based financing to national and regional equipment vendors and financing companies through two indirect national market funding programs, one of which focused on large loans and the other on small loans. Under both programs (which are described below), transactions were originated by third parties, such as equipment vendors or financial services companies, that provided TCB with borrower financial information and arranged for the borrowers' execution of loan documentation.[3] As of December 31, 2009, TCB's indirect national market funding programs accounted for about 25 percent of the bank's $1.17 billion loan portfolio.

- **Indirect (Large Loans).** Using a network of financial service companies and vendor partners, the bank provided financing to national middle-market and investment-grade companies. As of December 31, 2009, the average loan size under this program was $389,000. Collectively, the bank's loans under this program accounted for about 11 percent of the loan portfolio at year-end 2009.

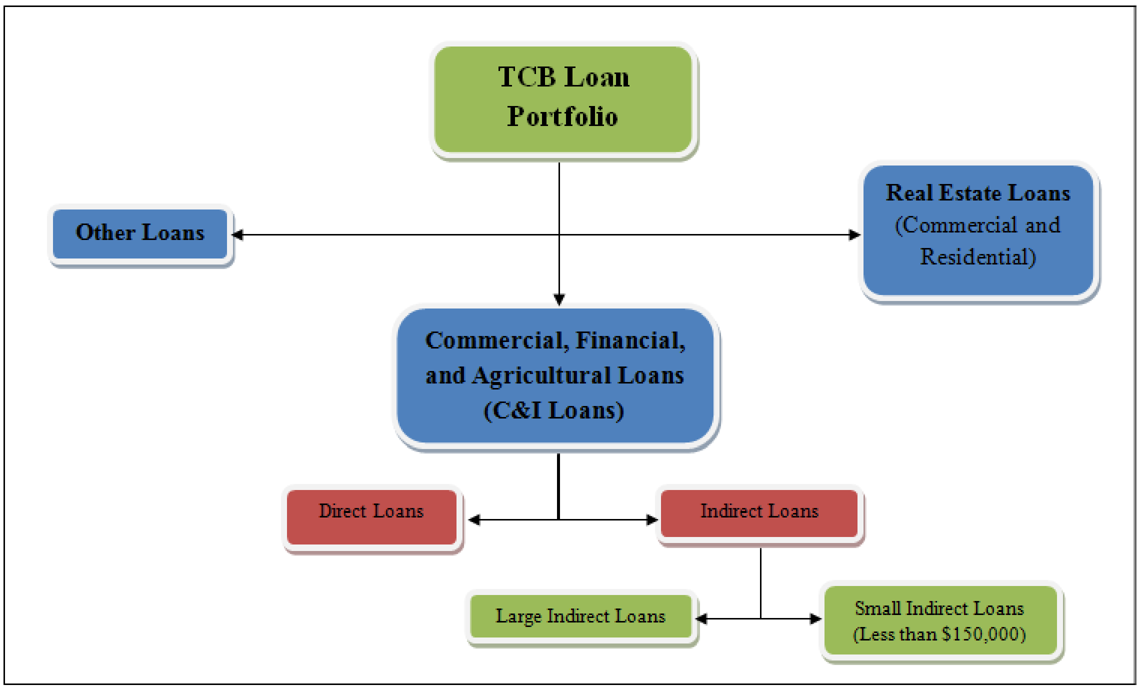
- **Indirect (Small Loans).** Using a network of financial service companies and vendors located in Tennessee, Alabama, Georgia, California, and Michigan, the bank financed business assets that were less than $150,000 at origination. As of December 31, 2009, the average loan size under this program was $45,000.

[2] Under Section 5(e) of the FDI Act, an insured depository institution is liable for any loss that the FDIC incurs, or reasonably expects to incur, in connection with resolving a commonly controlled institution. This is generally referred to as "cross-guarantee liability."
[3] While these transactions were originated and executed by third parties, indirect funding was subject to TCB's minimum credit scores and documentation standards.

Collectively, the bank's loans in this program accounted for about 14 percent of the loan portfolio at year-end 2009.

In addition to its main office in Franklin, TCB operated three loan production offices in Alabama, Minnesota, and Georgia prior to the downturn in its lending markets. By January 2011, all three loan production offices had closed. TCB also originated and sold loan packages and loan participations to increase its earnings and manage its exposure to borrowers. Figure 1 illustrates the structure of TCB's loan portfolio and classifications as described and referenced throughout this report.

Figure 1: TCB's Loan Portfolio Structure



Source: KPMG's analysis of TCB's Annual Reports on Form 10-K filed with the Securities and Exchange Commission (SEC).

Table 1 provides details on the bank's financial condition as of December 31, 2011, and for the 5 preceding years. As reflected in the table, TCB continued to grow its loan portfolio through 2010, with a majority of the portfolio focused on C&I lending. The bank also relied heavily on Internet and brokered deposits to make loans and provide for liquidity.

Table 1: Selected Financial Information for TCB, 2006-2011

Financial Data ($000s)	12/31/11	12/31/10	12/31/09	12/31/08	12/31/07	12/31/06
Total Assets	$1,009,154	$1,444,487	$1,372,861	$1,210,553	$899,068	$625,189
Total Loans	$897,186	$1,229,811	$1,171,301	$1,036,725	$794,322	$545,517
Annual Loan Growth Rate	(27%)	5%	13%	31%	46%	56%
Total Deposits	$1,037,716	$1,306,774	$1,247,085	$1,088,738	$815,830	$566,875
Brokered Deposits/Total Liabilities	16.43%	9.09%	12.92%	10.14%	12.31%	12.86%
Noncurrent Loans/Gross Loans	14.16%	4.54%	1.75%	2.93%	1.06%	0.66%
Net Interest Margin	2.80%	4.10%	3.75%	3.51%	3.74%	4.04%
Return on Average Assets	(12.00%)	0.43%	(0.26%)	0.98%	1.07%	1.12%

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

Causes of Failure and Material Loss

TCB failed primarily because its board of directors (Board) and management did not effectively manage the risks associated with the bank's sustained high growth in C&I lending. Notably, TCB had a significant concentration in an economically sensitive and specialized segment of the C&I market pertaining to the transportation industry. TCB's lending in this area included loans to leasing companies and lease brokers for the financing of trucks, buses, and other commercial use vehicles. However, TCB's underwriting, administration, monitoring, and collection procedures for these and other C&I loans was not adequate. Contributing to the bank's credit risk exposure were large and complex borrowing relationships that were not effectively managed. Further, TCB's funding strategy for sustaining loan growth and maintaining liquidity involved heavy reliance on non-core funding sources, such as Internet and brokered deposits, and capital injections from its holding company. Finally, TCB did not maintain capital at levels that were commensurate with its risk profile.

In 2007, TCB began to experience problems with its loans in the transportation industry due to the bank's lax lending practices and a softening economy. The credit quality of TCB's loan portfolio continued to decline in 2008 and accelerated as the economy deteriorated. However, TCB continued its high growth strategy, reporting that it originated over $90 million in new loans during the first quarter of 2009. In total, TCB originated or renewed about $400 million in loans from 2009 until its failure. The bank ultimately charged off about $64 million of the $400 million amount as loss. TCB's Board and management failed to recognize problems and losses in the bank's loan portfolio in a timely manner or to take appropriate action to address problems as they developed. TCB also engaged in unusual lending practices, such as insurance premium financing, and made a number of particularly risky loans to individuals in the banking sector that were secured by the stock of other banks in the years before its failure. These loans contributed to the bank's losses.

TCB's final Consolidated Reports of Condition and Income (Call Report) indicated that the bank lost more than $165 million during 2011 and had negative equity capital. The TDFI closed TCB on January 27, 2012 because the institution was unable to raise sufficient capital to support safe and sound banking operations.

Board and Management Oversight

The FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) states that the quality of an institution's management, including its Board and executive officers, is perhaps the single most important element in the successful operation of an institution. According to the Examination Manual, the Board has overall responsibility and authority for formulating sound policies and objectives for the institution and for effectively supervising the institution's affairs. Executive officers, such as the President and Chief Executive Officer and the Chief Financial Officer (CFO), have primary responsibility for managing the day-to-day operations and affairs of the bank. Further, ensuring appropriate corrective actions to regulatory concerns is a key responsibility of the Board.

TCB's Board and executive management team did not provide effective oversight and management of the institution. As discussed more fully in subsequent sections of this report, the Board and management implemented an unconventional and risky Business Bank strategy that exposed TCB to significant operational and credit risk in the event of a sustained downturn in the economy. Specifically, TCB:

- emphasized high loan growth and specialized lending without adequate risk management practices;

- developed large and complex borrowing relationships that exposed the bank to significant risk and credit losses;

- engaged in unusual lending practices, such as life insurance premium financing, without appropriately analyzing the associated risks or properly documenting the deliberations of the Board or management's rationale for conducting such practices;

- did not maintain capital at levels that were commensurate with the bank's risk profile; and

- executed a funding strategy for sustaining loan growth and maintaining liquidity that involved heavy reliance on non-core funding sources, particularly Internet and brokered deposits.

Throughout its history, TCB stressed operating efficiencies, as evidenced by the bank's efficiency ratio that placed TCB in the top 5 percent of its peer group average between

2007 and 2009.[4] During that same period, TCB's ratio of average assets per employee placed the bank in the top 3 percent of its peer group. Such metrics indicate that TCB was able to maintain low overhead expenses in relation to its revenue due to various factors, such as the lack of expenses associated with maintaining a branch network. However, these metrics may also have been an indication of inadequate personnel to manage the bank's specialized lending operations.

TCB's Board and management also failed to adequately address concerns identified during examinations of the bank. For example, the Board was reluctant to enter into a Memorandum of Understanding (MOU) with regulators to address risk management issues identified during the June 2009 examination and "strongly disagreed" with many of the findings in the August 2010 examination. The Board and management were also reluctant to accept the advice of external loan reviewers. Further, examination reports of TCB noted apparent violations of laws and contraventions of statements of policy pertaining to appraisals, legal lending limits, false and/or misleading statements, the Allowance for Loan and Lease Loss (ALLL) methodology, loans to a financial subsidiary, and the purchase of a large speculative asset. Such apparent violations and contraventions reflected negatively on TCB's Board and management.

Dissension among Board members and executive officers also presented distractions from the institution's financial problems at critical times. In July 2007, three independent Board members resigned as a result of their disagreement with the Board's action and policy regarding executive compensation and the manner in which the vote was taken to approve the policy. In late 2007, the CFO alleged material misstatements in the bank's financial reporting and misconduct by bank employees that was condoned or ignored by executive management.[5] RMS officials advised us that by 2011, the Board was divided between four independent directors and four executive officers, hindering the bank's ability to move forward and correct its many problems.

TCB's Board and management failed to appropriately adjust to changes in economic conditions. For example, the Board and management continued to expand the loan portfolio with loans of questionable repayment capacity despite a slowing economy when their peers were restricting loan growth.[6] As indicated by TCB management in a July 2009 press release, "We added $39.6 million in net loans in the second quarter... We believe Tennessee Commerce continues to attract new customers displaced by the larger banks who have slowed lending in recent quarters."

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[4] The efficiency ratio is a measure of total overhead expense expressed as a percentage of net interest income plus noninterest income. A low efficiency ratio is generally considered to be favorable.

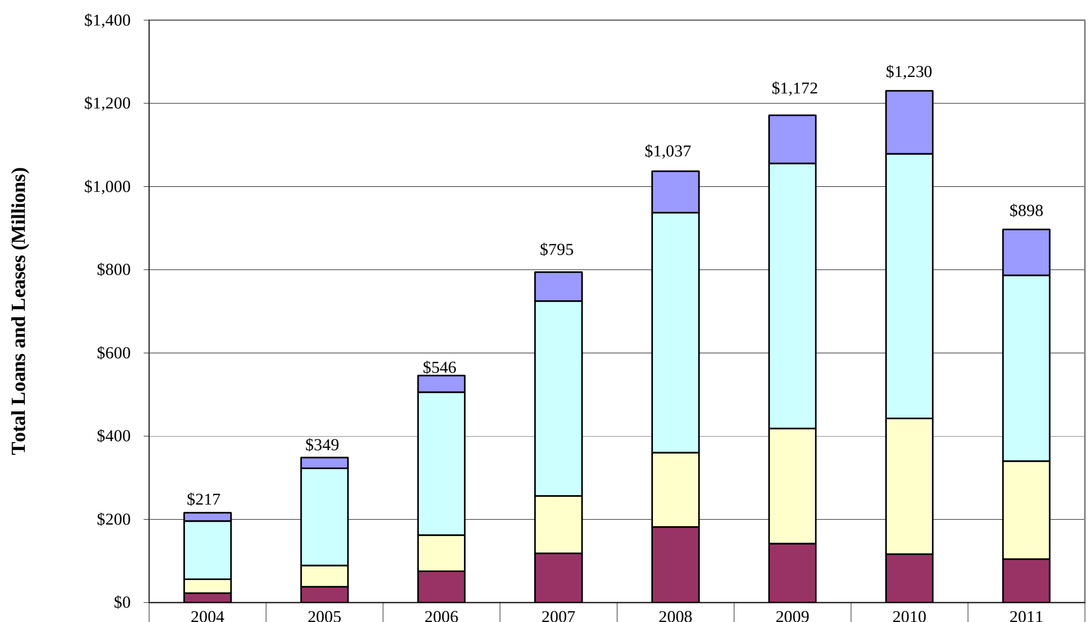
[5] Refer to the *2008 Supervisory Activities* section of this report for details on the supervisory response to the CFO's allegations.

[6] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. From 2008 to 2011, TCB's peer group consisted of insured commercial banks having assets between $1 billion and $3 billion. From 2005 to 2007, TCB's peer group consisted of insured commercial banks having assets between $300 million and $1 billion. For 2004, TCB's peer group consisted of insured commercial banks having assets between $100 million and $300 million.

High Growth and Concentrations

After opening in 2000, TCB embarked on a sustained high growth strategy centered in C&I loans. While many of TCB's C&I loans were made in its local market of middle Tennessee, a large amount were made in out-of-territory areas throughout the United States. The bank's assets, which totaled $97 million after two years of operations, grew by 1,343 percent to $1.4 billion by year-end 2010. Together with weak credit risk management practices (as described later), TCB's significant exposure to certain segments of the C&I industry made the bank vulnerable to a sustained economic downturn. Figure 2 illustrates the general composition of TCB's loan portfolio in the years preceding the institution's failure and highlights the high growth strategy that focused on C&I loans.

Figure 2: Composition and Growth of TCB's Loan Portfolio, 2004-2011



	2004	2005	2006	2007	2008	2009	2010	2011
All Other Loans	$20	$26	$40	$70	$100	$116	$151	$111
C&I	$140	$234	$343	$469	$576	$637	$636	$447
Other CRE	$34	$51	$88	$137	$179	$277	$326	$235
ADC	$23	$38	$75	$119	$182	$142	$117	$105

Source: KPMG's analysis of Call Reports for TCB.
Note: Some total loan amounts do not agree to Table 1 due to rounding.

As shown in Table 2, TCB had C&I loan concentrations as a percentage of total capital that significantly exceeded the bank's peer group averages. TCB's C&I portfolio consisted of loans secured by a wide range of collateral, with large concentrations in tractors/trailers/trucks, accounts receivables and inventory, equipment, and assignments of leases and notes.

Table 2: TCB's C&I Concentrations Compared to Peer

Year Ended	Bank C&I as a Percent of Total Capital	Peer Group C&I as a Percent of Total Capital	Bank Percentile
2004	532	112	98
2005	612	102	99
2006	576	100	99
2007	539	102	99
2008	477	117	99
2009	480	109	99
2010	438	100	99

Source: UBPRs for TCB.
Note: Data under the percentile column represents the percentile ranking or percentage position of TCB relative to other banks in its peer group.

TCB defined its industry concentrations as an exposure to any industry sector of more than 25 percent of Tier 1 Capital and 7 percent of the loan portfolio. Based on these criteria, TCB's industry concentrations included transportation and warehousing, manufacturing, finance and insurance, construction, CRE, and healthcare. TCB's exposure to C&I loans presented elevated risk to the bank due to the sensitivity of C&I loans to the economy and the limited marketability of specialized collateral securing many of the bank's C&I loans.

Commercial Lending Programs. As described in the *Background* section of this report, TCB extended credit to customers through a direct lending program within the bank's local market as well as through two indirect national market funding programs. Table 3 provides a breakdown of TCB's commercial loan portfolio by lending program type from 2004 to 2010.

Table 3: Composition of TCB's Commercial Loan Portfolio by Lending Program

Lending Program ($000s)	2010	2009	2008	2007	2006	2005	2004
Direct lending	416,519	351,933	267,542	193,943	151,692	94,742	60,471
Indirect lending							
Large	94,292	130,573	148,538	130,583	88,569	52,144	29,010
Small	137,376	166,969	173,438	153,140	113,735	87,062	50,318
Total	648,187	649,475	589,518	477,666	353,996	233,948	139,799
Annual Growth Rate	0%	10%	23%	35%	51%	67%	59%

Source: TCB's Annual Reports on Form 10-K filed with the SEC.

Large Borrowing Relationships. TCB's risk profile was further elevated by large and complex borrowing relationships that lacked adequate underwriting and administration. A December 2011 loan portfolio valuation report performed by a third party noted that TCB's 20 largest borrowing relationships accounted for over 26 percent of the bank's loan portfolio. These relationships presented significant risk of loss in the event of deterioration of a single large relationship. Examples of such borrowing relationships follow.

- The June 2009 joint examination report noted that 6 borrowing relationships accounted for $32.4 million (or 44 percent) of the $73.8 million in adversely classified loans at the examination. Industries pertaining to these relationships included transportation, construction, and manufacturing. Each relationship possessed weaknesses, such as inadequate cash flow or debt service capacity, past-due performance, and marginal collateral protection.

- TCB started a lending relationship (referred to in this report as Relationship A) as early as 2007 with a local borrower that grew into an interconnected, complex set of at least 17 loans to various entities related to the borrower. Some of the loans were loan participations purchased by TCB from entities related to the borrower, and a majority of the loans was secured by stock of the various entities affiliated with the borrower. These related interests were first identified as such during the April 2010 joint visitation, which showed a total exposure for Relationship A of $47.5 million. During the September 2011 joint examination, examiners determined that TCB's exposure to Relationship A had grown to a total of $65 million, or 57 percent of the bank's capital, surplus, and undivided profits. As a result of poor credit decisions, weak underwriting, and inadequate monitoring, examiners concluded that the entire $65 million needed to be adversely classified. Of this amount, $30.2 million was loss. Relationship A accounted for 24 percent of the $273.8 million in total loans identified for classification (and 40 percent of the $76.3 million in loss classifications) at the September 2011 joint examination.[7]

Nontraditional Lending. TCB also engaged in nontraditional lending arrangements, such as insurance premium financing, and made a number of particularly risky loans to individuals in the banking sector and secured by the stock of other banks (as described later). Some examples follow.

- Between March 2009 and May 2010, TCB originated loans that represented 100 percent funding of premiums on large life insurance policies which were owned by irrevocable life insurance trusts established by the insured individuals. Court decisions indicated that neither TCB, nor any successor beneficiary, could collect on the death benefits associated with the policies, upholding the insurance companies' argument that they would not have sold the life insurance policies if they knew that TCB had financed the initial premiums for the insured parties. TCB charged off all $5.2 million of these loans.

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[7] Pursuant to the bank's authority to collect a debt previously contracted (DPC) as authorized under Tennessee Law, TCA 45-2-607, in September 2011, TCB exercised its rights to foreclose on the stock of Commerce Bancshares, Inc. (parent of Peoples) and Farmers Bancorp, Inc. (parent of Farmers), that had secured loans to the borrower. Based upon review of examination documentation and correspondence, we found no evidence that the acquisition of bank stock through the DPC transaction had an impact on the TDFI's and FDIC's decision to close TCB.

- In December 2009, TCB established a limited liability company (LLC) for the purpose of purchasing, holding, and administering a life insurance policy on a guarantor whose defaulted loans resulted in a $4.1 million loss to the bank. The bank's actions were in apparent violation of the law as the LLC was considered a financial subsidiary of the bank and was prohibited from purchasing life insurance for speculation. Based upon our discussion with RMS examination officials, the bank's strategy of recovering from the losses on the original loans proved to be flawed and led to losses totaling at least $4.7 million.[8]

- TCB made a number of poorly underwritten loans to independent members of the Board which, although not a primary cause of failure, accounted for at least $3.3 million in losses incurred at the time of TCB's failure.

Lending Practices

Ineffective credit underwriting, administration, monitoring, and collection practices contributed to the asset quality problems that developed at TCB when the economy and the bank's target lending markets deteriorated. As discussed below, TCB's management did not administer the loan portfolio consistent with internal loan policy or industry standards. The April 2007 and April 2008 examination reports indicated that TCB's lending practices were generally satisfactory, although the reports included some recommended improvements. However, subsequent examination reports became increasingly critical of the bank's lending practices as the bank's financial condition deteriorated and weak risk management practices became more apparent and widespread. Examples of TCB's weak lending practices follow.

Loan Underwriting. FDIC and/or TDFI examiners noted the following.

- High loan-to-value (LTV) positions for many loans resulted in thin collateral protection margins, and LTV limits were not established on loans secured by publicly traded or closely held stock (June 2009 and August 2010 examinations).

- There was a lack of perfection of security interests in collateral and/or an ability to substantiate collateral values for indirect small loans (June 2009 examination).

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[8] Financial Institution Letter (FIL)-127-2004, entitled *Interagency Statement on the Purchase and Risk Management of Life Insurance*, states that the purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on an obligation that has been charged off, or is expected to be charged off, for reasons other than the borrower's death. In the case of a charged-off loan, the purchase of life insurance on the borrower does not protect the institution from a risk of loss since the loss has already occurred. Therefore, the institution does not need to purchase insurance, and acquiring insurance that an institution does not need may subject the institution to unwarranted risks, which would be an unsafe and unsound banking practice.

- The bank's use of personal guarantees was inadequate or ineffective. For example, guarantors did not always provide guarantees or provided only partial guarantees (August 2010 examination).

- There was a lack of detail regarding any analysis of cash flows and/or repayment capacity in credit memoranda, and a lack of, or inadequate, global cash flow analyses (August 2010 and September 2011 examinations).

- Appraisals were either not obtained, obtained after loans were funded, or were outdated and prepared by the borrower (August 2010 examination).

- Loans extended to individuals involved in banking or secured by the stock of other financial institutions exhibited particularly poor underwriting and resulted in significant losses. A number of these loans contained little, if any, documented financial analysis before the loans were made (August 2010 examination).

- Additional credit was extended to borrowers after their lines had reached the maximum limit (August 2010 and September 2011 examinations).

The December 2011 loan portfolio valuation report, referenced earlier in this report, noted that TCB's underwriting guidelines and loan terms were not consistent with industry standards, citing examples of high LTV positions and poor loan monitoring processes. Further, bank management had established a standardized credit approval process for the indirect national market small loan portfolio which was subject to less stringent underwriting guidelines than the remainder of the loan portfolio.

Credit Administration. FDIC and/or TDFI examiners noted the following.

- Documented reviews and analyses of interim or annual financial data were not adequate (April 2007 examination).

- Certain portions of the loan policy were too general and brief and needed enhancement. Of particular note were policies pertaining to collection procedures (April 2007 examination).

- Management was lax in placing loans on nonaccrual in line with the established loan policy (August 2010 examination).

- Several large loans had been restructured with concessions, resulting in reduced payments, and were not reported as a Troubled Debt Restructuring (TDR). Loans that qualify as TDRs are required to be evaluated for impairment. Failure to properly identify TDRs could result in misstatements to the bank's ALLL allocation (August 2010 examination).

- In general, loan officers did not appear to have an adequate working knowledge of their borrowers (August 2010 examination).

- Monitoring and valuation of collateral was inadequate (August 2010 and September 2011 examinations).

- Loan proceeds were used for purposes other than their stated purpose or management was unaware of what the loan proceeds were used for (September 2011 examination).

Loan Quality Monitoring and the ALLL Methodology. TCB's loan grading system was not appropriately applied, resulting in numerous and large credit downgrades during examinations. The August 2010 and September 2011 examination reports noted that, in many cases, management was aware of the declining ability of borrowers to service their debt, but appeared reluctant to downgrade loans to an appropriate loan grade. This had the effect of delaying recognition of problem loans and not adequately providing for known credit losses via the ALLL.

According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. As a result, each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the ALLL. Management failed to appropriately identify, measure, and provide for the level of deterioration in the loan portfolio in 2010 and 2011. Specifically, examiners noted during the August 2010 examination that an additional provision of at least $16.3 million to the ALLL was warranted to provide for the risk in the loan portfolio. The bank also needed to adopt a more robust Financial Accounting Standard (FAS) 5 and FAS 114 methodology and use a shorter time frame for calculating historical loan losses to reflect the risk in the loan portfolio and the environment in which the bank was operating.[9]

Examiners noted at the September 2011 joint examination that the ALLL was severely deficient in relation to the level of risk in the loan portfolio and that an additional provision of $80.2 million was warranted. In addition, the bank's FAS 114 impairment analyses were either inadequately supported, inadequately measured, or used invalid assumptions. Further, management failed to recognize credit losses in a timely manner, which resulted in an insufficient FAS 5 ALLL allocation since the calculation was based on historical losses. The bank's external auditors also noted in 2011 that controls over estimating the ALLL were not adequate. An underfunded ALLL can have the effect of delaying the recognition of deterioration in the credit quality of the loan portfolio.

[9] Accounting Standard Codification (ASC) Subtopics 450-20 (formerly Statement of FAS No. 5) and ASC 310-10-35 (formerly Statement of FAS No. 114) provide accounting guidance for loss contingencies on a pool basis and the impairment of loans on an individual basis, respectively.

Repossession and Disposition of Collateral Assets. TCB's C&I lending included loans to borrowers who were referred to the bank by third parties—primarily leasing companies and lease brokers—under the bank's indirect funding programs. These loans were often structured such that the borrower was the lessor (or owner of the equipment—typically transportation vehicles—under the lease). The loan agreements transferred the borrower's responsibility for repayment to the lessee and, depending upon the loan agreement, the borrower also guaranteed the debt. These loans were often secured by a Security Agreement, which assigned TCB a security interest in the lease, the lease payments, and the equipment under the lease.

Such lending has long been viewed by credit professionals as a specialized area with unique risks. Such risks include heavy reliance on cash flows due to collateral dissipation resulting from obsolescence, poor collateral/asset liquidity due to limited markets and/or marketability, and exposure to economic factors that can significantly alter the repayment capacity of obligors and quickly lessen recovery potential. Further, the likelihood of loss on such loans quickly increases as payment delinquency becomes protracted. TCB's own Annual Reports on Form 10-K stated, "This lending causes us to have somewhat different risks than those typical for community banks generally. Our loan portfolio is somewhat geographically diverse, and as a result the loan collateral is also disbursed geographically. This may result in longer time periods to locate collateral and higher costs to dispose of collateral in the event that the collateral is used to satisfy the loan obligation."

TCB had no repossessed assets as of December 31, 2006. However, by the close of 2007, the bank had repossessed assets of about $7 million consisting primarily of trucks that were leased through the bank's indirect funding programs. Management attributed the high level of repossessions to increases in fuel costs and the resulting impact on the trucking industry. In addition, due to the structure of the leases through the brokers, the bank was not becoming aware of the problems until the leases were 90 to 120 days past due. Examiners noted that a significant portion of the bank's repossessions were held in excess of the 6-month maximum period permitted under Tennessee law.[10] TCB subsequently formed a subsidiary called the Tennessee Commercial Asset Services, Inc., to hold repossessed assets beyond the 6-month period allowed by Tennessee law and assist the bank in selling and collecting proceeds from repossessed assets.

As of July 2010, repossessions totaled $28.3 million, of which $26.4 million consisted of trucks and over-the-road equipment. In addition, the bank had 381 loans secured primarily by tractor/trailers that were over 180 days past due and the collateral had not yet been repossessed. A total of 153 of the 381 loans were over 300 days past due.

TCB did not have adequate loss mitigation policies and procedures to monitor the repossession and timely disposition of collateral. TCB often relied on various third-party dealers and brokers for payment collection and collateral repossession services. It does not appear that the bank adequately understood, assessed, or monitored the risk exposure

[10] Tennessee Code Annotated, Section 45-2-607, states that all property acquired in satisfaction of a loan except real property shall be sold within 6 months or such additional period as the TDFI Commissioner may allow.

related to these third-party relationships. For example, we observed an instance in which a single broker was servicing over 1,100 leases valued at over $58 million, yet the broker had only 4 employees performing collection services. This suggests an inadequate infrastructure that may have limited the broker's ability to support and service a labor-intensive lease portfolio on behalf of TCB. To further illustrate management's inadequate monitoring of broker relationships, an examiner loan review of a broker relationship at the 2009 joint examination noted numerous deficiencies, including but not limited to, a lack of a physical on-site collateral inspection, a lack of a formalized agreement between TCB and the broker, and a potential conflict of interest involving used tractor/trailer sales and inventory.

We also noted instances during 2011 in which TCB disposed of repossessed collateral by originating a new loan to a new borrower secured by the repossessed collateral. This practice resulted in numerous loans secured by the same collateral. In many cases, a portion of the funds to finance the new loan were applied to the balance of the original defaulted loan secured by the collateral, leaving a residual balance on the original loan that the bank did not recognize as a loss in a timely manner. While it is possible that the bank may have continued to pursue deficiency judgments on the original borrower and collections from guarantors, a prudent banking practice would have been to recognize the loss when the collection was deemed unlikely and reporting any future collections as a recovery. The net impact of this practice resulted in at least $22 million in residual balances on loans that should have been recognized as losses.[11]

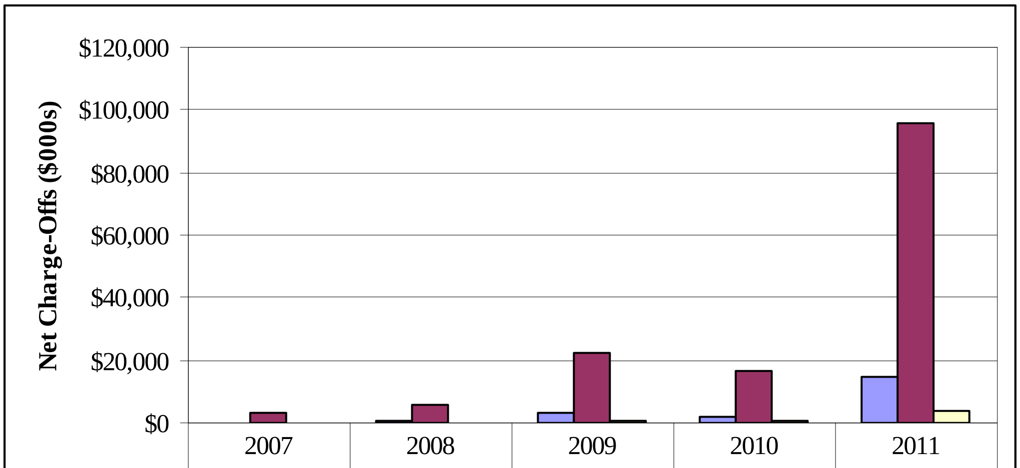
Decline in the Loan Portfolio

At the time of the June 2009 joint examination, TCB's adversely classified items totaled approximately $95 million, or 75 percent of Tier 1 Capital plus the ALLL. Approximately 44 percent of this amount pertained to six large borrowing relationships and 39 percent pertained to small loans, many of which consisted of equipment lending, truck lease financing, and small ticket commercial lending. Adversely classified items increased to $239.5 million (or 168 percent of Tier 1 capital plus the ALLL) at the August 2010 joint examination, and to $298.9 million (or 505 percent of Tier 1 Capital plus the ALLL) during the September 2011 joint examination.

A third-party evaluation found that 14 percent of TCB's loan portfolio was nonperforming as of November 2011. TCB's final Call Report for December 31, 2011 reported that 26 percent of the C&I portfolio and 25 percent of the CRE portfolio was greater than 30 days past due or in non-accrual status. These classifications, in addition to an increase in past due loans, posed a significant risk to the institution and resulted in large loan losses. As reflected in Figure 3, loan charge-offs increased significantly in 2011, with a majority of the charge-offs pertaining to C&I loans, indicating a failure to recognize losses in a timely manner and reflect those losses within the appropriate reporting period.

[11] These amounts were identified by DRR in November 2011 as part of their due diligence and asset valuation review for the bank.

Figure 3: TCB's Net Charge-offs on Loans and Leases, 2007-2011



	2007	2008	2009	2010	2011
CRE	$32	$389	$3,264	$1,600	$14,950
C&I	$3,260	$5,620	$22,462	$16,853	$95,840
Other	$17	$89	$358	$415	$3,567

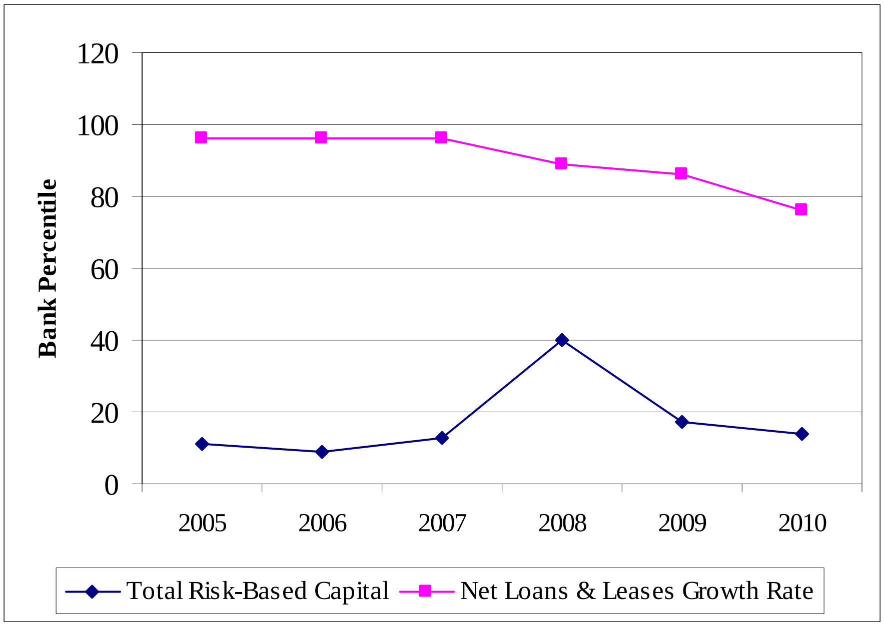
Source: KPMG's analysis of Call Reports.

Based on our analysis of documentation pertaining to TCB's failure, it appears that a majority of the C&I losses consisted of direct loans and indirect small loans. Of the approximately $169.1 million in total charge-offs booked throughout the history of the bank's operations, $77.4 million (or 46 percent) were classified as direct commercial loans and were comprised of 121 loans, and $58.5 million (or 35 percent) were classified as indirect small loans and were comprised of 3,694 loans. Of those charge-offs, approximately $49.1 million (or 63 percent) of the direct loans and $29.7 million (or 51 percent) of the indirect small loans were originated in 2008 and 2009, a time period in which restrained loan growth would have been a prudent strategy given the weakness in the overall economy.

Capital Levels Relative to Loan Growth. The Examination Manual states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed and the ability of management to identify, measure, monitor, and control those risks. Further, the amount of capital necessary for safety and soundness purposes may differ significantly from the amounts needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for purposes of PCA.

TCB relied on its parent holding company for capital injections from public stock offerings and the issuance of Trust Preferred Securities (TPS) to support loan growth and to maintain a *Well Capitalized* status. As described later, TCB also used capital obtained from the United States Department of the Treasury's (Treasury) Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP) to sustain its loan growth and provide for liquidity.[12] However, TCB did not maintain capital levels that were commensurate with its risk profile. As reflected in Figure 4, TCB's risk profile continued to increase as a result of high annual growth rates in loans and leases (including a substantial exposure to economically sensitive and specialized C&I loans) compared to their peer group, while the bank's level of Total Risk-Based Capital was below its peer group average. Had TCB maintained higher capital ratios, its loan growth may have been constrained and losses to the DIF may have been mitigated to some extent.

Figure 4: TCB's Total Risk-Based Capital and Growth Rate Compared to Peer



Source: KPMG's analysis of UBPRs for TCB.

Funding Strategies

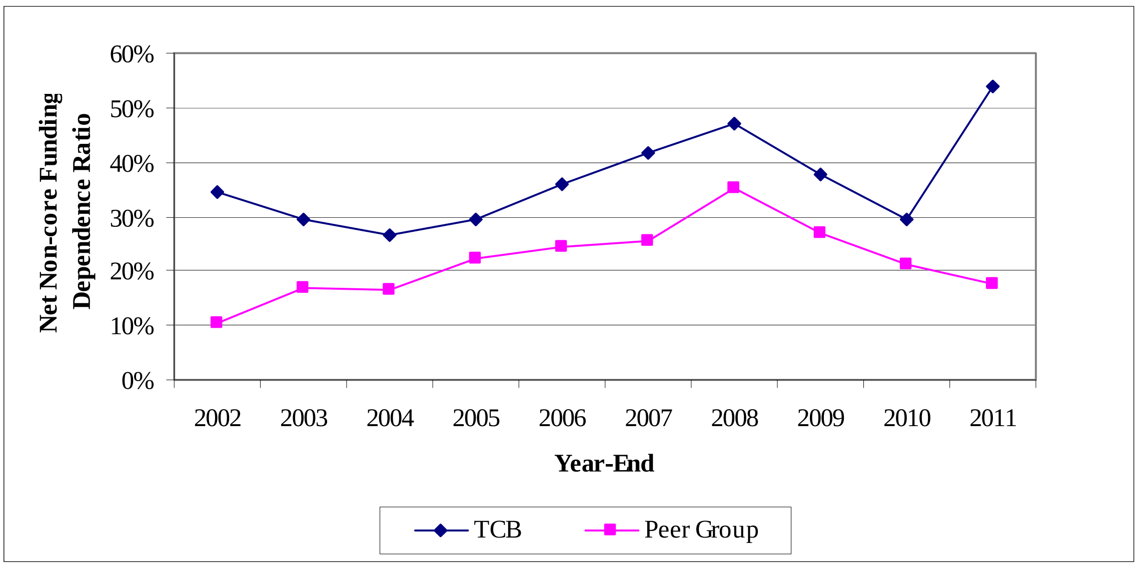
TCB relied heavily on non-core funding sources, particularly time deposits above the insurance limit, Internet deposits, and brokered deposits, to fund its loan growth and maintain liquidity. When properly managed, non-core funding sources offer a number of important benefits, such as ready access to funds in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as increased volatility when interest rates change and difficulty accessing such funds when the financial condition of an institution deteriorates. In addition, institutions become subject to limitations on the use of brokered deposits and the interest rates they can offer on deposits when the institutions fall below *Well Capitalized*. Under distressed financial or economic conditions, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs. In March 2009, the FDIC issued FIL-13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*, which

[12] Bancorp received $30 million in CPP funds in December 2008, of which $24 million was down streamed to TCB. The FDIC's supervisory activities pertaining to TCB's CPP funds are discussed later in this report.

indicated that institutions with aggressive growth strategies or excessive reliance on volatile funding sources are subject to heightened supervisory monitoring and examination.

The Examination Manual states that the net non-core funding dependence ratio is a measure of the degree to which a bank relies on potentially volatile liabilities, such as, but not limited to, certificates of deposit over $100,000 and brokered deposits, to fund long-term earning assets (such as loans that mature in more than 1 year).[13] Generally, the lower the ratio, the less risk exposure there is for a bank, whereas higher ratios reflect reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. TCB's net non-core funding dependence ratio consistently exceeded the bank's peer group average throughout the bank's history. Figure 5 illustrates the trend in TCB's net non-core funding dependence ratio relative to its peer group during the period 2002 to 2011.

Figure 5: TCB's Net Non-Core Funding Dependence Ratio Compared to Peer



Source: KPMG's analysis of UBPRs for TCB.
Note: The increase in 2011 is primarily attributed to a decrease in long-term assets.

The April 2006 examination report noted that TCB's Internet deposits represented 52 percent of the bank's core deposits (which accounted for 67 percent of total deposits). TCB obtained its Internet deposits through an electronic bulletin board that linked banks and sellers of deposits to deposit purchasers, such as credit unions, school districts, labor unions, and other organizations with excess liquidity. TCB purchased its Internet deposits in increments of $99,000, which resulted in a net non-core funding dependence ratio that did not fully reflect the bank's reliance on potentially volatile funding sources.

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[13] Net non-core funding dependence ratio is a measurement of noncore liabilities, less short-term investments divided by long-term assets. Internet deposits below $100,000 are classified as core deposits under the UBPR definition; therefore, while Internet deposits may exhibit the characteristics of non-core deposits, they are not reflected in the net non-core funding dependence ratio.

TCB acquired Internet deposits, in part, because it did not maintain a traditional branch network.

The bank's liquidity position began to weaken as asset quality issues in the loan portfolio became prevalent. At the August 2010 joint examination, examiners largely attributed a decrease in TCB's net non-core funding dependence ratio to a decrease in time deposits of $100,000 or more and an increase in Other Savings Deposits, which are classified as core deposits, through promotional rates that were three times higher than the bank's peer group average. Examiners noted that the potential volatility of the Other Savings Deposits was similar, or possibly even greater than, traditional noncore funding sources. By September 2011, examiners determined that TCB's liquidity was critically deficient and threatened the viability of the institution.

TCB was able to reduce its level of non-core deposits and bolster core deposits between 2008 and 2010. However, TCB's dependence on large time deposits, brokered deposits, and Internet deposits facilitated TCB's high loan growth strategy, which ultimately contributed to the financial problems that occurred when the bank's lending markets deteriorated.

The FDIC's Supervision of Tennessee Commerce Bank

The FDIC, in coordination with the TDFI, provided ongoing supervisory oversight of TCB through regular onsite examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and a formal enforcement action. Such risks included concerns related to the Board and management's oversight of the institution, the bank's lending strategy, loan underwriting, credit administration, the decline in the loan portfolio, and TCB's heavy reliance on non-core funding sources. As described later, more proactive supervisory action to address the bank's risky business activities during earlier examinations may have been prudent. The following sections detail our analysis of TCB's supervisory history, the pursuit of enforcement actions, the FDIC's offsite monitoring activities, the supervisory response to key risks, the FDIC's supervisory activities related to CPP funds, PCA activities, and supervisory lessons learned.

Supervisory History

Although poorly rated during its first 3 years of operation because of management and asset quality concerns, TCB was satisfactorily rated from 2003 through 2008. Between April 2007 and TCB's closing in January 2012 (the focus of our audit), the FDIC and TDFI conducted five onsite examinations and three visitations of TCB. Except for a relatively minor delay in starting the June 2009 examination, the frequency of this onsite examination activity was consistent with relevant statutory and regulatory requirements.[14] Table 4 summarizes key supervisory information pertaining to TCB's examinations and visitations.

Table 4: Examination History of TCB, 2007-2011

Event Start Date	Event Type	Regulator(s)	Supervisory Ratings (UFIRS)*	Informal or Formal Action Taken**
4/3/2007	Examination	FDIC	222222/2	None
4/21/2008	Examination	TDFI	223222/2	None
4/23/2008	Visitation	FDIC	No rating changes	None
6/29/2009	Examination	Joint	333432/3	MOU pursued, but not signed by TCB****
4/5/2010	Visitation	Joint	No rating changes	None
8/2/2010	Examination	Joint	455443/4	Consent Order effective 5/25/2011, TDFI Written Agreement effective 10/27/2011
3/28/2011	Visitation	Joint	No rating changes	None
9/26/2011***	Examination	Joint	555555/5	Consent Order still in effect

Source: KPMG's analysis of examination and visitation reports and information in the FDIC's Virtual Supervisory Information on the Net system (ViSION) for TCB.
* See the Glossary for a definition of UFIRS, which establishes the CAMELS rating system.
** Informal actions can take the form of a Bank Board Resolution (BBR) or MOU. Formal enforcement actions often take the form of a Consent Order or Supervisory Directive.
*** The September 26, 2011 examination report was not finalized before the bank failed. Therefore, any comments and references in this report to that examination are based on preliminary results and findings.
**** TCB's Board adopted a BBR on October 22, 2009. However, the FDIC did not recognize the BBR as an acceptable corrective action and continued pursuit of the MOU.

Pursuit of Enforcement Actions

Based on the results of the June 2009 joint examination, the FDIC and TDFI provided TCB's Board with a proposed MOU on January 21, 2010 that was intended to assist the Board and management in improving the condition of the bank. Among other things, the proposed MOU included provisions for the Board to:

- submit a capital plan to achieve and maintain Leverage, Tier 1 Risk-Based, and Total Risk-Based capital ratios of 9 percent, 11 percent, and 13 percent, respectively;

[14] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, on-site examinations of every state non-member bank at least once during every 12-month period and allows for 18-month intervals for certain small institutions (i.e., total assets of less than $500 million) if certain conditions are satisfied.

- prohibit salary increases or bonus payments for top executive managers or loan officers without the prior written approval of the Regional Director and the TDFI Commissioner until the bank could achieve sustained profitability;

- formulate, adopt, and submit a written plan of action to address the bank's volatile liability dependence ratio;

- approve a revised internal credit grading system for internal loan review purposes;

- develop a written plan to reduce the level of nonperforming assets, repossessions, and assets classified adversely at the June 2009 joint examination;

- restrict additional advances to any borrower for whom the bank holds an uncollected charged-off asset or whose extension of credit is adversely classified; and

- restrict asset growth to 10 percent during any consecutive 6-month period without providing a growth plan to regulators.

In a letter to the FDIC and TDFI dated February 19, 2010, TCB's legal representatives requested that a BBR adopted by TCB's Board on October 22, 2009 be considered a sufficient response to address the findings of the June 2009 joint examination. In April 2010, the FDIC and TDFI performed a joint visitation of TCB to follow up on the recommendations and findings of the June 2009 joint examination. The visitation included an assessment of compliance relative to each provision of the proposed, but unsigned, MOU. In a letter dated June 23, 2010, the FDIC and TDFI responded to TCB's February 2010 letter, noting that, after review of the BBR, an MOU appeared to be the most appropriate action for continued improvement with respect to certain risk management practices.[15] The regulators presented TCB's Board with a revised MOU, which reflected some bank-requested changes, and the Board was urged to accept and sign the revised MOU.

TCB's Board never signed an MOU with the FDIC and TDFI, and many of the objectives and goals of the proposed MOU were not met. Based on serious financial and managerial deficiencies identified during the August 2010 joint examination, the FDIC and TDFI notified the Board in a letter dated February 11, 2011 that a formal enforcement action would be pursued. TCB's management strongly disagreed with many of the examination's findings, adding that it planned to "vigorously appeal" what it believed to be various inaccuracies in the report of examination.

[15] The FDIC may pursue an MOU as informal corrective action instead of a BBR, such as when there is reason to believe that the deficiencies noted during an examination warrant a more structured program or specific terms to effect corrective action.

In March 2011, the FDIC and TDFI performed a joint visitation of TCB. Although an enforcement action was not yet in place at that time, examiners assessed the bank's actions against the unsigned Consent Order. While examiners noted progress in some areas, they also noted that TCB's management either disagreed or had not achieved prescribed actions with respect to some of the other provisions of the Consent Order, including restrictions on volatile liabilities and adequate capital levels. TCB's Board subsequently stipulated to the issuance of a Consent Order, which became effective on May 25, 2011. The Order remained in effect until the bank was closed in January 2012. Among other things, the Consent Order required TCB to:

- increase the Board's participation in the affairs of the bank;

- submit a capital plan to achieve and maintain Leverage, Tier 1 Risk-Based, and Total Risk-Based capital ratios of 8.5 percent, 10 percent, and 11.5 percent, respectively;

- formulate and submit a plan for the reduction and collection of delinquent loans;

- review the loan policy and procedures for effectiveness and make all necessary revisions in order to strengthen the bank's lending procedures and abate additional loan deterioration;

- maintain an adequate ALLL in accordance with generally accepted accounting standards and supervisory guidance;

- develop and submit a written plan addressing liquidity, volatile liabilities, and asset/liability management;

- restrict additional advances to any borrower for whom the bank holds an uncollected charged-off asset or whose extension of credit is adversely classified;

- restrict increases in total assets to no more than 5 percent during any consecutive 12 month period, and restrict any new line of business without the prior consent of the FDIC and TDFI; and

- eliminate and/or correct all apparent violations of laws and regulations.

Offsite Monitoring

The FDIC has established an offsite review program that is designed to identify emerging supervisory concerns and potential problems so that bank supervisory strategies can be adjusted appropriately. The program uses automated tools to help identify potential supervisory concerns.[16] Under the program, offsite reviews are performed quarterly for each bank that appears on the Offsite Review List (ORL). TCB appeared on the ORL in September 2007 and subsequently in each consecutive quarter from June 2008 to December 2009, as well as in December 2010. In addition to documenting the financial condition of the bank at the time, the reviews generally noted the bank's high-risk profile as a result of rapid or sustained growth, with a focus on commercial loans that were secured by specialized leases and equipment.

To a large extent, the comments in the offsite reviews reiterated the comments and observations made during on-site examinations and visitations, and further monitoring was usually deferred to the subsequent or ongoing on-site examination or visitation. The offsite reviews were conducted in accordance with policy and, as such, focused on numerical measures of risk with less emphasis on unsafe or unsound practices, such as risk management practices. Offsite monitoring did not appear to have significantly changed the FDIC's approach to supervising the institution because on-site examinations or visitations were either recently completed or scheduled to begin relatively soon thereafter.

Supervisory Response to Key Risks

In the years preceding TCB's failure, the FDIC and TDFI identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and recommendations. In addition, the FDIC pursued an MOU in 2010 and issued a Consent Order in May 2011, and the TDFI issued a written agreement in October 2011. A summary of supervisory activities related to the bank's key risks follows.

2007 Supervisory Activities

Examiners determined during the April 2007 FDIC examination that TCB's overall condition was satisfactory. However, the examination report noted that the institution's Business Bank model exhibited "niche bank" characteristics that were "unusual, if not unique with respect to growth, portfolio composition, and funds management practices." According to the report, a significant portion of the loan portfolio consisted of commercial loans secured by highly specialized leases and equipment and half of all deposits consisted of Internet and brokered deposits. The report indicated that the overall risk profile of the asset structure was relatively high, but remained satisfactory, even with

[16] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. The tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions with rapid growth and/or a funding structure highly dependent on non-core funding sources.

robust growth, as economic conditions within the bank's extensive trade area were stable and loan demand was strong.[17]

The April 2007 examination report noted some weaknesses in loan underwriting and credit administration, although they were not prevalent. For example, examiners observed instances in which risk rating downgrades, inclusions on the watch list, and subsequent charge-offs occurred within a period of weeks, suggesting ineffective credit monitoring. Examiners noted that earlier recognition of potentially problem loans, particularly within the small indirect loan portfolio, could substantially reduce losses. The report also indicated that review and analysis of large borrowing relationships needed improvement and that the bank's loan policy, which addressed most major topics recommended by prevailing guidance, needed enhancement in some areas, including collection procedures.

The examination report stated that the achievement of the bank's long-term growth projections may not be accomplished without additional capital infusions. Because additional capital was considered by examiners to be essential to the continued viability of the bank's business model, the report stated that TCB should define its strategies for acquiring additional capital in a capital plan that is reviewed and approved by the Board. Such a plan should establish minimum acceptable capital levels, identify possible sources of capital, and describe capital retention objectives. With respect to liquidity, the examination report noted that TCB's net non-core funding dependence ratio of 36 percent remained on an upward trend and exceeded peer groups averages.

Changes in Board Composition

In July 2007, three of TCB's Board directors resigned as a result of a disagreement with the Board's action and policy regarding executive compensation and the manner in which the vote was taken to approve the policy. One director's resignation letter questioned "whether [they were] a board of directors or a board of directed," and noted that "the executive officers/directors [had] concluded that the board [could] be manipulated in whatever manner deemed desirable (by executive officers)." Based upon our review, we determined that the FDIC expressed concern regarding these events via email correspondence and considered whether supervisory action would be appropriate. RMS officials advised us that, after coordination with the TDFI, supervisory action was not deemed necessary with respect to the resignation of the directors or the matters that prompted their resignation.

2008 Supervisory Activities

Examiners determined during the April 2008 TDFI examination that TCB's overall condition was satisfactory. However, examiners found that oversight of the bank's

[17] The April 2006 examination report stated that the overall risk profile of TCB's asset structure was relatively high due to the concentration of the bank's assets in C&I loans. The report stated that this risk potential was more prominent due to the limited marketability of specialized collateral and economic variables that could significantly alter the repayment capacity of borrowers and lessen recovery potential.

operations by the Board and management needed improvement and downgraded the management component rating from a “2” to a “3.” Specifically, the April 2008 examination report stated that:

- The bank’s Asset/Liability Committee had not met on a regular basis since the prior regulatory examination. However, “minutes” of what were actually “very informal discussions” among the Committee members were inappropriately submitted to the Board. The examination report stated that the minutes “appear to be false and misleading statements provided in reports to the Board” and that they had the potential to mislead the directorate as well as examiners that review Board meeting documentation. The report cited TCB with an apparent violation of Tennessee Code Annotated Section 45-2-1706—Improper Maintenance of accounts—False or deceptive entries and statements.

- Strategic planning needed to be strengthened. Specifically, TCB’s Board had not reviewed the bank’s strategic plan on an annual basis and the plan had not been amended to reflect changes in the bank’s activities.

- The banks’ external audit for the year-ended 2007 included two material weaknesses pertaining to (1) a failure to follow policies related to employee accounts and (2) a failure of the Asset/Liability Committee to hold formal meetings in 2007.

- The Board did not develop a capital plan as recommended in the prior-year examination report.

Examiners also noted that TCB’s CFO had been terminated in May 2008, that three Board directors had resigned, and that one additional director had retired.

Examiners considered asset quality to be satisfactory and assigned that component a “2” rating. While the adversely classified items coverage ratio had increased from 10 percent to 19 percent, the TDFI determined the level to be manageable and within acceptable regulatory standards. Examiners noted an increase in repossessed assets—primarily trucks that were leased through the bank’s lease pool program. These repossessions resulted in an apparent violation of Tennessee law because a significant portion of the repossessions were held by the bank in excess of the 6-month maximum permitted by state statute. TCB’s management attributed the high level of repossessed assets, which were centered in the small indirect loan portfolio, to adverse conditions in the trucking industry. In addition, TCB’s C&I concentration at year-end 2007 was 539 percent of total capital (which placed TCB in the 99th percentile of its peer group). However, the 2008 TDFI examination report was silent in regard to the concentrations within the C&I portfolio and the associated impact on TCB’s risk profile.

Examiners noted that the bank’s sustained high asset growth, which ranked in the 96th percentile compared to its peer group average at year-end 2007, continued to erode the bank’s capital position. Examiners again recommended that the Board adopt a written capital plan. Nevertheless, capital was considered to be adequate and positively affected by the absence of dividend payments and by a holding company injection through the issuance of TPS. Further, examiners assigned TCB a composite rating of “2,” indicating the institution was capable of withstanding business fluctuations.

<u>Loan Review</u>

According to the April 2008 TDFI examination report, $136.8 million (or 16.48 percent) of the bank’s total loans as of April 18, 2008 was reviewed by examiners. This amount is significantly smaller than the amount of loans reviewed at either the April 2007 FDIC or June 2009 joint examinations, which was $200.1 million (or 40 percent) of total loans and $339 million (or 31 percent) of total loans, respectively. TDFI officials recognized that the loan penetration at the April 2008 examination was low compared to the prior and subsequent examinations but informed us that the volume of loan penetration at the April 2008 examination was commensurate with examination risk-profile scoping criteria, including the satisfactory asset quality finding at the April 2007 FDIC examination. However, we noted that the April 2007 FDIC examination report stated the overall risk profile of the asset structure was relatively high.

<u>April 2008 Visitation</u>

The FDIC performed a visitation in April 2008 in response to the CFO’s allegations of material misstatements in the bank’s financial reporting and alleged misconduct by bank employees in late 2007. TCB’s management acknowledged that operational deficiencies existed and noted that corrective measures were administered by bank executive management. Examiners reviewed the matter and concluded, after consultation with FDIC legal counsel, that the CFO’s allegations and concerns did not support a formal supervisory action. As noted earlier, TCB’s external audit for the year-ended 2007 cited two material weaknesses in internal controls. Examiners noted at the April 2008 TDFI examination that management had taken appropriate steps to correct the weaknesses noted in the external audit.

2009 Supervisory Activities

Examiners determined during the June 2009 joint examination that TCB’s financial condition was less than satisfactory and downgraded the bank’s composite rating to a “3.” The examination report stated that the bank’s performance reflected the decline in the economy over the prior 12 months, the organization’s inability to generate sufficient operating income through normal operations, and management’s inadequate actions to address deterioration in the bank’s loan portfolio. Examiners noted that adverse loan and lease classifications had quadrupled since year-end 2007, delinquent loans had increased nearly two-fold, and loans charged off had increased substantially.

Notably, six borrowing relationships (not including Relationship A) accounted for 44 percent of adversely classified loans. Examiners attributed a sizeable portion of adverse loan classifications, including small indirect loans, to slowing economic conditions in the trucking and tour bus industries. As a result of the bank's less-than-satisfactory asset quality, earnings were insufficient to support operations or augment capital. Examiners also found that liquidity needed improvement, adding that liquidity contingency plans emphasizing potential asset-based sources of liquidity needed to be developed given the bank's financial condition.

Examiners noted that although the loan policy was adequate, lax underwriting, administration, and monitoring practices were evident. For example, examiners noted instances in which credit reports were not obtained prior to loan origination, global cash flow analyses were not performed, LTVs were high, and financial information on borrowers was missing.

Examiners also noted that TCB's most recent internal loan review, performed as of January 2009, identified a moderate level of documentation exceptions, generally pertaining to a lack of current financial information on borrowers and not obtaining loan guarantees. The June 2009 joint examination report suggested that refresher training be provided for all employees with loan authority or who had responsibility for credit documentation to reinforce the importance of strong credit practices in a declining economy. The report added that implementing a credit culture consistent with the then current economic environment that was evident throughout Tennessee and the nation, as well as reassessing the organization's risk appetite, would be a prudent plan of action.

TCB's loan portfolio had grown by $310 million (or 39 percent) since the prior examination. Examiners suggested that the Board consider suspending or curtailing its growth strategy while evaluating the systemic risk to the institution. Examiners further suggested that management consider establishing concentration criteria relative to capital in order to manage the bank's significant industry exposure and concentration risk, as had been done by regulatory agencies related to CRE lending.[18] While the bank demonstrated awareness of the concentrations as a percentage of capital, examiners noted that the financial condition of the bank was highly sensitive to economic conditions, and recommended that the Board and management carefully consider additional strategies to further mitigate concentration risk going forward.

In a letter dated October 8, 2009, the FDIC notified TCB's Board that the bank was deemed to be in a "troubled condition." The letter outlined the FDIC's expectations of the Board and management, and instructed them to administer the bank in such a way as to stabilize its risk profile and strengthen its financial condition. The letter also noted that pursuit of informal corrective action would be recommended to the RMS Regional Director. As previously mentioned, the FDIC and TDFI pursued informal corrective action in the form of an MOU based on the results of the June 2009 joint examination.

[18] In December 2006, the FDIC, the Office of the Comptroller of the Currency, and Board of Governors of the Federal Reserve System issued joint guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, which defines criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk.

2010 Supervisory Activities

The FDIC and TDFI performed a joint visitation in April 2010. The purpose of the visitation was to follow up on recommendations and exceptions from the June 2009 examination, review the bank's financial condition, and assess compliance with the proposed MOU that was presented to the Board in January 2010. The visitation noted some progress, but the overall condition of the bank remained less than satisfactory. Notably, the balance of repossessed assets had more than doubled, and earnings continued to suffer from high provision expenses. Examiners also found that the bank's credit grading, administration, and underwriting practices related to Relationship A were questionable and that additional information regarding the debt service ability, collateral valuation, and ownership of pledged collateral was needed to fully assess the risk associated with the relationship.

The August 2010 joint examination found that the overall condition of the bank had deteriorated, and a composite "4" rating was assigned. Adverse classifications posed an imminent threat to the bank's viability. Examiners attributed the deterioration in asset quality to credit administration and underwriting weaknesses. Earnings were considered insufficient to support operations and maintain appropriate capital and allowance levels. Examiners also noted that liquidity was deficient and that the bank's ability to obtain sufficient funds on reasonable terms to meet liquidity needs was threatened.

The August 2010 joint examination report stated that TCB's Board and management had failed to provide appropriate oversight of the operation of the bank and its performance. As mentioned earlier, examiners noted concern regarding the lack of proper analysis by the bank before entering into new and unconventional lending practices involving insurance premium financing, as well as the lax lending practices related to credits extended to individuals involved with banking and on loans secured by other financial institutions' stock—most notably Relationship A. Further, management's failure to recognize losses in a timely manner and reflect those losses within the appropriate period resulted in inaccurate financial reporting. Matters requiring the Board's attention included, but were not limited to, the following:

- a $16.3 million provision to the ALLL was needed to provide for the inherent risk in the loan portfolio;

- the bank's capital plan needed to be revised to address short-term needs, minimum capital requirements, and potential capital sources;

- the ALLL calculation required a more robust FAS 114 and FAS 5 methodology;

- Call Reports for June 30, 2010, March 31, 2010, and December 31, 2009, needed to be amended to reflect the true financial condition of the bank;

- apparent violations of laws, rules, regulations, and contraventions of statements of policy were in need of immediate correction; and

- improved monitoring of the C&I portfolio, which totaled 465 of Total Risk-Based Capital at the time of the examination.

As noted earlier, examiners requested that TCB's Board enter into an MOU to address a number of concerns identified during the June 2009 joint examination. However, an MOU was never executed. Examiners noted that many of the objectives and goals of the proposed MOU had not been met. Examiners also determined that it did not appear that management had complied with the instructions communicated in the October 2009 troubled bank notification letter to administer the bank in such a way as to stabilize its risk profile and strengthen its financial condition. Based on our discussions with FDIC examiners, the Board and management appeared to be spending time resisting regulatory recommendations rather than devoting their full attention to addressing and correcting the serious issues and supervisory concerns that the bank was facing.

2011 Supervisory Activities

In a letter dated February 11, 2011, the FDIC provided TCB's Board with a proposed formal enforcement action to address the concerns identified during the August 2010 joint examination. The FDIC and TDFI subsequently provided the Board with the final August 2010 examination report on March 17, 2011.[19] In a letter dated March 24, 2011, TCB's Board advised the FDIC of its belief that the findings of the examination report were significantly flawed and that the bank intended to appeal the results of the examination. On April 6, 2011, the FDIC responded to the various concerns conveyed by the bank regarding the August 2010 examination report, and informed the bank that under the FDIC's *Guidelines for Appeals of Material Supervisory Determinations,* when the FDIC provides written notice to the bank indicating intent to pursue formal enforcement action, a bank's right to appeal the determinations, facts, and circumstances that form the basis for the formal enforcement action is terminated.[20]

The FDIC and TDFI performed a joint visitation in March 2011 to assess the financial condition of the bank and its compliance with the unsigned Order that was provided to the Board in February 2011. While a reduction in the balances of previously classified loans was noted, the level of classifications, combined with management's previous and continued resistance to recognize problem loans, remained a concern to examiners. The ALLL remained significantly underfunded, and management appeared to have been focused more on arguing the merits of particular classifications instead of assessing, measuring, and adequately providing for the risks in the loan portfolio. However, the Board stipulated to the proposed Order effective May 25, 2011.

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[19] In the same communication, the Board was notified that the TDFI intended to pursue parallel formal action in the form of a Written Agreement, which was issued on October 27, 2011.

[20] In September 2008, the FDIC adopted revised *Guidelines for Appeals of Material Supervisory Determinations* to better align the FDIC's appeals review process with other Federal banking agencies. As it relates to decisions to proceed with formal enforcement action, an independent review requirement includes an administrative hearing held before an impartial administrative law judge who makes findings of facts, conclusions of law and recommends a decision to the FDIC Board of Directors, which ultimately decides the outcome of any contested enforcement action.

A joint examination commenced in September 2011. The examination included an assessment of the bank's efforts to comply with the Consent Order. An examination report was not finalized prior to TCB's failure. However, based on the preliminary findings of the examination, examiners noted that the financial condition of the bank was critically deficient and that near-term failure was highly probable, absent an immediate, large infusion of new capital. Consequently, a "5" rating was proposed for all components and the composite rating. The Board was considered to be fractured, and examiners had little confidence in management's ability to reverse the negative financial trends facing the bank. Among other things, examiners noted the following deficiencies:

- Apparent violations, including an apparent legal lending limit violation and contravention of Statements of Policy (some of which were repeat criticisms).

- Management and the Board failed to appropriately adjust for changing economic conditions and identify risk in the loan portfolio. The bank continued to grow loans in an uncertain economic environment, while their peers were restricting loan growth. Examiners noted that several classified loans were originated during a time of economic uncertainty, and without a full understanding or consideration of the level of risk-exposure to the bank.

- Poor credit administration practices and inadequate monitoring of the loan portfolio had resulted in an excessive level of adversely classified items (i.e., $298.9 million, or 21 percent of the bank's assets and 506 percent of Tier 1 Capital plus the ALLL). Adversely classified loans totaling $76.3 million were identified as loss, which included two large borrowing relationships of $47.8 million.

- The ALLL was severely deficient and an additional provision expense of $80.2 million was required to reflect examination-identified loan losses and to replenish the ALLL to an appropriate level.

- An independent loan review performed in June 2011 identified nine borrowers with loans totaling $65.9 million warranting downgrades from management's internal loan grades. Examiners identified $157.3 million in loan downgrades at the examination.

- Loans related to Relationship A were underwritten without adequate global cash flow analyses and without realistic in-depth analysis of the value of the collateral. In addition, there were no policies and procedures in place for the types of loans extended to the borrowers, which resulted in credit risk not being adequately assessed.

- Liquidity was critically deficient and threatened the viability of the bank. Examiners noted that access to secondary funding sources had ceased due to substantial deterioration in asset quality and capital.

For the remainder of 2011, and until the bank's closing in January 2012, the FDIC continued to monitor the bank's liquidity, efforts to raise capital, and compliance with the Consent Order.

Capital Purchase Program

On October 3, 2008, the President signed the Emergency Economic Stabilization Act of 2008 (EESA) into law. Among other things, the Act authorized the TARP, which is administered by the Treasury. Under the TARP, the Treasury has implemented the CPP through which the Treasury purchases senior preferred stock (and, if appropriate, warrants of common stock) from viable institutions of all sizes. The Treasury issued guidelines for publicly held financial institutions, such as Bancorp, to apply for funds under the CPP on October 20, 2008. The CPP application period for publicly held institutions closed on November 14, 2008.

Qualifying financial institutions were permitted to apply for funds under the CPP after consulting with their primary federal regulator. After receiving an application for CPP funds, primary federal regulators used a standardized process established by the Treasury for evaluating the application. The evaluation process contained viability criteria for use in assessing the applications. In general, if an institution met the Treasury's viability criteria, the appropriate federal banking agency recommended that the Treasury approve CPP funding. Applications that did not satisfy the viability criteria were forwarded to an interagency CPP Council for further review and action. The Assistant Secretary for Financial Stability within the Treasury had final authority to approve CPP applications.

On February 9, 2009, the FDIC issued a Regional Directors Memorandum, entitled *Examination Guidance for Financial Institutions Receiving Subscriptions from the U.S. Department of the Treasury's TARP CPP Program*. The memorandum provides examination work steps for assessing the compliance efforts of institutions participating in the CPP and the Treasury's executive compensation rules. According to the memorandum, examiners are required to assess compliance with CPP securities purchase agreements (CPP Agreement) between the Treasury and state nonmember banks and the requirements of the EESA as applied through the CPP Agreements.[21]

The February 2009 memorandum states that the FDIC expects state nonmember banks to use CPP funds to augment capital and support lending needs, even though the terms of CPP Agreements do not mandate specific use of CPP funds. In that regard, on November 12, 2008, the federal banking agencies issued the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* (Interagency Statement) encouraging banks to responsibly make credit available, particularly in light of federal initiatives (such as the CPP) designed to bolster financial and credit market liquidity. As part of the FDIC's distribution of the Interagency Statement through FIL-128-08, the FDIC

[21] CPP Agreements require compliance with prudential standards for executive compensation, corporate governance, dividends, and other criteria.

encourages state nonmember banks participating in these initiatives to prudently make credit available in their markets and to work with home mortgage borrowers experiencing difficulty in making payments. The FIL states that FDIC examiners will consider banks' lending, mortgage foreclosure prevention efforts, and executive compensation when assigning risk management, compliance, and CRA ratings. Further, the February 2009 memorandum states that examination reports should include a summary of how CPP funds have been used and whether compliance efforts and processes to implement the Interagency Statement are effective.

The FDIC's Recommendation of Bancorp for CPP Funding

On November 7, 2008, Bancorp filed a CPP application with the Federal Reserve Bank of Atlanta, its primary regulator, and the FDIC. The FDIC, TCB's primary regulator, reviewed the application and recommended that the Treasury approve CPP funds for Bancorp. At the time of its application, TCB met all of the Treasury's eligibility criteria and the FDIC considered TCB to be a viable institution.

Examiners' Evaluation of CPP Funds

On December 19, 2008, Bancorp entered into a CPP Agreement with the Treasury and received $30 million in funds under the CPP. Bancorp subsequently down streamed $24 million of the funds to TCB, $5 million to Tennessee Commercial Asset Services, Inc., and retained $1 million at the holding company level to cover expenses. Examiners obtained documentation during the June 2009 joint examination that addressed TCB's use of the CPP funds and efforts to comply with executive compensation requirements associated with CPP funding. While examiners noted in the June 2009 joint examination report that the CPP funds were utilized to fund loan growth, the report did not address TCB's compliance with the CPP Agreement.

The August 2010 joint examination report stated that examiners were unable to determine whether TCB fully complied with the CPP Agreement and the requirements of EESA based on limited information provided by the bank. According to RMS officials, examiners made multiple attempts to gain information from the CFO and other bank management officials, as well as by reviewing financial information and Board committee minutes. Examiners noted that the bank's Board minutes were silent regarding TCB's use of the $24 million in funds down streamed from Bancorp. Examiners also noted that the Board approved a new expenditure policy and revised several employment contracts and deferred compensation agreements to comply with Treasury requirements. However, the complete terms of the contracts and agreements were not disclosed to examiners. Examiners further noted that Compensation Committee minutes, which were only provided through May 2009, documented the bank's efforts to comply with EESA. We did not find evidence that examiners performed follow-up inquiries with TCB's management after the 2010 joint examination to obtain additional information regarding the bank's compliance with the CPP Agreement.

Examiners at the September 2011 joint examination evaluated TCB's compliance with the CPP Agreement within the examination workpapers. While examiners did not identify any violations with CPP Agreement, a final determination and full assessment of compliance was not completed as the examination report was not completed prior to the bank's failure in September 2012. Under EESA, the CPP funds provided to Bancorp are subject to review by the Special Inspector General for the TARP.

Implementation of PCA

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory 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 level deteriorates. The purpose of section 38 is to resolve the problems of insured depository institutions at the least possible 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 (CRP) and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its CRP, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to TCB, the FDIC properly implemented the applicable PCA provisions of section 38. TCB was considered *Well Capitalized* or *Adequately Capitalized* for PCA purposes until its September 30, 2011 Call Report filing, at which point the institution became *Critically Undercapitalized*. Table 5 summarizes TCB's capital ratios relative to the PCA thresholds for *Well Capitalized* institutions during examinations and at other key points in time. A chronological description of the changes in the bank's capital categories and the FDIC's implementation of PCA follows the table.

Table 5: TCB's Capital Levels

Examination or Event Date	As of Date	Total Risk-Based	Tier 1 Risk-Based	Leverage	PCA Capital Category
Well Capitalized Threshold		**≥10%**	**≥6%**	**≥5%**	
4/3/2007 Examination	12/31/2006	10.43	9.22	8.77	*Well Capitalized*
4/21/2008 Examination	12/31/2007	10.40	9.27	8.75	*Well Capitalized*
6/29/2009 Examination	3/31/2009	10.30	9.40	8.98	*Well Capitalized*
8/2/2010 Examination	6/30/2010	9.51	8.24	7.58	*Adequately Capitalized*
6/2/2011 PCA Notification	5/25/2011 Order	N/A	N/A	N/A	*Adequately Capitalized*
11/2/2011 PCA Directive and Notification	9/30/2011	2.34	1.17	0.95	*Critically Undercapitalized**

Source: KPMG's Analysis of TCB examination reports and PCA Activities.
* TCB became *Critically Undercapitalized* when its tangible equity to total assets ratio fell below 2 percent.

TCB was considered *Well Capitalized* for PCA purposes until the August 2010 joint examination, at which time the bank fell to *Adequately Capitalized* based on the results of the examination. Subsequent to the August 2010 examination, Bancorp injected $6 million of capital into the bank through a stock offering that generated approximately $24 million in new capital for the holding company, returning the bank to a *Well Capitalized* position. The FDIC notified the Board in a letter dated June 2, 2011 that the bank fell to *Adequately Capitalized* upon the issuance of the Consent Order, effective May 25, 2011.[22] The FDIC recommended that the Board review the mandatory restrictions in Section 38 that apply to *Adequately Capitalized* institutions, and further noted restrictions regarding the use of brokered deposits and interest rates paid pursuant to Section 337 of the FDIC Rules and Regulations.

The FDIC notified the Board in a letter dated November 2, 2011 that the bank fell to *Critically Undercapitalized* based on its September 30, 2011 Call Report filing. The letter detailed the requirements of, and restrictions on, *Critically Undercapitalized* institutions as defined in section 38, including, but not limited to, the submission of a CRP by November 15, 2011. The letter added that the FDIC would be required to place the bank into receivership on January 27, 2012, unless it was determined that that a different action would better carry out the purposes of section 38. The FDIC issued a PCA Directive on November 2, 2011 due to the bank's rapidly deteriorating capital condition and the inability of TCB management to return the bank to a safe and sound

[22] Part 325 Subpart B, *Prompt Corrective Action*, of the FDIC Rules and Regulations states that a *Well Capitalized* status indicates that a bank (1) meets prescribed capital ratios and (2) is not subject to any written agreement, Order, capital directive, or PCA Directive to meet and maintain a specific capital level.

condition. Among other things, the provisions of the PCA Directive required the bank to take certain actions including, but not limited to:

- recapitalizing the bank within 30 days;
- restricting interest rates paid on deposits;
- refraining from accepting, renewing, or rolling over any brokered deposits; and
- refraining from making any capital distributions or dividend payments.

In a letter dated January 20, 2012, the FDIC informed the bank that RMS had received TCB's CRP on December 21, 2011 and that the CRP was due on November 15, 2011. The CRP identified alternatives to increase the bank's capital levels that included soliciting bids for a whole bank transaction and on a portfolio basis, as well as raising capital through certain personal relationships. However, no definitive agreements had been reached. The FDIC determined that the CRP was not acceptable and requested that a revised CRP be submitted within 30 days. Efforts to recapitalize the bank were ultimately unsuccessful, and TCB was closed on January 27, 2012.

Supervisory Lessons Learned

TCB exhibited a high risk profile in the years preceding the bank's financial decline. Key factors contributing to the bank's elevated risk profile included:

- sustained high growth and heavy concentrations in economically sensitive segments of C&I lending, including emphasis on specialized lending to leasing companies and lease brokers in the transportation industry, the nature of which exposed the bank to elevated credit risk.
- reliance on outside sources of capital to maintain growth and capital ratios that were marginally above the PCA thresholds for *Well Capitalized* institutions.
- exposure to large and complex borrowing relationships without adequate underwriting and administration.
- dependence on non-core funding sources, such as Internet and brokered deposits, to support loan growth and liquidity.

Examination reports issued in the years before TCB's financial decline noted that the bank had a relatively high risk profile and included recommendations to TCB's Board and management to address risks identified during the examinations. During those periods, TCB was profitable, its financial condition was satisfactory, and conditions in its lending markets were generally favorable. Under the FDIC's current approach to supervision (described in more detail below), banks with elevated risk profiles, such as

TCB, are subject to increased supervisory analysis and a more proactive supervisory response—including accelerated examinations or visitations, lower ratings, and/or supervisory actions—when risks are not properly managed.

In the case of TCB, a more proactive supervisory response to the bank's risky business activities during earlier examinations may have been prudent. Such a response could have included placing greater emphasis on TCB establishing prudent limits on its industry and borrower concentrations, holding higher levels of capital, and implementing stronger risk management practices—particularly with respect to its specialized lending and funds management practices. For example, examiners could have promptly followed up with TCB's Board to ensure it developed and approved an acceptable capital plan as recommended in the April 2007 examination report. Examiners learned during the following year's examination that the Board had not acted on the recommendation. Examiners again recommended in 2008 that the Board adopt a capital plan.

A more in-depth review of TCB's loan portfolio during the April 2008 TDFI examination may also have been warranted given the risk and complexity of the bank's lending practices, its continued high growth, and management's less-than-satisfactory oversight of the bank. Further, examiners could have expressed greater concern within the examination report regarding the risks associated with segments of TCB's C&I loan portfolio, including concentrations of credit pertaining to the transportation industry.

Based on the results of the June 2009 examination, the FDIC pursued an MOU with TCB's Board to address key risk management concerns at the bank. Although TCB's Board passed a BBR to address the issues identified during the examination, the FDIC was unable to persuade the bank to execute an MOU. The FDIC performed a visitation of the bank in April 2010 to assess the bank's actions to address the proposed requirements in the MOU. In retrospect, accelerating the next full-scope examination may have resulted in the necessary support to pursue a formal action sooner than the Consent Order that became effective in May 2011.

More proactive supervisory action during earlier examinations may have produced a different supervisory response and better positioned TCB to work through the financial difficulties that it experienced when economic conditions in its lending markets deteriorated.

The FDIC informed us that it has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crisis.
With respect to the issues discussed in this report, the FDIC has, among other things, completed a training initiative in 2010 for its entire supervisory workforce that focused on placing greater emphasis on risk management practices for institutions with elevated risk profiles. The training addressed the importance of considering management practices as well as current financial performance or trends when assigning ratings, consistent with existing examination guidance. The FDIC has also issued FIL-84-2008, entitled *Liquidity Risk Management*, which highlights the importance of (among other things) contingency funding plans in addressing relevant stress events. Further, the FDIC issued FIL-13-

2009, *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*, which heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

As it relates to the specialty lending areas at TCB, the FDIC completed updates to Examination Documentation (ED) Modules related to C&I Loans and Lease Financing in September 2009 and July 2010, respectively. The ED Modules are an examination tool that focuses on risk management practices and guides examiners to establish an appropriate examination scope. Further, on January 26, 2010, the FDIC issued guidance to its examiners that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed.

Objectives, Scope, and Methodology

Objectives

We performed this performance audit to satisfy the requirements of section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the DIF 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. Section 38(k), as amended, establishes an MLR threshold of $150 million for losses that occur for the period January 1, 2012 through December 31, 2013. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Consistent with the FDI Act provisions described above, the objectives of this MLR were to (1) determine the causes of TCB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of TCB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

Our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG communicates those to FDIC management for its consideration. As resources allow, the FDIC OIG conducts more comprehensive reviews of specific aspects of the FDIC's supervision program and makes recommendations as warranted.

We conducted this performance audit from April 2012 to June 2012 in accordance with GAGAS. 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 TCB from April 2007 until its failure on January 27, 2012. Our audit also entailed an evaluation of the regulatory supervision of the institution over the same period. Additionally, we reviewed the FDIC's consideration of the application for deposit insurance, given supervisory concerns that were noted at the bank's inception in 2000.

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

- Analyzed examination and visitation reports prepared by FDIC and TDFI examiners from 2007 to 2011

- Reviewed the following documentation:
    - Financial institution data and correspondence maintained at the RMS Dallas Regional Office and Nashville Field Office, as provided to KPMG by RMS
    - Reports prepared by DRR and RMS relating to TCB's closure
    - Pertinent RMS policies and procedures
    - The FDIC summary of investigation report for the bank's application for deposit insurance
- Interviewed relevant FDIC officials who had supervisory responsibilities pertaining to TCB, which included RMS regional officials from the Dallas Regional Office and examination staff in the Nashville Field Office
- Interviewed appropriate officials from the TDFI to discuss the historical perspectives of the institution, applicable examinations, and other activities regarding the TDFI's supervision of the bank
- Researched various banking laws and regulations

KPMG relied primarily upon the materials provided by the FDIC OIG, RMS, and DRR, including information and other data collected during interviews. We also met with DRR officials and reviewed original bank records maintained by DRR. KPMG did not perform specific audit procedures to ensure the information and data were complete and accurate. KPMG is, however, aware that Circular 12000.1, *Cooperation with the Office of Inspector General*, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in examination reports and other relevant supervisory correspondence between the FDIC, TDFI, and the bank. KPMG relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

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

Consistent with the audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in the FDIC's systems, reports, and interviews of examiners to understand TCB's management controls pertaining to the causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems, but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination and visitation 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 MLR, we did not assess the strengths and weaknesses of RMS's annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. RMS's compliance with the Results Act is reviewed in OIG's program audits of RMS operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC's Rules and Regulations. The results of our tests are discussed, where appropriate, in this report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

We were provided with a memorandum issued by the OIG on May 1, 2009 that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. As discussed earlier in this report, the OIG issued an audit report, entitled *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum and (2) identify trends and issues that have emerged from subsequent MLRs.

Further, with respect to more in-depth coverage of specific issues, the OIGs of the FDIC, the Department of the Treasury, and the Board of Governors of the Federal Reserve System issued an evaluation report in September 2011, entitled, *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which assessed the role and Federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA*, and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Additionally, the FDIC OIG has informed us that they have an ongoing evaluation that is studying the characteristics and related supervisory approaches that may have prevented FDIC-supervised institutions with significant Acquisition, Development, and Construction (ADC) loan concentrations from being designated as problem banks or failing during the recent financial crisis. Further, in January 2012, the President signed Public Law 112-88 (H.R. 2056, as amended), which requires the Inspector General of the FDIC to conduct a comprehensive study on the impact of the failure of insured depository institutions. In connection with this study, the FDIC OIG has initiated work in the following areas of bank supervision:

- evaluation and use of appraisals,
- implementation of FDIC policy statement on CRE loan workouts,
- risk management enforcement actions, and
- examiner assessment of capital.

The Inspector General is required to submit a report on the results of the study and any related recommendations to Congress by January 3, 2013.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction, and that provide interim financing for constructing residential or commercial structures.
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 uncollectable 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.
Annual Report on Form 10-K	An annual report required by the Securities and Exchange Commission that provides a comprehensive summary of a public company's performance. The report includes information such as company history, organizational structure, executive compensation, equity, subsidiaries, and audited financial statements, among other information.
Bank Board Resolution (BBR)	A BBR in an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. BBRs may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity. The FDIC is not a party to these resolutions, but may review or draft the documents as a means of initiating corrective action.
Call Report	Consolidated Reports of Condition and Income (also known as Call Reports) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the FDI Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.

Term	Definition
Capital Restoration Plan (CRP)	Section 325.104(a)(1) of the FDIC Rules and Regulations requires a bank to file a written CRP with the appropriate FDIC regional director within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is *Undercapitalized*, *Significantly Undercapitalized*, or *Critically Undercapitalized*, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
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.
Consent Order	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A Consent Order may be terminated by the regulators when they have determined that the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow analysis must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, current and complete operating statements of all related entities, and future economic conditions. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Loan Participation	The transfer of an undivided interest in all or part of the principle amount of a loan from a seller, known as the "lead," to a buyer, known as the "participant," without recourse to the lead, pursuant to an agreement between the lead and the participant. "Without recourse" means that the loan participation is not subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant upon the borrower's default on the underlying loan.

Term	Definition
Loan Production Office	Loan production offices are banking offices that take loan applications and arrange financing for corporations and small businesses, but they do not accept deposits. Loan applications are subject to approval by the lending institution.
Loan-to-Value (LTV)	A ratio for a single loan and collateral calculated by dividing the total loan amount at origination by the market value of the collateral securing the credit plus any readily marketable collateral or other acceptable collateral.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2012 and ending December 31, 2013, a material loss is defined as any estimated loss to the DIF in excess of $150 million.
Memorandum of Understanding (MOU)	A MOU is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify a bank's emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the ORL. Regional management is responsible for implementing procedures to ensure that offsite review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
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 Deposit Insurance Fund. 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 determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately*

Term	Definition
	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.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based capital framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Risk-Based Capital Rules	Part 325 Appendix A—*Statement of Policy on Risk-Based Capital*—defines the FDIC's risk-based capital rules. Appendix A states that an institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together, and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution's qualifying total capital base is the numerator of the ratio.
Tier 1 Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, 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 securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Troubled Debt Restructuring (TDR)	Troubled debt restructurings are compromises (concessions) that lenders make to improve collectability or reduce losses on problem loans. These concessions emanate from a borrower's deteriorating financial condition, which in turn prompts the lender to focus on achieving the maximum recovery. Qualifying restructuring activities include one or more of the following: asset transfers, granting of equity interests, and modification of loans terms. Not

Term	Definition
	all debt restructuring is considered "troubled." Loan renewals or extensions at interest rates that are equal to the current interest rate or a market rate of interest are not considered renegotiated debt.
Trust Preferred Securities (TPS)	Hybrid instruments possessing characteristics typically associated with debt obligations. Under the basic structure of TPS, a corporate issuer, such as a bank holding company, first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the corporate issuer, and TPS, which are sold to investors. The business trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The corporate issuer makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the TPS to the investors. The subordinated debentures have a stated maturity and may also be redeemed under other circumstances. Most TPS are subject to a mandatory redemption upon the repayment of the debentures.
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component, and an overall composite, is assigned a rating of "1" through "5," with "1" having the least regulatory concern and "5" having the greatest concern.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ASC	Accounting Standard Codification
BBR	Bank Board Resolution
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CFO	Chief Financial Officer
C&I	Commercial and Industrial
CPP	Capital Purchase Program
CRP	Capital Restoration Plan
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DPC	Debt Previously Contracted
DRR	Division of Resolutions and Receiverships
ED	Examination Documentation
FAS	Financial Accounting Standard
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
GAGAS	Generally Accepted Government Auditing Standards
LLC	Limited Liability Company
LTV	Loan-to-Value
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
ORL	Offsite Review List
PCA	Prompt Corrective Action
RMS	Division of Risk Management Supervision
SEC	Securities and Exchange Commission
TARP	Troubled Asset Relief Program
TCB	Tennessee Commerce Bank
TDFI	Tennessee Department of Financial Institutions
TDR	Troubled Debt Restructuring
TPS	Trust Preferred Securities
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

Corporation Comments and OIG Evaluation

Corporation Comments and OIG Evaluation

Subsequent to the issuance of KPMG's draft report, RMS and TDFI officials provided additional information for KPMG's consideration, and KPMG revised its report to reflect this information, as appropriate. On September 11, 2012, the Director, RMS, provided a written response to a draft of this report. That response is provided in its entirety on pages II-2 and II-3 of this report.

In the response, the Director reiterated the causes of TCB's failure and the supervisory activities described in the report. Further, RMS has recognized the threat that institutions with high risk profiles, such as TCB, pose to the DIF and issued additional guidance to examiners related to C&I loans and lease financing in 2009 and 2010. RMS also issued a FIL to FDIC-supervised institutions in 2009 entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition.* According to RMS, this FIL heightened its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

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

September 11, 2012

TO: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

FROM: Sandra L. Thompson /**Signed**/
Director

SUBJECT: Draft Audit Report *Entitled Material Loss Review of Tennessee Commerce Bank, Franklin, Tennessee*

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of Tennessee Commerce Bank (TCB) which failed on January 27, 2012. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on August 9, 2012, and subsequent revisions.

TCB failed primarily because its Board and management did not effectively manage the risks associated with loan growth; exposure to large, complex borrower relationships; and concentrations in economically sensitive and specialized segments of the commercial and industrial (C&I) market. Lax oversight of the lending and credit administration functions contributed to asset quality weaknesses. In addition, TCB did not maintain capital at levels that were commensurate with its increasing risk profile. TCB also relied on capital injections from the holding company and non-core funding sources to support loan growth. By September 2011, TCB's loan portfolio had significantly deteriorated, requiring increases to the allowance for loan and lease losses that depleted earnings, eroded capital, and strained liquidity. TCB was unable to raise additional capital to sustain safe and sound operations.

From 2007 to 2012, the FDIC and the Tennessee Department of Financial Institutions (TDFI) conducted five onsite risk management examinations, three onsite visitations, and offsite monitoring. Examiners identified key risks in TCB's operations, brought these to the attention of the Board and management, and made recommendations for improvement. However, TCB's Board and management did not take adequate steps to address the weaknesses. In 2009, examiners downgraded TCB and proposed a Memorandum of Understanding (MOU), which TCB's Board refused to sign. Although TCB adopted a Board Resolution instead, the key objectives and goals of the proposed MOU were not addressed. The 2011 joint examination noted that all areas of the bank had become critically deficient, at which point examiners further downgraded TCB and secured a stipulation by the Board to a Consent Order.

In 2009, TCB's parent, Tennessee Commerce Bancorp, Inc., received $30 million under the Treasury Department' Capital Purchase Program (CPP), $24 million of which was down-streamed to TCB. TCB stated the CPP funds were used to augment capital and support lending needs. Examiners reviewed TCB's use of CPP capital during the 2009 and 2010 examinations in accordance with internal procedures. However, the 2010 examination report reflects that examiners were unable to determine whether TCB fully complied with provisions of the Emergency Economic Stabilization Act of 2008 despite multiple attempts by examiners to obtain information from the TCB's Chief Financial Officer and other bank management officials.

RMS has recognized the threat that institutions with high risk profiles, such as TCB, pose to the Deposit Insurance Fund and issued additional guidance to examiners related to C&I loans and lease financing in 2009 and 2010. RMS also issued to FDIC-supervised institutions a Financial Institution Letter (FIL) in 2009 entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*. This FIL heightened our supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources.

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