Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-024

Material Loss Review of First State Bank, Sarasota, Florida

March 2010

Office of Inspector General

Executive Summary

Material Loss Review of First State Bank, Sarasota, Florida

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Why We Did The Audit

On August 7, 2009, the Florida Office of Financial Regulation (OFR) closed First State Bank (FSB) and named the FDIC as receiver. On September 10, 2009, the FDIC notified the OIG that FSB's total assets at closing were $467.1 million and the material loss to the Deposit Insurance Fund (DIF) was $116.2 million. As of December 31, 2009, the loss had increased to $124.6 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of FSB.

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

Background

FSB opened on October 27, 1988 as a state nonmember bank regulated by the FDIC. Headquartered in Sarasota, Florida, FSB also operated with nine branch offices in Sarasota and Pinellas Counties. FSB was wholly-owned by First State Financial Corporation (FSFC), a publicly-traded, one-bank holding company. Since 1994, a group of investors led by Marshall T. Reynolds controlled FSFC. Mr. Reynolds headed a chain banking organization (CBO), with four holding companies, including FSFC, and 11 banks with combined assets of $2.8 billion.

FSB engaged in community banking and commercial real estate (CRE) lending activities, including a significant amount of residential and commercial acquisition, development, and construction (ADC) lending. Most of the bank's lending was within Florida.

Audit Results

Causes of Failure and Material Loss

FSB failed because its Board of Directors (Board) and management did not implement adequate controls to identify, measure, monitor, and control the risks associated with the bank's growth and concentrations in CRE loans and, in particular, ADC loans. In addition, FSB failed to implement adequate credit risk management practices and ensure that the bank maintained an adequate allowance for loan and lease losses (ALLL). By mid-2009, cumulative net losses associated with deterioration in FSB's CRE, ADC, and commercial and industrial (C&I) loans far exceeded the bank's earnings and severely eroded capital. The bank's capital was further reduced by (1) $8.9 million because that portion of a $13.6 million deferred tax asset (DTA) was improperly included in the DTA based on projected operating losses identified by examiners and (2) a $4.6 million termination fee associated with a repurchase agreement resulting from the bank's capital falling below *Well Capitalized*. The OFR closed FSB after the bank became *Critically Undercapitalized* because FSB's Board and management were unable to find a suitable acquirer or raise sufficient capital to support the bank's operations and improve its capital position.

The FDIC's Supervision of FSB

From March 2003 until the bank failed in August 2009, the FDIC, in conjunction with the OFR, provided ongoing supervision of FSB through six on-site risk management examinations. The FDIC also conducted offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in FSB's operations and brought these risks to the attention of the bank's Board and management through examination reports, other correspondence, and meetings with bank management. Such risks included FSB's concentrations in CRE and ADC loans, and weaknesses related to credit underwriting and administration and the ALLL. Examiners reported apparent violations of regulations and contraventions of interagency policy associated with FSB's lending practices. Examiners also (1) identified issues that had significant impact on the bank's capital position during 2008 and 2009 and (2) issued enforcement actions to correct problems identified in the August 2002, March 2008, and April 2009 examinations. However, earlier and greater supervisory attention to FSB may have been warranted after the October 2006 examination, in light of the significant risk associated with the bank's CRE and ADC concentrations in a declining real estate market and concerns expressed by examiners at that time.

With respect to PCA, we concluded that the FDIC had properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for FSB.

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 9, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

DSC reiterated the OIG's conclusions regarding the causes of FSB's failure. In addition, DSC agreed that it is important to follow-up on bank management's efforts to correct deficiencies identified in examinations. Further, DSC stated that follow-up for troubled institutions is conducted through monitoring of compliance with enforcement actions. To ensure that follow-up is conducted on non-troubled institutions as well, the FDIC recently issued examiner guidance that defines procedures for ensuring that examiner concerns and recommendations are appropriately addressed by bank management.

Contents

DATE: March 10, 2010

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

/Signed/

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

SUBJECT: *Material Loss Review of First State Bank, Sarasota, Florida*
(Report No. MLR-10-024)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of First State Bank (FSB), Sarasota, Florida. On August 7, 2009, the Florida Office of Financial Regulation (OFR) closed the institution and named the FDIC as receiver. On September 10, 2009, the FDIC notified the OIG that FSB's total assets at closing were $467.1 million and the material loss to the Deposit Insurance Fund (DIF) was $116.2 million. As of December 31, 2009, the loss had increased to $124.6 million.

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

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

This report presents the FDIC OIG's analysis of FSB's failure and the FDIC's efforts to ensure FSB's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics

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[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.

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

Background

FSB opened on October 27, 1988 as a state nonmember bank regulated by the FDIC. Headquartered in Sarasota, Florida, FSB also operated with nine branch offices in Sarasota and Pinellas Counties. FSB was wholly-owned by First State Financial Corporation (FSFC), a publicly-traded, one-bank holding company. Since 1994, a group of investors led by Marshall T. Reynolds controlled FSFC. Mr. Reynolds headed a chain banking organization (CBO),[3] with four holding companies, including FSFC, and 11 banks with combined assets of $2.8 billion.

FSB engaged in community banking and commercial real estate (CRE) lending activities, including a significant amount of residential and commercial acquisition, development, and construction (ADC) lending. Most of the bank's lending was within Florida.

Table 1 presents a summary of FSB's financial condition as of June 2009 and for the 5 preceding calendar years.

Table 1: Financial Condition of FSB

Financial Measure	Jun-09	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
(Dollars in Thousands)						
Total Assets	447,667	463,330	474,885	453,442	372,681	274,003
Total Loans	362,809	387,019	403,144	379,024	340,218	227,122
Total Deposits	394,701	386,098	395,555	400,353	312,706	212,679
Loan Loss Allowance	21,414	20,679	7,633	4,357	3,397	2,727
Net Income (Loss)	(22,453)	(20,787)	2,591	5,621	3,958	2,152

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

Causes of Failure and Material Loss

FSB failed because its Board of Directors (Board) and management did not implement adequate controls to identify, measure, monitor, and control the risks associated with the

[3] According to the FDIC's Examination Documentation Module, entitled, *Related Organizations*, dated November 2005, a chain banking group is a group (two or more) of banks or savings associations and/or their holding companies that are controlled directly or indirectly by an individual or company acting alone or through or in concert with any other individual or company. We did not identify any transactions between FSB and the other banks in the CBO that significantly contributed to FSB's failure.

bank's growth and concentrations in CRE loans and, in particular, ADC loans. In addition, FSB failed to implement adequate credit risk management practices and ensure that the bank maintained an adequate allowance for loan and lease losses (ALLL). By mid-2009, cumulative net losses associated with deterioration in FSB's CRE, ADC, and commercial and industrial (C&I) loans far exceeded the bank's earnings and severely eroded capital. The bank's capital was further reduced by (1) $8.9 million because that portion of a $13.6 million deferred tax asset (DTA) was improperly included in the DTA based on projected operating losses identified by examiners and (2) a $4.6 million termination fee associated with a repurchase agreement resulting from the bank's capital falling below *Well Capitalized*. The OFR closed FSB after the bank became *Critically Undercapitalized* because FSB's Board and management were unable to find a suitable acquirer or raise sufficient capital to support the bank's operations and improve its capital position.

Board and Management Planning and Oversight

FSB's Board and management failed to effectively supervise the operations and promote the overall welfare of the institution. FSB's Board and management implemented an ambitious growth plan that included rapid growth and a goal to become a $1 billion bank by 2010. Examiners identified FSB's plans for increased growth as early as 2005. Specifically, according to the OFR September 2005 examination report,[4] the bank's assets, as of August 2005, represented a 111-percent increase since 2002 and was part of a plan to increase the bank's size through rapid growth, primarily by acquiring existing banks, and aggressive pursuit of business development opportunities. The September 2005 examination concluded that FSB would soon exceed the 2006 total asset projection of $345 million and that FSB's management should update its strategic plan.

According to DSC's *Risk Management Manual of Examination Policies* (Examination Manual), the quality of management is probably the single most important element in the successful operation of a bank. The Board formulates sound policies and objectives and provides for the effective supervision of its affairs and promotion of a bank's welfare. The primary responsibility of senior management is to implement the Board's policies and objectives into the bank's day-to-day operations.

Examiners first expressed concerns regarding FSB's management during the March 2008 examination. Although this examination concluded that bank management was experienced and capable, examiners also expressed concern regarding management's ability in view of the bank's declining asset quality, weakened earnings, and lack of attendance at Board meetings by 1 of the 13 directors. At the FDIC's April 2009 examination,[5] examiners identified continued deterioration in FSB's asset quality and earnings, among other areas, and expressed heightened concern over the Board and management's failure to provide proper oversight. Examiners concluded that the Board had engaged in an aggressive growth strategy with deficient risk management practices,

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[4] Unless otherwise noted in this report, references to examination dates will refer to the month and year of the examination start dates.

[5] The April 2009 examination report was drafted but not finalized or issued to FSB prior to its failure.

and specifically failed to:

- establish risk limits on CRE and appropriately monitor concentrations;

- establish appropriate risk management practices related to strategic planning, budgeting, internal audits, insider transactions, and affiliate relationships;

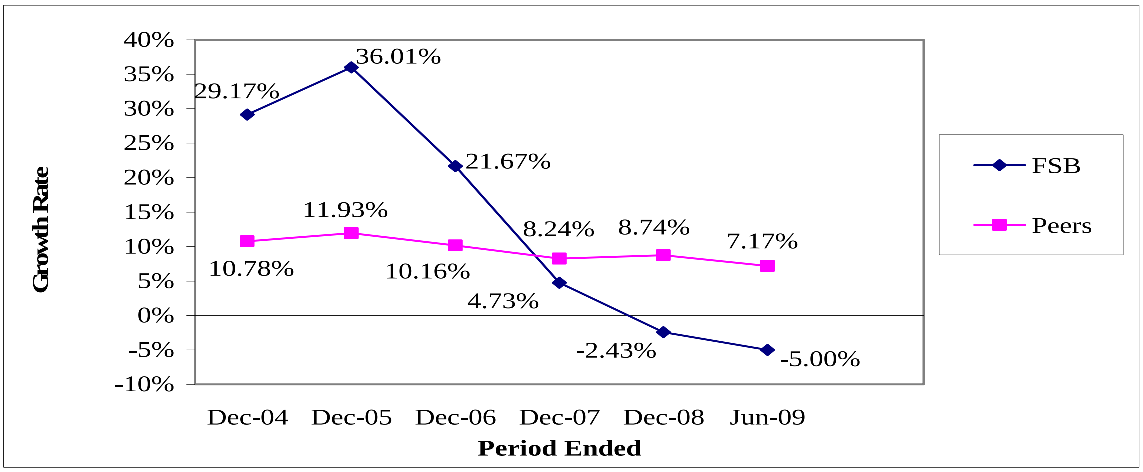
- ensure compliance with rules, regulations, statements of policy, and outstanding guidance, resulting in apparent violations and contraventions; and

- adhere to provisions of supervisory action.

FSB's Business Strategy

As shown in Figure 1, FSB's business strategy included rapid asset growth that significantly exceeded the average for its peers[6] from December 2004 to December 2006, with its highest annual asset growth of 36.01 percent occurring during 2005.

Figure 1: FSB's Annual Asset Growth Compared to Peers



Source: UBPRs for FSB.

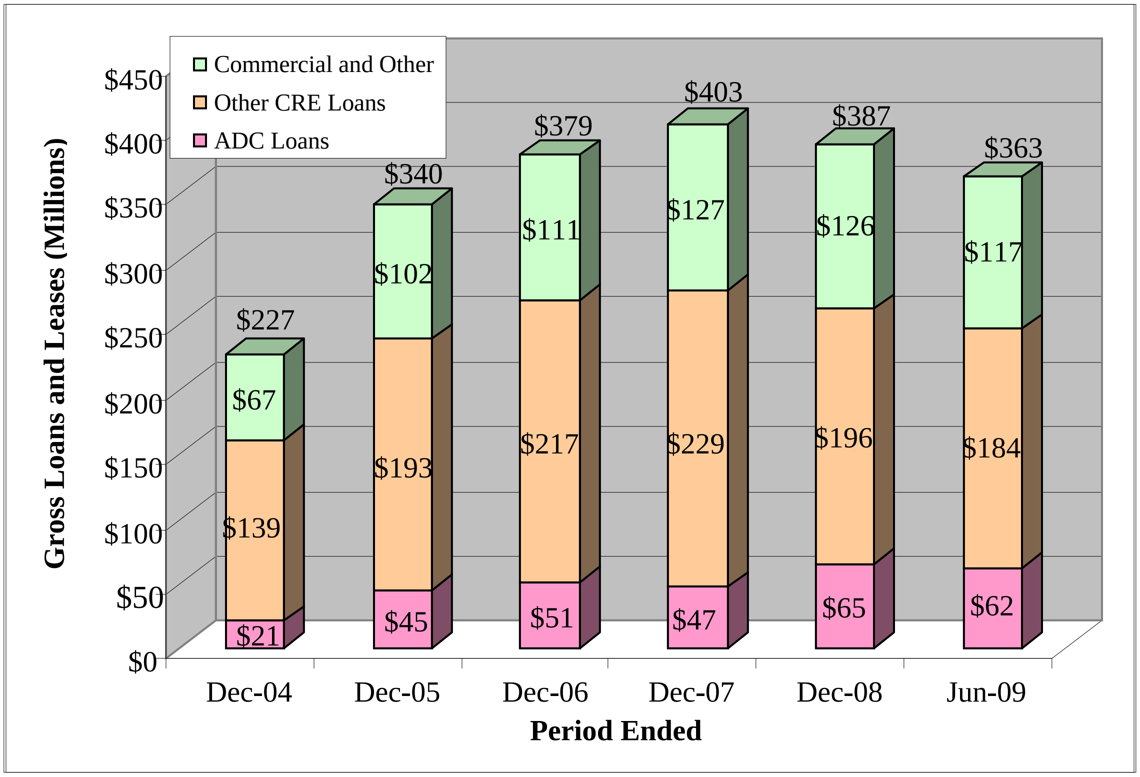
The extensive growth in FSB's assets occurred between 2004 and 2006 as the real estate market in Florida boomed. FSB's annual loan growth as of December 2005 was about 50 percent and was more than 3½ times greater than the bank's peers. Although management slowed the bank's growth in 2007 and later years, the poor quality of loans originated from 2004 through 2006 would ultimately prove detrimental to FSB's viability.

[6] Commercial banks are assigned to one of 25 peer groups based on asset size and other criteria. From 2005 through 2009, FSB's peer group was all insured commercial banks having assets between $300 million and $1 billion. Prior to that, FSB's peer group was all insured commercial banks with assets between $100 million and $300 million.

CRE and ADC Loan Concentrations

As discussed previously, FSB's lending strategy included a focus on CRE and ADC loans, which accounted for a substantial amount of FSB's loan portfolio. Specifically, between December 2004 and June 2009, FSB's total CRE and ADC loans accounted for 67.3 percent to 70.5 percent of the bank's total loan portfolio, with ADC loans ranging from 9.3 percent to 17.1 percent during that same period. Figure 2 illustrates FSB's loan composition from December 2004 to June 2009.

Figure 2: FSB's Loan Portfolio Composition and Growth



Source: OIG analysis of Consolidated Reports of Condition and Income (Call Reports) for FSB.

FSB's CRE loans grew cumulatively by 65 percent between December 2004 and December 2007. ADC loans grew at an even greater pace, with a cumulative growth of 143 percent between December 2004 and December 2006.

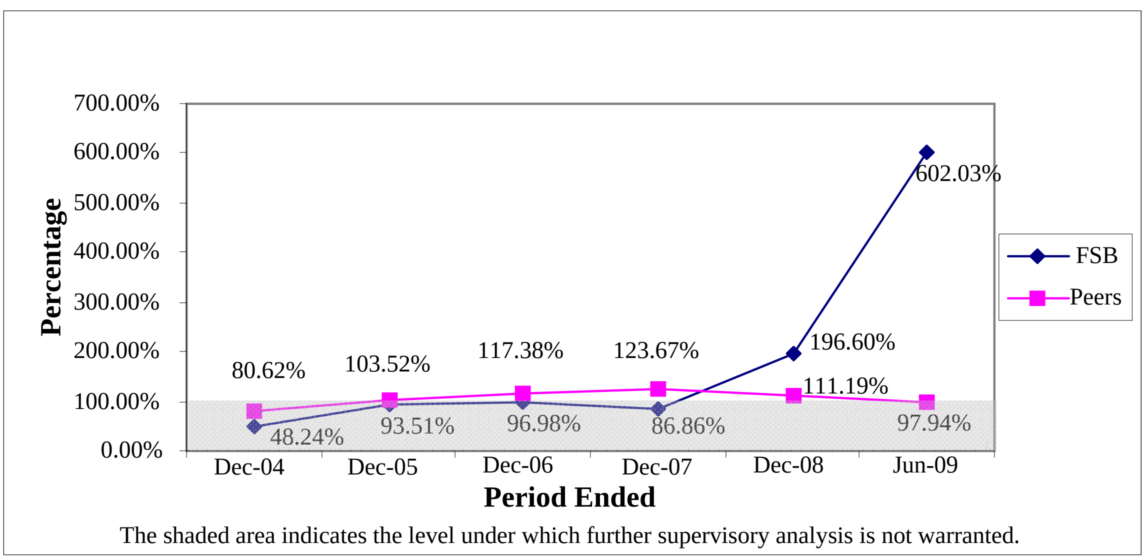
The risks that CRE and ADC concentrations pose to financial institutions' earnings and capital have been evident to supervisory agencies, which have provided guidance on managing these risks to financial institutions as far back as 1998 and more recently in December 2006. Specifically, Financial Institution Letter (FIL) 110-98, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, dated October 8, 1998, states that ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that the activity remains profitable. Guidance issued in December 2006, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,* (Joint Guidance) does not establish specific CRE lending limits, but defines criteria to identify institutions potentially exposed to significant CRE concentration risk. According to the guidance, a bank that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total reported loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of Total Capital; or

- Total CRE loans representing 300 percent or more of Total Capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

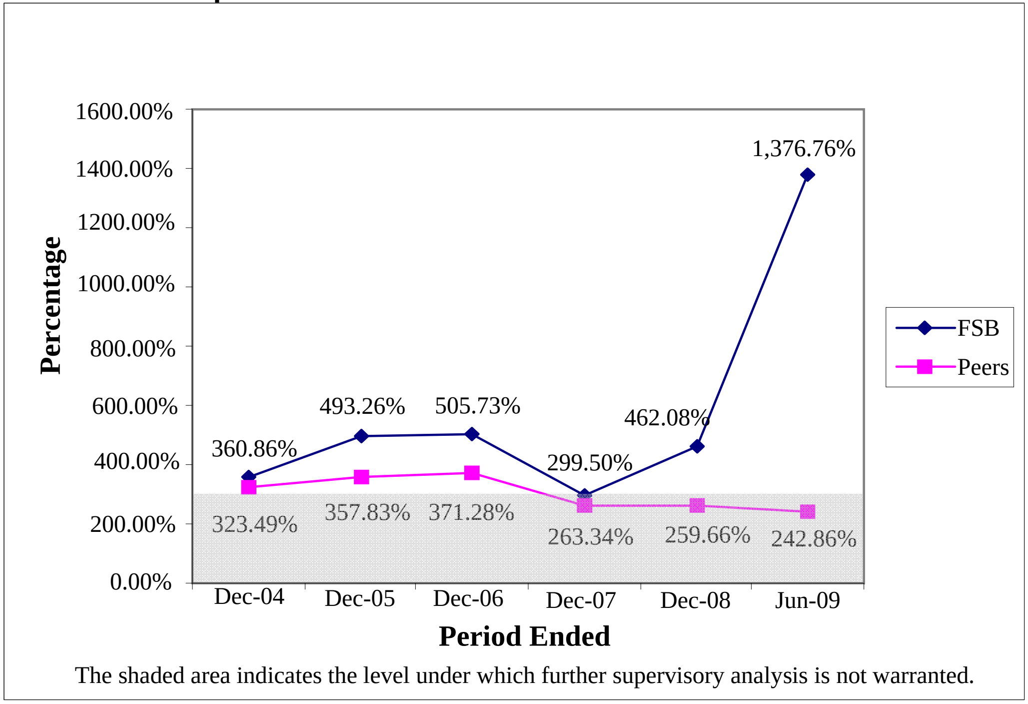
During the October 2006 examination, FSB officials stated that management was familiar with the proposed 2006 Joint Guidance and recognized the importance of maintaining heightened risk management practices commensurate with the degree of concentration risk in the bank's CRE portfolio. FSB's management reduced the volume of ADC loans in 2007 subsequent to the issuance of the Joint Guidance and slowed CRE loan growth. However, the bank's ADC concentration increased during 2008. Figures 3 and 4 show FSB's ADC and CRE totals, respectively, as a percent of Total Capital compared to the bank's peers and illustrate whether and to what extent FSB's CRE and ADC loans exceeded the levels that may be identified for further supervisory analysis. As previously noted, the poor quality of CRE and ADC loans originated from 2004 through 2006 ultimately proved detrimental to the viability of FSB and was indicative of FSB's failure to develop and follow adequate risk management controls, as discussed in the *Credit Risk Management Practices for CRE and ADC Lending* section of this report.

Figure 3: FSB's ADC Loan Concentration as a Percent of Total Capital Compared to Peers



Source: UBPRs for FSB.
Note: The increase in the ADC loan concentration ratio in 2009 resulted from a decline in FSB's capital.

Figure 4: FSB's CRE Loan Concentration as a Percent of Total Capital Compared to Peers



Source: UBPRs for FSB.
Note: Owner-occupied loans are not included in the percentages for the 2007 through 2009. The increase in the CRE concentration in 2008 and 2009 resulted from a decline in FSB's capital.

Although FSB's ADC concentrations did not exceed the bank's peers, and fell below the level warranting greater supervisory analysis for some reporting periods, the Board and management's high tolerance for risk was reflected in the type of loans it approved and weaknesses in underwriting and credit administration practices, which increased the bank's risk profile. Following are two examples of such high-risk loans that FSB originated that were noted in the April 2009 examination report.

Example 1. FSB approved a $5 million loan in 2005 for the acquisition and development of 35 acres of land into a commercial office park with 22 lots. The loan proceeds were to be used, in part, to refinance and pay off another financial institution for the original land purchase. A portion of the proceeds was also used to establish interest reserves of $450,000. The borrower received cash back of almost $2.3 million for other investment purposes. FSB's credit analyst noted numerous concerns regarding the loan due to the amount of cash provided at origination, the speculative nature of the development, the lack of review of the development plans, and the guarantor's poor credit rating of 568 and marginal debt service coverage.

In 2008, FSB modified the loan to provide an additional $3.3 million to the borrower, including an additional interest reserve of $650,000. FSB's credit analyst again noted areas of concern prior to the approval, including, but not limited to, minimal cash equity and loan-to-cost that had already exceeded 100 percent. The credit analyst's recommendations to improve the underwriting for this credit again were apparently ignored. Those recommendations included eliminating the interest reserve, requiring pre-sales, obtaining financial information, and reviewing construction and engineering costs. To assist the borrower in paying for county-required road extensions, FSB increased the debt by $571,000 to pay for the road expansion. As of the April 2009 examination, there had been no lot sales for this development. Examiners classified $2.6 million of this loan as Loss and $6.2 million as Substandard.

Example 2. FSB approved a $5.4 million loan originated in 2005 for the acquisition of an office building to be occupied by the borrower. The loan included $1.8 million of owner financing, representing 100-percent financing for the borrower. FSB's credit department raised concerns at origination that were apparently ignored. Those concerns related to the lack of detail regarding revenue and expense recognition and the borrower's ability to manage and control rapid growth in the borrower's company. In addition, the credit department noted that reliance was being placed on the ability to lease the building to third-parties. The credit department requested that the borrower prepare a vision and business plan that covered a depressed real estate market. By the April 2009 examination, the credit department's concern regarding this loan was realized because the borrower had filed for bankruptcy in 2007 and was vacating the leased space. As of the April 2009 examination, examiners classified $5.1 million of the loan as Substandard.

The Board and management's disregard for controlling the bank's risk exposure was evident in these examples. As noted, some of the policy exceptions and weaknesses were pointed out by FSB's own credit analyst prior to the approval of the loans. Nonetheless, FSB's Board and management approved the loans, thereby subjecting the bank to an increased level of risk.

Impact on FSB's Earnings

Between December 2004 and December 2007, FSB's business strategy was profitable. At the October 2006 examination, earnings were deemed to be strong, with a 1.34 percent return on average assets and a 4.67 percent net interest margin, which, according to examiners, reflected steady improvement over the previous 3 years. Net income of about $4.1 million for the first 9 months of 2006 exceeded FSB's projections and the bank's total 2005 earnings. Examiners attributed such improvement in the bank's earnings, in part, to FSB's rapid loan production.

However, between the October 2006 and the March 2008 examinations (an almost 18-month period), FSB's earnings declined significantly. The decline continued and became more severe through June 2009. FSB paid a considerable cash dividend of $2.1 million to its holding company, as the bank's net income began to significantly decrease during 2007. The rate of cash dividends to net income was considerably higher than FSB's peers, and the bank's retained earnings were considerably below its peers, decreasing from 8.32 percent to only 1.04 percent. Further, as FSB suffered a more than $20.7 million loss as of December 2008, the bank paid dividends totaling $948,000 to the bank's holding company.

Credit Risk Management Practices for CRE and ADC Lending

FSB failed to develop and follow an adequate credit risk management framework commensurate with the inherent risks associated with its CRE and ADC concentrations. According to the Joint Guidance, strong risk management practices are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans. The guidance also states that financial institutions with CRE concentrations should ensure implementation of risk management practices appropriate to the size of the portfolio, as well as the level and nature of concentrations, and the associated risk to the institution. Further, financial institutions should establish a risk management framework that effectively identifies, monitors, and controls CRE concentration risk. The guidance specifically notes the importance of portfolio management, credit underwriting standards, and credit risk review, among other risk management elements.

Examinations conducted from 2003 through 2005 generally found credit risk management practices, including loan underwriting and credit administration, to be adequate. Examiners began to report on weaknesses in the bank's risk management policies and practices during the October 2006 examination and continued to do so through the April 2009 examination. Specifically, the March 2008 examination identified:

- Interest reserves and other underwriting weaknesses that exposed the bank to increased credit risk with the downturn in the real estate market and its effects on the overall economy, and the lack of pre-lease or pre-sale contracts before granting interest reserves.

  - Although only 12 loans totaling $40.4 million were funded with interest reserves, five of those loans totaling $16.2 million were classified Substandard. In addition, the interest reserve on each of these loans was near depletion and the guarantors' financial statements did not support the ability to service the debts out-of-pocket.

  - Examiners recommended that FSB verify that the borrower's financial capacity to service the debt and pre-sale or pre-lease contracts were in place prior to funding interest reserves.

  - The practice of using interest reserves assisted in masking weaknesses in the loan portfolio by showing credits as current and performing. Loans with interest reserves would not be considered non-performing or delinquent until the interest reserves were depleted or the loan matured and the borrower could not make the payments.

- The need to strengthen loan underwriting and administration related to (1) stale-dated financial information, (2) delinquent real estate taxes, and (3) inaccurate information on loan relationships.

In July 2008, FSB responded to the OFR's examination results and stated that bank management had implemented processes to address the deficiencies identified during the March 2008 examination. However, during the April 2009 examination, 1 year after the March 2008 examination and over 2 years since the FDIC first discussed the significance of the 2006 Joint Guidance with FSB, examiners concluded and bank management admitted that it had failed to develop a CRE program to comply with that guidance. Bank management stated that it would begin to develop such a program within 90 days.

The impact of an inadequate CRE monitoring program became evident during the April 2009 examination, as risk management practices and policies were considered deficient and exposed the bank to a high level of risk. FSB's failure to establish strong credit risk management practices led to difficulties in resolving problem credits and monitoring and managing rapidly increasing troubled loan and other real estate assets. In addition, the bank's loan policy was inadequate because it failed to provide sufficient guidance to address CRE concentrations, including guidance for a CRE monitoring program and the establishment of risk limits to help control and mitigate risks in the CRE lending portfolio. Further, deficiencies related to FSB's underwriting practices included:

- over-emphasis on perceived collateral protection based on appraisals obtained during periods of significant real estate appreciation and failure to offset the associated risk of not making credit decisions based on the borrower's ability to repay and insufficient cash flow to service the debt;

- extended amortizations and interest-only requirements to enhance debt service capacity;

- reliance on incomplete credit information regarding feasibility or budgets for projects; and

- advancing funds to problem borrowers.

The April 2009 examination also noted that FSB's credit administration practices were weak and exposed the bank to significant losses. Examiners concluded that FSB's Board and management had not adequately overseen and supervised the lending function. Examiners cited FSB's management for various real estate lending-related apparent violations and contraventions, including a contravention of the Joint Guidance.

Commercial and Industrial Loans and Related Practices

In addition to the bank's CRE and ADC concentrations, FSB also had C&I loans that ultimately resulted in charge-offs totaling about $9.5 million in 2008 and 2009 and contributed to the bank's failure. A large part of those loans represented individual or relationship concentrations. According to the Pre-Examination Planning (PEP) Memorandum for the October 2006 examination, FSB attempted to diversify the bank's loan portfolio by increasing its C&I lending from 2004 to 2006. At that time, losses associated with the C&I portfolio had been minimal. However, in late 2008 and early

2009, it was determined that the deterioration in the C&I portfolio had progressively worsened. For example:

- On November 25, 2008, FSB informed the FDIC that loan reviews conducted in October 2008 determined that one credit, representing 46 percent of the $10.5 million of credits collateralized by accounts receivable, was impaired, and 25 percent of loans secured by business assets were impaired.

- According to the 2009 examination, FSB's failure to monitor collateral related to business asset lending was determined to be a significant credit administration weakness and included the (1) lack of oversight and monitoring of inventory and equipment collateral and (2) failure to monitor accounts receivable aging reports, compliance with borrowing base limits, inventory valuations, and collateral related to business asset lending. Lack of monitoring resulted in $3.7 million in charge-offs on two properties.

Allowance for Loan and Lease Losses

The March 2003 through March 2008 examinations generally concluded that FSB's ALLL methodology and balance were sufficient. However, between the September 2005 and April 2009 examinations, the bank's adversely classified items and ALLL balance increased significantly from $4.5 million to $103.8 million, and $2.9 million to $20.3 million, respectively. According to FSB's *Annual Report* for the fiscal year ended December 31, 2008, the bank's impaired loans increased from $31 million to $98 million and, as a result, FSB made a substantial provision to the ALLL to address the additional risks in the loan portfolio. The additional provision contributed to the bank's lower, *Adequately Capitalized*, PCA category.

As assets deteriorated further, the need to increase the ALLL continued into 2009. By the April 2009 examination, examiners recommended that FSB increase the ALLL by $10 million and concluded that the bank's ALLL methodology was deficient. In addition, FSB's adversely classified coverage ratio increased from 9.9 percent in 2005 to 277 percent in 2009. Further, examiners cited FSB for an apparent contravention of the 2006 *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies*[7] because examiners identified (1) various deficiencies in bank management's identification of loans that needed to be chargedoff, (2) additional loans classified as "Loss", and (3) an inadequately funded ALLL.

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[7] This policy statement reiterates key concepts and requirements included in Generally Accepted Accounting Principles and existing supervisory guidance for maintaining the ALLL at an appropriate level. The policy statement requires an institution to maintain an appropriate ALLL level, discusses items that need to be addressed in written policies and procedures, and describes methodologies that institutions need to use to determine an appropriate level.

Additional Events That Negatively Impacted FSB's Capital Position

During late 2008 and early 2009, FSB's capital position was negatively impacted by two other events that contributed to the determination that FSB was *Critically Undercapitalized* and led to the bank's ultimate failure. Those events were the reclassification of a large portion of a DTA on FSB's books because it was not realizable, and an early termination fee associated with a repurchase agreement with Citigroup Global Markets, Inc., (CGMI).

Disallowed Deferred Tax Asset

During the April 2009 examination, FDIC examiners determined that FSB's management and external auditor had failed to properly account for $13.6 million related to a DTA and an "other asset" account. A DTA is the potential tax benefit of operating losses. It represents the amount by which taxes receivable are expected to be realized from Net Operating Loss carrybacks or future operating income. However, because FSB's viability was in question due to the bank's substantial financial deterioration, examiners determined that only $4.7 million of the $13.6 million was actually realizable as a future tax offset, and that the remaining $8.9 million should have been disallowed by the bank's management and audit firm and deducted from the bank's capital.[8]

Specifically, FDIC examiners:

- Discovered the error when analyzing a DTA totaling $7.5 million and $6.1 million in an "other asset" account.

- Determined that the $6.1 million other asset was actually a DTA, raising the total DTA to $13.6 million.

- Determined that only $4.7 million of the $13.6 million was realizable, leaving a balance of $8.9 million categorized as not realizable. FSB management initially considered the $8.9 million as an asset contingent upon future income. However, examiners disagreed with that conclusion based on the large operating losses that FSB was expected to experience during 2009.

The impact of the correction and reclassification of $8.9 million as not realizable, combined with FSB's first quarter operating losses of $16.3 million, significantly reduced FSB's capital. In addition, correcting the error required FSB to amend its Call Reports for the periods ending December 31, 2008 and March 31, 2009, and restate the bank's audited financial statements for the period ending December 31, 2008. Further, the reduction in the bank's capital caused the institution to fall from *Adequately Capitalized*, as of December 31, 2008, to *Significantly Undercapitalized*, as of March 31, 2009.

[8] The FDIC issued a final rule, entitled, *Capital Maintenance*, in the Federal Register (Vol 60, No. 29), in February 1995. Refer to Appendix 2 of this report for additional information.

Repurchase Agreement Termination Penalty

FSB's PCA category of *Adequately Capitalized*, as of December 31, 2008, triggered an event that continued to significantly impact the bank's capital and, ultimately, its ability to continue as a going concern. Specifically, between May and September 2007, FSB entered into 3-10 year repurchase agreements with CGMI, which included provisions that FSB maintain a *Well Capitalized* capital position.[9]

The decrease in FSB's capital category to *Adequately Capitalized*, as of December 31, 2008, triggered the "termination event" clauses in all three repurchase agreements with CGMI. Because FSB was no longer considered *Well Capitalized*, CGMI considered the bank to be in default and requested FSB to (1) repurchase the $25 million in securities previously sold to CGMI by FSB and (2) pay a $4.6 million early termination fee as of April 13, 2009.

During the April 2009 examination, examiners adjusted FSB's capital to account for the repurchase agreement penalty fee, the DTA, and additional ALLL provisions due to severe deterioration in the bank's loan portfolio. These adjustments resulted in FSB's capital position falling to *Critically Undercapitalized*, and, ultimately, the bank's insolvency.

The FDIC's Supervision of FSB

From March 2003 until the bank failed in August 2009, the FDIC, in conjunction with the OFR, provided ongoing supervision of FSB through six on-site risk management examinations. The FDIC also conducted offsite monitoring activities.[10] Through its supervisory efforts, the FDIC identified risks in FSB's operations and brought these risks to the attention of the bank's Board and management through examination reports, other correspondence, and meetings with bank management. Such risks included FSB's concentrations in CRE and ADC loans, and weaknesses related to credit underwriting and administration and the ALLL. Examiners reported apparent violations of regulations and contraventions of interagency policy associated with FSB's lending practices. Examiners also (1) identified issues that had significant impact on the bank's capital position during 2008 and 2009 and (2) issued enforcement actions to correct problems identified in the August 2002, March 2008, and April 2009 examinations. However, earlier and greater supervisory attention to FSB may have been warranted after the October 2006 examination, in light of the significant risk associated with the bank's CRE and ADC concentrations in a declining real estate market and concerns expressed by examiners at that time.

[9] According to FSB's Form 10-K/A, Amendment No. 1, as filed on May 5, 2009, the agreements were callable immediately because the bank did not maintain its *Well Capitalized* status with the FDIC. The borrowings were collateralized by $32.5 million in securities at December 31, 2008.
[10] The FDIC uses various offsite monitoring tools including, but not limited to, the Statistical CAMELS Offsite Rating (SCOR) system, the Growth Monitoring System (GMS), and the Real Estate Stress Test (REST) to help examiners assess the financial condition of institutions and assist DSC in determining the appropriate supervisory approach for FDIC-supervised institutions.

Supervisory History

The FDIC and the OFR conducted examinations on an alternating basis from March 2003 through April 2009. FSB consistently received composite "2" CAMELS[11] ratings until the OFR March 2008 examination, which revealed significant financial deterioration in the bank's overall performance. As a result, its composite rating was downgraded to a "3". At the FDIC's April 2009 examination, examiners identified continued and more significant deterioration in the bank's performance that resulted in a further downgrade of the composite rating to a "5", indicating extremely unsafe and unsound practices or conditions, critically deficient performance, and inadequate risk management practices. Table 2 provides the supervisory history for FSB from 2003 to 2009, CAMELS component and composite ratings, and enforcement actions taken. The latter included Bank Board Resolutions (BBR) issued in September 2002 and August 2008 and a Cease and Desist (C&D) Order drafted as a result of the April 2009 examination, but not issued.

Table 2: FSB's Examination History, 2003 to 2009

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Enforcement Action
03/03/2003	12/31/2002	OFR	222322/2	BBR–Effective September 17, 2002.
09/13/2004	06/30/2004	FDIC	212222/2	None
09/19/2005	06/30/2005	OFR	112222/2	None
10/02/2006	06/30/2006	FDIC	122122/2	None
03/31/2008	12/31/2007	OFR	233322/3	BBR–Effective August 26, 2008.
04/13/2009	03/31/2009	FDIC	555555/5	C&D–Drafted but not issued.

Source: Examination reports for FSB.

Offsite Reviews. In addition to on-site examinations, DSC's relationship manager for FSB made several contacts with the bank between 2005 and 2008. The purpose of those contacts included, but was not limited to, discussion of the bank's overall financial condition, the proposed Joint Guidance, and the significant decline in FSB's earnings in 2007. In December 2006, the FDIC developed a supervisory plan for calendar year 2007, noting that FSB's overall satisfactory performance and plans to expand the bank's market area through branching activities. The FDIC concluded that it would conduct an interim contact with FSB during the third quarter of 2007 to follow up on management's commitment to address examination concerns; monitor trends in the housing market; and update the availability of windstorm insurance for real estate, loan collateral, and bank premises. The supervisory plan also noted that the proposed examination cycle would

[11] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

change from 12 months to 18 months due to proposed legislation[12] and that the next examination was scheduled for April 2008.

In October 2006, examiners conducted an in-depth review of the impact of the Marshall T. Reynolds CBO on FSB operations. Specifically, the examiners reviewed information about the ownership structure of FSFC and FSB, among other issues, and the influence of the CBO over FSB. Examiners did not identify any significant concerns that warranted increased supervisory attention. Examiners concluded that subsequent examinations should look for and review transactions between FSB and other members of the CBO.[13]

March 2008 Examination. The OFR's March 2008 examination revealed significant deterioration in the ADC portfolio. Developers whose financial capacities were tied to the market were unable to satisfy obligations once interest reserves were exhausted. The OFR assigned a "3" composite rating in addition to "3" ratings for asset quality, management, and earnings. As a result of those findings, the OFR drafted a BBR, which FSB's Board adopted in August 2008.

August 2008 BBR. The BBR included provisions related to asset quality, management, earnings, and ALLL and required FSB to provide periodic progress reports to the OFR. Specifically, the BBR included 12 provisions to address the following issues:

- adversely classified assets, ALLL and loan review, and loan underwriting and credit administration;
- required notification of new Board and executive management members;
- inadequate internal controls;
- revisions needed to the bank's business plan and budgets for 2008, 2009, and 2010, including growth rates and limitations;
- annual review of plans, policies and procedures; and
- written progress reports.

April 2009 Examination. Examiners concluded that FSB's financial condition was critically deficient and of heightened supervisory concern. The examination showed that FSB's actions had not been sufficient to offset the continued deterioration in real estate values, and adversely classified assets had increased considerably. FSB's Board and

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[12] The legislation passed and the FDIC issued official guidance in the Regional Directors Memorandum 2007-014, entitled, *Expanded Examination Cycle for Certain Small Insured Depository Institutions and U.S. Branches and Agencies of Foreign Banks*, dated May 10, 2007. The guidance provided qualifying criteria that institutions had to meet before their examination cycle could change from a 12-month to an 18-month schedule. FSB met the conditions for the 18-month examination cycle after the 2006 examination. However, based on section 10 of the FDI Act and section 337.12 of the FDIC Rules and Regulations, the FDIC has the authority to examine financial institutions more frequently if deemed necessary.

[13] In addition to the FDIC's offsite monitoring activities, the Federal Reserve conducted offsite monitoring activities related to FSB's holding company, FSFC. In August 2008, the Federal Reserve agreed with the OFR's conclusion that FSB's condition was less than satisfactory and expressed concern regarding the bank's asset quality, earnings, management, and credit concentrations. Although the Federal Reserve did not identify any concerns regarding the activities of the holding company, it required FSFC to adopt a BBR to strengthen the financial condition of the holding company and its subsidiary bank, FSB.

management were determined to be inadequate to address the bank's severe problems, which were beyond the Board's ability to control. Specifically, examiners concluded that

- the Board's oversight was deficient and risk management practices were inadequate given the rapid deterioration of FSB's financial condition;

- asset quality was critically deficient with further deterioration probable based on management's deficient underwriting practices and the current economic recession, and escalating losses threatened the continued viability of the institution;

- liquidity and funds management practices were also critically deficient and given the substantial operating losses and capital insolvency, sensitivity to market risk posed an imminent threat to the bank's viability; and

- capital was critically deficient and the bank was insolvent, and an immediate capital injection from shareholders or other external sources was required for the bank to remain viable.

As a result of FSB's deteriorated condition, the FDIC drafted a problem bank memorandum, dated August 6, 2009, designating FSB as a problem institution.

Supervisory Oversight of FSB's Board and Management

The October 2006 examination report concluded that FSB's policies and practices were satisfactory and deficiencies and/or weaknesses in the areas of asset quality, loan underwriting and administration, liquidity, market risk, and apparent violations were considered correctable in the normal course of business. Examiners also concluded that FSB's management was responsive to supervisory recommendations and implemented certain suggested improvements during the examination. Examiners initially recommended a management component rating of "1". However, following the DSC Regional Office's review, the rating was downgraded to a "2" due to deficiencies related to safety and soundness and information technology, apparent violations, and a declining trend in asset quality.

According to the FDIC *Case Manager Procedures Manual*, the transmittal for the examination report can be used as a tool in the regulatory process and its tone should be consistent with the overall condition of the institution. For financial institutions that have a composite rating of "1" or "2", the transmittal letter can merely reference the examination report and request the bank's Board to review the report and note its review in the minutes. For those institutions with moderate concerns, the transmittal letter should include a brief discussion of problem areas and a request for a written response, perhaps targeting specific areas such as increased classifications or a decline in capital. The status of any outstanding corrective action program should also be addressed.

The transmittal letter for the FDIC's October 2006 examination stated that the examination report reflected an overall satisfactory financial condition for FSB.

However, the transmittal also outlined the following concerns regarding FSB's condition that could have resulted in a different supervisory approach for FSB during 2007:

- the diminishing quality of the bank's loan portfolio;

- FSB's aggressive growth posture and the need for careful and prudent loan underwriting and administration; and

- the need to closely monitor FSB's capital position even though the bank's capital remained strong, in light of FSB's asset growth and lower asset quality.

Because FSB was a "2" rated bank, the transmittal letter did not require that FSB provide a response to the 2006 examination results or submit status reports on actions planned or taken to address examiner concerns. FSB was not examined during 2007 because the bank was on an 18-month examination cycle. However, the calendar year 2007 supervisory plan indicated that the FDIC would conduct an interim contact with FSB during the third quarter of 2007 to follow up on management's commitment to address examination concerns and to monitor trends in the housing market. This interim contact did occur, and noted various reasons for the decline in FSB's earnings. In addition, the contact noted that there had been a slowdown in fees associated with the origination and sale of residential mortgage loans compared to the first half of 2006, reflecting the loss of a high producing loan originator and a slowing residential real estate market. However, the interim contact did not specifically address the following concerns that were outlined in the transmittal letter for the October 2006 examination: the quality of the loan portfolio, loan underwriting and administration, and the bank's capital levels.

As previously noted, FSB was not examined during 2007 because the bank was on an 18-month examination cycle. At the next examination conducted in March 2008, examiners concluded that although management was experienced and capable, the deteriorating asset quality and weakened earnings did not reflect favorably on its performance. The examination also concluded that bank management realized it faced significant challenges due to the condition of the economy at that time and was taking measures to address them. The area's weakened real estate market and economy created uncertainty as to whether there would be further deterioration in asset quality. Given the poor performance in asset quality and earnings since the October 2006 examination, FSB's management rating was deemed less than satisfactory and was downgraded to a "3".

By the April 2009 examination, substantial deterioration in FSB's condition had occurred and examiners' concerns regarding FSB's management were extensive. Examiners concluded that FSB's management:

- was deficient, ultimately responsible for the bank' critically deficient financial condition, and had failed to provide proper oversight;

- was unfamiliar with the terms of the CGMI repurchase agreement that resulted in a $4.6 million loss and the improper accounting for the $8.9 million DTA, which required restatement of the 2008 financial statements [and amended the Call Reports for the periods ending December 31, 2008 and March 31, 2009]; and

- had failed to ensure compliance with various rules, regulations, statements of policy, and other guidance apparently due to inexperienced management, lack of Board oversight, or the bank's troubled condition.

The lack of Board and management oversight in a declining economic period significantly contributed to the failure of FSB. Specific weaknesses identified in 2008 and 2009 had also been identified in 2006. The 2007 supervisory plan indicated that the FDIC would conduct an interim contact with FSB during the third quarter of 2007 to follow up on management's commitment to address examination concerns and to monitor trends in the housing market. While DSC did contact FSB as planned, the third quarter contact focused on the decline in FSB's earnings and did not address management's efforts to address examination concerns that resulted from the October 2006 examination. As discussed in more detail in the next section of this report, the FDIC may have missed an opportunity to conduct offsite monitoring or a visitation in 2007 to ensure that management was taking action to mitigate risks identified at the October 2006 examination.

Supervisory Approach to CRE and ADC Concentrations

Although the planning process for the October 2006 examination and the examination results identified risks associated with FSB's CRE and ADC concentrations, those risks did not result in a substantial change in the supervision of FSB until the subsequent March 2008 examination.

The PEP memorandum for the FDIC's October 2006 examination noted the following.

- Bank management continued to press the aggressive growth which was observed at the 2005 examination. The pace of growth was nearly 33 percent, well in excess of the national peer average and in stark contrast to the "slowdown" of lending at other banks in the same market area.

- The REST[14] score for FSB was 4.87; exposure to non-farm, non-residential real estate collateral values was 420 percent and ADC loans equaled 103 percent of Tier 1 Capital and the ALLL, respectively. Our review of offsite monitoring data

[14] REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. The primary risk factor is the ratio of construction and development loans to total assets. Other risk factors include the percentage of CRE loans, percentage of multifamily loans, percentage of commercial and industrial loans, and high non-core funding and rapid asset growth. A bank with a high concentration in construction and development loans, coupled with rapid asset growth, would appear to be riskier than a bank with similar concentrations but low asset growth. REST uses statistical techniques and Call Report data to forecast an institution's condition over a 3- to 5-year period and provides a single rating from 1 to 5 in descending order of performance quality.

for FSB further noted that, in fact, FSB's REST score had been just slightly below "5" from December 2002 to June 2006, ranging from 4.35 to 4.92.

- Total real estate loans exceeded 600 percent of Tier 1 Capital and the ALLL.

- Past due ratios indicated that delinquencies remained well-controlled—maintained at a 20-percent ratio, according to bank management—although the loan loss rate had increased.

In addition, the preliminary risk assessment included in the PEP stated that a larger loan sample would be reviewed due to the pace of FSB's loan growth and the FDIC's scrutiny of CRE exposure in most banks in the region. Accordingly, during the October 2006 examination, which was conducted under *Maximum Efficiency, Risk-focused, Institution Targeted* (MERIT)[15] examination procedures, examiners reviewed more than $81.4 million of FSB's loans, of which $58.6 million, or 72 percent, represented CRE loans.

- It was during this examination that examiners first raised concerns regarding FSB's asset quality, downgrading the component rating from a "1" to "2", and noted an increase in the adversely classified assets from about 10 percent to nearly 15 percent.

- Examiners also concluded that the bank's CRE exposure was "heightened" due to insufficient control and monitoring of excessive loan-to-values. Examiners noted various credit administration weaknesses that included missing title policies and insurance verifications, flawed cash flow analysis, stale or missing borrower financials, and a trend toward collateral dependency.

- Although the bank's capital position was considered strong, examiners noted that the Tier 1 Capital ratio was declining due to the bank's substantial asset growth.

In addition, it was at the October 2006 examination that examiners first noted the bank's CRE and ADC concentrations. Examiners concluded that FSB generally identified and controlled the attendant risks in a prudent fashion, was monitoring the risks and trends in the industry, and was working to diversify the loan portfolio due to recognition that real estate was a "bubble." However, the examination report included recommendations to improve the bank's risk management policies and practices for the credit function.

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

According to the October 2006 examination workpapers, examiners:

- discussed the implications of the not-yet issued Joint Guidance with FSB management who acknowledged the significance of appropriate risk management for CRE and ADC concentrations;

- determined that FSB's CRE levels, at that time, would have exceeded the 300-percent supervisory criteria included in the Joint Guidance; and

- planned to view the bank's CRE levels as significant in the future.

However, during the almost 18-month period that FSB was not examined by the FDIC or the OFR, a severe national and local market area economic decline and substantial deterioration in the bank's financial condition occurred, resulting in increased regulatory concern at subsequent examinations. Although FSB was not examined during 2007, a bank contact conducted on July 25, 2007 focused on the decrease in FSB's income but did not address the bank's CRE and ADC concentrations or followup on examiner concerns reported during the October 2006 examination, as noted previously, particularly the declining trend in the bank's asset quality.

The OFR's March 2008 examination determined that the declining trend in asset quality had continued and increased, concluded that asset quality was less than satisfactory, and downgraded the asset quality rating to "3". Concerns initially identified during the October 2006 examination had become more severe, and it became evident that bank management had not taken the appropriate steps to shield the bank from the risks associated with its loan portfolio. The OFR identified:

- deficiencies in FSB's credit risk management policies and practices, including stale-dated financial information, and the use of interest reserves, which contributed to FSB's increased credit risk;

- an increase in the level of adversely classified items, from about 15 percent of Tier 1 Capital and reserves in 2006, to 112 percent as of December 2007, representing $63.7 million of loans;

- a significant increase in past-due and nonaccrual loans;

- inadequate credit administration and underwriting practices to control risks; and

- the need for large provisions to the ALLL, which impacted the bank's earnings performance and capital.

By the April 2009 examination, the bank's financial condition had severely deteriorated and the asset quality rating and all other ratings were downgraded to "5".

At the time of the October 2006 examination, FSB's capital position was above the minimum threshold for *Well Capitalized* institutions, the institution had minimal classified assets, and management indicated a commitment to address examiner recommendations. Therefore, the supervisory approach to FSB was reasonable and consistent with policies and practices at the time for an institution with FSB's risk profile. However, a lesson learned with respect to institutions that have significant CRE and ADC concentrations and the associated risks, like those at FSB, is that early and aggressive supervisory intervention is prudent rather than relying too heavily on promises made by bank management to address deficiencies. With the benefit of hindsight, additional supervisory steps such as additional and more targeted offsite monitoring or follow-up prior to the March 2008 examination may have been prudent to assess the institution's:

- plans for growth;
- progress in correcting deficiencies identified at the 2006 examination;
- declining asset quality trend, including the increase in adversely classified assets;
- heightened CRE exposure; and
- declining Tier 1 Capital.

The FDIC issued guidance to its examiners on January 26, 2010 that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed. Specifically, the guidance defines a standard approach for communicating matters requiring Board attention (e.g., examiner concerns and recommendations) in examination reports. The guidance also states that examination staff should request a response from the institution regarding the actions that it will take to mitigate the risks identified during the examination and correct noted deficiencies.

Implementation of PCA

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

Based on the supervisory actions taken for FSB, the FDIC implemented applicable PCA provisions of section 38 of the FDI Act in the manner and timeframe required. FSB was categorized as *Well Capitalized* from December 2004 through December 2007, as indicated in Table 3.

Table 3: FSB's Capital Ratios Relative to PCA Thresholds for Well Capitalized Banks

Capital Category	PCA Thresholds	Dec 04	Dec 05	Dec 06	Dec 07	Dec 08	Jun 09
		FSB's Capital Ratios (Percentages)					
Tier 1 Leverage Capital	5% or more	16.51	12.53	10.96	10.33	5.76	1.18
Tier 1 Risk-Based Capital	6% or more	17.99	13.12	12.54	11.60	6.77	1.37
Total Risk-Based Capital	10% or more	19.16	14.12	13.66	12.82	8.07	2.67
PCA Category[a]	W	W	W	W	W	A[b]	CU

Source: Call Reports for FSB.
[a] W–*Well Capitalized*, U–*Undercapitalized*, SU–*Significantly Undercapitalized*, CU–*Critically Undercapitalized*.
[b] FSB submitted a brokered deposit application waiver to the FDIC on March 5, 2009, but withdrew the application on March 17, 2009.

FSB generally maintained capital levels that exceeded the bank's peers. Although FSB received capital injections from its holding company in 2007, the need for additional capital became evident nearing the end of 2008, and on November 12, 2008 FSB submitted an application under the Troubled Asset Relief Program for $12 million. However, the application was subsequently withdrawn. Beginning in December 2008, substantial deterioration in FSB's capital levels began, as previously noted. By May 2009, FSB was *Significantly Undercapitalized* and by June 2009 it had fallen to *Critically Undercapitalized*. The FDIC provided PCA notifications based on declines in FSB's capital, as indicated in Table 4.

Table 4: FSB's PCA Notifications Provided by the FDIC

PCA Notification or Directive Date	PCA Category	Basis for PCA Notification
April 28, 2009	*Adequately Capitalized*	12/31/2008 Call Report[a]
May 5, 2009	*Undercapitalized*	3/31/2009 Call Report
May 18, 2009	*Significantly Undercapitalized*	3/31/2009 Call Report (amended)
June 11, 2009	*Critically Undercapitalized*	FDIC April 2009 examination
July 10, 2009 (PCA Directive)	*Critically Undercapitalized*	FDIC April 2009 examination

Source: Call Reports for FSB.
[a] The December 31, 2008 Call Report was amended in March 2009 to take into consideration the need for additional loss provisions identified during FSB's year-end audit.

On July 10, 2009, the FDIC issued a Supervisory PCA Directive to FSB that specified actions required for and outlined restrictions due to FSB's *Critically Undercapitalized* status pursuant to Part 325 of the FDIC Rules and Regulations, based on the bank's FDIC April 2009 examination. In response, FSB developed a capital restoration plan that required the bank to increase the capital level sufficient to restore the bank to a Total Risk-Based Capital ratio of 10 percent within 90 days. According to the PCA Directive, in the event that FSB did not meet the requirement to increase the bank's capital, FSB was required to (1) take action to be acquired by another depository institution holding company or (2) merge with another depository institution. In addition, FSB was required to comply with all PCA requirements under section 38 of the FDI Act, including, but not limited to, restricting asset growth; restricting the payment of dividends, other capital distributions, and management fees; and obtaining approval from the FDIC before entering into any material transactions, other than those related to the ordinary course of business.

According to FSB's August 2009 capital restoration plan, the bank needed to raise approximately $31 million in order to be *Well Capitalized*. In addition, FSB was projected to lose approximately $8 million during the remainder of 2009 and 2010 unless additional capital was obtained. The bank's holding company and shareholders were unwilling or unable to provide additional capital to FSB. Accordingly, on August 7, 2009, the OFR closed FSB due to FSB's severely deteriorated financial condition and the bank's inability to raise capital to the required level, and named the FDIC as receiver.

Corporation Comments

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 9, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

DSC reiterated the OIG's conclusions regarding the causes of FSB's failure. In addition, DSC agreed that it is important to follow-up on bank management's efforts to correct deficiencies identified in examinations. Further, DSC stated that follow-up for troubled institutions is conducted through monitoring of compliance with enforcement actions. To ensure that follow-up is conducted on non-troubled institutions as well, the FDIC recently issued examiner guidance that defines procedures for ensuring that examiner concerns and recommendations are appropriately addressed by bank management.

Objectives, Scope, and Methodology

Objectives

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

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

We conducted this performance audit from December 2009 to February 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of FSB's operations from December 31, 2002 until its failure on August 7, 2009.

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

- Analyzed examination reports issued by the FDIC and the OFR from 2003 to 2009.

- Reviewed the following:

    - Available work papers for FDIC examinations and correspondence maintained at DSC's Atlanta Regional Office and Tampa, Florida Field Office.

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

    - Audit reports prepared by the bank's external auditor, Crowe Horwath LLP (formerly Crowe Chizek).

Objectives, Scope, and Methodology

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

  - Actions that DSC implemented to comply with (1) provisions of section 29 and the FDIC Rules and Regulations, Part 337, *Unsafe and Unsound Banking Practices* restricting FSB's use of brokered deposits; and (2) section 38 of the FDI Act, including, but not limited to, issuing PCA notification letters and a PCA Directive, and restricting the bank's asset growth and payment of dividends, when applicable, based on the bank's capital category.

- Interviewed the following FDIC officials:

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

  - FDIC examiners from the DSC Tampa Field Office and Atlanta Regional Office, who participated in examinations or reviews of examinations of FSB.

  - DRR officials at the FDIC Dallas Regional Office.

- Interviewed an official from the OFR to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

- Interviewed partners from FSB's external auditor, Crowe Horwath LLP.

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

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

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

Objectives, Scope, and Methodology

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

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Annual Report on Form 10-K	The federal securities laws require publicly traded companies to disclose information on an ongoing basis. The Form 10-K provides a comprehensive overview of the company's business and financial condition and includes audited financial statements. Form 10-K is to be filed with the Securities and Exchange Commission within 90 days after the end of the company's fiscal year.
Bank Board Resolution (BBR)	A Bank Board Resolution is 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. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Consolidated Reports of Condition and Income (also know as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank with the FDIC pursuant to the Federal Deposit Insurance 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.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop unsafe or unsound practices or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Chain Banking Organization (CBO)	According to the FDIC *Case Manager Procedures Manual*, a chain banking organization is a group of insured institutions that are controlled, directly or indirectly, by an individual acting alone, through, or in concert with any other individual(s). The individual(s) must own or control 25 percent or more of the institutions' voting securities; the power to control in any manner the election of a majority of the directors of the institutions; or the power to exercise a controlling influence over the management or policies of the institutions.

Glossary of Terms

Term	Definition
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.
Deferred Tax Asset (DTA)	A deferred tax asset is an asset that reflects, for financial reporting purposes, amounts that will be realized as reductions of future taxes or as future receivables from a taxing authority.
FDIC Capital Maintenance Rule on Deferred Tax Assets	The Capital Maintenance final rule amended the capital standards for insured state nonmember banks to establish a limitation on the amount of certain DTAs that may be included in Tier 1 Capital for risk-based and leverage capital purposes.
Problem Bank Memorandum	A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented and is also used to effect interim rating changes on the FDIC's systems.
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 action 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 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 undercapitalized categories.
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Treasury Department to purchase assets and equity from financial institutions to strengthen the financial sector.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
C&I	Commercial and Industrial
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CBO	Chain Banking Organization
CGMI	Citigroup Global Markets, Inc.
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
DTA	Deferred Tax Asset
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
FSB	First State Bank
FSFC	First State Financial Corporation
MERIT	Maximum Efficiency, Risk-focused, Institution Targeted
OFR	Office of Financial Regulation
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PEP	Pre-Examination Planning
REST	Real Estate Stress Test
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

March 5, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of First State Bank, Sarasota, Florida (Assignment No. 2009-072)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of First State Bank, Sarasota, Florida (FSB) which failed on August 7, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on February 24, 2010.

The Report concludes FSB failed due to its Board of Directors (Board) and management not implementing adequate controls to identify, measure, monitor, and control the risks associated with FSB's growth and the concentrations in commercial real estate (CRE) loans, and in particular acquisition, development, and construction loans. Losses associated with deterioration in FSB's loan portfolio far exceeded the bank's earnings and eroded capital. Bank capital was further reduced by necessary writedowns to the bank's deferred tax asset and recognition of a termination fee associated with a repurchase agreement resulting from the bank's capital falling below the Well Capitalized level. The Florida Office of Financial Regulation closed FSB after the bank became unable to find a suitable acquirer or raise sufficient capital to support the bank's operations and improve its capital position.

The Report concludes that the FDIC's supervisory approach to FSB was reasonable and consistent with policies and practices for an institution with FSB's risk profile. The Report further states that, with the benefit of hindsight, additional follow-up prior to the March 2008 examination may have been prudent to track management's progress in correcting deficiencies identified at the 2006 examination, at which time the bank was assigned a composite rating of 2.

We agree that it is important to follow-up on management's efforts to correct deficiencies identified in examinations. In troubled institutions, follow-up is conducted through monitoring of compliance with enforcement actions. To ensure that follow-up is conducted on non-troubled institutions as well, the FDIC recently issued examiner guidance that defines procedures for ensuring that examiner concerns and recommendations are appropriately addressed by bank management.

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