Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-031

Material Loss Review of Colonial Bank, Montgomery, Alabama

April 2010

Office of Inspector General

Executive Summary

Material Loss Review of Colonial Bank, Montgomery, Alabama

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Why We Did The Audit

On August 14, 2009, the Alabama State Banking Department (ASBD) closed Colonial Bank (Colonial) and named the FDIC as receiver. On October 24, 2009, the FDIC notified the Office of Inspector General (OIG) that Colonial's total assets at closing were $25.2 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $2.7 billion. As of March 31, 2010, the estimated loss to the DIF had increased to $3.8 billion. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Colonial.

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) provisions of section 38. As discussed throughout our report, Colonial switched its charter from a national to a state nonmember bank in June 2008, just 14 months prior to its failure. As a result, our material loss review also addresses the Office of the Comptroller of the Currency's (OCC) supervisory activities as the primary federal regulator (PFR) and the FDIC's monitoring of the bank as backup federal regulator from 2004 through 2008.

Background

Colonial was a state-chartered nonmember bank that was insured in 1934. As shown in the following table, the bank converted its charter three times between 1997 and 2008, most recently in June 2008 when it converted from a national charter to a state-chartered nonmember bank.

Colonial's Charter Changes, 1997 to 2008

Effective Date of Charter Change	Primary Federal Regulator (Change From)	Primary Federal Regulator (Change To)
June 13, 1997	FDIC	Board of Governors of the Federal Reserve System
August 8, 2003	Board of Governors of the Federal Reserve System	OCC
June 10, 2008	OCC	FDIC

Source: The FDIC's Virtual Supervisory Information on the Net system.

For the period of our review, the bank was supervised by the OCC, the FDIC, and the ASBD.

Colonial was headquartered in Montgomery, Alabama and had 346 offices located in Alabama, Georgia, Florida, Texas, and Nevada. The bank segmented its operations into five regional bank groups and one mortgage warehouse lending (MWL) operation, located in Orlando, Florida. Asset growth averaged 12 percent, annually, from 2002 through 2007. Colonial's loan portfolio was concentrated in commercial real estate with an emphasis on acquisition, development, and construction (ADC) loans. The bank's ADC loan portfolio, higher-risk security investments, and MWL-related loans were concentrated within the high-growth real estate markets of Florida, Georgia, and Nevada and were negatively impacted when these real estate markets experienced a downturn in 2007.

Executive Summary

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Audit Results

Causes of Failure and Material Loss

Colonial failed due to a liquidity crisis brought on by (1) bank management's failure to implement adequate risk management practices pertaining to its significant concentrations in ADC loans and investments in higher-risk, mortgage-backed securities; (2) deficiencies in loan underwriting, credit administration, and risk analysis and recognition; and (3) an alleged fraud affecting its MWL operation. In the years preceding the bank's failure, the OCC, the FDIC, and the ASBD each expressed concern about Colonial's risk management practices and made recommendations for improvement. However, the actions taken by Colonial's Board and management to address these concerns and recommendations were not timely or adequate.

Weaknesses in Colonial's risk management practices translated into a decline in the quality of the bank's ADC loans, mortgage-backed securities, and MWL operation, as the bank's primary real estate lending markets began to deteriorate in 2007. From January 2006 to June 2009, the bank charged off $998 million in loans, of which $752 million (75 percent) were losses within the ADC loan portfolio. In addition, loan delinquencies significantly increased and, as of June 2009, 25 percent of the bank's ADC loan portfolio was 90 days past due or on nonaccrual. The loan-related losses and provisions associated with this decline depleted earnings, eroded capital, and impaired the bank's liquidity position. As of June 2009, the bank also had $377 million in unrealized securities losses in its Other Mortgage-Backed Securities portfolio, which increased to a realized loss of $760 million upon sale of the securities by the FDIC through its resolution process. Further, the FDIC estimated that the bank incurred an approximate loss of $1.7 billion due to activities related to the MWL operation. Ultimately, the ASBD closed Colonial based on a determination that the institution did not have a sufficient level of liquidity, losses would deplete capital, and the bank had no credible prospect for raising additional equity.

Regulatory Supervision of Colonial

When the bank became a state-chartered institution in June 2008, the FDIC promptly devoted substantial resources to overseeing Colonial, primarily through a continuous on-site examination of the bank. The FDIC served as the bank's PFR for approximately 14 months – from June 2008 to August 2009. During this period, the FDIC identified and addressed key risks in Colonial's management practices and operations – including some that the OCC had already reported on and was in the process of addressing through rating downgrades and a Cease and Desist Order (C&D) – and brought these risks to the attention of the bank's Board and management through regular discussions and correspondence, timely targeted reviews and memoranda, and an examination report. These risks included weak risk management practices pertaining to the bank's ADC loan concentrations, loan underwriting, credit administration, and risk analysis and recognition.

To address the weaknesses identified at the institution, the FDIC utilized various tools to obtain corrective actions, including recommendations, interim rating downgrades, and informal and formal actions. Within 3 months of becoming Colonial's PFR, the FDIC downgraded the bank's composite rating and, 3 months later, executed a Memorandum of Understanding (MOU) with Colonial. Six months after executing the MOU, the FDIC further downgraded the bank and issued a C&D. Although bank management made some improvements to the bank's operations, its actions were insufficient to prevent Colonial's failure.

Based on the supervisory actions taken with respect to Colonial, the FDIC properly implemented applicable PCA provisions of section 38. However, by the time Colonial's capital levels fell below the required thresholds necessary to implement PCA, the bank's condition had deteriorated to the point at which the institution could not raise additional capital in the time period necessary to prevent its failure. As a result, the ASBD closed Colonial on August 14, 2009.

The FDIC's Monitoring of Colonial as Backup Regulator

In its role as insurer and backup regulator, the FDIC is responsible for regularly monitoring and assessing potential risk to the DIF at all insured institutions, including those for which it is not the PFR. In the case of Colonial, from 2004 to 2008, the FDIC performed its backup monitoring activities in accordance with policies, procedures, and practices in effect at the time. Case managers reviewed OCC examination reports and other financial data and produced reports that indicated their assessment of risk at Colonial was consistent with that of the OCC. Further, at the end of 2007, the FDIC's case manager noted that a high concentration in ADC and CRE loans, primarily in Florida, were keys risks and regulatory concerns—as the OCC had also concluded at that time.

On April 9, 2010, the OIGs of the FDIC and the U.S. Department of the Treasury jointly issued a report, entitled, *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank* (Report No. EVAL-10-002). The report provides a comprehensive look at a failed institution from both the primary and backup regulatory perspective. The report highlighted two major concerns related to deposit insurance regulations and the interagency agreement governing backup authority and included two recommendations – which the FDIC is working to implement – to address these concerns.

Regulator Comments

We issued a draft of this report to FDIC management on April 9, 2010. We also provided the draft to the ASBD and the OCC for their review. The FDIC's Director of the Division of Supervision and Consumer Protection (DSC) and the ASBD provided formal written comments on April 23, 2010. The OCC provided informal feedback on the draft report. The views of the FDIC, ASBD, and OCC have been incorporated in our report, as appropriate.

In its response, DSC reiterated the OIG's conclusions regarding the causes of Colonial's failure. With regard to our assessment of the FDIC's supervision of Colonial, DSC's response stated that after converting to a state-chartered institution in June 2008, Colonial was placed under DSC's continuous examination program, and ratings were adjusted and corrective actions taken as warranted by Colonial's practices and condition. DSC also stated that "FDIC has the authority to conduct special or 'back-up' examinations of insured institutions for which FDIC is not the primary federal regulator. However, under the terms of an Interagency Agreement with the other PFRs, that examination authority is limited for insured institutions that have a composite rating of "1" or "2." In recognition that greater information sharing is needed to adequately assess risks to the Deposit Insurance Fund, the FDIC has proposed to the other PFRs modifications to strengthen that Interagency Agreement. We are hopeful that a consensus can be reached on those changes in the near future."

In its comments, the ASBD stated that attempts by regulators over the years to discourage or limit Colonial's CRE and ADC exposures were viewed as attempts to micromanage the bank and change its

basic business model. With regard to the cause of failure, the ASBD indicated that our report is accurate. In commenting on the supervision of Colonial, the ASBD reiterated our findings regarding the effectiveness of coordination among the regulators after Colonial converted to a state-chartered bank in 2008 and agreed with our assessment of the FDIC's post-conversion supervision of the institution. The ASBD also provided its views on the policy statement on regulatory conversions, PCA guidelines, and the FDIC's exercise of backup authority.

Contents

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

Office of Material Loss Reviews
Office of Inspector General

DATE: April 23, 2010

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

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

SUBJECT: *Material Loss Review of Colonial Bank, Montgomery, Alabama* (Report No. MLR-10-031)

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 (MLR) of the failure of Colonial Bank, Montgomery, Alabama (Colonial). The Alabama State Banking Department (ASBD) closed the institution on August 14, 2009, and named the FDIC as receiver. On October 24, 2009, the FDIC notified the OIG that Colonial's total assets at closing were $25.2 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $2.7 billion. As of March 31, 2010, the estimated loss to the DIF had increased to $3.8 billion.

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

The objectives of this MLR were to (1) determine the causes of Colonial's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. As discussed throughout this report, Colonial converted its charter from a national to a state nonmember bank in June 2008, just 14 months prior to its failure. As a result, our MLR also describes the Office of the Comptroller of the Currency's (OCC)

[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.

supervisory activities as the primary federal regulator (PFR) from 2004 through 2008 and briefly addresses the FDIC's monitoring of the bank as backup federal regulator during that time.

This report presents our analysis of Colonial's failure and the supervisory efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our MLRs, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted. Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of terms; and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

Colonial was a state-chartered nonmember bank that was insured in 1934. As shown in Table 1, the bank converted its charter three times between 1997 and 2008, most recently in June 2008 when it converted from a national charter to a state-chartered nonmember bank.

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Source: The FDIC's Virtual Supervisory Information on the Net (ViSION) system.

For the period of our review, the bank was supervised by the OCC, the FDIC, and the ASBD.

Colonial was headquartered in Montgomery, Alabama and had 346 offices located in Alabama, Georgia, Florida, Texas, and Nevada. The bank segmented its operations into five regional bank groups and one mortgage warehouse lending (MWL) operation, located in Orlando, Florida. Asset growth averaged 12 percent, annually, from 2002 through 2007. Colonial's loan portfolio was concentrated in commercial real estate (CRE) with an emphasis on acquisition, development, and construction (ADC) loans. The bank's ADC loan portfolio, higher-risk security investments, and MWL-related loans were concentrated within the high-growth real estate markets of Florida, Georgia, and Nevada and were negatively impacted when these real estate markets experienced a downturn in 2007.

Colonial was wholly-owned by Colonial BancGroup, Inc., a one-bank holding company. The bank's former Chairman of the Board, President, and Chief Executive Officer controlled 4 percent of the holding company stock and was the largest individual shareholder. Table 2 summarizes selected financial information for Colonial for the quarter ending June 30, 2009, and for the 4 preceding calendar years.

Table 2: Selected Financial Information for Colonial, 2005 to 2009

Financial Measure	June-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	25,455,112	25,638,730	25,937,048	22,730,585	21,394,976
Total Deposits ($000s)	20,072,099	18,778,726	18,610,966	16,249,435	15,545,282
Total Loans* ($000s)	16,233,255	16,180,314	17,235,875	16,790,079	15,830,601
Net Income (Loss) ($000s)	(727,340)	(849,008)	192,136	280,117	243,938

Source: Uniform Bank Performance Reports (UBPR) for Colonial.
* Total Loans net of Allowance for Loan and Lease Losses (ALLL).

Causes of Failure and Material Loss

Colonial failed due to a liquidity crisis brought on by (1) bank management's failure to implement adequate risk management practices pertaining to its significant concentrations in ADC loans and investments in higher-risk, mortgage-backed securities; (2) deficiencies in loan underwriting, credit administration, and risk analysis and recognition; and (3) an alleged fraud affecting its MWL operation. In the years preceding the bank's failure, the OCC, the FDIC, and the ASBD each expressed concern about Colonial's risk management practices and made recommendations for improvement. However, the actions taken by Colonial's Board and management to address these concerns and recommendations were not timely or adequate.

Weaknesses in Colonial's risk management practices translated into a decline in the quality of the bank's ADC loans, mortgage-backed securities, and MWL operation, as the bank's primary real estate lending markets began to deteriorate in 2007. From January 2006 to June 2009, the bank charged off $998 million in loans, of which $752 million (75 percent) were losses within the ADC loan portfolio. In addition, loan delinquencies significantly increased and, as of June 2009, 25 percent of the bank's ADC loan portfolio was 90 days past due or on nonaccrual. The loan-related losses and provisions associated with this decline depleted earnings, eroded capital, and impaired the bank's liquidity position. As of June 2009, the bank also had $377 million in unrealized securities losses in its Other Mortgage-Backed Securities portfolio, which increased to a realized loss of $760 million upon sale of the securities by the FDIC through its resolution process.[3] Further, the FDIC estimated that the bank incurred an approximate loss of $1.7 billion due to activities related to the MWL operation. Ultimately, the ASBD closed Colonial based on a determination that the institution did not have a sufficient level of liquidity, losses would deplete capital, and the bank had no credible prospect for raising additional equity.

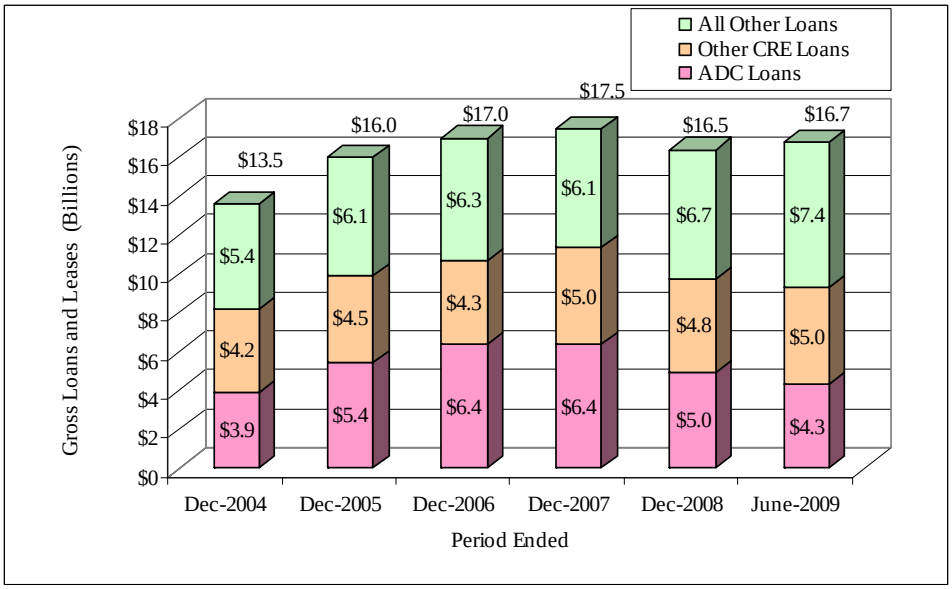
[3] On August 14, 2009, the FDIC sold these securities to Branch Banking and Trust Company (BB&T) under a Purchase and Assumption Agreement subject to a Commercial Shared-Loss Agreement.

ADC Loans and Other Mortgage-Backed Securities Concentrations

Colonial's business strategy resulted in concentrated assets in ADC loans and higher-risk securities in high-growth and dispersed geographic markets, without sufficient mitigating controls. As the economy deteriorated, bank management was slow to recognize and effectively react to the bank's deteriorating condition. Colonial's asset quality problems were exacerbated by the bank's concentrations. As of June 2009, the bank's ADC loans equaled 274 percent of total capital and its portfolio of Other Mortgage-Backed Securities equaled 103 percent of total capital – based on the securities' amortized cost. Colonial's management permitted these loan and security concentrations to exist without adequate risk identification, measurement, monitoring, and control.

Figure 1 illustrates the general composition and growth of Colonial's loan portfolio in the years preceding the institution's failure. As reflected in the figure, ADC loans were a significant segment of the bank's loan portfolio. Although overall loan portfolio growth appears moderate from 2004 to 2006, the ADC loan portfolio and the associated risk increased significantly over this 3-year period.

Figure 1: Composition and Growth of Colonial's Loan Portfolio



Source: OIG analysis of UBPRs and Reports of Condition and Income (Call Report) for Colonial.

In addition, the bank's concentration in Other Mortgage-Backed Securities significantly increased, from $687 million in 2003 to $1.7 billion in 2004 (an increase of 147 percent). As of December 2004, the securities equaled 110 percent of total capital. This category of assets remained a major product segment into 2009.

ADC Loan Portfolio

The FDIC's June 2008 Report of Examination (ROE), issued in May 2009, reported that the bank's deteriorating financial condition was a result of management's strategic focus on real estate lending, and that excessive concentrations in ADC lending from a period of

rapid growth (primarily consisting of higher-risk land acquisition and development loans) were indicative of management's risk appetite. In addition to management's focus on ADC lending, the bank developed concentrations in geographic areas of rapid growth. As these high-growth markets declined, the business strategy that fueled the bank's growth and operations accelerated the bank's deterioration. The FDIC also stated in the June 2008 examination report that bank management was slow to accurately identify and react to the deteriorating credit quality and the overall condition of the institution during 2008. Further, the FDIC noted in a May 2009 problem bank memorandum that management's pursuit of these higher-risk lending portfolios ignored many of the prudent banking guidelines that recommended diversification by geography, collateral type, industry, and/or source of repayment. The memorandum also indicated that Colonial's Board and senior management had not adequately identified, measured, monitored, or controlled the various risks associated with the bank.

Joint guidance issued by the FDIC, the OCC, and the Board of Governors of the Federal Reserve System, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, dated December 12, 2006, recognizes that there are substantial risks posed by CRE and ADC concentrations. Such risks include unanticipated earnings and capital volatility during an adverse downturn in the real estate market. The Joint Guidance defines institutions with significant CRE concentrations as those reporting:

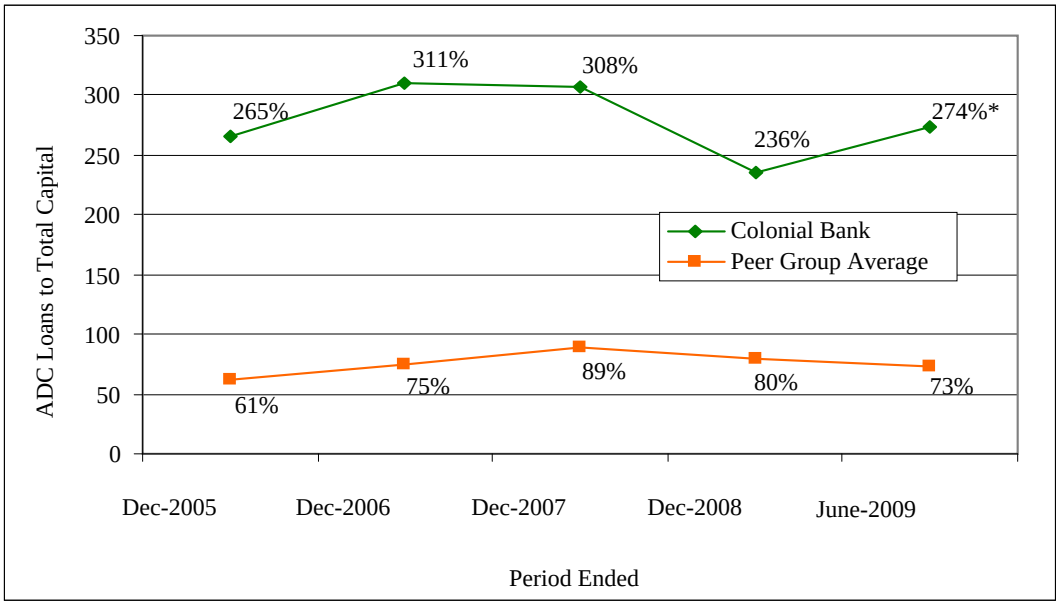
- Loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or

- Total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months.

According to the guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the previous criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk. As shown in Figure 2, concentrations in ADC loans existed over an extended period of time and significantly exceeded the bank's peer group averages.[4]

[4] Commercial banks are assigned to one of 25 peer groups based on asset size and other criteria. From 2005 through 2009, Colonial's peer group was all insured commercial banks having assets in excess of $3 billion.

Figure 2: ADC Loan Concentrations (Loans as a Percentage of Total Capital)



Source: OIG analysis of the UBPRs for Colonial.
* The increase in the concentration level in 2009 is the result of increasing losses and declining capital levels, rather than asset growth.

ASBD examiners told us that ADC loans that were originated in 2004 and 2005 ultimately resulted in significant losses and contributed to the bank's failure. The ASBD noted that a substantial amount of these ADC loans were originated with planned project completion periods of 2 to 3 years. The ASBD also indicated that 2004 and 2005 marked the height of the market for condominiums and land transactions, and by late 2006 and 2007, there was no market appreciation and limited funding for new ADC loans.

Other Mortgage-Backed Securities Portfolio

In 2004, bank management significantly increased its investment in high-yielding and higher-risk mortgage-backed securities, also known as private label mortgage-backed securities, from 50 percent of total capital in December 2003, to 110 percent as of December 2004. Based on our review of the FDIC's July 2008 targeted review and the bank's investment policy, it appears that all of the securities were considered investment grade at the time of purchase and were in the second highest rating category (AA/Aa2), as provided by nationally-recognized credit rating agencies.[5] However, many of these securities were subsequently downgraded and subject to a significant level of unrealized loss. At its peak, in March 2007, the bank held over $1.7 billion in Other Mortgage-Backed Securities, which represented over 8.5 percent of total earning assets and 113 percent of Tier 1 Capital.

The securities were complex investment instruments that were largely collateralized by nontraditional mortgages. Underwriting characteristics of the underlying mortgages

[5] The AA and Aa2 ratings were provided by Standard & Poor's and Moody's Investor Services, respectively.

included limited documentation loans, low Fair Isaac Corporation (FICO)[6] scores, low average coverage ratios, and adjustable interest rates. In addition, nearly all of the securities were collateralized by loans concentrated in high-growth real estate markets that eventually experienced significant market declines, such as California, Florida, Arizona, and Nevada. As of December 2008, Colonial incurred an unrealized loss of $506 million in its Other Mortgage-Backed Securities portfolio, and about 12 percent of the securities had been downgraded and were considered below investment grade status.

Despite the collapse of the subprime and nontraditional mortgage markets in mid-2007, bank management was slow to recognize and react to the deteriorating market conditions. For example, in December 2007, bank management notified the OCC that the bank noticed a "tremendous" decline in trading volumes and liquidity for these securities; however, management officials advised the regulator that they did not intend to undertake any change in investment strategy. Management began to address the bank's deteriorating securities portfolio only after the securities were downgraded by the various credit rating agencies and after the FDIC began to adversely classify the securities portfolio.

In the June 2008 examination report, the FDIC stated that although the bank's policies allowed them to invest in these types of securities, the level of exposure to these instruments was not appropriately limited in practice. In addition, our review of the bank's investment policies indicated that:

- the policies lacked risk limits and operating parameters for these investments;
- the bank did not establish proactive investment strategies, based on key market indicators, to further mitigate risk in case of deteriorating conditions; and
- the bank did not appropriately consider the suitability determination of these securities as an investment strategy.

In March 2009, the bank restructured a large segment of the securities portfolio by re-issuing a Real Estate Mortgage Investment Conduit (Re-REMIC).[7] The Re-REMIC created a new and more complex security structure by cross-collateralizing the bank's Other Mortgage-Backed Securities and provided an additional enhancement by adding various U.S. Department of the Treasury Separate Trading of Registered Interest and

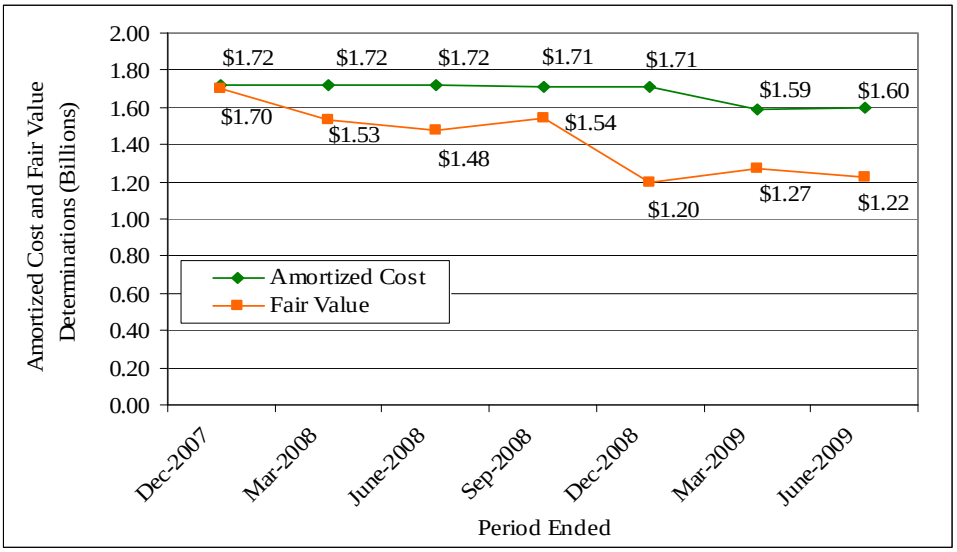
[6] A FICO score is a numerical indicator used to predict the credit risk of a consumer based on financial information in the consumer's credit report. The term FICO is derived from the mathematical model originated by the Fair Isaac Corporation.

[7] A REMIC mortgage derivative is a type of mortgage-backed security that is secured by pass-through mortgage-backed securities or pools of individual loans whose collateral cash flows (principal and interest payments) are divided among multiple tranches/classes to create securities with distinctive risk/return characteristics. A Re-REMIC is a security collateralized by previously-issued mortgage derivative tranches rather than by the pass-through mortgage-backed securities. This structure generally adds an additional layer of complexity to the mortgage derivatives market.

Principal Securities (U.S. Treasury STRIPS)[8] with an approximate fair value of $38 million and book value of $100 million to the structure. Due to Colonial's restructuring process, bank management was able to improve the securities' investment quality ratings, avoid any loss (impairment) recognition, and reduce the bank's level of unrealized loss by approximately $300 million from February to March 2009.

Notwithstanding the effect of the Re-REMIC, as reflected in Figure 3, the bank recognized a significant level of unrealized loss from March 2008 (represented by the differences between the amortized cost and the fair value) through June 2009.

Figure 3: Colonial's Other Mortgage-Backed Securities Valuations



Source: OIG analysis of the Call Reports and the Purchase and Assumption Agreement for Colonial.

Upon the bank's failure and liquidation by the FDIC, these securities were sold for a loss of $760 million.

In Financial Institution Letter (FIL) 20-2009, entitled, *Risk Management of Investments in Structured Credit Products*, dated April 2009, the FDIC re-emphasized existing supervisory guidance[9] to banks on the purchase and holding of complex structured credit products, such as Other Mortgage-Backed Securities. Specifically, FIL 20-2009 states:

> Risk management of investments in structured credit products should include adequate due diligence, reasonable exposure limits, accurate risk measurement, an understanding of the tranched structure, knowledge of the collateral performance, and a determination of investment suitability. . . Institutions should strive to limit

[8] U.S. Treasury STRIPS are zero-coupon fixed-income securities backed by the U.S. government. The securities are sold at a significant discount to face value and offer no interest payments because they mature at par value. The securities allow investors to hold the interest and principal components of eligible Treasury notes and bonds as separate securities.

[9] The existing supervisory guidance was primarily contained in FIL-45-98, *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, and FIL-70-2004, *Uniform Agreement on the Classification of Assets and Appraisal of Securities*.

> concentrations in any one investment category, especially complex, illiquid, and high-risk investments such as structured credit products. . . Institutions must understand not only an investment's structural characteristics, but also the composition and credit characteristics of the underlying collateral. Management should conduct analysis at both the deal and pool level using information that sufficiently captures collateral characteristics. Such analysis should be conducted prior to acquisition and on an ongoing basis to monitor and limit risk exposures.

Loan Underwriting, Credit Administration, and Risk Analysis and Recognition Practices

Weaknesses in Colonial's loan underwriting, credit administration, and risk analysis and recognition practices were contributing factors in the asset quality problems that developed when the bank's real estate markets began to deteriorate in 2007. Following the August 2006 examination, the OCC and the FDIC each identified significant deficiencies in these areas within the bank's ADC loan portfolio. In addition, in the June 2008 examination report, the FDIC stated that Colonial's Board and executive management were slow to accurately identify and react to deterioration in credit quality and the overall condition of the institution. The weaknesses identified by the OCC and the FDIC included:

Loan Underwriting

- Aggressive underwriting during periods of hyper real estate market growth.
- Lack of consistency and discipline within the credit function, including the failure to standardize underwriting and analysis practices/processes.
- Inadequate and/or insufficient financial analysis needed to properly assess the borrower's repayment capability and guarantor support (i.e., lack of global cash flow and collateral analysis and lack of verified guarantor liquidity).
- Weak appraisal reviews, including the failure to ensure adjustments for rapidly changing market conditions. (Of particular note, examiners recommended that the bank's appraisal review, lending, and special assets staff should adopt a more skeptical view when reviewing market-based appraisals and validating appraisal assumptions.)
- Inconsistent and/or insufficient use of absorption sensitivity analysis, including the impact of changes to interest rates, rental/vacancy rates, and expenses in assessing credit risk (stress testing).
- Inappropriate use and subsequent modification of interest reserves and other soft cost allowances for delayed, closed, and cancelled projects, resulting in increased loan balances where little or no development of the property took place and collateral values declined.
- Failure to obtain support or approval for loan policy exceptions.

Credit Administration

- A high-risk credit culture in need of strategic change and revised strategic objectives to mitigate the effects of systemic market risks.
- Insufficient staff resources - in need of training and/or replacement to enhance employee skill sets and experience levels necessary to implement change.
- Inadequate policies and procedures to monitor and control risks from concentrations of credit.
- Insufficient credit monitoring, including the failure to generate current or adequate annual reviews, and to update loan project status, collateral values, and risk ratings when merited.
- Insufficient market analysis, including the review of market, submarket, or project status updates.
- Weak enforcement of loan covenants and lending terms.
- Stale borrower and guarantor financial information.

Risk Analysis and Recognition Practices

- Inaccurate credit risk ratings and failure to identify problem credits in a timely manner.
- Failure to perform portfolio-level stress testing or sensitivity analysis.
- Inadequate ALLL methodology and/or position.
  - Weaknesses noted in determining general reserves based on historical data – Statement of Financial Accounting Standards (SFAS) 5.
  - Weaknesses noted in determining specific reserves for impaired loans concerning justification for discount rates, appraisal review, and file documentation – SFAS 114.
  - Failure to allocate reserves for impairment on guarantor-dependent loans, including loans with declining collateral values, limited guarantor capacity, insufficient cash flow, and poor to nonexistent sales.
- Failure to place loans on nonaccrual.
- Within the bank's Special Assets Department, the lack of formal policies, procedures, and reporting requirements and the need for personnel with the necessary skills and access to resources to effectively perform duties.

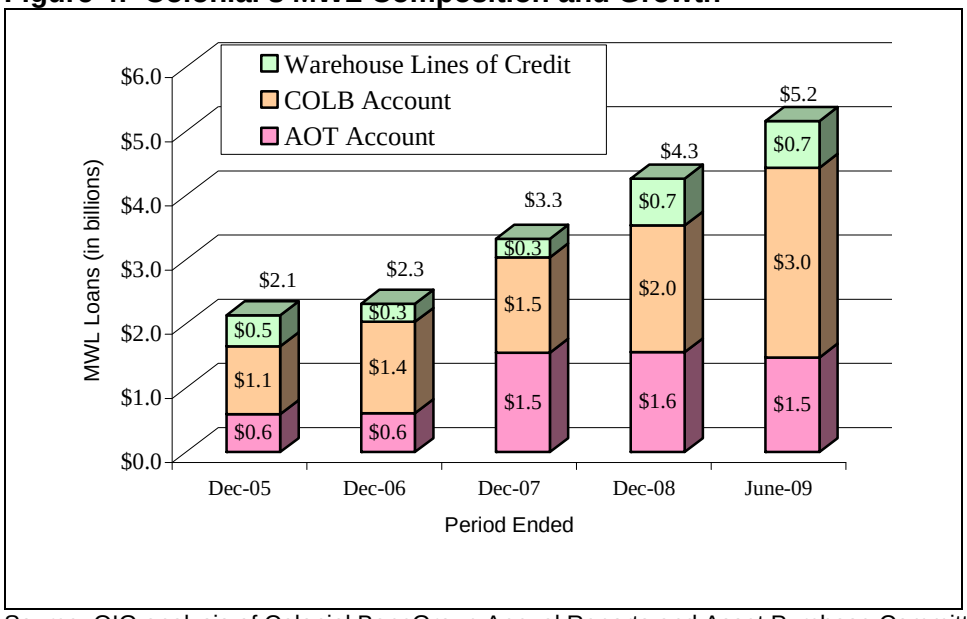
Mortgage Warehouse Lending Operation

Colonial suffered substantial losses in its MWL operation, which provided short-term secured funding to various mortgage companies and represented a significant volume of the bank's business activities. As of June 2009, Colonial's MWL assets totaled $5.2 billion, which represented 20 percent of the bank's total assets and consisted of the:

- Mortgage Loans Held for Sale account – known as the COLB account.[10]
- Securities Purchased Under Agreements to Resell account – known as the Assignment of Trade (AOT) account.[11]
- Mortgage warehouse lines of credit, which were used by mortgage companies to finance mortgage production and were secured by first residential mortgages.

As of June 2009, COLB loans totaled $3 billion, AOT loans totaled $1.5 billion, and mortgage warehouse lines totaled $725 million. Figure 4 presents the growth of Colonial's MWL operation and the individual loan segments from December 2005 to June 2009.

Figure 4: Colonial's MWL Composition and Growth



Source: OIG analysis of Colonial BancGroup Annual Reports and Asset Purchase Committee Reports.

In August 2009, regulatory authorities suspended TBW's operations. The suspension was prompted by allegations of fraud associated with these operations and the potential financial impact, as discussed further in the next section of this report. As of August 10, 2009, the FDIC estimated that the bank incurred an approximate loss of $1.7 billion due to activities related to the MWL operation – $900 million within the COLB account and $800 million within the AOT account.

[10] The COLB account was described by the FDIC as a secondary source of short-term secured funding that was provided to a variety of mortgage companies. These loans represented mortgages and construction loans purchased from the bank's MWL customers, including Taylor, Bean & Whitaker Mortgage Corporation (TBW) of Ocala, Florida. As of June 2009, Colonial's relationship with TBW represented $3.3 billion, or 63 percent, of its total MWL assets.

[11] The AOT account was described by the FDIC as interim funding for mortgage loans purchased from TBW (that Colonial certified as underwritten to agency and secondary market standards) and in the process of securitization under agreements to resell. Although owned by the bank, TBW serviced the loans.

Available Liquidity

Due to Colonial's deteriorating financial condition and increasing losses associated with the ADC loan portfolio, the bank's available liquidity became strained and secondary sources of liquidity were also significantly curtailed or restricted. Specifically, according to the FDIC's June 2008 examination report, the bank experienced a rapid decline in contingency funding sources, the securities portfolio was largely unavailable to meet short-term funding needs, the Federal Home Loan Bank (FHLB) line was fully drawn, and all unsecured federal funds lines were terminated.

The FDIC was also concerned that Colonial's liquidity could be further impacted by an investigation of fraud allegations involving MWL activities. Specifically, according to an August 4, 2009 problem bank memorandum,

> In addition to the poor financial condition reported for the second quarter of 2009, on August 3, 2009, the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) served sealed [search] warrants to the bank at its Orlando, FL mortgage warehouse lending operation and at the Ocala, FL headquarters of Taylor, Bean, & Whitaker, the largest mortgage warehouse customer. Press reports of the raids have been picked up by national news outlets. The potential for an adverse liquidity event is amplified by the bank's poor liquidity cushion. Additionally, if the SIGTARP investigation discloses any significant level of fraud, potential losses and the resulting erosion to capital will further endanger the bank's viability.

The memorandum further stated that given the liquidity concerns, declining asset quality, and the significant amount of information not yet known regarding the SIGTARP investigation, the institution posed a significant risk to the DIF and would need to be closed one quarter earlier than contemplated.[12]

As of August 5, 2009, Colonial held approximately $189 million in cash and $1.7 billion in interest-bearing deposits and federal funds sold. However, the bank also held approximately $875 million in escrow deposits related to mortgage-backed securities serviced by TBW. Due to TBW's closure, control of the escrow deposits was transferred/re-titled to the Government National Mortgage Association, and deposits at the bank were at risk of withdrawal. The FDIC was concerned at the time that the loss of the $875 million in escrow deposits would have a devastating impact on the bank's liquidity.

[12] Although not indicated as such in the problem bank memorandum, SIGTARP agents were accompanied by agents from the Federal Bureau of Investigation, Department of Housing and Urban Development OIG, and FDIC OIG, when executing the warrants.

Regulatory Supervision of Colonial

When the bank became a state-chartered institution in June 2008, the FDIC promptly devoted substantial resources to overseeing Colonial, primarily through a continuous on-site examination[13] of the bank. The FDIC served as the bank's PFR for approximately 14 months – from June 2008 to August 2009. During this period, the FDIC identified and addressed key risks in Colonial's management practices and operations – including some that the OCC had already reported on and was in the process of addressing through rating downgrades and a Cease and Desist Order (C&D) – and brought these risks to the attention of the bank's Board and management through regular discussions and correspondence, timely targeted reviews and memoranda, and an examination report. These risks included weak risk management practices pertaining to the bank's ADC loan concentrations, loan underwriting, credit administration, and risk analysis and recognition.

To address the weaknesses identified at the institution, the FDIC utilized various tools to obtain corrective actions, including recommendations, interim rating downgrades, and informal and formal actions. Within 3 months of becoming Colonial's PFR, the FDIC downgraded the bank's composite rating and, 3 months later, executed a Memorandum of Understanding (MOU) with Colonial. Six months after executing the MOU, the FDIC further downgraded the bank and issued a C&D. Although bank management made some improvements to the bank's operations, its actions were insufficient to prevent Colonial's failure.

While Colonial was supervised by the OCC, the FDIC functioned as the bank's backup federal regulator and performed various monitoring activities as a result of Colonial's "large institution" status. A brief overview of those activities is also provided in this report.

Supervisory History

During the period of our review, Colonial was considered a well-performing institution and consistently received composite "2" supervisory ratings under the OCC's supervision. From August 2004 to June 2008, the OCC performed four continuous risk management examinations and numerous targeted reviews of Colonial, and assigned one interim rating change. Given the bank's pursuit of, and approval for, a charter change in June 2008, the OCC's August 2007 examination was not formally documented in an examination report, although interim supervisory letters had been issued conveying examination findings and significant concerns, particularly relating to the MWL operation. At that time, the OCC had also drafted, but did not impose, a C&D on the bank, since it was no longer the PFR.

[13] Continuous on-site examinations are performed, as needed, for certain larger state nonmember institutions under the FDIC's Large State Nonmember Bank Onsite Supervision Program. This program includes visitations and targeted reviews throughout the year as opposed to the traditional, annual point-in-time examination. Findings resulting from ongoing targeted reviews are updated as needed and incorporated into an annual ROE.

Consistent with the FDI Act,[14] the ASBD approved Colonial's final charter change application in 2008 and the FDIC replaced OCC as the new PFR. Of note is the fact that the FDI Act did not call for the FDIC to participate in the review or approval of the application. However, the FDIC and the ASBD promptly met with the OCC, identified the key risks facing the bank, and initiated a continuous supervisory review program. FDIC regional officials stated that the meeting was held to ensure that issues identified by the OCC received proper follow-up. According to OCC officials, issues discussed at the meeting included the bank's MWL operation, deterioration in asset quality, liquidity, and bank management. The FDIC regional officials recalled that the OCC had particular concerns with accounting issues and credit concentrations associated with the bank's MWL operation. Based on these concerns, the FDIC scheduled a targeted review of the MWL operation in July 2008. During the year that followed, the FDIC and the ASBD also initiated various rating downgrades and enforcement actions against the bank.

To address the impact of such charter change requests, the Federal Financial Institutions Examination Council (FFIEC) issued a policy statement in July 2009, entitled, *FFIEC Statement on Regulatory Conversions*, that gives the FDIC a role in reviewing and approving all charter change applications, and should assist regulators in addressing situations where an institution is seeking to change charters to avoid an enforcement action or a supervisory CAMELS composite rating downgrade.

As discussed previously, the OCC was pursuing ratings downgrades and a C&D at the time of the charter change. As a result, there was clearly a possibility that regulatory action to address risks at Colonial could be delayed, and in OCC's view, that was the case. However, based on the coordination between the regulators involved, and the aggressive approach taken by FDIC and ASBD examiners to address prior OCC concerns and their own, it does not appear that in broad terms Colonial's final charter change significantly delayed effective supervisory action. Absent those efforts, however, the opportunity existed for Colonial to avoid supervisory action as contemplated by the July 2009 policy statement discussed above.

Table 3 summarizes Colonial's examination history from 2004 to 2009, including the supervisory actions taken.

[14] Section 18(i)(2) of the FDI Act, 12 U.S.C. 1828(i).

Table 3: Colonial's Examination History, 2004 to 2009

Event Date or Period	Agency	Supervisory Ratings (UFIRS)*	Supervisory Action
Aug. 2009	FDIC/ASBD	555555/5	Temporary C&D and Interim Rating Change. (The bank was closed on 8/14/2009.)
June 2008 – June 2009	FDIC/ASBD	444443/4	C&D issued June 2009.
Sept. 2008	FDIC/ASBD	343433/3	Interim Rating Change. (An MOU was signed in December 2008.)
Aug. 2007 – June 2008	OCC	243332/3	Proposed Rating Change and C&D. (The examination report was not drafted before the bank changed its charter.)
Feb. 2008	OCC	232222/2	Interim Rating Change.
Aug. 2006 – Aug. 2007	OCC	222222/2	N/A
Aug. 2005 – Aug. 2006	OCC	212222/2	N/A
Aug. 2004 – Aug. 2005	OCC	222222/2	N/A

Source: ROEs, Large Insured Depository Institution report, problem bank memoranda, and informal and formal enforcement actions for Colonial.

* 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.

A brief description of the OCC's proposed C&D and the FDIC's/ASBD's enforcement actions follows.

- Proposed C&D. The OCC's draft C&D contained seven articles/provisions that addressed such areas as violations and improving the accounting, policies and procedures, reporting and management information systems, ALLL, and credit risk management of the MWL operation. Among other things, the order required the bank to define the responsibilities of management (within the bank's MWL operation) to ensure the integrity of data/process flow.

- December 2008 MOU. The FDIC and the ASBD entered into an MOU with Colonial based on the results of ongoing targeted reviews and Call Report financial data. The MOU contained 20 provisions, addressing such areas as appropriate management, personnel performance standards and reviews, asset quality, growth and concentration objectives, the ALLL, written loan policies, loan documentation systems, capital, dividend payments, liquidity, violations, and Board minutes. Of particular note, the MOU specifically required Colonial to designate a chief lending officer with the requisite authority to implement sound lending practices and assume overall responsibility for the lending area. In addition, the MOU required that the bank maintain a Tier 1 Leverage Capital ratio

of not less than 8 percent and a Total Risk-Based Capital ratio of not less than 12 percent.

- June 2009 C&D. Colonial's Board stipulated to a C&D based on the results of the June 2008 joint examination. The C&D replaced the bank's December 2008 MOU and contained 14 provisions, addressing such areas as management responsibilities and evaluations, Board participation, capital, credit concentrations, the ALLL, asset quality, credit underwriting, liquidity, dividend payments, brokered deposits, and shareholder disclosure. Among other things, the C&D specifically required Colonial to retain qualified management, including, but not limited to, a chief executive officer, a senior lending officer, and a chief financial officer. In addition, the C&D required that management develop a plan to reduce its credit concentrations.

- August 2009 Temporary C&D. The FDIC and the ASBD placed a temporary C&D on Colonial based on alleged unsafe and unsound banking practices. The C&D required, among other things, that the bank halt all transactions with TBW and the bank's holding company and maintain and provide the FDIC unrestricted access to all records.

Supervisory Response to Key Risks

Overall, the FDIC appropriately followed up on key risks in areas identified by the OCC, as well as other risks subsequently identified by FDIC and ASBD examiners; scheduled timely reviews of these areas; and pursued appropriate corrective actions. These areas included Colonial's risk management practices pertaining to ADC loan concentrations, loan underwriting and credit administration, and the MWL operation.

The sections that follow describe the OCC's findings and assess the FDIC's supervision in the areas identified as the primary causes of Colonial's failure. Additionally, although not directly related to the objectives of our MLR, this report briefly discusses the FDIC's backup regulatory activities for Colonial from 2004 to 2008.

ADC Loan Concentrations

In its August 2003 through August 2005 examination reports, the OCC routinely identified the bank's ADC concentration levels as a potential concern but indicated that the concerns were mitigated by the bank's diverse loan types, sizes, and locations of collateral. By August 2007, the OCC expressed a heightened level of concern over the bank's concentration levels and encouraged bank management to further strengthen risk monitoring and reporting systems. The OCC also downgraded the bank's Asset Quality component rating to a "3" in February 2008 through an Interim Rating Change.

As the bank's PFR as of June 2008, the FDIC also expressed repeated concern with the bank's ADC concentrations and recommended that bank management diversify its loan portfolio and establish and strictly enforce concentration limits. Based on the FDIC's findings and a December 2008 MOU, Colonial's Board revised its concentration limits to

levels below the parameters established within the Joint Guidance as warranting further supervisory analysis. Although the Board revised its concentration limits, bank management was not able to meet these new operating parameters. Further, as discussed elsewhere in this report, the FDIC noted in a May 2009 problem bank memorandum that management's pursuit of a higher-risk lending portfolio ignored many of the prudent banking guidelines that recommended diversification by geography, collateral type, industry, and/or source of repayment.

A lesson learned in the case of Colonial, and other bank failures that have been subject to MLRs, is that earlier and more formal supervisory action to mitigate the risk associated with ADC concentrations is prudent. Ultimately, had earlier action been taken to reduce the bank's ADC loan concentration, losses to the bank and the DIF may have been mitigated.

Other Mortgage-Backed Securities Portfolio

In its August 2003 through August 2006 examination reports, the OCC did not report concerns with the bank's investment practices. Further, in its January 2007 Supervisory Letter,[15] the OCC reported that the bank's investment portfolio quality was strong with high-quality-rated corporate Collateralized Mortgage Obligations (Other Mortgage-Backed Securities) dominating the portfolio. The OCC also reported that strong, although informal, pre-purchase analysis was performed and performance was routinely monitored. To put this in perspective, from December 2003 to December 2004, Colonial's investment in these securities had grown from $687 million to $1.7 billion, an increase of 147 percent. Colonial's investment in these securities remained at over $1.5 billion until the institution was closed.

In the June 2008 examination report, the FDIC reported that Colonial had not appropriately limited its level of exposure to the Other Mortgage-Backed Securities. The FDIC also reported on the significant devaluation of the securities and the bank's re-securitization of the Other Mortgage-Backed Securities portfolio (discussed earlier in this report). With respect to the re-securitization, the FDIC reported that Colonial's intent was to improve the risk ratings of the securities in order to preclude their adverse classification and, therefore, to improve regulatory capital. Before the re-securitization, the FDIC stated that the bank's Other Mortgage-Backed Securities were still protected by junior support tranches (not in default). After the re-securitization, the portfolio was deemed to be investment grade by an investment rating agency. According to the FDIC, before the bank restructured its Other Mortgage-Backed Securities, the bank's external auditors discussed the proposed accounting treatment with FDIC officials, including the Chief Accountant. Although the FDIC did not specifically approve Colonial's re-securitization plans, it did not object to the bank's planned accounting treatment for the re-securitization and determined that the securities should be excluded from adverse classification.

[15] A Supervisory Letter is the term the OCC uses for its targeted review report.

The role that Colonial's investments in Other Mortgage-Backed Securities played in the bank's failure offers an important lesson learned regarding the risks associated with complex structured credit products. That is, when institutions make significant investments in such products without appropriate risk management controls, such practices may require a prompt and aggressive supervisory response. In that regard, as noted previously, in April 2009, the FDIC issued guidance to banks on the purchase and holding of complex structured credit products. This guidance can also be used by examiners to evaluate controls in these areas.

Loan Underwriting, Credit Administration, and Risk Analysis and Recognition

In its August 2003 through August 2005 examination reports, the OCC did not report any significant weaknesses in the bank's loan underwriting, credit administration, and risk analysis and recognition practices. However, during the August 2006 examination, the OCC recognized the economic slowdown and its impact on the bank's financial condition. In addition, the OCC highlighted the bank's credit administration and risk analysis and recognition practices as potential areas of concern and encouraged bank management to continue efforts to strengthen the bank's processes. The OCC also identified the need for bank management to improve global cash flow analysis, stress testing, and market analysis. Following the August 2006 examination, the OCC continued to identify significant loan underwriting, credit administration, and risk analysis and recognition weaknesses within the bank's ADC loan portfolio. In February 2008, in response to continuing asset quality deterioration, the OCC downgraded this component rating to a "3," and proposed a further downgrade to a "4" just before the bank's charter conversion.

Once it became the bank's PFR in June 2008, the FDIC assigned various component rating downgrades, and took both informal and formal actions because of significant risk management weaknesses identified within the bank's ADC loan portfolio. In particular, the FDIC sought the designation of a qualified chief lending officer and the hiring or improvement of personnel with appropriately assigned responsibilities, and requisite knowledge, skills, and abilities.

Mortgage Warehouse Lending Operation

From 2005 to 2007, the OCC performed three targeted reviews of the bank's MWL operation, and identified and discussed in its August 2007 examination report the bank's deteriorating market conditions, increasing risk profile, and concerns regarding accounting treatment and loss recognition in COLB loans. During a follow-up review in March 2008, the OCC determined that the bank had not corrected the issues within the MWL operation, and the examiners identified additional significant weaknesses in the MWL operation. The OCC determined that these weaknesses constituted unsafe and unsound banking practices and began to pursue a C&D. Specifically, the Mortgage Warehouse Lines of Credit and the COLB account had a significant volume of mortgages that were aged over 120 days (stale). The OCC noted that these loans would significantly impact the bank's level of nonperforming credits and that their valuation was questionable. In addition, the OCC found that the bank's internal loan grading system

was weak, loans were not accurately risk rated, and the ALLL methodology was unsupported and grossly underfunded. The OCC also found that, because of these weaknesses, the bank had materially misstated its March 2008 Call Report.

As a result of its findings, the OCC made significant recommendations to improve the bank's policies and procedures, assignment of management responsibility and accountability, and management information systems. The OCC also sought to have the bank obtain an independent valuation and verification of assets and end-investor commitments, and to ensure the appropriate assignment of risk ratings, non-accrual status, and write-downs. According to the OCC, in response to the examiners' findings, bank management became argumentative and recalcitrant and, unbeknownst to the OCC, bank management also sought out a charter change.

In July 2008, soon after Colonial's charter change, the FDIC performed a targeted review of the MWL operation to follow up on the OCC's concerns. According to FDIC regional officials, at the request of the FDIC and the ASBD, bank management provided a written response to the OCC's findings as presented in the Supervisory Letter, and the letter and the bank's response were considered during the FDIC's review. Table 4 summarizes the OCC's concerns expressed in its March 2008 Supervisory Letter, and the FDIC's scope of review based on the July 2008 Targeted Memorandum and our discussions with FDIC examiners.

Table 4: The OCC's Identified Concerns and the FDIC's Follow-up Response

The OCC's Identified Concerns	The FDIC's Action
Significant volume of aged loans.	Reviewed aging schedules for the Mortgage Warehouse Lines and COLB account. Did not review a loan aging schedule for the AOT account.
Insufficient internal and external audit coverage of commitments and verification of certain data.	Reviewed a schedule of commitments.
Inaccurate credit risk rating and loss recognition in the Mortgage Warehouse Lines.	Sampled Mortgage Warehouse Lines and made recommendations regarding risk identification and the allowance allocation for the MWL portfolio.
Weak accounting practices and controls, and inaccurate accounting and valuation practices over hedging activities and fair value measurements. Call reports were materially misstated.	Reviewed accounting practices and the results of third-party professional opinions concerning financial reporting.
Insufficient ALLL and inadequate methodology.	Reviewed the ALLL balance and methodology and made recommendations for enhancement.
Lack of formal policies for troubled borrowers/problem loans and accounting practices.	Reviewed policies and procedures and documented that management had addressed the recommendations made by the OCC.
Weak management information systems and key reports contained inaccurate or missing data.	Reviewed selected aging and management information reports and documented that management had incorporated the recommendations made by the OCC.

Source: Supervisory Letters, Targeted Review Memoranda, and ROEs for Colonial.

The FDIC's scope of review for the MWL operation included reviewing a sample of Mortgage Warehouse Lines of Credit and obtaining and reviewing the bank's loan aging schedules for the credit lines, as well as an aging schedule for the COLB account. The credit sample of the Mortgage Warehouse Lines of Credit included 21 relationships with $427 million in commitments and $278 million in outstanding credits, or about 49 percent of this specific portfolio segment, as of June 30, 2008. Based on the July 2008 MWL review, the FDIC concluded that Colonial's risk management practices were acceptable and improvements were largely being made. Among the improvements noted, Colonial presented loan aging schedules that showed a significant decrease in the amount of aged loans reported from December 2007 to June 2008. Within the July 2008 Targeted Memorandum, the FDIC reported that the bank was able to reduce the volume of aged/stale warehoused loans by improving policies, adjusting market pricing calculations, discontinuing hedge accounting, and improving covenant enforcement and servicing discipline.

Available Liquidity

The bank's lack of available liquidity was largely a consequence of Colonial's deteriorating financial condition related mainly to declining asset quality and the impact

of activities related to its MWL operation. In the December 2008 MOU, the FDIC recommended that Colonial review and implement liquidity objectives, plans, and procedures aimed, in part, at improving balance sheet liquidity. In the June 2009 C&D, the FDIC required that the bank improve its liquidity position, develop contingency liquidity plans, and develop appropriate liquidity and funds management policies and plans. In addition, according to the FDIC, as Colonial's financial condition deteriorated, the FDIC and the ASBD monitored the bank's available liquidity on a daily basis. However, the FDIC and the ASBD determined that the bank would have to be closed sooner than projected based, in part, on the "devastating" impact that the loss of TBW's escrow deposits would have on the bank's available liquidity. In short, it does not appear that the FDIC could have done anything further to mitigate the risks associated with Colonial's liquidity position.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC's Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken with respect to Colonial, the FDIC properly implemented applicable PCA provisions of section 38.

At the time of the June 2008 examination, which was completed in April 2009, Colonial was considered *Well Capitalized* for PCA purposes. However, examiners concluded during the examination that the overall financial condition of the institution was unsatisfactory and that the probability of the bank's failure was a distinct possibility if the problems and weaknesses were not satisfactorily addressed and resolved. On December 15, 2008, the FDIC and the ASBD entered into an MOU with Colonial, which, among other things, contained a capital provision for Colonial to increase and maintain a Tier 1 Leverage Capital ratio of 8 percent and a Total Risk-Based Capital ratio of 12 percent – amounts that are greater than required by PCA for *Well Capitalized* institutions. On June 15, 2009, the FDIC and the ASBD issued a joint C&D, which contained the same capital requirements as in the MOU and also required the bank to submit a written capital plan. As a result of stipulating to the C&D, the institution became subject to certain restrictions defined in PCA, including the prohibition on the acceptance, renewal, or roll-over of brokered deposits without a waiver from the FDIC.

As of March 2009, 12.5 percent of Colonial's deposit base had consisted of brokered deposits, 90 percent of which were to mature within the year. Due to PCA restrictions, Colonial submitted a brokered deposit waiver application to the FDIC and on June 16, 2009, the FDIC's Atlanta Regional Office approved a limited brokered deposit waiver for the renewal of certain brokered certificates of deposit maturing through September 30, 2009. The FDIC approved the waiver to provide the bank the liquidity needed to facilitate daily operations until an orderly resolution could be implemented. Table 5 illustrates Colonial's capital levels relative to the PCA thresholds for *Well Capitalized* institutions, as of the June 2008 examination and as of June 2009.

Table 5: Colonial's Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions

Capital Ratio	Well Capitalized Threshold	June 2008 Examination (As of December 2008)	As of June 2009
Tier 1 Leverage Capital	5% or more	6.03%	4.18%
Tier 1 Risk-Based Capital	6% or more	8.54%	6.46%
Total Risk Based Capital	10% or more	11.37%	9.21%

Source: OIG Analysis of UBPRs, and the June 2008 ROE for Colonial, as well as Section 38 of the FDI Act and 57 Federal Register 44866-01.

Colonial submitted an application for the Troubled Asset Relief Program (TARP) in October 2008, which was approved in December 2008 for approximately $550 million, contingent on the bank raising an additional $300 million in private capital. The bank was unable meet the TARP condition of raising additional capital. On August 14, 2009, the ASBD closed the institution and named the FDIC as receiver, due to the bank's lack of available liquidity resulting, in part, from eroding/deteriorating capital and unrecognized losses related to its MWL operation.

The FDIC's Monitoring of Colonial as Backup Regulator

In its role as insurer and backup regulator, the FDIC is responsible for regularly monitoring and assessing potential risk to the DIF at all insured institutions, including those for which it is not the PFR. Section 10(b)(3) of the FDI Act provides the FDIC special examination authority (also known as backup authority) to make any special examination of any insured depository whenever the FDIC Board of Directors determines a special examination of any such depository institution is necessary to determine the condition of the institution for insurance purposes. In January 2002, the FDIC's Board of Directors approved an interagency agreement that established a set of principles related to use of special examination authority for those institutions that present "heightened risk" to the DIF and delegated its authority to the Division of Supervision and Consumer Protection (DSC). The term "heightened risk" is defined under statute as an institution having a composite rating of "3," "4," or "5" or that is *Undercapitalized* as defined under PCA rules. Further, the FDIC may request permission from the primary federal regulator to participate in an examination for an institution that does not meet the heightened risk definition but exhibits material deteriorating conditions or other adverse developments that may result in the institution being troubled in the near-term.

The FDIC monitors non-FDIC supervised institutions, such as Colonial, through its Case Manager Program and a number of monitoring systems. Due to Colonial's size, the bank was also monitored through the FDIC's Large Insured Depository Institution (LIDI) program. Case managers, along with senior regional management, are generally responsible for ensuring that the level of regulatory oversight accorded to an institution is commensurate with the level of risk it poses to the DIF. Case managers regularly monitor potential risks by reviewing examination reports prepared by the PFR, analyzing data from quarterly institution Call Reports, and analyzing other financial and economic

data from government and private sources to monitor the financial condition of an institution.

In the case of Colonial, from 2004 to 2008, the FDIC performed its backup monitoring activities in accordance with policies, procedures, and practices in effect at the time. Case managers reviewed OCC examination reports and other financial data and produced LIDI reports that indicated their assessment of risk at Colonial was consistent with that of the OCC. Further, at the end of 2007, the FDIC's case manager noted that a high concentration in ADC and CRE loans, primarily in Florida, were keys risks and regulatory concerns—as the OCC had also concluded at that time.

On April 9, 2010, the OIGs of the FDIC and the U.S. Department of the Treasury jointly issued a report, entitled, *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank* (Report No. EVAL-10-002). The report provides a comprehensive look at a failed institution from both the primary and backup regulatory perspective and has resulted in significant insights regarding the effectiveness of each and interplay between the two. The report highlighted two major concerns related to deposit insurance regulations and the interagency agreement governing backup authority and included two recommendations to address these concerns. The FDIC concurred with both recommendations and is working to implement them by the end of the year.

Regulator Comments

We issued a draft of this report to FDIC management on April 9, 2010. We also provided the draft to the ASBD and the OCC for their review. The FDIC's DSC Director and the ASBD provided formal written comments on April 23, 2010. The OCC provided informal feedback on the draft report. The views of the FDIC, ASBD, and OCC have been incorporated in our report, as appropriate. The DSC response is provided in its entirety as Appendix 4.

In its response, DSC reiterated the OIG's conclusions regarding the causes of Colonial's failure. With regard to our assessment of the FDIC's supervision of Colonial, DSC's response stated that after converting to a state-chartered institution in June 2008, Colonial was placed under DSC's continuous examination program, and ratings were adjusted and corrective actions taken as warranted by Colonial's practices and condition. DSC also stated that "FDIC has the authority to conduct special or 'back-up' examinations of insured institutions for which FDIC is not the primary federal regulator. However, under the terms of an Interagency Agreement with the other PFRs, that examination authority is limited for insured institutions that have a composite rating of "1" or "2." In recognition that greater information sharing is needed to adequately assess risks to the Deposit Insurance Fund, the FDIC has proposed to the other PFRs modifications to strengthen that Interagency Agreement. We are hopeful that a consensus can be reached on those changes in the near future."

In its comments, the ASBD discussed its perspective on bank management based on the department's long, regulatory involvement with Colonial. In brief, the ASBD stated that attempts by regulators over the years to discourage or limit Colonial's CRE and ADC exposures were viewed as attempts to micromanage the bank and change its basic business model. Management's philosophy also called for aggressive growth into Florida and other high-growth real estate markets while operating the bank with significant leverage. Consequently, the bank generally operated with lower capital ratios than other banks regulated by the ASBD.

With regard to the specific cause of Colonial's failure, the ASBD indicated that the report accurately stated the ASBD's reasons for closing the bank on August 14, 2009. The ASBD pointed out that although the MWL operations caused significant losses, the CRE and ADC exposures would have brought down the bank by themselves.

With respect to supervision, the ASBD stated that when Colonial pursued charter changes in 2003 and 2008, the Boards of Directors and management were not receptive to the findings and recommendations conveyed to them by examiners prior to the respective conversions. Additionally, the relationship between examiners and senior management had become increasingly strained and communication had deteriorated. The ASBD noted that banks should not be allowed to ignore examiner concerns and recommendations no matter how determined bank management is to do so. In that regard, the ASBD strongly agreed with most of the improvements in the policy statement on regulatory conversions discussed in the body of our report. The ASBD also indicated that it would not do another conversion without a full-scope examination and that it is very important, in its view, that the existing regulator be allowed to follow up on any outstanding issues post-conversion.

The ASBD stated that, in the case of Colonial, the transition meeting with the FDIC and the OCC after the conversion was effected was a very positive step. In its view, prompt and appropriate regulatory actions were taken by the FDIC during the period of its supervision. Further, the ASBD believes that there were no significant delays in downgrading CAMELS ratings and putting enforcement actions in place to address the bank's problems.

Finally, the ASBD provided its views on PCA and the FDIC's backup authority, noting that:

- The PCA capital guidelines do not properly account for current experience in this banking crisis, the guidelines should be increased, and the term "well capitalized" should be eliminated; and

- The FDIC should be able to exercise backup authority any time it sees excessive risks at insured institutions.

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 April 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 Colonial's operations from 2003 until its failure in 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period, including an assessment of the FDIC's supervision as backup regulator. With respect to the OCC's supervision of Colonial, we described, but did not assess, the OCC's activities for the period August 8, 2005 until Colonial changed its charter from a national to state-chartered nonmember bank on June 10, 2008.

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

- Analyzed OCC examination reports from 2003 to 2007 and supervisory letters from 2005 to 2008.
- Analyzed a joint FDIC/ASBD examination report and targeted review memoranda prepared by the FDIC and the ASBD from 2008 to 2009.
- Analyzed available work papers prepared by the FDIC from 2008 to 2009.
- Reviewed the following:
  - Bank data contained in UBPRs and Call Reports.
  - Correspondence maintained at DSC's Atlanta Regional and Montgomery Field Offices.

- DSC's Virtual Supervisory Information on the Net (ViSION) Modules, including Supervisory Tracking & Reporting.
- Reports from the bank's internal auditors, Crowe Horwath LLP, prepared from 2007 through 2009 and external auditors, PricewaterhouseCoopers LLP, for the years ended 2005 through 2008.
- Pertinent DSC policies and procedures.

- Interviewed and/or contacted the following FDIC officials:

  - DSC management in Washington, D.C. and the Atlanta Regional Office.
  - DSC examiners in the Montgomery Field Office.
  - Division of Resolutions and Receiverships officials in Washington, D.C.

- Interviewed officials from the OCC and the ASBD to discuss the historical perspective of the institution, its examinations, and other activities regarding the OCC's and the ASBD's supervision of the bank.

To assess the FDIC's supervision as backup regulator, we performed the following procedures:

- Interviewed the FDIC case manager responsible for reviewing the OCC's examination reports and financial information for Colonial and preparing the Colonial LIDI reports.

- Reviewed the FDIC's LIDI reports for Colonial and compared those reports to the OCC's examination reports.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, ROEs, and interviews of examiners to understand Colonial'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.

Appendix 1

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.
Call Report	The report filed by a bank pursuant to 12 U.S.C. 1817(a)(1), which requires each insured State nonmember bank and each foreign bank having an insured branch which is not a Federal branch to make to the Corporation reports of condition in a form and that shall contain such information as the Board of Directors may require. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop 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.
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.
Federal Home Loan Bank (FHLB)	The Federal Home Loan Bank System provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to its members. Advances are available to members with a wide variety of terms to maturity, from overnight to long term, and are collateralized. Advances are designed to prevent any possible loss to FHLBs, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail. To protect their position, FHLBs have a claim on any of the additional eligible collateral in the failed bank. In addition, the FDIC has a regulation that reaffirms FHLB priority, and FHLBs can demand prepayment of advances when institutions fail.

Glossary of Terms

Memorandum of Understanding (MOU)	An informal corrective administrative action for institutions considered to be of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, an MOU is to be considered for all institutions rated a composite 3.
Other Mortgage-Backed Securities	Other Mortgage-Backed Securities is a specific line item in a bank's Report of Condition and Income (Call Report). Mortgage-Backed Securities are debt instruments secured by an underlying pool of mortgages. As monthly payments are made on these underlying mortgages, the cash flow is distributed to bondholders according to the terms of the bond. The Mortgage-Backed Security market is comprised of two broad categories: mortgage pass-through securities and mortgage derivative securities.
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 DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations (C.F.R.), section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C. section 1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*.
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ASBD	Alabama State Banking Department
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
LIDI	Large Insured Depository Institution
MLR	Material Loss Review
MOU	Memorandum of Understanding
MWL	Mortgage Warehouse Lending
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
ORL	Offsite Review List
PCA	Prompt Corrective Action
PFR	Primary Federal Regulator
REMIC	Real Estate Mortgage Investment Conduit
ROE	Report of Examination
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
TARP	Troubled Asset Relief Program
TBW	Taylor, Bean & Whitaker Mortgage Corporation
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

April 23, 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 Colonial Bank, Montgomery, Alabama (Assignment No. 2009-056)

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 Colonial Bank, Montgomery, Alabama (Colonial) which failed on August 14, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on April 9, 2010.

The Report concludes Colonial failed because the Board of Directors (Board) and management did not develop and implement adequate risk management practices pertaining to: its significant concentration in acquisition, development, and construction (ADC) loans and investments in higher-risk, mortgage-backed securities; loan underwriting, credit administration, and risk analysis and recognition; and mortgage warehouse lending operations. Colonial's decision to aggressively pursue rapid growth by acquiring 25 banks in high growth residential markets, such as Florida, Nevada, and Georgia, along with concentrating the loan portfolio in ADC loans, eventually led to large losses and capital and liquidity deficiencies.

In the years preceding Colonial's failure, the Office of the Comptroller of the Currency, the FDIC and the Alabama State Banking Department each expressed concern about Colonial's risk management practices and made recommendations for improvement. However, Colonial's Board and management did not take adequate or timely actions to address these concerns and recommendations, nor did they maintain a control environment commensurate with the growth, size, and complexity of its operations.

After converting to a state-chartered institution in June 2008, Colonial was placed under DSC's continuous examination program; and ratings were adjusted and corrective actions taken as warranted by Colonial's practices and condition. Three months after becoming the Primary Federal Regulator (PFR), the FDIC downgraded Colonial's composite rating to a "3" in September 2008, and subsequently executed a Memorandum of Understanding with Colonial in December 2008. In May 2009, the FDIC downgraded Colonial's composite rating to a "4," and one month later further downgraded Colonial's composite rating to a "5" and issued a formal Order to Cease and Desist.

In the Report, the OIG noted that FDIC has the authority to conduct special or "back-up" examinations of insured institutions for which FDIC is not the primary federal regulator. However, under the terms of an Interagency Agreement with the other PFRs, that examination authority is limited for insured institutions that have a composite rating of "1" or "2". In

recognition that greater information sharing is needed to adequately assess risks to the Deposit Insurance Fund, the FDIC has proposed to the other PFRs modifications to strengthen that Interagency Agreement. We are hopeful that a consensus can be reached on those changes in the near future.

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