Office of Inspector General

Office of Audits
Report No. AUD-11-008

Material Loss Review of Hillcrest Bank, Overland Park, Kansas

May 2011

Office of Inspector General

Executive Summary

Material Loss Review of Hillcrest Bank, Overland Park, Kansas

Report No. AUD-11-008
May 2011

Why We Did The Audit

On October 22, 2010, the Kansas Office of the State Bank Commissioner (OSBC) closed Hillcrest Bank (Hillcrest), Overland Park, Kansas, and the FDIC was named receiver. On November 18, 2010, the FDIC notified the Office of Inspector General (OIG) that Hillcrest's total assets at closing were $1.6 billion, and the estimated loss to the Deposit Insurance Fund (DIF) was $312 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of Hillcrest.

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

Background

Hillcrest was established in 1987 as a state-chartered nonmember bank. The institution provided full-service banking and had 41 branches throughout Kansas, Missouri, Colorado, and Texas. Hillcrest's lending strategy focused on commercial real estate (CRE), with an emphasis on acquisition, development, and construction (ADC) in 22 states and The Bahamas. The bank was wholly-owned by Hillcrest Bancshares, Inc. (HBI) of Overland Park, Kansas, which was a one-bank holding company.

Hillcrest originally opened in Kansas City, Missouri, and was almost immediately acquired by the newly formed HBI. The bank subsequently became affiliated with the Oak Park Bank, Overland Park, Kansas, and The Olathe Bank, Olathe, Kansas, through the common ownership of two principal shareholders. On December 31, 1996, Hillcrest and The Olathe Bank merged with the Oak Park Bank. In addition, Hillcrest absorbed the American Bank, Wichita, Kansas, in November 1999; the First State Bank of Hill County, Dallas, Texas, in December 2005; and the Colonial Bank, Loveland, Colorado, in November 2006. Hillcrest was also affiliated with Hillcrest Bank Florida, Naples, Florida, which failed in October 2009.

Audit Results

Causes of Failure and Material Loss

Hillcrest failed because its Board of Directors (Board) and management did not effectively manage the risks associated with the institution's significant concentration in ADC loans. From 2005 to 2008, Hillcrest's Board and management aggressively grew the bank's ADC loan portfolio. Many of the loans originated or acquired during this period were outside of the bank's local business area. This strategy greatly elevated the institution's risk profile and its vulnerability to an economic downturn. As real estate markets in the bank's lending areas began to decline, the institution's CRE loans (particularly its ADC loans) were negatively affected. Weak credit administration practices also contributed to the bank's loan quality problems. Management did not diversify the bank's loan portfolio or adjust its risk management infrastructure in a timely manner in response to the deterioration in its loan portfolio. The resulting substantial loan losses eliminated Hillcrest's earnings and depleted capital.

Although Hillcrest's Board and management curtailed lending activities in 2008 and attempted to pursue corrective actions to improve the bank's deteriorating financial condition, the ADC loan and other loan losses rendered the bank *Critically Undercapitalized*. Because Hillcrest was unable to raise sufficient capital to support safe and sound operations, the OSBC closed the bank in October 2010.

The FDIC's Supervision of Hillcrest

Between 2005 and 2010, the FDIC and the OSBC conducted timely examinations of Hillcrest and made recommendations to strengthen the bank's risk management practices. Following the 2008 examination, the FDIC and the OSBC downgraded the bank's composite and component ratings and addressed weaknesses in Hillcrest's management through the implementation of a Bank Board Resolution. The FDIC and the OSBC subsequently monitored Hillcrest's condition through visitations and examinations, and in 2009, addressed unsafe and unsound practices by implementing a Cease and Desist Order. Despite the increased supervisory attention and Hillcrest's efforts to address its loan concentrations and management deficiencies, the institution was not prepared to handle the rapid, severe, and prolonged economic downturn that occurred. As a result, the bank's financial condition became critically deficient, and the Board and management were unable to restore the institution to a safe and sound condition.

With the benefit of hindsight, greater supervisory emphasis on, and a more forward-looking assessment of, Hillcrest's management practices and risk profile may have been prudent during its growth period, taking into consideration Hillcrest's:

(1) large and growing ADC concentrations, which made the bank vulnerable to an economic downturn;
(2) repeat loan review deficiencies and other credit administration weaknesses;
(3) reluctance to adequately staff the credit department; and
(4) significant amount of out-of-area lending.

Examiners could have recommended during earlier examinations that Hillcrest focus greater attention on analyzing the potential impact of a downturn in the economy on its operations, including the need for a viable plan to mitigate the bank's concentration risks. Further, the FDIC could have placed greater emphasis on Hillcrest's management practices and risk profile when assigning ratings during the 2007 examination. Such an approach could have reinforced supervisory expectations and increased supervisory oversight. It may also have influenced the Board and management to reduce its CRE and ADC exposure prior to the downturn in the real estate market and commit to a plan and a timeline for implementing corrective actions at a critical time.

The FDIC has taken a number of important actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. With respect to the issues discussed in the report, the FDIC has, among other things, reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Further, the FDIC completed a training initiative in 2010 for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

Management Response

The Director of the FDIC's Division of Risk Management Supervision, provided a written response, dated May 12, 2011, to a draft of the report. In the response, the Director reiterated the OIG's conclusions regarding the causes of Hillcrest's failure and described key supervisory actions that the FDIC and the OSBC took to address the bank's deteriorating financial condition. The response also stated that RMS recognized the threat that institutions with high-risk profiles, such as Hillcrest, pose to the DIF and that RMS had issued a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. Additionally, the response indicated that RMS had issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

Contents

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

Office of Audits
Office of Inspector General

DATE: May 18, 2011

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

/Signed/

FROM: Mark F. Mulholland
Deputy Assistant Inspector General for Audits

SUBJECT: Audit Report Entitled, *Material Loss Review of Hillcrest Bank, Overland Park, Kansas* (Report No. AUD-11-008)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Hillcrest Bank (Hillcrest), Overland Park, Kansas. The Kansas Office of the State Bank Commissioner (OSBC) closed the bank on October 22, 2010, and the FDIC was named receiver. On November 18, 2010, the FDIC notified the OIG that Hillcrest's total assets at closing were $1.6 billion, and the estimated loss to the Deposit Insurance Fund (DIF) was $312 million. The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

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

The objectives of this material loss review were to (1) determine the causes of Hillcrest's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Hillcrest, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

[1] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of this report.

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of key terms; Appendix 3 contains a list of acronyms; and Appendix 4 contains management's written comments on a draft of this report.

We note that, in conjunction with other organizational changes made to enhance the FDIC's ability to carry out its new and enhanced responsibilities under the Financial Reform Act, the Division of Supervision and Consumer Protection (DSC) became the Division of Risk Management Supervision effective February 13, 2011. As a result of the timing of our review, we refer to DSC throughout this report.

Background

Hillcrest was established in 1987 as a state-chartered nonmember bank. The institution provided full-service banking and had 41 branches throughout Kansas, Missouri, Colorado, and Texas. Hillcrest's lending strategy focused on commercial real estate (CRE), with an emphasis on acquisition, development, and construction (ADC) in 22 states and The Bahamas. The bank was wholly-owned by Hillcrest Bancshares, Inc. (HBI) of Overland Park, Kansas, which was a one-bank holding company.

Hillcrest originally opened in Kansas City, Missouri, and was almost immediately acquired by the newly formed HBI. The bank subsequently became affiliated with the Oak Park Bank, Overland Park, Kansas, and The Olathe Bank, Olathe, Kansas, through the common ownership of two principal shareholders. On December 31, 1996, Hillcrest and The Olathe Bank merged with the Oak Park Bank. In addition, Hillcrest absorbed the American Bank, Wichita, Kansas, in November 1999; the First State Bank of Hill County, Dallas, Texas, in December 2005; and the Colonial Bank, Loveland, Colorado, in November 2006. Hillcrest was also affiliated with Hillcrest Bank Florida, Naples, Florida,[2] through the common ownership of two principal shareholders. Table 1 summarizes selected financial information for Hillcrest as of September 30, 2010 and for the 5 preceding calendar years.

Table 1: Financial Information for Hillcrest, 2005 to 2010

Financial Measure ($000s)	Sep-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets	1,583,611	1,766,482	1,927,090	1,779,588	1,556,530	1,320,172
Total Loans	1,025,505	1,260,377	1,586,442	1,545,125	1,300,912	967,600
Total Investments	431,986	406,100	305,208	193,730	214,572	313,399
Total Deposits	1,488,785	1,590,997	1,619,522	1,442,004	1,242,284	1,012,719
Brokered Deposits	266,638	395,394	636,136	436,346	307,377	159,620
Net Income (Loss)	(69,281)	(83,469)	(4,966)	18,670	28,501	18,174

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

[2] Hillcrest Bank Florida, Naples, Florida, was closed by the Florida Office of Financial Regulation on October 23, 2009.

Causes of Failure and Material Loss

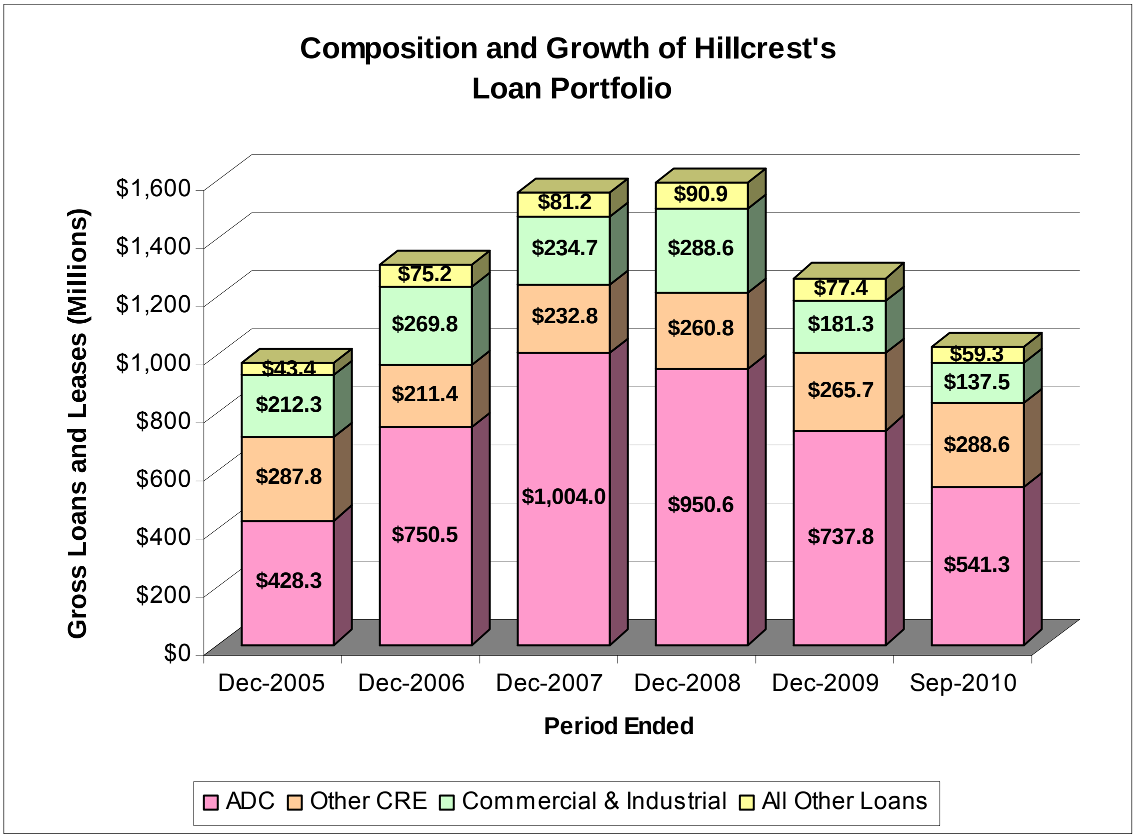
Hillcrest failed because its Board of Directors (Board) and management did not effectively manage the risks associated with the institution's significant concentration in ADC loans. From 2005 to 2008, Hillcrest's Board and management aggressively grew the bank's ADC loan portfolio. Many of the loans originated or acquired during this period were outside of the bank's local business area. This strategy greatly elevated the institution's risk profile and its vulnerability to an economic downturn. As real estate markets in the bank's lending areas began to decline, the institution's CRE loans (particularly its ADC loans) were negatively affected. Weak credit administration practices also contributed to the bank's loan quality problems. Management did not diversify the bank's loan portfolio or adjust its risk management infrastructure in a timely manner in response to the deterioration in its loan portfolio. The resulting substantial loan losses eliminated Hillcrest's earnings and depleted capital.

Although Hillcrest's Board and management curtailed lending activities in 2008 and attempted to pursue corrective actions to improve the bank's deteriorating financial condition, the ADC loan and other loan losses rendered the bank *Critically Undercapitalized*. Because Hillcrest was unable to raise sufficient capital to support safe and sound operations, the OSBC closed the bank in October 2010.

Aggressive Growth Concentrated in ADC Lending

From December 31, 2004 to December 31, 2007, Hillcrest's loan portfolio grew from $892.4 million to $1.5 billion (or 70 percent), funded, in part, with brokered deposits. During this period, Hillcrest's concentration in ADC loans significantly increased, and its loan portfolio became less diversified. As of December 31, 2004, Hillcrest's concentration in ADC loans represented 34 percent of the loan portfolio, and by December 31, 2007, ADC loans represented 63 percent of the loan portfolio. The vast majority of these ADC loans were for land development and commercial construction, such as condominium projects, shopping centers, office buildings, and raw land. Examination reports issued between 2005 and 2010 consistently identified the bank's high levels of CRE and ADC loan concentrations and indicated a need for management to closely monitor the concentrations. Figure 1 illustrates the extent to which Hillcrest's loan portfolio was concentrated in ADC loans for the 5 years preceding the bank's failure.

Figure 1: Composition of Hillcrest's Loan Portfolio, 2005 to 2010



Source: Reports of Condition and Income (Call Report) for Hillcrest.
Note: The amounts shown in Figure 1 include unearned income.

The extent of a bank's loan concentration can be measured in terms of its percentage of total capital and as a percentage of average gross loans. As shown in Table 2, ADC loans, as a percentage of total capital and as a percentage of average gross loans, exceeded 300 percent and 40 percent, respectively, from 2005 to 2009. These concentration levels substantially exceeded Hillcrest's peer group[3] averages.

Table 2: Hillcrest's ADC Loans Compared to Peer Group

Year Ended	ADC Loans as a Percentage of Total Capital		ADC Loans as a Percentage of Average Gross Loans	
	Hillcrest	Peer Group	Hillcrest	Peer Group
2005	319.04	107.13	40.82	13.12
2006	456.80	136.09	50.81	16.86
2007	545.81	147.33	62.95	18.61
2008	537.01	139.42	61.95	18.01
2009	813.81	97.83	59.62	14.56

Source: UBPRs for Hillcrest.

[3] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. Hillcrest's peer group included all insured institutions with assets between $1 billion and $3 billion.

In December 2006, the federal bank regulatory agencies issued Joint Guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) to reinforce existing regulations and guidelines for real estate lending and safety and soundness.[4] The Joint Guidance focuses on those CRE loans for which cash flow from real estate is the primary source of repayment (i.e., ADC lending). The Joint Guidance states that the agencies had observed an increasing trend in the number of institutions with concentrations in CRE loans and noted that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Although the Joint Guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint 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 following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- 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; or

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

As of December 31, 2007, Hillcrest's CRE loans represented 682 percent of the institution's total capital. Further, the bank's ADC loan concentration at year-end 2007 represented 545 percent of total capital. Both of these concentrations significantly exceeded the levels defined in the Joint Guidance as possibly warranting further supervisory analysis.

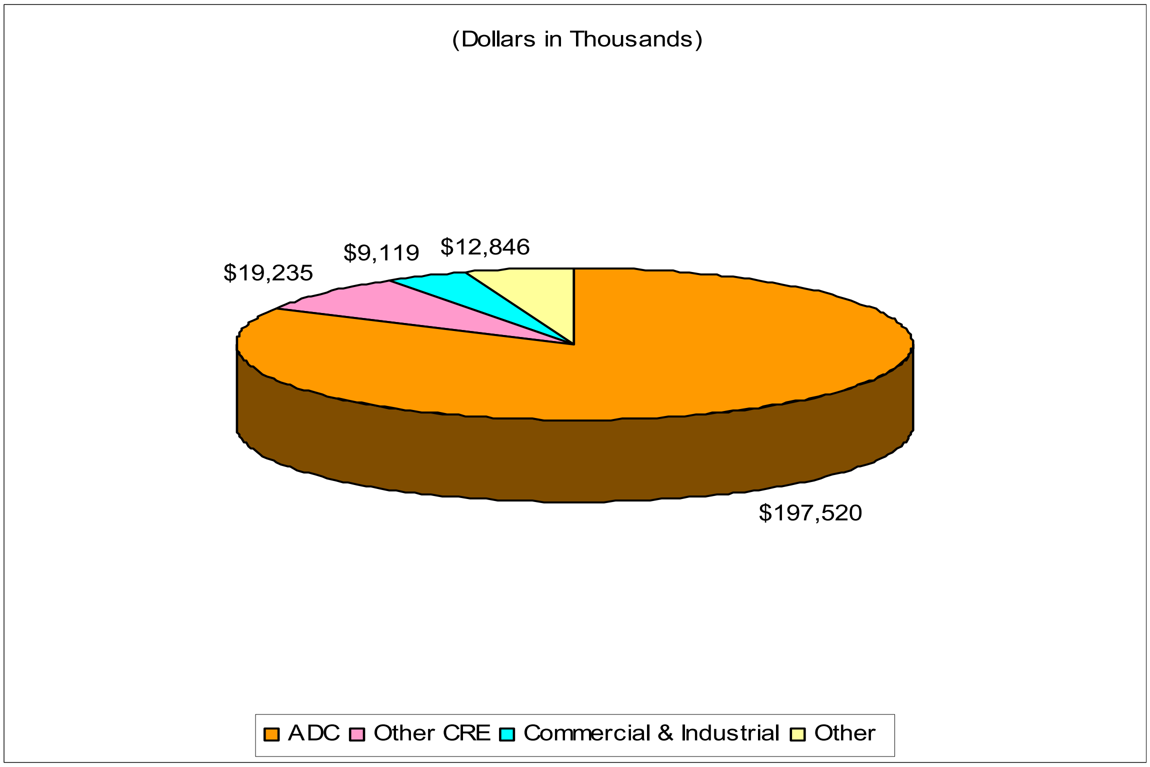
As noted in Hillcrest's May 2009 examination report, the economic downturn caused a diminished demand for housing, lack of take-out financing options, depressed collateral values, and illiquid borrowers and guarantors. This resulted in an upward trend in classified credits. Specifically, Hillcrest's highly concentrated ADC lending strategy led to a dramatic increase in the bank's Adversely Classified Items Coverage Ratio,[5] from 46 percent as of March 31, 2007 to 179 percent as of March 31, 2009. As shown in Figure 2, $197.5 million of the $238.7 million in loan charge-offs by Hillcrest between January 1, 2005 and September 30, 2010 pertained to ADC loans.

---

[4] The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC.

[5] The Adversely Classified Items Coverage Ratio is a measure of the level of asset risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and may also indicate less ability to absorb the consequences of bad loans.

Figure 2: Net Charge-offs on Loans and Leases as of September 30, 2010



Source: Call Reports for Hillcrest.

Other Lending Ratios. In addition to high CRE and ADC loan concentrations, Hillcrest's risk profile was increased by individual borrower concentrations and substantial lending outside of the bank's primary business areas. The following points illustrate these risks.

- As of March 31, 2007, Hillcrest had eight affiliated credit relationships totaling $393.8 million, or 260 percent of Tier 1 Capital, and as of March 31, 2009, Hillcrest's loan portfolio included 11 affiliated credit relationships totaling $581 million, or 378 percent of Tier 1 Capital.

- As of March 31, 2006, approximately 58 percent of Hillcrest's loan portfolio consisted of credits in 22 states and The Bahamas. The bank's out-of-area loans totaled $645.7 million, or 515 percent of Tier 1 Capital. Many of these loans were in areas heavily impacted by declining real estate prices in 2007 and 2008, such as Florida, Arizona, Nevada, and California.

Credit Administration Weaknesses

Examinations conducted during the 5-year period prior to Hillcrest's failure identified various credit administration weaknesses that contributed to the bank's loan quality problems. Although the economic decline adversely affected banks' loan portfolios in general, the following credit administration weaknesses hampered Hillcrest's ability to effectively measure, monitor, and control risks in its loan portfolio.

Loan Review. Lending institutions should maintain a strong loan review and associated risk rating system that identifies deteriorating credit trends early. However, loan review weaknesses were continually identified by examiners at Hillcrest. For example:

- The April 2005 examination report stated that although the bank's staffing levels appeared adequate to appropriately manage the bank's daily affairs, management should closely monitor and assess these levels in the construction/development lending department and the loan review section to ensure they would be able to handle the volume of work in their respective departments going forward.

- The May 2007 examination report noted that it appeared the bank would benefit from more resources in the loan review area, particularly in light of the downturn in economic conditions and the bank's increased asset quality problems. In addition, examiners noted that the loan portfolio had grown substantially, and additional responsibilities had been delegated to the credit department, such as appraisal reviews. However, the number of loan review personnel had remained relatively unchanged.

- Examiners reported in the 2009 examination that independent loan review personnel were minimally involved in the review and risk-rating of problem loans. Instead, the servicing loan officer was accountable for analyzing his/her own portfolio of problem credits, and shared responsibility with the Special Asset Committee to properly risk-rate the loans.

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), a bank's loan officers should be responsible for ongoing credit analysis and the prompt identification of emerging problems. The Examination Manual cautions that institutions should avoid overreliance on loan officers, adding that management should ensure, when feasible, that all significant loans are reviewed by individuals who are not part of, or influenced by, anyone associated with the loan approval process. While examiners found loan officers' analyses to generally reflect the problems within most credit relationships, this process often did not result in an appropriate risk rating. As a result, examiners downgraded a number of loans and found the bank's internal loan Watch List[6] to be substantially inaccurate.

Loan Monitoring. The Examination Manual states that lending institutions should maintain effective systems and controls for identifying, monitoring, and addressing asset quality problems in a timely manner. The institutions should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques, even when additional financing is not being contemplated. Examples of such situations include large credit exposures and out-of-area loans.

[6] A Watch List is a record of a bank's loans that have received less than satisfactory risk ratings.

Hillcrest's ADC loan portfolio included both large credit exposures and out-of-area loans. Weaknesses related to Hillcrest's monitoring of ADC projects were noted in examination reports as described below.

- The April 2005 examination report noted that ongoing project monitoring was not always supported with documented draw requests and collateral inspection reports. In addition, file comments by loan officers, subsequent to the initial underwriting presentation, were lacking, particularly on large and complex credits.

- The May 2007 examination report indicated that the level of classified items had significantly increased since the prior examination. Examiners concluded that these adverse classifications were the direct result of a softening in the housing and development sector, weakening economic conditions in the Florida real estate market, or inadequate and improper monitoring and handling of the credit relationship by the loan officer. Examiners noted instances in which the terms and conditions in the loan covenants and/or presentations to the Executive Loan Committee were not being met. Specifically, loan officers were not monitoring or enforcing requirements for obtaining financial information as defined in the loan covenants. Other unique or nonstandard covenants, such as requiring a certain amount of certificates of deposit be pledged before releasing other collateral, were not met.

Loan File Documentation. Part 364 of the FDIC Rules and Regulations, Appendix A, *Interagency Guidelines Establishing Standards for Safety and Soundness*, requires institutions to establish and maintain loan documentation practices that, among other things, enable institutions to: make an informed lending decision and assess risk, as necessary, on an ongoing basis; identify the purpose of a loan and the source of repayment; assess the ability of the borrower to repay the indebtedness in a timely manner; and demonstrate appropriate administration and monitoring of loans. Financial Institution Letter (FIL) 22-2008, dated March 17, 2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, also emphasizes the importance of institutions maintaining updated borrower financial and analytical information. As described below, examiners consistently identified loan file documentation deficiencies during examinations of Hillcrest.

- The May 2007 examination report noted deficiencies in approximately 49 percent of the total dollar volume of loans reviewed (or 31 percent of the total number of loans reviewed). The most prevalent exceptions related to missing or outdated financial information for borrowers and/or guarantors. Isolated instances of a missing proof of insurance and an inadequate appraisal were also noted that resulted in violations of the FDIC Rules and Regulations, Part 323 – *Appraisals*, and the Kansas Administration Regulations (KAR) on loan documentation requirements.

- The May 2008 examination report noted loan file documentation deficiencies, such as four instances in which appraisals were determined to be incomplete or inadequate and missing or outdated financial information. The 2009 examination report indicated that documentation deficiencies were found in 34 percent of the loans that were reviewed. Of particular concern was that the majority of the exceptions involved a lack of data, such as current borrower and guarantor financial and income information, which is needed to support prudent lending decisions.

Global Financial Analysis. FIL-22-2008 suggests that financial institutions with significant CRE concentrations maintain updated financial and analytical information to help manage concentrations through changes in market conditions. FIL-22-008 states that "Global financial analysis of obligors should be emphasized, as well as concentrations of credit to individual builders or developers in a loan portfolio." This level of analysis is essential in determining whether it is prudent to continue to work with a borrower or pursue an exit strategy. However, examiners indicated that Hillcrest's loan department was not utilizing global cash flow analysis in analyzing credits. For example:

- The May 2007 examination report identified several loans that were originated without evidence of a global financial analysis.

- Examiners advised Hillcrest's management during the May 2009 examination that the lending department needed to adjust its analytical requirements to provide a more global assessment of borrower/guarantor ability to carry a project, with consideration given to all of the borrower/guarantor debt and cash resources. Examiners reported that, for several credit relationships, loan officers failed to account for all contingent liabilities and cash sources for loan guarantors.

The FDIC's Supervision of Hillcrest

Between 2005 and 2010, the FDIC and the OSBC conducted timely examinations of Hillcrest and made recommendations to strengthen the bank's risk management practices. Following the 2008 examination, the FDIC and the OSBC downgraded the bank's composite and component ratings and addressed weaknesses in Hillcrest's management through the implementation of a Bank Board Resolution (BBR). The FDIC and the OSBC subsequently monitored Hillcrest's condition through visitations and examinations, and in 2009, addressed unsafe and unsound practices by implementing a Cease and Desist Order (C&D). Despite the increased supervisory attention and Hillcrest's efforts to address its loan concentrations and management deficiencies, the institution was not prepared to handle the rapid, severe, and prolonged economic downturn that occurred. As a result, the bank's financial condition became critically deficient, and the Board and management were unable to restore the institution to a safe and sound condition.

With the benefit of hindsight, greater supervisory emphasis on, and a more forward-looking assessment of, Hillcrest's management practices and risk profile may have been prudent during its growth period, taking into consideration Hillcrest's:

(1) large and growing ADC concentration, which made the bank vulnerable to an economic downturn;
(2) repeat loan review deficiencies and other credit administration weaknesses;
(3) reluctance to adequately staff the credit department; and
(4) significant amount of out-of-area lending.

Examiners could have recommended during earlier examinations that Hillcrest focus greater attention on analyzing the potential impact of a downturn in the economy on its operations, including the need for a viable plan to mitigate the bank's concentration risks. Further, the FDIC could have placed greater emphasis on Hillcrest's management practices and risk profile when assigning ratings during the 2007 examination. Such an approach could have reinforced supervisory expectations and increased supervisory oversight. It may also have influenced the Board and management to reduce its CRE and ADC exposure prior to the downturn in the real estate market and commit to a plan and a timeline for implementing corrective actions at a critical time.

The FDIC has taken a number of important actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Further, the FDIC completed a training initiative in 2010 for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends when assigning ratings, as allowable under existing examination guidance.

Supervisory History

Between 2005 and 2010, the FDIC and the OSBC conducted six onsite examinations of Hillcrest as required by the FDI Act.[7] The FDIC and the OSBC also conducted two onsite visitations and monitored Hillcrest's financial condition using various offsite monitoring tools. The 2009 and 2010 examinations and both visitations were conducted jointly by the FDIC and the OSBC. Table 3 summarizes key supervisory information pertaining to the examination and visitations.

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

Table 3: Examinations and Visitations of Hillcrest, 2005 to 2010

Examination Start Date	Examination As of Date	Agency	Supervisory Ratings	Enforcement Actions	Violations of Law or Contravention of Policy Reported
04/01/2005	12/31/2004	FDIC	111121/1	N/A	✓
05/08/2006	03/31/2006	OSBC	111121/1	N/A	✓
05/07/2007	03/31/2007	FDIC	122121/2	N/A	✓
05/27/2008	03/31/2008	OSBC	333333/3	BBR dated 09/2008	✓
11/17/2008 (V)*	09/30/2008	Joint	333333/3	BBR still in effect	
05/04/2009	03/31/2009	Joint	454544/4	C&D dated 10/2009	✓
11/12/09 (V)	09/30/2009	Joint	454544/4	C&D still in effect	
06/07/2010	03/31/1010	Joint	554545/5	C&D still in effect	✓

Source: Reports of Examination, Visitation Reports, and enforcement actions for Hillcrest.
*V – Visitation.

In addition to onsite examinations, the FDIC conducted offsite monitoring, which generally consisted of periodic contacts with bank management to discuss current or emerging issues and the use of various offsite monitoring tools, including the Offsite Review List (ORL),[8] to monitor institutions between examinations. The FDIC contacted bank officials as part of the pre-examination planning process and to follow up on emerging issues or concerns. Hillcrest was flagged by the ORL for offsite review due to the high volume of past-due loans in the March 31, 2008; June 30, 2008; and September 30, 2008 Call Reports. During the May 2008 examination, the institution was downgraded to a composite "3" CAMELS rating. Hillcrest was again flagged by the ORL for offsite review based on the June 30, 2009 Call Report for concerns regarding the adequacy of the bank's Allowance for Loan and Lease Losses (ALLL) and its PCA category.

Supervisory Response Related to Key Risks

As summarized below, examiners consistently identified Hillcrest's loan concentrations and credit administration weaknesses in examination and visitation reports. In addition, as the deterioration in the bank's financial condition became evident, regulators worked to address management weaknesses and improve the bank's risk management practices. In retrospect, a more forward-looking assessment of Hillcrest's risk profile, especially the bank's exposure to a sustained downturn in the real estate market, may have been prudent during earlier examinations, particularly the May 2007 examination.

[8] The FDIC electronically generates an Offsite Review List each quarter and performs offsite reviews for each 1-and 2-rated bank that appears on the list.

2005 Supervisory Activities

In the April 2005 examination, examiners assigned Hillcrest a composite "1" CAMELS rating, concluding that the overall condition of the bank was sound. However, examiners rated Hillcrest's Liquidity component a "2" because of the bank's use of brokered deposits and occasional use of borrowing lines to fund growth. While the bank's Asset Quality component was considered strong ("1"), examiners recommended that the loan review system be enhanced by including ongoing reviews of the large and complex relationships. At that time, ongoing reviews of the bank's large credit relationships were not being conducted. Examiners recommended that loan officers continue to make file comments subsequent to the initial underwriting presentation, which would further enhance credit administration, particularly on the more complex credits.

Examiners also rated management's performance strong ("1"). However, examiners noted that while the bank's staffing levels appeared adequate to appropriately manage the bank's daily affairs, management should closely monitor and assess the staffing levels in the construction/development lending department and the loan review section to ensure that staff could handle the volume of work in their respective departments going forward.

2006 Supervisory Activities

The OSBC's May 2006 examination report noted that the overall condition of the institution was healthy, with quality leadership and an informed Directorate. Examiners assigned a composite "1" CAMELS rating along with a "1" rating in all components except Liquidity. Examiners reported that asset quality continued to improve and was a leading indicator of the institution's strength.

Although asset quality was determined to be strong, examiners encouraged management to continually address credit administration policies relative to lending practices, especially in light of the risk presented from the relative high levels of out-of-area lending and credit concentrations. Examiners commented that, on numerous notes, loan covenants were not followed. Examiners recommended that management identify all notes where loan covenants were not being followed and implement a process to review covenant compliance. In the area of loan review, examiners recommended that management evaluate whether long-term financed loans were being reviewed at appropriate intervals and implement a process to address follow-up items recommended by the loan reviewer. Management was also reminded of the risk associated with the bank's credit concentrations. At that time, Hillcrest had seven large individual borrower credit concentrations and an out-of-area concentration. CRE and ADC loan concentrations were also present and, according to examiners, were being monitored by the Board.

Examiners reported that bank oversight was led by what appeared to be an active Directorate and an involved Chairman and Chief Executive Officer. Management information systems and formal reporting provided excellent data to assist in identifying, measuring, monitoring, and controlling risk. While examiners identified apparent violations of law, examiners noted that these violations were not a primary concern. Apparent violations identified during the examination consisted of: an instance in which an appraisal was completed by an unqualified individual as defined in Part 323 of the FDIC Rules and Regulations, - *Appraisals*; seven credits for which relevant documents relating to title insurance, property insurance, or financial statements were not properly maintained in violation of the KAR; and an asset from the collection of a debt that was in violation of the KAR because the asset remained on the bank's balance sheet in excess of 1 year.

2007 Supervisory Activities

The FDIC's May 2007 examination found that Hillcrest's overall condition had declined from strong to satisfactory. Examiners assigned a composite "2" CAMELS rating, reflecting declines in the bank's Asset Quality and Management ratings. Liquidity continued to be rated as satisfactory. Examiners concluded that capital remained strong relative to the bank's overall risk profile and assigned a Capital component rating of "1."

Examiners downgraded Hillcrest's Asset Quality rating to a "2" and reported that the level of criticized assets increased significantly from 5 percent to 46 percent of Tier 1 Capital plus the ALLL since the prior examination. The level of criticized assets at this examination was the highest dollar volume and percentage of Tier 1 Capital plus the ALLL the bank had experienced in over 10 years. Examiners reported that most of the adverse classifications were the direct result of a softening in the housing and development sector, weakening economic conditions in the Florida real estate market, or inadequate and improper monitoring and handling of credit relationships by the loan officer. Several of the criticized loans were characterized by borrowers with leveraged financial statements, limited or inadequate income sources, and/or marginal/inadequate collateral protection.

Credit administration and loan underwriting were found to be generally satisfactory. However, examiners identified documentation deficiencies and several instances in which the terms and conditions described in the loan covenants and/or presentations to the Executive Loan Committee were not met or followed. With respect to loan concentrations, examiners reported that management had appropriately addressed a majority of the six key elements for establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk as defined in the December 2006 Joint Guidance. However, examiners recommended that management take the following actions to strengthen the bank's overall risk management program:

- Establish CRE concentration limits.

- Further stratify the CRE portfolio to distinguish between short-term construction, land development, and longer-term permanent financed lending.

- Develop real estate concentration reports that further stratify the portfolio segments by the bank's primary market areas.

- Perform portfolio-level stress testing or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital.

Management stated that it would consider the examiners' recommendations.

Examiners reported that management's performance was satisfactory relative to the bank's size, complexity, and risk profile. The Management component rating was downgraded to a "2." Although examiners reported that management operated the bank in a generally sound manner, examiners also noted that the report contained recommendations, some of which were repeated from prior examinations, for various areas that deserved the Board's attention. Among other things, examiners recommended that management closely monitor and assess the staffing levels in the loan review section and the internal audit department to ensure that these areas would be able to handle the volume of work going forward. In light of the bank's 34-percent loan growth in 2006, recent asset quality problems, the declining economic conditions in various parts of the United States, and the bank's recent expansion into Texas and Colorado, it appeared that additional resources in the loan review and internal audit areas would be beneficial.

A Hillcrest Board Director disagreed that additional resources were needed in these areas based on the Director's personal observations that: a majority of the bank's credits involved attorney-prepared documents; most credits had received a post-closing review; the median amounts of the bank's loans were very high, and as a result, the total number of loans in the bank were low; the bank had few commercial and industrial loans; and the bank had a significant amount of land, bridge, and construction loans, with the latter being partly reviewed through draw requests and the inspection process.

Examiners also recommended that management establish an overall tracking system to monitor corrective actions taken regarding regulatory examination and audit findings. Further, although examiners found management's methodology for calculating and evaluating the ALLL to be adequate, examiners made recommendations to revise the ALLL policy and methodology to incorporate provisions of the December 13, 2006 *Interagency Policy Statement on the ALLL*. Management responded that it would develop and implement these recommendations. No new violations of laws and regulations were reported; however, repeat infractions regarding appraisals and documentation deficiencies from the May 2006 OSBC examination occurred.

With the benefit of hindsight, although examiners downgraded the Asset Quality rating to a "2" as a result of Hillcrest's weak practices in this area, a lower Asset Quality rating may have been warranted. A "2" rating indicates satisfactory asset quality and credit administration practices and a level and severity of classifications and other weaknesses warranting a limited level of supervisory attention. A "2" rating also indicates risk exposure commensurate with capital protection and management's abilities. By comparison, a "3" rating indicates that asset quality or credit administration practices are less than satisfactory. In addition, trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is also generally a need to improve credit administration and risk management practices.

Hillcrest's significant exposure to ADC loans coupled with the emerging deterioration in the real estate market and weak risk management practices in some areas appear to be more consistent with the definition of a "3" Asset Quality rating. Had the FDIC assigned a lower Asset Quality rating, it is more likely that an informal enforcement action may have been pursued. Such an action would have increased supervisory oversight of Hillcrest and resulted in a more formal commitment from management to correct the weaknesses identified by examiners.

We asked FDIC examiners and other FDIC officials whether a further downgrade and/or enforcement action were considered based on the results of the 2007 examination. They stated that, based on the bank's asset quality deterioration, a component "3" Asset Quality rating was considered. However, because Hillcrest's management had adequately addressed its asset quality problems in 2002, examiners believed that a downgrade to a "2" was appropriate at the time. In addition, although the bank was considered *Well Capitalized* for PCA purposes and received a Capital component rating of "1," FDIC officials indicated that, in hindsight, a lower Capital component rating may have been appropriate given the bank's risk profile.

2008 Supervisory Activities

Based on the results of the OSBC's 2008 examination, examiners determined that the overall condition of the bank had declined because of large increases in non-accrual loans, reliance on noncore funding sources, large loan losses, and asset quality concerns due to the high levels of CRE exposure. Examiners downgraded the bank's CAMELS composite rating and all component ratings to a "3." The examination report concluded that management's increasing exposure to CRE during a time of nationwide CRE market decline was a concern, especially considering the possibility of additional problems in the future. Examiners found asset quality to be less than satisfactory. Adversely classified loans had nearly doubled and represented 74 percent of Tier 1 Capital and the ALLL. A majority of the classified assets were ADC loans located in different markets across the nation. Significant declines in the value of properties nationwide had caused some borrowers to be unable to obtain permanent financing, since the present values of projects were well below the loan balances.

Examiners noted that Hillcrest's management had already taken significant positive actions to strengthen credit risk, but examiners reported that, given asset quality trends and continued nationwide CRE weakness, the Board should review staffing to determine its sufficiency for effective loan administration. During the examination, a group of shareholders purchased more than $40 million of non-performing loans and owned real estate. Removing these assets from the list of adversely classified assets reduced the Adversely Classified Items Coverage ratio to approximately 53 percent, a level still warranting supervisory concern and attention.

Internal risk identification appeared adequate, and management had recognized losses in several credits in a timely manner. Examiners recommended that the Board review staffing levels in the commercial lending area to determine if personnel and work-out resources were sufficient to effectively administer the loan portfolio to prevent further erosion of asset quality. Examiners reported that management was successful in correcting the majority of technical credit administration exceptions, but expressed concern that many of those exceptions were associated with loans on the bank's Watch List. Examples of exceptions included incomplete or inadequate appraisals, missing or outdated financial information, and missing or outdated income information on borrowers. In addition, examiners made several recommendations to enhance the bank's loan policy, which management committed to address.

Hillcrest's Board adopted a BBR to address the weaknesses noted during the May 2008 examination. The BBR, which became effective on September 24, 2008, included provisions for reducing adversely classified assets, improving the internal and external loan grading process, addressing credit administration and underwriting weaknesses, reducing loan concentration risk, improving the methodology for determining the appropriateness of the ALLL, implementing a written strategic plan that included capital and profitability targets, and improving asset and liability management policies and practices. FDIC and OSBC officials told us that serious consideration was given to a stronger enforcement action at this time. However, because bank management had recognized its asset quality problems and was working to take corrective action, a stronger enforcement action was not pursued.

The FDIC and the OSBC conducted a joint visitation in November 2008 to follow up on management's efforts to address the deterioration in asset quality, the elevated CRE concentrations, and the liquidity concerns identified in the May 2008 examination and to assess management's actions and plans relative to the outstanding BBR. Examiners found that the bank's loan quality had continued to deteriorate since the May 2008 OSBC examination. Despite the $40 million shareholder asset purchase and the $9.9 million in charge-offs since the OSBC examination, the Adversely Classified Items Coverage ratio had increased from 53 percent (after the shareholder purchase) to 66 percent. The visitation report noted that management appeared to have completed the most significant items in the BBR and was addressing each of its provisions.

According to the visitation report, although management had taken positive steps, deterioration in the loan portfolio continued to result from management's prior risk selection decisions and aggressive loan growth strategies. Vulnerability to current adverse economic trends had been exacerbated by concentrations of the loans in weak markets outside of the bank's local area. This is evident in the following breakout of Hillcrest's Watch List loans originated in other markets: Florida – 30 percent, Pennsylvania – 14 percent, Nevada - 10 percent, and Arizona – 9 percent. Problems encountered with these credits often involved extreme collateral devaluation, extended project duration due to soft demand, and illiquid borrowers and guarantors.

Hillcrest's goal of reducing its loan concentrations by selling loans was generally unsuccessful due to the tight credit market as well as the size and types of its loans. Examiners reported that management was closely monitoring its loan concentrations, including performing in-depth analyses of each concentrated market. In addition, Hillcrest's liquidity position remained a concern due to the bank's continued dependence on volatile liabilities. Approximately 51 percent of the bank's funding consisted of Federal Home Loan Bank (FHLB) borrowings and brokered deposits. Further, Hillcrest's Total Risk-Based Capital ratio had declined since the prior OSBC examination and was 10.89 percent as of September 30, 2008. The parent holding company's owners continued to seek outside investors. However, no new capital sources had materialized.

In meetings with management, examiners made recommendations for the bank to periodically assess whether skill levels in the credit department were appropriate regarding loan workouts, ensure that the use of interest reserves was appropriate, and require that monthly liquidity monitoring reports be submitted to the Board.

2009 Supervisory Activities

The May 2009 examination report indicated that the bank's overall condition had declined from less than satisfactory to deficient. Examiners assigned Hillcrest a composite "4" CAMELS rating, reflecting declines in all CAMELS component ratings. Asset quality was critically deficient, and its rapid deterioration had materially compromised the bank's condition. The Adversely Classified Items Coverage ratio rose to an excessive 179 percent, increasing by approximately $179 million and representing 17 percent of total assets. Based on the results of the 2009 examination, examiners met with the Board on June 24, 2009 and informed them that the BBR would be replaced by a formal enforcement action. Hillcrest's Board subsequently stipulated to the provisions of a C&D with the FDIC and the OSBC, which became effective on October 21, 2009. Among other things the C&D required the bank to:

- engage an independent consultant to analyze and assess the performance and needs of the Bank's senior executive officers and prepare a written report to the Board;
- develop a Capital Plan, within 10 days of the effective date of the C&D, to achieve and maintain a Tier 1 Leverage Capital ratio of not less than 10 percent and a Total Risk-Based Capital ratio of not less than 13 percent;
- not declare or pay cash dividends without the prior written approval of the FDIC and the OSBC;
- eliminate all assets from its books by either charge-off or collection of those assets that were classified as loss by examiners in the May 2009 examination report;
- develop and complete a written plan to decrease the bank's risk exposure for each asset in excess of $2 million classified "substandard" or "doubtful" in the May 2009 examination report; and

- develop a written plan for systematically reducing and monitoring the bank's CRE concentration.

The FDIC and the OSBC conducted a limited scope visitation on November 12, 2009, to assess the bank's performance since the May 2009 examination. The visitation focused on the bank's asset quality, capital adequacy, and liquidity. The visitation report stated that:

- Despite some improvements resulting from prior examiner recommendations, the overall financial condition of the bank had deteriorated since the prior examination.

- Asset quality had continued to deteriorate, with larger-than-projected losses and increased volumes of nonperforming assets that led to a tremendous operating loss for the year.

- Capital was of the utmost concern. Negative earnings had diminished the bank's capital levels, and no progress had been made in raising additional capital.

- Management was making measurable progress in improving liquidity and adhering to its plans to reduce reliance on wholesale funds and increase asset-based liquidity.

2010 Supervisory Activities

The June 2010 examination report stated that the bank's overall condition had declined from deficient to "critically poor," and examiners assigned a composite "5" CAMELS rating, reflecting declines in the Capital and Sensitivity to Market Risk component ratings. At that time, a capital injection of approximately $170 million was needed to comply with the capital mandate of the C&D. Examiners noted that asset quality deterioration was proving to be insurmountable and had depleted capital. Loan losses had been substantial, with losses of nearly $50 million, over $107 million, and more than $62 million in 2008, 2009, and the first 6 months of 2010, respectively.

Despite its efforts, management had been unable to improve the overall condition of the bank or attract capital needed to ensure the future viability of the institution. While progress had been made in several areas to comply with the October 2009 C&D, examiners noted that several areas required further attention such as restoring capital, reducing problem assets, maintaining an appropriate ALLL, reducing concentrations, and developing a profit plan. Examiners recommended that the Board focus its full attention on (1) developing a Capital Plan that results in an immediate capital injection, (2) devising strategies to improve earnings, and (3) providing for an appropriate ALLL.

Supervisory Lessons Learned

A general lesson learned with respect to weak risk management practices is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has relatively few classified assets. As described below, the FDIC could have placed greater emphasis on Hillcrest's risk management practices when determining supervisory responses to key risks identified at earlier examinations.

In hindsight, it may have been prudent for examiners to have placed greater emphasis on Hillcrest's vulnerability to an economic downturn during earlier examinations, especially given the bank's significant CRE and ADC loan concentrations and the fact that history has demonstrated that CRE markets can change rapidly. For example, examiners could have recommended that Hillcrest focus greater attention on analyzing the potential impact of a downturn in the economy on its operations, including the need for a viable plan to mitigate the bank's concentration risks. Further, the FDIC could have placed greater emphasis on Hillcrest's management practices and risk profile when assigning Asset Quality and Capital component ratings during the 2007 examination. Once the broad and rapid economic downturn began, the effectiveness of supervisory enforcement actions to improve the bank's financial condition became limited.

We recognize that the supervisory thresholds in the Joint Guidance do not constitute limits on an institution's lending activity and are intended to serve as high-level indicators to identify institutions potentially exposed to CRE concentration risk. We also recognize that examiners generally found Hillcrest's underwriting to be adequate. Nevertheless, examiners could have placed greater emphasis on the inherent risk posed to the institution from its emphasis on CRE and ADC lending and the reluctance of bank management to address staffing levels and other examiner concerns. Such emphasis may have influenced the Board and management to reduce its CRE and ADC exposure prior to the downturn in the real estate market. It may also have helped focus management's attention on developing a contingency plan to mitigate its risks and make the investments needed to strengthen the bank's credit function.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crises. With respect to the issues discussed in this report, the FDIC has, among other things, issued FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices. It also articulated the FDIC's concerns regarding the need for proper controls over interest reserves used for ADC loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

Further, the FDIC completed a training initiative in 2010 for its entire supervisory workforce that emphasized the need to assess a bank's risk profile using forward-looking supervision. The training addressed the importance of considering management practices, as well as current financial performance or trends, when assigning ratings, consistent with existing examination guidance.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards (if any) imposed by the FDIC to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to Hillcrest, the FDIC properly implemented applicable PCA provisions of section 38. Hillcrest was considered *Well Capitalized* until the filing of its June 30, 2009 Call Report, at which time the institution fell to *Adequately Capitalized*. Specifically, the bank's Total Risk-Based Capital Ratio fell to 8.85 percent, below the 10-percent minimum threshold for maintaining a *Well Capitalized* position. As a result, pursuant to section 29, Hillcrest could not accept, renew, or rollover any broker deposits unless it applied for, and the FDIC granted, a waiver. The FDIC approved two brokered deposit waiver requests from Hillcrest in September 2009 and January 2010.

In a letter dated February 8, 2010, the FDIC notified Hillcrest's Board that the bank had fallen to *Undercapitalized* based on the December 31, 2009 Call Report. The notification letter included a reminder regarding the restrictions imposed on *Undercapitalized* institutions, including restrictions on dividends; other capital distributions; management fees; asset growth; and acquisitions, branching, or entering new lines of business as described in sections 38(d)(1), 38(d)(2), 38(e)(3), and 38(e)(4) of the FDI Act. Based on the March 31, 2010 Call Report, the FDIC notified Hillcrest's Board, in a letter dated May 12, 2010, that the bank had fallen to *Significantly Undercapitalized.*

In a letter dated July 28, 2010, the FDIC notified Hillcrest's Board that the bank had fallen to *Critically Undercapitalized* based on the institution's June 30, 2010 Call Report. The notification letter indicated that the FDIC was required to place Hillcrest into receivership within 90 days of July 28, 2010 (or by October 26, 2010), unless the FDIC determined that a different action was warranted. Hillcrest continued to explore strategic alternatives for improving its capital position, such as seeking new investors or selling its retail branches. However, these efforts were not successful. As a result, the OSBC closed Hillcrest on

October 22, 2010. Table 4 illustrates the rapid decline in Hillcrest's capital category between 2009 and 2010.

Table 4: Hillcrest's Capital Levels Relative to PCA Thresholds for *Well Capitalized* Institutions

Year Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Threshold for *Well Capitalized*	**5% or more**	**6% or more**	**10% or more**	**PCA Capital Category**
Dec-05	9.31	10.61	11.76	*Well Capitalized*
Dec-06	9.63	9.98	11.23	*Well Capitalized*
Dec-07	9.19	9.39	10.65	*Well Capitalized*
Dec-08	8.08	9.04	10.29	*Well Capitalized*
Jun-09	6.46	7.59	8.85	*Adequately Capitalized*
Dec-09	3.88	5.15	6.41	*Undercapitalized*
Mar 31-10	3.53	4.68	5.95	*Significantly Undercapitalized*
June 30-10	0.58	0.81	1.63	*Critically Undercapitalized*

Source: UBPRs for Hillcrest.

Capital Plans. On October 1, 2009, Hillcrest submitted a Capital Plan in anticipation of the C&D. The plan described three scenarios: (1) a base scenario that assumed no significant actions would be taken with regard to the sale of assets or deposits, (2) a sale of substantially all of the assets and deposits in the bank's Kansas City Metropolitan market (referred to herein as the KC Franchise), and (3) a sale of the KC Franchise plus the sale of the bank's non-performing assets. On November 20, 2009, the FDIC formally rejected the bank's Capital Plan based on concerns with respect to Hillcrest's ability to implement either or both of the latter scenarios in a timely manner in the then current economic environment. Further, the FDIC noted that the Capital Plan did not provide adequate details of the proposed asset/deposit sales. Moreover, the Capital Plan did not include contingency plans or specific action dates. The FDIC directed the bank's Board to provide a new or revised Capital Plan to the FDIC and the OSBC by December 14, 2009.

On December 14, 2009, Hillcrest submitted a revised Capital Plan predicated on the successful sale of the bank's Texas branches by March 31, 2010, along with separate capital injections of $40 million, $45 million, and $52.5 million, to raise capital ratios to the required levels by September 30, 2010. On January 21, 2010, the FDIC requested that Hillcrest provide the following information: (1) revised projections reflecting year-end 2009 operating results, (2) support for the Capital Plan's projections of other real estate and troubled asset reductions without incurring additional losses, and (3) specific information regarding the source and timing of projected equity injections. This information was requested to be submitted to the supervisory agencies by February 12, 2010.

On February 17, 2010, the FDIC received a revised Capital Plan, dated February 12, 2010, from Hillcrest. The new plan contained revised projections outlining increased provisions and charge-offs, the impact of selling Hillcrest's Florida loan participations, proposals to sell Hillcrest's Texas branches, and new potential capital investors. On March 3, 2010, the FDIC notified Hillcrest's Board of the FDIC's acceptance of the Capital Plan, with the understanding that Hillcrest would identify the source(s) of its equity investors and the Texas sale would be consummated by June 30, 2010. The FDIC's notification stated that if the components of the Capital Plan were not accomplished by June 30, 2010, a revised Capital Plan would need to be submitted by July 16, 2010. However, the FDIC never received an updated Capital Plan from Hillcrest.

Although Hillcrest explored a number of strategic alternatives for raising capital, such as working with private equity firms to obtain investments and applying for funds under the Department of the Treasury's Capital Purchase Program, these efforts were ultimately not successful. The OSBC closed the institution on October 22, 2010 because it did not have enough capital to continue safe and sound operations.

OIG Evaluation of Corporation Comments

The Director, DSC, provided a written response, dated May 12, 2011, to a draft of this report. In the response, the Director reiterated the OIG's conclusions regarding the causes of Hillcrest's failure and described key supervisory actions that the FDIC and the OSBC took to address the bank's deteriorating financial condition. The response also stated that RMS recognized the threat that institutions with high-risk profiles, such as Hillcrest, pose to the DIF and that RMS had issued a FIL to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. Additionally, the response indicated that RMS had issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the DIF incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate Federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. 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 Hillcrest's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Hillcrest, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from December 2010 to March 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of Hillcrest's operations from April 1, 2005 until its failure on October 22, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by the FDIC and the OSBC between April 2005 and June 2010.

- Reviewed the following:

    - Selected examination work papers prepared by the FDIC between 2007 to 2010 pertaining to examinations and visitations.

    - Bank data contained in UBPRs and Call Reports.

    - Correspondence in the Kansas City Regional Office and Kansas City Field Office.

Objectives, Scope, and Methodology

- Various other reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed records provided by DRR that would provide insight into the bank's failure.

- Information in the FDIC's *Virtual Supervisory Information on the Net* system.

- Financial statements for Hillcrest for 2005 through 2010.

- Federal Reserve Bank inspection reports for 2005, 2008, and 2009.

- Pertinent DSC policies, procedures, and guidelines.

- Interviewed the following officials:

  - DSC officials in the Kansas City Regional Office.

  - DSC examiners from the Kansas City Field Office.

  - OSBC examiners and officials in Topeka, Kansas.

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

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

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

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this MLR, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act

Objectives, Scope, and Methodology

because such an assessment was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG program audits of DSC operations.
Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations. The results of our tests are 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.

Related Coverage of Financial Institution Failures

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

Further, with respect to more in-depth coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and Federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *Prompt Corrective Action*, and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.

Glossary of Terms

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.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. Seq. implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 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*. 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.
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 FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from data reported in Reports of Condition and Income submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: **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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institution's Examination Council
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
HBI	Hillcrest Bancshares, Inc.
KAR	Kansas Administrative Regulations
MLR	Material Loss Review
OIG	Office of Inspector General
ORL	Offsite Review List
OSBC	Kansas Office of the State Bank Commissioner
PCA	Prompt Corrective Action
UBPR	Uniform Bank Performance Report

Corporation Comments

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

May 12, 2011

TO: Mark Mulholland
Deputy Assistant Inspector General for Audits

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Hillcrest Bank, Overland Park, Kansas (Assignment No. 2011-008))

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of Hillcrest Bank (Hillcrest), which failed on October 22, 2010. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on April 15, 2011.

Hillcrest failed due to the Board's and management's aggressive growth strategy centered on high concentration of acquisition, development and construction (ADC) loans. The origination and acquisition of ADC loans outside their local region made Hillcrest vulnerable to economic downturns and decline of the real estate market within those lending areas. Inadequate oversight of Hillcrest's elevated risk profile and lax credit administration practices contributed to the deterioration in the quality of the loan portfolio, causing substantial losses that eliminated earnings and depleted capital. Hillcrest was unable to raise additional capital to support a safe and sound operation.

From 2005 to 2010, the FDIC and the Kansas Office of the State Bank Commissioner (OSBC) conducted six onsite risk management examinations, two onsite visitations and ongoing offsite monitoring. As early as 2006 examiners noted the risk in the relatively high levels of out-of-area lending and credit concentrations. In 2007 examiners recommended that management strengthen Hillcrest risk management program to stem its declining condition. With further deterioration noted at the 2009 examination, examiners downgraded Hillcrest and issued a cease and desist order.

RMS recognized the threat that institutions with high risk profiles, such as Hillcrest, pose to the Deposit Insurance Fund and has issued a Financial Institution Letter (FIL) to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. Additionally, RMS issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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