Office of Inspector General

Office of Audits
Report No. AUD-11-012

Material Loss Review of Peninsula Bank, Englewood, Florida

July 2011

Office of Inspector General

Executive Summary

Material Loss Review of Peninsula Bank, Englewood, Florida

AUD-11-012
July 2011

Why We Did The Audit

On June 25, 2010, the Florida Office of Financial Regulation (OFR) closed Peninsula Bank (Peninsula), Englewood, Florida, and the FDIC was appointed receiver. On September 10, 2010, the FDIC notified the Office of Inspector General (OIG) that the bank's total assets at closing were $655.3 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $192.6 million. As of September 30, 2010, the estimated loss had increased to $214.5 million, and since that time has remained above $200 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 Peninsula. The objectives of the review were to (1) determine the causes of Peninsula's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

Peninsula was established as a state nonmember bank in 1986. The bank's main office was in Englewood, Florida, which is located on the Gulf of Mexico in southwest Florida. The bank maintained 12 branches in the southern Florida counties of Charlotte, Sarasota, Miami-Dade, Broward, and Palm Beach. The bank had no holding company, and the institution's shares were widely held with no individual shareholder owning more than 10 percent of the outstanding stock.

For a period of several years prior to 2007, and to a lesser extent in 2008, Peninsula's management emphasized loan growth. Much of this growth was centered in commercial real estate (CRE), primarily acquisition, development, and construction (ADC) loans.

Audit Results

Causes of Failure and Material Loss

Peninsula failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the institution's rapid growth from 2003 to 2006 that led to a heavy concentration in CRE and ADC loans. Prior to 2009, Peninsula was considered either *Well Capitalized* or *Adequately Capitalized*. However, the bank's capital levels did not increase commensurate with the risk exposure to CRE and ADC loans that the institution assumed during its growth period and maintained thereafter. Liberal underwriting practices and lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in Peninsula's lending markets deteriorated. Although not a primary cause of failure, Peninsula developed a dependency on non-core funding sources, particularly time deposits of $100,000 or more, and to a lesser extent in later years, brokered deposits and FHLB borrowings, to support its lending and operations. These funding sources became limited when Peninsula's financial condition deteriorated, straining the institution's liquidity position.

Peninsula's excessive concentration in CRE and ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the Florida real estate market. In early 2007, conditions in Peninsula's primary lending areas began to deteriorate, resulting in a subsequent decline in the quality of the bank's loan portfolio. By April 30, 2009, the quality of Peninsula's loan portfolio had deteriorated significantly, with the majority of problems centered in CRE loans, particularly ADC loans. Peninsula's financial condition continued to deteriorate throughout 2009 and into 2010. The associated provisions for loan losses depleted Peninsula's earnings, eroded its capital, and strained its liquidity. The OFR closed Peninsula on June 25, 2010 because the institution was unable to raise sufficient capital to support safe and sound operations.

The FDIC's Supervision of Peninsula

The FDIC, in coordination with the OFR, provided ongoing supervisory oversight of Peninsula through regular on-site examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and enforcement actions. Such risks included the bank's heavy concentration in CRE and ADC loans, liberal loan underwriting and weak credit administration practices, and reliance on non-core funding sources.

Deterioration in Peninsula's financial condition was first identified during a visitation initiated by the FDIC in March 2008. Notably, the visitation preceded the next required on-site examination by several months and was prompted by an off-site analysis of institutions considered by the FDIC to be at risk due to their significant exposure to CRE and ADC loans. As a result of the financial deterioration that was identified during the March 2008 visitation and in the subsequent June 2008 examination, the FDIC and the OFR entered into a Memorandum of Understanding (MOU) with Peninsula's Board in November 2008. The MOU addressed, among other things, the need to properly monitor and reduce the bank's CRE concentration and improve underwriting and credit administration practices.

The FDIC identified further deterioration in Peninsula's condition during the May 2009 examination. Based on the results of that examination, the FDIC replaced the MOU with a Cease and Desist Order (C&D) in November 2009 that addressed key risks, including the bank's elevated CRE loan concentrations, reliance on non-core funding sources, and need for more capital. By this time, however, the institution's lending markets had experienced a significant deterioration, making remedial efforts difficult. The OFR closed Peninsula in June 2010 because the institution was unable to raise sufficient capital to support safe and sound operations.

The perspectives gained from the failure of Peninsula are not unique. Like other institutions that failed in recent years, Peninsula developed a significant exposure to CRE and ADC loans at a time when the bank's financial condition and lending markets were favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market. Such an exposure would be subject to a more forward-looking risk assessment under the FDIC's current approach to supervision. Further, a more conservative supervisory approach with respect to the bank's reliance on non-core funding, including time deposits of $100,000 or more and brokered deposits, to support its lending and operations might also have been prudent. Such an approach may have better positioned the bank to work through its problems when its lending markets deteriorated.

The FDIC has taken a number of actions to increase its supervisory attention to banks that have risk profiles similar to Peninsula. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.

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

Management Response

The Director, Division of Risk Management Supervision (RMS), provided a written response, dated July 15, 2011, to a draft of the report. In the response, RMS reiterated the causes of failure and the supervisory activities described in the report. The response also noted that the FDIC issued a Financial Institution Letter (FIL) in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. In addition, the response referenced a 2009 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition,* issued by RMS to enhance FDIC supervision of institutions with concentrated CRE lending and reliance on volatile, non-core funding sources.

Contents

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

Office of Audits
Office of Inspector General

DATE: July 21, 2011

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

/**Signed**/

FROM: Mark F. Mulholland
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Peninsula Bank, Englewood, Florida* (AUD-11-012)

As required by section 38(k) of the Federal Deposit Insurance Act (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 Peninsula Bank (Peninsula), Englewood, Florida. The Florida Office of Financial Regulation (OFR) closed the institution on June 25, 2010, and the FDIC was appointed receiver. On September 10, 2010, the FDIC notified the OIG that the bank's total assets at closing were $655.3 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $192.6 million. However, the estimated loss increased to $214.5 million as of September 30, 2010, and since that time has remained above the $200 million MLR threshold established by the Financial Reform Act for losses occurring between January 1, 2010 and December 31, 2011.

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 the review were to (1) determine the causes of Peninsula's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, 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 MLRs, 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 our report.

This report includes several appendixes. Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of key terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, otherwise known as the CAMELS ratings; Appendix 3 contains a list of acronyms; and Appendix 4 contains a summary of Peninsula's risk management weaknesses included in examination and visitation reports issued from 2006 to 2009. Appendix 5 contains the Corporation's comments on this report.

Background

Peninsula was established as a state nonmember bank in 1986. The bank's main office was in Englewood, Florida, which is located on the Gulf of Mexico in southwest Florida. The bank maintained 12 branches in the southern Florida counties of Charlotte, Sarasota, Miami-Dade, Broward, and Palm Beach. The bank had no holding company, and the institution's shares were widely held with no individual shareholder owning more than 10 percent of the outstanding stock. Several years prior to Peninsula's failure, a majority of the bank's shareholders entered into an irrevocable agreement to exercise their voting rights in accordance with the majority recommendation of a shareholder committee. The shareholder committee consisted of the Chairman of the Board of Directors (Board) and Chief Executive Officer and two other shareholders.

In an effort to diversify its income sources, Peninsula implemented a Certificate of Deposit (CD) Custodial Program in 1997. Under the program, Peninsula served as a CD custodian, performed recordkeeping, and remitted cash flows primarily for CD brokers. In 2002, litigation was brought against the bank in connection with a custodial relationship under the program, resulting in a $13 million judgment against the bank. The judgment created a net loss for the institution in 2006. However, Peninsula recovered $8 million upon appeal in 2010.

For a period of several years prior to 2007, and to a lesser extent in 2008, Peninsula's management emphasized loan growth. Much of this growth was centered in commercial real estate (CRE), primarily acquisition, development, and construction (ADC) loans. Peninsula also relied on potentially volatile time deposits of $100,000 or more, and beginning in 2008, on brokered deposits and Federal Home Loan Bank (FHLB) advances to support its lending and operations. Table 1 summarizes selected financial information for Peninsula as of March 31, 2010 and for the 4 preceding calendar year-ends.

Table 1: Select Financial Information for Peninsula, 2006-2010

Financial Data ($000s)	Mar-10	Dec-09	Dec-08	Dec-07	Dec-06
Total Assets	630,179	625,594	656,256	623,519	668,711
Total Loans	403,181	407,831	460,427	430,792	447,320
Time Deposits of $100,000 or More	251,635	214,631	247,336	244,511	252,272
Brokered Deposits	693	17,651	54,591	15,077	12,390
Total Deposits	580,140	560,789	528,927	549,355	598,470
FHLB Advances	50,000	50,000	50,018	0	0
Net Income (Loss)	(3,770)	(48,612)	(5,293)	6,418	(737)

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

Causes of Failure and Material Loss

Peninsula failed primarily because its Board and management did not effectively manage the risks associated with the institution's rapid growth from 2003 to 2006 that led to a heavy concentration in CRE and ADC loans. Prior to 2009, Peninsula was considered either *Well Capitalized* or *Adequately Capitalized*. However, the bank's capital levels did not increase commensurate with the risk exposure to CRE and ADC loans that the institution assumed during its growth period and maintained thereafter. Liberal underwriting practices and lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in Peninsula's lending markets deteriorated. Although not a primary cause of failure, Peninsula developed a dependency on non-core funding sources, particularly time deposits of $100,000 or more, and to a lesser extent in later years, brokered deposits and FHLB advances, to support its lending and operations. These funding sources became limited when Peninsula's financial condition deteriorated, straining the institution's liquidity position.

Peninsula's excessive concentration in CRE and ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the Florida real estate market. In early 2007, conditions in Peninsula's primary lending areas began to deteriorate, resulting in a subsequent decline in the quality of the bank's loan portfolio. By April 30, 2009, the quality of Peninsula's loan portfolio had deteriorated significantly, with the majority of problems centered in CRE loans, particularly ADC loans. Peninsula's financial condition continued to deteriorate throughout 2009 and into 2010. The associated provisions for loan losses depleted Peninsula's earnings, eroded its capital, and strained its liquidity. The OFR closed Peninsula on June 25, 2010 because the institution was unable to raise sufficient capital to support safe and sound operations.

Concentrations in CRE and ADC Loans

Peninsula's Board Chairman and CEO exerted significant influence over the bank's other Board members and steered the bank toward a high-growth strategy that resulted in excessive exposure to CRE and ADC loans. This strategy, coupled with ineffective risk management practices, was a primary factor in the bank's critically deficient asset quality, capital, and earnings.

During the 3-year period ended December 31, 2006, Peninsula grew its loan portfolio by 126 percent. Contributing to this growth was an increase in total CRE loans (including ADC loans) from $170 million at year-end 2003 to $381 million at year-end 2006. As of December 31, 2007, ADC loans represented 59 percent of Peninsula's $357 million CRE portfolio.[2] Peninsula's ADC loans included speculative construction and land development projects in Florida.[3]

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The purpose of the Joint Guidance was to reinforce existing regulations and guidelines for real estate lending and safety and soundness. The Joint Guidance states that the federal banking agencies have 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:

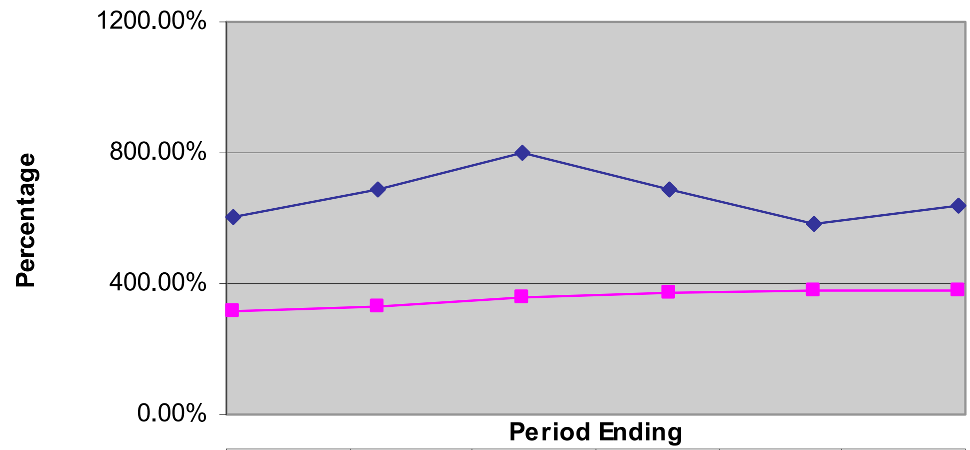
- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

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

[2] In 2007, an FDIC compliance examiner found that Peninsula had erroneously identified $137 million in ADC loans as other CRE loans in the bank's Call Reports. With the FDIC's consent, the bank adjusted its Call Reports back to the first quarter of 2007. As a result, no records are available that clearly identify the extent of the bank's ADC lending within its CRE loan portfolio prior to 2007.
[3] Speculative construction lending involves the financing of projects for which a buyer has not yet been identified.

As of December 31, 2007, Peninsula's non-owner-occupied[4] CRE loans and ADC loans represented 562 percent and 344 percent, respectively, of the institution's total capital. These concentrations significantly exceeded the levels defined in the Joint Guidance as possibly warranting further supervisory analysis. Peninsula's total CRE loan concentration also significantly exceeded the bank's peer group average, as reflected in the figure below.

Peninsula's CRE Loan Concentration Compared to Peer Group



	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08
Peninsula	603.22%	686.78%	797.18%	689.67%	579.37%	641.07%
Peer	312.34%	330.64%	358.11%	371.53%	377.29%	380.10%

Source: OIG analysis of UBPRs for Peninsula.

Prior to 2009, Peninsula was considered either *Well Capitalized* or *Adequately Capitalized*. However, the bank's capital levels did not increase commensurate with the risk exposure to CRE and ADC loans that the institution assumed during its growth period and maintained thereafter.[5] This had the effect of reducing the bank's ability to absorb losses due to unforeseen circumstances and contributed to the losses incurred by the DIF when the institution failed.

---

[4] Although the 2006 Joint Guidance includes non-owner and owner-occupied CRE loans in the CRE concentration ratio, the Joint Guidance recognizes the rationale for excluding owner-occupied CRE loans where the primary source of repayment is not from cash flow of the real estate collateral. The Joint Guidance also recognizes that risk characteristics vary by different property types of CRE loans and that institutions are in the best position to identify potential concentrations by stratifying their CRE portfolios into segments with common risk characteristics.

[5] The FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) states that institutions should maintain capital commensurate with the level and nature of risk to which the institutions are exposed. In addition, the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for PCA purposes.

At the time of the June 2008 examination, Peninsula's adversely classified assets were $76.2 million (or 123 percent of Tier 1 Capital and the Allowance for Loan and Lease Losses (ALLL)), posing significant risk to the institution. Approximately $60 million of the classifications consisted of loans, the majority of which were ADC loans. By the May 2009 examination, adversely classified assets had increased to $195.5 million (or 332 percent of Tier 1 Capital and the ALLL). The majority of these classifications consisted of ADC loans. In its final Call Report for the quarter ended March 31, 2010, Peninsula reported that 40 percent of its total loan portfolio was in a nonaccrual status. Further, about 64 percent of the bank's ADC loan portfolio was not performing at that time.

Risk Management Practices

ADC lending generally involves a greater degree of risk than permanent financing for finished residences or commercial buildings. Associated risks include adverse changes in market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans.

Concentration Risk Management Practices

Examiners noted during the April 2006 examination that Peninsula's concentration risk management practices needed improvement. Specifically, examiners recommended that the Board expand the Loan Policy to include risk targets for loan concentrations as a percentage of capital and adopt comprehensive monitoring procedures for real estate concentrations. At that time, the loan policy did not contain specific concentration limits by loan category, such as land or residential, or underwriting criteria for managing CRE risk. During the June 2008 examination, examiners noted that the institution had not implemented formal market analyses regarding CRE trends or stress tested the loan portfolio as prescribed in the Joint Guidance.[6] Examiners recommended that Peninsula properly monitor and reduce the overall CRE concentration, including the ADC concentration.

Loan Underwriting, Credit Administration, and Related Monitoring

Peninsula's weak risk management of its lending function also contributed to the asset quality problems that developed when economic conditions in the bank's lending markets deteriorated. With the exception of the June 2007 examination, examiners noted weaknesses in Peninsula's loan underwriting, credit administration, and related monitoring practices at every examination and visitation conducted between 2006 until the bank's failure. Notably, Peninsula's loan policy lacked detailed guidance on underwriting and

[6] The Joint Guidance recommends that institutions develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse market conditions. Such strategies could include, for example, loan participations, loan sales, and securitizations, to mitigate concentration risk.

credit administration criteria. For example, the policy did not adequately address the use of interest reserves, the capitalization of interest, renewal and extension procedures, advances to internally classified borrowers, cash flow requirements or analyses, or regulatory requirements related to the ALLL. A summary of Peninsula's weak lending practices follows. Additionally, Appendix 4 contains a summary of risk management weaknesses identified during examinations and visitations conducted between 2006 and 2009.

Loan Underwriting. Examiners identified the following weak underwriting practices.

- **Loan Extensions and Renewals.** According to the Examination Manual, it is important that a bank's real estate loan policy ensure that loans are granted with a reasonable probability that debtors will be able and willing to meet their payment terms. Peninsula frequently renewed, extended, or modified loans without taking adequate steps to ensure that the borrower had the capacity to repay the loan. Further, the bank routinely extended and renewed loans without the full collection of accrued interest and without reducing the principal balance of the loan when appropriate.

- **Interest Reserves.** Regional Directors Memorandum 2008-021, *Supervising Institutions with Commercial Real Estate Concentrations*, issued by the FDIC's Division of Risk Management Supervision (RMS),[7] describes risks associated with the use of interest reserves. The memorandum states that if a project experiences delays or has diminished feasibility resulting from a weak local real estate market, interest reserves can inappropriately disguise a problem credit relationship from showing up on delinquency reports. Accordingly, the effectiveness of a bank's control of interest reserves and its internal reporting on the use of these reserves is vitally important to institutions with construction and development loan concentrations. Examiners noted that Peninsula did not use interest reserves appropriately. For example, examiners noted instances in which additional interest reserves were granted for holding and speculating on undeveloped land without foreseeable improvement in the property's markets. The bank also inappropriately funded additional interest reserves when the original interest reserve was depleted or the loan was renewed or extended.

- **Reliance on Collateral Value.** The Examination Manual states that placing undue reliance upon a property's appraised value in lieu of an adequate initial assessment of the debtor's repayment ability is a potential mistake. The Manual states that management should analyze the borrower's financial statements for sources of repayment other than the expected return from the property's development. Examiners noted that Peninsula placed excessive reliance on collateral values at loan inception and throughout the loan term, rather than obtaining the borrower's documented cash flow.

[7] 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 became RMS effective February 13, 2011.

- **Global Cash Flow Analyses.** FDIC Financial Institution Letter (FIL) 22-2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, emphasizes the importance of performing global financial analyses for obligors. Such analyses can provide early indications of problems and are essential in determining whether it is prudent to continue to work with a borrower or pursue an exit strategy. Peninsula did not perform adequate global cash flow analyses of borrowers when loans were originated or renewed. For example, contingent liabilities and debt service requirements of borrowers were often not fully considered.

Credit Administration and Loan Monitoring. As described below, examiners identified deficiencies pertaining to credit administration and loan monitoring during examinations of Peninsula.

- **Borrower Financial Information.** The Examination Manual discusses the importance of maintaining current loan documentation, such as borrower financial statements and cash flow statements. Peninsula did not consistently maintain current or updated financial information during the terms of its loans.

- **Appraisals.** Part 323, *Appraisals*, of the FDIC Rules and Regulations, identifies real estate financial transactions requiring the services of an appraiser. The June 2008 and May 2009 examination reports noted a lack of appraisals on certain real estate loans, resulting in apparent violations of the appraisal regulations.

- **Loan Review.** According to the Examination Manual, it is essential that all institutions have an effective loan review system. Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. Peninsula did not have an effective loan review and internal grading system as management failed to recognize problem credits in a timely and appropriate manner.

Reliance on Non-core Funding Sources

Although not a primary cause of failure, Peninsula used non-core funding sources, such as time deposits of $100,000 or more, and to a lesser extent, brokered deposits, repurchase agreements, and FHLB advances, to fund its lending and operations. When properly managed, non-core funding sources offer a number of important benefits, such as ready access to funds in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as increased volatility when interest rates change, and statutory and regulatory restrictions that take effect when the financial condition of an institution deteriorates. Under distressed financial or economic conditions, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs. As reflected in Table 2, Peninsula maintained an elevated net non-core funding dependence ratio[8] between 2007 and the institution's failure.

Table 2: Peninsula's Non-core Funding Sources and Related Dependence Ratios

Non-core Funding Sources ($000)	Mar 2010	Dec 2009	Dec 2008	Dec 2007	Dec 2006	Dec 2005
	Amount ($000)					
Time Deposits of $100,000 or More	251,635	214,631	247,336	244,511	252,272	139,753
Brokered Deposits	693	17,651	54,591	15,077	12,390	26,907
FHLB Advances	50,000	50,000	50,018	0	0	0
Net Non-core Funding Dependence Ratio	48.49%	44.27%	55.94%	35.01%	24.45%	17.49%

Source: OIG analysis of UBPRs for Peninsula.

Contributing to the increase in Peninsula's potentially volatile liabilities were large time deposits, brokered deposits, and FHLB advances. Between June 30, 2007 and December 31, 2008, brokered deposits increased from $6 million (or 1 percent of total deposits) to $55 million (or 10 percent of total deposits). Concurrently, FHLB advances increased from zero to $50 million. Time deposits of $100,000 or more represented the bank's largest potentially volatile liability, averaging approximately 46 percent of total deposits between 2007 and 2008. The high cost of these deposits contributed to Peninsula's declining net interest margins.

As discussed more fully in *The FDIC's Supervision of Peninsula* section of this report, the FDIC granted the bank a brokered deposit waiver on May 25, 2006 after the bank became *Adequately Capitalized* as of September 30, 2005. The waiver permitted Peninsula to obtain and renew up to $50 million in brokered deposits for a period of 1 year. During the fourth quarter of 2006, Peninsula became *Well Capitalized* and no longer needed the waiver. By March 31, 2009, the institution had fallen back to *Adequately Capitalized* and was again prohibited from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. As a result of the May 2009 examination, Peninsula reported an *Undercapitalized* position in its June 30, 2009 Call Report, which, by statute, prohibited the bank from accepting brokered deposits.

While Peninsula made efforts during 2008 and 2009 to increase its core deposits, the ongoing decline in the bank's financial condition increased its liquidity risk profile. During the 2009 examination, examiners reported that the bank needed a contingency liquidity plan that addressed funding strategies under adverse economic and operating conditions. By May 2010, Peninsula's inability to access funding sources, such as FHLB advances and brokered deposits, was straining its liquidity position.

---

8 This ratio is a measure of the degree to which an institution relies on non-core funding to support long-term assets (such as loans that mature in over 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources.

The FDIC's Supervision of Peninsula

The FDIC, in coordination with the OFR, provided ongoing supervisory oversight of Peninsula through regular on-site examinations, visitations, and various offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and enforcement actions. Such risks included the bank's heavy concentration in CRE and ADC loans, liberal loan underwriting and weak credit administration practices, and reliance on non-core funding sources.

Deterioration in Peninsula's financial condition was first identified during a visitation initiated by the FDIC in March 2008. Notably, the visitation preceded the next required on-site examination by several months and was prompted by an off-site analysis of institutions considered by the FDIC to be at risk due to their significant exposure to CRE and ADC loans. As a result of the financial deterioration that was identified during the March 2008 visitation and in the subsequent June 2008 examination, the FDIC and the OFR entered into a Memorandum of Understanding (MOU) with Peninsula's Board in November 2008. The MOU addressed, among other things, the need to properly monitor and reduce the bank's CRE concentration and improve underwriting and credit administration practices.

The FDIC identified further deterioration in Peninsula's condition during the May 2009 examination. Based on the results of that examination, the FDIC replaced the MOU with a Cease and Desist Order (C&D) in November 2009 that addressed key risks, including the bank's elevated CRE loan concentrations, reliance on non-core funding sources, and need for more capital. By this time, however, the institution's lending markets had experienced a significant deterioration, making remedial efforts difficult. The OFR closed Peninsula in June 2010 because the institution was unable to raise sufficient capital to support safe and sound operations.

The perspectives gained from the failure of Peninsula are not unique. Like other institutions that failed in recent years, Peninsula developed a significant exposure to CRE and ADC loans at a time when the bank's financial condition and lending markets were favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market. Such an exposure would be subject to a more forward-looking risk assessment under the FDIC's current approach to supervision. Further, a more conservative supervisory approach with respect to the bank's reliance on non-core funding, including time deposits of $100,000 or more and brokered deposits, to support its lending and operations might also have been prudent. Such an approach may have better positioned the bank to work through its problems when its lending markets deteriorated.

The FDIC has taken a number of actions to increase its supervisory attention to banks that have risk profiles similar to Peninsula. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.

Supervisory History

Between 2006 and 2010, the FDIC and the OFR conducted four onsite examinations and three visitations of Peninsula. The frequency of this examination activity was consistent with relevant provisions of the FDI Act and the FDIC Rules and Regulations.[9] Table 3 summarizes key supervisory information pertaining to these examinations and visitations.

Table 3: Onsite Examinations and Visitations of Peninsula

Examination or Visitation Start Date	Examination or Visitation as of Date	Regulator	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken
4/10/2006	12/31/2005	FDIC	212121/2	None
6/4/2007	3/31/2007	OFR	111211/1	None
3/17/2008*	12/31/2007	FDIC	None	None
6/16/2008	3/31/2008	FDIC	343422/3	MOU dated 11/20/2008
5/26/2009	3/31/2009	FDIC/OFR	555544/5	C&D dated 11/20/2009
12/14/2009*	9/30/2009	FDIC	555554/5	C&D still in effect
5/3/2010*	3/31/2010	FDIC	555555/5	C&D still in effect

Source: OIG analysis of examination and visitation reports and information in the FDIC's Virtual Supervisory Information on the Net system for Peninsula.
* Denotes a visitation.

Offsite Monitoring

The FDIC's offsite monitoring procedures generally consisted of contacting the bank's management from time to time to discuss current and emerging business issues and using automated tools[10] to help identify potential supervisory concerns. As previously mentioned, the FDIC conducted an onsite analysis in early 2008 to identify institutions that were at risk due to their significant exposure to CRE and ADC loans. The analysis was performed in response to the adverse effect that the downturn in the housing market was having on construction and real estate development activity at that time. Recognizing that banks with large exposures to CRE loans, especially ADC loans, may be negatively affected, the FDIC analyzed Call Report information to identify banks with concentrated exposures in CRE and ADC loans that were operating in markets that the FDIC designated as "distressed" or "at risk." One of the institutions identified was Peninsula. The FDIC initiated a visitation of the bank in March 2008.

In July 2008, an offsite review triggered by Peninsula's March 31, 2008 Call Report noted problems. At that time, SCOR was indicating a probability of more than 30 percent that all of the bank's CAMELS component ratings would be downgraded at the next

[9] 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 (i.e., total assets of less than $500 million) if certain conditions are satisfied.
[10] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating system (SCOR) and the Growth Monitoring System. Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

examination. The probability of a downgrade in the Asset Quality component rating was 89 percent, in large part due to an increase in loans that were more than 90 days past due and loans that were designated nonaccrual. Since the preliminary results of the June 2008 examination verified the deterioration in Peninsula's asset quality, no additional offsite action was taken at that time.

Informal and Formal Actions

Based on the results of the June 2008 examination, the FDIC, in coordination with the OFR, entered into an MOU with Peninsula in November 2008. Among other things, the MOU required Peninsula to:

- address the management weaknesses identified during the examination;
- reduce credit concentrations and improve monitoring procedures;
- strengthen loan underwriting and credit administration; and
- improve loan review practices and the bank's internal grading system.

Based on the results of the May 2009 examination, the FDIC, in coordination with the OFR, issued a C&D against Peninsula in November 2009. Among other things, the C&D required the bank to:

- increase the level of participation by its Board in the affairs of the institution;
- maintain a Tier 1 Leverage Capital ratio of 8 percent or more and a Total Risk-Based Capital ratio of 12 percent or more;
- reduce credit concentrations and improve monitoring procedures;
- perform periodic reviews of the bank's loan portfolio on the basis of credit quality;
- reduce the bank's reliance on non-core funding sources and develop a plan to improve liquidity, contingency funding, interest rate risk, and asset liability management; and
- discontinue accepting, renewing, or rolling over brokered deposits consistent with FDIC regulations.

Supervisory Response to Key Risks

The scope of our work focused on the FDIC's supervision of the bank from 2006 to the bank's closure in June 2010. A summary of supervisory activities related to the bank's key risks during that period follows.

2006 Supervisory Activities

Examiners determined during the April 2006 examination that Peninsula's overall financial and operational condition was satisfactory. At that time, real estate conditions in the bank's lending markets were showing some signs of weakening. Further, the examination report recommended that the bank improve its risk management practices in various areas. Most notably, examiners recommended that the bank better monitor its loan concentrations and amend its loan policy to establish risk tolerance limits for its concentrations. At the time of the examination, the bank was experiencing rapid growth, and its non-owner-occupied CRE loan concentration represented 700 percent of Tier 1 Capital and the ALLL.

Examiners determined that Peninsula's capital position was satisfactory for the bank's risk profile. Based on Call Report data, Peninsula had fallen to *Adequately Capitalized* as of September 30, 2005. As a result, Peninsula was restricted by section 29 of the FDI Act and section 337 of the FDIC Rules and Regulations from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. Notwithstanding these restrictions, Peninsula increased its level of brokered deposits during the fourth quarter of 2005 by $8 million in apparent violation of the referenced brokered deposit restrictions. Examiners did not cite the apparent violation in the examination report due to an oversight.

Bank management informed the examiners during the examination that the institution's goal was to maintain a *Well Capitalized* position, with a Tier 1 Leverage Capital ratio above 8 percent. In May 2006, the FDIC granted Peninsula a brokered deposit waiver that permitted the bank to obtain and renew up to $50 million in brokered deposits for a period of 1 year. At that time, the bank had about $17 million in brokered deposits. During the fourth quarter of 2006, Peninsula returned to *Well Capitalized* after raising $17 million in new capital and no longer needed a waiver to obtain brokered deposits.

2007 Supervisory Activities

During the June 2007 examination, OFR examiners determined that Peninsula's overall financial and operational condition was strong. Examiners assigned a composite rating of "1" and component ratings of "1" with the exception of the Earnings component, which received a rating of "2." Examiners determined that earnings were satisfactory, notwithstanding a loss stemming from a nonrecurring charge of $13 million in connection with the bank's CD Custodial Program (discussed in the *Background* section of this report).

Conditions in Peninsula's lending markets were weakening, and the examination report noted that the bank's adversely classified loans had increased from $262,000 at the prior examination to $6.3 million. In addition, the bank's classified assets coverage ratio was 13 percent. The report also noted that a large amount of the bank's classifications pertained to seven loans totaling $5.3 million, five of which were transferred to other real estate owned. The examination report further stated that the bank had a large concentration of CRE loans, representing 658 percent of risk-based capital. Examiners concluded that Peninsula's CRE loan concentration was satisfactorily monitored and reported and that the bank had adequately addressed related recommendations made in the prior examination report. The examination report added that Peninsula was relying on potentially volatile liabilities to fund long-term assets.

Notwithstanding the bank's apparent sound financial condition at the time of the examination, the ratings assigned did not fully reflect (on a forward-looking basis) the substantial risk associated with the institution's CRE loan portfolio.

2008 Supervisory Activities

The FDIC conducted a limited scope visitation in March 2008 to assess the risk associated with Peninsula's significant CRE loan concentration. Examiners determined that the bank's asset quality had deteriorated. Concerns were also identified pertaining to the bank's CRE lending risk management practices, increasing past-due and nonaccrual loans, and underwriting and credit administration. Further, examiners noted instances of outdated appraisals and a lack of financial information and global cash flow analyses for borrowers. Examiners recommended that management set risk limits for the CRE concentration, improve internal loan review practices, and develop an interest reserve policy for ADC loans.

Examiners determined during the June 2008 examination that Peninsula's overall financial and operational condition was less than satisfactory and downgraded the bank's composite rating from a "1" to a "3." The bank's adversely classified assets had significantly increased following the previous examination, and the bank still had a significant exposure to CRE and ADC loans. Examiners downgraded the Asset Quality component from a "1" to a "4" and recommended that the bank establish risk limits for the CRE portfolio, set individual loan risk limits, and better measure and monitor CRE risks. In addition, the bank's loan underwriting and credit administration practices were inadequate. Specifically, examiners determined that the bank's loan policy needed to be enhanced to better address the use of interest reserves, renewals and extensions, and cash flow analyses. Examiners also identified apparent violations of law and contraventions of regulatory policies with respect to appraisals, CRE concentration and lending risk, and the ALLL.

Although the bank continued to be *Well Capitalized* for PCA purposes, examiners determined that the bank's capital position was less than satisfactory for its risk profile. The bank's liquidity position also fell from strong at the previous examination, to satisfactory. In addition, the bank had increased its reliance on non-core funding sources, such as lines of credit, FHLB advances, and repurchase agreements.

Based on the results of the examination, the FDIC and the OFR entered into an MOU with Peninsula. Among other things, the MOU required the bank to reduce and monitor the CRE loan concentration, recognize and/or reserve for troubled assets, and enhance the loan policy with respect to underwriting and credit administration. Following the examination, bank management provided the FDIC and the OFR with periodic status reports describing its efforts to address the items contained in the MOU.

2009 Supervisory Activities

During the May 2009 examination, FDIC and OFR examiners identified further significant deterioration in Peninsula's financial and operational condition and downgraded the bank's composite rating to a "5." Examiners determined that adversely classified items totaled 332 percent of Tier 1 Capital and the ALLL, much of which pertained to ADC loans. Although the bank had not originated many new CRE loans following the prior examination, the administration of existing CRE loans was weak. For example, examiners identified instances in which interest reserves were not used appropriately and loans were being renewed without a credit review or principal reduction. Apparent violations of regulations and contraventions of statements of policy also existed pertaining to real estate concentrations, appraisals, and the ALLL.

Further, examiners determined that Peninsula's capital was critically deficient in relation to the bank's risk profile and that secondary sources of funding were limited, elevating the bank's liquidity risk profile. Examiners made several recommendations, including to reduce the bank's reliance on non-core funding and develop a comprehensive contingency funding plan that addressed funding strategies under critical economic and operating conditions. In addition, examiners found that compliance with critical provisions of the November 2008 MOU had not been achieved, including provisions pertaining to recognizing problem loans.

In a letter dated August 14, 2009, the FDIC notified Peninsula's Board that the bank had fallen to *Undercapitalized* based on its June 30, 2009 Call Report. Consistent with the requirements of section 38, Peninsula provided the FDIC with a capital restoration plan dated September 25, 2009. On November 20, 2009, the FDIC, in conjunction with the OFR, issued a C&D to address the findings of the May 2009 examination. The C&D included provisions addressing, among other things, management, capital, concentrations, and earnings. Peninsula provided the FDIC and the OFR with status reports describing the bank's efforts to address the items contained in the C&D.

In December 2009, the FDIC conducted a limited scope visitation to assess the bank's financial condition and compliance with the C&D. Examiners found further deterioration in the bank's condition during the visitation. Among other things, classified assets had increased to 416 percent of Tier 1 Capital and the ALLL, and Liquidity was downgraded to a "5." Further, the bank had fallen to a *Significantly Undercapitalized* position.

2010 Supervisory Activities

The bank was determined to be *Critically Undercapitalized* for PCA purposes in March 2010 when the December 31, 2009 Call Report was revised. The FDIC conducted a limited scope visitation in May 2010 to assess the bank's capital position and plans to raise needed capital. Efforts to raise needed capital had not been successful. Examiners also found that classified assets had increased to 573 percent of Tier 1 Capital and the ALLL, earnings were critically deficient, and a significant provision was needed to replenish the ALLL. Although management had put forth efforts to comply with the C&D, the bank remained in non-compliance with several of the C&D's provisions, including provisions to reduce the bank's CRE risk exposure, improve earnings, and increase capital. Absent a substantial capital infusion, examiners determined that the probability of the bank's failure was significant.

Supervisory Lessons Learned

Like other institutions that failed in recent years, Peninsula developed a significant exposure to CRE and ADC loans at a time when the bank's financial condition and lending markets were favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market. Such an exposure would be subject to a more forward-looking risk assessment under the FDIC's current approach to supervision. As previously stated, Peninsula's supervisory ratings during the June 2007 OFR examination did not fully reflect the substantial risk associated with the institution's CRE loan portfolio.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from the financial crisis. Among other things, the FDIC has provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized. The FDIC has also issued supervisory guidance addressing risks associated with CRE and ADC lending.

A more conservative supervisory approach with respect to the bank's reliance on non-core funding sources, including time deposits of $100,000 or more and brokered deposits, to support its operations (including lending) might also have been prudent. Such an approach could have included requiring the bank to submit a plan for stabilizing or reducing its risk exposure to non-core funding sources when the bank became *Adequately Capitalized* in 2005 and again in 2008 when the bank began relying more heavily on such sources. Such a plan could have served as an additional control for curbing the bank's use of non-core funding in the years immediately preceding the bank's failure.

In August 2008, the FDIC issued FIL-84-2008, entitled *Liquidity Risk Management*, which stresses the importance of contingency funding plans for institutions that use wholesale funding sources, including brokered deposits. In addition, in March 2009, the FDIC issued FIL-13-2009, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions that are in Weakened Condition*. FIL-13-2009 states that FDIC-supervised institutions having a composite rating of "3," "4," or "5" are expected to establish and implement appropriate plans to mitigate the risks associated with the use of potentially volatile liabilities.

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 the problems of insured depository institutions at the least possible cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans 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 imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to Peninsula, the FDIC properly implemented applicable PCA provisions of section 38. Among other things, the FDIC requested and evaluated the bank's capital restoration plans, reviewed and monitored the institution's Call Report information, and conducted discussions with management regarding its efforts to raise needed capital. As described below, it may also have been beneficial to formally notify Peninsula of its *Adequately Capitalized* status and associated restrictions in 2005. Table 4 illustrates Peninsula's capital levels relative to the PCA thresholds for *Well Capitalized* institutions as reported by the bank in its Call Reports. A chronological description of the changes in the bank's capital categories and the FDIC's implementation of PCA follow the table.

Table 4: Peninsula's Capital Levels, 2005-2010

Period Ended	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based	PCA Capital Category
***Well Capitalized* Threshold**	**5% or more**	**6% or more**	**10% or more**	
Dec-05	7.68%	8.67%	9.29%	*Adequately Capitalized*
Dec-06	7.87%	9.94%	10.66%	*Well Capitalized*
Dec-07	9.30%	11.32%	12.19%	*Well Capitalized*
Dec-08	8.21%	8.97%	10.22%	*Well Capitalized*
Dec-09	0.35%	0.47%	0.95%	*Significantly Undercapitalized*
Mar-10	-1.53%	-2.04%	-2.04%	*Critically Undercapitalized*

Source: OIG analysis of UBPRs and examination reports for Peninsula and Part 325 of the FDIC Rules and Regulations.

Peninsula was considered *Well Capitalized* for PCA purposes until the institution filed its September 30, 2005 Call Report reflecting an *Adequately Capitalized* position. Although not required by statute or policy, it may have been beneficial to formally notify Peninsula of its *Adequately Capitalized* status and associated restrictions in 2005.[11] As previously stated, the institution increased its brokered deposits while it was *Adequately Capitalized*, in apparent violation of the FDI Act. Notifying the institution would have promoted awareness on the part of the Board regarding its obligations to comply with the restrictions imposed on *Adequately Capitalized* banks. As previously discussed, Peninsula received a brokered deposit waiver from the FDIC in May 2006. In November 2006, the bank received a capital infusion of $17 million and, as a result, reported a *Well Capitalized* position in its December 31, 2006 Call Report.

[11] FDIC policy requires that institutions be notified in writing when they fall to *Undercapitalized*, *Significantly Undercapitalized*, or *Critically Undercapitalized*. The policy does not require notification for institutions that fall to an *Adequately Capitalized* position.

Peninsula fell back to *Adequately Capitalized* based on its March 31, 2009 Call Report. In a letter dated August 14, 2009, the FDIC notified Peninsula's Board that, based on its June 30, 2009 Call Report, the bank had fallen to *Undercapitalized*. The letter included a reminder regarding the restrictions imposed on *Undercapitalized* institutions, including restrictions pertaining to asset growth, dividends, and management fees. The letter also requested that the bank submit a capital restoration plan within 45 days of receipt of the letter. Peninsula submitted a capital restoration plan dated September 25, 2009. However, RMS could not provide evidence of written notice to the bank advising of the approval or disapproval of the plan.[12] On November 20, 2009, the bank became subject to a C&D, with a capital provision that required the bank to have Tier 1 Capital of at least 8 percent and total risk-based capital of at least 12 percent of the bank's total risk-weighted assets. In the months that followed, the FDIC monitored the bank's capital levels and ongoing efforts to raise new capital through the status reports required by the C&D, the December 2009 visitation, and meetings and discussions with bank management.

In a letter dated March 26, 2010, the FDIC notified Peninsula's Board that, based on its December 31, 2009 Call Report, the bank had fallen to *Significantly Undercapitalized.* The letter included a reminder regarding the restrictions imposed on *Significantly Undercapitalized* institutions. On April 5, 2010, the OFR requested that the bank achieve a Tier 1 Leverage Capital ratio of no less than 8 percent by May 5, 2010. In response to the OFR's request, Peninsula submitted a revised capital restoration plan. In a letter dated April 16, 2010, the FDIC notified Peninsula's Board that, based on its revised December 31, 2009 Call Report, the bank had fallen to *Critically Undercapitalized.* The notice included reminders regarding the requirements imposed on *Critically Undercapitalized* institutions. The bank submitted a revised capital restoration plan, dated April 20, 2010.

Peninsula explored a number of strategic alternatives for raising capital, such as working with investor groups to obtain investments and applying for funds under the Department of the Treasury's Capital Purchase Program. However, these efforts were ultimately not successful. The OFR closed the institution on June 25, 2010 because it did not have enough capital to continue safe and sound operations.

OIG Evaluation of Corporation Comments

The Director, RMS, provided a written response, dated July 15, 2011, to a draft of this report. That response is provided in its entirety as Appendix 5 of this report. In the response, RMS reiterated the causes of failure and supervisory activities described in our report. The response also noted that the FDIC issued a FIL in 2008, entitled *Managing*

[12] Section 325.104(c) of the FDIC Rules and Regulation states that the FDIC shall provide written notice to a bank as to whether its capital restoration plan required under PCA has been approved within 60 days of receiving the plan. However, the bank became subject to a C&D with a capital maintenance provision within 60 days of submitting the capital restoration plan. In addition, the FDIC had regular communication with Peninsula's management regarding the bank's ongoing efforts to improve its capital position. As a result, in our view, the lack of written notice was inconsequential to the supervision or failure of the bank.

Commercial Real Estate Concentrations in a Challenging Environment, that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. In addition, the response referenced a 2009 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*, issued by RMS to enhance FDIC supervision of institutions with concentrated CRE lending and reliance on volatile, non-core funding sources.

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. The initial estimated DIF loss for Peninsula was under the applicable $200 million MLR threshold, but the loss estimate subsequently increased, requiring an MLR.

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

We conducted this performance audit from March 2011 to June 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 the audit focused primarily on Peninsula's operations from April 2006 until its failure in June 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period. In addition, we analyzed information pertaining to certain other matters that occurred prior to 2006 that we considered relevant to the audit.

To achieve the objectives, we performed the following audit procedures:

- Analyzed key documentation, including:
    - Examination and visitation reports issued by the FDIC and the OFR from 2006 to 2010.
    - Institution data in Call Reports, UBPRs, and other reports.

Objectives, Scope, and Methodology

- FDIC and OFR correspondence.
- Other relevant documents prepared by the FDIC relating to the institution.
- Pertinent FDIC regulations, policies, procedures, and guidance.

- Interviewed RMS examination staff in the Washington, D.C. office; the Atlanta Regional Office; and the Tampa Field Office.
- Interviewed OFR examination staff to obtain their perspectives on the failure and to discuss their role in the supervision of the institution.

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

Consistent with the audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in RMS systems, reports, and interviews of examiners to understand Peninsula'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 reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA. We performed 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.

Objectives, Scope, and Methodology

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 indicated that the OIG planned to provide more in-depth 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. The OIG also began an evaluation to study the characteristics and related supervisory approaches that may have prevented FDIC-supervised institutions with significant ADC loan concentrations from being designated as problem banks or failing during the recent financial crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction, and that provide interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of 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.
Capital Purchase Program	On October 3, 2008, the President signed the Emergency Economic Stabilization Act of 2008 into law. Among other things, the Act authorized the Secretary of the Department of the Treasury to establish the Troubled Asset Relief Program (TARP), which is administered by the Treasury. Under TARP, the Treasury implemented the Capital Purchase Program through which the Treasury purchased senior preferred stock (and, if appropriate, warrants of common stock) from viable institutions of all sizes. Qualifying financial institutions were permitted to apply for funds under the Capital Purchase Program after consulting with their primary federal regulator.
Capital Restoration Plan	Section 325.104(a)(1) of the FDIC Rules and Regulations requires a bank to file a written capital restoration plan with the appropriate FDIC regional director within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is *Undercapitalized*, *Significantly Undercapitalized,* or *Critically Undercapitalized*, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 US Code (U.S.C.) section 1818 to a bank or

Glossary of Terms

	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.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Contingency Funding (or Liquidity) Plan	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency funding plans should be regularly tested and updated to ensure that they are operationally sound. RMS uses the terms contingency funding plan and contingency liquidity plan interchangeably.
FDIC's Supervision Program	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 institutions. The FDIC's RMS (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.
Federal Home Loan Bank (FHLB)	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Financial Reform Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss to the DIF in excess of $200 million.

Glossary of Terms

Memorandum of Understanding (MOU)	An MOU is an informal agreement between the institution and the FDIC, signed by both parties. The state authority may also be a party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Non-core Funding	Non-core funding generally consists of large time deposits (greater than $100,000), borrowings/advances, brokered deposits, federal funds purchased, repurchase agreements, and foreign deposits.
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.
Tier 1 (Core) Capital	In general, this term is defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations (C.F.R.), section 325.2(v), as: **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
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.

Glossary of Terms

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
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
MLR	Material Loss Review
MOU	Memorandum of Understanding
OFR	Office of Financial Regulation
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RMS	Division of Risk Management Supervision
SCOR	Statistical CAMELS Offsite Rating
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Peninsula's Risk Management Weaknesses by Examination and Visitation

Reports of Examination Dates	***2006***	***2007***	***2008****	***2008***	***2009***	***2009****
Risk/Deficiency						
Significant Concentration in CRE and ADC Loans	✓	✓	✓	✓	✓	✓
Loan Underwriting						
Liberal renewal and extension practices				✓	✓	✓
Inappropriate use of interest reserves			✓	✓	✓	✓
Inadequate appraisal evaluation			✓	✓	✓	
Inadequate analyses of contingent liabilities, global cash flow, and competitive projects at loan origination			✓	✓	✓	
Reliance on collateral protection for loan repayment			✓	✓	✓	
Credit Administration						
Loan Policy did not include risk targets for loan concentrations as a percentage of capital or limits by individual and overall categories.	✓		✓	✓		
Lack of comprehensive enhanced monitoring procedures for CRE concentration	✓			✓		
Lack of formal mechanisms to monitor market trends				✓		
Inadequate or lack of global cash flow and financial statements/repayment capacity			✓	✓	✓	
Lack of updated credit memoranda			✓			
Lack of due diligence on purchased participation loans				✓		
Lack of adherence to the loan policy				✓	✓	
Lack of revised loan policy			✓	✓		
Inadequate loan review and problem loan identification/grading/ALLL methodology			✓	✓	✓	✓
Apparent Violations and Contraventions						
Joint G*uidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*				✓	✓	
Part 323/Statement of Policy - *Appraisals*				✓	✓	
Interagency Statement of Policy on ALLL				✓	✓	
Appendix A, Parts II (A), (D), (G) to Part 364 - Interagency Guidelines Establishing *Standards for Safety and Soundness* pursuant to section 39					✓	
Section 658.67(9)(a), Florida Statutes - *Acquisitions of Property as Security*				✓	✓	
Section 655.044(1), Florida Statutes - *Accounting Practices; Bad Debts Ineligible to be Carried as Assets*					✓	✓

Source: OIG analysis of examination and visitation reports issued from 2006 to 2009.
* Denotes visitation report.

Corporation Comments

FDIC

Federal Deposit Insurance Corporation

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

July 15, 2011

TO: Mark Mulholland
Deputy Assistant Inspector General for Audits

/**Signed**/

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Peninsula Bank Englewood, Florida (Assignment No. 2011-048)

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 Peninsula Bank (Peninsula), which failed on June 25, 2010. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on June 20, 2011.

Peninsula failed due to the Board's and management's ineffective oversight of the risks associated with the rapid growth experienced between 2003 and 2006. This growth led to heavy concentration in its commercial real estate (CRE) loans and a reliance on non-core funding. Inadequate credit underwriting practices and oversight of the lending function contributed to a decline in the quality of the loan portfolio. By April 2009 Peninsula's asset quality had significantly deteriorated, requiring increases in the loan loss provisions that depleted earnings, eroded capital and strained liquidity. Peninsula was unable to raise additional capital to sustain safe and sound operations.

From 2006 to 2010 the FDIC and the Florida Office of Financial Regulations (OFR) conducted four on-site examinations, three on-site visitations and offsite monitoring. The 2008 FDIC visitation and subsequent examination found weaknesses in Peninsula's loan quality and risk management practices and that the Board and management had not established a framework to manage those risks. Peninsula was downgraded and entered into a memorandum of understanding (MOU) with the FDIC and the OFR. The 2009 joint examination found that full compliance with the existing MOU had not been achieved in critical areas and that Peninsula's overall condition had deteriorated. Peninsula was further downgraded and a cease and desist order was issued that required increased Board's participation in the affairs of the institution, the reduction of credit concentrations, and the need to reduce reliance on non-core funding.

RMS has recognized the threat that institutions with high risk profiles, such as Peninsula, pose to the Deposit Insurance Fund and issued a Financial Institution Letter to banks in 2008 on *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued a Financial Institution Letter in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance our supervision of institutions with concentrated CRE lending and reliance on volatile non-core funding.

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