# Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-044

## Material Loss Review of Florida Community Bank, Immokalee, Florida

August 2010

Office of Inspector General

**Executive Summary**

# Material Loss Review of Florida Community Bank, Immokalee, Florida

Report No. MLR-10-044
August 2010

## Why We Did The Audit

On January 29, 2010, the Florida Office of Financial Regulation (OFR) closed Florida Community Bank (Florida Community), Immokalee, Florida and named the FDIC as receiver. On March 1, 2010, the FDIC notified the Office of Inspector General (OIG) that Florida Community's total assets at closing were $897.8 million and the estimated material loss to the Deposit Insurance Fund (DIF) was $349.1 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 Florida Community.

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

## Background

Florida Community was a state nonmember bank established in 1923 as the Bank of the Everglades, Everglades City, Florida. In 1966, the bank changed its name to First Bank of Immokalee and moved its headquarters to Immokalee, Florida. In 1996, the name of the bank was changed to Florida Community. In addition to a main office in Immokalee, Florida, the bank had 10 branches throughout 4 southern Florida counties. Historically a generally well-rated agricultural bank, Florida Community's risk profile changed significantly in 2000 when management decided to increase its origination of commercial real estate (CRE) loans. Florida Community was wholly-owned by Florida Community Banks, Inc., a one-bank holding company formed in 2002, and also headquartered in Immokalee, Florida.

## Audit Results

### Causes of Failure and Material Loss

Florida Community's failure can be primarily attributed to deficient Board of Directors (Board) and management oversight of the institution's risk management practices associated with its CRE and acquisition, development, and construction (ADC) loan portfolios. Beginning in 2003, the overall size and complexity of the bank increased substantially; however, the bank's risk management processes failed to keep pace with this higher risk profile. Specifically, the Board did not establish an effective organizational structure to plan for and respond to the risks arising from changes in economic conditions and collateral values. Beginning in 2003, the FDIC and the OFR repeatedly urged management to establish more robust underwriting and loan portfolio management practices. However, these practices were not fully developed and bank management did not implement effective measures to address all of the examiners' concerns. When the deterioration of the real estate market occurred, the risk management deficiencies resulted in a significant decline in the quality of the institution's loan portfolio. Provisions for losses and actual losses depleted earnings, eroded capital, and strained liquidity. Ultimately, the OFR closed Florida Community because prospects for a capital injection or sale of the bank were poor.

### The FDIC's Supervision of Florida Community

Our review focused on supervisory oversight of Florida Community between 2003 and 2009. During that period, the FDIC and the OFR conducted seven onsite risk management examinations and the FDIC monitored current and emerging issues at the bank through its offsite monitoring program. Through those supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's concentrations in CRE and ADC lending and weak loan underwriting and credit administration policies and practices. In addition, the FDIC and the OFR initiated enforcement actions related to the identified weaknesses after the 2006, 2008, and 2009 examinations.

Florida Community's overall financial condition was considered satisfactory until the OFR 2006 examination. The OFR downgraded the bank to a composite "3" rating at the 2006 examination and pursued a Cease and Desist Order to address numerous high-risk practices and deficiencies identified by examiners. At the 2007 examination, the FDIC upgraded the bank to a composite "2" rating due to improvements made related to the Bank Secrecy Act program and in the bank's liquidity. In 2008, the OFR downgraded the bank to a composite "4" rating due to significant deterioration in asset quality and continued loan underwriting and credit administration weaknesses. By the 2009 examination, the FDIC determined that asset quality, capital, and earnings were critically deficient and appeared to be beyond management's ability to control, and further downgraded the bank to a composite "5" rating.

Although the FDIC's supervisory approach was consistent with practices in place at the time for an institution with Florida Community's risk profile, the composite "2" rating assigned at the 2007 examination may not have been representative of the risk management deficiencies and negative trends in financial performance identified in the report. Further, more thorough follow-up at that examination to ensure prior examination recommendations were addressed would have been beneficial in mitigating apparent risks at Florida Community. Specifically, had the FDIC ensured that Florida Community addressed the recommendations in the 2003 to 2006 examinations earlier and made improvements to the bank's risk monitoring, underwriting standards, and Board oversight, losses incurred by the DIF, to some extent, may have been mitigated. Ultimately, although the FDIC and the OFR pursued supervisory actions in 2008 and 2009, and Florida Community took steps to address them, the actions and responses were not timely or sufficient to prevent the bank's failure.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

## Management Response

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response, dated August 19, 2010, to the draft report. In its response, DSC reiterated the OIG's conclusions regarding the causes of Florida Community's failure. With regard to our assessment of the FDIC's supervision of Florida Community, DSC summarized the supervisory history, including offsite monitoring activities, described in our report. Further, DSC recognized that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as Florida Community, and indicated that it had issued a Financial Institution Letter to banks that re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and sets forth broad supervisory expectations.

# Contents

**Federal Deposit Insurance Corporation**
3501 Fairfax Drive, Arlington, Virginia 22226

Office of Material Loss Reviews
Office of Inspector General

**DATE:** August 30, 2010

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

**/Signed/**

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

**SUBJECT:** *Material Loss Review of Florida Community Bank, Immokalee, Florida* (Report No. MLR-10-044)

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 (Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Florida Community Bank (Florida Community), Immokalee, Florida. The Florida Office of Financial Regulation (OFR) closed the institution on January 29, 2010 and named the FDIC as receiver. On March 1, 2010, the FDIC notified the OIG that Florida Community's total assets at closing were $897.8 million and the estimated loss to the Deposit Insurance Fund (DIF) was $349.1 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. As of August 6, 2010, the estimated loss to the DIF had decreased to $308 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency. 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 Florida Community's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Florida Community, including implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Florida Community's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of financial 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]

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, 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, Appendix 4 summarizes Florida Community's weakness as identified in examination reports from 2003 through 2009, and Appendix 5 contains the Corporation's comments on this report.

## Background

Florida Community was a state nonmember bank established in 1923 as the Bank of the Everglades, Everglades City, Florida. In 1966, the bank changed its name to First Bank of Immokalee and moved its headquarters to Immokalee, Florida. In 1996, the name of the bank was changed to Florida Community. In addition to a main office in Immokalee, Florida, the bank had 10 branches throughout 4 southern Florida counties. Historically a generally well-rated agricultural bank, Florida Community's risk profile changed significantly in 2000 when management decided to increase its origination of commercial real estate loans. Florida Community was wholly-owned by Florida Community Banks, Inc., a one-bank holding company formed in 2002, and also headquartered in Immokalee, Florida. The company's stock was widely held. Table 1 provides details on Florida Community's financial condition as of September 30, 2009 and for the 4 preceding calendar years.

**Table 1: Selected Financial Information for Florida Community, 2005 to 2009**

| Financial Measure | Sept 2009 | Dec 2008 | Dec 2007 | Dec 2006 | Dec 2005 |
|---|---|---|---|---|---|
| Total Assets ($000s) | $875,473 | $954,629 | $932,692 | $1,009,299 | $906,143 |
| Total Loans ($000s) | $570,101 | $624,634 | $752,931 | $863,744 | $791,609 |
| Total Deposits ($000s) | $795,454 | $846,440 | $754,805 | $839,683 | $737,840 |
| Net Income (Loss) ($000s) | ($29,603) | ($75,354) | $ 12,027 | $24,028 | $18,759 |

Source: Uniform Bank Performance Report (UBPR) data for Florida Community.

## Causes of Failure and Material Loss

Florida Community's failure can be primarily attributed to deficient Board and management oversight of the institution's risk management practices associated with its commercial real estate (CRE) and acquisition, development, and construction (ADC) loan portfolios. Beginning in 2003, the overall size and complexity of the bank increased substantially; however, the bank's risk management processes failed to keep pace with this higher risk profile. Specifically, the Board did not establish an effective

[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.

organizational structure to plan for and respond to the risks arising from changes in economic conditions and collateral values. Beginning in 2003, the FDIC and the OFR repeatedly urged management to establish more robust underwriting and loan portfolio management practices. However, these practices were not fully developed and management did not implement effective measures to address all of the examiners' concerns. When the deterioration of the real estate market occurred, the risk management deficiencies resulted in a significant decline in the quality of the institution's loan portfolio. Provisions for losses and actual losses depleted earnings, eroded capital, and strained liquidity. Ultimately, the OFR closed Florida Community because prospects for a capital injection or sale of the bank were poor.

## Oversight and Risk Management Practices

Beginning in 2003, Florida Community embarked on a strategy of loan portfolio expansion, primarily in ADC and outside of the bank's market area. Throughout its expansion period, Florida Community's Board and management did not implement sound risk management, loan underwriting, or credit administration practices commensurate with the significant concentrations in ADC and CRE loans. In addition, Florida Community operated under a dominant official and a Board that was reluctant to correct previously identified deficiencies or implement regulatory recommendations.

The FDIC's 2009 and final examination report stated that over the past several years, bank management had failed to exert ample supervision over the rapid growth of the loan portfolio, underwriting, and credit risk management, which ultimately resulted in a massive volume of problem assets and credit losses.

In addition, from 2004 through 2009, regulators expressed concerns related to Florida Community's reliance on non-core funding sources[2] to grow the bank. As early as 2006, brokered deposits alone accounted for 42 percent of total deposits, which according to examiners reflected a shift in the bank's business plan from steadily building a core deposit base to fund asset growth to one funded by volatile wholesale liabilities. According to the OFR 2008 examination report, the bank was operating with an over-reliance on and excessive level of brokered deposits, which the OFR considered to be an unsafe and unsound practice. The 2009 FDIC examination report stated that the bank's funding was largely dependent on high-cost certificates of deposits because certain borrowing lines were curtailed or canceled.

### Risk Management Practices Related to CRE and ADC Lending

Florida Community's Board and management failed to adequately oversee the CRE lending division and ensure that effective risk management processes were in place to identify and control the concentration of risk in CRE, and ADC lending in particular. This lack of oversight resulted in numerous loan classifications, charge-offs, and write-

[2] Florida Community's non-core funds included Internet time deposits, customer time deposits of $100,000 and over, brokered deposits, and Federal Home Loan Bank (FHLB) of Atlanta and Federal funds purchased.

downs that were exacerbated by declining real estate values. Examiners attributed the level and severity of adverse classifications to several factors:

- Loan growth that more than doubled from $430 million in 2003 to $864 million in 2006.

- An excessive concentration in ADC lending.

- Weakened credit quality due to management's failure to establish effective project and construction monitoring and inadequate checks and balances over the credit administration process that relied exceedingly on loan officers to assess borrowers' adherence to prescribed loan covenants, financial condition, and overall credit worthiness.

- Weak loan underwriting that relied excessively on interest reserves and emphasized collateral coverage over repayment capacity and cash flow adequacy.

Examiners noted concern with the risk associated with the bank's increasing levels of CRE concentrations from 2003 through 2009. Starting in 2003, examination reports noted that improvements were needed in tracking and reporting asset concentrations to the Board, and Florida Community needed to implement a comprehensive concentration risk management system. Also, according to the 2007 through 2009 examination reports, several of the bank's internal target limits related to CRE concentrations appeared excessive given the depressed economic environment of the bank's market area and dismal performance of ADC credits. The losses related to these concentrations caused excessive charge-offs that impaired capital and, ultimately, the viability of the bank.

Loan Underwriting and Credit Administration

From 2005 through 2009, examiners identified the need for improvement in the bank's loan underwriting and credit administration practices. In addition, during 2006 and 2007, Florida Community operated without a credit department, and a Senior Credit Underwriter was not hired until December 2007.

During the March 2009 examination, the bank was cited for a *Contravention to Part 364 Appendix A* of the FDIC Rules and Regulations, which in part requires an institution to establish and maintain prudent loan documentation and credit underwriting practices before capital becomes impaired. The examination reported the following loan underwriting and credit administration weaknesses:

- Inappropriate and excessive use of interest reserves.
- Excessive reliance on extensions and renewals.
- Excessive volume of loans on interest-only payment schedules.
- Poor selection of risks as evidenced by:
    - loans made for the speculative purchase of land or lot assemblage,
    - loans made without adequate owner equity,

    - loans that were adequately protected by collateral but involved a borrower with limited or unassessed repayment ability, and
    - loans made to finance risky real estate business ventures.
- Over-lending to one borrower.
- Excessive reliance on borrower's reputation and lack of attention to changing economic conditions.

Some of the above weaknesses were also identified by examiners prior to the 2009 examination. For example, as shown in Appendix 4, examiners noted the inappropriate use of interest reserves in the 2005, 2007, and 2009 examination reports.

Dominant Official and Inadequate Board Oversight

From the early 1990s through 2009, Florida Community was influenced by a dominant official who over time held the titles of President, Chief Executive Officer (CEO), and Chairman of the Board.[3] As CEO, this individual put in place a business strategy to yield higher profits that was heavily reliant on CRE lending. He was the only inside director and according to examiners, operated the bank as a "classic one man show." The CEO was very active in establishing bank direction and policy and operating the bank on a day-to-day basis, including making all major credit decisions. Although Florida Community branch office presidents were involved in producing loans, the CEO, to a significant degree, acted as the Chief Credit Officer, promoting policy and reviewing and approving all major credits. Further, the CEO formulated the basic business philosophy of the bank, which emphasized collateral.

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), "One Man Banks" are institutions where the principal officer and stockholder dominates virtually all phases of the bank's policies and operations. Often this situation stems from the personality of the principal officer or ownership control, and it is usually abetted by an apathetic Board. This development is facilitated by the fact that directors are very often nominated by bank officers to whom they feel indebted for the honor, even though stockholders elect them. Over the years, an officer can influence the election of a sufficient number of directors so that the officer is ultimately able to dominate the Board and the affairs of the bank. There are at least two potential dangers inherent in a "One Man Bank" situation:

- Incapacitation of the dominant officer may deprive the bank of competent management, and because of the immediate need to fill the managerial void, may render the bank vulnerable to dishonest or incompetent replacement leadership.

- Problem situations resulting from mismanagement are more difficult to solve through normal supervisory efforts because the bank's problems are often attributed to the one individual that dominates the bank.

[3] The official joined the bank in 1981 and was appointed President in December 1983, CEO in January 1990, and Chairman of the Board in January 2000.

As early as 1992, examiners noted that the CEO retained control over much of the bank's operations, seemed reluctant to delegate responsibility to other officers, and appeared to have a disregard for written policies and documentation. At that time, he originated 80 percent to 90 percent of the loans, wrote most of the bank's policies, conducted a majority of in-house appraisals and outside appraisal reviews, and managed the bank's daily affairs. He remained the dominant policymaker and was responsible for day-to-day management until an Executive Vice President was hired in 2006 to assume primary responsibility for the bank's daily operations.

According to FDIC and OFR examiners, the CEO operated as a "one man show" with a Board that allowed him to do so. Further, it was noted that he argued and fought examination criticisms and findings and had been generally uncooperative with regulators.

The CEO also met the Examination Manual's description of a "dominant" official.

- The CEO dominated virtually all phases of the bank's policies and operations. Historically an agricultural bank, its profile changed significantly under his leadership. The bank expanded outside of Immokalee and developed a presence in the Naples, Fort Myers, Port Charlotte, Lehigh, and LaBelle markets. He was very active in establishing bank direction and policy and operating the bank on a day-to-day basis, including influencing all major credit decisions, Bank Secrecy Act (BSA) decisions, personnel issues, and operational matters. According to examiners, the CEO stated that he operated the bank as a "benevolent dictator." In addition, according to examiners, any dissention or question of his authority by bank management was not welcomed.

- The CEO was abetted by the Board. The Board did not adequately exert its authority, and Board members did not have sufficient CRE expertise to question the judgment of the CEO. There was no apparent effort to seek new Board members to complement the bank's geographic expansion into the major metropolitan areas of Southwest Florida, or to change the CRE lending emphasis.

- There was a lack of competent management to run the bank in the absence of the CEO. It was the examiners' opinion that the members of the Board did not have expertise in CRE lending, making them unqualified to step in if the CEO left the bank. Examiners also noted that the bank's branch presidents did not appear to have the requisite qualifications for managing a $1 billion bank with an excessive and complicated CRE concentration. Further, the lack of a credit department would have further exacerbated problems if the CEO was no longer able to serve in that position. Although an Executive Vice President was hired in 2006, examiners did not think he would be able to provide meaningful assistance because he did not have specific expertise in CRE lending, was from out-of-state, and was not familiar with the local markets and borrowers.

Failure to Correct Previously Identified Deficiencies

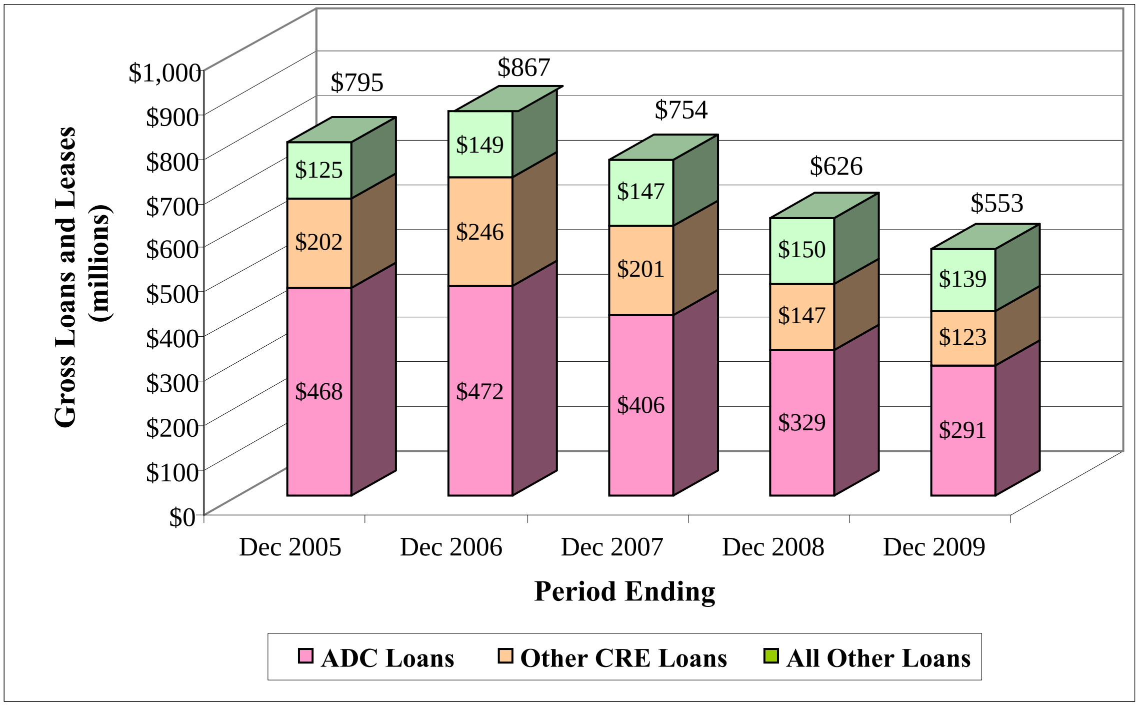
Although the FDIC and the OFR repeatedly urged management to establish more robust underwriting and loan portfolio management practices, bank management did not fully develop and implement effective measures to address all examiner concerns. In 2003, examiners determined that bank management had not established adequate risk processes to identify, measure, monitor, and control concentrations. In the 2006 OFR examination report, the bank was warned that if the real estate market were to deteriorate, the bank could be exposed to significant credit losses. At that examination, examiners rated management less than satisfactory due to a lack of oversight by the Board and the reluctance to establish risk management practices commensurate with the bank's growth and increased risk profile. However, as discussed in subsequent examination reports, the bank failed to address these concerns, particularly as they related to CRE concentrations, credit underwriting and administration, and compliance with regulations related to loan-to-value (LTV) requirements. Appendix 4 provides a list of concerns addressed in examination reports from 2003 through 2009.

## ADC and CRE Loan Concentrations

Losses within Florida Community's ADC and CRE loan portfolios were principal factors leading to the bank's deteriorating financial condition and subsequent failure. The losses were beyond the bank's ability to effectively manage in a declining economic environment and, as previously discussed, were the result of inadequate risk management practices. Although this lending strategy provided significant earnings when real estate values were increasing, these concentrations exposed the bank to excessive credit risk as real estate values declined.

The figure following illustrates the general composition of Florida Community's loan portfolio in the years preceding the institution's failure. In total, Florida Community's portfolio of ADC and other CRE loans was significant – ranging from 75 percent to 84 percent of gross loans and leases over the period 2005 to 2009.

**Composition of Florida Community's Loan Portfolio from 2005 to 2009**




Source: OIG analysis based on Call Report data for Florida Community.

Asset quality deteriorated significantly during the period between the FDIC 2007 and 2009 examinations, with adversely classified items increasing from $88.5 million to $350.7 million, representing 258 percent of Tier 1 Capital and reserves, or 36 percent of total assets. As a result, substantial provision expenses were necessary to replenish the allowance for loan and lease losses (ALLL).

Table 2 provides details on Florida Community's loan charge-offs. From 2004 to 2009, 84 percent ($64.6 million) of the bank's charge-offs were in the CRE loan portfolio, with 69 percent ($53.3 million) of the charge-offs attributed to the ADC loans.

**Table 2: Florida Community's ADC and CRE Charge-Offs**

| Period Ended | Total Loan Charge-Offs ($000s) | CRE Charge-Offs ($000s) | | | % CRE Charge-Offs/Total Loan Charge-Offs |
|---|---|---|---|---|---|
| | | ADC | Other CRE | Total CRE | |
| December 2004 | 455 | 0 | 0 | 0 | 0 |
| December 2005 | 181 | 0 | 0 | 0 | 0 |
| December 2006 | 265 | 119 | 0 | 119 | 45 |
| December 2007 | 2,341 | 733 | 17 | 750 | 32 |
| December 2008 | 51,216 | 35,239 | 9,434 | 44,673 | 87 |
| December 2009 | 22,356 | 17,186 | 1,846 | 19,032 | 85 |
| **Total** | **76,814** | **53,277** | **11,297** | **64,574** | **84** |

Source: OIG analysis based on Call Report data for Florida Community.
Note: The remaining charge-offs of $12.2 million (16 percent) were related to the following types of loans: loans secured by farmland; revolving loans; open-ended loans secured by 1-4 family residential; closed-end loans secured by 1-4 family residential first liens; closed-end loans secured by 1-4 family residential second liens; commercial and industrial loans; loans to individuals; single payment and installment; and all other loans.

Federal banking regulatory agencies issued guidance in December 2006, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), recognizing that there are substantial risks posed by CRE and ADC concentrations.[4] The Joint Guidance specifically notes that concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets have contributed to significant credit losses in the past and that such concentrations may make institutions more vulnerable to cyclical CRE markets.

The Joint Guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. According to the guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the previous criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk.

As shown in Table 3, Florida Community's concentration in ADC loans from 2006 to 2009 exceeded the criteria used to identify institutions that may warrant further supervisory analysis. In addition, ADC loans as a percent of the bank's total capital and total loans were significantly above its peer group[5] averages during the same period.

---

[4] The guidance was issued jointly by the Office of the Comptroller of Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).
[5] Florida Community's peer group included institutions located in a metropolitan statistical area with assets between $300 million and $1 billion.

**Table 3: Florida Community's ADC Concentrations Compared to Peer Group**

| Period Ended | ADC Loans As a Percentage of Total Capital | | | ADC Loans As a Percentage of Total Loans | | |
|---|---|---|---|---|---|---|
| | Florida Community | Peer | Percentile | Florida Community | Peer | Percentile |
| Dec 2006 | 386.08 | 135.57 | 95 | 54.66 | 17.75 | 96 |
| Dec 2007 | 315.30 | 123.67 | 91 | 53.95 | 16.49 | 98 |
| Dec 2008 | 547.30 | 139.17 | 98 | 52.62 | 16.98 | 98 |
| Sept 2009 | 1,033.63* | 92.28 | 99 | 53.56 | 12.35 | 99 |

Source: UBPR data for Florida Community.
* The increase in risk exposure from CRE loans in 2009 was due primarily to the decline in capital levels.

As shown in Table 4, Florida Community's CRE concentrations from 2007 to 2009 also exceeded the CRE concentration criteria in the Joint Guidance. In addition, CRE loans as a percent of total capital and total loans were significantly above the bank's peer group averages from 2007 to 2009.

**Table 4: Florida Community's CRE Concentrations Compared to Peer Group**

| Period Ended | CRE Loans As a Percentage of Total Capital * | | | CRE Loans As a Percentage of Total Loans | | |
|---|---|---|---|---|---|---|
| | Florida Community | Peer | Percentile | Florida Community | Peer | Percentile |
| Dec 2007 | 432.92 | 263.41 | 84 | 74.08 | 35.24 | 97 |
| Dec 2008 | 711.08 | 307.45 | 95 | 68.36 | 38.05 | 94 |
| Sept 2009 | 1,338.86** | 239.24 | 99 | 69.37 | 32.20 | 97 |

Source: UBPR data for Florida Community.
* Percentages for Florida Community and its peer group excluded owner-occupied CRE. We did not include CRE information for 2006 because the Joint Guidance did not require banks to maintain information on non-owner occupied CRE prior to 2007.
** The increase in risk exposure from CRE loans in 2009 was due primarily to the decline in capital levels.

The OFR 2006 examination report stated that the overall condition of the bank was less than satisfactory, and asset quality appeared to be deteriorating. The criticized loans at that examination were all centered in CRE and showed significant underwriting and credit administration weaknesses. According to examiners, the high concentration in CRE loans was alarming in view of the loan underwriting and credit administration weaknesses documented in the examination report. Also, according to the 2007 through 2009 examination reports, several of the bank's internal target limits for CRE and ADC lending appeared excessive given the depressed economic environment of the bank's market area and dismal performance of ADC credits. As previously noted, asset quality deteriorated significantly during the period between the 2007 and 2009 examinations, resulting in adversely classified items that were at an unmanageable level. The losses related to the concentrations caused excessive charge-offs that impaired capital and ultimately the viability of the bank.

## The FDIC's Supervision of Florida Community

Our review focused on supervisory oversight of Florida Community between 2003 and 2009. During that period, the FDIC and the OFR conducted seven onsite risk management examinations and the FDIC monitored current and emerging issues at the bank through its offsite monitoring program. Through those supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's concentrations in CRE and ADC lending, and weak loan underwriting and credit administration policies and practices. In addition, the FDIC and the OFR initiated enforcement actions related to the identified weaknesses after the 2006, 2008, and 2009 examinations.

Florida Community's overall financial condition was considered satisfactory until the 2006 OFR examination. The OFR downgraded the bank to a composite "3" rating at the 2006 examination and pursued a Cease and Desist Order (C&D) to address numerous high-risk practices and deficiencies identified by examiners. At the 2007 examination, the FDIC upgraded Florida Community to a composite "2" rating due to improvements made in its BSA program and in the bank's liquidity. In 2008, the OFR downgraded the bank to a composite "4" rating due to significant deterioration in asset quality and continued loan underwriting and credit administration weaknesses and pursued a second C&D. By the 2009 examination, the FDIC determined that asset quality, capital, and earnings were critically deficient and appeared to be beyond management's ability to control, and further downgraded the bank to a composite "5" rating.

Although the FDIC's supervisory approach was consistent with practices in place at the time for an institution with Florida Community's risk profile, the composite "2" rating assigned at the 2007 examination may not have been representative of the risk management deficiencies and negative trends in financial performance identified in the report. Further, more thorough follow-up at that examination to ensure prior examination recommendations were addressed would have been beneficial in mitigating apparent risks at Florida Community. Specifically, had the FDIC ensured that Florida Community's management addressed the recommendations in the 2003 to 2006 examinations earlier and made improvements to the bank's risk monitoring, underwriting standards, and Board oversight, losses incurred by the DIF, to some extent, may have been mitigated. Ultimately, although the FDIC and the OFR pursued supervisory actions in 2008 and 2009, and Florida Community took steps to address them, the actions and responses were not timely or sufficient to prevent the bank's failure.

### Supervisory History

Table 5 summarizes the supervisory history for Florida Community from 2003 to 2009. In addition to seven risk management examinations conducted by the FDIC and the OFR during this period, the FDIC conducted two visitations at Florida Community.

**Table 5: Florida Community's Examination History from 2003 to 2009**

| Examination/Visitation Start Date | Agency | Supervisory Ratings | Supervisory Action |
|---|---|---|---|
| February 10, 2003 | FDIC | 223122/2 | N/A |
| February 17, 2004 | OFR | 122122/2 | N/A |
| February 14, 2005 | FDIC | 122122/2 | N/A |
| April 17, 2006 | OFR | 233132/3 | C&D |
| January 29, 2007 (Visitation) | FDIC | N/A | N/A |
| March 5, 2007 | FDIC | 233122/2 | N/A |
| April 28, 2008 | OFR | 354433/4 | C&D |
| March 9, 2009 | FDIC | 555554/5 | C&D* |
| December 10, 2009 (Visitation) | FDIC | N/A | N/A |

Source: The FDIC's Virtual Supervisory Information on the Net and examination reports for Florida Community.
* This action was in process at the time the bank was closed.

Offsite Reviews

Florida Community was flagged by the Statistical CAMELS Off-Site Review Program (SCOR)[6] in December 2003, and seven times between June 30, 2007 and June 30, 2009. The SCOR reviews generally noted potential deterioration in asset quality as evidenced by the increased level of non-performing loans; however, the reviews noted that either in-process or upcoming examinations eliminated the need for further offsite action.

Enforcement Actions

The OFR and the FDIC each pursued formal enforcement actions to address weak risk management practices identified by examiners.

**May 2007 C&D.** During the April 2006 OFR examination, Florida Community's condition was found to be less than satisfactory and, as a result, the OFR initiated a C&D against the bank. According to FDIC regional management, the FDIC did not join in the C&D with OFR because the action was originated based on the OFR's examination results and not on a joint examination, and legally the FDIC cannot defend an order that is based solely on a state examination. Florida Community's Board would not stipulate to the C&D and requested an administrative hearing. In October 2006, the OFR issued an Administrative Complaint and Notice of Rights (Complaint), and subsequently served the Complaint on Florida Community. Finally, on May 25, 2007, the OFR and Florida Community agreed to a C&D, which required the bank's Board and management to, among other things:

- Immediately increase their participation in the affairs of the bank.

[6] SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.

- Conduct evaluations to assess the qualifications and performance of all senior managers to determine if each person had the experience commensurate with his or her duties and responsibilities at the bank.

- Recruit and hire any additional or replacement personnel needed to properly staff the bank with qualified experienced officers.

- Maintain a Directors' Loan Committee that would oversee Florida Community's policies, procedures, and compliance with state and federal laws and regulations concerning the bank's lending activities.

- Ensure that Florida Community's Directors received training in the review and underwriting of commercial real estate loans.

- Maintain a viable program to identify, measure, and monitor credit concentrations.

- Establish a credit department.

- Employ a full-time, qualified, experienced Chief Credit Officer who was independent of loan production and would manage, implement, coordinate, and monitor approved loan policies, the quality assessment program, and perform day-to-day loan review.

**October 2008 C&D.** As a result of the adverse findings identified at the April 2008 OFR examination, a C&D was pursued to promote a corrective program. The C&D became effective October 17, 2008 and required the bank to, among other things, address concerns pertaining to management, capital, asset quality, earnings, liquidity, and sensitivity to market risk. The C&D included, but was not limited to, the following provisions:

- Establish a search committee, comprised entirely of outside directors, to identify and recruit new Board members with sufficient expertise to return the bank to a safe and sound condition.

- Develop a Capital Plan to maintain a *Well Capitalized* institution with specific capital ratios.

- Develop a plan to address loan administration and underwriting deficiencies noted in the examination report (Underwriting Plan).

- Develop a written plan to reduce concentrations.

- Review the adequacy of the ALLL.

- Formulate and implement a written plan to improve earnings (Earnings Plan).

- Submit to the Supervisory Authorities for review and comment a written plan for reducing Florida Community's reliance on brokered deposits (Deposit Plan).

**November 2009 C&D.** On November 10, 2009, the FDIC proposed a C&D to address additional weaknesses discovered at the FDIC March 2009 examination. The findings of this examination indicated that management had failed to comply with several key provisions of the 2008 OFR C&D. Further, according to the FDIC, the problems identified at the March 2009 examination were much more severe and, as a result, a new C&D was drafted to replace the existing 2008 OFR C&D. The new areas covered by the proposed FDIC C&D included: (1) implementation of written lending policies to address examination criticisms, including those regarding loan renewals; (2) implementation of a policy limiting the use of loan interest reserves; (3) revision of the internal loan review grading system to address examination concerns; and (4) formulation of a written strategic plan. The C&D was in process but had not been implemented at the time the bank was closed.

### Supervisory Response to Key Risks

FDIC and OFR examiners consistently identified concerns and made recommendations related to the risks associated with Florida Community's CRE loan concentrations and poor risk management practices. The following provides a brief synopsis of examination efforts related to those risks from 2005 to 2009.

#### FDIC February 2005 Examination

Overall, the bank's financial condition was considered satisfactory and the bank was assigned a composite "2" rating. According to examiners, the level and severity of classified, delinquent, and nonperforming assets was moderate; however, weaknesses were noted related to the bank's credit administration and processes for tracking and reporting asset concentrations to the Board. Specifically, the bank had not fully implemented a comprehensive concentration risk management system to identify, measure, monitor, and control the risk associated with asset concentrations. In addition, the bank was cited for an apparent contravention of the *Interagency Guidelines for Real Estate Lending Policies*, Appendix A to Part 365 of the FDIC's Rules and Regulations, because it was not reporting loan exceptions in excess of the supervisory LTV limits to the Board as required by the guidelines. Examiners noted that these issues had been addressed in the prior two regulatory examination reports and had not been adequately resolved by the bank.

#### OFR April 2006 Examination

According to the examination report, the overall condition of the bank was found to be less than satisfactory. The OFR downgraded the bank to a composite "3" rating, citing numerous deficiencies related to CRE concentrations and loan underwriting and credit administration practices. Examiners noted that asset quality had deteriorated from prior examinations, and loan classifications and criticized assets had increased significantly.

The OFR also reported that management was less than satisfactory and was downgraded due to a lack of oversight by the Board and the reluctance to provide risk management practices commensurate with the bank's growth and increased risk profile. Credit administration resources and practices had not kept pace with loan growth and the increases in more sophisticated lending products. Bank management had not established adequate risk processes to identify, measure, monitor, and control concentrations. CRE loans had increased to 737 percent of total capital and exhibited significant loan underwriting and credit administration weaknesses. Examiners warned that if the real estate market was to deteriorate, the bank could be exposed to significant credit losses. As discussed earlier, the OFR initiated a C&D to address the identified weaknesses.

FDIC March 2007 Examination

The examination report described Florida Community's asset quality as less than satisfactory. Adverse classifications had increased to $88.6 million (71.5 percent of capital and reserves), from $44.8 million and $8.7 million as of the 2006 and 2005 examinations, respectively. The level of past-due and nonaccrual loans had increased to 6.47 percent of gross loans compared to the peer average of 1.28 percent. Classified loans were concentrated in ADC loans. Items listed for Special Mention totaled $39.5 million and were identified as such primarily due to lenient underwriting standards, which placed undue reliance on real estate values, and the failure by the bank to establish effective monitoring controls for project financing.

Examiners reported that although Board and management oversight was generally satisfactory, credit risk management practices needed to improve given the bank's size and complexity of lending activities. Declining real estate market prices, sales, and valuations in certain areas were severe and management was not adequately monitoring the exposure. Control of individual credits by the four branch office presidents had contributed to inconsistent and weak loan structuring and loan account monitoring. The bank needed to establishment a Credit Department that prepared credit analyses, reviewed appraisals, conducted periodic analyses of borrowers' and guarantors' financial conditions, and ensured lending activities were consistent with internal underwriting and regulatory standards. Also, weaknesses were identified in the bank's credit policy, global cash flow analyses, appraisal reviews, and project/market analyses. These deficiencies highlighted the need for management to establish more prudent loan portfolio management standards and processes.

The March 2007 examination report noted that asset quality and related credit risk management practices remained in need of improvement. Specifically:

- Asset quality had deteriorated since the OFR April 2006 examination and adversely classified items had significantly increased. Classified assets, as well as those listed for Special Mention, exhibited some loan underwriting and credit administration weaknesses that needed to be addressed, such as inadequate cash flow analysis and outdated financial information on borrowers and guarantors.

- The bank had a large concentration in CRE, comprised largely of land, ADC, and construction loans. Examiners noted that, in light of this type of portfolio, more appropriate risk diversification guidelines were needed.

- Examiners recommended improvements to the loan policy and internal reporting, and advised the bank to change to a more centralized portfolio management structure.

Although the Management component was rated a "3", no supervisory action was pursued to address the deficiencies detailed in the examination report. Further, according to the examination report, the bank received a composite "2" rating based on its strong earnings and capital support, satisfactory funds management practices, and access to sufficient sources of funds on acceptable terms.

OFR April 2008 Examination

Examiners found that the overall condition of Florida Community had deteriorated significantly since the previous FDIC examination and was considered poor and rated the bank a composite "4". The examination report noted that the deterioration was largely the result of poor risk management practices employed by the Board and management, coupled with a general decline in economic conditions in southern Florida. The loan portfolio contained an elevated level of risk due to large concentrations in CRE and ADC loans. In addition, asset quality was unsatisfactory, with adversely classified assets totaling $232 million, or roughly 25 percent of total assets. The level of adversely classified assets had increased 162 percent since the prior examination. According to examiners, operating with this level of adversely classified assets was an unsafe and unsound practice. As a result of the examination findings, the OFR pursued a C&D to correct the identified deficiencies.[7]

FDIC March 2009 Examination

The bank was further downgraded to a composite "5" rating. The examination report stated that the condition of the bank was poor, with performance measures in all areas at critically deficient levels. According to the examination report, over the past several years, management had failed to exert ample supervision over the rapid growth of the loan portfolio, underwriting, and credit risk management, which ultimately resulted in a massive volume of problem assets and credit losses. According to examiners, absent a direct capital infusion or material recovery, the viability of the bank was threatened.

[7] To help the bank meet the minimum capital level requirements stipulated by the 2008 C&D, on December 30, 2008, Florida Community's holding company made a capital contribution of $7.4 million.

### Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. 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 Florida Community, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

On May 5, 2009, the FDIC sent a letter to Florida Community's Board notifying the bank that it was considered *Significantly Undercapitalized* and that it was subject to restrictions on asset growth, dividends, other capital distributions, and management fees. The letter also required the bank to file a written capital restoration plan within 45 days, or no later than June 19, 2009, in accordance with Section 38(e)(2) of the FDI Act. Based on March 31, 2009 call report data, Florida Community's capital levels were:

- Tier I Leverage Ratio: 3.65 percent
- Tier I Risk-Based Capital Ratio: 4.57 percent
- Total Risk-Based Capital Ratio: 5.87 percent

To be considered *Well Capitalized* under PCA, banks must maintain the following capital levels.

- Tier I Leverage Ratio: 5.00 percent
- Tier I Risk-Based Capital Ratio: 6.00 percent
- Total Risk-Based Capital Ratio: 10.00 percent

On May 26, 2009, the FDIC received Florida Community's capital plan. On September 22, 2009, the FDIC notified the bank's Board that the plan had been disapproved because it did not adequately address PCA requirements concerning the specific steps the bank would take to become *Adequately Capitalized*.[8] The plan also did not include the performance guarantees required by Section 38(e)(2)(c) nor was it likely to succeed in restoring the institution's capital.

On October 22, 2009, the FDIC received an amended capital plan from Florida Community. On December 22, 2009, the FDIC notified the bank that the amended plan was not acceptable because it was not based on realistic assumptions and was not likely

[8] The FDIC acted on the bank's capital restoration plan 119 days after receiving the plan, which was beyond the 60 days required under the FDI Act. However, as discussed previously, Florida Community was under an existing C&D that required the bank to develop a Capital Plan to maintain a *Well Capitalized* institution. As a result, in our view, this delay was inconsequential to the supervision and failure of the bank.

to succeed in restoring the institution's capital. During that same timeframe, Florida Community applied for but withdrew an application for $15 million in funding under the U.S. Department of the Treasury's Troubled Asset Relief Program. On January 29, 2010, the OFR closed the bank and appointed the FDIC as receiver.

### Supervisory Lessons Learned

Based on the FDIC's examination findings, it appears that the composite "2" rating assigned at the 2007 examination was not consistent with the financial condition and risk profile of the bank. The 2007 examination report states that composite "2" ratings are assigned to financial institutions that are fundamentally sound. For a financial institution to receive this rating, in general:

- No component rating should be more severe than a "3".
- Only moderate weaknesses are present and are well within the Board's and management's capabilities and willingness to correct.
- These financial institutions are stable and are capable of withstanding business fluctuations.
- These financial institutions are in substantial compliance with laws and regulations.
- Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile.
- There are no material supervisory concerns.

Based on the results of the 2007 examination, it does not appear that the bank exhibited the characteristics listed above. For example, as noted in the FDIC's March 2007 examination report, asset quality had deteriorated since the OFR April 2006 examination and adversely classified items had significantly increased. In addition, examiners noted that more appropriate risk diversification guidelines were needed in light of the fact that the bank had large concentrations in CRE and ADC loans. Further, many of the identified weaknesses were repeat criticisms, indicating the Board's and management's incapability or unwillingness to correct such weaknesses.

We discussed the rationale for upgrading the bank from a composite "3" rating at the 2006 OFR examination to a "2" rating during the 2007 examination with regional office management and field office examiners. We noted that, based on our review of the examination report, safety and soundness issues had not improved and were very similar to the conditions found at the prior examination. According to those individuals we interviewed, profitability, strong earnings, and sufficient capital were difficult for examiners to dismiss when assigning ratings. In that regard, the return on assets was strong at over 2 percent, the bank's capital and earnings ratios were in the top 5 to 10 banks in the country, the ALLL calculation was sound, the net interest margin was

100 basis points over peer, and overhead was low.  Nevertheless, faced with the same circumstances today, examiners would likely place greater emphasis on management practices when assigning ratings as called for in the FDIC's *Forward Looking Supervision* initiative.  This initiative stresses, among other things, the importance of considering high-risk practices as well as financial condition in assessing risk and assigning ratings.

## Corporation Comments

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response, dated August 19, 2010, to the draft report.  That response is provided in its entirety as Appendix 5 of this report.  DSC reiterated the OIG's conclusions regarding the causes of Florida Community's failure.  With regard to our assessment of the FDIC's supervision of Florida Community, DSC summarized the supervisory history, including offsite monitoring activities, described in our report.   Further, DSC recognized that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as Florida Community, and indicated that it had issued a Financial Institution Letter to banks that re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and sets forth broad supervisory expectations.

# Objectives, Scope, and Methodology

## Objectives

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

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

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

## Scope and Methodology

The scope of this audit included an analysis of Florida Community's operations from 2003 until its failure on January 29, 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 FDIC and OFR examiners from 2003 to 2009.

- Reviewed the following:

  - Bank data and correspondence maintained on various FDIC systems.

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

  - Audit reports prepared by the bank's external auditor.

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

## Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:
  - DSC management in the Atlanta Regional Office, and Sunrise, Florida Field Office.
  - DRR officials at the Dallas Regional Office, and Jacksonville, Florida office.
  - FDIC examiners from the DSC Sunrise, Florida Field Office who participated in examinations and visitations of Florida Community.
  - Officials from the OFR to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

We performed the audit work at the OIG office in Arlington, Virginia.

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

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

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

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

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. In that regard, although not consequential to the overall

## Objectives, Scope, and Methodology

supervision of the institution, we note on page 17 that the FDIC did not meet the requirement in section 38 of the FDI Act to ". . . act on capital restoration plans expeditiously, and generally not later than 60 days after the plan is submitted."

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 June 2010, the OIG initiated an audit, the objectives of which are 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.

In addition, with respect to more comprehensive 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, *PCA* 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. |
| | |
| **Bank Secrecy Act (BSA)** | Congress enacted the BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file certain reports, including cash transactions over $10,000 via the Currency Transactions Reports. These reports are used in criminal, tax, or regulatory investigations or proceedings. |
| | |
| **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 pursuant to 12 U.S.C. section 1818 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

| | |
|---|---|
| **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 Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners. |
| **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. |
| **Global Cash Flow Analysis** | A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: a guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan. |
| **Interest Reserve Account** | An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. Frequently, ADC loan budgets will include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sellout or lease-up period. |
| **Loan-to-Value (LTV)** | A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. |
| **Material Loss** | As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million. |

# Glossary of Terms

| | |
|---|---|
| **Nonaccrual Status** | The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status. |
| **Peer Group** | Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. |
| **Prompt Corrective Action (PCA)** | The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized.<br><br>A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions. |
| **Risk-Based Capital** | A “supplemental” capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank’s qualifying total capital base consists of two types of capital elements, “core capital” (Tier 1) and “supplementary capital” (Tier 2). |
| **Special Mention Assets** | A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. |

# Glossary of Terms

| | |
|---|---|
| **Tier 1 (Core) Capital** | Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as<br>**The sum of:**<br>• 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);<br>• Non-cumulative perpetual preferred stock; and<br>• Minority interest in consolidated subsidiaries;<br>**Minus:**<br>• Certain intangible assets;<br>• Identified losses;<br>• Investments in securities subsidiaries subject to section 337.4; and<br>• Deferred tax assets in excess of the limit set forth in section 325.5(g). |
| | |
| **Troubled Asset Relief Program (TARP)** | TARP was established under the Emergency Economic Stabilization Act of 2008, which established the Office of Financial Stability within the Department of the Treasury. Under TARP, Treasury will purchase up to $250 billion of preferred shares from qualifying institutions as part of the Capital Purchase Program. |
| | |
| **Uniform Bank Performance Report (UBPR)** | The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks. |
| | |
| **Uniform Financial Institutions Rating System (UFIRS)** | Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern. |
| | |
| **Wholesale Funding** | Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs. |

# Acronyms

| | |
|---|---|
| ADC | Acquisition, Development, and Construction |
| ALLL | Allowance for Loan and Lease Losses |
| BSA | Bank Secrecy Act |
| C&D | Cease and Desist Order |
| CAMELS | **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk |
| CEO | Chief Executive Officer |
| 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 |
| FHLB | Federal Home Loan Bank |
| LTV | Loan-to-Value |
| OFR | Florida Office of Financial Regulation |
| OIG | Office of Inspector General |
| PCA | Prompt Corrective Action |
| SCOR | Statistical CAMELS Off-Site Rating |
| UBPR | Uniform Bank Performance Report |
| UFIRS | Uniform Financial Institutions Rating System |

Appendix 4

## Florida Community's Weaknesses Identified by Examiners

| Examination Date | Feb 2003 FDIC | Feb 2004 OFR | Feb 2005 FDIC | Apr 2006 OFR | Mar 2007 FDIC | Apr 2008 OFR | Mar 2009 FDIC |
|---|---|---|---|---|---|---|---|
| Rapid growth in loan portfolio | √ | | | √ | | | |
| Lending based on collateral value | √ | √ | | √ | √ | | |
| Not complying with LTV requirements for loans in excess of limits | √ | √ | √ | √ | √ | | |
| No process for out-of-area loan monitoring/ analysis | | | | √ | √ | | |
| Appraisal violations | √ | √ | | | | | √ |
| Weak appraisal review process | | | | √ | √ | √ | |
| Internal loan review process needs improvement | √ | | | √ | | | |
| **CRE Concentrations** | | | | | | | |
| No comprehensive concentration monitoring program | √ | √ | √ | √ | √ | √ | √ |
| No stress testing of CRE loan portfolio | | | | | √ | √ | √ |
| Concentration monitoring needs strengthening | | | | | √ | √ | √ |
| CRE limits/thresholds too lenient/excessive | | | | | √ | √ | √ |
| CRE 2006 Guidance not implemented | | | | | | √ | √ |
| **Underwriting and Credit Administration** | | | | | | | |
| No Chief Credit Officer or credit department | | | | √ | √ | | |
| Ineffective, decentralized credit underwriting process | | | | √ | √ | | |
| Deficient underwriting /credit administration | | √ | √ | √ | √ | √ | √ |
| Need to improve cash flow analyses | √ | √ | | √ | √ | √ | |
| Inappropriate use of interest reserves | | | √ | | √ | | √ |
| Not complying with guidelines for principal reduction at renewal | | | | | √ | √ | √ |
| Need accurate and consistent credit memos | √ | | | | √ | √ | |
| Not obtaining current financials at loan renewal | | | | | √ | | √ |
| Not obtaining new appraisals at loan renewal | | | | | √ | | √ |
| Excessive reliance on extensions and renewals without justification or support | | | | | | | √ |
| **Loan Policy** | | | | | | | |
| Loan policy not consistent with complexity of credit transactions and proposed management structure | | | | | √ | | |
| Loan policy weaknesses: | | | | | | | |
| - CRE concentration strategies | | | | | √ | | |
| - ALLL Interagency Policy (2006) not followed | | | | | √ | √ | |
| - Land underwriting requirements | | | | | √ | | |
| - Guidelines for income-producing properties | | | | | √ | | |
| - Work-out and Special Asset programs | | | √ | | | √ | √ |
| - Interest Reserves | | | | | | | √ |

Source: Reports of Examination.

## Corporation Comments

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

August 19, 2010

**TO:** Stephen Beard
Assistant Inspector General for Material Loss Reviews

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

**SUBJECT**: Draft Audit Report Entitled, Material Loss Review of Florida Community Bank, Immokalee, Florida (Assignment 2010-025)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Florida Community Bank, Immokalee, FL (Florida Community), which failed on January 29, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on July 27, 2010.

Florida Community failed due to deficient Board and management oversight of the bank's risk management practices, specifically those risks associated with the commercial real estate (CRE) and acquisition, development and construction (ADC) loan portfolios. Florida Community pursued an ADC and CRE loan portfolio expansion strategy without implementing risk management, loan underwriting, and credit administration practices commensurate with the increase risk. In addition, from 2004 through 2009, Florida Community relied on noncore funding sources to fuel growth, reflecting a shift in the institution's business plan that called for building a core deposit base to fund asset growth.

From 2004 through 2009, the FDIC and the Florida Office of Financial Regulation (OFR) conducted six onsite risk management examinations. The FDIC also monitored current and emerging issues through its offsite monitoring program. The 2007 FDIC examination noted that the bank's loan portfolio contained an elevated level of risk due to large concentrations in CRE and ADC loans and recommended that management establish an appropriate loan portfolio diversification policy, setting limits to control loan growth by product, market and portfolio segment. However, at the 2008 OFR examination, elevated risk in the CRE and ADC loan portfolios continued, and the level of adversely classified assets increased. As a result, Florida Community was downgraded to a "4" composite rating. By the 2009 FDIC examination, asset quality further deteriorated because management failed to implement effective risk management processes or implement regulatory recommendations. Excessive CRE losses depleted earnings and caused severe capital deficiency, and Florida Community was downgraded to a composite "5" rating. OFR closed Florida Community on January 29, 2010, because of its inability to secure a capital injection or interest a buyer.

In recognition that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, DSC issued a Financial Institution Letter to banks that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

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