Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-11-011

Material Loss Review of Crescent Bank and Trust Company, Jasper, Georgia

January 2011

Office of Inspector General

Executive Summary

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Why We Did The Audit

On July 23, 2010, the Georgia Department of Banking and Finance (GDBF) closed Crescent Bank and Trust Company (Crescent), Jasper, Georgia, and named the FDIC as receiver. On July 29, 2010, the FDIC notified the Office of Inspector General (OIG) that Crescent's total assets at closing were $974.9 million and the estimated loss to the Deposit Insurance Fund (DIF) was $240.8 million. As of December 31, 2010, the estimated loss had increased to $279.8 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.

The objectives were to (1) determine the causes of Crescent'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

Crescent was established in August 1989 as a state-chartered nonmember bank. The institution was wholly owned by the Crescent Banking Company, a publicly traded one-bank holding company. Crescent's principal executive offices were headquartered in Jasper, which is located approximately 60 miles north of Atlanta, Georgia. In addition to its main office, the bank operated 10 branches in Georgia.

The institution's lending activities historically focused on commercial real estate (CRE) in its primary market area of northern Georgia. In 2003, the bank sold its mortgage banking operations and began emphasizing residential acquisition, development, and construction (ADC) loans. In April 2005, Crescent acquired Futurus Financial Services, Inc. (Futurus Financial) and Futurus Bank, N.A., a wholly-owned subsidiary of Futurus Financial. Futurus Financial was a one-bank holding company with approximately $56 million in assets. Futurus Bank, N.A. operated one office in Alpharetta, Georgia and a commercial lending office in Loganville, Georgia. The acquisition provided Cresent an increased presence in the Atlanta metropolitan area.

Audit Results

Causes of Failure and Material Loss

Crescent failed primarily because its Board and management did not effectively manage the risks associated with the institution's aggressive growth and heavy concentration in ADC loans. Notably, Crescent did not maintain capital at levels that were commensurate with the increasing risk in its loan portfolio, reducing the institution's ability to absorb losses due to unforeseen circumstances. Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in Crescent's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. Further, Crescent relied on non-core funding sources, particularly out-of-market and brokered deposits, to support its lending activities and maintain adequate liquidity. These funding sources became restricted when Crescent's credit risk profile deteriorated, straining the institution's liquidity position.

Crescent's heavy concentration in ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the Georgia real estate market. During 2007, conditions in Crescent's primary lending areas began to decline. By year-end 2008, the quality of Crescent's loan portfolio had deteriorated significantly, with the majority of problems centered in ADC loans. Further deterioration occurred in 2009. The associated provisions for loan losses depleted Crescent's earnings, eroded its capital, and strained its liquidity. The GDBF closed Crescent in July 2010 because the institution was unable to raise sufficient capital to support its operations.

The FDIC's Supervision of Crescent

The FDIC, in coordination with the GDBF, provided ongoing supervisory oversight of Crescent through regular on-site examinations, a visitation, 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 and correspondence. Such risks included the bank's significant concentration in ADC loans, weak loan underwriting and credit administration practices, and reliance on non-core funding sources. The FDIC and the GDBF also made numerous recommendations for improvement and imposed informal and formal enforcement actions.

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

The FDIC could have recommended that Crescent reduce its ADC loan exposure and/or hold higher levels of capital commensurate with the bank's risk profile as early as the May 2006 examination. We recognize that (1) Crescent's financial condition was satisfactory and its lending markets were favorable at that time and (2) the December 2006 interagency guidance (Joint Guidance) that defined criteria for identifying institutions potentially exposed to significant CRE and ADC concentration risk had not yet been issued. Nevertheless, the institution was experiencing rapid growth, its ADC loan concentration was high, and its capital level was equal to the minimum threshold for maintaining a *Well Capitalized* status. Increased emphasis on Crescent's capital adequacy during the June 2007 GDBF examination may also have been warranted given the bank's elevated risk profile and less than *Well Capitalized* status. By that time, the Joint Guidance had been issued, providing examiners additional support for taking such action.

Further, a different supervisory approach to Crescent's reliance on non-core funding sources, particularly brokered deposits, to support lending activities may also have been warranted. Specifically, the FDIC approved a brokered deposit waiver in December 2006 that permitted the bank to increase its brokered deposits for the purpose of funding loan growth. As noted earlier, the bank's financial condition was satisfactory and its lending markets were favorable. In retrospect, however, the waiver allowed the bank to assume additional risk. Disapproving the waiver may have influenced the bank to reduce its ADC loan exposure and/or raise additional capital.

Examiners became sharply critical of Crescent's risk management practices during the June 2008 and July 2009 examinations. In addition, the FDIC issued a Cease and Desist (C&D) Order in May 2009 to address the bank's weak risk management practices. However, by that time, the institution's lending

markets were rapidly deteriorating, making remedial efforts difficult. A more proactive supervisory approach, as discussed above, may have influenced the bank to curb its ADC lending, increase its capital levels, and strengthen its risk management controls before the Georgia real estate market deteriorated, potentially mitigating, to some extent, the financial problems experienced by the bank.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, recently 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 ADC lending and funds management practices.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On January 28, 2011, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. In the response, DSC reiterated the causes of Crescent's failure and the supervisory activities described in our 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 and set forth broad supervisory expectations. In addition, the response referenced a 2007 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*. Among other things, this FIL states that FDIC-supervised institutions that engage in aggressive growth strategies or rely excessively on a volatile funding mix are subject to heightened off-site monitoring and on-site examinations that are more extensive than those applicable to other institutions.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: January 28, 2011

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 Crescent Bank and Trust Company, Jasper, Georgia* (Report No. MLR-11-011)

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 Crescent Bank and Trust Company (Crescent), Jasper, Georgia. The Georgia Department of Banking and Finance (GDBF) closed the institution on July 23, 2010, and named the FDIC as receiver. On July 29, 2010, the FDIC notified the OIG that Crescent's total assets at closing were $974.9 million and the estimated loss to the Deposit Insurance Fund (DIF) was $240.8 million. As of December 31, 2010, the estimated loss had increased to $279.8 million. The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

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

The objectives of this material loss review were to (1) determine the causes of Crescent's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Crescent, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Crescent'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 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 in-depth 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.

Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a summary of risk management weaknesses and recommendations contained in examination reports for Crescent. Appendix 3 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 4 contains a list of acronyms. Appendix 5 contains the Corporation's comments on our draft report.

Background

Crescent was established in August 1989 as a state-chartered nonmember bank. The institution was wholly owned by the Crescent Banking Company, a publicly traded one-bank holding company. Crescent's principal executive offices were headquartered in Jasper, which is located approximately 60 miles north of Atlanta, Georgia. In addition to its main office, the bank operated 10 branches in Georgia.

Crescent's lending historically focused on commercial real estate (CRE) in its primary market area of northern Georgia. In 2003, the bank sold its mortgage banking operations and began emphasizing residential acquisition, development, and construction (ADC) loans. In April 2005, Crescent acquired Futurus Financial Services, Inc. (Futurus Financial) and Futurus Bank, N.A., a wholly owned subsidiary of Futurus Financial. Futurus Financial was a one-bank holding company with approximately $56 million in assets. Futurus Bank, N.A. operated one office in Alpharetta, Georgia and a commercial lending office in Loganville, Georgia. The acquisition provided Crescent an increased presence in the Atlanta metropolitan area. Table 1 summarizes selected financial information pertaining to Crescent as of June 30, 2010 and for the 6 preceding years.

Table 1: Financial Information for Crescent, 2004 to 2010

Financial Data ($000s)	Jun-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets	970,235	991,838	1,035,337	916,462	776,823	699,875	506,461
Total Loans	649,858	731,572	786,062	815,238	697,538	594,722	434,762
Total Investments	205,349	191,631	183,941	43,662	32,219	57,011	38,920
Total Deposits	932,809	933,054	937,831	788,622	663,511	585,847	414,766
Time Deposits $100,000 & More	357,735	296,563	295,680	247,006	169,695	144,433	104,058
Brokered Deposits	35,825	66,109	139,616	85,385	23,586	16,523	8,292
Federal Home Loan Bank (FHLB) Borrowings	25,000	28,000	31,000	36,000	38,000	49,000	39,000
Net Income (Loss)	(19,030)	(34,382)	(29,705)	7,326	7,644	4,447	1,120

Source: Uniform Bank Performance Reports (UBPR) and Reports of Condition and Income (Call Report) data for Crescent Posted on the FDIC's Public Web-site.

Causes of Failure and Material Loss

Crescent failed primarily because its Board and management did not effectively manage the risks associated with the institution's aggressive growth and heavy concentration in ADC loans. Notably, Crescent did not maintain capital at levels that were commensurate with the increasing risk in its loan portfolio, reducing the institution's ability to absorb losses due to unforeseen circumstances. Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in Crescent's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. Further, Crescent relied on non-core funding sources, particularly out-of-market and brokered deposits, to support its lending activities and maintain adequate liquidity. These funding sources became restricted when Crescent's credit risk profile deteriorated, straining the institution's liquidity position.

Crescent's heavy concentration in ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the Georgia real estate market. During 2007, conditions in Crescent's primary lending areas began to decline. By year-end 2008, the quality of Crescent's loan portfolio had deteriorated significantly, with the majority of problems centered in ADC loans. Further deterioration occurred in 2009. The associated provisions for loan losses depleted Crescent's earnings, eroded its capital, and strained its liquidity. The GDBF closed Crescent on July 23, 2010 because the institution was unable to raise sufficient capital to support its operations.

Aggressive Growth and ADC Loan Concentration

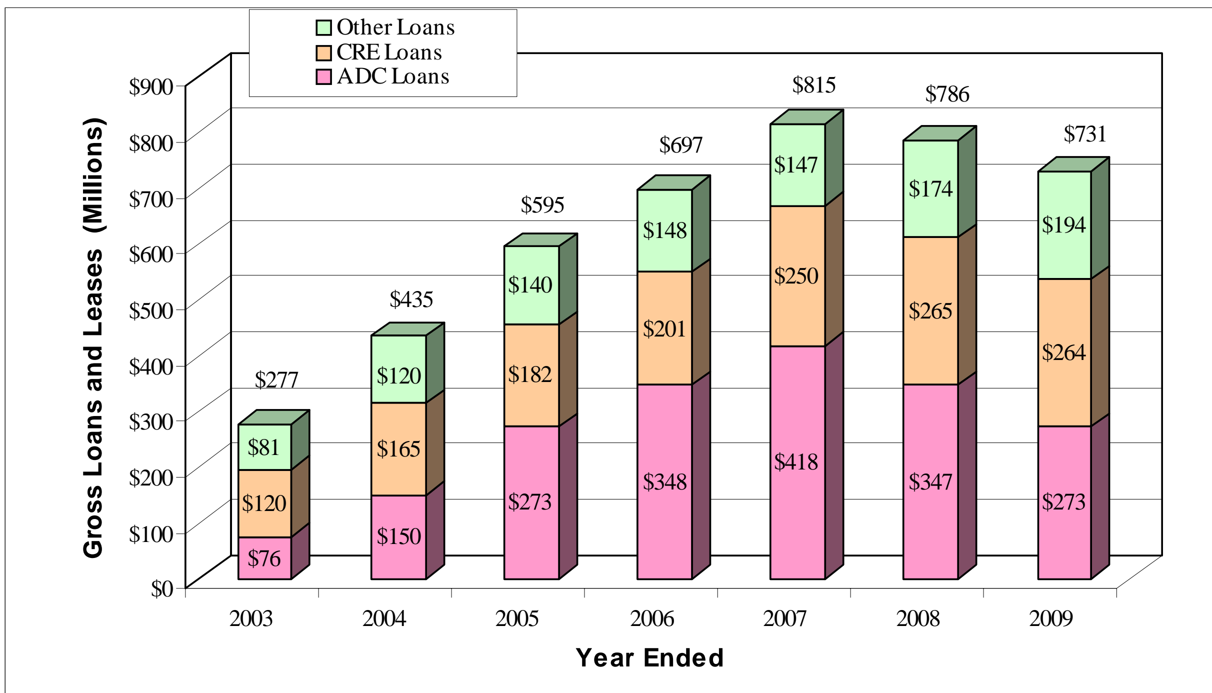
In 2003, Crescent embarked on an aggressive growth strategy centered in CRE and ADC loans in response to a strong real estate market. However, Crescent's Board and management did not effectively manage the risks associated with the institution's rapid growth and ensuing concentrations in CRE and ADC loans. A description of the institution's strategy and risk management practices in this area follows.

Aggressive Growth

During the 4-year period ended December 31, 2007, Crescent grew its loan portfolio almost 300 percent. Contributing to this growth was an increase in total CRE loans (including ADC loans) from \$196 million at year-end 2003 to \$668 million at year-end 2007. During this same period, ADC loans grew from \$76 million (or 27 percent of the loan portfolio) to \$418 million (or 51 percent of the loan portfolio). Crescent's ADC lending included speculative construction and land development projects in northern Georgia.[2] Figure 1 illustrates the general composition and growth of Crescent's loan portfolio in the years preceding the institution's failure.

[2] Speculative construction lending involves the financing of projects for which a buyer has not yet been identified.

Figure 1: Composition and Growth of Crescent's Loan Portfolio, 2003 to 2009



Source: OIG Analysis of Call Report data for Crescent posted on the FDIC's Public Web-site.

CRE and ADC Loan Concentrations

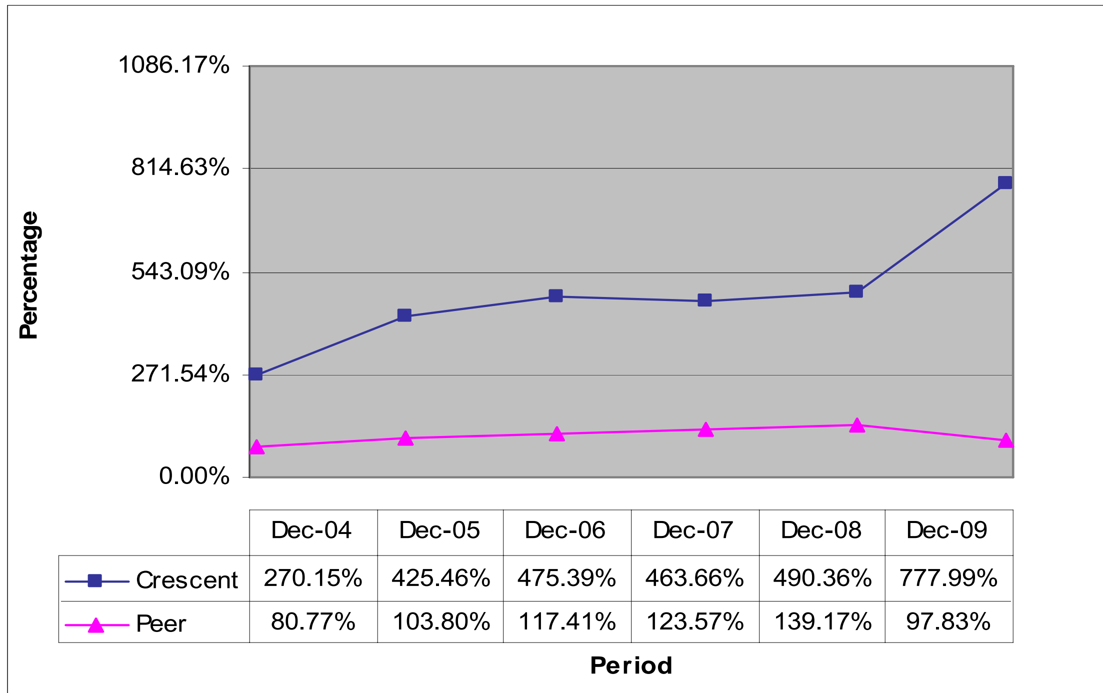
In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The purpose of the Joint Guidance was to 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) representing 100 percent or more of total capital.

As of December 31, 2007, Crescent's non-owner occupied CRE loans represented 617 percent of the institution's total capital. Further, the bank's ADC loan concentration at year-end 2007 represented 464 percent of total capital. Both of these concentrations significantly exceeded the levels defined in the Joint Guidance as possibly warranting further supervisory analysis. Crescent's ADC loan concentration also significantly exceeded the bank's peer group average, as reflected in Figure 2 below.

Figure 2: Crescent's ADC Loan Concentration Compared to Peer Group



	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09
Crescent	270.15%	425.46%	475.39%	463.66%	490.36%	777.99%
Peer	80.77%	103.80%	117.41%	123.57%	139.17%	97.83%

Source: UBPRs for Crescent.
Note: The increase in ADC as a percentage of total capital during 2009 was largely attributable to a decrease in capital rather than new ADC lending.

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.

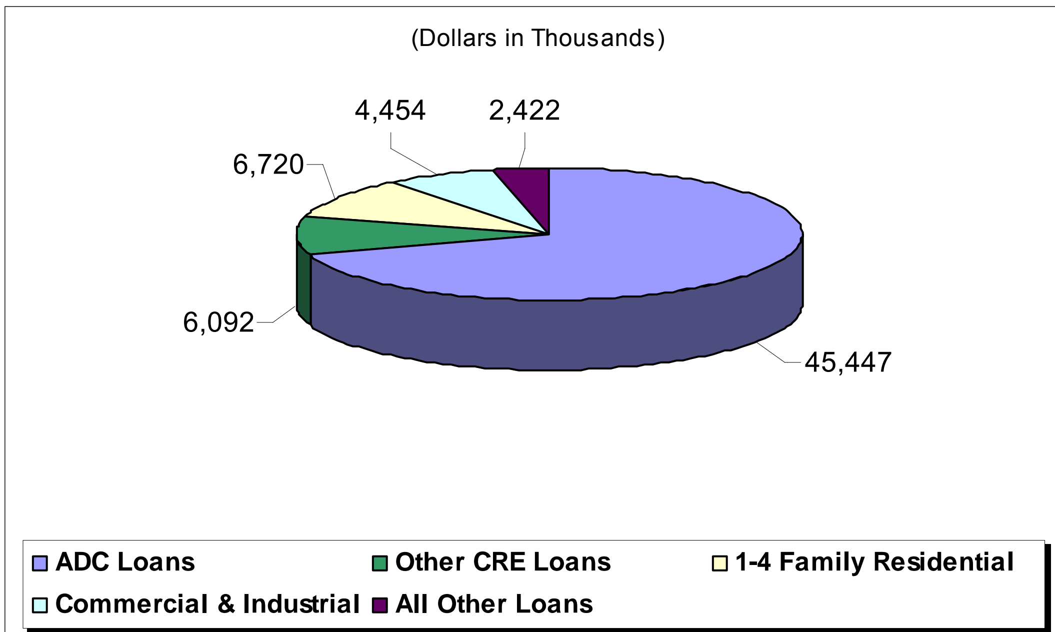
Although Crescent had implemented certain controls for managing its CRE and ADC loan concentrations, its concentration risk management practices were not adequate. Among other things, the institution's ADC loan concentration limits were high. Specifically, Crescent's loan policy allowed ADC concentrations of up to 500 percent of the bank's Tier 1 Capital on a funded basis (and 750 percent of Tier 1 Capital on a committed basis), exposing the institution to potential adverse market conditions. In addition, prior to the June 2008 examination, the loan policy did not contain limits for certain key CRE and ADC subcategories, such as speculative and pre-sold development and construction loans.

Further, the institution did not stress test its CRE and ADC loan portfolios to assess the impact that various economic scenarios might have on the institution's asset quality, capital, earnings, and liquidity as described in the Joint Guidance. The bank had also not developed a formal contingency plan to mitigate the risks associated with its ADC loan concentration in the event of adverse market conditions.[3]

ADC Loan Losses

At the time of the June 2008 examination, Crescent's adversely classified assets were $96.1 million (or 106 percent of Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL)), posing significant risk to the institution. Approximately $88 million of the classifications consisted of loans, the majority of which were ADC loans. By the July 2009 examination, adversely classified assets had increased to $266.2 million (or 378 percent of Tier 1 Capital plus the ALLL). The majority of these classifications consisted of ADC loans. In its final Call Report for the quarter ended June 30, 2010, Crescent reported that nearly 17 percent of its total loan portfolio was in non-accrual status. Further, about 66 percent of the bank's ADC loan portfolio was not performing at that time. As reflected in Figure 3, the majority of loan charge-offs between December 31, 2005 and June 30, 2010 pertained to ADC loans.

Figure 3: Crescent's Net Charge-offs on Loans and Leases as of June 30, 2010



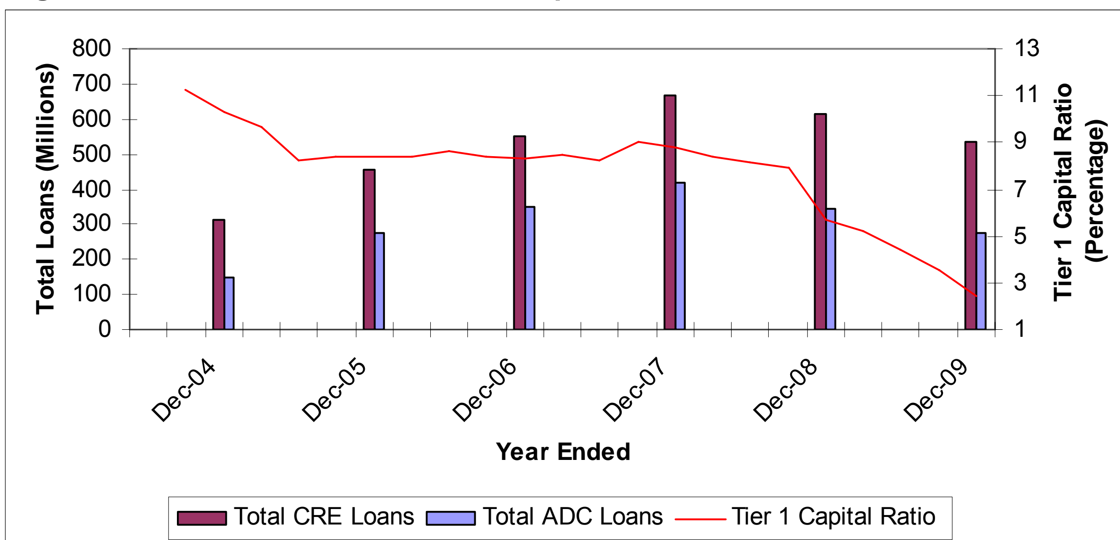
Source: Call Reports for Crescent.

[3] 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. Contingency plans facilitate a proactive (rather than reactive) approach to dealing with adverse market conditions.

Capital Levels Relative to CRE and ADC Loan Growth

While risk in the loan portfolio increased due to Crescent's aggressive ADC loan growth, capital levels remained relatively constant or declined. This trend limited the bank's ability to absorb losses due to unforeseen circumstances and contributed to the losses incurred by the DIF when the institution failed. Figure 4 illustrates the trend in Crescent's Tier 1 Capital relative to CRE and ADC loans.

Figure 4: Trend in Crescent's Tier 1 Capital Relative to CRE and ADC Loan Growth



Source: UBPRs for Crescent.

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 Examination Manual indicates that 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. Between 2005 and 2008, Crescent's capital ratios were either *Adequately Capitalized* or only slightly above *Well Capitalized*. Notably, Crescent's Capital Policy approved by the Board in February 2006 allowed the bank to maintain an *Adequately Capitalized* position. However, such a capital position was not commensurate with the bank's risk profile. Maintaining higher capital levels may have restrained Crescent's loan growth and/or limited, to some extent, the losses incurred by the DIF.

Oversight of the Lending Function

Ineffective Board and management oversight of the lending function contributed to the asset quality problems that developed when economic conditions in Crescent's lending markets deteriorated. Except for the May 2006 examination, examiners noted weak loan underwriting, credit administration, and related monitoring practices during every examination and visitation conducted between 2005 and the bank's failure. These weaknesses, which were most prevalent in the June 2008 examination report, are briefly

described below. Also see Appendix 2 for a summary of risk management weaknesses and recommendations in examination reports issued between 2005 and 2009.

Loan Underwriting

Weak underwriting practices included:

- **Borrower Equity.** The bank often required little borrower equity and guarantor support when originating and renewing ADC loans. Examiners noted that the bank had a large number of loans that exceeded the supervisory loan-to-value (LTV) limits defined in Appendix A, *Interagency Guidelines for Real Estate Lending Policies*, to Part 365 of the FDIC Rules and Regulations, *Real Estate Lending Standards* (Interagency Guidelines).[4] In addition, examiners noted that the bank sometimes originated loans based on LTV ratios that were just under the LTV limits defined in the Interagency Guidelines. Such practices introduced additional risk because a relatively small decline in real estate values could result in increased LTV exceptions.

- **Global Cash Flow Analyses.** The institution did not perform adequate global cash flow analyses of borrowers or guarantors when loans were originated or renewed. For example, contingent liabilities and debt service requirements of borrowers were often not fully considered. In addition, the progress of the borrowers' other real estate projects funded by other institutions was not considered. Such analyses can provide early indications of problems.

- **Loan Agreements.** The bank did not establish loan agreements for some construction and development loans. Such agreements are an important step in holding a borrower accountable for achieving basic performance guidelines and protecting the bank's interest. For example, loan agreements can include provisions that require minimum debt service coverage ratios, liquidity ratios, and equity requirements for borrowers.

- **Loan Renewals, Extensions, and Modifications.** Crescent frequently renewed, extended, or modified loans without taking adequate steps to ensure that the borrower had the capacity to repay the loan or without identifying viable exit strategies.

- **Loan Approvals.** In some cases, loan terms approved by the Board differed from actual loan terms without any written explanation for the deviation.

[4] The Interagency Guidelines recognize that there may be circumstances in which it is appropriate to originate or purchase loans with LTV ratios that exceed the LTV limits in the guidelines, if justified by other credit factors. In such cases, the loans should be identified in the institution's records and their aggregate amount reported at least quarterly to the institution's Board.

Credit Administration and Related Monitoring

Weak credit administration and related loan monitoring practices that were reported by examiners included:

- **Inspection and Draw Procedures.** Collateral inspections for construction and development projects were sometimes not available for examiner review. In some cases, construction projects were overfunded based on the percentage of the project that had actually been completed, and loan disbursement files lacked invoices to support draw requests or lien waivers from subcontractors. Further, the bank's loan policy did not contain guidelines for monitoring development and construction loan disbursements.

- **Interest Reserves.** The bank did not adequately track or monitor interest reserves on its ADC loans. Although at least half of the bank's ADC loans had an interest reserve component at the time of the June 2007 examination, the bank's loan policy did not include guidance regarding the use of interest reserves.

- **Appraisal Reviews.** The June 2008 examination report noted that the loan policy did not establish procedures for an effective appraisal review program. Management allowed loan officers to conduct appraisal reviews after loan funds had been disbursed. The lack of appropriate appraisal reviews resulted in apparent violations of section 323.4 of the FDIC Rules and Regulations for minimum appraisal standards as well as contraventions of the *Statement of Policy on Interagency Appraisal and Evaluations Guidelines* for an effective appraisal review program.

- **Feasibility Studies.** Loans for some construction projects lacked adequate feasibility studies and risk analyses.

- **LTV Exception Reporting.** Management reports on LTV loan exceptions submitted to the institution's Board were often inaccurate because they did not include all exceptions, thus limiting the institution's ability to effectively manage the risks associated with high LTV loans.

- **Loan Files.** Loan files often lacked sufficient or current financial information on borrowers, guarantors, and construction projects (e.g., financial statements, appraisals, and real estate tax returns).

Reliance on Non-core Funding Sources

In the years preceding its failure, Crescent relied on non-core funding sources, such as out-of-market and brokered deposits and Federal Home Loan Bank (FHLB) borrowings, to fund its loan growth and maintain adequate liquidity. 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 other restrictions when the credit risk profile of an institution deteriorates. In addition, institutions become subject to limitations on the interest rates they can offer on deposits when the institutions fall below *Well Capitalized*. 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.

During 2007 and the first quarter of 2008, Crescent significantly increased its use of out-of-market and brokered deposits to fund loan growth. Specifically, out-of-market and brokered deposits increased from $79 million (or almost 12 percent of total deposits) to $201.1 million (or approximately 25 percent of total deposits). Management determined that the costs of these deposits were less than the cost of deposits with similar maturities in the bank's local market area. As discussed more fully in *The FDIC's Supervision of Crescent* section of this report, the FDIC permitted the bank to increase its brokered deposits during 2007 while the institution was operating under an FDIC-approved brokered deposit waiver. During the last 9 months of 2008, Crescent determined that the cost of out-of-market and brokered deposits had increased to levels equal to or exceeding the cost of funds in the bank's local market. At year-end 2008, Crescent's out-of-market and brokered deposits totaled $240.1 million. While Crescent's out-of-market and brokered deposits were increasing, its FHLB borrowings were decreasing. Specifically, as of December 31, 2008, the bank's FHLB borrowings totaled $31 million, down from $36 million at year-end 2007 and $38 million at year-end 2006.

In August 2007, Crescent received a $10 million capital infusion following the closing of a Trust Preferred Securities offering, resulting in the bank returning to a *Well Capitalized* position. However, the June 2008 examination identified significant deterioration in Crescent's financial and operational condition. Based on the results of the examination, the bank's Board adopted an Action Plan to address key issues and concerns raised by examiners. The plan included a goal to reduce brokered deposits from approximately $149.2 million (or 16 percent of total deposits) as of September 30, 2008 to $75 million (or about 9 percent of total deposits) by year-end 2009. By the close of 2008, Crescent had fallen back to *Adequately Capitalized* and was again prohibited from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. Crescent's *Adequately Capitalized* position also resulted in limits on the interest rates that the bank could offer on its time deposits, including out-of-market deposits. Crescent did not request a brokered deposit waiver after it fell to *Adequately Capitalized* at year-end 2008. In its March 31, 2009 Call Report, Crescent reported an *Undercapitalized* position, which, by statute, prohibited the bank from accessing brokered deposits.

During 2008 and 2009, Crescent worked to replace its maturing brokered deposits with other funding sources. By the close of 2009, brokered deposits stood at about $66.1 million, or 7 percent of the bank's $933 million in total deposits. However, Crescent's inability to access funding sources, such as FHLB borrowings and brokered deposits, was straining its liquidity. In its Annual Report on Form 10-K (Annual Report) filed with the Securities and Exchange Commission (SEC) for the fiscal year-ended

December 31, 2009, Crescent's parent holding company stated that the bank's potential lack of liquidity sources raised substantial doubt about its ability to continue to as a going concern. Further, examiners determined during the July 2009 examination that the rates Crescent was paying on certain of its time deposits failed to comply with Part 337 of the FDIC Rules and Regulations. Under the FDIC Rules and Regulations, such deposits are considered brokered deposits.

The FDIC's Supervision of Crescent

The FDIC, in coordination with the GDBF, provided ongoing supervisory oversight of Crescent through regular on-site examinations, a visitation, 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 and correspondence. Such risks included the bank's significant concentration in ADC loans, weak loan underwriting and credit administration practices, and reliance on non-core funding sources. The FDIC and the GDBF also made numerous recommendations for improvement and imposed informal and formal enforcement actions.

A general lesson learned with respect to weak risk management practices is that early supervisory intervention is prudent, even when an institution is considered *Well Capitalized* and has relatively few classified assets. In this regard, recognizing that Crescent's financial condition and markets were generally favorable during earlier examinations, the FDIC could have placed greater emphasis on Crescent's risk management practices when determining supervisory responses to key risks identified at the time. Examiners became sharply critical of Crescent's risk management practices during the June 2008 and July 2009 examinations. In addition, the FDIC issued a Cease and Desist (C&D) Order in May 2009 to address the bank's weak risk management practices. However, by that time, the institution's financial condition and lending markets were rapidly deteriorating, making remedial efforts difficult. A more proactive supervisory approach may have influenced the bank to curb its ADC lending, increase its capital levels, and strengthen its risk management controls before the Georgia real estate market deteriorated, potentially mitigating, to some extent, the financial problems experienced by the bank.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, recently 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 ADC lending and funds management practices.

Supervisory History

Between 2005 and 2010, the FDIC and the GDBF conducted five onsite examinations and one visitation of Crescent. Such on-site examination activity was consistent with relevant regulatory requirements.[5] The scope of our work focused on the FDIC's supervision of the bank between 2005 and the bank's closure in July 2010. Table 2 summarizes key supervisory information pertaining to the examinations and visitation.

Table 2: Onsite Examinations and Visitation of Crescent

Examination Start Date	Examination or Visitation	Regulator	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken*
3/15/10	Visitation	FDIC	555555/5	C&D Still in Effect
7/27/09	Examination	FDIC/GBDF	555555/5	C&D Still in Effect
6/17/08	Examination	FDIC	344443/4	C&D Effective May 11, 2009
6/4/07	Examination	GBDF	222232/2	None
5/15/06	Examination	FDIC	222222/2	None
4/18/05	Examination	GBDF	222322/2	BBR from Prior Examination Still in Effect

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for Crescent.
* Informal corrective actions often take the form of Bank Board Resolutions (BBR) or Memoranda of Understanding. Formal corrective actions often take the form of C&Ds, Supervisory Directives, and under severe circumstances can include insurance termination proceedings.

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[6] to help identify potential supervisory concerns. The FDIC's offsite monitoring procedures did not identify serious concerns at Crescent until July 2, 2008, at which time an offsite review of the bank's March 31, 2008 Call Report noted problems. Among other things, the review found that the bank's return on average assets was -0.69 percent, non-performing assets represented 25 percent of Tier 1 Capital plus the ALLL, and ADC loans represented 503 percent of total capital. The offsite review also found that the bank's risk profile was trending higher. Since an onsite examination of Crescent had begun the prior month, no additional offsite action was taken at that time. Based on the results of the June 2008 examination, the FDIC, working in coordination

[5] 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.

[6] 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 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.

with the GDBF, issued a C&D in May 2009. Among other things, the C&D required Crescent to:

- ensure an increased level of participation by its Board in the affairs of the bank,
- maintain a Tier 1 Leverage Capital ratio of 8 percent or more and a Total Risk-Based Capital ratio of 10 percent or more,
- reduce its credit concentrations and improve its monitoring procedures,
- reduce its reliance on non-core funding sources and develop a liquidity contingency funding plan that included restrictions on the use of brokered and internet deposits, and
- discontinue accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC.

Supervisory Response to Crescent's Weak Risk Management Practices

In the years preceding Crescent's failure, the FDIC and GDBF 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 recommendations. In addition, the FDIC, in coordination with the GDBF, implemented a BBR in 2004 and a C&D in 2009. A brief summary follows.

2005 Supervisory Activities

Examiners determined during the April 2005 examination that Crescent's overall financial and operational condition was satisfactory. At that time, conditions in the bank's lending markets were favorable and the institution's adversely classified assets were at a manageable level. However, the examination report identified a number of weak risk management practices and included recommendations for improvement. Notably, examiners recommended that the bank better monitor its loan concentrations and amend its loan policy to establish risk tolerance limits for its ADC loan concentration. At the time of the examination, the bank was experiencing significant growth, and its ADC loan concentration represented 237 percent of Tier 1 Capital.

The examination report also noted that Crescent's loan underwriting and credit administration practices needed improvement. For example, examiners noted that more than half of the loan files reviewed lacked relevant documentation, the terms of some loans differed from what had been formally approved by the bank, inspection and draw procedures for construction loans were not adequate, and apparent violations of laws and regulations existed with respect to the lending function. A number of the underwriting and credit administration weaknesses had already been included in an April 22, 2004 BBR adopted by Crescent based on the results of the prior examination conducted in February 2004.

Examiners determined that Crescent's capital position was satisfactory. Management advised the examiners during the April 2005 examination that the bank's goal was to maintain a *Well Capitalized* position, with a Tier 1 Leverage Capital ratio above 8 percent. Based on the bank's planned asset growth, new capital would be raised as needed to maintain the bank's *Well Capitalized* position. While the bank continued to be profitable, examiners determined that earnings were less than satisfactory, limiting to some extent, the ability of earnings to augment capital.

2006 Supervisory Activities

During the May 2006 examination, examiners determined that Crescent's overall financial and operational condition continued to be satisfactory. Conditions in Crescent's lending markets continued to be favorable and the bank's adversely classified assets decreased slightly from the prior examination. However, the examination report noted that the bank was continuing its aggressive growth strategy and that substantial additional growth was projected into 2007. According to information contained in the report, we determined that the bank's ADC loan concentration had increased to over 400 percent of Tier 1 Capital and the bank had a substantial volume of real estate loans exceeding the LTV limits defined in the Interagency Guidelines. The report noted that the bank's rapid growth, ADC loan concentration, and high number of LTV loan exceptions were collectively increasing the bank's risk profile. However, examiners concluded that the bank's ADC loan concentration was satisfactorily monitored and managed and that the bank had addressed all of the loan underwriting and credit administration weaknesses identified in the prior examination report.

Although Crescent's Tier 1 Leverage Capital ratio remained above the bank's 7 percent target benchmark, the bank's Total Risk-Based Capital ratio was exactly 10 percent, which is the minimum level of such capital required to be designated as *Well Capitalized* for PCA purposes. In addition, examiners determined that the bank's earnings had improved following the prior examination, due in large part to the high yields associated with the bank's emphasis on ADC loans. In its September 30, 2006 Call Report, Crescent reported that its Total Risk-Based Capital ratio had declined to 9.99 percent. As a result, the bank fell to *Adequately Capitalized* and was restricted from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC. The FDIC received an application for a brokered deposit waiver from Crescent on November 21, 2006. The application requested that the prohibition on brokered deposits be waived for up to 1 year to support the bank's continued loan growth. As of September 30, 2006, Crescent's brokered deposits totaled $17.9 million (or 2.8 percent of total deposits). According to information provided with the application, Crescent planned to increase its brokered deposits to $80 million (or 12 percent of total deposits) by September 30, 2007.

Crescent's management advised the FDIC that brokered deposits represented a cost-effective alternative to local funding sources. In addition, the bank's out-of-market certificates of deposit, which included brokered deposits, were limited by bank policy to no more that 30 percent of total deposits. Further, management projected that future earnings would support the bank's planned asset growth and result in stable capital ratios. Moreover, management had successfully raised capital in the past to support loan growth

and anticipated no problems doing so again, if needed. Based on these and other factors, the FDIC determined that approving a brokered deposit waiver would not represent an unsafe or unsound practice. Accordingly, in a letter dated December 15, 2006, the FDIC approved a waiver of up to $80 million in brokered deposits through September 30, 2007.

2007 Supervisory Activities

Examiners determined during the June 2007 examination that Crescent's overall financial and operational condition remained satisfactory. In addition, the bank's adversely classified assets had only increased slightly following the prior examination and the bank had lowered its projected annual asset growth rate from about 40 percent during the prior examination to 12 percent. The examination report noted that the bank's ADC loan concentration had increased to 414 percent of Tier 1 Capital and that four credit concentrations with large borrowing relationships existed. The four concentrations ranged from 25 to 48 percent of Tier 1 Capital. Examiners recommended that the bank strengthen its industry and individual concentration reporting practices.

Examiners determined that the bank's loan underwriting and credit administration practices were generally adequate, although weaknesses in some areas were noted. For example, the report stated that the bank needed to better monitor and track its use of interest reserves for ADC loans, modify the loan policy to ensure appropriate Board or Loan Committee approvals of large borrowing relationships, and create a report to aggregate loan relationships.[7] Examiners also identified apparent violations with respect to appraisals, LTV exceptions, and loan approvals.

Although examiners assigned a Capital component rating of "2" during the June 2007 examination, the examination report noted that Crescent was *Adequately Capitalized* and continued to operate under a brokered deposit waiver. Further, the bank's liquidity position had deteriorated and was less than satisfactory. Specifically, the bank had a relatively low liquidity level and outside sources of liquidity were limited. According to the examination report, the bank's capital level, earnings, and credit concentrations created a heightened risk profile that necessitated a comprehensive report for calculating sources and uses of funds to help measure, monitor, and control liquidity risk. Examiners also recommended that the bank strengthen its Liquidity Policy to include a formal contingency plan outlining the bank's primary and secondary sources of liquidity.

Between December 31, 2006 and June 30, 2007 (much of the period during which the bank relied on the waiver to access brokered deposits), the bank took advantage of the brokered deposit waiver and increased brokered deposits from $23.6 million to $67.6 million. According to Crescent's Quarterly Report on Form 10-Q filed with the SEC for the quarter ended June 30, 2007, the bank mainly used out-of-market and brokered deposits to fund loan growth during the first half of 2007. In August 2007, Crescent raised new capital, resulting in the bank reporting a *Well Capitalized* position in

[7] Such a report would be used to monitor and report the risks associated with multiple loans dependent upon the strength of one or a few borrowers.

its September 30, 2007 Call Report. As a result, the bank no longer needed a waiver to solicit, renew, or roll over brokered deposits.

2008 Supervisory Activities

During the June 2008 examination, examiners determined that Crescent's overall condition was unsatisfactory and downgraded the bank's composite rating to a "4." Conditions in the bank's lending markets were deteriorating and the bank's adversely classified assets totaled $96 million, or 106 percent of Tier 1 Capital plus the ALLL, posing significant risk to the institution. The majority of asset quality problems were centered in ADC loans. The examination report noted that the bank's ADC loan concentration had increased to 522 percent of Tier 1 Capital, exceeding the bank's loan policy limit of 500 percent of Tier 1 Capital. Examiners recommended that the bank develop plans to reduce its ADC loan concentration to a level within the bank's policy limitations and establish sub-limits on speculative and pre-sold development and construction loans. Examiners also recommended that the bank enhance its procedures for monitoring the ADC concentration.

The examination report identified numerous loan underwriting, credit administration, and related monitoring weaknesses and included recommendations for improvement. Among other things, the report stated that the bank needed to improve collateral inspections; loan disbursements; appraisal reviews; file documentation; and compliance with laws, regulations, and statements of policy.[8] Of particular note, the report stated that the bank had not established adequate controls over interest reserves used on ADC loans. The prior examination report had identified a similar deficiency. Although the bank continued to be *Well Capitalized* for PCA purposes, examiners determined that the bank's capital ratios were marginally adequate for its risk profile and recommended that the bank develop a capital plan.

The examination report further stated that the bank relied on non-core funding sources to support its growth and that its liquidity levels were deficient. In addition, the liquidity contingency plan developed in response to a prior examiner recommendation was found to be inadequate for the bank's risk profile. Examiners made several recommendations to improve the bank's liquidity risk profile, including reducing the bank's dependence on brokered deposits and developing a comprehensive contingency funding plan that addressed, among other things, statutory restrictions on brokered deposits.

The FDIC pursued a C&D to address the findings of the June 2008 examination. However, the C&D was not implemented until May 2009, approximately 8 months after the completion of the examination on September 30, 2008. In the interim, Crescent's Board passed a resolution on October 16, 2008 to adopt an Action Plan that addressed the findings of the June 2008 examination. Among other things, the plan called for reducing the ADC loan concentration; recognizing and/or reserving for troubled assets; and reducing non-core funds, including brokered deposits. Similar to an informal enforcement

[8] See *Oversight of the Lending Function* in the *Causes of Failure and Material Loss* section of this report for more information on Crescent's weak underwriting, credit administration, and related monitoring practices.

action, bank management provided the FDIC and the GDBF with periodic status reports describing its efforts to address the items contained in the Action Plan.

2009 and 2010 Supervisory Activities

During the July 2009 examination, examiners identified further significant deterioration in Crescent's financial and operational condition and downgraded the bank's composite rating to a "5." At the time of the examination, adversely classified assets totaled 377 percent of Tier 1 Capital and the ALLL. Examiners attributed much of the deterioration to excessive ADC loan exposure. Although the bank had not originated many new loans following the prior examination, the administration of existing loans was weak. For example, examiners noted instances in which loans were renewed without adequate financial analysis. Apparent violations of regulations and contraventions of statements of policy also existed. Further, examiners determined that Crescent's capital was critically deficient in relation to the bank's risk profile and that secondary sources of funding were unavailable, elevating the bank's liquidity risk profile. In addition, examiners found that compliance with critical provisions of the May 2009 C&D, including provisions pertaining to capital adequacy and brokered deposits, had not been achieved. Absent the sale of the bank or a substantial capital infusion, examiners determined that the probability of the bank's failure was significant.

The FDIC conducted a limited scope visitation in March 2010 to assess the bank's financial condition and compliance with the C&D. Examiners found further deterioration in the bank's condition. Among other things, classified assets had increased to 550 percent of Tier 1 Capital, earnings were critically deficient, and a significant provision was needed to replenish the ALLL. Further, the bank was *Critically Undercapitalized* for PCA purposes. Although management had put forth efforts to comply with the C&D, the bank remained in non-compliance with several of the order's provisions. The GDBF closed the institution on July 23, 2010 because it did not have enough capital to continue safe and sound operations.

Supervisory Lessons Learned

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

Examiners recommended during the April 2005 examination that Crescent establish risk tolerance limits for its loan concentrations. The bank established such limits for ADC loans, but the limits were high.[9] At the time the May 2006 examination was conducted, Crescent's financial condition was satisfactory, its lending markets were favorable, and the December 2006 Joint Guidance had not yet been issued. Nevertheless, the institution

[9] Crescent's loan policy allowed ADC loan concentrations of up to 500 percent of Tier 1 Capital on a funded basis and up to 750 percent of Tier 1 Capital on an unfunded basis.

was experiencing rapid growth centered in ADC loans and its ADC loan concentration was more than 400 percent of Tier 1 Capital. Further, many of Crescent's loans had high LTV ratios and the bank's Total Risk-Based Capital ratio was exactly 10 percent, the minimum threshold for maintaining a *Well Capitalized* status. Therefore, with the benefit of hindsight, examiners could have recommended that Crescent reduce its ADC loan exposure and/or hold higher levels of capital commensurate with the bank's risk profile.

A more critical assessment of Crescent's capital adequacy during the June 2007 examination conducted by the GDBF may also have been warranted. Specifically, examiners could have lowered the Capital component rating below a "2" to reflect the bank's increased risk profile and less than *Well Capitalized* status. At that time, the Joint Guidance had been issued, providing examiners additional support for taking such action. Further, additional follow-up to ensure that the bank promptly and adequately addressed the loan underwriting and credit administration weaknesses identified during the June 2007 examination may have been beneficial. During the June 2008 examination, examiners noted weaknesses that had been identified in prior examinations pertaining to interest reserves, LTV exception reporting, appraisal reviews, and contingency funding planning.

Finally, a different supervisory approach to Crescent's reliance on non-core funding sources, particularly brokered deposits, to support lending activities may have been warranted. Specifically, the FDIC approved a brokered deposit waiver in December 2006 that permitted the bank to increase its brokered deposits for the purpose of funding loan growth. As noted earlier, the bank's financial condition was satisfactory and its lending markets were favorable at that time. In retrospect, however, the waiver allowed the bank to assume additional risk. The Examination Manual notes that rapid asset growth funded by potentially volatile liabilities is an early warning indicator of risk. Disapproving the waiver may have influenced the bank to reduce its ADC loan exposure and/or raise additional capital.

Examiners became sharply critical of Crescent's risk management practices during the June 2008 and July 2009 examinations. In addition, the FDIC issued a C&D in May 2009 to address the bank's weak risk management practices. However, by that time, the institution's lending markets were rapidly deteriorating, making remedial efforts difficult. A more proactive supervisory approach as described above may have influenced the bank to curb its ADC lending and strengthen its risk management controls before the Georgia real estate market deteriorated, potentially mitigating, to some extent, the financial problems experienced by the bank.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, recently 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 ADC lending and funds management practices. For example, the FDIC issued Financial Institution Letter (FIL)-

22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterates broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations. With respect to funds management practices, the FDIC had issued FIL-84-2008, entitled *Liquidity Risk Management*, which highlights the importance of contingency funding plans in addressing relevant stress events and requirements governing the acceptance, renewal, or roll-over of brokered deposits.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible 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 Crescent, the FDIC properly implemented applicable PCA provisions of section 38. Notably, the FDIC formally notified the bank when its capital category changed, reviewed 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. Table 3 illustrates Crescent's capital levels relative to the PCA thresholds for *Well Capitalized* institutions as reported by the institution 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 3: Crescent's Capital Levels, 2005 to 2010

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
PCA Threshold	**5% or more**	**6% or more**	**10% or more**	***Well Capitalized***
Dec-05	8.36%	8.99%	10.04%	*Well Capitalized*
Dec-06	8.31%	8.82%	9.91%	*Adequately Capitalized*
Dec-07	8.82%	9.27%	10.40%	*Well Capitalized*
Dec-08	5.72%	7.04%	8.31%	*Adequately Capitalized*
Dec-09	2.45%	3.16%	4.43%	*Significantly Undercapitalized*
June-10	0.60%	0.79%	1.58%	*Critically Undercapitalized*

Source: UBPRs for Crescent.

Crescent was considered *Well Capitalized* for PCA purposes until the institution filed its September 30, 2006 Call Report reflecting an *Adequately Capitalized* position. Crescent's December 31, 2006 Call Report indicated that the bank remained *Adequately Capitalized*. In a letter dated February 8, 2007, the FDIC notified Crescent's Board that the bank was *Adequately Capitalized*.[10] The letter included a reminder that *Adequately Capitalized* institutions are restricted from soliciting, accepting, or rolling over brokered deposits without a waiver from the FDIC. As previously discussed, Crescent was operating under a brokered deposit waiver that had been approved in December 2006 and, in August 2007, received a capital infusion of $10 million. As a result, the bank reported a *Well Capitalized* position in its September 30, 2007 Call Report.

In a letter dated February 26, 2009, the FDIC notified Crescent's Board that, based on its December 31, 2008 Call Report, the bank had fallen back to *Adequately Capitalized*. The letter included a reminder regarding the regulatory restrictions imposed on *Adequately Capitalized* institutions. In a letter dated May 27, 2009, the FDIC notified Crescent's Board that, based on its March 31, 2009 Call Report, the bank had fallen to *Undercapitalized*. The letter included a reminder regarding the restrictions imposed on *Undercapitalized* institutions and requested that the bank submit a capital restoration plan within 45 days of receipt of the letter. Crescent submitted a capital restoration plan on July 14, 2009. After reviewing the plan, the FDIC advised Crescent's Board in an August 19, 2009 letter that the plan was unacceptable because it did not provide sufficient detail regarding the bank's capital raising efforts. Crescent submitted a revised capital restoration plan on September 9, 2009. The FDIC determined that the bank had substantially addressed the concerns pertaining to the prior plan and approved the revised plan on September 29, 2009.

In a letter dated November 17, 2009, the FDIC notified Crescent's Board that, based on its September 30, 2009 Call Report, the bank had fallen to *Significantly Undercapitalized*. The letter included a reminder regarding the restrictions imposed on *Significantly Undercapitalized* institutions. The letter also noted that a planned private equity investment of $25 million described in the bank's approved capital restoration plan had not yet occurred. The FDIC inquired about the status of the investment and requested that the bank advise the FDIC of any changes in the approved capital restoration plan. Because the institution did not formally respond to this request, the FDIC reiterated the need for an updated status on the planned equity investment and the plan itself in a letter to Crescent's Board dated December 3, 2009. Crescent's President and CEO advised the FDIC in a January 28, 2010 letter that the private equity investment had not occurred, and that the bank was working to revise its capital restoration plan to focus on a more viable short-term capital solution.

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 March

[10] 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 *Adequately Capitalized*. The Atlanta Regional Office notified Crescent of its *Adequately Capitalized* capital category as a courtesy.

2010 visitation, and meetings and discussions with bank management. On May 5, 2010, the FDIC notified Crescent that, based on the institution's March 31, 2010 Call Report, the institution had fallen to *Critically Undercapitalized*. The notice included reminders regarding the requirements imposed on *Critically Undercapitalized* institutions. Although Crescent explored a number of strategic alternatives for raising capital, such as working with private equity firms to obtain investments and applying for funds under the Department of the Treasury's Capital Purchase Program, these efforts were ultimately not successful. The GDBF closed the institution on July 23, 2010 because it did not have enough capital to continue safe and sound operations.

Corporation Comments

We issued a draft of this report on January 7, 2011. The Division of Supervision and Consumer Protection (DSC) subsequently provided us with additional information for our consideration, and we revised our report to reflect this information, as appropriate. On January 28, 2011, the Director, DSC, provided a written response to the draft report. In the response, DSC reiterated the causes of Crescent's failure and the supervisory activities described in our report. The response also noted that the FDIC issued a FIL in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that re-emphasized the importance of robust credit risk-management practices and set forth broad supervisory expectations. In addition, the response referenced a 2007 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*. Among other things, this FIL states that FDIC-supervised institutions that engage in aggressive growth strategies or rely excessively on a volatile funding mix are subject to heightened off-site monitoring and on-site examinations that are more extensive than those applicable to other institutions.

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 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 Financial Reform Act amends section 38(k) by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

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

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

Scope and Methodology

The scope of this audit included an analysis of Crescent's operations from April 18, 2005 until its failure on July 23, 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 audit procedures:

- Analyzed key documentation, including:
    - Examination and visitation reports issued by the FDIC and the GDBF between 2005 and 2010.
    - Institution data in Call Reports, UBPRs, and other reports.
    - FDIC and GDBF correspondence.
    - Other relevant documents prepared by the FDIC relating to the institution.

- Crescent's Financial Filings with the SEC, including Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q.

- Pertinent FDIC regulations, policies, procedures, and guidance.

- Interviewed DSC examination staff in the Washington D.C. Office, the Atlanta Regional Office, and the Atlanta Field Office.

- Interviewed GDBF 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 DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, and interviews of examiners to understand Crescent'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 was used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this 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 was 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 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 material loss review 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, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Selected Risk Management Weaknesses and Recommendations by Examination Report

Report of Examination Start Dates	***4/18/2005***	***5/15/2006***	***6/4/2007***	***6/17/2008***	***7/27/2009***
Recommendation/Weakness is indicated with a ✓					
Loan Underwriting					
Track and Monitor Interest Reserves			✓	✓	
Establish Effective Appraisal Review Program/Obtain Updated Appraisals			✓	✓	✓
Improve LTV and Exceptions Reporting	✓	✓	✓	✓	
Credit Administration					
Set Limits or Do Not Exceed Policy Limits on ADC Concentrations	✓			✓	
Monitor/Track/Report ADC Concentration Levels and Projects	✓		✓	✓	
Obtain Global Cash Flow and/or Financial Analysis/Repayment Capacity/Borrower Equity	✓		✓	✓	✓
Update Credit Memoranda				✓	
Maintain Loan Relationship Report			✓		
Perform Feasibility Studies and Stress Test on Large Credits for Viability				✓	
Perform Due Diligence on Purchased Participation Loans				✓	
Amend or Adhere to Loan Policy	✓		✓	✓	
Obtain Prior Loan Approvals for Extensions, Renewals, and Deviations from Approved Terms	✓		✓		
Conduct Collateral Inspections	✓			✓	
Expand Loan Review Scope	✓				
Revise ALLL Methodology	✓			✓	
Violations and Contraventions					
Contravention to Statement of Policy, Part 365, Real Estate Lending Standards	✓	✓	✓	✓	
Part 323, Statement of Policy, Appraisal			✓	✓	✓
Joint Guidance on Concentrations in CRE Lending				✓	✓
Section 80-1-5.04(1), Participations				✓	
State Section 7-1-285(a)(1), Prior Loan Approval			✓		
State Section 7-1-285(b), Legal Lending Limits				✓	✓
State Section 7-1-286, Real Estate Loan Limits	✓				
Part 337.6, Brokered Deposits					✓

Source: OIG analysis of examination reports issued between 2005 and 2009.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate 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.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	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.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be

Glossary of Terms

Term	Definition
	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. DSC uses the term contingency funding plan and contingency liquidity plan interchangeably.
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.
Loan-to-Value	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.
Non-core Funding	Non-core funding generally consists of large time deposits (greater than $100,000), borrowings, 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

Glossary of Terms

	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 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 Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from data reported in Reports of Condition and Income submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the 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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GDBF	Georgia Department of Banking and Finance
LTV	Loan-to-Value
MLR	Material Loss Review
OIG	Office of Inspector General
PCA	Prompt Corrective Action
SEC	Securities and Exchange Commission
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

January 28, 2011

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews,
Office of Inspector General

/**Signed**/
FROM: Sandra L. Thompson [signed by Sandra L. Thompson]
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Crescent Bank and Trust Company, Jasper, Georgia (Assignment No. 2010-086)

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 Office of Inspector General (OIG) conducted a material loss review of Crescent Bank and Trust Company (Crescent), which failed on July 23, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received on January 7, 2011.

Crescent failed due to the Board and management's insufficient oversight of the risk associated with the high concentration of acquisition, development and construction (ADC) loans. Crescent pursued an aggressive ADC lending strategy fueled by volatile funding sources, such as brokered deposits, without implementing appropriate risk management, loan underwriting, and credit administration practices commensurate with the increased risk. Capital levels were inadequate to support the risk associated with the rapid growth in ADC lending and were insufficient to absorb losses. Liquidity became strained as asset quality and capital levels declined.

From 2005 through 2010, the FDIC and the Georgia Department of Banking and Finance conducted five risk management examinations. The FDIC also conducted off-site reviews and one visitation. In 2006, examiners noted that Crescent's strategic plan projected a rapid increase in assets in 2007. Examiners recommended the implementation of risk management practices to manage asset quality and ensure adequate liquidity and capital. At the 2008 FDIC examination, liquidity levels were deficient, and examiners issued a Cease and Desist Order. At the 2009 joint examination, asset quality and capital levels were critically deficient, and examiners noted that Crescent's Board and management failed to implement appropriate risk management practices. The 2010 FDIC visitation concluded that a capital injection was imperative to ensure viability.

DSC issued a Financial Institution Letter (FIL) in 2008 on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasized the importance of robust credit risk-management practices and set forth broad supervisory expectations. Additionally, DSC issued a FIL in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*

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