Audit Report

OIG-11-067

SAFETY AND SOUNDNESS: Material Loss Review of Flagship National Bank

May 3, 2011

Office of Inspector General

Department of the Treasury

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Audit Report

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Abbreviations

CRE	commercial real estate
FDIC	Federal Deposit Insurance Corporation
Flagship	Flagship National Bank
MLR	material loss review
OIG	Department of the Treasury Office of Inspector General
OCC	Office of the Comptroller of the Currency
PCA	prompt corrective action
ROE	report of examination

May 3, 2011

John G. Walsh
Acting Comptroller of the Currency

This report presents the results of our review of the failure of Flagship National Bank (Flagship), of Bradenton, Florida, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed Flagship and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on October 23, 2009. This review was mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of Flagship's estimated loss to the Deposit Insurance Fund.[1] As of March 31, 2011, FDIC estimated the loss to be $66.8 million.

Our objectives were to determine the causes of Flagship's failure; assess OCC's supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed OCC and FDIC officials. We conducted our fieldwork from May 2010 through July 2010. Appendix 1 contains a more detailed description of our review objectives, scope, and methodology. Appendix 2 contains background information on Flagship's history and OCC's assessment fees and examination hours. Certain terms that are underlined when first used in this report, are defined in, *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (April 11, 2011). That document is available on the Treasury Office of Inspector General's (OIG) website at http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx.

[1] At the time of Flagship's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

In brief, Flagship failed primarily because it had a high concentration in commercial real estate (CRE)-related loans[2] and inadequate credit risk management, underwriting, and credit administration. Regarding supervision, OCC examiners did not take timely action to address Flagship's CRE concentration or bring to management's attention the bank's inadequate risk management, underwriting, and credit administration. However, we determined that OCC appropriately used its authority under PCA. As Flagship's capital levels deteriorated, OCC acted timely to impose PCA restrictions on the bank.

We are not making any new recommendations in this report, but are reaffirming two recommendations made in our previous material loss reviews (MLR) of OCC-regulated banks,[3] where we identified similar causes of failure and reported similar findings regarding OCC's supervision of the banks.

In a written response, OCC agreed with our reaffirmed recommendations and has taken action or is continuing various actions. OCC noted that in interagency forums, it proposed a group to study the issue of CRE concentrations. The proposal was not acted upon so OCC convened an internal group to study it and develop proposed solutions. CRE concentrations have been a common element in a number of bank failures and we support OCC's efforts to address this issue. OCC's full response is provided in Appendix 3.

Causes of Flagship's Failure

The primary cause of Flagship's failure was its high concentrations in CRE-related loans. The CRE concentration exceeded 300 percent of its total risk-based capital for the entire period of our review—June 2005 through October 2009. Flagship's board and management failed to implement risk-management practices commensurate with the risks associated with the large CRE-related

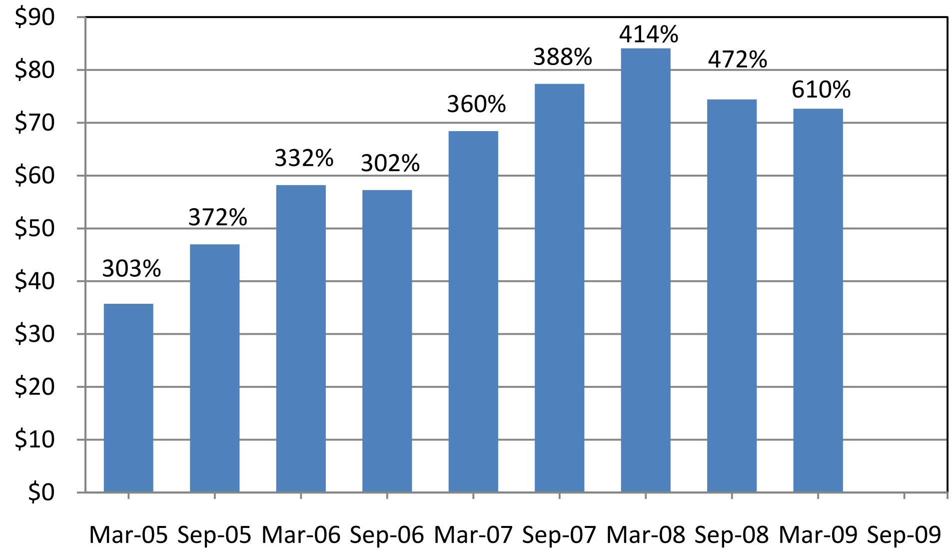
[2] Construction and land development loans, nonfarm/nonresidential real estate loans, and multifamily residential real estate loans collectively constitute CRE-related loans.
[3] *Safety and Soundness: Material Loss Review of Union Bank, National Association*, OIG-CA-10-009 (May 11, 2010), and *Safety and Soundness: Material Loss Review of TeamBank, National Association,* OIG-10-001 (Oct. 7, 2009).

loan portfolio. The bank's liberal loan underwriting and inadequate credit administration led to rapid asset quality deterioration and substantial loan losses when the local real estate market declined.

High Concentration of CRE-Related Loans

OCC broadly defines concentrations as groups or classes of credit exposures that share common risk characteristics or sensitivities to economic, financial, or business developments. According to OCC, a concentration exists when the common credit exposures exceed 25 percent of the bank's capital structure. Figure 1 shows Flagship's CRE-related loan growth from 2005 to 2009.

Figure 1: Flagship's CRE-Related Loan Growth and Concentration as a Percentage of Risk-Based Capital, March 2005–September 2009 (millions)



Source: OIG analysis of Flagship call reports.
Note: A concentration percent for the third quarter of 2009 is not shown because Flagship was in a negative capital position.

Flagship's CRE-related loan portfolio grew steadily from 2005, reaching more than $80 million in March 2008. Although the portfolio decreased after March 2008, Flagship's concentration of CRE-related loans continued to increase because the bank's capital levels declined more rapidly.

CRE-related loans pose significant risk to a bank when they are speculative in nature, and the risk is increased when a bank maintains a high concentration of such loans. From our analysis of loan samples taken by OCC examiners, we found that Flagship's CRE-related loans were mostly speculative. In addition, we found loans that were approved without developers' securing enough tenants or buyers for the properties in question and loans that were processed without sufficient documentation or thorough evaluation of borrowers' loan repayment abilities.

The risk associated with speculative lending became apparent when Florida's housing market started declining during the economic crisis that began in 2007. The quality of Flagship's CRE-related loans deteriorated rapidly during this time. Flagship's nonperforming CRE-related loans increased from $130,000 as of March 31, 2007, to $15.4 million as of March 31, 2009. During that period, Flagship recognized extensive loan losses and had to make large provisions to its allowance for loan and lease losses, which eroded capital and caused the bank to become unprofitable. Flagship reported a $7.1 million loss for 2008 and a $32.1 million loss for the first three quarters of 2009.

Inadequate Risk Management, Underwriting, and Credit Administration

Flagship's risk management practices were inadequate, and its underwriting and credit administration were inappropriate. In OCC's 2008 report of examination (ROE), examiners reported that the bank's credit administration was weak, its underwriting had been superficial, and its credit risk management was deficient for the size and complexity of its portfolio. Also included in the ROE was that Flagship management did not implement risk management practices commensurate with a large CRE-related portfolio.

The loan samples taken by OCC examiners revealed that Flagship management did not gather sufficient information on its borrowers and was not fully aware of borrowers' outside debts and payment responsibilities. The examiners also found that Flagship management approved loans for borrowers with severe financial weaknesses that were identified prior to loan approval, including

- unverified stated outside liquidity (assets held outside of Flagship);

- incomes heavily concentrated in speculative real estate;
- poor credit histories at Flagship, with numerous overdrafts; and
- credit reports showing low credit scores, numerous late payments, and foreclosures.

OCC's Supervision of Flagship

OCC performed timely examinations of Flagship in accordance with examination guidelines but did not report or take actions to address the bank's CRE concentrations or its inadequate credit risk management, liberal underwriting, and poor credit administration until the 2008 examination. These conditions had existed before—from 2005 through 2007—but OCC did not address them during the earlier examinations.

Summary of OCC's Flagship Supervisory Actions

Table 1 summarizes OCC's examinations of Flagship and related enforcement actions from June 2005 to August 2009.

Table 1: OCC Examinations of Flagship (June 2005–August 2009)

		Examination Results			
Date started/ Type of examination	**Assets (millions)**	**CAMELS rating**	**Number of matters requiring attention (MRA)**	**Number of recommendations**	**Formal enforcement action**
6/27/2005 (full-scope examination)	$126	2/222222	0	0	None
2/5/2007 (full-scope examination)	$203	2/222222	0	2	None
7/28/2008 (full-scope examination)	$226	4/444432	5	5	11/20/2008 Formal agreement
3/16/2009 (joint visit with FDIC)	$209	4/454542	4	0	Formal agreement (in place)
8/17/2009 (review)	$194	5/555555	0	0	Formal agreement (in place)

Source: OCC ROEs and PCA directive.

OCC Did Not Take Timely Action to Address Flagship's CRE Concentration

According to interagency guidance on CRE concentration risk, an institution whose CRE loans represent 300 percent or more of its total capital may be identified for further supervisory analysis to assess the nature and risk posed by the concentration. The guidance also provides a framework for supervisory monitoring of the concentrations.[4]

As shown in figure 1, Flagship's CRE-related loans grew steadily from 2005, reaching 388 percent of total risk-based capital in September 2007. OCC's 2007 examination did not report on Flagship's CRE-related credit concentration and did not mention or follow the new interagency guidance, which was released in December 2006. In this regard, OCC examiners did not assess the nature and risk posed by the concentration and did not assess the bank's risk management practices until the 2008 examination.

OCC Did Not Promptly Report Flagship's Poor Risk Management, Underwriting, and Credit Administration

In the 2008 ROE, OCC examiners identified previously unreported problems with Flagship's loans. They discovered problems with the bank's underwriting of new and renewed loans, several instances of indefinite or liberal repayment programs, inadequate financial analyses, inappropriate interest reserves, and underperforming loans approved for speculative purposes. These problems were not reported in the 2005 ROE or the 2007 ROE.

Upon reviewing the workpapers of the loan sample reviews conducted by OCC during the 2005 and 2007 examinations, we found that the examiners had identified many of the same deficiencies reported on in the 2008 ROE. For example, the examiners were aware that Flagship management did not gather sufficient information on its borrowers and was not fully aware of borrowers' outside debts and payment responsibilities. The examiners were also aware that Flagship management approved loans for borrowers with severe financial weaknesses that were

[4] OCC Bulletin 2006-46, Interagency Guidance on CRE Concentration Risk Management (Dec. 6, 2006).

identified prior to loan approval. But these deficiencies were not reported in OCC's 2005 or 2007 ROE.

An examiner who worked on the 2005 examination told us that Flagship had no underwriting issues as of 2005. An examiner who worked on the 2007 examination told us that Flagship had several underwriting exceptions but that he did not see that as a problem. On the other hand, an examiner who worked on the 2008 examination told us that Flagship's loan problems were systemic.

OCC Appropriately Used PCA

Although we determined that OCC should have acted more forcefully and sooner to address the unsafe and unsound practices with Flagship, we concluded that OCC appropriately used its authority under PCA. As Flagship's capital levels deteriorated, OCC acted timely to impose PCA restrictions on the bank.

The purpose of PCA is to resolve problems of insured depository institutions with the least possible long-term loss to the Deposit Insurance Fund. PCA requires federal banking agencies to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility to discipline institutions based on criteria other than capital levels to help reduce deposit insurance losses caused by unsafe and unsound practices.

OCC took the following key actions related to Flagship:

- On November 20, 2008, OCC entered into a formal agreement with Flagship that required the bank to achieve by March 31, 2009, and thereafter maintain, a Tier 1 leverage capital ratio of at least 9 percent and a total risk-based capital ratio of at least 13 percent. The formal agreement also required the bank to submit a 3-year capital plan and take steps to address excessive CRE-related concentrations, problem loan management, and inadequate credit administration.

- Flagship submitted a capital plan on March 31, 2009, and a revised capital plan on June 23, 2009, but OCC rejected both on the grounds that they failed to identify the sources, timing, and terms of potential capital needed to comply with the minimum capital requirements.

- By the second quarter of 2009, Flagship became significantly undercapitalized. OCC required the bank to submit a capital restoration plan no later than September 13, 2009. OCC also restricted the bank from accepting, renewing, or rolling over brokered deposits and restricted the yield that the bank could offer on deposits.

- On September 17, 2009, OCC notified the bank that it was critically undercapitalized and that it disapproved the bank's capital restoration plan. On October 23, 2009, OCC closed Flagship and appointed FDIC as receiver.

Recommendations

We are not making any new recommendations in this report, but are reaffirming two recommendations made in our previous MLRs of OCC-regulated banks.

In our May 2010 MLR report on Union Bank,[5] we reported that the bank failed primarily because of high CRE concentrations and stated that a strong supervisory response by OCC was warranted to address the high CRE concentrations. We recommended that OCC work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high-risk concentrations. The failure of Flagship was another case in which a bank failed primarily because it had a high concentration in CRE loans that warranted a strong supervisory response by OCC. Therefore, we reaffirm the recommendation made in the Union Bank MLR.

In our October 2009 MLR report on TeamBank,[6] we also reported that the bank failed due to its high-risk concentration in CRE loans

[5] *Safety and Soundness: Material Loss Review of Union Bank, National Association*, OIG-CA-10-009 (May 11, 2010). The review of Union Bank was performed by Mayer Hoffman McCann P.C., an independent certified public accounting firm, under the supervision of OIG.
[6] *Safety and Soundness: Material Loss Review of TeamBank, National Association,* OIG-10-001 (Oct. 7, 2009).

coupled with deficient underwriting and credit administration. We recommended that OCC emphasize to examiners that MRAs are to be issued in ROEs in accordance with the criteria regarding deviations from sound management and noncompliance with laws or policies listed in the Comptroller's Handbook. Flagship's high concentration in CRE-related loans was a deviation from sound management and warranted a proper supervisory action. Therefore, we reaffirm the recommendation made in the TeamBank MLR.

Management Response

OCC responded that in interagency forums it proposed a group to study the issue of CRE concentrations. The proposal was not acted upon so it convened an internal group to study it and develop proposed solutions. OCC said its policy for utilizing MRAs is clearly stated within the Comptroller's Handbook. In addition, it distributed a MRA Reference Guide in July 2010, to further emphasize expectations for proactive supervision, clear and assertive communication of concerns to the Board of Directors, and prompt follow-up on commitments for corrective action. Training was also conducted on the Guide in all field offices in 2010.

OIG Comment

OCC's actions meet the intent of our prior MLR recommendations.

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We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-6512 or Myung G. Han, Audit Manager, at (202) 927-4878. Major contributors to this report are listed in appendix 4.

Michael J. Maloney /s/
Audit Director

We conducted this material loss review of Flagship National Bank (Flagship) of Bradenton, Florida, in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[7] This section provides that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that

- ascertains why the institution's problems resulted in a material loss to the insurance fund;
- reviews the agency's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38; and
- makes recommendations for preventing any such loss in the future.

At the time of Flagship's failure, on October 23, 2009, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. We initiated a material loss review of Flagship based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC), which on the date of failure was $58.2 million. As of March 31, 2011, FDIC estimated that the loss to the Deposit Insurance Fund from Flagship's failure would be $66.8 million.

Our objectives were to determine the causes of Flagship's failure and assess the Office of the Comptroller of the Currency's (OCC) supervision of the bank. To accomplish our review, we conducted fieldwork at OCC headquarters in Washington, D.C., and its field office in Jacksonville, Florida. We interviewed headquarters and field office personnel. We performed work at FDIC's Division of Resolutions and Receiverships in Jacksonville, Florida, and interviewed personnel involved in Flagship's closing and receivership. We also interviewed personnel from FDIC's Division of Supervision and Consumer Protection via teleconference. We conducted our fieldwork from May 2010 through July 2010.

To assess the adequacy of OCC's supervision of Flagship, we performed the following work.

[7] 12 U.S.C. § 1831o(k).

- We reviewed OCC's supervisory files and records for Flagship from 2005 through 2009. We analyzed examination reports, supporting workpapers, and related supervisory correspondence to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the regulatory action OCC used to compel bank management to address deficient conditions.

- We interviewed and discussed various aspects of the supervision of Flagship with OCC officials and examiners to obtain their perspective on the bank's condition and the scope of the examinations. We also interviewed FDIC officials responsible for monitoring Flagship for federal deposit insurance purposes.

- We interviewed personnel from FDIC's Division of Resolutions and Receiverships involved in the receivership process, which was conducted before and after Flagship's closure and appointment of a receiver.

- We assessed OCC's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act (12 U.S.C. § 1811 et seq.).

We conducted this performance audit 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.

History of Flagship National Bank

Flagship National Bank (Flagship) was a federally chartered national bank. It was established as a community bank in 1999 and had no holding company or affiliates. Flagship's main office was in Bradenton, Florida, and the bank had three branches in Sarasota, Florida.

OCC Assessments Paid by Flagship

OCC funds its operations in part through semiannual assessments on national banks. OCC publishes annual fee schedules, which include general assessments to be paid by each institution based on the institution's total assets. If the institution is a problem bank (i.e., it has a CAMELS composite rating of 3, 4, or 5), OCC also applies a surcharge to the institution's assessment to cover additional supervisory costs. These surcharges are calculated by multiplying the sum of the general assessment by 50 percent for 3-rated institutions or by 100 percent for 4- and 5-rated institutions. Table 2 shows the assessments that Flagship paid to OCC from 2005 through 2009 and their share of the total assessments paid by OCC-regulated banks.

Table 2: Assessments Paid by Flagship to OCC, 2005–2009

Billing Period	Exam Rating	Amount Paid	% of Total Collection
1/1/2005–6/30/2005	2	$26,060	0.009%
7/1/2005–12/31/2005	2	$27,614	0.009%
1/1/2006–6/30/2006	2	$30,521	0.010%
7/1/2006–12/31/2006	2	$31,704	0.010%
1/1/2007–6/30/2007	2	$36,247	0.011%
7/1/2007–12/31/2007	2	$38,563	0.011%
1/1/2008–6/30/2008	2	$36,475	0.010%
7/1/2008–12/31/2008	4	$36,877	0.010%
1/1/2009–6/30/2009	4	$72,292	0.019%
7/1/2009–12/31/2009	5	$68,818	0.018%

Source: OCC $MART database.

Number of OCC Staff Hours Spent Examining Flagship

Table 3 shows the number of OCC staff hours spent examining Flagship from 2005 to 2009.

Table 3: Number of OCC Hours Spent on Examining Flagship, 2005–2009

Examination Start Date	Number of Examination Hours
6/27/2005	355
2/5/2007	311
7/28/2008	750
3/16/2009	406
8/17/2009	875

Source: OCC Examiner View.
Note: Examination hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations. They do not include time spent performing off-site monitoring.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Michael J. Maloney, Director of Fiscal Audits

From: John Walsh, Acting Comptroller of the Currency /s/

Date: April 15, 2011

Subject: Response to Material Loss Review of Flagship National Bank of Bradenton, Bradenton, Florida

We have reviewed your draft report titled "Material Loss Review of Flagship National Bank (Flagship), of Bradenton, Florida." Your overall objectives were to determine the cause of the failure of Flagship, assess the OCC's supervision of the bank, including implementation of the Prompt Corrective Action (PCA) provisions of section 38(k); and make recommendations for preventing future losses.

You concluded that Flagship failed primarily because it had a high concentration in commercial real estate (CRE) –related loans and inadequate credit risk management, underwriting, and credit administration. You concluded that the OCC should have acted more forcefully and sooner to address the unsafe and unsound practices with Flagship's CRE concentration, inadequate risk management, and underwriting and credit administration. You also determined that the OCC appropriately used its authority under PCA. We agree with these conclusions.

Your report reaffirmed two recommendations made in previous material loss reviews (MLR) of OCC-regulated banks, where you identified similar causes of failure and made similar findings regarding OCC's supervision of banks. Our response to your specific recommendations is listed below.

Work with Regulatory Partners to Determine Whether to Propose Legislation and/or Change Regulatory Guidance for Concentrations or Other Controls

We agree. The OCC works with other regulators to develop guidance on a variety of subjects where common issues or concerns exist. CRE concentrations in this and previous economic down cycles were a significant contributing factor for large increases in problem banks and bank failures, with resulting loss to the deposit insurance fund. In interagency forums, the OCC proposed that a group be formed to study the issue of CRE concentrations and what should be done to reasonably prevent a recurrence of recent and past experience. However, the proposal was not acted upon. Therefore, the OCC has convened an internal group to study the issue and develop proposed solutions.

Use of Matters Requiring Attention (MRAs) to Address Supervisory Concerns

We agree it is critical that examiners properly use MRAs to clearly communicate our concerns and expectations to bank boards and management in a timely manner. OCC's policy for utilizing MRAs is clearly stated in the Comptroller's Handbook. In addition, on July 1, 2010, SDC Kelly distributed a MRA Reference Guide (Guide) and cover memo further emphasizing expectations for proactive supervision, clear and assertive communication of concerns to the Board of Directors, and prompt follow-up on commitments for corrective action. Training was conducted on the Guide in all field offices in 2010.

Thank you for the opportunity to review and comment on your draft report. If you have questions or need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-874-5020.

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Chairman
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U.S. Senate

Chairman and Ranking Member,
Committee on Banking, Housing and Urban Affairs

Chairman and Ranking Member,
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U.S. House of Representatives

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