# Audit Report

OIG-11-083

SAFETY AND SOUNDNESS: Material Loss Review of Century Bank, FSB

July 14, 2011

# Office of Inspector General

## Department of the Treasury

# Contents

## Audit Report



## Appendices



## Abbreviations

| | |
|---|---|
| ALLL | allowance for loan and lease losses |
| C&D order | cease and desist order |

| | |
|---|---|
| Century | Century Bank, FSB |
| FDIC | Federal Deposit Insurance Corporation |
| HELOC | home equity line of credit |
| MRBA | matter requiring board attention |
| OIG | Treasury Office of Inspector General |
| OTS | Office of Thrift Supervision |
| PCA | prompt corrective action |
| ROE | report of examination |
| TFR | thrift financial report |

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This report presents the results of our material loss review of the failure of Century Bank, FSB (Century), of Sarasota, Florida, and of the Office of Thrift Supervision's (OTS) supervision of the institution. OTS closed Century and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on November 13, 2009. Section 38(k) of the Federal Deposit Insurance Act mandated this review because of the magnitude of Century's estimated loss to the Deposit Insurance Fund.[1] As of March 31, 2011, FDIC estimated a loss of $266.5 million to the Deposit Insurance Fund and a loss of $598,960 to the Transaction Account Guarantee Program.[2]

Our objectives were to determine the cause of Century's failure; assess OTS's supervision of Century, 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 officials at OTS and FDIC. We conducted our fieldwork from January 2010 through March 2010. Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains a detailed discussion of loans involving improper accounting practices. Appendix 3 contains background information on Century's history and OTS's assessment fees and examination hours.

[1] At the time of Century's failure, section 38(k) defined a loss as material if it exceeds 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 year 2014 or after (with a provision that the threshold be raised temporary to $75 million under certain conditions).
[2] 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/Documents/oig11065%20(508).pdf.

In brief, the primary causes of Century's failure were its (1) aggressive growth strategy and excessive concentrations in higher-risk loans, (2) ineffective management and inadequate board oversight, and (3) insufficient capital relative to the risk level of its loans. These conditions were exacerbated by the severe downturn in real estate values in Florida, the primary market that Century served. It should also be noted that on July 29, 2008, Century backdated a $7 million capital contribution. Finally, we found that the thrift made several questionable loans that concealed and distorted Century's true financial condition.

OTS's supervision of Century did not prevent a material loss to the Deposit Insurance Fund. OTS did not timely downgrade Century's asset quality and management ratings nor issue an informal enforcement action when the thrift's conditions were declining. In addition, OTS also did not issue a temporary cease and desist order (C&D order) when conditions warranted an elevation in enforcement action and did not require Century to hold additional capital to support the thrift's risk profile. Furthermore, OTS did not identify credit concentrations at Century early enough where a supervisory response may have made a difference and the actions OTS did eventually take were not adequate to address the risk associated with the credit concentrations.

We also found that OTS did not require Century to correct and refile its thrift financial reports (TFR) after OTS discovered that the thrift had backdated a capital contribution.[3] As a result, Century appeared to be a well capitalized institution when it was actually adequately capitalized.[4]

We concluded that starting in September 2008, as Century's capital fell below adequately capitalized OTS used its authority under PCA, but those actions did not prevent Century's failure or a material loss to the Deposit Insurance Fund.

[3] Century was one of six OTS regulated thrifts (thrift 2) that backdated capital contributions as we reportedin our May 21, 2009, audit report entitled *Safety and Soundness: OTS Involvement with Backdated Capital Contributions by Thrifts*, OIG-09-037..
[4] Prompt corrective action sets minimum requirements for each capital category. The five established capital classifications are well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Our related audit product entitled *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065, provides further details on the specific capital requirements for each capital category.

We are reaffirming prior material loss review recommendations regarding higher-risk concentrations. We are also reaffirming the need for examiners to ensure appropriate ratings are assigned to institutions, which has been a problem reported in a number of other failed bank reviews by our office. OTS has issued guidance regarding the timeliness of enforcement actions. Also, it should be noted that pursuant to P.L. 111-203, OTS's functions are to transfer to other federal banking agencies on July 21, 2011. Accordingly, we are not making any new recommendations based on this material loss review.

We referred certain matters involving Century's improper credit administration practices and financial reporting to the Treasury Inspector General's Office of Investigations.

In a written response, OTS stated that it has been responsive to prior MLR reports and internally prepared assessments of other thrift failures, and has implemented actions for the recommendations in prior reports. OTS's response is provided as appendix 4.

## Causes of Century's Failure

Century failed because of its aggressive growth strategy and concentrations in higher-risk loans, ineffective management and inadequate board oversight, and insufficient capital relative to the risk level of its loans. With the downturn in Florida's real estate market, Century's asset quality declined significantly, resulting in a substantial volume of problem loans and significant loan losses. In turn, these loan losses significantly diminished earnings, resulted in negative capital, and ultimately Century's failure.

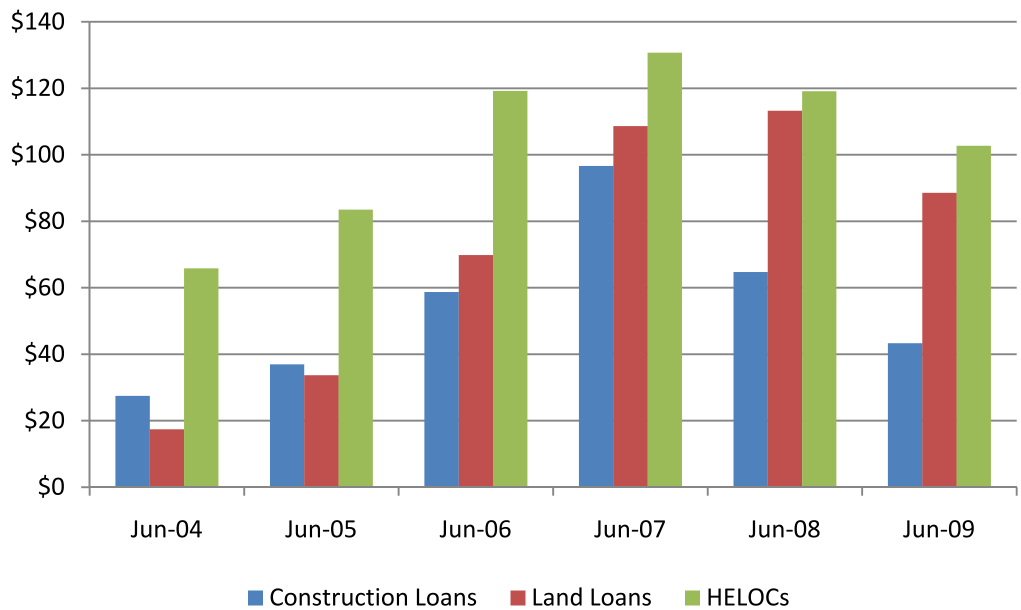
### Aggressive Growth Strategy and Excessive Concentrations In Higher-Risk Loans

Century had an aggressive growth strategy, held an excessive concentration of higher-risk loans, and did not adequately identify or monitor the risks associated with those loans. These higher-risk loans consisted of home equity lines of credit (HELOC), land loans, nonresidential, and interest-only adjustable-rate mortgage loans. Century's asset quality deteriorated significantly in 2008 primarily due to the decline in the Florida real estate market.

Century pursued rapid and aggressive growth at the height of the real estate market. The thrift's total assets increased from $552 million to $889 million, or by 61 percent, from June 2005 to June 2007. Century achieved this growth primarily through wholesale origination of residential mortgage loans and non-homogeneous loans.[5]

Figure 1 shows the significant growth from 2004 through 2007 in construction loans, land loans, and HELOCs. Beginning in 2008, Century's deteriorating asset quality resulted in an increase in charge-offs; and a decrease in the volume of these loans.

**Figure 1. Growth in Century's Construction Loans, Land Loans, and HELOCs, June 2004–June 2009 (in millions)**




Source: 2006 and 2007 reports of examination (ROE) and 2008 and 2009 Uniform Thrift Performance Reports for Century.

OTS defines a concentration as a group of similar types of assets or liabilities that, when aggregated, exceeds 25 percent of a thrift's risk-based capital (core capital plus allowance for loan and lease losses (ALLL)). If a thrift's assets are highly concentrated in a particular category, negative events affecting that category can be highly detrimental to the thrift as a whole. In this regard, as of March 31, 2008, HELOCs equaled 178 percent of Century's total risk-based capital, land

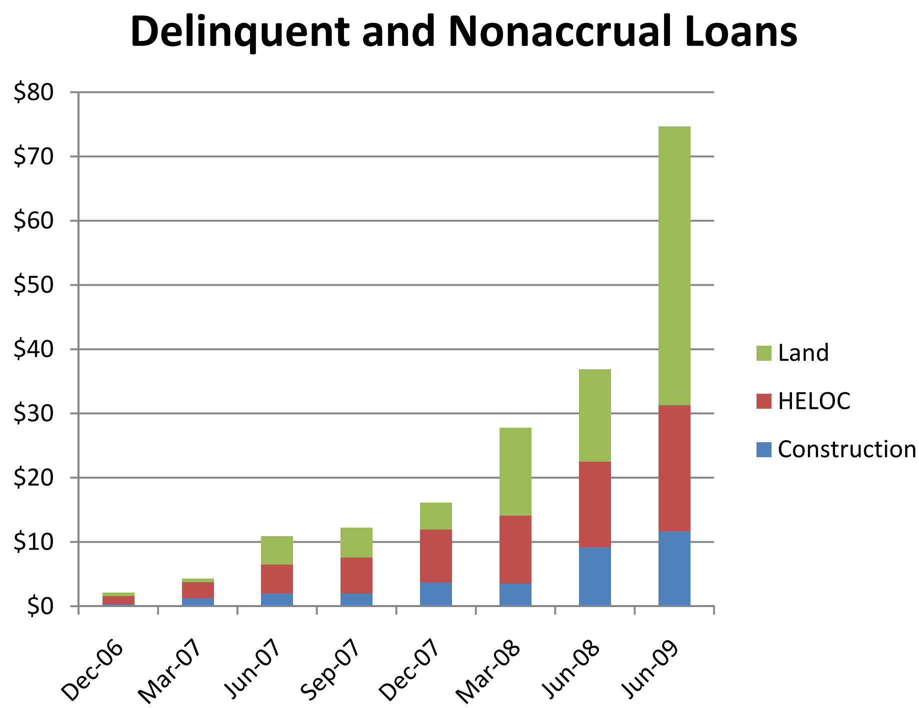
[5] Century's non-homogeneous loans consisted of multifamily, nonresidential real estate loans, construction loans, land loans, and nonmortgage commercial loans.

loans equaled 163 percent, and construction loans equaled 108 percent. Century continued making these higher-risk loans, and by June 2009 HELOCs represented 451 percent of risk-based capital, and construction loans and land loans represented 579 percent of risk-based capital.

According to OTS's 2008 ROE for the thrift, Century was able to increase its HELOC loan portfolio significantly because it relied excessively during the loan approval process on the inflated value of borrowers' primary residences as collateral for the HELOCs. OTS also noted that 59 percent of the HELOC portfolio was originated in 2005 and 2006, during the housing boom, but this portion of the portfolio contained 85 percent of the delinquent HELOCs.

Asset quality began to deteriorate in the quarter ended June 30, 2007, and delinquencies began to rise. As shown in figure 2, delinquent and nonaccrual construction loans, land loans, and HELOCs increased considerably from December 2006 to June 2008, leading to significant losses beginning with the quarter ended December 31, 2007.

**Figure 2. Century's Delinquent and Nonaccrual Construction Loans, Land Loans, and HELOCs (in millions)**




Source: 2008 ROE for Century; OTS workpaper.

**Ineffective Management and Inadequate Board Oversight**

Century's management did not adequately identify, measure, monitor, or control significant risks that threatened the viability of the thrift, as evidenced by (1) improper credit administration practices, (2) the heavy influence of the thrift's president and its owner over senior management and the board of directors, (3) poor risk management, and (4) a backdated capital contribution. These practices led to inaccurate financial reporting, which masked the dire financial condition of the thrift.

<u>Improper Credit Administration Practices</u>

Century made a number of questionable loans using improper credit administration practices that concealed and distorted Century's true financial condition. Century (1) failed to timely identify and classify problem loans, (2) did not obtain timely appraisals and ignored unfavorable appraisals, and (3) advanced funds to pay delinquent interest in order to keep loans current. These activities postponed loss recognition, understated asset quality deterioration, and overstated capital and interest income. Many of the loans involved more than one unacceptable credit administration practice. Appendix 2 contains a more detailed discussion of the circumstances surrounding specific problem loans.

Influence of Century's Owner and Its President on Senior Management and the Board of Directors

Century's owner and its president both had significant influence over senior management and the everyday operations of the thrift. In many cases, the thrift's management, with the board's knowledge and consent, engaged in high-risk lending practices to defer timely recognition of mounting asset quality problems. For example, the thrift's president approved a stated income loan of $12 million for a home located in Columbus, Ohio, which was outside of Century's lending area. Comparable properties used to determine the appraisal value of the home were located far from the subject property; for example one of the comparables was located in Atlanta, Georgia. An OTS examiner told us that there were indicators that Century's owner was also involved in the loan approval process. (For more information, see appendix 2, Loan 5.) In addition, according to OTS examiners, Century's owner and president sometimes overrode decisions by the thrift's underwriters. In some cases, the owner and president approved loans via e-mail messages without reviewing relevant documentation.

The thrift's board of directors is ultimately responsible for overseeing the affairs of the thrift. Among the board's responsibilities are (1) establishing business goals, standards, policies, procedures, and operating strategies; (2) approving standards for ensuring that the savings association's transactions with affiliates are sound; (3) periodically evaluating management's performance; and (4) reviewing thrift operations. However, an OTS examiner told us that oversight by Century's board was severely lacking, primarily because of the influence of the owner. Century also made questionable loans to the thrift directors' personal and business associates.

Poor Risk Management

In its 2006 ROE for Century, OTS recommended that management enhance loan portfolio reporting by including concentration reports and portfolio analyses.[6] As of May 2008, however, these analyses were not in place for some of Century's loan portfolios and management was not adequately identifying or monitoring the layers of risk in its HELOC, land, nonresidential, and interest-only adjustable-rate mortgage loans. For example, while updated credit scores and property values for the HELOC portfolio was obtained, it was not entered into the loan system nor were analyses performed on the portfolio's risk using that updated data.

Backdated Capital Contribution

On July 29, 2008, Century's holding company made a $7 million capital contribution to Century. Century then backdated the transaction in its TFR for the quarter ended June 30, 2008, so that it would appear to have occurred during that quarter. OTS objected to backdating the transaction and instructed thrift management not to do it. Century management nevertheless proceeded with the backdating and, as a result, filed a misleading TFR, which overstated the thrift's capital level and misrepresented the true financial condition of the thrift. As a result, Century appeared to be a well-capitalized institution when it was actually only adequately capitalized. Furthermore, OTS took no additional action against the thrift with regard to the misleading TFR.

**Inadequate Capital Levels**

Historically, Century's business strategy focused on maintaining capital at a level just above well-capitalized. Century was considered well-capitalized under PCA requirements until the quarter ending June 30, 2008, when it fell to adequately capitalized.[7] Nevertheless, Century's capital levels were inadequate to support its significant exposure to loans with higher levels of credit risk. According to section 120 of the OTS Examination Handbook, thrifts that engage in higher-risk activities require more capital, especially if the activities are conducted at significant

[6] A portfolio analysis examines a portfolio's concentrations and risk factors based data such as Fair Isaac Corporation scores of the borrowers, loan-to-values, geographic locations, origination dates, and delinquency status.
[7] For quarter ended June 30, 2008, Century should have been deemed adequately capitalized. However, since Century backdated $7 million capital contribution Century appeared to be well-capitalized.

concentration levels. Century's strategy of maintaining capital just above the well-capitalized standard afforded it little cushion for unanticipated adverse events, such as the downturn in the real estate market that began in 2007.

**Decline in Real Estate Values**

Century's loans were mainly concentrated in southwestern Florida. In late 2007, the housing market began to deteriorate across the country, and the Florida real estate market began experiencing a severe downturn. Within its residential mortgage portfolio, Century experienced significant losses in its HELOCs. As noted earlier, Century heavily relied on the inflated value of borrowers' primary residences as collateral for HELOCs during the loan approval process. These HELOCs were often used by borrowers to purchase second homes or investment properties. As the economy declined, home prices fell, and collateral values dropped. At the same time, many borrowers were unable to service the debt on their second homes or investment properties. As a result, Century's suffered losses on its HELOCs, as well as in its other loan portfolios. In turn, this seriously eroded the thrift's capital to the point of being negative. Century's significant loan losses, diminished earnings, and negative capital led ultimately to the thrift's failure.

## OTS's Supervision of Century

OTS's supervision of Century did not prevent a material loss to the Deposit Insurance Fund. OTS did not downgrade Century's asset quality and management ratings or issue any type of enforcement action even after its 2007 limited examination revealed the thrift's conditions were deteriorating. OTS also did not require Century to hold additional capital to support the thrift's risk profile. Furthermore, OTS did not identify credit concentrations early enough, and when it did, it did not take adequate measures to address the risk. In addition, OTS did not require Century to refile its TFR after the thrift backdated a capital contribution. By not doing so, PCA was delayed for more than 1 year. However, we concluded that starting in December 2008, OTS properly used its authority under PCA in accordance with PCA requirements, but those actions did not prevent Century's failure or a material loss to the Deposit Insurance Fund.

## Summary of OTS's Supervisory Actions

Table 1 summarizes the results of OTS's safety and soundness full-scope and limited-scope examinations of Century from 2005 until its closure in November 2009. Generally, matters requiring board attention (MRBAs) represent the most significant items reported in ROEs requiring corrective action.

**Table 1. Summary of OTS's Examinations of and Enforcement Actions Against Century**

| | | Examination Results | | | |
|---|---|---|---|---|---|
| **Date started/date completed** | **Total assets (in $ millions) at time of examination** | **CAMELS rating** | **No. of MRBAs** | **No. of recommendations/ corrective actions** | **Informal/formal enforcement actions** |
| 8/29/2005<br>11/14/2005<br>Full-scope examination | $552 | 2/222121 | 8 | 13 | None |
| 12/29/2006<br>3/20/2007<br>Full-scope examination | $819 | 2/222121 | 0 | 2 | None |
| 8/28/2007<br>9/25/2007<br>Limited examination | $889 | N/A | 0 | 3 | None |
| 5/19/2008<br>8/27/2008<br>Full-scope examination | $921 | 4/443442 | 10 | 23 | OTS issued a troubled condition letter on 9/26/2008.<br><br>OTS issued a proposed C&D order on 12/11/2008 which was not accepted by Century's board. OTS issued a proposed revised C&D order on 2/12/2009. Century's board consented to the C&D on 8/11/2009. |
| 6/15/2009<br>6/25/2009<br>Limited examination (No report issued)* | $899 | 5/554542 | None | None | None |

| Table 1. Summary of OTS's Examinations of and Enforcement Actions Against Century | | | | | |
|---|---|---|---|---|---|
| | | Examination Results | | | |
| Date started/date completed | Total assets (in $ millions) at time of examination | CAMELS rating | No. of MRBAs | No. of recommendations/ corrective actions | Informal/formal enforcement actions |
| 07/20/2009<br>11/6/2009<br>Full-scope examination<br>(No ROE issued) ** | $841 | 5/555554 | N/A | N/A | The thrift's board consented to the C&D order on 8/11/2009. |
| 9/30/2009<br>9/30/2009<br>Limited examination | $847 | 5/554542 | None | None | None |

*Century's examination was never formally communicated to the thrift. According to OTS, this was an oversight.
**Century was put into receivership before the report was issued.

### OTS Did Not Downgrade Century's Asset Quality and Management Ratings or Issue an Enforcement Action After a 2007 Examination Found Its Conditions Were Deteriorating

A principal objective of the CAMELS rating process is to identify institutions that pose a risk of failure and merit more than normal supervisory attention. Among the CAMELS component ratings, asset quality is among the most important components in determining a thrift's overall condition. Accordingly, when asset quality is in doubt, the component rating should reflect this concern. That said, according to the OTS Examination Handbook, a rating of 3 is to be assigned for less than satisfactory asset quality and credit administration practices. Furthermore, one of the key objectives of a safety and soundness examination is to evaluate the quality and effectiveness of a savings association's management. Here again, according to the OTS Examination Handbook, a rating of 3 for the management component should be assigned when improvement is needed in management and board of directors' performance or the thrift has less than satisfactory risk management practices.

On August 28, 2007, OTS started a limited examination of Century to assess asset quality trends since its last full scope examination in December 2006. During that limited examination, examiners concluded that asset quality had deteriorated significantly. The examiners also found that, among other things, thrift management was not adequately monitoring, measuring, or controlling risks, resulting in less than satisfactory risk management practices. We believe both these conditions met the criteria for rating the asset quality component and management component as a 3.

Despite this, OTS did not downgrade either Century's asset quality component or management component rating as a result of the limited examination. In fact, it was not until the May 2008 examination was completed, 11 months later, that OTS downgraded these ratings, from 2 to 4. When we asked why the ratings were not downgraded as a result of the 2007 limited examination, we were told that although the adverse trends discussed were observed, the level of classified assets to Tier 1 capital and allowances would not necessarily be considered inconsistent with the 2 rating assigned to asset quality at the prior comprehensive exam. Furthermore, the thrift continued to be highly profitable without significant charge-offs to that point. These factors, however, are not considerations in OTS guidance for assigning the component ratings. In our opinion, failing to adjust CAMELS ratings for conditions that are unsatisfactory sends a mixed and inappropriate supervisory message to the institution and its board, and is contrary to the very purpose for which regulators use the CAMELS rating system.

Furthermore, we believe that an informal enforcement action was warranted based on the results of the 2007 limited examination to address Century's deteriorating asset quality and inadequacies in Century's management. According to the OTS Examination Handbook, OTS may use informal enforcement action when a thrift's overall condition is sound, but it is necessary to obtain written commitments from an association's board of directors or management to ensure that it will correct the identified problems and weaknesses. OTS, however, did not issue any informal enforcement actions to Century. Instead, it waited until December 2008, almost 15 months later, to issue a formal enforcement action.

Given the rapidly deteriorating condition of the thrift and inadequate and unreliable risk management mechanisms, a long term problem at this thrift, we believe that OTS should have downgraded Century's asset quality component and management component from a 2 to at least a 3, and issued an informal enforcement action after its August 2007 limited examination. Had OTS taken one or both of these steps, some of Century's problems might have been addressed earlier, which in turn might have reduced losses to the Deposit Insurance Fund.

**OTS Did Not Issue a Temporary Cease and Desist Order While Century Contested a Proposed Cease and Desist Order**

OTS can issue a C&D order either by consent or following a formal administrative hearing when a thrift is required to correct a violation of law, regulation, or an unsafe or unsound practice. OTS can issue a temporary C&D order when it is necessary for a thrift to take immediate action to address insolvency, dissipation of assets, or weakened condition. It can also be used to order a thrift to stop any activity pending the completion of a C&D proceeding. C&D orders and temporary C&D orders are public actions and legally enforceable.

On September 26, 2008, based on the results of its full-scope examination which began in May 2008, OTS notified Century that it was in troubled condition and imposed restrictions relating to asset growth, compensation and benefits, third party contracts, dividends, brokered deposits, and transactions with affiliates. Also at that time, the OTS southeast region supervisory action committee approved the issuance of a C&D order to address Century's unsafe and unsound practices. OTS, however, did not issue the proposed C&D order[8] until December 11, 2008, almost 3 months later. On January 7, 2009, Century responded to OTS's proposed C&D order indicating that (1) the findings in the 2008 ROE were inaccurate, (2) the board was appealing various ratings in the report, and (3) the proposed C&D order was inappropriate and should be modified to a supervisory agreement.[9]

After negotiating with the thrift for several weeks in an effort to reach consent over the proposed C&D order, OTS provided Century with a final proposed C&D order on February 12, 2009. The final C&D order included notification to Century that if the thrift did not timely consent to the order, the matter would be transferred to the OTS chief counsel's office in Washington, D.C., for an issuance of a formal notice of charges.[10] Century responded to OTS on February 19, 2009, stating that it would not consent to the C&D order. As a result, OTS issued a notice of charges on March 3, 2009, and on April 17, 2009 an administrative law judge set an administrative hearing for October 19, 2009. We

[8] OTS directed Century's board to consent to the proposed C&D order by December 26, 2008.
[9] A supervisory agreement is a formal (public) enforcement action, but is not legally enforceable.
[10] A notice of charges is required when a temporary C&D order is issued and initiates the proceeding for a permanent C&D order. However, a notice of charges can be issued without issuing a temporary C&D order.

acknowledge that OTS had no control as to the timing of when the administrative hearing would be set. However, in this case, we believe it would have been prudent and reasonable for OTS to avail itself of its other supervisory tools, such as issuing a temporary C&D, to prevent the thrift from originating more loans; OTS did not take any such action against Century. Instead, it took nearly 11 months after OTS first determined that a C&D should be issued, before Century consented to the C&D order.[11]

OTS's regional enforcement counsel told us that OTS discussed issuing a temporary C&D order in April 2009, but at that time, they felt they needed more evidence to show harm. However, we believe that in light of the history of this thrift's management and board of directors' performance, as discussed above, and the evidence OTS had in order to support the issuance of the proposed C&D order, the issuance of a temporary C&D order was warranted, and necessary to prevent Century from continuing its unsafe and unsound lending activities, and potentially limit losses to the Deposit Insurance Fund.

**OTS Did Not Require Century to Hold Additional Capital**

OTS can impose individual minimum capital requirements on a thrift whenever an examiner finds capital to be insufficient relative to a thrift's risk profile. For example, higher capital levels may be appropriate for a thrift that engages in higher-risk activities, especially if the activities are conducted at significant concentration levels. In addition, higher capital requirements may be appropriate for a thrift that has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly credit concentrations and nontraditional activities.

As previously discussed, Century's business strategy was to keep just enough capital to be at the well-capitalized level. As early as 1999, examiners noted that given the thrift's risk profile, both capital and ALLL were maintained at the lowest acceptable levels, leaving little cushion for unforeseen contingencies. Even though Century's capital was at minimal

[11] The permanent C&D order became effective August 11, 2009. It required Century to (1) prepare a capital augmentation plan; (2) maintain core and risk-based capital ratios of 8 and 12 percent, respectively; (3) develop a business plan and detailed written plan to reduce problem assets; (4) address ALLL adequacy and the ALLL methodology; and (5) implement the 2008 ROE and other corrective actions.

acceptable levels relative to its risk profile, OTS did not take supervisory action to require Century to hold additional capital.

When we asked OTS whether it considered imposing an individual minimum capital requirement on Century after the 2007 limited-scope examination, we were told that during the time, the thrift's earnings remained strong and the examination team did not believe that capital was threatened by credit quality issues. However, because of Century's deteriorating asset quality, high concentrations in HELOCs, construction loans, and land loans, and inadequate management, we believe OTS should have imposed a minimum capital requirement after the 2007 limited-scope examination. Such a requirement might have prevented Century from increasing its high-risk loan portfolio and potentially lessen losses to the Deposit Insurance Fund.

**OTS Did Not Take Forceful and Timely Actions to Address Century's Unsafe Concentrations in Higher-Risk Lending**

OTS's ROEs identified Century's increasing concentrations in higher-risk lending. However, OTS did not take timely action to limit growing concentrations.

By June 2005, Century had high concentrations in HELOCs, construction loans, and land loans; however, OTS did not use MRBAs or corrective actions to limit or restrict the thrift's concentration in and growth of these loans until it issued a corrective action in the May 2008 ROE. This corrective action stated that the board should establish comprehensive loan concentration limits to ensure that reasonable levels of concentrations are maintained. We believe that OTS should have taken stronger supervisory action by at least 2006 to address the thrift's concentrations in higher-risk lending.

**OTS Did Not Require Century to Refile Its TFR After It Backdated a Capital Contribution**

In June 2009, we reported on the circumstances surrounding inappropriately backdated capital contributions by six thrifts.[12] One of those thrifts was Century. As mentioned earlier, Century's holding company made a $7 million capital contribution to the thrift on July 29,

[12] *Safety and Soundness: OTS Involvement With Backdated Capital Contributions by Thrifts*, OIG-09-037 (May 21, 2009).

2008, and backdated the transaction in its TFR for the period ended June 30, 2008. OTS objected to Century's backdating the transaction and instructed the thrift's management not to do so, but the thrift's management proceeded to do so nonetheless. We determined that if OTS had required Century to refile its TFR without the $7 million backdated capital contribution, the thrift's total risk-based capital would have been about 9.2 percent. In that case, Century would have been categorized as adequately capitalized, rather than well-capitalized, at June 30, 2008.

**OTS's Use of PCA Was Reasonable**

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund. According to PCA requirements, federal banking agencies are to take certain actions when an institution's capital drops below the adequately capitalized level. Under PCA, regulators also have flexibility to take other supervisory actions against institutions based on criteria other than capital levels to help reduce deposit insurance losses caused by unsafe and unsound practices.

We concluded that OTS used its authority under PCA in accordance with PCA requirements once Century's capital level fell below adequately capitalized. A description of OTS's key actions follows:

- On August 3, 2009, based on Century's filing of its June 30, 2009, TFR, OTS timely notified Century that it had fallen into the significantly undercapitalized capital category. The notice required Century to file a capital restoration plan no later than August 28, 2009. It also required Century to abide by mandatory PCA restrictions, which included limits on capital distributions, acquiring interest in any company or insured depository institution, and establishing additional branch offices. The PCA notice also required Century to notify OTS of any changes in directors or senior executive officers and of any transaction with affiliates.

- On September 30, 2009, OTS notified Century that it was deemed critically undercapitalized and that the capital restoration plan submitted in response to its August 3, 2009, notice was disapproved. The notice also requested that Century's board consent to a PCA directive.[13] Century's board consented to the issuance of the PCA directive on October 19, 2009. The PCA directive became effective on October 22, 2009. OTS closed Century and appointed FDIC as receiver on November 13, 2009.

The PCA and other enforcement actions taken by OTS ultimately were unsuccessful in preventing the thrift's failure.

**OTS Internal Failed Bank Review**

In accordance with its policy, OTS performed an internal review of Century's failure to determine the causes of failure, evaluate its supervision, and provide recommendations.[14] Similar to what we found, OTS's review determined that Century's failure was caused by losses experienced in its higher risk and geographically concentrated loan portfolios, which eroded the thrift's capital. The asset quality deterioration was exacerbated by the failure of Century's management and board of directors to ensure that adequate risk management practices were in place to manage and control the significant credit risk of these portfolios during the period of aggressive loan growth.

Although the review concluded that OTS provided regular oversight of Century, it also identified instances where OTS supervision could have been more stringent in regard to requiring the thrift to set concentration limits for higher risk lending activities, establishing and maintaining appropriate risk management practices to control and manage credit risk, and maintaining adequate capital levels to support higher risk lending. Furthermore, the review concluded that OTS could have taken additional supervisory actions in an effort to mitigate the risk at Century until Century's board consented to OTS's proposed C&D order, including issuing a temporary C&D order.

[13] The PCA directive required the thrift, in part, to (1) recapitalize by either merging with or being acquired by another entity or the sale of all or substantially all of the institution's assets and liabilities; (2) achieve and maintain, at a minimum, total risk based capital ratio of 8 percent, tier 1 core risk based capital ratio of 4 percent and leverage ratio of 4 percent; (3) make diligent and good faith efforts to seek capital; (4) obtain prior approval from OTS before entering into certain agreements; (5) comply with all mandatory PCA restrictions for critically undercapitalized category institutions; (6) not pay interest rates on deposits that exceed the prevailing rates; and (7) not to provide any compensation to directors, officers or employees beyond those determined reasonable and prudent for a capital deficient institution.

[14] The scope of the review focused primarily on OTS's supervision from August 2005 through November 2009.

OTS also noted in its review that its ROE dated June 25, 2009, had downgraded ratings that were not entered into its examination data system or communicated to the bank. This was an oversight by OTS supervision. Century's ratings were not downgraded or formally communicated to the thrift until September 2009.

The internal review identified four recommendations. For three recommendations, two related to concentration risks (risk management and capital requirements) and one related to timeframes for taking enforcement actions, the review noted that these issues had been identified previously and addressed by the issuance of additional OTS guidance. The review identified a new recommendation—to add an edit check for field visits in the OTS examination data system to ensure oversights of entering changes in ratings will not recur.

## Concluding Remarks

We have reported on excessive concentrations in higher-risk real estate loans and a lack of strong supervisory responses in a number of our material loss reviews during the current economic crisis. To address the need for more direction on concentration limits, OTS issued guidance to thrifts in July 2009 regarding asset and liability concentrations and related risk management practices.[15] The guidance emphasizes important risk management practices and encourages financial institutions to revisit existing concentration policies. It alerts thrifts that OTS examiners will scrutinize high-risk concentrations and pursue appropriate corrective or enforcement action when an institution does not maintain appropriate concentration limits or takes excessive risks. The guidance clearly states that OTS will monitor institutions with a concentration exceeding 100 percent of core capital plus ALLL. While we believe that this July 2009 guidance is better than what had been available to thrifts previously, it is too soon to tell whether the guidance will be effective at controlling risky concentrations going forward. Furthermore, there has been no recent update to examination procedures that identifies a trigger where concentrations are excessive from a safety and soundness perspective

[15] Chief Executive Officer (CEO) Letter No. 311, Risk Management: Asset and Liability Concentrations (July 9, 2009)

or provide examiners a range of responses to address excessive concentrations.[16]

The material loss review of Peoples Community Bank[17], completed by a contractor under our supervision, included a recommendation that OTS 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. Our material loss review of Century reaffirms the need for action on this recommendation.

With respect to the long delay by OTS in issuing the C&D order to Century (September 2008 to August 2009), OTS did not have any guidelines in place at the time as to when a proposed C&D order should be issued once approved. However, in August 2009, OTS implemented national guidelines that formal enforcement actions should be issued by the regional director and effective within 60 calendar days of the enforcement review committee approval.[18]

We have also previously reported on the need for examiners to issue appropriate CAMELS ratings based on the conditions found and not let factors like profitability and earnings unduly influence those ratings. This is a matter that requires continued attention by examiners.

Based on the above, and in light of the pending transfer of OTS functions to other federal banking agencies on July 21, 2011, we are making no recommendations from our material loss review of Century.

[16] The last update to the OTS Examination Handbook pertaining to this subject was in June 2005.
[17] *Safety and Soundness: Material Loss Review of Peoples Community Bank*, OIG-10-040 (May 27, 2010).
[18] OTS New Direction Bulletin 09-11a, Regional Enforcement Review Committees, August 7, 2009.

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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) 927-5776 or Amni Samson, Audit Manager, at (202) 927-0264. Major contributors to this report are listed in appendix 5.

/s/

Susan Barron
Audit Director

We conducted this material loss review of Century Bank, FSB (Century), of Sarasota, Florida, in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[19] 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 (PCA) provisions of section 38; and

- makes recommendations for preventing any such loss in the future.

The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

We initiated a material loss review of Century based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC), which was $344 million at the date of its failure on November 13, 2009. As of March 11, 2011, FDIC estimated that the loss would be $266.5 million. FDIC also estimated that Century's failure resulted in a loss of $598,960 to the Transaction Account Guarantee Program.

Our objectives were to determine the causes of Century's failure; assess the Office of Thrift Supervision's (OTS) supervision of Century, including implementation of the PCA provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish our review, we conducted fieldwork at OTS's headquarters in Washington, D.C.; OTS's southeast region office in Atlanta, Georgia; and Century's headquarters in Sarasota, Florida. We also interviewed officials of FDIC's Division of

[19] 12 U.S.C. § 1831o(k).

Supervision and Consumer Protection. We conducted our fieldwork from January 2010 through March 2010.

To assess the adequacy of OTS's supervision of Century, we determined (1) when OTS first identified Century's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the thrift to correct the problems. We also assessed whether OTS (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following work:

- We determined that the time period relating to OTS's supervision of Century covered by our audit would be from August 2005 through Century's failure on November 13, 2009. This period included three full-scope safety and soundness examinations prior to OTS's September 2008 designation of Century as a troubled institution and three limited-scope examinations.

- We reviewed OTS's supervisory files and records for Century from 2005 through 2009. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OTS used to assess the thrift's condition, and the regulatory action used by OTS to compel thrift management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.

- We interviewed and discussed various aspects of the supervision of Century with OTS officials and examiners to obtain their perspectives on the thrift's condition and the scope of the examinations.

- We interviewed FDIC officials who were responsible for monitoring Century for federal deposit insurance purposes.

- We reviewed Century documents that had been taken by FDIC and inventoried by FDIC Division of Resolutions and Receiverships personnel.

- We assessed OTS's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[20]

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.

[20] 12 U.S.C. § 1811 et seq.

## Loans Involving Improper Accounting Practices

Century Bank, FSB (Century) made a number of questionable loans then concealed and distorted its financial condition through improper credit administration practices. In this regard, Century (1) failed to timely identify and classify problem loans, (2) did not obtain timely appraisals and ignored unfavorable appraisals, and (3) advanced funds to pay delinquent interest in order to keep loans current. Six Century questionable loans are discussed below.

### Loan One

In January 2007, Century originated a loan for $5.6 million primarily for construction of the borrower's home located in Dunedin, Florida. From December 2008 through February 2009, Century inappropriately used $120,000 in construction funds to pay the interest payments and keep the loan current. As a result, Century continued to fund a delinquent borrower and failed to timely classify the problem loan.

An independent inspector was hired by Century to review each loan draw submitted by the borrower, inspect the project to ascertain that the work had been completed, and make a recommendation to Century whether to pay the draw. In the later part of 2008, a new appraisal indicated construction had not progressed to a 91 percent complete status as represented in a prior inspection report. As of June 30, 2009, 98 percent of the initial loan funds were disbursed. However, based on an updated inspection valuation received on July 1, 2009, an estimated additional $1 million was needed to get the project to "designer-ready" status (defined as 70 percent complete). Litigation between Century and the inspection company ensued for improper approvals of construction draws. The following photograph shows the condition of the property as of March 11, 2010, which indicates substantial construction work is still needed to finish the home.

**Figure 5: Property as of March 11, 2010**

Source: OIG observation.

Loan 2

In November 2006, Century made a $4 million acquisition and development loan and a $4 million guidance line of credit to a borrower, for a total credit of $8 million.[21] In January 2008, Century's management used $274,000 of the undisbursed loan balance funds to keep the loan current. In addition, in March 2009, the property, which was located in Riverview, Florida, was valued "as is" at $1.4 million, which represented a significant decline in collateral value. At that time, Century management should have downgraded the loan or performed an impairment analysis. Instead management did not classify the loan as substandard until May 2009, 2 months later, and did not categorize the loan as nonaccrual until June 2009.[22]As a result, Century did not timely

[21] A guidance line of credit is a line of credit approved by a thrift, but not disclosed to the borrower until some specific event, usually a request for funding from the borrower.
[22] According to section 260 of the Office of Thrift Supervision Examination Handbook, Asset Quality, institutions should report loans as nonaccrual when payments are contractually past due 30 days or more and full payment of principal and interest is not expected.

establish an appropriate valuation allowance and therefore did not properly value the loan in its March 2009 thrift financial report.

Loan 3

In October 2006, Century originated a $9 million loan to refinance 273 acres of agricultural land located in Ellenton, Florida. In January 2008, the interest reserve was depleted and the loan became delinquent. Century then improperly advanced $280,000 to the borrower for the purpose of paying delinquent interest. OTS criticized Century for providing this advance when there was no equity in the collateral. In August 2008, the borrower provided Century with $203,000 in checks, which were later returned for insufficient funds, and $684,000 in post-dated checks, which the thrift never deposited. These funds were supposed to pay off the previous advance to bring the loan current and establish an interest reserve. Century's management made a commitment to OTS to recognize an impairment loss by September 30, 2008, if the borrower failed to honor the post-dated checks. Instead, Century's management provided the borrower another loan for $641,000 on September 30, 2008, that was used to pay off the $280,000 loan, and to pay delinquent payments and late charges on the $9 million loan. This loan was a fifth mortgage on the property—agriculture land for which Century did not obtain an updated appraisal to verify its value as collateral. In addition, Century failed to timely identify the problem loan and did not record an impairment for loan until it filed an amended June 2009 TFR on August 21, 2009.

Loan 4

Century made seven loans to the borrower, which were mostly residential loans involving cash-out refinances and totaling $9.3 million. In late 2008, due to the borrower's financial difficulties and cash flow concerns, Century provided the borrower with two additional commercial loans totaling $643,000. However, these funds were not disbursed to the borrower but were used for interest payments on the residential loans and for a partial paydown on another loan. The collateral for the two commercial loans was a fifth lien on a landfill and a third lien on a nonoperating dirt pit. According to OTS staff we interviewed, it is common to see first and second liens but highly unusual to see third and fifth liens. Most lenders want to be in a first lien position because in the event of a default, they are the first creditor to receive remuneration. Occasionally, a lender accepts a second lien position. Since Century had a third and a fifth lien position on these properties, it was unlikely it would receive any remuneration from the collateral in the event of a default on the commercial loans.

Loan 5

In January 2007, Century approved a $12 million stated income loan to a borrower in Ohio, which was outside of Century's normal lending area. The loan was used to pay off two loans totaling $6 million on the borrower's residence and provide the borrower with $3 million in cash. The remaining$3 million of the loan was placed in a certificate of deposit issued by Century to be held as collateral for the loan until the balance was paid down to less than $9 million. In 2006, the property was appraised twice with both appraisals estimating a value of $16 million. The appraised property was located in Columbus, Ohio, and consisted of a 27,400 square foot luxury residence and a 6,400 square foot guest house. Comparable properties used to determine the appraisal value were located far from the subject property (one comparable property, for example, was located in Atlanta, Georgia), and none of the comparables were similar in size (one comparable property, for example, was a 13,325 square foot home located in Franklin, Tennessee). During a 2007 field visit, OTS required Century to obtain a new appraisal and submit it to OTS. During its May 2008 examination, OTS found that Century still had not obtained a new appraisal. In August 2008, Century's management obtained a "drive-by" appraisal that was never submitted to OTS or provided to OTS examiners. OTS examiners found the updated appraisal during its July 2009 examination. The updated appraisal estimated the value of the collateral was $4.2 million as of August 2008, which represented a significant decline in value since the original appraisals. Since Century did not obtain the appraisal in a timely manner and ignored the appraisal they later received, Century delayed recognizing the loss and consequently distorted the thrift's true financial condition.

Loan 6

In May 2006, Century was a lead lender in a $10.5 million loan to refinance 10 developed residential lots in the Florida panhandle. A $2.5 million participating interest was sold to another bank. In December 2006, OTS designated the loan special mention based on (1) the inability of the borrower to sell the lots; (2) the contingent liabilities of the guarantors; and (3) the property location, which was outside of Century's normal lending area. Although Century management agreed to designate the loan special mention, it did not do so until after a subsequent OTS field visit, in August 2007. In June 2008, Century was the successful bidder of these lots at the foreclosure sale. In August 2008, an appraisal of the three lots property indicated a total of $4 million but the thrift recorded the assets on the books at $5.8 million. Given the appraised value at this time, Century should have written the loan down further than it did.

We referred these questionable loan transactions to the OIG Office of Investigations.

## History of Century Bank

Century Bank, FSB (Century), formally began operations on April 1, 1985, as Century Federal Savings and Loan Association. In 1988, a Florida businessman bought Century and in 1991 changed its name to Century Bank, FSB. Century operated in the Sarasota, Florida, area with a network of 10 branches in Sarasota and Manatee counties and 1 branch on the east coast of Florida, in Pompano Beach. Century was wholly owned by Century Financial Group, Inc., a unitary, nondiversified, shell holding company whose primary activity was ownership of the thrift. Century's owner controlled over 96 percent of the holding company's stock through personal and family interests. Century was primarily engaged in residential real estate lending and, to a lesser degree, commercial and consumer lending.

Beginning in 2007, Century's overall financial condition rapidly deteriorated. The deterioration in asset quality was primarily attributable to the declining real estate market in Florida and to management's aggressive loan growth policy and a lack of adequate risk management practices. On October 30, 2009, Century filed its September 30, 2009, thrift financial report, which reflected its insolvency. On November 13, 2009, OTS closed Century and appointed the Federal Deposit Insurance Corporation as receiver.

### OTS Assessments Paid by Century

OTS funds its operations in part through semiannual assessments on savings associations. OTS determines each institution's assessment by adding together three components reflecting the size, condition, and complexity of an institution. OTS computes the size component by multiplying an institution's total assets, as reported on its thrift financial report, by the applicable assessment rate. The condition component is a percentage of the size component and is imposed on institutions that have a 3, 4, or 5 CAMELS composite rating. OTS imposes a complexity component if (1) a thrift administers more than $1 billion in trust assets; (2) the outstanding balance of assets fully or partially covered by recourse obligations or direct credit substitutes exceeds $1 billion, or (3) the thrift services over $1 billion of loans for others. OTS calculates the complexity component by multiplying set rates by the amounts by which an association exceeds each threshold. Table 4 shows the assessments that Century paid to OTS from 2005 through 2009.

**Table 4: Assessments Paid by Century to OTS, 2005–2009**

| Billing Period | Exam Rating | Amount Paid |
|---|---|---|
| 1/1/2005–6/30/2005 | 2 | $53,111 |
| 7/1/2005–12/31/2005 | 2 | $59,967 |
| 1/1/2006–6/30/2006 | 2 | $65,193 |
| 7/1/2006–12/31/2006 | 2 | $71,462 |
| 1/1/2007–6/30/2007 | 2 | $82,813 |
| 7/1/2007–12/31/2007 | 2 | $94,674 |
| 1/1/2008–6/30/2008 | 2 | $101,134 |
| 7/1/2008–12/31/2008 | 2 | $103,731 |
| 1/1/2009–6/30/2009 | 4 | $211,148 |
| 7/1/2009–12/31/2009 | 4 | $205,594 |
| **Total** | | **$1,048,827** |

Source: OTS.

### Number of OTS Staff Hours Spent Examining Century

Table 5 shows the number of OTS staff hours spent examining Century from 2005 to 2009.

**Table 5: Number of OTS Hours Spent on Examining Century, 2005-2009**

| Examination Start Date | Examination Type | Number of Examination Hours |
|---|---|---|
| 8/29/2005 | Full Scope | 1,003 |
| 12/29/2006 | Full Scope | 1,145 |
| 8/28/2007 | Limited Scope | 204 |
| 5/19/2008 | Full Scope | 1,377 |
| 6/15/2009 | Limited Scope | 72 |

*Hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations.
Source: OTS.

**Office of Thrift Supervision**
Department of the Treasury

Thomas A. Barnes
*Deputy Director, Examinations, Supervision, and Consumer Protection*

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July 12, 2011

**MEMORANDUM FOR:** Jeffrey Dye
Director, Banking Audits
Office of Inspector General
U.S. Department of the Treasury

**FROM:** Thomas A. Barnes /s/
Deputy Director

**SUBJECT:** Draft Failed Bank Review of
Century Bank, FSB
Sarasota, Florida

Thank you for the opportunity to comment on your draft audit report entitled "Material Loss Review of Century Bank, FSB". The report focuses on the causes of the failure of Century Bank, FSB (Century) and the oversight responsibility of the Office of Thrift Supervision (OTS) for Century.

The Inspector General's report for Century contains no new recommendations but reaffirms recommendations made in previous MLR reports of OTS-regulated thrifts regarding concentration limits.

OTS has been responsive to prior Office of Inspector General (OIG) MLR reports and internally prepared assessments of other thrift failures, and has implemented actions for the recommendations in prior reports.

Thank you again for the opportunity to review and respond to your draft report of Century. We appreciate the professionalism and courtesies provided by the staff of the Office of the Inspector General.

Susan Barron, Audit Director
Jaideep Mathai, Audit Manager
Amni Samson, Audit Manager
Alicia Bruce, Auditor in Charge
Rachael Draper, Auditor
Kenneth Harness, Referencer

**Department of the Treasury**

Deputy Secretary of the Treasury
Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control

**Office of Thrift Supervision**

Acting Director
Liaison Officer

**Office of Management and Budget**

OIG Budget Examiner

**United States Senate**

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

Chairman and Ranking Member
Committee on Finance

**U.S. House of Representatives**

Chairman and Ranking Member
Committee on Financial Services

**Federal Deposit Insurance Corporation**

Acting Chairman
Inspector General

**U.S. Government Accountability Office**

Comptroller General of the United States