Board of Governors of the Federal Reserve System

Material Loss Review of CapitalSouth Bank

Office of Inspector General

March 2010

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

March 15, 2010

The Honorable Daniel K. Tarullo
Chairman
Committee on Supervisory and Regulatory Affairs
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of CapitalSouth Bank (CapitalSouth). The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) is material—that is, it exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

- review the institution's supervision, including the agency's implementation of Prompt Corrective Action;
- ascertain why the institution's problems resulted in a material loss to the DIF; and
- make recommendations for preventing any such loss in the future.

CapitalSouth was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Alabama Department of Banking and Finance (State). The State closed CapitalSouth on August 21, 2009, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. On September 15, 2009, the FDIC Inspector General notified us that CapitalSouth's failure would result in an estimated loss to the DIF of $146 million, or 24.8 percent of the bank's $588.5 million in total assets.

CapitalSouth, headquartered in Birmingham, Alabama, became a state member bank in October 1978. From its inception until 2003, the bank's primary business strategy involved lending to small- and medium-sized businesses in metropolitan areas. In 2003, CapitalSouth's strategy evolved to include expanding through (1) internal growth of the bank's traditional business lending activities, including commercial real estate (CRE) lending; and (2) targeted acquisitions. In September 2007, CapitalSouth acquired Monticello Bank (Monticello), a federal savings association, and its mortgage subsidiary, Mortgage Lion, Inc. (Mortgage Lion).

CapitalSouth failed because its Board of Directors and management did not implement a credit risk management infrastructure commensurate with its aggressive expansion strategy and high concentration of CRE loans, including acquisition, development, and construction loans. The bank pursued an aggressive expansion strategy even though its modest earnings and capital position did not provide the buffer necessary to withstand significant asset quality deterioration. CapitalSouth's acquisition of Monticello compounded CapitalSouth's preexisting credit risk management weaknesses. A declining real estate market revealed the full extent of the combined entity's credit administration and loan underwriting deficiencies and resulted in asset quality deterioration and significant losses. Mounting losses eliminated earnings, depleted capital, and ultimately caused the State to close CapitalSouth.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or loss to the DIF. Our analysis of FRB Atlanta's supervision of CapitalSouth indicated that examiners identified key weaknesses in 2005, but missed subsequent opportunities to take more forceful supervisory action.

In a 2005 examination report, FRB Atlanta highlighted a fundamental issue with the bank's growth strategy, observing that the bank had no margin for error and "cannot afford to have any substantial problem assets or loan losses given its robust growth objectives and modest earnings." We believe that FRB Atlanta should have stressed to CapitalSouth the need for solid earnings performance before the bank pursued its risky growth strategy. In our opinion, examiners should have suggested that CapitalSouth postpone its growth objectives until it enhanced its modest earnings and credit risk management practices. The eventual loss to the DIF may have been reduced if examiners took a more aggressive supervisory approach at this juncture.

FRB Atlanta, with the concurrence of Board applications staff, approved CapitalSouth's acquisition of Monticello, without conducting a pre-merger examination or documenting a waiver as specified in Supervision and Regulation (SR) Letter 98-28. This guidance establishes the criteria for conducting safety and soundness examinations of depository institutions seeking to become, or merge into, a state member bank. It outlines an "eligible bank" test and the factors to be evaluated when determining whether pre-merger examinations should be conducted, including whether the institution being acquired has a composite rating of 1 or 2, and has no major unresolved supervisory issues. At the time of the application, Monticello had a composite 3 rating and was under a Cease and Desist Order issued by its primary regulator, the Office of Thrift Supervision, because of its credit risk management weaknesses. In fact, post-acquisition examinations highlighted numerous high-risk elements in Mortgage Lion's loan portfolio, including sub-prime and "no documentation" lending activities. In our opinion, a full scope pre-merger examination was warranted and may have led FRB Atlanta to recommend that the Board deny the application. If CapitalSouth had not acquired Monticello, the loss to the DIF may have been reduced.

According to an FRB Atlanta official, the Reserve Bank's noncompliance with SR Letter 98-28 was attributable to the structure of the SR letter and confusion concerning how to apply the eligible bank test. Our report includes a recommendation that the guidance be clarified.

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that CapitalSouth's failure offers lessons learned that can be applied in supervising banks with similar characteristics and circumstances. Specifically, CapitalSouth's failure illustrates that banks with a pattern of modest earnings, an aggressive growth strategy, and a high CRE concentration require heightened supervisory attention. In these situations, examiners should ensure that the bank has (1) sufficient earnings and capital to support an aggressive expansion strategy, and (2) credit risk management controls that are sufficiently robust to fully support the bank's growth. In addition, CapitalSouth's failure demonstrates that pre-merger examinations need to be conducted consistent with the guidance in SR Letter 98-28.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review. The Director concurred with our conclusions, lessons learned, and recommendation. The Director said that he plans to implement our recommendation to clarify supervisory guidance that sets forth the conditions under which examinations should be conducted when depository institutions seek to become, or merge into, state member banks. We will follow up on the action taken to implement the recommendation. The Director's comments are found in Appendix 3.

We appreciate the cooperation that we received from FRB Atlanta and Board staff during our review. The principal contributors to this report are listed in Appendix 4. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

Elizabeth A. Coleman

Elizabeth A. Coleman
Inspector General

cc: Chairman Ben S. Bernanke
Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Governor Kevin M. Warsh
Mr. Stephen R. Malphrus
Mr. Patrick M. Parkinson
Mr. Michael Johnson

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Background

CapitalSouth Bank (CapitalSouth), headquartered in Birmingham, Alabama, became a state member bank of the Federal Reserve System on October 16, 1978. The bank's primary business strategy had involved lending to small- and medium-sized businesses. In 2003, CapitalSouth embarked upon an expansion strategy to grow its traditional business lending activities, including commercial real estate (CRE) lending, and acquire other institutions. On September 14, 2007, CapitalSouth acquired a federal savings association, Monticello Bank (Monticello), and its mortgage subsidiary, Mortgage Lion, Inc. (Mortgage Lion). CapitalSouth was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Alabama Department of Banking and Finance (State).

The State closed CapitalSouth on August 21, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $146 million loss to the Deposit Insurance Fund (DIF), or 24.8 percent of the bank's total assets of $588.5 million. In a letter dated September 15, 2009, the FDIC Inspector General advised us that the FDIC had determined that CapitalSouth's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

When a loss to the DIF is considered material, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency

- review the institution's supervision, including the agency's implementation of Prompt Corrective Action (PCA);
- ascertain why the institution's problems resulted in a material loss to the DIF; and
- make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected data from the Board in Washington, D.C.; FRB Atlanta; and the State. We also reviewed correspondence, Reports of Examination (examination reports) issued between 2004 and 2009, and examination work papers prepared by FRB Atlanta. Appendixes at the end of this report include a glossary of key banking and regulatory terms, and a description of the CAMELS rating system.[1] We conducted our fieldwork from November 2009 through January 2010, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

[1] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Cause of the Failure

CapitalSouth failed because its Board of Directors and management did not implement a credit risk management infrastructure commensurate with its aggressive expansion strategy and high concentration of CRE loans, including acquisition, development, and construction (ADC) loans. The bank pursued an aggressive expansion strategy even though its modest earnings and capital position did not provide the buffer necessary to withstand significant asset quality deterioration. In 2007, the bank acquired Monticello, which compounded CapitalSouth's preexisting credit risk management weaknesses. A declining real estate market revealed the full extent of the combined entity's credit administration and loan underwriting deficiencies and resulted in asset quality deterioration and significant losses. Mounting losses eliminated earnings, depleted capital, and ultimately caused the State to close CapitalSouth on August 21, 2009, and appoint the FDIC as receiver.

CapitalSouth Historically Had Modest Earnings and a Capital Position Lower Than Its Peers

In general, CapitalSouth's earnings performance lagged its national peers since 2000 because of the bank's high funding costs and low loan yields.[2] The bank relied on high-cost funding sources, such as Federal Home Loan Bank borrowings and internet certificates of deposit. In an effort to build a stable, local deposit base, the bank held a series of promotions to attract customers by paying comparatively higher interest rates. With respect to the bank's loan yields, substantial competition in the bank's key markets forced CapitalSouth to offer customers relatively low interest rates on its commercial loans. The combination of high funding costs and low yields reduced CapitalSouth's profit margin and resulted in modest earnings.

In addition to modest earnings, CapitalSouth's capital position also lagged its national peers. In a 2005 examination, FRB Atlanta noted that the bank was *well capitalized*, but expressed concern because the bank's capital had remained below its peer group since year-end 2003 and declined since the previous examination. The 2005 examination report required management to (1) enhance strategic and capital planning and (2) develop a comprehensive capital plan. The report also noted that management's current capital plan identified inadequate capital as a possible future risk to the bank, but it did not outline management's plans for raising the capital necessary to support the bank's CRE concentration and anticipated loan growth.

Aggressive Growth Strategy

Despite its modest earnings and capital position, CapitalSouth pursued an aggressive growth strategy that increased the bank's overhead expenses and continued to strain its earnings. Between 2003 and 2005, CapitalSouth's overhead expenses increased because the bank expanded into two new markets—Huntsville, Alabama, and Jacksonville, Florida—and more than tripled its branch network to a total of seven branches. Bank management anticipated that

[2] From 1999 through 2004, the bank's peer group included insured commercial banks having assets between $100 million and $300 million in a metro area with three or more full service offices. The bank's peer group from 2005 through 2009 included insured commercial banks with total assets between $300 million and $1 billion.

the deposits from the new branches would reduce CapitalSouth's reliance on high-cost funding sources. The 2005 examination report indicated that the bank's high-cost funding supported the bank's loan growth, but that it continued to strain the bank's net interest margin.[3] In 2005, examiners also noted that the bank's overhead costs had risen significantly. They further noted that the bank's earnings continued to remain below its peer group. The 2005 examination report emphasized that CapitalSouth "cannot afford to have any substantial problem assets or loan losses given its robust growth objectives and modest earnings."

Despite examiner's observations concerning the risks associated with management's growth objectives, the bank increased its loan portfolio significantly from 2005 through 2007. Management's expansion strategy resulted in the loan portfolio increasing 60 percent in a two-year period, with total loans increasing from $240 million in March 2005, to $384 million by March 2007. CapitalSouth's acquisition strategy produced similar loan growth results. The bank's acquisition of Monticello in 2007 increased the bank's loan portfolio by 59 percent to $644 million. Following the acquisition, Monticello loans comprised approximately 37 percent of CapitalSouth's total loan portfolio.

High Concentration in ADC Loans

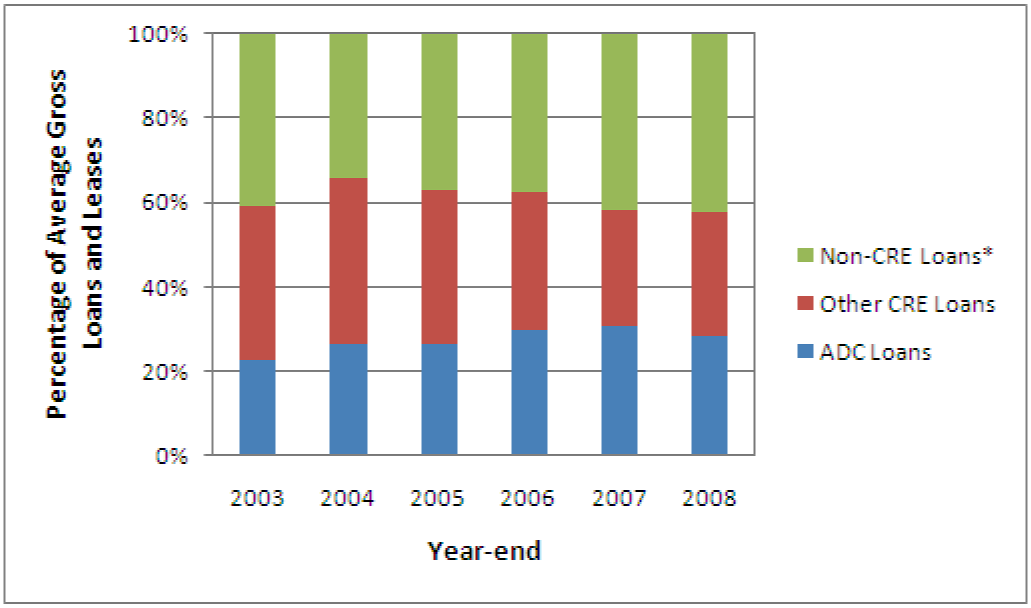
CapitalSouth's aggressive growth strategy included CRE lending, and the bank developed a high CRE concentration. CapitalSouth also had a high concentration in the ADC loan component of its CRE loan portfolio. In 2005, examiners noted that CapitalSouth's CRE concentration represented 583 percent of the bank's capital. Examiners also observed that ADC loans represented 231 percent of the bank's capital in 2005 and peaked at 308 percent by 2007. While the Monticello acquisition significantly increased the loan portfolio, it had a minimal impact on the bank's CRE and ADC concentration levels.[4]

As shown in Chart 1, CRE loans represented approximately 60 percent of the bank's total loans and leases from 2003 through 2008, and ADC loans comprised approximately 50 percent of the bank's total CRE portfolio from 2006 through 2008. In general, loan concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. As such, concentrations may represent a substantial risk to the safety and soundness of an institution. When combined with the bank's growth strategy and the weaknesses identified by examiners, concentrations in CRE loans, including ADC, heightened the bank's vulnerability to a real estate market downturn.

[3] Net interest margin is a performance metric used to evaluate a bank's profitability by measuring the difference between interest income generated in comparison to the interest paid.

[4] The Monticello acquisition changed CapitalSouth's loan mix by increasing one-to-four family residential mortgages from 14.7 percent to 24.1 percent of total gross loans, but the ADC concentration levels only increased by 7 percent of capital.

Chart 1: CapitalSouth's Loan Mix as a Percentage of Average Gross Loans and Leases



* Non-CRE loans include loans for one-to-four family residential, farmland, commercial and industrial, and individuals.

Management Failed to Address Weaknesses and Deficiencies

CapitalSouth's management failed to fully address examiners' longstanding concerns regarding the bank's modest earnings. The bank's earnings were rated 3 during 2006 and 2007, and examiners characterized the bank's earnings as "fair" and "less than satisfactory." Examiners acknowledged that management's asset growth strategy sacrificed earnings performance during this time period. A 2008 examination report noted that earnings had become "critically deficient and insufficient to support operations and maintain appropriate capital levels," and that the bank failed to implement measures to fully resolve its longstanding earnings issues. Management attributed its inability to resolve its earnings deficiencies to the intense competition in the bank's local markets and the fact that reducing its high funding costs was "a difficult endeavor."

CapitalSouth's management also failed to develop a comprehensive capital plan that reflected the bank's current condition. In 2005, examiners required the bank to develop a current long-term capital plan. In 2006, the State acknowledged the positive impact of a $9.3 million capital infusion from CapitalSouth's holding company and indicated that the bank was managing capital "effectively," but also noted that management still had not developed a current, comprehensive capital plan. The 2006 examination report indicated that the bank would present an updated capital plan to the Board of Directors later that year. The 2008 examination report indicated that the capital planning section of the bank's strategic plan had not been updated since 2006. It contained outdated references regarding the strength of the bank's capital and did not consider the impact of the recent acquisition of Monticello. Because of these deficiencies, FRB Atlanta again required the bank to develop a comprehensive capital plan in 2008, but CapitalSouth's Board of Directors and management did not submit an acceptable plan before the bank failed.

In addition, bank management failed to implement a loan review function commensurate with the bank's risk profile, which was a key credit administration weakness. Even though examiners reiterated the importance of loan review based on CapitalSouth's risk profile, the Board of Directors and management did not dedicate sufficient resources to improving this function. Examiners indicated that loan review was inadequate or required improvement during each of the three examinations preceding the bank's failure. In 2009, examiners concluded that "until recently, it was apparent that the directors did not understand or appreciate the severity of the bank's problems."

The Monticello acquisition compounded CapitalSouth's credit risk management challenges because Monticello had similar weaknesses. As part of the acquisition approval process, CapitalSouth's management committed to FRB Atlanta that it would correct and strengthen Monticello's credit risk management. However, during subsequent examinations, examiners noted the following key concerns about Mortgage Lion's underwriting and loan portfolio risk management practices:

- Mortgage Lion was originating sub-prime loans;
- many of its loans had little or no documentation; and
- 80 percent of the loans were made in Florida.[5]

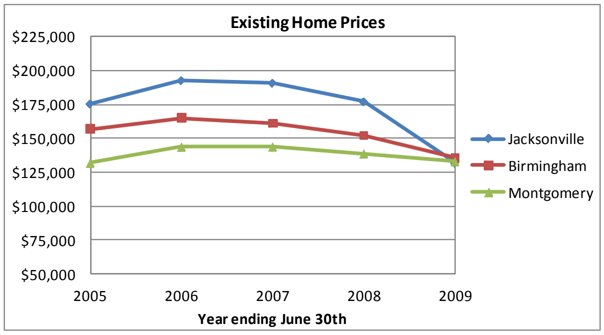
In addition, examiners consistently noted weaknesses in Mortgage Lion's credit administration, but CapitalSouth's management failed to fully address these deficiencies before the bank failed.

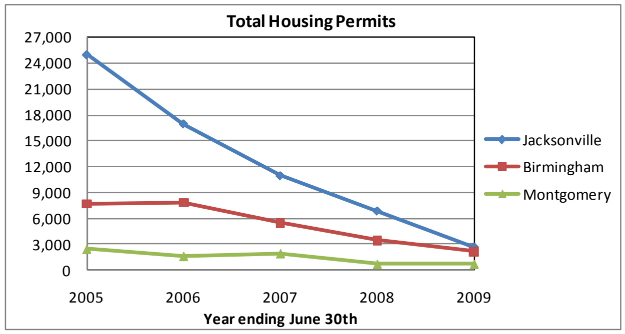
Real Estate Market Downturn

Residential real estate in CapitalSouth's primary markets (Jacksonville; Birmingham; and Montgomery, Alabama) exhibited moderate to robust growth and price appreciation until the second quarter of 2007, when the first definitive signs of a slowdown appeared. As shown in Charts 2 and 3, residential real estate permits in Jacksonville peaked at 25,008 in 2005, and decreased approximately 89 percent to 2,654 in four years. Housing prices in Jacksonville also deteriorated significantly, falling approximately 25 percent from the local market peak in 2006 through 2009. Birmingham experienced more gradual drops in home prices and housing permits than the Jacksonville market, while the Montgomery market experienced a mild decline by comparison. By 2009, residential construction levels were at historic lows in Jacksonville and Birmingham.

[5] Correspondence between CapitalSouth and FRB Atlanta application staff stated that Monticello had not been engaged in the subprime mortgage origination market and non-standard (Alt-A) lending had been minimal, reflecting less than 20 percent of its originations for the past two years.

Charts 2 and 3: Housing Market Data for CapitalSouth's Primary Markets

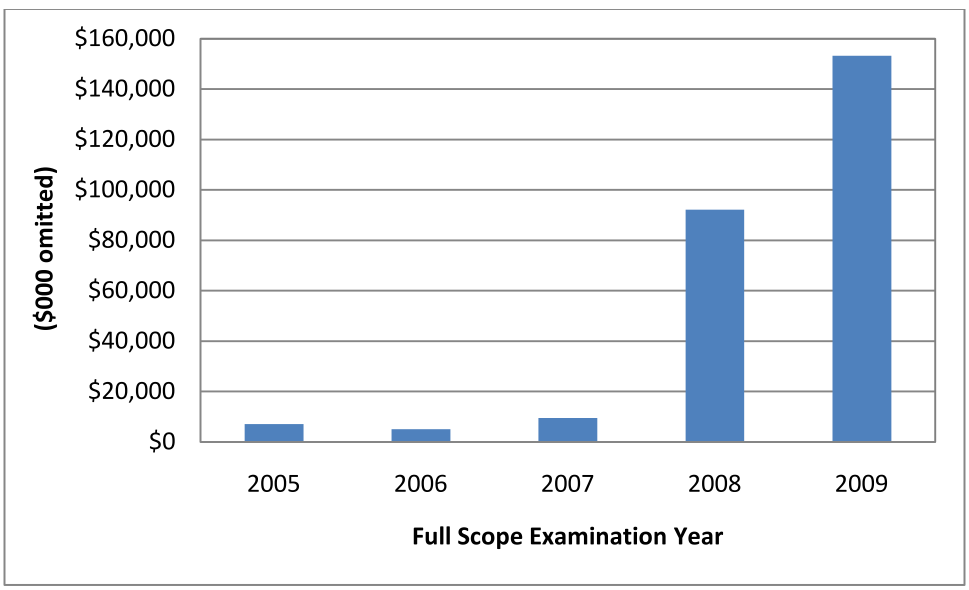




Problem Assets and Goodwill Impairment Eliminated Earnings

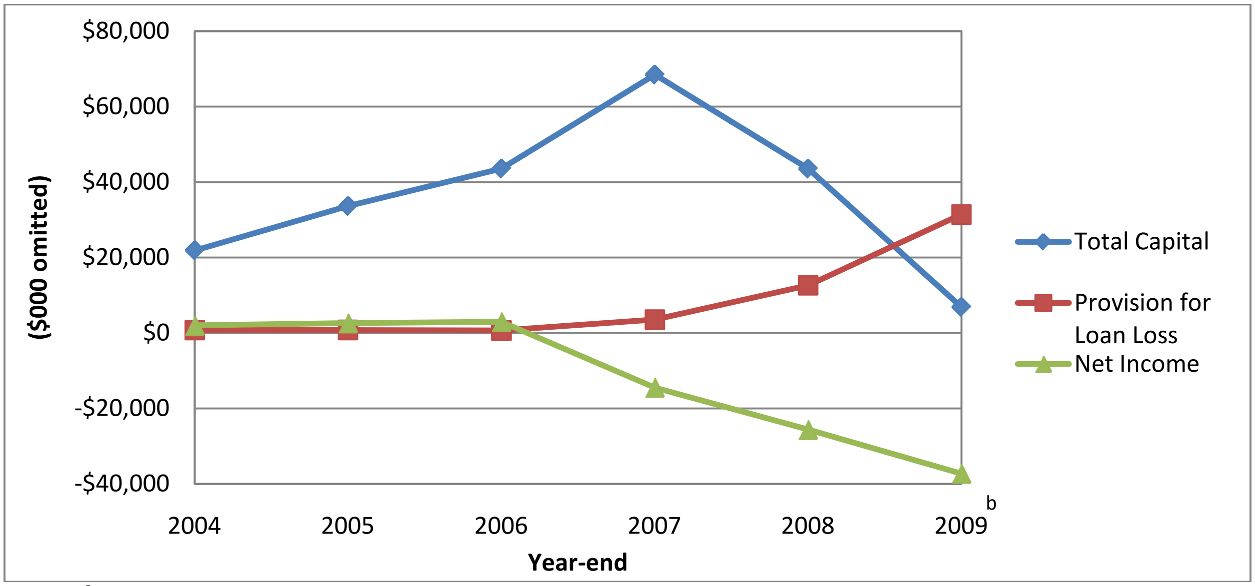
CapitalSouth's CRE and ADC loan concentrations, coupled with the rapid downturn in the Florida real estate market, led to significant growth in classified assets. As shown in Chart 4 below, the bank's classified assets increased more than thirty-fold from approximately $5 million in 2006, to $153 million in 2009. In 2008, examiners highlighted the Monticello acquisition as a contributing factor in the bank's asset quality deterioration, but also emphasized the substantial deterioration in CapitalSouth's pre-acquisition loan portfolio. According to examiners, during 2008, ADC loans represented 48 percent of the bank's total classified assets. Examiners also noted that Monticello loans represented 37 percent of total loan classifications as of July 2009. Classified assets spiked during 2008 and 2009 because management had not adequately identified problem loans and examiners questioned and adjusted the loan grades assigned by management.

Chart 4: Classified Assets Reported during Full Scope Examinations



The growth in classified assets prompted corresponding increases in CapitalSouth's allowance for loan and lease losses (ALLL) and loan loss provision expenses. The ALLL increased ten-fold from $2.8 million on December 31, 2004, to more than $30 million on June 30, 2009. The provision expense for the year ending December 31, 2008, totaled $12.6 million. By June 30, 2009, the provision more than doubled to $31.4 million, contributing to the bank's 2008 and 2009 net losses. In addition, the bank's external audit firm revealed a 100 percent goodwill impairment associated with the Monticello acquisition and instructed the bank to charge off the $26.3 million goodwill asset.[6] Although goodwill is an intangible asset, the write-downs are taken as a noninterest expense and contributed to the bank's net losses.[7] As shown in Chart 5, CapitalSouth's increasing provision expenses contributed to the bank's net losses and decreased the bank's capital.

Chart 5: Impact of Provision Expense on Earnings and Capital[a]



[a] CapitalSouth acquired Monticello in 2007. This acquisition caused CapitalSouth's total bank capital to grow, despite the net loss in 2007. The increase in bank capital from the acquisition was large enough to offset the drop in revenue and still increase overall capital levels.
[b] Data is as of June 30, 2009.

CapitalSouth's deteriorating capital position invoked the PCA provisions of the FDI Act. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled depository institutions. FRB Atlanta implemented PCA and made timely notifications when the bank reached various PCA categories. In June 2008, CapitalSouth fell from the *well capitalized* PCA threshold to *adequately capitalized* and was restricted from accepting, renewing, or rolling over brokered deposits.

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[6] Goodwill is an intangible asset found on an institution's balance sheet and is often created through acquisitions.
[7] This impairment was taken in two phases: a $17 million charge-off as of year-end 2007 and $9.3 million as of second quarter 2008.

A full scope examination that began in April 2009 revealed further asset quality deterioration, and on June 16, 2009, FRB Atlanta sent a letter notifying CapitalSouth that its PCA capital position had dropped to *critically undercapitalized*. This notification required the bank's Board of Directors to take specific corrective actions that included submitting a capital restoration plan by July 6, 2009. On July 16, 2009, FRB Atlanta informed CapitalSouth that its plan was not acceptable because it did not meet the regulatory criteria outlined in the June 16, 2009, letter. FRB Atlanta required management to resubmit a plan consistent with the requirements outlined in the June 16, 2009, letter. The bank submitted another capital plan that was again deemed unacceptable. On August 21, 2009, the State closed CapitalSouth, and the FDIC was named receiver.

Supervision of CapitalSouth

As shown in Table 1, FRB Atlanta and the State examined CapitalSouth seven times from 2004 through 2009. Examiners complied with supervisory guidance concerning the examination cycle. CapitalSouth received a CAMELS composite 2 (satisfactory) rating from 2004 through 2007. A 2008 examination resulted in a double downgrade to a CAMELS composite 4 (marginal) rating because a severe decline in asset quality decreased the bank's earnings, capital, and liquidity. Examiners' concerns regarding CapitalSouth's deteriorating financial condition prompted FRB Atlanta and the State to issue a Cease and Desist Order (C&D) in November 2008. FRB Atlanta and the State began an asset quality target examination in January 2009 that resulted in a downgrade to a CAMELS composite 5 (unsatisfactory) rating, and examiners questioned the bank's viability in light of its critically depleted capital position. A joint full scope examination completed in July 2009 assigned CapitalSouth another composite 5 rating and resulted in further downgrades to the bank's CAMELS component ratings.

Table 1: Supervisory Overview of CapitalSouth

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
4/5/2004	5/24/2004	Full	State	2	2	2	2	2	3	2	
4/11/2005	9/1/2005	Full	FRB	2	2	2	2	3	2	2	Informal Improvement Plan[a]
6/6/2006	7/21/2006	Full	State	2	2	2	2	3	1	2	
7/16/2007	10/5/2007	Full	Joint FRB Led	2	2	2	2	3	1	2	
5/5/2008	9/15/2008	Full	Joint State Led	4	4	4	4	5	3	3	Cease & Desist Order
1/12/2009	4/3/2009	Asset Quality Target	Joint FRB Led	5	4	5	5	5	3	3	
4/27/2009	7/10/2009	Full	Joint FRB Led	5	5	5	5	5	4	4	

[a] This Plan was not a public enforcement action.

A synopsis of key Federal Reserve supervisory activities follows, including full scope examinations, a target examination, and an enforcement action.

2004 through 2007 Examinations Repeatedly Noted Earnings and Credit Risk Management Concerns

Examiners considered the bank's overall condition and risk management practices to be satisfactory from 2004 through 2007. With the exception of earnings and liquidity, all CAMELS components received 2 (satisfactory) ratings during this time period. With respect to earnings, examiners emphasized in 2005 that the bank had little margin for error and could not afford to have any significant level of problem loans because of its modest earnings and growth strategy. Examiners also suggested that management should maintain strict credit underwriting standards to support the bank's anticipated loan growth. The following paragraphs further discuss examiners' observations about earnings, capital, and credit risk from 2004 through 2007.

CapitalSouth had a history of earnings deficiencies, largely due to high funding costs, which were exacerbated by high overhead costs associated with the bank's expansion strategy.[8] A

[8] In 2002 and 2003, examiners assigned a 3 rating to CapitalSouth's earnings component.

2004 examination report upgraded the bank's CAMELS component rating for earnings from a 3 (fair) to a 2 (satisfactory), although the examination report mentioned that the bank's return on average assets and net interest margin had declined. In a 2005 full scope examination, examiners downgraded the CAMELS component rating for earnings back to a 3 because the bank's earnings remained well below its peer group. The examination report suggested that management seek additional ways to improve earnings. The 2005 examination also resulted in a supervisory action that examiners labeled an "Informal Improvement Plan" (Plan).

The Plan required CapitalSouth's Board of Directors to approve a written action plan addressing, among other things, a long-term capital plan that considered earnings performance and projected asset growth. In 2006, an examination conducted by the State acknowledged the positive impact of a \$9.3 million capital infusion from CapitalSouth's holding company and indicated that the bank was "effectively" managing capital. State examiners noted, however, that management had not developed the comprehensive capital plan previously recommended by examiners. The 2006 State examination report indicated that the bank's updated capital plan would be presented to the Board of Directors later that year. A 2007 joint full scope examination report acknowledged that management implemented capital planning and quarterly forecasting to support the bank's growth and assure that it maintained its *well capitalized* designation. Examiners also noted that the bank's earnings declined because of management's efforts to build the bank's core deposit base by paying comparatively higher rates on deposit products. The 2008 examination revealed that the capital planning section of the bank's strategic plan had not been updated since 2006 and, therefore, would not have reflected these improvements.

With respect to credit risk, the 2005 examination conducted by FRB Atlanta acknowledged that the bank's credit risk trend was increasing.[9] In 2005, examiners deemed CapitalSouth's CRE concentration risk as high, but indicated that the bank's CRE concentration was generally well diversified by several different types of properties. As a result of the 2005 examination, FRB Atlanta included a section in the Plan that covered CRE. This section required CapitalSouth's Board of Directors to approve a written action plan to comply with draft interagency (the federal banking regulatory agencies) guidance on CRE concentration risk management by improving the bank's internal reporting and CRE controls. (The finalized interagency guidance was issued by the Board as Supervision and Regulation (SR) Letter 07-01.) The Plan also directed the bank to, among other things, provide greater stratification in its CRE reports,[10] establish appropriate CRE sub-limits,[11] conduct CRE portfolio stress testing, and update its strategic plan to address its high CRE concentrations.

A full scope examination conducted by the State in 2006 did not specifically comment on the bank's CRE concentration risk or management's progress towards addressing requirements contained in the Plan. State examiners focused on asset quality and concluded that it had improved and remained satisfactory. In the 2007 joint examination, examiners concluded that

[9] CapitalSouth was 1 of 25 state member community banks with high CRE concentrations included in a 2005 district-wide *CRE Review Program* to assess the risks associated with increasing CRE exposure and to determine if management implemented proper risk management tools.

[10] Stratifying the loan portfolio and establishing corresponding sub-limits provides management with additional information to identify, monitor, and manage its CRE concentration risk.

[11] Sub-limits are measured as a percentage of tier 1 capital plus the ALLL. Examples of sub-limits include property type and geographic location.

the bank's CRE concentration "has been satisfactorily managed through effective underwriting and credit administration practices" and that "risk management practices for CRE loans are satisfactory and generally adhere to the guidelines presented in SR Letter 07-01." FRB Atlanta terminated the Plan based on the results of the 2007 examination. However, the examination report noted the trend in credit risk was increasing, and examiners highlighted concerns with the slowing real estate market. Examiners reiterated that "given the bank's modest earnings and robust growth objectives, the bank cannot afford to have any substantial problem assets or loan losses."

FRB Atlanta Approved CapitalSouth's Monticello Acquisition

FRB Atlanta received CapitalSouth's application to acquire Monticello on April 30, 2007. The application was subject to Board review because Monticello's CAMELS composite rating was less than satisfactory and Monticello was under a C&D.[12] The C&D was issued by Monticello's primary federal regulator, the Office of Thrift Supervision (OTS). Among other things, the C&D addressed weaknesses in Monticello's oversight and administration of its construction loan portfolio and included specific actions for improving CRE risk management. The OTS advised FRB Atlanta that Monticello substantially complied with the C&D's requirements and that the C&D would be terminated upon the acquisition's approval.[13] On June 28, 2007, the Board transferred the application to FRB Atlanta for approval under delegated authority, following a joint review by the Board and the Reserve Bank. FRB Atlanta approved the merger on June 29, 2007, consistent with regulatory guidance that required processing within 60 days of the application. On September 14, 2007, CapitalSouth acquired Monticello and its residential mortgage subsidiary, Mortgage Lion.

Our analysis of CapitalSouth's supervisory history determined that FRB Atlanta and Board applications staff did not fully comply with SR Letter 98-28—which establishes the criteria for conducting safety and soundness examinations of banks seeking to become, or merge into, a state member bank—in connection with CapitalSouth's application to acquire Monticello. According to SR Letter 98-28, Federal Reserve examiners generally should conduct a pre-merger examination of an insured depository institution that does not meet each of the components of the following five-part test: (1) well capitalized; (2) a composite CAMELS rating of 1 or 2; (3) a Community Reinvestment Act (CRA) rating of "outstanding" or "satisfactory"; (4) a consumer compliance examination rating of 1 or 2; and (5) no major unresolved supervisory issues outstanding, as determined by the Board or appropriate Federal Reserve Bank "in its discretion." Monticello did not meet the second component because it had a CAMELS composite 3 rating at the time of the acquisition application, and it may not have met the fifth component because it was under a C&D, a formal enforcement action. However, a pre-merger examination of Monticello, which was an insured depository institution, was not conducted by FRB Atlanta. Staff at the Reserve Bank and the Board responsible for processing applications did not direct FRB Atlanta to conduct a pre-merger examination. Under SR Letter 98-28, pre-merger examinations can be waived under certain circumstances, but the Reserve Bank needs to

[12] Initial applications are usually submitted directly to the responsible Reserve Bank. The Board participates in processing applications when issues such as those discussed above are evident.

[13] The OTS stated there was only one unresolved issue in the C&D, and it required Monticello to create a three-year business plan. This requirement became moot following the acquisition approval.

document the supporting rationale. There was no documentation that a waiver was processed. An FRB Atlanta official attributed the Reserve Bank's noncompliance with the guidance to the structure of the SR letter and confusion concerning the application of the "eligible bank" test.

In hindsight, an FRB Atlanta pre-merger examination may have uncovered significant issues noted in subsequent examinations, such as (1) CapitalSouth management's apparent misrepresentation regarding Mortgage Lion's sub-prime loan origination activities—during the application process, CapitalSouth stated that Monticello did not originate sub-prime mortgages, (2) Mortgage Lion management's apparent misrepresentation regarding its rationale for retaining $74 million of Mortgage Lion's higher quality loans for cash management purposes—it was later determined that these loans could not be sold because they did not meet investor standards, and (3) the full extent of Mortgage Lion's "no documentation" loan program and weak practices for verifying borrowers' financial conditions. Knowledge of these significant issues may have resulted in FRB Atlanta recommending that the Board deny the application.

The State conducted its pre-merger examination in July 2007, after FRB Atlanta had already approved the acquisition. The State typically conducts pre-merger examinations "when the target is unknown to the State and the size of the acquisition is large relative to the acquirer." Unlike the Federal Reserve, the State is not bound by regulatory deadlines for application processing. As it relates to this proposed transaction, the State conducted two target pre-merger examinations that found Monticello's overall condition "satisfactory," and the State granted its approval of the acquisition on August 15, 2007.[14]

September 2008 Examination Report Downgraded the Bank's Composite Rating to 4 and Resulted in an Enforcement Action

The first full scope examination following the acquisition began in May 2008 and resulted in a double downgrade to a CAMELS composite 4 rating. According to supervisory guidance, institutions in this group pose a risk to the DIF, and failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved. Each of the CAMELS component ratings received double downgrades, with the exception of a single downgrade for the sensitivity to market risk component. The September 2008 examination report cited serious deterioration in the bank's condition due to a significant decline in asset quality.

The 2008 examination findings related to CRE contradicted the 2007 examination report's conclusion that the bank's CRE risk "has been satisfactorily managed through effective underwriting and credit administration practices."[15] The 2008 examination report commented that CapitalSouth's CRE risk management practices needed strengthening and that improvements were necessary for the bank to fully comply with the interagency CRE guidance disseminated in SR Letter 07-01. Examiners observed that management's oversight of the CRE portfolio was weak, as evidenced by the fact that only 41 percent of the loans criticized in the examination report also had been identified by management. The failure to properly detect weaknesses in the

[14] FRB Atlanta examiners accompanied the State during these examinations even though FRB Atlanta had already approved the acquisition.

[15] As noted earlier in this report, the Monticello acquisition did not have a substantial impact on CapitalSouth's CRE levels.

loan portfolio contributed to a deficient ALLL and the need for a significant provision expense. This provision negatively impacted earnings and capital. During this examination, the bank's CAMELS component rating for earnings received a double downgrade to a 5. Examiners noted that earnings were "critically deficient," would not replenish capital, and were substantially overstated due to a severely deficient ALLL.

FRB Atlanta and the State executed a formal enforcement action in the form of a C&D in November 2008. Among other things, the C&D required CapitalSouth to address a series of weaknesses noted during the examination, including Board of Directors and management oversight, credit risk management practices, lending and credit administration policies, and loan review policies. The State issued a separate provision to the C&D requiring CapitalSouth to maintain a minimum tier 1 capital ratio of 7.5 percent.

April 2009 Asset Quality Target Examination Report Downgraded the Bank's Composite Rating to 5

In January 2009, examiners began an asset quality target examination. The examination report issued in April 2009 noted that the bank continued to "decline very rapidly" and downgraded the bank to a CAMELS composite 5 rating. Banks in this group exhibit extremely unsafe and unsound practices or conditions and pose a significant risk to the DIF because failure is highly probable. CapitalSouth's asset quality and management component ratings each were also downgraded to 5. Examiners attributed the downgrades to asset quality deterioration based on extremely high levels of classified assets that further strained the bank's earnings and jeopardized the bank's solvency. FRB Atlanta observed that the bank's capital remained deficient and did not support its high-risk profile. Examiners acknowledged management's actions to address some of the C&D's requirements, but indicated that more aggressive action was required.

According to examiners, the bank's capital position was "unacceptable" and needed to be restored without delay because it had fallen beneath the minimum level established by the State's separate C&D provision. Examiners also noted that the bank's asset quality deterioration placed tremendous pressure on capital and earnings. During this examination, FRB Atlanta reiterated the critical importance of loan review and stated that the Board of Directors and management should devote sufficient resources to this function. Further, the examination report highlighted the need for management to give immediate attention to Mortgage Lion's problem loans to help mitigate losses and avoid further strain on earnings and capital. Among other things, examiners highlighted the following high-risk elements in the Mortgage Lion loan portfolio: (1) second mortgages used to purchase the homes that resulted in high combined loan-to-value ratios for borrowers; (2) past and increasing levels of low FICO (Fair Isaac Corporation) scores, which typically indicate sub-prime loans; and (3) loans with multiple high-risk elements, such as high debt-to-income ratios and low or no documentation.

July 2009 Examination Report Resulted in Further Downgrades

In April 2009, examiners began a joint full scope examination that resulted in another CAMELS composite 5 rating. Examiners downgraded CapitalSouth's component ratings for capital (from

4 to 5), liquidity (from 3 to 4), and sensitivity (from 3 to 4). Examiners noted that the bank was operating in a "critically unsafe and unsound" manner. Asset quality deterioration had significantly eroded capital and earnings to the point where failure was certain without a capital infusion. Examiners indicated that the bank would not return to profitability for the foreseeable future.

During this examination, the bank's CRE risk management practices continued to remain an area of concern, and examiners reiterated specific CRE risk management requirements originally contained in the Plan. This examination also highlighted a series of key prior commitments that CapitalSouth's management failed to address, including (1) revising and updating its strategic plan and capital plan, (2) addressing credit administration deficiencies in the Mortgage Lion portfolio, (3) hiring an independent loan review consultant to perform an assessment of the Jacksonville portfolio, and (4) engaging an independent loan review firm to conduct a portfolio-wide mortgage review.

Classified assets had increased 62 percent since the recent asset quality target examination. The July 2009 full scope examination report indicated that the ALLL was "seriously deficient" and that the provision necessary to correct this deficiency would cause the bank to report a significant operating loss. The examination report stated that without an immediate capital injection, the bank would fail. Efforts to sell or recapitalize the bank were unsuccessful, resulting in the State closing CapitalSouth on August 21, 2009, and appointing the FDIC as receiver.

Conclusions, Lessons Learned, and Recommendation

CapitalSouth failed because its Board of Directors and management did not implement a credit risk management infrastructure commensurate with its aggressive expansion strategy and high concentration of CRE, including ADC, loans. The bank pursued an aggressive expansion strategy even though its modest earnings and capital position did not provide the buffer necessary to withstand significant asset quality deterioration. In 2007, the bank acquired Monticello, which compounded CapitalSouth's preexisting credit risk management weaknesses. A declining real estate market revealed the full extent of the combined entity's credit administration and loan underwriting deficiencies and resulted in asset quality deterioration and significant losses. Mounting losses eliminated earnings, depleted capital, and ultimately caused the State to close CapitalSouth on August 21, 2009, and appoint the FDIC as receiver.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or loss to the DIF. Our analysis of FRB Atlanta's supervision of CapitalSouth indicated that examiners identified key weaknesses in 2005, but missed subsequent opportunities to take more forceful supervisory action.

In the 2005 examination report, FRB Atlanta highlighted a fundamental issue with the bank's growth strategy, observing that the bank had no margin for error and "cannot afford to have any substantial problem assets or loan losses given its robust growth objectives and modest earnings." We believe that FRB Atlanta should have stressed to CapitalSouth the need for solid earnings performance before the bank pursued its risky growth strategy. In our opinion, examiners should have suggested that CapitalSouth postpone its growth objectives until it enhanced its modest earnings and credit risk management practices. The eventual loss to the DIF may have been reduced if examiners took a more aggressive supervisory approach at this juncture.

FRB Atlanta, with the concurrence of Board applications staff, approved CapitalSouth's acquisition of Monticello, without conducting a pre-merger examination or documenting a waiver as specified in SR Letter 98-28. This guidance establishes the criteria for conducting safety and soundness examinations of depository institutions seeking to become, or merge into, a state member bank. SR Letter 98-28 outlines an eligible bank test and the factors to be evaluated when determining whether pre-merger examinations should be conducted, including whether the institution being acquired has a composite rating of 1 or 2, and has no major unresolved supervisory issues. At the time of the application, Monticello had a composite 3 rating and was under a C&D because of its credit risk management weaknesses. In fact, post-acquisition examinations highlighted numerous high-risk elements in Mortgage Lion's loan portfolio, including sub-prime and no documentation lending activities. In our opinion, a full scope pre-merger examination was warranted and may have led FRB Atlanta to recommend that the Board deny the application. If CapitalSouth had not acquired Monticello, the loss to the DIF may have been reduced.

According to an FRB Atlanta official, the Reserve Bank's noncompliance with SR Letter 98-28 was attributable to the structure of the SR letter and confusion concerning how to apply the eligible bank test. Our report includes a recommendation that the guidance be clarified.

Lessons Learned

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that CapitalSouth's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Specifically, CapitalSouth's failure illustrates that banks with a pattern of modest earnings, an aggressive growth strategy, and a high CRE concentration require heightened supervisory attention. In these situations, examiners should ensure that the bank has (1) sufficient earnings and capital to support an aggressive expansion strategy and (2) credit risk management controls that are sufficiently robust to fully support the bank's growth. In addition, CapitalSouth's failure demonstrates that pre-merger examinations need to be conducted consistent with the guidance in SR Letter 98-28.

Recommendation

We recommend that the Director of the Division of Banking Supervision and Regulation revise Supervision and Regulation Letter 98-28 to clarify how the "eligible bank" test should be applied when evaluating merger applications.

Our analysis of CapitalSouth's supervisory history determined that FRB Atlanta and the Board applications staff did not fully comply with the guidance contained in SR Letter 98-28. This guidance establishes the criteria for conducting safety and soundness examinations of depository institutions seeking to become, or merge into, a state member bank, as well as the state member bank itself. Specifically, the guidance outlines the eligible bank test and the factors to be evaluated when determining whether pre-merger examinations should be conducted. A bank must satisfy each of the following components of a five-part test to qualify as an eligible bank: (1) well capitalized; (2) a composite CAMELS rating of 1 or 2; (3) a CRA rating of "outstanding" or "satisfactory"; (4) a consumer compliance examination rating of 1 or 2; and (5) no major unresolved supervisory issues outstanding, as determined by the Board or appropriate Federal Reserve Bank "in its discretion." If an institution does not satisfy these criteria, a pre-merger examination is required. As discussed earlier, FRB Atlanta did not comply with these provisions of the SR letter. An FRB Atlanta official attributed the Reserve Bank's noncompliance with the guidance to the structure of the SR letter and confusion concerning the application of the eligible bank test.

Paragraphs four and six of the guidance describe how the eligible bank test should be applied; however, it is not obvious that these two paragraphs outline individual steps in a two-part analysis. The first part of the analysis outlined in paragraph four consists of evaluating whether the state member bank, on an existing and prospective post-merger basis, qualifies as an eligible bank. Paragraph six outlines a second part of the analysis that involves evaluating whether the depository institution to be merged also meets the eligible bank test. In the event that the institution to be acquired fails the eligible bank test, a pre-merger examination of the institution should occur. The guidance authorizes Reserve Banks to waive the examination requirement if certain conditions are met, and if the Reserve Bank documents the supporting rationale for the waiver.

In this situation, FRB Atlanta conducted the first step in the eligible bank analysis for pre-merger examinations, by determining that CapitalSouth qualified as an eligible bank. However, it did not perform the second step of the analysis. By not conducting the second step, FRB Atlanta did not recognize that Monticello failed the second and perhaps the fifth components of the test and that a pre-merger examination was required or a waiver would need to be processed. FRB Atlanta's misunderstanding of the guidance highlights the need for clarification to ensure that it is consistently and appropriately applied.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response, included as Appendix 3, indicates concurrence with the report's conclusion, lessons learned, and recommendation. The Director noted that examiners identified key weaknesses in 2005, 2008, and 2009, but missed opportunities in the interim to take more forceful supervisory action, including limiting CapitalSouth's aggressive growth plan until the bank's credit risk management issues were fully corrected. He also concurred that a full scope pre-merger examination should have been conducted prior to approval of the Monticello Bank application, and that such an examination may have surfaced the issues that contributed to and expedited the failure of CapitalSouth.

With respect to our recommendation, the Director agreed that SR Letter 98-28 could be misinterpreted as it is currently written. The Division will make the appropriate revisions. We will follow up on action taken to implement the recommendation.

The Director noted that our report's observations and contribution to understanding the reasons for CapitalSouth's failure were welcome. He stated that the report illustrates important lessons learned in supervising banks with a pattern of modest earnings, an aggressive growth strategy, and a high CRE concentration: examiners in these situations should ensure that the bank has (1) sufficient earnings and capital to support an aggressive expansion strategy, and (2) credit risk management controls that are sufficiently robust to fully support the bank's growth.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
The ALLL is a valuation reserve established and maintained by charges against the financial institution's operating income. As a valuation reserve, it 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. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.

Alt-A Mortgage
An Alt-A mortgage is a mortgage made to a borrower that typically does not involve verification or documentation of income, assets, or employment. Instead, the approval of the loan is based primarily on the applicant's credit score

Classified Assets
Classified assets are loans that exhibit well-defined weaknesses and a distinct possibility of loss. The term "classified" is divided into more specific subcategories ranging from least to most severe: "substandard," "doubtful," and "loss." An asset classified as "substandard" is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. An asset classified as "doubtful" has all the weaknesses inherent in one classified as "substandard," with the added characteristic that the weaknesses make full collection or liquidation highly questionable and improbable. Assets classified as "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

Commercial Real Estate (CRE) Loan
CRE loans are land development and construction loans (including one-to-four 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 primarily 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.

Core Deposits
Core deposits are deposits made by customers in a bank's general market area. A bank considers its core deposits to be a reliable source of funding.

Enforcement Actions
The Federal Reserve Board has a broad range of enforcement powers that include formal or informal enforcement actions that may be taken, typically after the completion of an on-site bank examination. Formal enforcement actions consist of Cease and Desist Orders and Written Agreements, while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Appendix 1 (continued)

Federal Home Loan Bank
The Federal Home Loan Bank is a government-sponsored enterprise chartered by Congress in 1932. Its purpose is to support residential mortgage lending and community investment at the local level by providing primary direct loans to its more than 8,000 member financial institutions (primarily banks and thrift institutions).

Goodwill
Goodwill is an intangible asset found on an institution's balance sheet and is often created through acquisitions.

Impairment
Impairment is the amount by which amortized cost exceeds fair value.

Intangible Assets
An intangible asset is an asset that is not physical in nature. These assets are difficult to value because of the lack of physical presence.

Net Interest Margin
Net interest margin is a performance metric examiners use to evaluate a bank's profitability by measuring the difference between interest income generated in comparison to the interest paid.

Non-core Deposit Sources
Non-core deposit sources are volatile funding sources that include liabilities that either are uninsured or are raised outside the bank's stable, local market.

Prompt Corrective Action (PCA)
PCA is a framework of supervisory actions, set forth in 12 U.S.C. 1831o, for insured depository institutions whose capital position has declined below certain threshold levels. It was intended to ensure that action is taken when institutions become financially troubled, in order to resolve the problems of the institutions at the least possible long-term loss to the DIF. The capital categories are *well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized,* and *critically undercapitalized*.

Return on Average Assets
Return on average assets is a metric that displays how efficiently a company is utilizing its assets. It is also useful to aid comparison among peers in the same industry.

Sub-prime loans
Sub-prime loans are loans made to borrowers with the following characteristics: (1) a FICO score of less than 620, (2) a late mortgage payment in the last 12 months (3) a bankruptcy in the last 24 months, and/or (4) a foreclosure in the last 36 months.

Appendix 1 (continued)

Tier 1 Capital
Tier 1 capital is a regulatory capital measure that may include common shareholder's equity (common stock, surplus, and retained earnings), non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

Underwriting
Underwriting is part of a bank's lending policies and procedures that enable the bank's lending staff to evaluate all relevant credit factors. These factors include the capacity of the borrower or income from the underlying property to adequately service the debt; the market value of the underlying real estate collateral; the overall creditworthiness of the borrower; the level of the borrower's equity invested in the property; any secondary sources of repayment; and any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

Appendix 2 – CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of the institution's financial condition and operations. These component factors address the adequacy of *capital*, the quality of *assets*, the capability of *management*, the quality and level of *earnings*, the adequacy of *liquidity*, and the *sensitivity* to market risk (CAMELS). Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definition

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the Board of Directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences, such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institutions' size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For financial institutions to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the Board of Directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institutions' size, complexity, and risk profile. There are no material supervisory concerns; and, as a result, the supervisory response is informal and limited.

Appendix 2 (continued)

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institutions' size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the Board of Directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the DIF. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institutions' size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institutions to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the DIF, and failure is highly probable.

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date:	March 12, 2010
To:	Elizabeth A. Coleman, Inspector General
From:	Patrick M. Parkinson, Director ***/signed/***
Subject:	Draft "Material Loss Review of CapitalSouth Bank"

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of CapitalSouth Bank ("CapitalSouth"), Birmingham, Alabama that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that CapitalSouth failed because its Board of Directors and management did not implement a credit risk management infrastructure commensurate with its aggressive expansion strategy and high concentration of commercial real estate ("CRE"), including acquisition, development, and construction loans. Additionally, in 2007, CapitalSouth's credit risk management weaknesses were compounded when it acquired Monticello Bank, a Florida thrift in less than satisfactory condition that was roughly half the size of the bank. Monticello Bank also owned a mortgage subsidiary that underwrote Alternative A-paper and subprime mortgages. CapitalSouth was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta) under delegated authority from the Board.

We concur with the conclusions, lessons learned, and recommendation contained in the report. FRB Atlanta and the State of Alabama examined CapitalSouth seven times between 2004 and 2009. We agree that examiners identified key weaknesses in 2005, 2008, and 2009, but missed opportunities in the interim to take more forceful supervisory action, including limiting CapitalSouth's aggressive growth plan until the bank's credit risk management issues were fully corrected. We also concur that a full-scope pre-merger examination should have been conducted prior to approval of the Monticello Bank application, and that such an examination may have surfaced the issues that contributed to and expedited the failure of CapitalSouth.

Consistent with the report's recommendation, the Division will revise SR Letter 98-28, which sets forth the conditions when pre-membership or pre-merger examinations should be conducted. We agree that the conditions under which pre-membership or pre-merger examinations need <u>not</u> be conducted that are contained in one paragraph of the letter could be misinterpreted as overriding the conditions contained in another paragraph that sets forth when such examinations should be conducted.

The report illustrates important lessons learned in supervising banks with a pattern of modest earnings, an aggressive growth strategy, and a high CRE concentration. As noted in the report, examiners in these situations should ensure that the bank has sufficient earnings and capital to support an aggressive expansion strategy, and credit risk management controls that are sufficiently robust to fully support the bank's growth.

Board staff very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for CapitalSouth's failure.

Appendix 4 – Principal Contributors to this Report

Margaret Angeloff, Auditor

Timothy P. Rogers, Team Leader for Material Loss Reviews and Senior Auditor

Kimberly A. Whitten, Project Manager

Anthony J. Castaldo, Assistant Inspector General for Inspections and Evaluations