Board of Governors of the Federal Reserve System

Review of the Failure of Marco Community Bank

Office of Inspector General

September 2010

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

OFFICE OF INSPECTOR GENERAL

September 30, 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), 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Inspector General of the Board of Governors of the Federal Reserve System (Federal Reserve Board) conducted an in-depth review of the failure of Marco Community Bank (Marco). Marco began operations in August 2003 and became a state member bank in December 2003. Marco was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Federal Reserve Board, and by the Florida Office of Financial Regulation (State). The State closed Marco on February 19, 2010, and named the Federal Deposit Insurance Corporation (FDIC) as receiver.

Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurs between January 1, 2010, and December 31, 2011. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal bank agency

- review the supervision of the institution, 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.

In addition, the Dodd-Frank Act requires an in-depth review of bank failures that result in losses below the materiality threshold when the Inspector General of the appropriate federal banking agency determines that the loss exhibits "unusual circumstances."

According to the FDIC Inspector General, Marco's failure will result in a $36.9 million loss to the DIF, or 29.1 percent of the bank's $126.9 million in total assets. While the loss is not material, we conducted an in-depth review after determining that Marco's failure presented unusual circumstances because (1) during its second year of operations, tier 1 capital dipped beneath the minimum required by regulatory guidance, and (2) the bank relied heavily on its holding company to augment the bank's capital throughout Marco's limited history. When unusual circumstances are identified, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review.

Marco failed because its Board of Directors and management did not provide adequate oversight of the bank's lending activities. Following its inception, the bank operated with a weak internal control environment due, in part, to frequent management turnover, vacancies in key positions, and inadequate staff expertise. The bank grew more quickly than management anticipated in its business plan and relied on capital injections from its holding company to sustain operations. The growth resulted in Marco developing high concentrations in (1) the construction, land, and land development component of the bank's commercial real estate loan portfolio, and (2) home equity lines of credit. Also, in 2006 and 2007, the bank executed management's strategic decision to supplement its declining loan production by purchasing a pool of short-term acquisition and renovation loans on properties primarily located in two Florida counties. These loan pools created an additional concentration risk for Marco. As the real estate market in Marco Island weakened, the bank's asset quality deteriorated significantly and resulted in large provision expenses that eliminated earnings and depleted capital.

With respect to supervision, FRB Atlanta and the State conducted six full scope examinations, four target examinations (including a limited scope examination), and a supervisory assessment between 2004 and 2010. Our analysis of FRB Atlanta's supervision of Marco revealed that FRB Atlanta did not fully comply with the Federal Reserve Board's supervisory standards for de novo banks. Specifically, FRB Atlanta did not comply with examination frequency guidelines and put Marco on a standard examination cycle despite noting issues that should have raised concerns about the bank's ability to operate on a sound basis—a consideration when determining if a de novo bank should be transitioned to a standard examination frequency cycle.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or a loss to the DIF. We believe that FRB Atlanta should not have transitioned to the standard examination cycle for this de novo bank after FRB Atlanta and the State had only conducted two full scope examinations. In hindsight, we believe that many of the issues noted during these first two examinations foreshadowed the bank's future problems. Nevertheless, it is not possible to determine the degree to which strict adherence to the supervisory guidelines for de novo banks may have altered the course of the bank's financial decline or affected the failure's cost to the DIF.

Although the failure of one de novo bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Marco's failure points to valuable lessons learned that can be applied when supervising de novo banks with similar characteristics. First, Marco's failure underscores that de novo banks require close supervision and that examiners should only implement the standard examination cycle when—consistent with regulatory guidance—the bank's corporate governance, financial condition, and internal controls warrant the transition. Second, this failure highlights the importance of examiners closely monitoring a de novo bank's performance when, as was the case with Marco, there are significant deviations from the business plan that is submitted as part of the application to become a state member bank.

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director concurred with our conclusion and lessons learned. His response is included as Appendix 3.

We appreciate the cooperation that we received from FRB Atlanta and Federal Reserve Board staff during our review. The principal Office of Inspector General 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
Governor Elizabeth A. Duke
Governor Kevin M. Warsh
Mr. Stephen R. Malphrus
Mr. Patrick M. Parkinson
Mr. Michael Johnson

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Background

Marco Community Bank (Marco), headquartered in Marco Island, Florida, was a subsidiary of Marco Community Bancorp Incorporated, a bank holding company. Marco began operations on August 18, 2003, as a state-chartered bank that was not a member of the Federal Reserve System. The bank's business strategy consisted of (1) meeting the mortgage needs of retirees and professionals on Marco Island and (2) lending to small to mid-size businesses in its local community. The bank became a state member bank (SMB) on December 29, 2003, and was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the Florida Office of Financial Regulation (State). As a de novo bank, Marco was subject to additional regulatory requirements following its approval as an SMB, including more frequent examinations and higher capital standards.[1]

The State closed Marco on February 19, 2010, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. In a letter dated March 18, 2010, the FDIC Inspector General advised us that the bank's failure would result in a $36.9 million loss to the Deposit Insurance Fund (DIF), or 29.1 percent of the bank's $126.9 million in total assets. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), a material loss to the DIF is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. However, the Dodd-Frank Act requires an in-depth review of any bank failure that creates a loss to the DIF when the Inspector General of the appropriate federal banking agency determines that the loss exhibits "unusual circumstances." We believe that Marco's failure presented unusual circumstances because (1) during the second year of operations, the bank's tier 1 capital dipped beneath the minimum required by regulatory guidance, and (2) the bank relied heavily on its holding company to augment its capital throughout its limited history.

Objectives, Scope, and Methodology

When a loss to the DIF presents unusual circumstances, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal bank agency

- review the agency's supervision of the failed institution, 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.

[1] Federal Reserve Board supervisory guidance defines a "de novo bank" as an SMB that has been in operation for five years or less.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed FRB Atlanta, State, and Federal Reserve Board staff and collected relevant data from FRB Atlanta records. We also reviewed correspondence, surveillance reports, regulatory reports filed by Marco, examination reports issued from 2004 through 2009, and examination work papers prepared by FRB Atlanta. Appendixes at the end of this report contain a glossary that defines key banking and regulatory terms and a description of the CAMELS rating system.[2] We conducted our fieldwork from May 2010 through July 2010 in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

Marco failed because its Board of Directors and management did not provide adequate oversight of the bank's lending activities. Following its inception, the bank operated with a weak internal control environment due, in part, to frequent management turnover, vacancies in key positions, and inadequate staff expertise. The bank grew more quickly than management anticipated in its business plan and relied on capital injections from the holding company to sustain operations. The growth resulted in Marco developing high concentrations in (1) the construction, land, and land development (CLD) component of the bank's commercial real estate (CRE) loan portfolio, and (2) home equity lines of credit (HELOCs). Also, in 2006 and 2007, the bank executed management's strategic decision to supplement its declining loan production by purchasing a pool of short-term acquisition and renovation loans on properties primarily located in two Florida counties.[3] These loan pools created an additional concentration risk for Marco. As the real estate market in Marco Island weakened, the bank's asset quality deteriorated significantly and resulted in large provision expenses that eliminated earnings and depleted capital. Marco ultimately became *critically undercapitalized*, and the State closed the bank on February 19, 2010, appointing the FDIC as receiver.

Staffing Challenges Were a Constant Concern for Marco

Marco consistently faced staffing challenges during its limited history. Prior to FRB Atlanta's initial examination in 2004, the bank's Chief Financial Officer resigned. During its first three years of operation, the bank had two presidents and an acting president. In addition, the Chief Executive Officer (CEO) left in July 2005. The bank operated without a CEO for nearly nine months before hiring a successor in March 2006. Examiners attributed Marco's recurring staffing challenges to the high cost of living in Southwest Florida, the lengthy commute to Marco Island from the mainland, and the bank's low salary structure.

Marco also experienced similar problems within its operational units. During its initial examination, FRB Atlanta noted that Marco's inadequate staffing levels hampered the bank's

[2] 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.

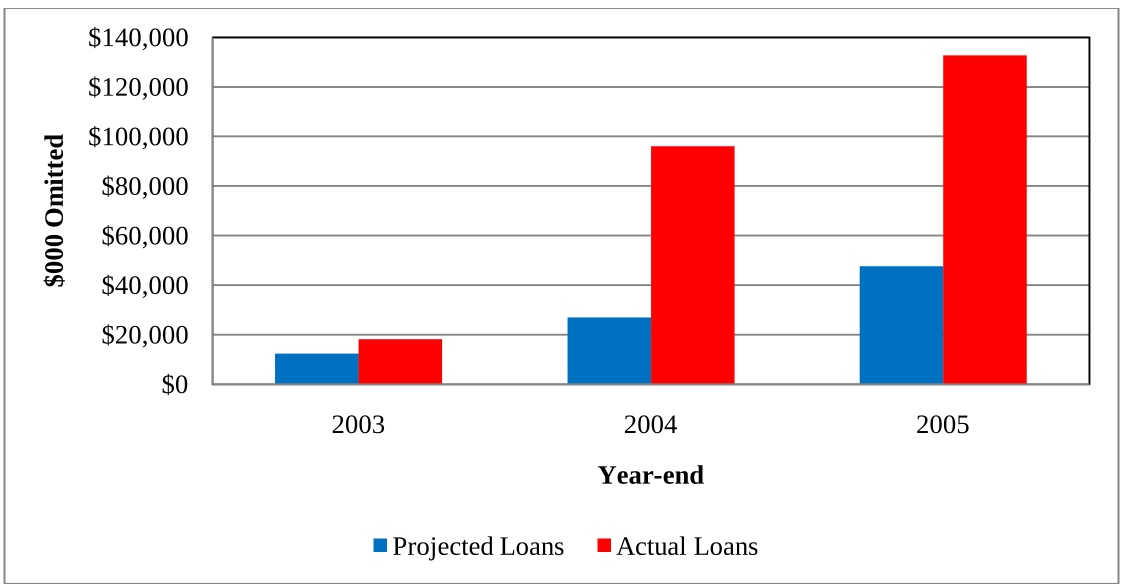
[3] These counties were Hillsborough, located in western, central Florida, and Duval, located in northeastern Florida.

ability to implement adequate segregation of duties and dual controls. In addition, key functional oversight positions remained vacant for lengthy periods of time. For example, Marco's senior credit officer position remained vacant for nearly 20 months after the bank opened—with the bank President serving in this capacity on an interim basis—even though examiners emphasized the importance of the position for successful long-term credit risk management. In 2007, examiners cited the bank's lack of staffing and management expertise as an "unsafe and unsound" banking practice. As discussed further below, these staffing issues contributed to the bank's deficient internal controls.

Marco's Growth Exceeded Its Business Plan and Created Loan Portfolio Concentrations

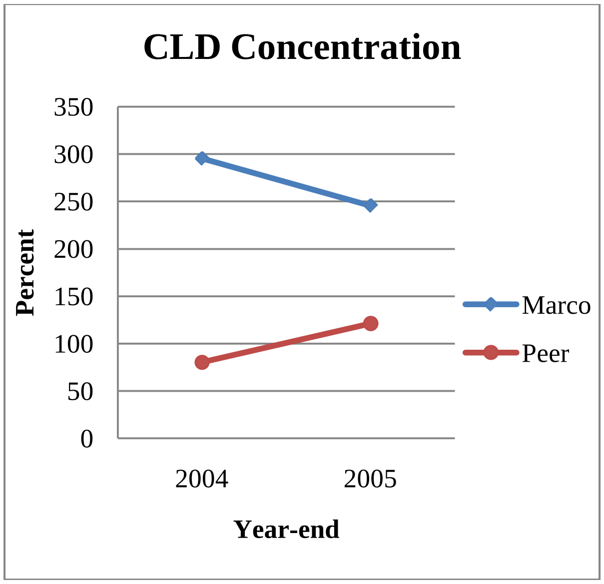
Marco's Federal Reserve System membership application projected total loans of $12.3 million for 2003, $26.9 million for 2004, and $47.6 million for 2005. As shown in Chart 1, the bank experienced growth that significantly exceeded management's projections, as total loans grew from $18.1 million in 2003, to $96.0 million in 2004, to $132.8 million in 2005. Between 2003 and 2005, the bank's loan portfolio grew 633 percent—more than double management's planned growth of 287 percent.

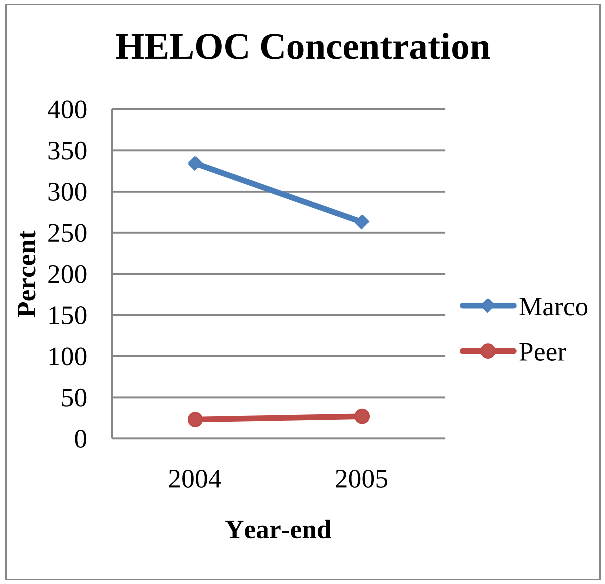
Chart 1: Marco Loan Portfolio Growth



In April 2005—approximately 16 months after Marco became an SMB—Marco hired its first dedicated senior credit officer to oversee the growth of the loan portfolio and improve internal controls surrounding lending activities. By the time the senior credit officer was hired, Marco's CLD and HELOC concentrations far exceeded its peer group averages as a percentage of total risk-based capital. As shown in Chart 2 on the next page, Marco's CLD and HELOC concentrations in 2004 were 295 and 334 percent of total risk-based capital, respectively, significantly exceeding the peer group averages of 80 percent and 23 percent. In general, credit concentrations pose a substantial risk to the safety and soundness of a financial institution and increase vulnerability to changes in the marketplace.

Chart 2: Concentrations of Credit as a Percent of Total Risk-Based Capital





Marco's HELOC portfolio included additional risk because many of these loans were collateralized by borrowers' second homes. In general, loans secured by second homes present increased credit risk because borrowers will prioritize and pay debts related to their primary residence before paying any debts related to second homes during stressful economic conditions. In addition, Marco's HELOCs secured by second liens rose from 35 percent in 2004 to 62 percent by 2008. In general, lenders that take a second lien position face increased risks because the proceeds from a sale or foreclosure of the property must pay off the first lien before any funds are available to satisfy the second lien.

Marco's Funding Strategy Deviated from Its Plans

Marco's strategy emphasized core deposits to fund loan growth, but management quickly deviated from this plan when it failed to attract sufficient core deposits. After experiencing success with a deposit promotion campaign in 2004, the bank was not able to attract sufficient deposits to keep pace with its loan growth. Therefore, Marco began to fund loan growth by relying on external sources, such as capital infusions from its holding company and brokered deposits. Capital infusions and brokered deposits became a consistent source of funding for the bank's operations.[4]

Ineffective Oversight Fostered a Weak Control Environment

Frequent senior management turnover and vacancies in key positions helped to foster a weak control environment. As mentioned above, Marco operated without a dedicated senior credit officer from the bank's inception until April 2005. Once hired, the senior credit officer focused exclusively on commercial lending and did not oversee the consumer loan portfolio, even though

[4] Since the bank's inception, Marco received $16.1 million in capital injections from the holding company.

a significant concentration existed in the HELOC portfolio. In 2006, examiners noted that a new management team had recently been hired to improve the bank's credit administration deficiencies. Key concerns previously noted by examiners included the prior management's failure to adequately monitor and control exceptions to regulatory loan-to-value (LTV) guidelines. This loan underwriting weakness further increased the bank's already high credit risk, since the bank frequently made larger loans than recommended by the LTV guidelines.[5] In 2007, State examiners questioned the effectiveness of the new management team and cited staff turnover and the lack of expertise as an unsafe and unsound banking practice. During this examination, the State highlighted that the bank was once again operating without a senior credit officer to oversee the loan portfolio.

According to examiners, weak management oversight and the bank's deficient internal controls resulted in multiple violations of law. In 2004, State examiners noted an apparent violation of Florida law because the bank exceeded statutory lending limits on loans to one borrower. In 2006, examiners observed multiple violations of Regulation O, *Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*, that pertained to bank director overdrafts.

After Marco's loan growth peaked in 2005, management decided to begin purchasing loan pools from a third party lender in Jacksonville, Florida, during the period spanning June 2006 to April 2007. As mentioned earlier, these loans were primarily short-term acquisition and renovation loans on properties primarily located in two Florida counties. Florida law allows banks to loan any "person" up to 25 percent of the bank's capital as long as the loan(s) are fully secured up to 15 percent of the bank's capital. Marco's August 2006 purchase of loan pools from a third party violated this law because the aggregate loans purchased represented 32 percent of the bank's capital. In November 2006, examiners advised the bank that it should contact the State to determine the applicability of this law. In April 2007, the State responded to the bank's inquiry and confirmed that a violation of law occurred. Despite the State's April 2007 ruling, Marco's President authorized the holding company to purchase another loan pool from the same third party in May 2007. Examiners stated that this purchase demonstrated senior management's disregard for the State's interpretation of law and regulatory authority.

Loan Pool Purchases Further Increased the Bank's Credit Risk and Demonstrated Additional Risk Management Deficiencies

The series of loan pool purchases resulted in Marco investing more than $14 million in loan pools issued and guaranteed by a single lender. The underlying loans in these pools were secured by properties in economically distressed areas of Florida and ultimately represented 98 percent of the bank's total capital—another significant concentration that added to the bank's already high credit risk. Despite the significance of the investment, the Board of Directors and management did not thoroughly conduct its due diligence of the loan pools and failed to comprehensively review (1) the delinquency status of the underlying loans, (2) the experience and qualifications of the borrowers, and (3) the quality of the third party's underwriting.

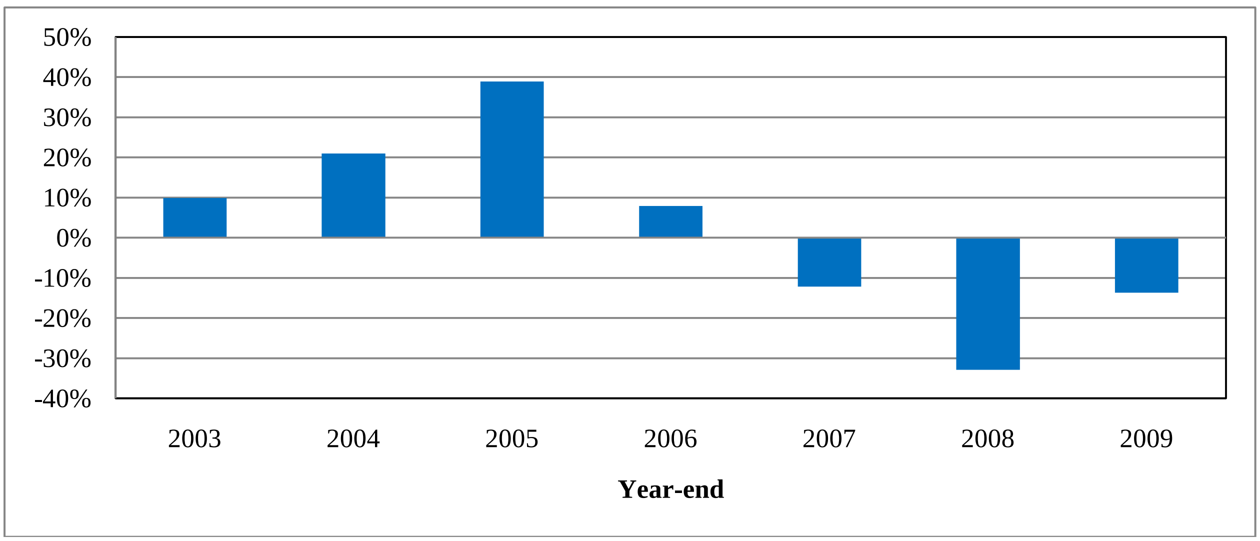
[5] The volume of these exceptions eventually rose to nearly three times the amount suggested in regulatory guidance.

By September 2007, the loans were in various stages of delinquency, with a majority in excess of 90 days delinquent. Marco ultimately recognized more than $7 million in loan losses from the loan pools. Examiners attributed these losses to Marco's failure to identify and consider that the third party lender allowed borrowers to provide minimal cash equity and did not thoroughly assess borrowers' repayment capacity.

Rapid Real Estate Declines in Marco Island Area Impacted the Bank's Asset Quality

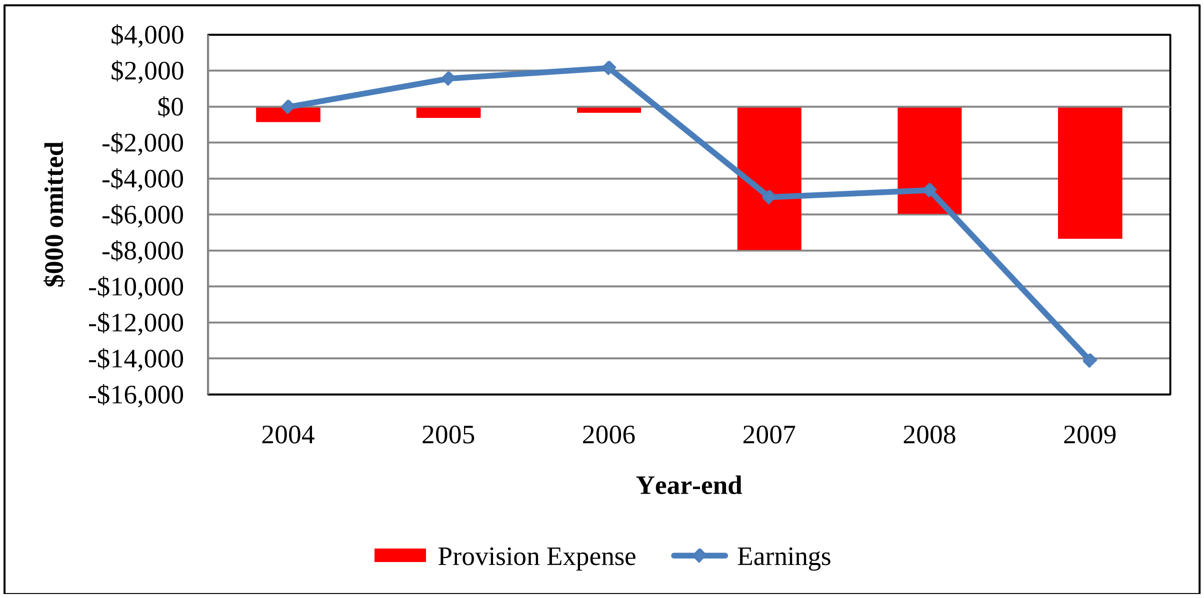
In addition to asset quality deterioration in the loan pools, Marco also experienced losses on the loans that it originated because of significant declines in the local real estate market. As shown in Chart 3, house prices in the Naples-Marco Island, Florida, Metropolitan Statistical Area (Marco MSA) appreciated rapidly from 2003 through 2005 but experienced consecutive years of declines from 2007 through 2009. For 2005, the Marco MSA registered house price appreciation of 39 percent. As of December 31, 2005, house price appreciation for the Marco MSA ranked second out of the 256 MSAs in the nation for the prior year. In contrast, house prices in the Marco MSA declined 12 percent in 2007, 33 percent in 2008, and 14 percent in 2009. As of December 31, 2009, the area ranked 287th out of the 299 MSAs in the nation for house price appreciation in the prior year.

Chart 3: Annual Percentage Changes in Home Prices for Naples–Marco Island, Florida



The bank's loan losses associated with the local real estate market decline affected Marco's earnings performance due to its concentration in risky loans. As of September 30, 2007, examiners concluded that Marco's earnings were critically deficient and did not allow for the formation of capital. Continued deterioration in asset quality prompted corresponding increases in Marco's loan loss provision expense. As shown in Chart 4 on the next page, the bank's provision expense increased from $0.3 million in 2006, to $8.0 million in 2007. Marco recorded additional provision expenses of $6.0 million and $7.4 million in 2008 and 2009, respectively. As shown in Chart 4, the significant provision expenses from 2007 through 2009 contributed to Marco's losses of $5.0 million in 2007, $4.6 million in 2008, and $14.1 million in 2009.

Chart 4: Impact of Provision Expense on Earnings



As noted previously, the bank received frequent capital support from its holding company to fund loan growth. As asset quality deteriorated, the bank relied on capital injections to help compensate for losses and sustain operations. In 2003, Marco received start-up capital of $6.4 million from the bank holding company. As shown in Table 1, the bank received a total of $16.1 million of additional capital from 2004 through 2009. The holding company's consistent financial support is significant because the bank's total assets never exceeded $163 million. The holding company eventually ran out of available capital to support the bank.

Table 1: Capital Injection History ($000 omitted)

2004	2005	2006	2007	2008	2009	Total
$5,000	$1,500	$1,250	$4,500	$2,000	$1,850	$16,100

FRB Atlanta implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies in troubled depository institutions. On August 4, 2009, Marco was notified that it was no longer *well capitalized*. On November 6, 2009, FRB Atlanta informed the Board of Directors that the bank was deemed *undercapitalized* and required Marco to submit an acceptable capital plan within 30 days. The bank submitted a capital plan that was deemed unacceptable because it assumed that a potential investment from a third party would occur, even though the transaction had not been finalized. Marco was declared *significantly undercapitalized* on January 27, 2010.

On February 2, 2010, FRB Atlanta informed the Board of Directors that the bank was deemed *critically undercapitalized*, citing Marco's tangible equity ratio. The Federal Reserve Board issued a PCA Directive on February 16, 2010, that, among other things, required Marco to accomplish the following by March 31, 2010: (1) raise additional capital or take other measures to achieve the *adequately capitalized* PCA designation or (2) be acquired by, or merge with, another depository institution. The State closed the bank on February 19, 2010, citing concern about Marco's imminent insolvency.

Supervision of Marco Community Bank

As shown in Table 2, FRB Atlanta and the State conducted six full scope examinations, four target examinations (including a limited scope examination), and a supervisory assessment before Marco's failure in February 2010. The bank received a CAMELS composite 2 (satisfactory) rating for each of the first three full scope examinations conducted by FRB Atlanta and the State. Marco received a CAMELS composite 4 (marginal) rating as a result of a May 2007 State examination. During this examination, the asset quality and earnings CAMELS component ratings were double downgraded from 2 to 4. In August 2007, FRB Atlanta issued a Written Agreement to address the bank's weaknesses.

FRB examiners began a full scope examination in December 2007 that resulted in a second CAMELS composite 4 rating. In July 2008, FRB Atlanta performed a target examination that revealed marginal improvements, but examiners did not change Marco's CAMELS ratings. FRB Atlanta and the State began a joint full scope examination in January 2009 and determined that the bank's asset quality showed signs of improvement and that Marco was generally compliant with the provisions of the Written Agreement. Although the bank's CAMELS composite rating remained a 4, examiners upgraded the component ratings for capital, asset quality, management, and liquidity. In July 2009, FRB Atlanta and the State conducted concurrent target examinations and downgraded these recently upgraded CAMELS component ratings. Specifically, Marco's CAMELS composite rating remained a 4, but the bank's component ratings for capital, asset quality, management, and liquidity all received downgrades.

FRB Atlanta's subsequent off-site monitoring activities and ongoing discussions with management revealed that Marco's capital had deteriorated because of losses related to declining asset quality. As a result, in a December 2009 supervisory assessment, FRB Atlanta downgraded Marco's CAMELS composite and capital component ratings to 5 (unsatisfactory). The Federal Reserve Board issued a PCA Directive on February 16, 2010, that required Marco to become *adequately capitalized* or be acquired by, or merge with, another depository institution. However, the State closed the bank on February 19, 2010, due to concerns about Marco's imminent insolvency.

Our analysis of FRB Atlanta's supervision of Marco revealed that FRB Atlanta did not fully comply with the Board's supervisory standards for de novo banks. Specifically, FRB Atlanta did not comply with the examination frequency guidelines and transitioned to a standard examination cycle despite noting issues that should have raised concerns about the bank's ability to operate on a sound basis—a consideration when determining if a de novo bank should be transitioned to a standard examination frequency cycle.

Table 2: Marco Supervisory Overview

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
2/2/2004	3/25/2004	Full	FRB	2	1	1	2	3	2	3	
8/23/2004	9/27/2004	Full	State	2	2	1	2	3	2	2	
9/12/2005	11/15/2005	Asset Quality Target	FRB	NA	NA	NA	NA	NA	NA	NA	
3/20/2006	5/26/2006	Full	FRB	2	2	2	3	2	2	2	Board Resolution
5/7/2007	7/3/2007	Full	State	4	3	4	4	4	2	3	Written Agreement
12/3/2007	4/15/2008	Full	FRB	4	3	5	4	5	3	3	
7/21/2008	10/21/2008	Asset Quality Target	FRB	4	3	5	4	5	3	3	
1/26/2009	4/21/2009	Full	Joint	4	2	4	3	5	2	3	
7/6/2009	10/5/2009[a]	Asset Quality Target	Concurrent	4	4	5	4	5	3	3	
NA	12/23/2009	Supervisory Assessment	FRB	5	5	5	4	5	3	3	
NA	2/16/2010	Offsite Monitoring	FRB	NA	NA	NA	NA	NA	NA	NA	PCA Directive

[a] The State conducted a limited scope examination and issued its examination report on September 25, 2009.

Initial Examination Resulted in a CAMELS Composite 2 Rating

In February 2004, FRB Atlanta conducted its initial examination of Marco. The full scope examination resulted in a CAMELS composite 2 rating. According to the March 2004 examination report, the bank was in satisfactory condition. Examiners noted that the bank's rapid asset growth, which is not uncommon for a de novo bank, deviated from the projections contained in its business plan. Examiners attributed this growth, in part, to a successful initial marketing campaign and deposit promotion. FRB Atlanta expressed confidence in the bank's ability to manage its growth. Asset quality was considered strong and received a 1 rating, and examiners noted that sound credit underwriting and administrative processes were in place. While earnings were considered fair and received a 3 rating, examiners concluded that Marco had satisfactory management and an experienced group of directors who closely monitored operating results. Capital, which received a 1 rating, was deemed strong and sufficient to keep the institution *well capitalized* until it reached its projected point of initial profitability—$60 million in total assets.[6]

Contrary to these positive comments, examiners also stated that the bank's senior credit officer position remained vacant and that the president had been acting in that capacity. FRB Atlanta warned that the bank needed to recruit an experienced and effective senior credit officer to help the bank successfully manage its long-term credit risk. In addition, examiners noted that the Board of Directors had not actively supervised the bank's operations because two directors had less than satisfactory attendance records at Board meetings—one director attended half of the meetings and the other attended two-thirds of the meetings. According to examiners, attending less than 75 percent of regular Board meetings renders a director ineffective. Examiners also noted that the bank was operating without a Board of Directors' approved business continuity plan or a plan for safeguarding customer information. Further, the bank was operating without Board of Directors approved policies and procedures on a wide range of accounting and bookkeeping functions.

September 2004 State Examination Report Maintained CAMELS Composite 2 Rating

In August 2004, the State, with an FRB Atlanta examiner participating, began a full scope examination that maintained the bank's CAMELS composite rating assigned during the prior examination. State examiners concluded that an experienced and effective management team supported the Board of Directors and that the Board of Directors' oversight was satisfactory. Examiners continued to rate asset quality "strong," citing low risk in the loan portfolio and the lack of loan classifications. According to examiners, even though the loan portfolio had not "seasoned," credit risk was low because most loans had conservative LTV ratios.

Although earnings remained fair, the bank reported its first monthly profit in July 2004, and management projected monthly profits for the remainder of 2004. Because of substantial loan growth, examiners recommended that management consider adding staff to the bank's loan documentation function. Examiners also noted that management's use of brokered deposits (as of June 30, 2004) as a funding source deviated from Marco's initial and revised business plans. According to the examination report, Marco's liquidity policy did not address the use of brokered deposits. In addition, the report noted there was a violation of Florida law concerning limits on loans to a single borrower.

According to examiners, the bank's capital ratios had declined significantly since the previous examination due to Marco's substantial asset growth. As of June 30, 2004, examiners noted that one of these capital ratios, the bank's tier 1 leverage ratio, had dropped to 7.98 percent. According to Supervision and Regulation (SR) Letter 91-17, *Application and Supervision Standards for De Novo State Member Banks,* de novo banks must maintain a tier 1 leverage ratio greater than 9 percent during the initial three years of operation.[7] The examination report noted that capital had declined significantly, but the bank remained *well capitalized*. Examiners

[6] As of December 31, 2003, the bank had $28.8 million in total assets.

[7] Our analysis of regulatory financial reports revealed that Marco's tier 1 leverage ratio remained below 9 percent (8.27 percent) as of September 30, 2004.

downgraded the bank's CAMELS component rating for capital to 2, but noted that the holding company "continues to be a source of financial support" for the bank—Marco received a $2.65 million capital infusion from its parent in the fourth quarter of 2004. SR letter 91-17 states that a de novo bank's asset growth and earnings performance should "reasonably support the bank's ability to maintain this ratio without reliance on additional capital injections." Thus, Marco's tier 1 leverage ratio and the action designed to bring the bank into compliance with the 9 percent tier 1 leverage ratio requirement were inconsistent with SR Letter 91-17.

Issues with Examination Frequency

FRB Atlanta transitioned Marco to the standard examination cycle based on Marco receiving CAMELS composite 2 ratings for its first two examinations. However, this action did not fully comply with the Board's supervisory guidance concerning examination frequency for de novo banks. SR Letter 91-17 requires examinations of de novo banks on the following schedule:

- a limited scope examination should be conducted by the Reserve Bank after a newly-converted state member bank completes its first quarter of operations,
- a full scope examination should be conducted by the Reserve Bank six months after the end of the first quarter of operations, and
- a full scope examination should be conducted for each six-month interval thereafter.

According to SR Letter 91-17, a de novo bank is subject to this examination schedule until it receives two consecutive CAMELS composite ratings of 1 or 2 and, in the judgment of the Reserve Bank, can be expected to continue operating on a sound basis.[8] Once these criteria are met, a de novo bank with assets greater than $250 million is eligible for the standard examination schedule, which requires at least one examination during each 12-month period, while banks (like Marco) with less than $250 million in assets can be examined once every 18 months.

Strict application of the above guidance would result in a de novo bank being under close supervision for a minimum of 15 months. However, three months after Marco became a state member bank, FRB Atlanta conducted a full scope examination rather than the limited scope examination required by SR Letter 91-17. Discussions with FRB Atlanta revealed that examiners conducted a full scope examination to minimize the regulatory burden on Marco, since the State was required to examine the bank within six months of FRB Atlanta's initial examination. According to examiners, performing the limited scope examination would have subjected Marco to three examinations in a nine-month period. In August, the State conducted a full scope examination, with an FRB Atlanta examiner participating. Based on the two examinations resulting in CAMELS composite 2 ratings and Marco qualifying as a small institution, examiners subsequently applied the standard examination cycle and did not conduct the next full scope examination for approximately 18 months.

[8] Our material loss review report for Community Bank of West Georgia contained a recommendation to the Director of the Division of Banking Supervision and Regulation to update the *Commercial Bank Examination Manual* to include the examination frequency requirements for de novo banks and a cross reference to SR Letter 91-17.

In our opinion, FRB Atlanta prematurely transitioned Marco to the standard examination cycle. Examiners did not conduct the initial limited scope examination required by SR Letter 91-17, and FRB Atlanta relied upon the State's CAMELS composite 2 rating to satisfy the requirement for two consecutive CAMELS composite 1 or 2 ratings. Further, we believe that the findings noted during these two examinations should have raised questions about the bank's ability to operate on a sound basis. For example, Marco's tier 1 leverage ratio fell below the required 9 percent, and the bank was relying on capital infusions from its holding company to raise its tier 1 leverage ratio above the required 9 percent. The assessment of a bank's ability to operate on a safe and sound basis is a key component in evaluating a de novo bank's readiness to transition to the standard examination cycle.

November 2005 Asset Quality Target Examination Report Noted Enhancements

In September 2005, FRB Atlanta began a target examination focused on Marco's real estate portfolio, including CLD loans and HELOCs. FRB Atlanta did not assign CAMELS ratings in the November 2005 examination report. Examiners acknowledged that Marco's rapid growth had resulted in the bank becoming profitable within two years of commencing operations. According to examiners, Marco's asset quality had not been "seriously affected" by the bank's rapid growth because of the Board of Directors' and management's familiarity with the local market and experience with a previous institution. Nevertheless, examiners recommended that Marco enhance its loan policies and procedures before continuing to grow.

Examiners observed that, although bank management routinely documented borrowers' credit scores, received their tax returns, and computed debt-to-income ratios, the bank generally had not completely documented borrowers' overall capacity to service their loans. In addition, examiners recommended that the bank improve its loan underwriting documentation and monitoring reports prepared for the Board of Directors. Examiners noted that a senior credit officer had been hired in April 2005, but that the bank's President left the institution in July 2005. Despite the senior management turnover, examiners stated that management appeared to be making many of the required improvements to the bank's loan policies and underwriting practices.

May 2006 Full Scope Examination Report Maintained Satisfactory Composite Rating, but Resulted in Component Downgrades and a Board Resolution

FRB Atlanta began a full scope examination in March 2006 that resulted in a CAMELS composite 2 rating. The May 2006 examination report downgraded the bank's asset quality component ratings from 1 to 2 and the management component rating from 2 to 3. Examiners indicated that Marco's Board of Directors had not provided proper oversight and that the bank had high credit risk. Asset quality was deemed satisfactory even though examiners identified various credit risk management weaknesses, such as underwriting and documentation deficiencies and excessive LTV exceptions. Loans exceeding LTV limits represented 295 percent of total capital—well in excess of the supervisory LTV limitation for real estate lending of 100 percent of total capital prescribed in Regulation H.[9] Examiners also noted that overdrafts by certain Marco directors violated Regulation O limits on extensions of credit to insiders.

Examiners concluded that, despite annual asset growth of 33.5 percent, Marco was *well capitalized* under PCA and maintained the minimum 9 percent minimum leverage ratio required for de novo banks during the first three years of operation. To arrive at this conclusion, the examination report included a "Capital Ratios and Trends" chart that contained year-end results from 2003 through 2005. This chart indicated that the bank's tier 1 leverage ratio for 2004 was 9.64 percent, which reflected the impact of the holding company's $2.65 million capital injection in the fourth quarter of 2004. As stated previously, according to the State's 2004 examination report, Marco's June 30, 2004, tier 1 leverage ratio was 7.98 percent; and according to regulatory financial reports, the ratio was 8.27 percent as of September 30, 2004.

According to the May 2006 examination report, the Board of Directors had become more involved in the bank's affairs and had hired qualified staff to assist in addressing previously noted deficiencies. However, FRB Atlanta imposed an informal enforcement action in the form of a Board Resolution (which was adopted by Marco's Board of Directors in June 2006) as a result of examiners' concerns regarding (1) the effectiveness of the Board of Directors' supervision of the bank's activities, (2) senior management turnover, (3) the volume of exceptions to LTV guidelines, (4) credit risk management deficiencies and asset concentrations, and (5) violations of law and regulations. The broad language in the Board Resolution stated that the Board of Directors should (1) affirm its commitment to address the bank's weaknesses timely and aggressively and (2) develop a formal written action plan to address, among other things, "its outstanding weaknesses to prevent any significant deterioration in the bank's overall condition." Examiners indicated that a follow-up visit should occur within six months to confirm the bank's adherence to the plan. A November 2006 visit noted that bank management was taking appropriate steps to address examiners' concerns.

July 2007 State Examination Report Resulted in a Double Downgrade to a CAMELS Composite 4 Rating and Written Agreement

The State began a full scope examination in May 2007 that resulted in a double downgrade of Marco's CAMELS composite rating to 4. According to supervisory guidance, institutions in this group pose a risk to the DIF, and failure is a distinct possibility if the bank's problems and weaknesses are not satisfactorily addressed and resolved. The component ratings for capital, management, and sensitivity received single downgrades, while asset quality and earnings received double downgrades. The State's examination report revealed serious deterioration in asset quality and the bank's financial condition. As of March 31, 2007, the total of Marco's classified assets was $25.5 million, or 129.5 percent of tier 1 capital and the ALLL, combined.

According to the July 2007 report, "the Board of Directors and management had exhibited imprudent judgment in their business decisions and supervision of the bank's affairs, and unsafe and unsound practices and procedures had caused serious deterioration in the bank's overall condition." Examiners highlighted that the Board of Directors and management continued to

[9] Regulation H, Appendix C, *Interagency Guidelines for Real Estate Lending Policies,* defines, in part, the supervisory LTV limits for real estate lending applicable to SMBs.

operate the bank without sufficient staffing depth and expertise. Other unsafe and unsound practices included the failure to develop and implement a strategic plan that identified the bank's weaknesses, strengths, competitive pressures, and external issues.

Examiners attributed the loan portfolio deterioration to (1) management's failure to limit to prudent levels the bank's investment in loan pools originated by a third party and (2) underwriting practices that allowed borrowers to provide minimal cash equity without a thorough assessment of the borrower's repayment capacity. Examiners stated that the decision to invest 98 percent of total capital in the [third party loan pools] showed blatant disregard for compliance with governing laws and exposed the bank to unnecessary credit risk.[10]

Although Marco remained *well capitalized* under the PCA guidelines, examiners noted that the bank's capital did not support its elevated risk profile. Earnings were not sufficient to augment capital, and the bank still required capital injections from the holding company. From 2004 through 2006, the holding company provided approximately $7.8 million in addition to the $6.4 million used to launch the bank. Examiners advised the Board of Directors and management to develop a capital plan that would maintain sufficient capital and allow the bank to resolve its asset quality and earnings problems.

In response to the unsafe and unsound banking practices and violations of law identified during the examination, the State issued an Emergency Cease-and-Desist Order in July 2007. In August 2007, FRB Atlanta issued a Written Agreement that incorporated the required actions of the Emergency Cease-and-Desist Order and superseded the order. The Written Agreement required the bank to address violations of law and unsafe and unsound practices related to asset quality, credit administration, management, risk management, and affiliate transactions. In addition, it required the Board of Directors to submit (1) a staffing analysis, (2) a capital plan, (3) a written business plan for 2007 to improve the earnings and overall condition of the bank, and (4) a written plan to strengthen and maintain effective Board of Directors oversight of management and bank operations.

April 2008 Examination Report Resulted in a CAMELS Composite 4 Rating

In December 2007, FRB Atlanta initiated a full scope examination that resulted in Marco's second consecutive CAMELS composite 4 rating. FRB Atlanta downgraded the bank's CAMELS component ratings for asset quality and earnings to 5. According to the April 2008 examination report, Marco's overall condition remained poor because the high level of problem assets continued to erode the bank's earnings and capital. Examiners stated that the third party loan pools comprised a significant portion of the bank's problem assets. In addition, other loans experienced significant deterioration due to local real estate market declines. During the examination, classified assets increased to $28.8 million, or 152 percent of tier 1 capital plus the ALLL.

[10] Regulation H, Appendix C, establishes guidelines for real estate loans granted with high LTV ratios. The guidance limits the aggregate of high LTV loans not representing one- to four-family mortgages to less than 30 percent of the institution's capital.

According to examiners, inherent credit risk remained high and the trend was increasing based on market conditions and the elevated concentration of CRE loans. Examiners stated the bank's weakened condition resulted from poor risk management practices, including inadequate Board of Directors and senior management oversight. The examination report noted that prior management turnover and staffing issues also contributed to the bank's weakened condition.

Examiners recognized Marco's recent aggressive efforts to mitigate losses from the third party loan pools, but noted concerns with the bank's capital and the need for additional internal control enhancements to return to a satisfactory condition. Earnings were critically deficient due to high loan loss provision expenses and did not support operations or allow for the formation of capital. Although the bank was *well capitalized* under PCA guidelines, examiners questioned whether capital levels were sufficient given the bank's elevated risk profile. Examiners also noted that additional action was needed to fully comply with the Written Agreement.

Marco's CAMELS Composite Rating Remained Unchanged after an October 2008 Target Examination Report

FRB Atlanta conducted a target examination of Marco's asset quality beginning in July 2008 that did not change the bank's previously issued CAMELS ratings. The examination revealed that Marco's Board of Directors and senior management had been responsive to several areas of concern identified during the previous examination. Examiners noted improvements in credit risk identification, the loan review function, appraisal processes, and credit underwriting. Examiners acknowledged substantial progress in achieving compliance with the Written Agreement, but noted weaknesses in the ALLL methodology, CRE concentration risk management, appraisal independence, timely recognition of charge-offs, and capital planning.

Classified assets remained high at $23 million, or 110 percent of tier 1 capital plus the ALLL, but had improved since the previous examination because of payoffs and additional write-downs on the third party loan pools. According to examiners, earnings continued to be a significant concern due to the high level of classified assets and the need for substantial loan loss provisions. Marco's capital exceeded the PCA threshold for a *well capitalized* institution, but examiners reiterated that the bank's capital did not support its risk profile.

April 2009 Joint Examination Report Resulted in Another CAMELS Composite 4 Rating

In January 2009, FRB Atlanta and the State conducted a joint full scope examination that resulted in another CAMELS composite 4 rating, although all component ratings except for earnings and sensitivity received upgrades. According to the April 2009 examination report, Marco's asset quality remained unsatisfactory, but examiners noted some improvement, such as (1) a significant reduction in the bank's exposure to third party loans, and (2) a decrease in classified assets to $23.9 million, or 137.9 percent of tier 1 capital plus the ALLL.

Earnings were deemed critically deficient, and examiners noted that Marco's 2009 budget appeared optimistic because it did not fully reflect the impact of the bank's poor asset quality and the unfavorable economic climate. The bank remained *well capitalized*, but examiners noted that capital was "under considerable pressure" due to poor asset quality and poor earnings.

According to examiners, management had taken positive steps to resolve the bank's problems and had made progress addressing the requirements of the Written Agreement, but certain provisions of the enforcement action required further efforts.

October 2009 Concurrent Examinations Resulted in a CAMELS Composite 4 Rating

Beginning on July 6, 2009, FRB Atlanta conducted a target examination of Marco, concurrent with a limited scope examination by the State. As a result of the examination, Marco received a CAMELS composite 4 rating in the October 2009 examination report, but the component ratings for capital, asset quality, management, and liquidity all received downgrades within six months of the previous upgrades. Capital received a double downgrade from 2 to 4, and asset quality went from 4 to 5. In our opinion, these abrupt component rating reversals indicate that the upgrades recorded in the prior examination may have been premature.

The examination revealed noncompliance with the Written Agreement requirement pertaining to the ALLL methodology, but cited partial compliance with other key provisions, such as capital and strategic planning. According to examiners, asset quality remained unsatisfactory and critical weaknesses remained in Marco’s credit risk management practices.

Classified assets increased to 207 percent of tier 1 capital plus the ALLL, up from 137 percent as of December 30, 2008. In addition, examiners noted that the holding company no longer had the desire, or resources, to provide Marco with capital infusions; therefore, Marco no longer had the financial support to cushion its high operating losses related to ongoing asset quality deterioration. Examiners observed that the bank needed a substantial capital infusion to remain viable.

December 2009 Supervisory Assessment Resulted in a Downgrade to a CAMELS Composite 5 Rating

In December 2009, FRB Atlanta’s off-site monitoring and ongoing discussions with Marco senior management revealed that Marco’s capital levels had continued to erode due to operational losses. As a result, FRB Atlanta downgraded Marco's CAMELS composite rating from 4 to 5. 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. In January 2010, FRB Atlanta notified Marco’s Board of Directors that the bank was deemed *significantly undercapitalized* for PCA purposes and that the bank's revised capital plan was unacceptable because the plan assumed support from a potential investor, but management had not secured a definitive agreement.

On February 2, 2010, FRB Atlanta informed the Board of Directors that the bank was deemed *critically undercapitalized.* The Federal Reserve Board issued a PCA Directive on February 16, 2010, that, among other things, required Marco to accomplish the following by March 31, 2010: (1) raise additional capital or take other measures to achieve the *adequately capitalized* PCA designation, or (2) be acquired by, or merge with, another depository institution. The State closed the bank on February 19, 2010, citing concern about Marco’s imminent insolvency.

Conclusion and Lessons Learned

Marco failed because its Board of Directors and management did not provide adequate oversight of the bank's lending activities. Following its inception, the bank operated with a weak internal control environment due, in part, to frequent management turnover, vacancies in key positions, and inadequate staff expertise. The bank grew more quickly than management anticipated in its business plan and relied on capital injections from the holding company to sustain operations. The growth resulted in Marco developing high concentrations in the CLD component of the bank's CRE loan portfolio and in HELOCs. Also, in 2006 and 2007, the bank executed management's strategic decision to supplement its declining loan production by purchasing a pool of short-term acquisition and renovation loans on properties primarily located in two Florida counties. These loan pools created an additional concentration risk for Marco. As the real estate market in Marco Island weakened, the bank's asset quality deteriorated significantly and resulted in large provision expenses that eliminated earnings and depleted capital. Marco ultimately became *critically undercapitalized*, and the State closed the bank on February 19, 2010, appointing the FDIC as receiver.

With respect to supervision, FRB Atlanta and the State conducted six full scope examinations, four target examinations (including a limited scope examination), and a supervisory assessment between 2004 and 2010. Our analysis of FRB Atlanta's supervision of Marco revealed that FRB Atlanta did not fully comply with the Board's supervisory standards for de novo banks. Specifically, FRB Atlanta did not comply with the examination frequency guidelines and put Marco on a standard examination cycle despite noting issues that should have raised concerns about the bank's ability to operate on a sound basis—a consideration when determining if a de novo bank should be transitioned to a standard examination frequency cycle.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or a loss to the DIF. We believe that FRB Atlanta should not have transitioned to the standard examination cycle for this de novo bank after the State's full scope examination in 2004. In hindsight, we believe that many of the issues noted during the first two examinations foreshadowed the bank's future problems. Nevertheless, it is not possible to determine the degree to which strict adherence to the supervisory guidelines for de novo banks may have altered the course of the bank's financial decline or affected the failure's cost to the DIF.

Lessons Learned

Although the failure of one de novo bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Marco's failure points to valuable lessons learned that can be applied when supervising de novo banks with similar characteristics. First, Marco's failure underscores that de novo banks require close supervision and that examiners should only implement the standard examination cycle when—consistent with regulatory guidance—the bank's corporate governance, financial condition, and internal controls warrant the transition. Second, this failure highlights the importance of examiners closely monitoring a de novo bank's performance when there are significant deviations from the business plan that is submitted as part of the application to become an SMB.

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 is included as Appendix 3. The Director concurred with the conclusion and lessons learned contained in the report.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
A valuation reserve established and maintained by charges against the bank'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. The reserve must be sufficient to absorb probable losses inherent in the institution's loan and lease portfolio.

Brokered Deposits
A deposit purchased from a broker acting as an agent for depositors. The broker pools certificates of deposit from many small investors and markets them to financial institutions, usually in blocks nearing $100,000, and negotiates a higher rate for certificates of deposit placed with the purchaser. Federal law prohibits undercapitalized banks and thrifts from accepting brokered deposits.

Classified Assets
Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Classified assets are 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. An asset classified as "loss" is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted.

Collateral
An asset pledged as security to ensure payment or performance of an obligation. If the borrower defaults, the asset pledged may be taken and sold by the lender to fulfill completion of the original contract.

Commercial Real Estate (CRE) Loans
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 derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Concentration
A significant amount of direct or indirect extensions of credit and contingent obligations that possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations.

Appendix 1 (continued)

Construction and Land Development (CLD) Loans
A subset of commercial real estate loans, secured by real estate (including non-agricultural vacant land), for (1) on-sight construction of industrial, commercial, residential, or farm buildings, and (2) land development, including pre-construction preparatory work, such as laying sewer and water pipes.

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 Written Agreements, temporary Cease-and-Desist Orders, Cease-and-Desist Orders, prohibition and removal orders, and Prompt Corrective Action Directives; while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Liquidity
The ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

Non-core Deposits
Deposits that are generally unstable and costly. Such deposits include certificates of deposit greater than $100,000, brokered deposits, and deposits obtained from outside a bank's general market area.

Nonperforming Assets
The sum of (1) the total of loans and lease financing receivables past due 90 or more days and still accruing interest, (2) the total of nonaccrual loans and lease financing receivables, and (3) the total of other real estate owned.

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

Appendix 1 (continued)

Tier 1 Capital
The sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

Tier 1 Leverage Ratio
The ratio of tier 1 capital to average total consolidated assets calculated in accordance with the Federal Reserve Board's capital adequacy guidelines.

Written Agreement
A formal supervisory enforcement action that is generally issued when a financial institution or an institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Federal Reserve Board or a Federal Reserve Bank that may require the financial institution or the institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. This enforcement action is the least severe of the formal enforcement actions.

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:	September 29, 2010
To:	Elizabeth A. Coleman, Inspector General
From:	Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***
Subject:	Material Loss Review of Marco Community Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Marco Community Bank of Marco Island, Florida, prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The report finds that Marco Community Bank failed because its Board of Directors and management did not provide adequate oversight of the bank's lending. The bank operated with a weak internal control environment, grew more quickly than management anticipated in its business plan and relied on capital injections from its holding company parent to sustain operations. The growth led to high concentrations in construction, land, and land development (CLD) loans and home equity lines of credit (HELOCs). As the local real estate market weakened, asset quality deteriorated significantly resulting in large provision expenses that eliminated earnings and depleted capital. Marco Community Bank was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta) under delegated authority from the Board.

Banking Supervision and Regulation staff concur with the conclusions and lessons learned in the report. FRB Atlanta, along with the State, conducted six full scope examinations, four target examinations, and a supervisory assessment between 2004 and 2010. Marco Community Bank was subject to a Board Resolution in 2006, as well as a Written Agreement in 2007 and a PCA Directive in 2010. The report notes that FRB Atlanta did not comply with the examination frequency guidelines for de novo banks. In particular, FRB Atlanta did not conduct an initial limited scope examination as described in SR Letter 91-17 and put Marco Community Bank on a standard examination cycle prematurely despite noting issues that should have raised concerns about the bank's ability to operate on a sound basis. As recognized in the lessons learned, de novo banks require close supervisory attention and should only be moved to a standard examination cycle when the bank's corporate governance, financial condition, and internal controls support such an action. Further, we concur with the report's identified lesson that examiners should closely monitor a de novo bank's performance when there are significant deviations from the business plan that is submitted as part of its application to become a state member bank.

Staff notes that in response to an earlier recommendation from the IG, we have updated the *Commercial Bank Examination Manual* (section 1000.1) to include the examination frequency guidelines for de novo banks and a cross reference to SR Letter 91-17.

Appendix 4 –Office of Inspector General Principal Contributors to this Report

Kyle R. Brown, Project Leader and Senior Auditor

Sam Nop, Auditor

Kimberly A. Whitten, Project Manager

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