Board of Governors of the Federal Reserve System

Material Loss Review of Orion Bank

Office of Inspector General

June 2010

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

OFFICE OF INSPECTOR GENERAL

June 14, 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 Orion Bank (Orion). 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.

Orion became a state-chartered member bank in 2002 through the merger of two national banks—First National Bank of the Florida Keys and Gulf Coast National Bank. Headquartered in Naples, Florida, Orion had as many as 24 branch offices in Southwest Florida, the Florida Keys, and Palm Beach County. The bank 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).

On November 9, 2009, the Federal Reserve Board issued an enforcement action in the form of a non-consent Prompt Corrective Action (PCA) Directive that included a provision ordering the removal of Orion's Chief Executive Officer (CEO), who also served as the bank President and the Chairman of the Board of Directors. The non-consent PCA Directive stated that, in the July 2009 timeframe, the bank's CEO made false statements to the Federal Reserve and, among other things, permitted the bank to make loans that (1) exceeded and, therefore, violated the Florida legal lending limit statute; (2) had inadequate analysis of the borrower's creditworthiness or capacity for repayment; and (3) were structured in a manner to make it appear that Orion was reducing its level of classified assets. In addition, the non-consent PCA

Directive indicated that the CEO had knowledge that these loans were used to acquire Orion's common and preferred stock and to purchase low quality assets from the bank. We have provided our report to the Office of Inspector General's investigations section for further review and analysis.

The State closed Orion on November 13, 2009, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. In a letter dated December 14, 2009, the FDIC Inspector General advised us that the bank's failure would result in a $593.8 million loss to the DIF, or 22 percent of the bank's $2.7 billion in total assets, which would be a material loss to the DIF.

Orion failed because its Board of Directors and management did not control the risks associated with rapid growth and an extremely high concentration in commercial real estate (CRE) and, in particular, acquisition, development, and construction (ADC) loans. Under the direction of the CEO, who had a dominant role in the bank and held a controlling interest in the parent bank holding company, Orion aggressively expanded its CRE and ADC loan portfolios in the south Florida market from 2004 through 2006. A subsequent rapid decline in the Florida real estate market led to deteriorating asset quality and significant losses, particularly in the ADC portfolio. Bank management failed to acknowledge the extent of the real estate market downturn and was slow in recognizing and mitigating credit risk exposure. Mounting loan losses eliminated the bank's earnings, depleted capital, and ultimately led the State to close Orion and appoint the FDIC as receiver on November 13, 2009.

With respect to supervision, FRB Atlanta complied with examination frequency guidelines for the timeframe we reviewed, 2005 through 2009, and conducted regular off-site monitoring. During this period, FRB Atlanta and the State conducted six examinations and executed three formal enforcement actions: a Written Agreement, a Cease and Desist Order, and a non-consent PCA Directive.

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. Our analysis of FRB Atlanta's supervision of Orion revealed that a State examination report issued in March 2007 identified a notable change in the bank's risk profile resulting from a deteriorating real estate market and newly identified weaknesses in credit risk management and Board of Directors oversight. We believe the findings included in the State examination report should have signaled to FRB Atlanta that additional, timely supervisory attention was warranted earlier in 2007, instead of waiting until December 2007 to begin on-site examination work.

The State's March 2007 examination report revealed that the real estate market in Orion's service areas had deteriorated; however, the bank's CRE and ADC loan concentrations continued to increase. In addition, examiners noted that a $533 million, or 70 percent, increase in CRE loans, and a $406 million, or 84 percent, increase in ADC loans, registered during the 12-month period ending March 31, 2006, exposed the bank to "greater credit risk." In contrast to the generally favorable assessment cited in a March 2006 FRB Atlanta examination report, State examiners described Orion's loan review program as ineffective, and noted that the bank's internal loan grading did not identify certain problem loans. Examiners warned that "the untimely identification of loan problems could expose the bank to additional credit losses." The State examination report also raised concerns that "appraisals made at the height of the real estate market in 2004 and 2005 may not represent the realistic fair value of the collateral today," and that Orion's allowance for loan and lease losses methodology should be reconsidered in light of the residential real estate market slowdown and the bank's concentration in CRE loans. In addition, contrary to the positive opinion expressed in FRB Atlanta's 2006 examination report, State examiners commented that Orion's Board of Directors seemed to offer little direction or supervision, and that the CEO appeared to view the Board of Directors as a hindrance more than anything else.

While we believe that the circumstances presented in the March 2007 State examination report provided an opportunity for an earlier supervisory response in 2007, given the rapid decline in the real estate markets served by Orion, it is not possible to determine whether earlier supervisory attention would have affected Orion's subsequent decline or the failure's cost to the DIF.

Orion's failure offers a valuable lesson learned that can be applied when supervising banks with similar characteristics and circumstances. In our opinion, Orion's failure illustrates that financial institutions with a dominant CEO, a weak Board of Directors, and extremely high concentrations in risky assets such as CRE and ADC loans require (1) heightened supervisory attention even when financial performance is strong, and (2) an immediate and forceful supervisory response when signs of market deterioration or weaknesses in credit risk management first become apparent.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. Overall, the Director concurred with our conclusions and lesson 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 Office of Inspector General 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

Orion Bank (Orion) became a state-chartered member bank in 2002 through the merger of two national banks—First National Bank of the Florida Keys and Gulf Coast National Bank. Headquartered in Naples, Florida, Orion had as many as 24 branch offices in Southwest Florida, the Florida Keys, and Palm Beach County. The bank 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).

On November 9, 2009, the Federal Reserve Board issued an enforcement action in the form of a non-consent Prompt Corrective Action (PCA) Directive that included a provision ordering the removal of Orion's Chief Executive Officer (CEO), who also served as the bank President and the Chairman of the Board of Directors.[1] The non-consent PCA Directive stated that, in the July 2009 timeframe, the bank's CEO made false statements to the Federal Reserve and, among other things, permitted the bank to make loans that (1) exceeded and, therefore, violated the Florida legal lending limit statute; (2) had inadequate analysis of the borrower's creditworthiness or capacity for repayment; and (3) were structured in a manner to make it appear that Orion was reducing its level of classified assets. In addition, the non-consent PCA Directive indicated that the CEO had knowledge that these loans were used to acquire Orion's common and preferred stock and to purchase low quality assets from the bank. We have provided our report to the Office of Inspector General's investigations section for further review and analysis.

The State closed Orion on November 13, 2009, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. In a letter dated December 14, 2009, the FDIC Inspector General advised us that the bank's failure would result in a $593.8 million loss to the Deposit Insurance Fund (DIF), or 22 percent of the bank's $2.7 billion in total assets, which would be a material loss to the DIF.[2] 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 agency's supervision of the failed institution, including the agency's implementation of PCA;

[1] A non-consent PCA Directive is a formal enforcement action requiring bank management to take certain actions due to the bank's weakened capital position. The Directive is issued without the Board of Directors' concurrence and allows the bank to appeal within 14 calendar days of receipt.

[2] Subsequently, the FDIC revised the estimated loss to the DIF to be approximately $653.2 million, as of December 31, 2009.

- 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 Federal Reserve Board in Washington, D.C.; FRB Atlanta; the State; and the FDIC. We also reviewed bank reports, correspondence, surveillance reports, enforcement actions, Reports of Examination (examination reports) issued from 2005 through 2009, and examination work papers prepared by FRB Atlanta. Appendixes at the end of this report contain a glossary of key banking and regulatory terms and a description of the CAMELS rating system.[3] We conducted our fieldwork from December 2009 through April 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

Orion failed because its Board of Directors and management did not control the risks associated with rapid growth and an extremely high concentration in commercial real estate (CRE) and, in particular, acquisition, development, and construction (ADC) loans. Under the direction of the CEO, who had a dominant role in the bank and held a controlling interest in the parent bank holding company, Orion aggressively expanded its CRE and ADC loan portfolios in the south Florida market from 2004 through 2006. A subsequent rapid decline in the Florida real estate market led to deteriorating asset quality and significant losses, particularly in the ADC portfolio. Bank management failed to acknowledge the extent of the real estate market downturn and was slow in recognizing and mitigating credit risk exposure. Mounting loan losses eliminated the bank's earnings, depleted capital, and ultimately led the State to close Orion and appoint the FDIC as receiver on November 13, 2009.

Dominant CEO and Weak Board of Directors

Orion's Board of Directors consisted of five members—the CEO and four outside directors—which was the minimum number of directors required under federal and state statutes. Orion's CEO owned 24 percent of the parent bank holding company's stock, making him the largest shareholder. The CEO was the dominant force in establishing the bank's strategic direction and overall risk profile, including day-to-day management. None of the outside directors had banking experience, and examiners noted that (1) the CEO "does not look to the directorate for support in managing the affairs of the bank," and (2) the Board of Directors' oversight was inadequate.

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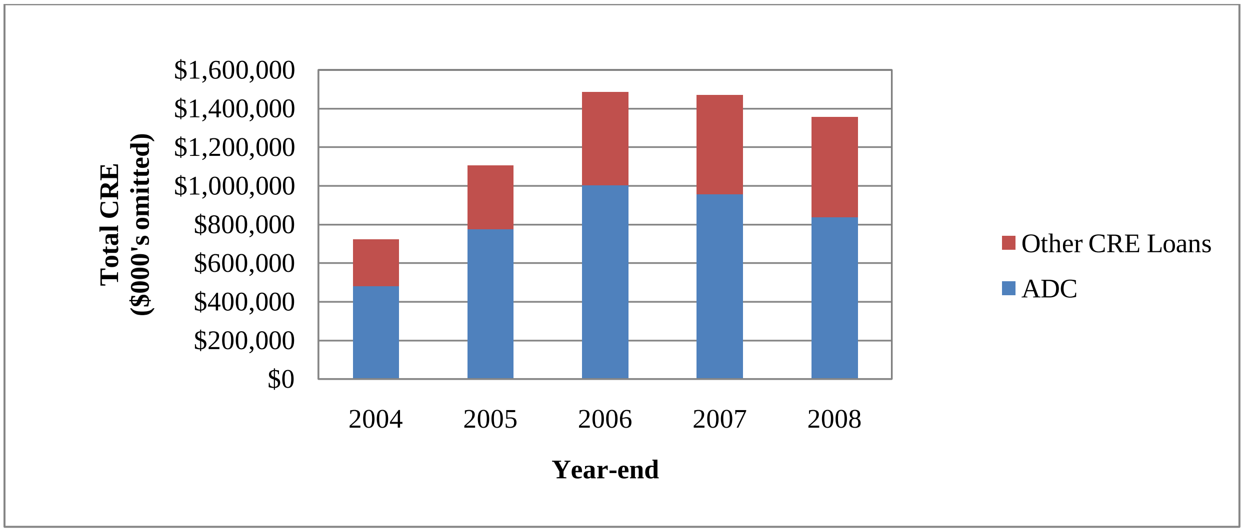
[3] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the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

Aggressive Growth Resulted in High CRE and ADC Loan Concentrations

Orion's business strategy, which was heavily influenced by the CEO, focused on aggressive growth in the bank's loan portfolio. Management projected annual loan growth rates of 31 percent in 2005, and 25 percent in 2006. The bank's actual growth rate significantly exceeded these projections in both years, reaching 41 percent and 32 percent, respectively. Orion funded its loan growth with non-core funding, including brokered deposits.[4] Orion's growth was driven primarily by CRE loans, particularly ADC loans tied to the residential real estate market. The growth in CRE and ADC loans was attributed to an expanding south Florida real estate market. As shown in Chart 1 below, total CRE loans more than doubled from $722.3 million in 2004, to $1.49 billion in 2006, with ADC loans increasing from $481 million to $1 billion during the same period. A decline in CRE and ADC loans that began in 2007 resulted from losses related to the deteriorating real estate market.

Chart 1: Growth in CRE and ADC Loans



Orion's aggressive growth led to high concentrations in CRE and ADC loans.[5] In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. As shown in Chart 2a on page 12, the bank's CRE loan concentration was approximately 700 percent of total risk-based capital in 2006. Orion's CRE loan concentration reached 739 percent of total risk-based capital by December 31, 2008. Historically, Orion's CRE loan concentration was well above its peer

[4] Brokered deposits can have a significant negative effect on liquidity because these funds may not be available in times of financial stress or adverse changes in market conditions. Although Orion's use of non-core funding was a concern for examiners, liquidity was not a primary factor in Orion's failure.

[5] According to the Federal Reserve Board's Supervision and Regulation Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate,* an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported loans for construction, land development, and other land represent 100 percent or more of an institution's total capital; or (2) total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

group.[6] As illustrated in Chart 2b, the bank's ADC loan concentration also consistently exceeded its peer group and remained over 450 percent from 2005 through 2008. Most of the bank's CRE portfolio, particularly its ADC loans, was centered in four south Florida counties—Collier, Lee, Sarasota, and Manatee.

Chart 2a: CRE Loan Concentration

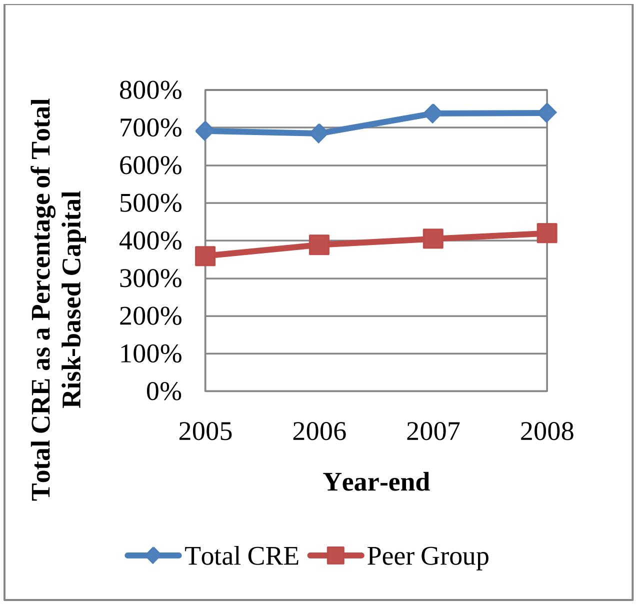
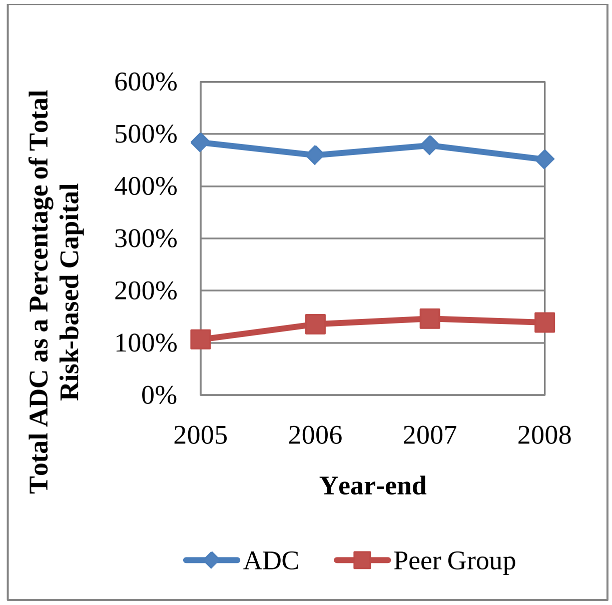


Chart 2b: ADC Loan Concentration



Real Estate Market Decline Led to Loan Portfolio Deterioration

Orion's vulnerability as a result of its high CRE and ADC loan concentrations became evident as the south Florida residential real estate market deteriorated. As Chart 3 shows, total building permits issued for Collier, Lee, Sarasota, and Manatee counties declined 79 percent from 50,071 in 2005, to 10,679 in 2007. Total building permits continued to decrease, although at a slower rate, through June 2009. In addition, housing prices for the Metropolitan Statistical Areas (MSA) located in these counties began to decline in 2006, with each MSA experiencing a greater than 20 percent decrease in 2008.[7]

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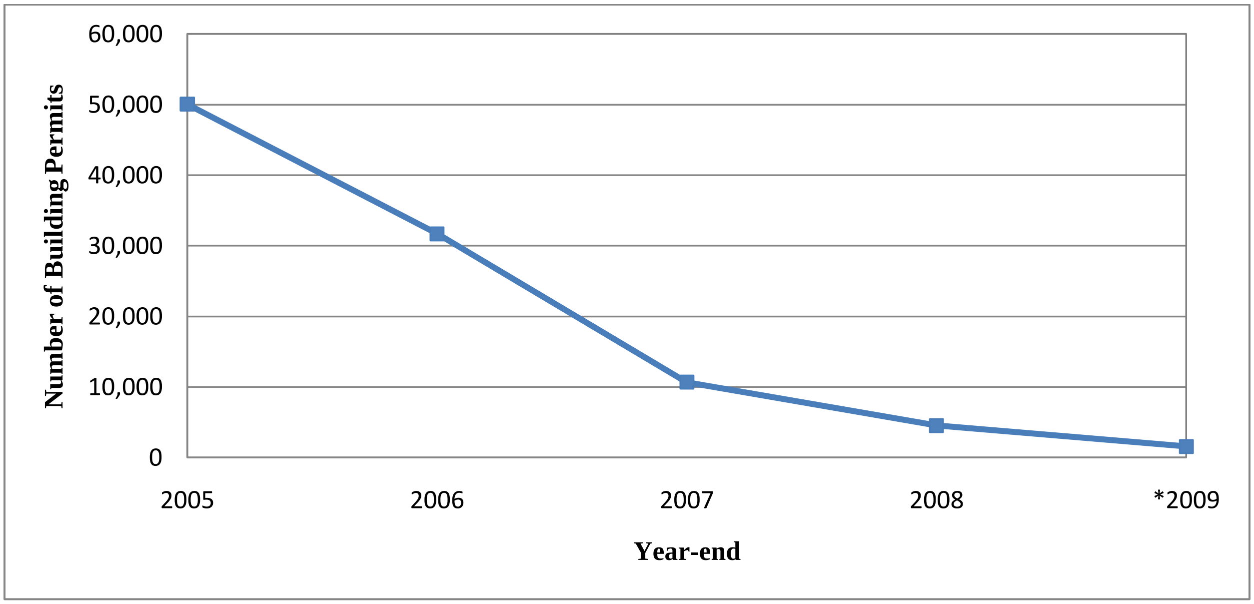
[6] Peer group includes all insured commercial banks having assets between $1 billion and $3 billion.

[7] MSAs are geographic entities defined by the U.S. Office of Management and Budget for use by federal statistical agencies in collecting, tabulating, and publishing federal statistics.

Chart 3: Total Building Permits Issued in Collier, Lee, Sarasota, and Manatee Counties



*As of 6/30/2009

Orion's Board of Directors and management failed to recognize the extent of the local real estate market downturn and were slow to identify problem loans. As a result, examiners frequently disagreed with management's loan grading decisions and downgraded a substantial number of loans, particularly in the ADC portfolio. Nevertheless, management did not strengthen its credit underwriting practices to account for the market downturn, and renewed or extended loans using the original terms despite clear declines in the value of underlying projects and deteriorating real estate market conditions. Examiners noted that many of these loans were kept current with bank funded interest reserves, so the level of past due loans was understated.[8]

Loan Portfolio Losses Eroded Capital

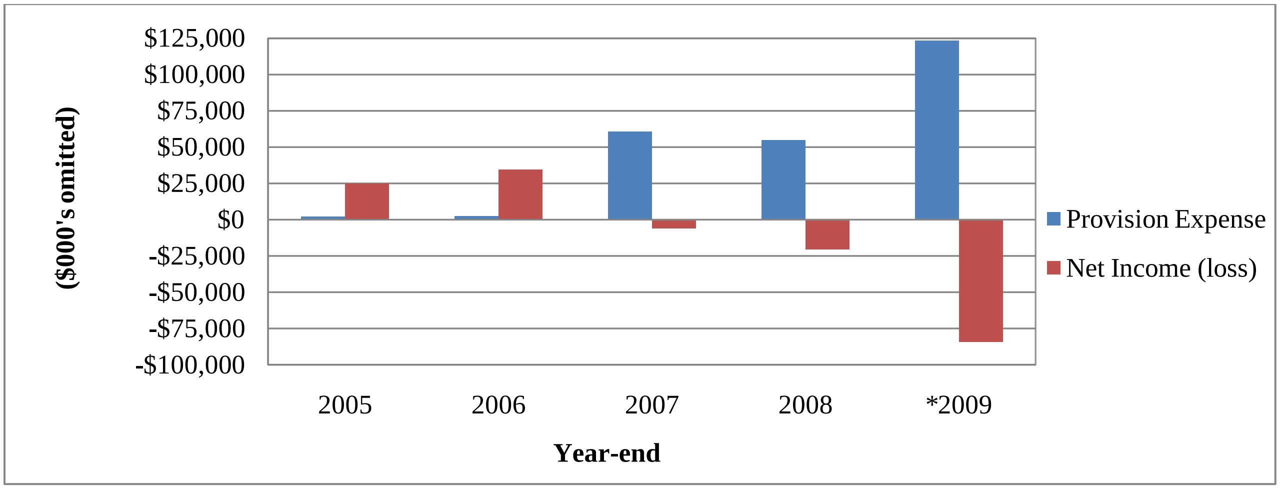
The declining local real estate market led to significant deterioration in Orion's asset quality, particularly in ADC loans. The bank's total classified assets increased 474 percent from $54 million in 2006, to $310 million in 2007. In addition, nonaccrual loans increased 2,659 percent throughout 2007, from $2.9 million in the first quarter to $81 million by year-end.[9] ADC loans represented approximately $74 million of the $81 million year-end nonaccrual total balance. Although the bank's asset quality experienced significant deterioration, examiners noted that the level of classified assets, local economic deterioration, and high CRE concentration "were not met with any comparable increase in the bank's ALLL [allowance for loan and lease losses]." The bank's asset quality continued to deteriorate in 2008; by year end,

[8] Lenders may establish an interest reserve account to periodically advance loan funds to pay interest charges on the outstanding balance of an ADC loan. The interest is capitalized and added to the loan balance. This practice can mask loans that would otherwise be reported as delinquent and erode collateral protection, increasing a lender's exposure to credit losses.

[9] Nonaccrual status means loans with overdue interest payments and uncertainty regarding collection of principal; no interest income is recognized on these loans for reporting purposes.

nonaccrual loans reached $154 million, with ADC loans accounting for $128 million of the total. Examiners repeatedly directed bank management to increase the ALLL and loan loss provision expense, which, as shown in Chart 4, led to large losses, reduced Orion's retained earnings, and eroded capital.

Chart 4: Impact of Provision Expense on Earnings



*As of 9/30/2009

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 at troubled depository institutions. The bank was notified in August 2008 that it was no longer *well capitalized.* Orion was informed that it could not accept, renew, or roll over any brokered deposits. Subsequently, Orion received capital injections from the bank holding company that restored its *well capitalized* status. However, during a 2009 full scope examination, examiners noted that an additional $40.4 million of provision expense was required for year-end 2008, which caused the bank to fall back to *adequately capitalized* in May 2009.

In July 2009, Orion filed a regulatory report that showed the bank had returned to *well capitalized*. However, in August 2009, examiners analyzed the regulatory report and found that Orion made errors in calculations supporting the bank's return to the *well capitalized* status. Accordingly, Orion filed an amended regulatory report in late August 2009, and on September 1, 2009, FRB Atlanta notified the bank that it was *adequately capitalized.*

Asset quality continued to deteriorate, and in October 2009, FRB Atlanta notified Orion that its PCA capital position had dropped to *critically undercapitalized*. As noted earlier, the Federal Reserve Board issued a PCA Directive on November 9, 2009. In addition to requiring the removal of the CEO, it required the bank to (1) raise additional capital to achieve the *adequately capitalized* PCA designation, or (2) be acquired by or merge with another depository institution. The State closed Orion on November 13, 2009.

Supervision of Orion Bank

FRB Atlanta complied with examination frequency guidelines for the timeframe that we reviewed, 2005 through 2009, and conducted regular off-site monitoring. During the almost five-year period preceding Orion's failure in November 2009, FRB Atlanta and the State conducted six examinations and executed three formal supervisory actions: a Written Agreement, a Cease and Desist (C&D) Order, and a non-consent PCA Directive.

As shown in Table 4 on page 16, the bank received a CAMELS composite 2 (satisfactory) rating through March 2007. Orion was double downgraded to a CAMELS composite 4 (marginal) rating in mid-2008 based on a full scope examination that resulted in an August 2008 Written Agreement. In July 2009, Orion was downgraded to a CAMELS composite 5 (unsatisfactory) rating, and the bank was placed under a C&D Order. An asset quality target examination that began in August 2009 resulted in a non-consent PCA Directive; however, the bank was closed before the examination report was issued.

Our analysis of FRB Atlanta's supervision of Orion revealed that a March 2007 State examination report identified a notable change in the bank's risk profile, which should have signaled to FRB Atlanta that additional, earlier supervisory attention was warranted in 2007.

Table 4: Supervisory Overview of Orion Bank

<table>
<tr><th colspan="3">Examination</th><th rowspan="2">Agency Conducting the Examination</th><th rowspan="2">CAMELS Composite Rating</th><th colspan="6">CAMELS Component Ratings</th><th rowspan="2">Supervisory Actions</th></tr>
<tr><th>Start Date</th><th>Report Issue Date</th><th>Scope</th><th>Capital</th><th>Asset Quality</th><th>Management</th><th>Earnings</th><th>Liquidity</th><th>Sensitivity</th></tr>
<tr><td>11/07/2005</td><td>03/03/2006</td><td>Full</td><td>FRB Atlanta</td><td>2</td><td>2</td><td>1</td><td>2</td><td>1</td><td>2</td><td>2</td><td></td></tr>
<tr><td>12/11/2006</td><td>03/28/2007</td><td>Full</td><td>State</td><td>2</td><td>2</td><td>2</td><td>2</td><td>1</td><td>2</td><td>2</td><td></td></tr>
<tr><td>12/03/2007</td><td>07/02/2008</td><td>Full</td><td>FRB Atlanta</td><td>4</td><td>4</td><td>4</td><td>4</td><td>4</td><td>4</td><td>3</td><td>Written Agreement</td></tr>
<tr><td>10/27/2008</td><td>02/09/2009</td><td>Asset Quality Target</td><td>FRB Atlanta</td><td>4</td><td>4</td><td>5</td><td>4</td><td>5</td><td>4</td><td>3</td><td></td></tr>
<tr><td>01/30/2009</td><td>06/12/2009</td><td rowspan="2">Full</td><td rowspan="2">Concurrent[a]</td><td>4
(State results)</td><td>4</td><td>5</td><td>4</td><td>5</td><td>4</td><td>3</td><td></td></tr>
<tr><td>01/30/2009</td><td>07/09/2009</td><td>5
(FRB Atlanta results)</td><td>5</td><td>5</td><td>4</td><td>5</td><td>4</td><td>3</td><td>C&D Order</td></tr>
<tr><td>08/17/2009</td><td>n/a [b]</td><td>Asset Quality Target</td><td>Concurrent[a]</td><td>n/a</td><td>n/a</td><td>n/a</td><td>n/a</td><td>n/a</td><td>n/a</td><td>n/a</td><td>Non-consent PCA Directive</td></tr>
</table>

[a]FDIC participated in the examination
[b]Orion was closed before an examination report was issued

November 2005 Full Scope Examination Resulted in a CAMELS Composite 2 Rating

In November 2005, FRB Atlanta conducted a full scope examination that resulted in a CAMELS composite 2 rating, with asset quality and earnings rated 1 (strong). The examination report cited low levels of loan losses, delinquencies, and classified assets, and noted that "the bank operates with a seasoned management team who has demonstrated the ability to effectively manage risk." In addition, examiners stated that management depth was adequate and that the Board of Directors appeared to be well informed and active in committees; however, examiners noted that the CEO dominated the bank's policies and had a firm control of the bank's day-to-day operations. Examiners indicated that credit administration, credit analysis, underwriting, and appraisals were satisfactory, and that management (1) effectively identified and accurately assessed credit risk and (2) appropriately graded problem loans. Additionally, reports and information systems were cited as providing management and the Board of Directors with sufficient data to enable informed decisions.

The examination report noted that Orion's CRE concentration exposed the bank to a high degree of inherent credit risk and that well designed controls were necessary. Examiners recommended that Orion (1) perform stress testing of the entire loan portfolio; (2) establish CRE limits and sub-limits; (3) segment the ADC portfolio by markets; and (4) monitor speculative construction by borrower, product type, and location.

December 2006 Full Scope State Examination Resulted in Another CAMELS Composite 2 Rating

In December 2006, the State began a full scope examination that resulted in another CAMELS composite 2 rating, although asset quality was downgraded to 2. The March 2007 examination report noted that the residential real estate market in south Florida had deteriorated, yet Orion's CRE and ADC concentrations continued to increase. Examiners pointed to a $533 million, or 70 percent, increase in CRE loans, and a $406 million, or 84 percent, increase in ADC loans, registered during the 12-month period ending March 31, 2006, as exposing the bank to "greater credit risk."

In contrast to the positive assessment of loan grading cited in the March 2006 FRB Atlanta examination report, State examiners noted that the bank's internal loan grading did not identify certain problem loans, and concluded that Orion's loan review program was ineffective. Examiners stated that "the untimely identification of loan problems could expose the bank to additional credit losses." In addition, examiners expressed concern that "appraisals made at the height of the real estate market in 2004 and 2005 may not represent the realistic fair value of the collateral today." Furthermore, the examination report noted that Orion's ALLL methodology should be reconsidered in light of the residential real estate market slowdown and the bank's concentration in CRE loans. According to examiners, Orion's ALLL may not be sufficient "should deterioration in the real estate market continue," and the real estate market decline should be a critical factor in management's assessment of its ALLL adequacy.

The examination report indicated that management decisions continued to be heavily influenced by the CEO, who was involved in every aspect of the bank, including day-to-day management. However, contrary to the most recent FRB Atlanta examination, State examiners noted that Orion's four outside directors seemed to offer little direction or supervision and that the Board of Directors' decisions were dominated by the CEO, who appeared to view the Board as a hindrance more than anything else.

Off-site Monitoring Activities in 2007

In a July 2007 email, an FRB Atlanta official advised staff that Orion was on the official's "Top 5" list of banks that caused "the most concern." The official suggested that a visitation or an earlier start date for the next examination might be indicated. A staff member indicated general comfort "with the lending team at Orion," and that the bank's recent reports indicated low delinquency rates and "flat to modest declining CRE growth in 2007." Based on this response, the full scope examination originally planned to begin in February 2008 was not accelerated; however, FRB Atlanta continued its monitoring of CRE concentrations and past due accounts. After receiving a report from Orion in November 2007 indicating a three-fold increase in past due loans, FRB Atlanta changed its plans and began a full scope examination in December 2007, eight months after the State issued its last examination report.

December 2007 Full Scope Examination Resulted in a Double Downgrade to a CAMELS Composite 4 Rating and a Written Agreement

In December 2007, FRB Atlanta started a full scope examination that resulted in a double downgrade to a CAMELS composite 4 (marginal) rating. The capital, asset quality, management, and liquidity components were also double downgraded from 2 to 4, while the earnings component received a triple downgrade from 1 to 4. The July 2008 examination report stated that financial institutions with CAMELS composite 4 ratings pose a risk to the DIF and that failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved. Orion's CEO and management strongly disagreed with the findings presented at a mid-April 2008 examination exit meeting. In an attempt to dispute the examination findings, Orion submitted additional information and, in April and May of 2008, attended two meetings at FRB Atlanta and one meeting at the Federal Reserve Board. The information provided by the bank was considered, but dismissed by FRB Atlanta, and examiners began the process of issuing a formal supervisory action while finalizing the examination report.

According to the examiners, Orion's weak credit risk management practices, along with extremely high CRE and ADC concentrations and the deteriorating south Florida real estate market, contributed to the bank's troubled condition. Management was slow to recognize problem loans, so examiners downgraded loans valued at $172 million, or 62 percent of the bank's $310 million in total classified assets. The examination report revealed that the volume of examiner downgrades "reflects ineffective loan grading and risk identification by management and suggests that additional unidentified credit risk is embedded in the remaining portfolio." Examiners noted that management disagreed with an overwhelming majority of the examiner downgrades.

The examination report stated that management dealt with problem loans by extending or renewing the loans on an interest only basis, in an attempt to allow the borrowers more time to sell the underlying collateral. However, examiners noted that borrowers "seem to have had limited success in moving the properties, even with the renewals and extensions." According to examiners, a number of problem loans continued to "perform only because of payments from bank-funded interest reserves."

Examiners noted that the bank's ALLL "has not been directionally consistent with the elevated risk within the bank's loan portfolio, including the sharp rise in past due and nonperforming loans." In addition, examiners found that the ALLL methodology could not produce a reliable estimate of loss exposure in the loan portfolio. During the examination, FRB Atlanta created a process for estimating an appropriate ALLL for Orion. This process was incorporated in Federal Reserve Board guidance now used to estimate the ALLL when examiners determine that a community bank's methodology is inadequate. The examination report stated that an additional provision of $42 million was needed to bring Orion's ALLL to a minimally acceptable level.

According to examiners, Orion had appraisal program deficiencies that were cause for significant regulatory concern. Examiners noted that many loans were supported by stale appraisals or by appraisals containing highly questionable or outdated assumptions. In addition, examiners stated that the bank was not in compliance with the *Interagency Appraisal and Evaluation Guidelines*

(Federal Reserve Board Supervision and Regulation Letter 94-55) because, among other things, Orion had not established processes to ensure that appraisals and evaluations were being reviewed by qualified individuals independent of the loan production process.[10]

Examiners stated that the Board of Directors and senior management did not properly identify, manage, and mitigate the risks inherent in the bank's high concentrations in CRE and ADC loans. Furthermore, management failed to implement critical risk mitigation plans in a deteriorating real estate market. Examiners noted that the CEO dominated the bank's policies and operations and had an annual bonus tied to the bank's earnings growth, which provided an "incentive to delay recognition of problem credits [loans] and associated provisions."

FRB Atlanta and the State executed a formal enforcement action in the form of a Written Agreement on August 25, 2008. The Written Agreement required the Board of Directors to address a variety of issues, including loan renewal, use of interest reserves, appraisals, problem loan identification, board oversight of management and bank operations, concentrations of credit, lending and credit administration, the ALLL, and capital.

October 2008 Target Examination Resulted in Another CAMELS Composite 4 Rating

In October 2008, FRB Atlanta began a target examination that focused on asset quality. It resulted in another CAMELS composite 4 rating, with earnings and asset quality being downgraded to 5. Examiners characterized the bank's financial condition as extremely poor and deteriorating, and stated that the Board of Directors and senior management "must do much more to recognize the extent of the bank's problems and effect meaningful improvement." Examiners noted that management had not adequately responded to required actions identified during the prior examination and that the bank was substantially noncompliant with the Written Agreement.

According to examiners, Orion's classified and nonperforming assets were extremely high and had increased since the prior examination. Examiners found that management prematurely upgraded previously classified assets, and once again identified significant weaknesses in problem loan identification and the ALLL methodology. Examiners concluded that Orion's ALLL was deficient by $26.9 million. In addition, the examination report once again expressed concerns regarding Orion's use of interest reserves. FRB Atlanta and the State began concurrent full scope examinations in January 2009, approximately two weeks before the target examination report was issued on February 9, 2009.

[10] The Federal Reserve Board's Supervision and Regulation Letter 94-55 provides specific guidance on several aspects of regulated institutions' appraisal and evaluation programs, including: (1) procedures for obtaining an appraisal or evaluation report in a timely manner to facilitate an institution's underwriting decision; (2) selection criteria and procedures to evaluate and monitor the performance of individuals who perform appraisals and evaluations; (3) criteria for using an existing appraisal or evaluation to support a subsequent transaction; and (4) internal controls for promoting compliance with the appraisal regulation.

January 2009 Concurrent Full Scope Examinations Resulted in a Cease and Desist Order

In January 2009, FRB Atlanta and the State began concurrent full scope examinations that resulted in the organizations issuing separate reports. The reports were generally consistent and, among other things, focused on Orion's deteriorating financial condition, repeat findings from prior examinations, and the Board of Directors' and management's failure to fully comply with the Written Agreement.

Examiners stated that Orion's credit risk management practices were critically deficient and that the bank continued to experience asset quality problems because management failed to (1) take timely action to reduce CRE concentrations when market conditions began to weaken, (2) establish effective controls to identify problem loans, and (3) develop an adequate ALLL methodology. According to examiners, earnings were critically deficient because of the bank's severe asset quality problems and the need to substantially increase the ALLL and corresponding provision expense. As a result, examiners noted that Orion's capital had eroded significantly.

Examiners stated that the CEO's "belief that the problems facing the bank are not as severe as those facing the industry has proven inaccurate." Examiners criticized the Board of Directors and management for their unsatisfactory compliance with the Written Agreement provisions. According to examiners, Orion's failure to implement policies, practices, and procedures to resolve the problems facing the bank was an unsafe and unsound practice.

The State examination report, issued on June 12, 2009, resulted in another CAMELS composite 4 rating, with individual component ratings identical to the previous examination. Examiners noted that management planned to improve the bank's capital position by issuing $75 million of stock in the parent bank holding company, and that Orion would receive $47 million of the stock issuance proceeds. Examiners recommended that Orion develop a capital contingency plan in the event that this attempt to raise capital did not succeed.

The FRB Atlanta examination report issued on July 9, 2009, downgraded the bank to a CAMELS composite 5 rating. The capital component also was downgraded to a 5, with all other components remaining the same from the previous examination. In our opinion, the repeat criticisms regarding management's failure to (1) comply with the Written Agreement and (2) take actions to resolve the bank's problems indicate that the management component rating could have been downgraded to a 5.

Examiners based the composite and capital component downgrades on additional information obtained after the State issued its examination report. The information indicated that Orion's attempt to raise $75 million was unsuccessful. According to examiners, only "$25 million in capital was raised by the parent company from two investors who are customers of the bank." Examiners stated that the amount of funds raised was well below the $75 million that management expected and was, therefore, insufficient to "fully support the bank, given its extremely high risk profile." According to examiners, the level of delinquent and classified assets "requires substantially more capital to absorb the risk in the portfolio."

The concurrent examinations revealed that the bank was operating "in substantial noncompliance" with the Written Agreement. Accordingly, the Federal Reserve Board and the State executed a C&D Order on September 18, 2009, which, among other things, required that Orion (1) obtain an independent review of the bank's corporate governance and qualifications of senior management and Board of Directors, (2) ensure the accuracy of regulatory reporting and financial statements, and (3) create a committee to monitor compliance with the order and the Written Agreement.

August 2009 Target Examination

In August 2009, FRB Atlanta and State examiners began concurrent asset quality target examinations; however, the bank was closed before the examination reports were completed. During the course of conducting examination work, examiners identified a number of recurring concerns, such as Orion's insufficient ALLL, weak appraisal process, inadequate problem loan identification, and critical deterioration of bank capital. As discussed previously, a non-consent PCA Directive was issued on November 9, 2009, and the State closed the bank and appointed the FDIC as receiver on November 13, 2009.

Conclusions and Lesson Learned

Orion failed because its Board of Directors and management did not control the risks associated with rapid growth and an extremely high concentration in CRE and, in particular, ADC loans. Under the direction of the CEO, who had a dominant role in the bank and held a controlling interest in the parent bank holding company, Orion aggressively expanded its CRE and ADC loan portfolios in the south Florida market from 2004 through 2006. A subsequent rapid decline in the Florida real estate market led to deteriorating asset quality and significant losses, particularly in the ADC portfolio. Bank management failed to acknowledge the extent of the real estate market downturn and was slow in recognizing and mitigating credit risk exposure. Mounting loan losses eliminated the bank's earnings, depleted capital, and ultimately led the State to close Orion and appoint the FDIC as receiver on November 13, 2009.

With respect to supervision, FRB Atlanta complied with examination frequency guidelines for the timeframe we reviewed, 2005 through 2009, and conducted regular off-site monitoring. During this period, FRB Atlanta and the State conducted six examinations and executed three formal enforcement actions: a Written Agreement, a C&D Order, and a non-consent PCA Directive.

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. Our analysis of FRB Atlanta's supervision of Orion revealed that the State examination report issued in March 2007 identified a notable change in the bank's risk profile resulting from a deteriorating real estate market and newly identified weaknesses in credit risk management and Board of Directors oversight. We believe the findings included in the State examination report should have signaled to FRB Atlanta that additional, timely supervisory attention was warranted earlier in 2007, instead of waiting until December 2007 to begin on-site examination work.

The State's March 2007 examination report revealed that the real estate market in Orion's service areas had deteriorated; however, the bank's CRE and ADC loan concentrations continued to increase. In addition, examiners noted that a $533 million, or 70 percent, increase in CRE loans, and a $406 million, or 84 percent, increase in ADC loans, registered during the 12-month period ending March 31, 2006, exposed the bank to "greater credit risk." In contrast to the generally favorable assessment cited in the March 2006 FRB Atlanta examination report, State examiners described Orion's loan review program as ineffective, and noted that the bank's internal loan grading did not identify certain problem loans. Examiners warned that "the untimely identification of loan problems could expose the bank to additional credit losses." The State examination report also raised concerns that "appraisals made at the height of the real estate market in 2004 and 2005 may not represent the realistic fair value of the collateral today," and that Orion's ALLL methodology should be reconsidered in light of the residential real estate market slowdown and the bank's concentration in CRE loans. In addition, contrary to the positive opinion expressed in FRB Atlanta's 2006 examination report, State examiners commented that Orion's Board of Directors seemed to offer little direction or supervision, and that the CEO appeared to view the Board of Directors as a hindrance more than anything else.

While we believe that the circumstances presented in the March 2007 State examination report provided an opportunity for an earlier supervisory response in 2007, given the rapid decline in the real estate markets served by Orion, it is not possible to determine whether earlier supervisory attention would have affected Orion's subsequent decline or the failure's cost to the DIF.

Lesson Learned

Orion's failure offers a valuable lesson learned that can be applied when supervising banks with similar characteristics and circumstances. In our opinion, Orion's failure illustrates that financial institutions with a dominant CEO, a weak Board of Directors, and extremely high concentrations in risky assets such as CRE and ADC loans require (1) heightened supervisory attention even when financial performance is strong, and (2) an immediate and forceful supervisory response when signs of market deterioration or weaknesses in credit risk management first become apparent.

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 conclusions and lesson learned contained in the report. He stated that "earlier supervisory action might have identified weaknesses sooner in 2007 reflecting market deterioration."

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Acquisition, Development, and Construction (ADC) Loans
ADC loans are a component of commercial real estate loans that provide funding for acquiring and developing land for future construction and interim financing for residential or commercial structures.

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.

Brokered Deposits
Brokered deposits are deposits that are placed in a savings institution by a broker who gathers funds from others and packages the funds in batches of $100,000. The broker then shops for financial institutions paying the highest rates and invests in multiple $100,000 certificates of deposit, which typically pay the highest rates of interest and are federally insured.

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. An asset classified as "loss" is considered uncollectible and of such little value that its 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 derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Concentration
A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets are similarly affected by adverse economic, financial, or business conditions and, in the aggregate, may pose risk to the safety and soundness of the institution.

Appendix 1 (continued)

Core Deposits
Core deposits are small denomination time deposits and checking accounts acquired in a bank's natural market area, counted as a stable source of funds for lending. These deposits have a predictable cost, imply a degree of customer loyalty, and are less interest rate sensitive than short-term certificates of deposit and money market deposit accounts.

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, Written Agreements, and Prompt Corrective Action Directives, while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Non-core Deposits
Non-core deposits include federal funds purchased, Federal Home Loan Bank advances, subordinated notes and debentures, certificates of deposit of more than $100,000, and brokered deposits.

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

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 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*.

Supervision and Regulation (SR) Letters
SR letters are issued by the Federal Reserve Board’s Division of Banking Supervision and Regulation. They address significant policy and procedural matters of continuing relevance to the Federal Reserve Board’s supervisory effort. SR letters are for distribution to supervised institutions as well as Reserve Banks.

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: June 14, 2010

To: Elizabeth A. Coleman, Inspector General

From: Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***

Subject: Material Loss Review of Orion Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft material Loss Review of Orion Bank of Naples, Florida, prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report finds that Orion Bank failed because its Board of Directors and management did not control the risks associated with rapid growth and an extremely high concentration in CRE and, in particular, ADC loans. Orion aggressively expanded its CRE and ADC loan portfolios from 2004 through 2006. A subsequent rapid decline in the local real estate market led to deteriorating asset quality and significant losses. Bank management failed to acknowledge the extent of the real estate market downturn and was slow in recognizing and mitigating credit risk exposure. Mounting losses eliminated the bank’s earnings and depleted its capital. Orion bank was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta) under delegated authority from the Board.

Banking Supervision and Regulation staff concurs with the conclusions and lesson learned in the report. FRB Atlanta complied with examination frequency guidelines for the period that was reviewed, 2005 through 2009, and conducted regular off-site monitoring. During this time period, FRB Atlanta and the State of Florida conducted six examinations and executed three formal enforcement actions: a Written Agreement in 2008, a Cease and Desist Order in 2009, and non-consent PCA Directive in 2009. The report indicates that the State examination report in early 2007 identified a notable change in the bank’s risk profile and should have signaled that additional, timely supervisory attention was warranted in early 2007. The report also states that it is not possible to determine whether earlier supervisory attention would have affected Orion Bank’s subsequent decline or the failure’s cost to the DIF. Staff concurs that earlier supervisory action might have identified weaknesses sooner in 2007 reflecting market deterioration. FRB Atlanta accelerated the start date for its full scope examination when repayment weaknesses became apparent. This December 2007 examination occurred 8 months after the issuance of the State examination report.

The report identifies an important lesson learned applicable to banks with similar characteristics and circumstances. Specifically, the report concludes that financial institutions with a dominant CEO, a weak Board of Directors, and extremely high concentrations in risky assets, such as CRE and ADC loans require heightened supervisory attention (even when financial performance is strong) and an immediate and forceful supervisory response when signs of market deterioration or weaknesses in credit risk management are evident.

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

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