Board of Governors of the Federal Reserve System

Material Loss Review of Riverside Bank of the Gulf Coast

Office of Inspector General

September 2009

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

OFFICE OF INSPECTOR GENERAL

September 9, 2009

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 Riverside Bank of the Gulf Coast. 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) exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

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

Riverside Bank of the Gulf Coast (Riverside-Gulf Coast) was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Florida Office of Financial Regulation (State). The State closed Riverside-Gulf Coast on February 13, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On March 9, 2009, the FDIC Inspector General notified us that, according to the FDIC, the failure of Riverside-Gulf Coast would result in an estimated loss to the DIF of $201.5 million, or 37.5 percent of the bank's $536.7 million in total assets.

Riverside-Gulf Coast failed because the bank did not adequately control the risks resulting from its (1) growth strategy to establish a residential real estate loan portfolio and (2) reliance on selling mortgages in the secondary market. The aggressive growth resulted in a commercial real estate (CRE) concentration in the bank's local service area that included a sizable number of residential construction loans to speculative investors. By 2007, the economic downturn caused credit tightening in the secondary markets, thereby hampering, and eventually eliminating, Riverside-Gulf Coast's ability to sell mortgages. In addition, the unprecedented drop in southwest Florida's real estate market decreased the underlying collateral value of the bank's real estate loan portfolio. These factors required Riverside-Gulf Coast to increase its allowance for loan losses, which negatively impacted earnings, resulting in insufficient capital to absorb losses, ultimately leading to the bank's insolvency.

With respect to supervision, FRB Atlanta complied with the frequency of safety and soundness examinations prescribed in regulatory guidance, and conducted off-site monitoring commensurate with concerns and risks identified during examinations. During a three-and-a-half-year period beginning in June 2005, FRB Atlanta performed on-site examination related work at Riverside-Gulf Coast on seven separate occasions. Examiners began focusing greater supervisory attention on the bank's high CRE concentration and speculative lending in 2005 and required Riverside-Gulf Coast to mitigate associated risks when the real estate market was robust and the bank's overall condition and asset quality were sound. Despite FRB Atlanta's supervisory efforts, the combination of an unusually rapid and severe real estate market downturn and the unexpected disappearance of the secondary market led to Riverside-Gulf Coast's failure.

Fulfilling our mandate under section 38(k) provides an opportunity to determine whether, in hindsight, the circumstances surrounding a bank's failure warranted additional or alternative supervisory actions. Based on our analysis of Riverside-Gulf Coast's supervision, we believe that emerging problems observed during a 2007 visitation provided FRB Atlanta with an opportunity for a more aggressive supervisory response. Specifically, FRB Atlanta noted a significant decline in the local residential housing market and observed that new appraisals indicated that the value of certain collateral, particularly developed lots ready for construction, declined by as much as 70 percent. In addition, examiners observed that Riverside-Gulf Coast could no longer sell mortgages in the secondary market and, therefore, would be required to hold and service these loans. According to examiners, classified assets were expected to increase in the near term, and earnings would be affected by an expected increase in the bank's loan loss reserves.

In our opinion, the circumstances that FRB Atlanta highlighted in the 2007 visitation signaled a sudden and total transformation of Riverside-Gulf Coast's longstanding business model and warranted more immediate supervisory attention, such as (1) conducting an asset quality target examination, (2) requiring the bank to prepare a new capital plan, or (3) further accelerating the full-scope examination that was conducted in March 2008. However, in light of the rapid deterioration in Riverside-Gulf Coast's local real estate market, it is not possible to determine the degree to which such an action would have affected the bank's subsequent decline or the failure's cost to the DIF.

In assessing Riverside-Gulf Coast's failure, we have also noted that the loss of the secondary market was a significant factor because the bank was suddenly forced to begin holding loans in a rapidly deteriorating market. As property values fell, speculative investors involved in ongoing residential real estate construction projects, as well as other more traditional mortgage borrowers, ceased making loan payments. Riverside-Gulf Coast's efforts to reduce losses by restructuring debts held in the bank's portfolio met with limited success because the modified loans were downgraded to classified assets after examiners determined that the loans were impaired.

We believe that Riverside-Gulf Coast's unprecedented and unexpected loss of the secondary market offers a lesson learned for Federal Reserve examiners and managers. In general, supervisory guidance recognizes the practice of selling loans in the secondary market as a viable strategy to mitigate real estate concentration risks, especially in adverse market conditions. Elements of this view were reflected in a 2003 FRB Atlanta internal supervisory document that indicated Riverside-Gulf Coast's use of the secondary market would likely provide several benefits that included serving as an effective tool in managing risk. Although the unique circumstances surrounding an individual bank failure do not necessarily warrant a change in supervisory guidance, at a minimum, the failure of Riverside-Gulf Coast reveals that the secondary market may not always be a reliable option, especially for banks facing sharp deterioration in their local real estate market.

We provided our draft report for review and comment to the Acting Director of the Division of Banking Supervision and Regulation. Overall, the Acting Director agreed with our conclusion. She also concurred with the lesson learned and noted that reliance on the secondary market to purchase mortgages "is not without its own risk." Her response is included as Appendix 4.

We appreciate the cooperation that we received from FRB Atlanta and Board staff during our review. The principal contributors to this report are listed in Appendix 5. 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
Inspector General

cc: Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Ms. Esther George
Mr. William B. Estes

Board of Governors of the Federal Reserve System

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Background

Riverside Bank of the Gulf Coast (Riverside-Gulf Coast) was a community bank headquartered in Cape Coral, Florida, that opened in 1997 and had as many as fifteen offices located in several counties in Southwest Florida.[1] The bank's strategy was to serve local residents and businesses by providing mortgage products and other services. Riverside-Gulf Coast became a state-chartered member bank of the Federal Reserve System (SMB) on October 27, 1997. 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 (Board), and by the Florida Office of Financial Regulation (State).

The State closed Riverside-Gulf Coast on February 13, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. At the time of closure, the FDIC estimated that the bank's failure would result in a $201.5 million loss to the Deposit Insurance Fund (DIF), or 37.5 percent of the bank's $536.7 million in total assets. In a letter dated March 9, 2009, the FDIC Inspector General advised us that the FDIC had determined that Riverside-Gulf Coast's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

When a loss to the DIF is considered material, Section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution, including the agency's implementation of Prompt Corrective Action, and

- ascertain why the institution's problems resulted in a loss to the DIF and
- make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected data from the Board in Washington, D.C.; FRB Atlanta; the State; the FDIC's Division of Resolutions and Receivership in Dallas, Texas; and the FDIC's Division of Supervision and Consumer Protection. We also reviewed correspondence, surveillance reports, Reports of Examination (examination reports) issued between 2003 and 2008, and examination work papers prepared by FRB Atlanta. Appendixes at the end of this report include a glossary that defines key banking and regulatory terms, a key events timeline, and a description of the CAMELS rating system.[2] We conducted our fieldwork from March 2009 through July 2009, in accordance with the *Quality Standards for Inspections* issued by the Council of Inspectors General on Integrity and Efficiency.

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[1] Riverside Bank of the Gulf Coast is a separate and independent company from Riverside National Bank and Riverside Bank of Central Florida.

[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 and 5 having the greatest concern.

Cause of the Failure

Riverside-Gulf Coast failed because the bank did not adequately control the risks resulting from its (1) growth strategy to establish a residential real estate loan portfolio and (2) reliance on selling mortgages in the secondary market. The aggressive growth resulted in a commercial real estate (CRE) concentration in the bank's local service area that included a sizable number of residential construction loans to speculative investors. By 2007, the economic downturn caused credit tightening in the secondary markets, thereby hampering, and eventually eliminating, Riverside-Gulf Coast's ability to sell mortgages. In addition, the unprecedented drop in southwest Florida's real estate market decreased the underlying collateral value of the bank's real estate loan portfolio. These factors required Riverside-Gulf Coast to increase its allowance for loan losses, which negatively impacted earnings, resulting in insufficient capital to absorb losses, ultimately leading to the bank's insolvency.

Business Strategy Featured Asset Growth Creating Concentrations

Historically, Riverside-Gulf Coast focused on growth through real estate lending in its local service area, a business strategy that created concentrations in both the type of loans and the geographic location. In general, local real estate concentrations increase a financial institution's vulnerability to cyclical changes in the local market place and may elevate a bank's safety and soundness risk. Examiners noted that Riverside-Gulf Coast experienced rapid growth during its first six years when the bank's total assets grew approximately 40 percent annually, to $275 million as of December 31, 2003. During this same time period, total loans and leases increased to $195 million, with total real estate loans comprising approximately 95 percent of the loan portfolio. By 2005, the bank had opened fifteen offices in five southwest Florida coastal counties, and many loans were originated in Lee County, the bank's primary market area.

Riverside-Gulf Coast's concentration in real estate loans ranged between 92 and 98 percent of total loans during 2003 to 2008. The bank's real estate portfolio included traditional one-to-four family mortgages and home equity lines of credit. In addition, a substantial number of Riverside-Gulf Coast's real estate loans, such as those for residential construction, were categorized as CRE because repayment was dependent on the rental income, sale, or refinancing of the underlying collateral.

Construction Loans to Speculative Investors and Use of the Secondary Market

Riverside-Gulf Coast's construction programs comprised over 90 percent of its total residential loan production in 2005 and peaked in the 2005/2006 timeframe, when the bank had over 1,300 units under construction. Before securing a construction loan, customers were required to arrange mortgage financing either from Riverside-Gulf Coast or another lender. Prior to 2007, construction loans were predominantly made to speculative investors who had little or no equity invested in the property and never intended to occupy the home. Instead, many of these investors would either sell the property or the construction contract before the home was completed.

With respect to one-to-four family mortgages underwritten by Riverside-Gulf Coast, the bank's practice was to sell the mortgages in the secondary market rather than holding them to maturity. The bank's underwriting standards were based on the guidelines established by the companies that purchased mortgages in the secondary market. Loans were granted to credit-worthy borrowers, including investors participating in the residential loan construction programs, provided that the underlying appraised collateral values met loan-to-value guidelines set by secondary market vendors.

Real Estate Market Downturn

Residential real estate in Riverside-Gulf Coast's primary market area of Lee County, Florida, exhibited robust growth and price appreciation until mid-decade, when the first definitive signs of a slowdown appeared. As shown in Table 1, residential real estate permits peaked at 28,343 in 2004 and decreased approximately 98 percent in four years. In addition, during the three-year period from 2005 to 2008, the supply of vacant developed lots climbed from less than one year to over ten years; eighteen to twenty-four months is considered an acceptable supply of vacant developed lots. Housing prices also deteriorated significantly over the same period, declining approximately 20 percent from 2007 to 2008.

Table 1
Housing Market Data for Lee County, Florida

	12/2003	12/2004	12/2005	12/2006	12/2007	12/2008
Residential Real Estate Permits	18,142	28,343	26,917	8,639	990	614[a]
Months' Supply of Vacant Developed Lots	22	12.1	10.6	17.3	50	139.1
Annual Percent Change in House Price	10.04%	19.71%	36.19%	5.02%	-12.37%	-32.93%

[a] The number represents the 13-month period ending January 31, 2009.

Market changes, combined with events in 2007, significantly altered Riverside-Gulf Coast's real estate lending practices. In August 2007, the bank's main secondary market vendor went bankrupt and ceased purchasing Riverside-Gulf Coast's loans. In addition, the bank's alternative vendor decided to curtail its secondary market purchasing in certain zip codes that included Riverside-Gulf Coast's market area. Faced with no viable options to sell mortgages in the secondary market, the bank was forced to hold and service mortgage loans originally intended for sale. According to examiners' comments in 2008, the mortgage portfolio was "underwater" because outstanding mortgage balances exceeded housing prices.

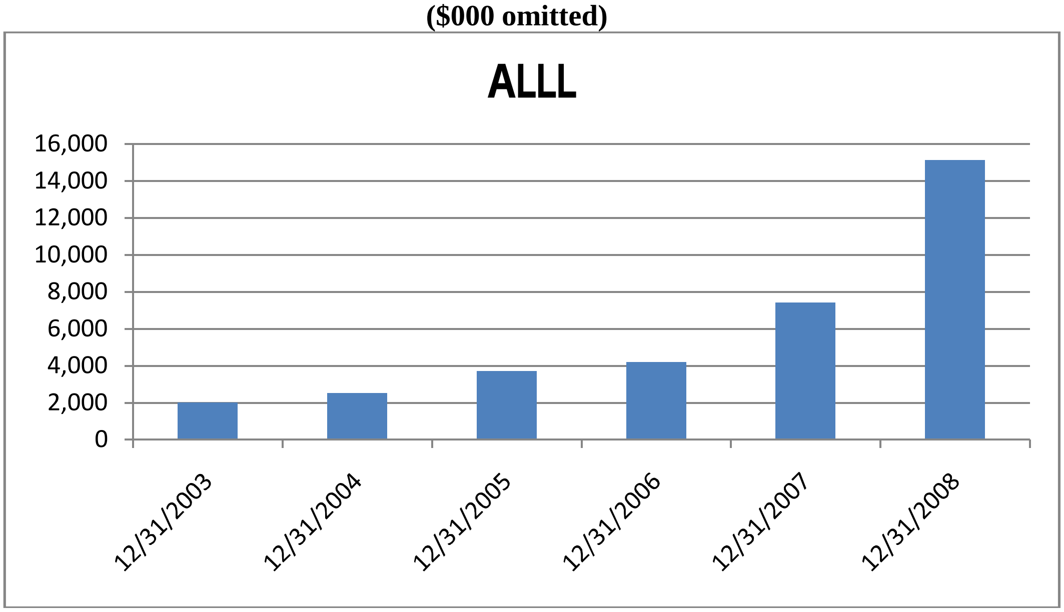
As the economy slowed and the residential real estate market declined, Riverside-Gulf Coast's asset quality deteriorated significantly, as loan delinquencies increased. In general, speculative investors involved in ongoing residential real estate construction projects stopped making payments when property values fell below the agreed-upon purchase price. The same held true for other borrowers holding traditional loans secured by existing homes, such as mortgages and home equity lines of credit. Riverside-Gulf Coast attempted to manage its real estate loan portfolio by restructuring loans to improve collectability and reduce losses. In a number of the restructured loans, mortgages exceeded property values, payments were delinquent, and the bank granted interest rate concessions that were sometimes below market. Restructured loans with these characteristics are generally considered troubled debt restructurings (TDRs).

Problem Assets Led to Depletion of Capital

Total classified assets increased by $79 million from $3 million in 2003 to $82 million in 2008, or approximately 2,633 percent. Riverside-Gulf Coast did not believe the TDRs met the definition of a classified asset. However, the loans restructured by Riverside-Gulf Coast carried inherent impairment and nonpayment risk, and in 2008, examiners noted that these loans should be classified. In February 2008, examiners determined that the bank's TDRs amounted to $35 million, or 43 percent of the bank's total classified assets.

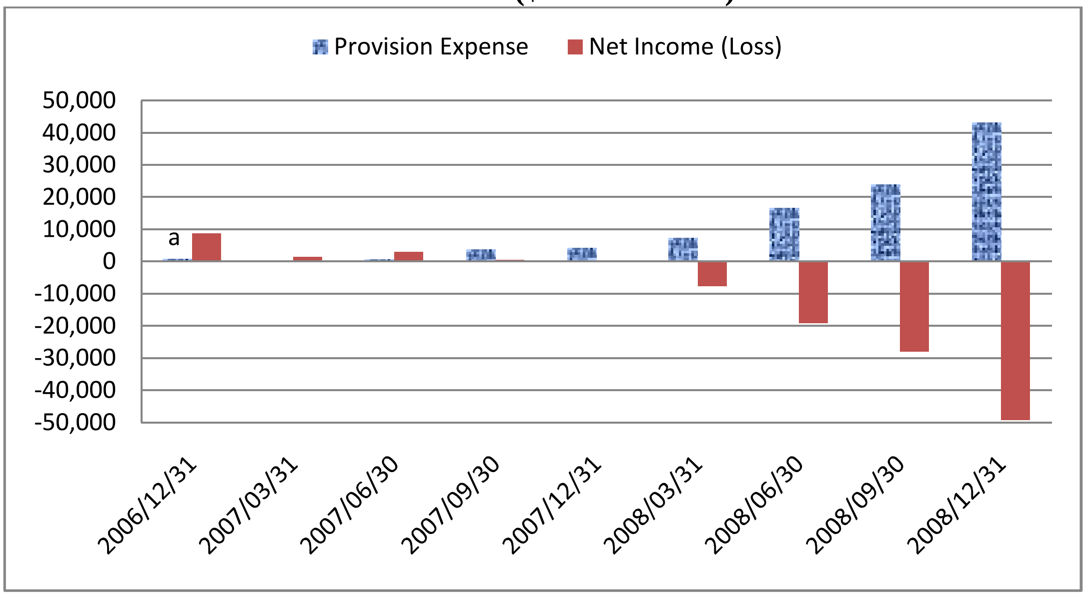
The growth in classified assets correlated to the increase in Riverside-Gulf Coast's allowance for loan and lease losses (ALLL). As shown in Chart 1, the ALLL grew incrementally until 2007, when it began to increase significantly. According to supervisory guidance, the ALLL should cover estimated losses on loans that are determined to be impaired, as well as estimated losses inherent in the remainder of the portfolio. In 2007, examiners noted weaknesses in the bank's ALLL methodology because it did not reflect the bank's recent experience with increasing losses or the devaluation of certain collateral in the current market.

Chart 1
Change in the Allowance for Loan and Lease Losses 2003 through 2008
($000 omitted)



Changes to the ALLL are reflected in the provision expense for loan and lease losses (provision).[3] As shown in Chart 2, the provision for the year ending December 31, 2006, totaled $863,000. By the end of the following year, the provision was $4.3 million, contributing to the bank's 2007 net loss of $75,000. In 2008, the bank recognized a provision of $43 million, leading to a net loss of $49 million. The loss eliminated retained earnings, and as a result, Tier 1 Capital was reduced significantly.

Chart 2
Impact of the Provision for Loan and Lease Losses on Net Income 2006 through 2008
($000's omitted)



[a] The provision for the year ending December 31, 2006, totaled $863,000.

Decline in Capital Led to Insolvency

Riverside-Gulf Coast's deteriorating capital position invoked the Prompt Corrective Action (PCA) provisions of the FDI Act. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled depository institutions. The cumulative provision for the first nine months of 2008 resulted in Riverside-Gulf Coast falling below the *well-capitalized* PCA threshold to *adequately capitalized*. As an *adequately capitalized* institution, Riverside-Gulf Coast was subject to regulatory restrictions on renewing or obtaining brokered deposits, which limited the bank's funding capacity. As the ALLL and corresponding provision grew, the bank's financial condition deteriorated to a *critically undercapitalized* position by year end 2008. On January 15, 2009, FRB Atlanta notified the bank that it had reached the *critically undercapitalized* PCA level. Riverside-Gulf Coast's efforts to obtain new capital or identify a viable acquisition or merger candidate were unsuccessful. On February 13, 2009, Riverside-Gulf Coast was closed by the State and the FDIC was named receiver.

[3] The provision expense reflects adjustments to the ALLL to bring it to an appropriate level at evaluation date. The ALLL includes estimates for losses as well as uncollectible amounts.

Supervision of Riverside Bank of the Gulf Coast

As shown in Table 2, Riverside-Gulf Coast was examined eight times between 2003 and 2008, six times by FRB Atlanta and twice by the State. Riverside-Gulf Coast was rated a CAMELS composite 2 between 2003 and 2007, and regulators performed on-site examination work within the eighteen-month examination cycle permissible for banks with this composite rating. Concerns over the southwest Florida real estate market in 2007 prompted FRB Atlanta to conduct a visitation in August, less than three months following a State examination. FRB Atlanta began a full-scope examination seven months later in March 2008. The examination report assigned the bank a CAMELS composite 4 based on the significant deterioration of Riverside-Gulf Coast's asset quality and the resulting negative effect on earnings. Four months after the examination report was issued, FRB Atlanta began a target examination that ultimately downgraded the bank to a CAMELS composite 5.

Table 2
Riverside-Gulf Coast Supervisory Overview

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Action/PCA Letter
Start Date	Report Issue Date	Scope			Capital	Asset quality	Manage-ment	Earnings	Liquidity	Sensitivity	
September 2003	December 2003	Full	FRB Atlanta	2	2	2	2	1	2	2	
November 2004	January 2005	Full	State	2	2	1	2	2	2	2	
June 2005[a]	July 2005	CRE Review	FRB Atlanta	n/a							
September 2005[b]	November 2005	Target	FRB Atlanta	2	2	1	2	2	2	2	
January 2006	March 2006	Full	FRB Atlanta	2	2	2	2	2	2	2	
March 2007	May 2007	Full	State	2	2	3	2	2	2	1	
August 2007[c]	August 2007	Visitation	FRB Atlanta	n/a							
March 2008	August 2008	Full	FRB Atlanta	4	4	5	4	5	4	3	Written Agreement
December 2008[d]		Target	FRB Atlanta	5	5	5	4	5	4	4	PCA Letter

[a] Riverside-Gulf Coast was one of twenty-five SMBs in FRB Atlanta's district-wide assessment of CRE.
[b] The target examination's CAMELS ratings are from the National Examination Database, as the report of examination did not contain the ratings.
[c] This visitation is not counted as an examination. This was an on-site visit to evaluate the impact of southwest Florida's residential housing market deterioration on Riverside-Gulf Coast. No CAMELS ratings were reported for the visitation.
[d] CAMELS ratings are from a PCA letter issued on January 15, 2009.

Supervision History from 2005 to 2007

FRB Atlanta recognized Riverside-Gulf Coast's CRE concentration, and in mid-2005, the bank was one of twenty-five institutions included in a district-wide *CRE Review Program* for state member community banks. An FRB Atlanta internal report that discussed the CRE Review results noted that Riverside-Gulf Coast's concentrations included speculative investor lending in residential real estate. Even though the bank's asset quality CAMELS component had been rated a 1 (strong), during the prior examination, the review prompted FRB Atlanta to begin a CRE concentration target examination one month later in September 2005. The target examination report issued in November 2005 cited Riverside-Gulf Coast's CRE practices as generally adequate; however, examiners recommended a variety of CRE risk management enhancements, such as incorporating market analysis into lending and policy decisions and improving portfolio management underwriting policies and procedures. In addition, examiners noted that most of the mortgages underwritten by the bank were sold in the secondary market, and few were retained on the bank's books.

FRB Atlanta returned to Riverside-Gulf Coast to conduct a full-scope examination two months later in January 2006. In addition to directing the bank to fully implement the recommendations made in the 2005 target examination, FRB Atlanta noted the risks associated with Riverside-Gulf Coast's high CRE concentration and elevated levels of speculative lending and required the bank to prepare a formal capital plan. Although Riverside-Gulf Coast had a relatively small volume of problem assets and the local real estate market was robust, FRB Atlanta cited the need for enhanced credit risk management and downgraded the bank's asset quality CAMELS component rating to a 2 (satisfactory).

Two FRB Atlanta examiners were assigned to assist the State during a full scope examination that began in March 2007. Signs of a downturn in the local residential housing market and the need for an update on the performance of Riverside-Gulf Coast's residential CRE portfolio were cited as reasons for FRB Atlanta's participation. The State's May 2007 examination report noted that Riverside-Gulf Coast had developed a capital plan that included strategies to remain *well capitalized*. The report also noted "recent" unfavorable developments in the residential real estate market and concerns regarding the availability of financing in the secondary market because credit standards had become more restrictive. The State characterized Riverside-Gulf Coast's asset quality as marginal and downgraded the bank's CAMELS rating for this component to a 3 (less than satisfactory); however, the CAMELS composite remained at 2.

Market Downturn Led to 2007 FRB Atlanta Visitation and Two Subsequent Examinations

Concerns regarding the local residential housing market in southwest Florida prompted FRB Atlanta to conduct a visitation in August 2007, four months after the State examination report was issued. An internal document summarizing the visitation results confirmed the continued decline in the local real estate market, and examiners noted that Riverside-Gulf Coast's management was focusing on problems in its residential construction loan portfolio. In addition, examiners observed that access to the secondary market had been curtailed because (1) the bank's main secondary market vendor went bankrupt and (2) an alternative vendor decided to stop purchasing mortgages in Riverside-Gulf Coast's market area. The internal document indicated that the absence of a secondary market would result in Riverside-Gulf Coast being required to hold and service loans, and that investors would be unable to sell their real estate or secure permanent financing without making a significant equity contribution. According to examiners, classified assets were expected to increase in the near term, and earnings would be affected by an expected increase in the bank's loan loss reserves.

FRB Atlanta accelerated its examination schedule for conducting a full-scope examination and returned to Riverside-Gulf Coast in March 2008, seven months after the August 2007 visitation. Examiners found that the rapid decline in the southwest Florida residential real estate market had weakened the bank and noted that an increase in the level of problem assets threatened Riverside-Gulf Coast's capital and liquidity positions. According to examiners, the bank's overall condition had become marginal, and immediate action was required to protect the bank's viability. Among other issues raised, examiners criticized the bank for its over-reliance on the secondary market as a purchaser for its residential construction loans. Examiners warned that without substantial additional capital or other changes, the bank would quickly fall from its *well capitalized* position to *adequately capitalized* or worse.

The examination report that was issued in August 2008 downgraded Riverside-Gulf Coast's asset quality CAMELS component rating to a 5 (critically deficient). In addition, the bank was assigned a CAMELS composite 4 rating, which represents banks that exhibit unsafe and unsound conditions, have serious financial or managerial deficiencies, and require close supervisory attention. Based on examination results, a formal enforcement action in the form of a Written Agreement was executed in October 2008. The Written Agreement required Riverside-Gulf Coast to take a variety of actions, which included preparing a capital plan and improving the bank's asset quality, credit risk management, loan review, and ALLL methodology.

Following the October 2008 Written Agreement, FRB Atlanta began an asset quality target examination in December 2008. Examiners found that the bank had taken initial action to address issues identified in the previous examination and the Written Agreement. However, earnings continued to be a significant concern due to the high level of classified assets and the need for substantial loan loss provisions. Examiners commented that Riverside-Gulf Coast's continued decline and likely near-term failure warranted a downgrade to a CAMELS composite 5 rating. The growing provisions related to the deteriorating loan portfolio led to an erosion of capital, and the bank fell to the *critically undercapitalized* PCA designation.

FRB Atlanta Implemented Prompt Corrective Action and Brokered Deposit Restriction

On November 5, 2008, FRB Atlanta notified Riverside-Gulf Coast that the bank's capital position, as defined under PCA, had declined to *adequately capitalized* as a result of the bank's third quarter 2008 regulatory report. The notification letter also advised the bank that it was prohibited from renewing or obtaining brokered deposits unless a waiver was granted by the FDIC. The December 2008 target examination revealed that continued deterioration in Riverside-Gulf Coast's loan portfolio further eroded the bank's capital.

On January 15, 2009, FRB Atlanta notified the bank that its PCA designation had fallen to *critically undercapitalized*, as a result of the bank's fourth quarter 2008 regulatory report. The notification letter required a revised capital restoration plan and imposed additional restrictions, including limits on asset growth and payments of dividends and bonuses. In addition, the bank was informed that the Board could appoint a receiver for the bank within ninety days. On January 16, 2009, the State issued a separate notice requiring Riverside-Gulf Coast to obtain sufficient capital by January 30, 2009, to raise the bank's capital designation to *well capitalized*. Riverside-Gulf Coast was unable to satisfy these requirements, and the State closed the bank in February 2009.

Conclusion and Lesson Learned

Riverside-Gulf Coast failed because the bank did not adequately control the risks resulting from its (1) growth strategy to establish a residential real estate loan portfolio and (2) reliance on selling mortgages in the secondary market. The aggressive growth resulted in a CRE concentration in the bank's local service area that included a sizable number of residential construction loans to speculative investors. By 2007, the economic downturn caused credit tightening in the secondary markets, thereby hampering, and eventually eliminating, Riverside-Gulf Coast's ability to sell mortgages. In addition, the unprecedented drop in southwest Florida's real estate market decreased the underlying collateral value of the bank's real estate loan portfolio. These factors required Riverside-Gulf Coast to increase its ALLL, which negatively impacted earnings, resulting in insufficient capital to absorb losses, ultimately leading to the bank's insolvency.

With respect to supervision, FRB Atlanta complied with the frequency of safety and soundness examinations prescribed in regulatory guidance, and conducted off-site monitoring commensurate with concerns and risks identified during examinations. During a three-and-a-half-year-period beginning in June 2005, FRB Atlanta performed on-site examination related work at Riverside-Gulf Coast on seven separate occasions. Examiners began focusing greater supervisory attention on the bank's high CRE concentration and speculative lending in 2005 and required Riverside-Gulf Coast to mitigate associated risks when the real estate market was robust and the bank's overall condition and asset quality were sound. Despite FRB Atlanta's supervisory efforts, the combination of an unusually rapid and severe real estate market downturn and the unexpected disappearance of the secondary market led to Riverside-Gulf Coast's failure.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine whether, in hindsight, the circumstances surrounding a bank's failure warranted additional or alternative supervisory actions. Based on our analysis of Riverside-Gulf Coast's supervision, we believe that emerging problems observed during the 2007 visitation provided FRB Atlanta with an opportunity for a more aggressive supervisory response. Specifically, FRB Atlanta noted a significant decline in the local residential housing market, and new appraisals indicating that the value of certain collateral, particularly developed lots ready for construction, declined by as much as 70 percent. In addition, examiners observed that Riverside-Gulf Coast could no longer sell mortgages on the secondary market and, therefore, would be required to hold and service these loans. According to examiners, classified assets were expected to increase in the near term, and earnings would be affected by an expected increase in the bank's loan loss reserves.

In our opinion, the circumstances FRB Atlanta highlighted in the 2007 visitation signaled a sudden and total transformation of Riverside-Gulf Coast's longstanding business model and warranted more immediate supervisory attention, such as (1) conducting an asset quality target examination, (2) requiring the bank to prepare a new capital plan, or (3) further accelerating the full-scope examination that was conducted in March 2008. However, in light of the rapid deterioration in Riverside-Gulf Coast's local real estate market, it is not possible to determine the degree to which such an action would have affected the bank's subsequent decline or the failure's cost to the DIF.

In assessing Riverside-Gulf Coast's failure, we have also noted that the loss of the secondary market was a significant factor because the bank was suddenly forced to begin holding loans in a rapidly deteriorating market. As property values fell, speculative investors involved in ongoing residential real estate construction projects, as well as other more traditional mortgage borrowers, ceased making loan payments. Riverside-Gulf Coast's efforts to reduce losses by restructuring debts being held in the bank's portfolio met with limited success because the modified loans were downgraded to classified assets after examiners determined that the loans were impaired.

Lesson Learned

We believe that Riverside-Gulf Coast's unprecedented and unexpected loss of the secondary market offers a lesson learned for Federal Reserve examiners and managers. In general, supervisory guidance recognizes the practice of selling loans in the secondary market as a viable strategy to mitigate real estate concentration risks, especially in adverse market conditions. Elements of this view were reflected in a 2003 FRB Atlanta internal supervisory document that indicated Riverside-Gulf Coast's use of the secondary market would likely provide several benefits that included serving as an effective tool in managing risk. Although the unique circumstances surrounding an individual bank failure do not necessarily warrant a change in supervisory guidance, at a minimum, the failure of Riverside-Gulf Coast reveals that the secondary market may not always be a reliable option, especially for banks facing sharp deterioration in their local real estate markets.

Analysis of Comments

We provided a copy of this report to the Acting Director of the Division of Banking Supervision and Regulation for review and comment. Her response, included as Appendix 4, indicates agreement with the report's conclusion and lesson learned. The Acting Director concurred that the loss of secondary market purchasers of mortgages and the significant decline in property values evident in August 2007 warranted more immediate supervisory attention, such as requiring a new capital plan and/or accelerating the March 2008 full-scope examination. She also agreed that the practice of relying on the secondary market to purchase mortgages "is not without its own risk."

Appendixes

APPENDIX 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
The ALLL is a valuation reserve established and maintained by charges against the financial institution's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.

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 ''doubtful" has all the weaknesses inherent in one classified as "substandard," with the added characteristic that the weaknesses make collection or liquidation in full, highly questionable and improbable. Assets classified "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

Collateral
Collateral is the property or properties securing or being improved by the extension of credit.

Commercial Real Estate (CRE) Loans
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 may, in the aggregate, present a substantial risk to the safety and soundness of the institution.

Delinquency
A loan is delinquent when it is unpaid within a given number of days from the payment due date as expressed in the loan agreement.

APPENDIX 1 (continued)

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

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 Deposit Insurance Fund. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

Secondary Mortgage Market
The secondary market consists of institutions engaged in buying and selling mortgages in the form of whole loans (that is, mortgages that have not been securitized) and mortgage-related securities.

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

Troubled Debt Restructuring (TDR)
Troubled debt restructurings are compromises ("concessions") that lenders make to improve collectability or reduce losses on problem loans. These concessions emanate from a borrower's deteriorating financial condition, which in turn prompts the lender to focus on achieving the maximum recovery. Qualifying restructuring activities include one or more of the following: asset transfers, granting of equity interests, and modification of loans terms. Not all debt restructuring is considered "troubled." Loan renewals or extensions at interest rates that are equal to the current interest rate or a market rate of interest are not considered renegotiated debt.

Uniform Bank Performance Report (UBPR)
The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced from quarterly data submitted by 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

APPENDIX 1 (continued)

underlying real estate collateral; the overall creditworthiness of the borrower; and the level of the borrower's equity invested in the property.

Written Agreement

A Written Agreement is a formal, legally enforceable, and publicly available action to correct practices that are believed to be unlawful, unsafe, or unsound. All Written Agreements must be approved by the Board's Director of the Division of Banking Supervision and Regulation and the Board's General Counsel.

APPENDIX 2 – Key Events Timeline

Date	Key Event
10/27/1997	Riverside Bank of the Gulf Coast became a state member bank.
12/15/1997	Riverside Bank of the Gulf Coast began operations in Cape Coral, Florida, located in Lee County.
12/15/1997	The bank's first President and Chief Executive Officer replicated products, services, and processes that were used at his previous employer, including the generation of mortgage loans for sale in the secondary market. He left on good terms in 2000.
03/23/1998	FRB Atlanta began a limited safety and soundness examination. Results led to a CAMELS composite 2 rating.
10/26/1998	FRB Atlanta began its first full-scope examination. An examination report issued December 1998 reported a CAMELS composite 2 rating.
05/12/1999	The State began a full-scope examination. An examination report issued July 1999 reported a CAMELS composite 2 rating.
12/26/2000	FRB Atlanta began a full-scope examination. An examination report issued March 2001 reported a CAMELS composite 2 rating.
05/01/2002	The State began a full-scope examination. An examination report issued July 2002 reported a CAMELS composite 2 rating.
09/22/2003	FRB Atlanta began a full-scope examination. An examination report issued December 2003 reported a CAMELS composite 2 rating.
11/16/2004	The State began a full-scope examination. An examination report issued January 2005 reported a CAMELS composite 2 rating.
11/16/2004	The State reported double-digit market appreciation in residential properties in the bank's trade area.
06/7/2005	Riverside Bank of the Gulf Coast was included in an FRB Atlanta district-wide assessment of twenty-five banks with high concentrations of commercial real estate (CRE Review Program).
09/19/2005	FRB Atlanta began a target examination. An examination report issued November 2005 reported a CAMELS composite 2 rating.

APPENDIX 2 (continued)

Date	Key Event
01/05/2006	FRB Atlanta began a full-scope examination. An examination report issued March 2006 reported a CAMELS composite 2 rating.
03/05/2007	The State began a full-scope examination. FRB Atlanta staff participated with the intent to obtain an update of the performance of the residential construction portfolio, given the decline in the local residential housing market. An examination report issued May 2007 reported a CAMELS composite 2 rating. However, the Asset quality rating, previously rated 2, was downgraded to 3, reflecting the bank's high residential exposure.
08/20/2007	FRB Atlanta conducted a visitation. An internal memorandum documented the purpose, scope, and findings in August 2007. Examiners noted a decline in the residential real estate market and loss of the secondary market, requiring the bank to hold and service the residential mortgages.
03/03/2008	FRB Atlanta began a full-scope examination. An examination report issued August 2008 reported a CAMELS composite 4 rating.
09/30/2008	Uniform Bank Performance Report reports for Riverside Bank of the Gulf Coast disclose an *adequately capitalized* status. A PCA letter was sent in November 2008.
10/28/2008	The Federal Reserve placed Riverside Bank of the Gulf Coast under a Written Agreement.
12/01/2008	FRB Atlanta began a target examination. A letter was issued in January 2009 that reported a CAMELS composite 5 rating.
01/15/2009	FRB Atlanta notified Riverside Bank of the Gulf Coast that it was *critically undercapitalized* for PCA purposes based on December 31, 2008, financial data.
02/13/2009	The State closed Riverside Bank of the Gulf Coast and appointed FDIC as receiver.

APPENDIX 3 – 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 an 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, therefore, 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 institution's size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be higher 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 institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

APPENDIX 3 (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 institution's 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 institution's 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 Deposit Insurance Fund. 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 institution's 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 institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

APPENDIX 4 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: September 3, 2009

To: Elizabeth A. Coleman, Inspector General

From: Esther George, Acting Director ***/signed/***

Subject: Material Loss Review of Riverside Bank of the Gulf Coast

The staff of the Division of Banking Supervision and Regulation has reviewed the Material Loss Review of Riverside Bank of the Gulf Coast ("Riverside Bank"), Cape Coral, Florida, that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that Riverside Bank failed because it did not adequately control the risks resulting from its (1) growth strategy to establish a residential real estate loan portfolio; and (2) reliance on selling mortgages in the secondary market. Riverside Bank's loan portfolio consisted of 1-4 family mortgages and home equity lines of credit as well as residential construction loans. By 2007, the economic downturn hampered and eventually eliminated Riverside Bank's ability to sell mortgages, and resulted in very significant declines in the underlying collateral value of the bank's real estate portfolio.

We concur with the conclusion and lesson learned contained in the report. The Federal Reserve Bank of Atlanta (FRB Atlanta) complied with the frequency of safety and soundness examinations prescribed in regulatory guidance and conducted off-site monitoring commensurate with the concerns and risks identified during examinations. As noted in the report, FRB Atlanta performed on-site examination work at the bank on seven separate occasions over a three and one-half year period beginning in June 2005. Nonetheless, we concur with the report's conclusion that the loss of secondary market purchasers of mortgages and the significant decline in property values evident in August 2007 warranted more immediate supervisory attention such as requiring a new capital plan and/or accelerating the March 2008 full scope examination. We also agree, however, that in light of the rapid deterioration in Riverside Bank's local real estate market, it is not possible to determine the degree to which such action would have affected the bank's subsequent decline or the cost of resolution to the DIF.

This Division very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for the failure of Riverside Bank. The events described in the report are another example of the dangers of concentrations in risky assets that are subject to dramatic and swift market swings, and a reminder that the risks arising from such may be beyond a bank's ability to control. The report also appropriately notes that reliance on the secondary market to purchase such assets is not without its own risk.

APPENDIX 5 – Principal Contributors to this Report

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