A CASE STUDY ON THE RISE AND FALL OF COLONIAL BANK

Bass Connections at Duke University: American Predatory Lending Team

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Colonial Bank began as a small Alabama community and commercial bank. In the two decades leading up to the Financial Crisis, this financial institution aggressively expanded via acquisitions of smaller banks, first in Alabama, then mostly on a regional basis, with a key focus on Florida. To compete with larger peers, it expanded its commercial and construction lending portfolio and relied heavily on its mortgage warehouse lending division, which lent money to third-party mortgage brokers and mortgage bankers. Colonial thus shared key features of myriad American financial institutions during the 1990s and 2000s. It eagerly embraced commercial real estate and construction as sectors deserving strategic engagement and paid close attention to emerging practices by competitors. These strategies kept it well positioned to take advantage of the seemingly insatiable demand for Sunbelt real estate development and the complex mortgage-backed financial instruments that funded it. Colonial, however, shied away from direct engagement with subprime lending, distinguishing itself from many peers. It also long maintained a conservative posture toward evaluation of the risks posed by individual borrowers, fostered by careful loan review processes and its "local touch" culture. The impulse to chase after high growth markets, however, led it into very choppy seas by 2008.

As a result, even with its professed conservative principles, Colonial faced the same fate as so many other banks once the crisis came – failure.[1] Like many other failed banks during this period, Colonial's downfall resulted in part from overexposure to commercial and construction lending, which made Colonial vulnerable to collapsing real estate prices. In the case of Colonial, however, particularly acute management problems in its warehouse lending unit abetted outright fraud, which served as an immediate trigger of insolvency.

I. Colonial's Roots in Alabama

Colonial's origins rested on a 1970s Alabama real estate business owned by the Lowder family, run by the family's patriarch, Ed Lowder. Robert "Bobby" Lowder, one of three sons, oversaw that firm's lending operations. In 1981, he and an investor group acquired a recently failed financial firm, Southland Bancorporation, which had accumulated a large volume of weak and non-performing loans,[2] and renamed it Colonial.[3] They adopted a slogan for the relaunched company, "Alabama's hometown bank."[4] Like many young southern bankers during the Reagan years, Bobby Lowder focused on a growth strategy. The bank made its ambitions public, with one newspaper advertisement proclaiming "Colonial BancGroup's mission is to become a major bank holding company in the state of Alabama and to be prepared to participate in interstate banking when it comes."[5]

The advertisement demonstrated close attention to ongoing policy developments around interstate banking. In 1982, six New England states had created a regional interstate banking

[1] There were 25 bank failures in 2008, followed by 140 in 2009 and 157 in 2010. By contrast, fewer than four banks failed on average from 2001 – 2007. For data on insured bank failures, see https://www.fdic.gov/bank/historical/bank/.
[2] The Associated Press, Friday, PM cycle, June 15, 1979, available via Duke University at https://advance-lexis-com.proxy.lib.duke.edu/api/document?collection=news&id=urn:contentItem:3SJ4-JRS0-0011-30HJ-00000-00&context=1516831.
[3] Colonial BancGroup, Inc., Form 10-K for the year ended December 31, 1995, p. 2; O'Keefe, Brian, "The man behind 2009's biggest bank bust," *Fortune.com*, October 12, 2009.
[4] Harlan Parrish Oral History, dated February 17, 2021.
[5] "Advertisement 33," Barron's National Business and Financial Weekly, June 4, 1984, available via Duke University at https://login.proxy.lib.duke.edu/login?url=https://www.proquest.com/newspapers/advertisement-33-no-title/docview/350657706/se-2?accountid=10598.

compact, and the southern states of Florida, Georgia, and North Carolina followed suit over the next few years, adopting legislation that permitted reciprocal cross-border bank expansion with any of eleven southern states, so long as those states enacted parallel legislation. Investment professionals took note, with an analyst at Merrill Lynch tagging Colonial later in 1984 as an "aggressive regional banking company," even though Alabama had not yet joined the regional banking compact.[6]

Lowder's goal at the time was to attain a critical mass of roughly $1 billion in assets by the end of the 1980's.[7] The bank holding company hoped to drive expansion of lending by existing branches and units, but Lowder also had an outward-facing mindset. From the start, Colonial looked to acquire banks, focusing initially on financial institutions based in Alabama's most dynamic metropolitan areas – Birmingham, Huntsville, Montgomery, and Mobile.[8]

Despite the impulse for rapid expansion of the overall loan portfolio, Colonial adopted conservative lending policies, especially with regard to its assessment of the creditworthiness of individual borrowers. These cautious underwriting standards reflected in part the outsized control Lowder possessed over Colonial, which meant that he and his family retained a great deal of personal risk. A 1994 profile of Bobby Lowder in *American Banker* highlighted the fact that greater than 90 percent of the contemporaneous control of Colonial sat with him and his family. Lowder's own employees also described him as among the most conservative bankers they encountered in their careers. He sat on the holding company's loan review committee and was reputed to have paid particular attention to commercial real estate loans.[9] Reflecting this aspect of the business, Colonial consistently underscored its conservatism in annual earnings releases, which touted Colonial's stringent underwriting standards as a key driver of profits.[10]

From its inception, then, Colonial attempted to blend rapid expansion into fast-growing urban and suburban Sunbelt markets with conservative underwriting. The bank's ability to execute the first dimension of this strategy initially was limited just to Alabama. Before the 1980s, American banking regulation mostly prohibited the opening or acquiring of branches outside of a depository institution's home state, with only a few exceptions. Dating back well into the nineteenth century, these early restrictions reflected regional concerns about the power of Wall Street, and opposition by smaller community banks to competition from their larger and more powerful urban counterparts.[11] These restrictions loosened gradually over the course of the twentieth century. In 1919, the Edge Act permitted bank holding companies to establish subsidiaries in other states, though only for the purposes of international banking. The 1927 McFadden Act liberalized **intrastate** branching, allowing banks with a national charter to set up

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[6] Forde, P. John, "Alabama Growth," *The American Banker*, August 23, 1984.

[7] Forde, P. John, "Alabama Growth," *The American Banker*, August 23, 1984.

[8] "Colonial BancGroup Announces Balance Sheet Restructuring," *BusinessWire*, December 20, 1989.

[9] Cline, Kenneth, "CEO Keeps Close Watch over the Family Business," *American Banker*, February 23, 1994.

[10] See for example, "Colonial BancGroup Nets $10.4 Million in 1991 Income; Declares Dividends," *BusinessWire*, January 16, 1992. Contemporaneous earnings releases celebrated how Colonial enjoyed the results of stringent underwriting standards and noted a "history of conservative provisions to the loan loss reserve, even in a recessionary economy." See, "Colonial BancGroup posts solid earnings," *BusinessWire*, July 18, 1991.

[11] Johnson A., Christian and Tara Rice, Federal Reserve Bank of Chicago, "Assessing a Decade of Interstate Branching,", Working Paper, April 2007; Mulloy, Patrick and Cynthia Lasker, Journal of Legislation, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition," Vol. 21, Issue 2, May 1, 1995.

branch networks in any state that allowed branching for state chartered financial institutions.[12] Amid post-World War II prosperity, the 1956 Bank Holding Company Act created a potential mechanism to facilitate **interstate** branching, though the goal of the legislation was actually to check any such expansion. This legislation prohibited bank holding companies from acquiring banks in other states unless a state explicitly enacted legislation permitting out-of-state banks to come into its territory.[13]

The economic stagflation of the 1970s, however, prompted a growing number of policymakers to reconsider the advantages of interstate banking. As part of wider conversations about deregulating core economic sectors like transportation, energy, and finance, the Carter Administration produced a report on interstate banking in 1980 that highlighted the potential that it held for improving access to capital and consumer service in local markets.[14] This analysis, along with ongoing economic headwinds in the early 1980s, prompted state governments in New England and the South to turn the provisions of the McFadden Act into springboards for regional interstate banking. New England led the way, creating a six-state compact to allow banks in any of those states to expand within the compact. By 1984, Georgia, Florida, and North Carolina adopted a similar framework, inviting other southern states, including Alabama, to join a separate compact (along with the District of Columbia). Alabama accepted this invitation in 1986, opening the door for Colonial to move across state lines beginning in July 1987.[15] The Riegle-Neal Interstate Banking and Branching Efficiency Act, enacted by Congress in 1994, consolidated these reforms, extending the ability of all American banks to acquire and expand across the country.[16]

When the Alabama legislation passed in February 1986, *American Banker* noted that the largest banks in the state had strongly supported the reform, but did not see fit to mention Colonial.[17] Bobby Lowder nonetheless kept a very close eye on developments, which were so crucial to his plans for growing out-of-state. As he explained in 1986 to a financial reporter, Colonial had every intention to pursue out-of-state takeovers once the state laws permitting them came into effect. The Alabama law established a mechanism for interstate banking with any of twelve southern states that established a reciprocal policy, which eight had created by 1987.[18] Colonial now had legal authority to go hunting for banks throughout the Southeast.

II. A Regional Footprint for Community Banking

Colonial immediately sought to take advantage of the new regulatory framework. Even before Alabama's new legislation came into effect, Colonial signed a letter of intent to purchase a small Florida panhandle financial institution, Pensacola's Liberty Bank.[19] This deal fell through,

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[12] "The McFadden Banking Act," *American Economic Review* 17 (1927): 201-218; Mulloy, Patrick and Cynthia Lasker, Journal of Legislation, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition," Vol. 21, Issue 2, May 1, 1995.
[13] George Hall, "Bank Holding Company Regulation: I. Introduction," *Southern Economic Review* 31:4 (April 1965): 344; Mulloy, Patrick and Cynthia Lasker, Journal of Legislation, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition," Vol. 21, Issue 2, May 1, 1995.
[14] Robert Bennett, "White House to Ask Full Bank Services Across State Lines," *New York Times*, Dec. 31, 1980, A1.
[15] Dan Munro, "Trigger Dates: A Rundown of Interstate Banking Laws," *American Banker* 151 (June 20, 1986): 12.
[16] Colonial BancGroup, Form 10-K for the year ended December 31, 1997, p. 3.
[17] "Alabama Banks Hail New Regional Banking Law," *American Banker* 151 (Feb. 25, 1986): 10.
[18] Anonymous, "Alabama Braces for Would-Be Buyers," *American Banker*, July 9, 1986.
[19] Peter Mantius, "Alabama Banks Are Ready to Go Interstate: 2 *American Banker* 152 (May 13, 1987): 1.

however, and in spite of Lowder's eagerness to move beyond the confines of Alabama, it took several years to line up and consummate its first major cross-border acquisition. Instead, Colonial focused on consolidating its position within Alabama. Colonial was able to expand across its home state in those intervening years and added hundreds of millions of dollars in Alabama-based assets. It retained its strong, local reputation as it consolidated its position within Alabama, with an executive at one of the acquired banks parroting the Lowder's slogan by referring to Colonial as "Alabama's hometown bank."[20] The table below shows acquisitions announced and publicized between 1986 and 1992.[21]

Acquired Bank	Year Acquired	Assets Acquired ($ Millions)
First Federal Bank of Opileka	1986	~ 60
First Federal Savings & Loan Andalusia	1991	~ 47
Home Federal Savings Bank of Alabama	1992	~ 85
Auburn Federal Savings Bank	1992	~ 32
United Savings Bank	1992	~ 57

Only in 1993 was Colonial able to set its wider regional ambitions in motion, when it entered Tennessee with the purchase of First AmFed, which boasted nine Alabama offices and four Tennessee offices.[22] A steady tempo of cross-border purchases followed. By 1995, Colonial had 103 branches across its home state of Alabama, and had expanded to Atlanta; soon thereafter, it gained a foothold in Orlando.[23] The resulting expansion in branches was accompanied by brisk increases in both deposits and assets.[24] Exhibit 1 shows the growth in branches and branch placement over time, including the key pivot to Florida in 1996.

[20] "Colonial BancGroup acquires Andalusia S&L; Jerry W. Allen named president," *BusinessWire*, September 27, 1991.

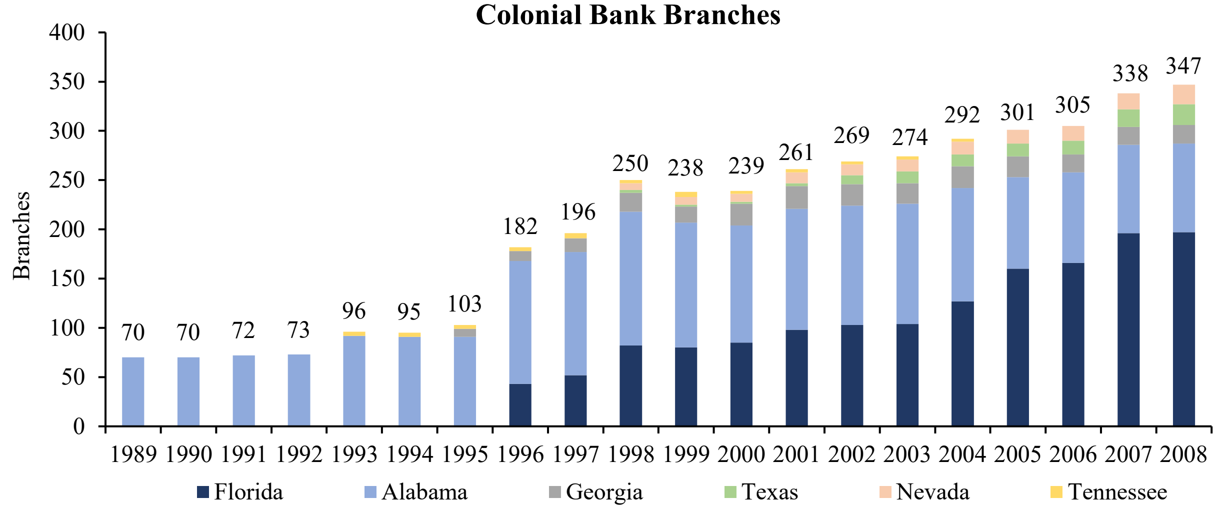
[21] Transactions were identified based on a search of news articles referencing acquisitions by Colonial. Deals which went unpublicized at the time are excluded from the table.

[22] "Colonial BancGroup, First AmFed shareholders approve merger," *BusinessWire,* November 24, 1993.

[23] Colonial BancGroup, Form 10-K for the year ended December 31, 1996, p. 36; Colonial BancGroup, Form 10-K for the year ended December 31, 1995, p. 13.

[24] The same trend is observed for assets and deposits, which grew in concentration in Florida and across other states in the Southeast. For example, in 1998 Florida-based assets were ~24% of Colonial's asset base, while by 2008 Florida-based assets represented ~62% of Colonial's asset base. The Texas portion of the asset base went from ~3% to ~7%. Alabama-based assets declined from ~36% to ~17%. The same gravitation towards Florida and throughout the Southeast is seen in deposits.

Exhibit 1
Colonial Bank Branches



Notes: Data are from Colonial Bank SEC filings and Colonial Bank news articles. Data prior to 1996 does not necessarily represent end of year branches.

Regional expansion accelerated over the next several years. In 1998, Colonial established beachheads in Nevada through its purchase of the Las Vegas-based Commercial Bank, with $120 million in assets, and in Texas via its acquisition of FirstBank, a Dallas-based institution with $162 million in assets.[25] The financial press gave extensive coverage to this acquisition binge, generating headlines such as "Colonial's hungry again" and "Alabama bank goes on Florida buying spree."[26] Barton Goldberg—president of a Florida financial institution until Colonial bought that bank—remarked that Colonial aimed to grow aggressively in Florida and beyond.[27] Michael Redden, CEO of the acquired FirstBank, described Colonial's business model as "acquir[ing] community banks, supply[ing] them with new products and more horsepower, and allow[ing] them to continue to do what they do best in their market."[28] At the apogee of its expansion, Colonial had approximately $26 billion in assets and 347 branches across five Southeastern states.[29]

As it had in Alabama, Colonial sought footholds in the highest growth markets once it surveyed the entire Southeast, and nowhere fit the bill better than greater Atlanta and several Florida cities.[30] As early as 1996, Lowder explained to a financial reporter that Colonial had "pinpointed two areas outside of the state of Alabama. That was the metro Atlanta area and the Orlando area. That's two of the fastest-growing areas in the Southeast […] We're looking at opportunities all

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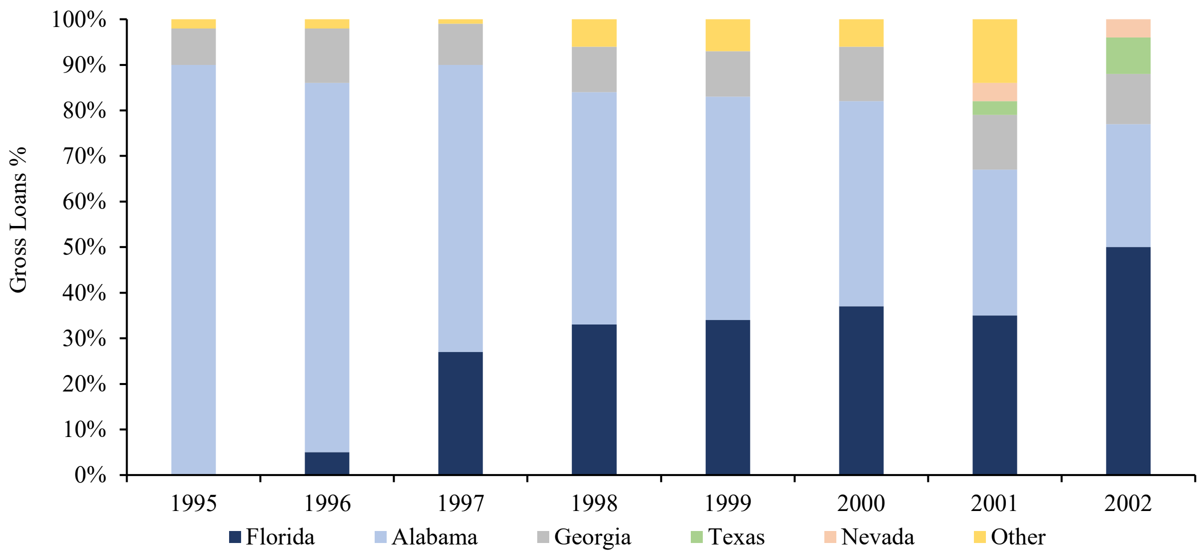
[25] "Colonial BancGroup Inc.: Agreement Reached to Buy Commercial Bank of Nevada," *Wall Street Journal*, Feb. 27, 1998, B9E; "Colonial Bank to Acquire FirstBank in Dallas," *BusinessWire,* May 5, 1998.
[26] Murray, Brendan, "Colonial's hungry again," Atlanta Business Chronicle, Vol. 20, Issue 41, March 6, 1998; Buettner, Michael, "Alabama Bank goes on Florida Buying Spree," Tampa Bay Business Journal, Vol. 16, Issue 43, October 18, 1996.
[27] "Colonial BancGroup's acquisitions turn it into a prominent player," South Florida Business Journal, Vol. 18, Issue 5, September 19, 1997.
[28] Cawley, Rusty, "Colonial enters Texas market with FirstBank buy," Dallas Business Journal, Vol. 21, Issue 42, June 12, 1998.
[29] Colonial BancGroup, Form 10-K for the year ended December 31, 2008, pp. 1, 21.
[30] Colonial BancGroup, Form 10-K for the year ended December 31, 1996, p. 6.

the time, and […] we are very interested in acquisitions."[31] The following year, reflecting on Florida opportunities, he observed that "[t]here are so many people down there, so much growth opportunity."[32] Colonial took pains to describe its focus on fast-growing Florida as a pivotal aspect of its business strategy.[33] The bank boasted in financial filings that between 1996 and 1998 it completed in excess of 20 acquisitions to reposition itself in these high-growth markets in Florida and elsewhere in the Southeast, allowing Colonial to accelerate its earnings growth.[34] By that point nearly a third of Colonial's branch locations were located in Florida. As one retail banking executive later reflected on this geographic shift, Colonial, on the margin, greatly preferred Florida's "high growth markets [and] good demographic growth" to Alabama's "very low growth index for future opportunities."[35] Exhibit 2 documents this shift to Florida-based lending and business activities, which by 2002 accounted for almost half of Colonial's loan portfolio, while Alabama's share had declined to just a bit more than a quarter. Bobby Lowder evinced great pride in Colonial's willingness to seize the opportunities presented by interstate banking, commenting in 2004 that his bank "got into the Florida market at an early stage."[36]

Exhibit 2
Colonial Bank Loans by State



Notes: Data are from SEC filings. Data are unavailable at the state level after 2002.

The pivot to Florida represented only one major strategic redirection for Colonial. During the 1990's, the bank also expanded the scope of its services. One key facet of this additional evolution involved the acquisition of another Lowder family-owned firm, the Colonial Mortgage

[31] Turner, Shannon, "Robert Lowder Chmn Pres and CEO of Colonial BancGroup," *Dow Jones Investor Network*, May 8, 1996.
[32] Gillam, Carey, "Alabama Banker Building a Southern Empire Series: 13," *American Banker*, March 12, 1997.
[33] Colonial BancGroup, Form 10-K for the year ended December 31, 1996, p. 22.
[34] Colonial BancGroup, Form 10-K for the year ended December 31, 1999, p. 13.
[35] Harlan Parrish Oral History, dated February 17, 2021.
[36] Rieker, Matthias, "Eyeing expansion, not sale; Colonial content in future as a midtier," *American Banker*, June 17, 2004.

Company (CMC), a mortgage banking firm engaged in both retail and wholesale channels.[37] Mortgage bankers, like CMC, find sources of capital, originate loans, and sell these loans into the secondary market. CMC's retail channel involved brick and mortar locations, in which brokers directly interfaced with borrowers. The wholesale channel provided capital to unaffiliated mortgage lenders, who directly dealt with borrowers and originated loans. For mortgage bankers like CMC, fees from loan origination and servicing provide key sources of revenue, known as noninterest or fee income.[38] CMC owned more than $9 billion of residential mortgage servicing rights by the end of 1995, and in the three years leading up to its acquisition, it originated over $5 billion in residential real estate loans.[39]

This acquisition was consistent with one of Colonial Bank's principal mid-1990's strategic goals. Keen to raise its percentage of noninterest (i.e. fee) income significantly to compete with its larger, more diverse, and more complex banking peers, Colonial bank acquired CMC in February 1995.[40] The merger provided the combined entity with a greater foothold across the entire mortgage value chain and diversified its business model. The addition of a significant portion of fee income also allowed Colonial to better weather economic downturns, as fee income correlated less strongly with business cycles than traditional net interest income.

The incorporation of CMC's operations also facilitated Colonial's efforts to extend community banking into faster-growing locations.[41] As a non-bank lender, CMC did not have to worry about restrictions on interstate activities. By 1995, it had extensive retail offices in Alabama, as well as six regional wholesale offices covering operations across 29 states.[42] This footprint allowed for Colonial to cross-sell and expand its products and offerings to both CMC and Colonial Bank customers.[43] Finally, Colonial Bank had expressed its desire in earnings reports from 1993 on to expand its residential real estate loan portfolio in order to "increase consumer lending, broaden the Company's customer base and create a significant stream of fee income."[44] The Colonial Mortgage acquisition did just that. The sum total of the changes with the CMC acquisition meant that Colonial Bank was a larger entity, more vertically integrated across the process of funding, originating, and servicing mortgages and more broadly entwined with its customers.

In addition to expanding the geographic footprint of its community banking concept and consummating the CMC acquisition, Colonial took other steps to flesh out a wider set of financial services. In 1997, the bank increased its efforts in private banking and asset management through trust services, and investment sales and services. It established an international banking unit to serve the needs of its Florida customers. With the emergence of the internet, Colonial took the opportunity to provide more convenient and easier financial access for its customer base. These services included the establishment of an electronic banking division,

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[37] CMC was also owned and controlled by Bobby Lowder, in partnership with his two brothers. Since both Colonial Bank and Colonial Mortgage were publicly traded, the acquisition required the approval and review of a Special Committee of the Board and other fiduciary oversight to consummate the transaction. "Colonial BancGroup announces proposed agreement concerning purchase of mortgage company," *BusinessWire*, May 27, 1994.
[38] Snyder, Jack, "Mortgage Bankers Scramble for New Customers," *Orlando Sentinel*, May 17, 1988; Office of the Comptroller of the Currency, "Mortgage Banking, Comptroller's Handbook," February 2014, pp. 3 – 8.
[39] Colonial BancGroup, Form 10-K for the year ended December 31, 1995, p. 8.
[40] Colonial BancGroup, Form 10-K for the year ended December 31, 1995, p. 8.
[41] Colonial BancGroup, Form 10-K for the year ended December 31, 1995, p. 8.
[42] Colonial BancGroup, Form 10-K for the year ended December 31, 1995, pp. 1 – 2.
[43] Colonial BancGroup, Form 10-K for the year ended December 31, 1995, p. 8.
[44] Colonial BancGroup, Form 10-K for the year ended December 31, 1995, p. 6.

ATM machines, and full-service banking locations in a number of Wal-Mart stores.[45] As the 1990s came to a close, Colonial had undergone a massive transformation from its early days as a local, community bank – a time one former executive referred to as generally more "high touch."[46] It now boasted operations throughout the Southeast, a much broader scope of services, and an enhanced platform for accelerating its lending engagement in the decade to come.

III. The Reach and Limits of a Conservative Mentality

For all of this expansion, Colonial management consistently described the company as a "community bank" that gave its branches and offices "autonomy in lending decisions and customer relationships." Its executives argued that this philosophy motivated its local management teams, allowing it to retain a strong customer base, particularly with respect to lending relationships. This philosophy was echoed by the recollection of a senior Colonial retail executive who recounted that:

> We had local Boards of Directors that were actually involved in making loan decisions. We had a director's loan committee of local, successful businesspeople that served on those committees, and it really tied us to those markets. The culture did evolve, but it was amazing how, when I would go out to Nevada or Texas to visit them, it was very similar to what was taking place in my area here in that we did have the autonomy.[47]

Colonial claimed that it had been successful in competing for loans against larger institutions due primarily to the company's local and relationship-based lending strategy.[48] This emphasis on local knowledge and personal interactions harkened back to the simple community-based lender model in which bankers evaluate risk based on both hard metrics and knowledge about borrowers that only local lenders could possess. In a 1996 interview, Bobby Lowder explicitly referenced this model, arguing that:

> [B]anking is still a people business, and […] our philosophy of local management, local boards of directors, keeps that local touch involved. People don't feel like they got to go 100 miles or 200 miles or 400 miles to talk to somebody about a loan relationship.[49]

Colonial's underwriting approach reflected an unrelenting focus on limiting borrower risk. Lowder boasted in a late 1980s interview that he and Ronnie Wynn (partners in the then-independent mortgage servicing entity Colonial Mortgage) had "always taken a very conservative approach to everything [they've] done. We've never been in the business for a quick dollar."[50] Colonial's Chief Credit Officer contextualized Lowder's careful approach in a 1994 interview, commenting that "[a]s a former residential home builder, [Lowder] scrutinizes commercial realty loans with particular care." He went on to add, "I thought I was conservative until I got on a loan committee[.]"[51]

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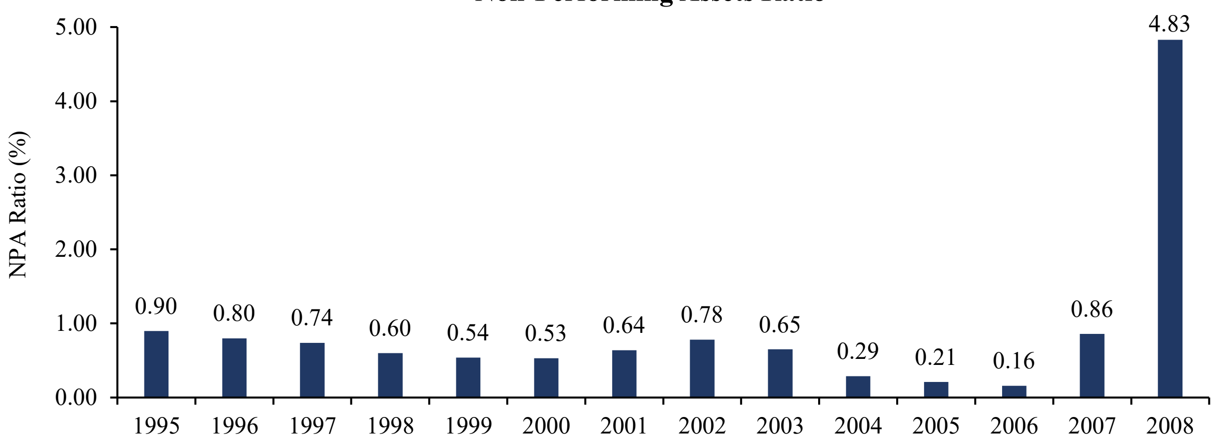
[45] Colonial BancGroup, Form 10-K for the year ended December 31, 1997, pp. 7, 24.
[46] Harlan Parrish Oral History, February 17, 2021.
[47] Harlan Parrish Oral History, February 17, 2021.
[48] Colonial BancGroup, Inc., Form 10-K for the year ended December 31, 1996, p. 5.
[49] Turner, Shannon, "Robert Lowder Chmn Pres and CEO of Colonial BancGroup," *Dow Jones Investor Network*, May 8, 1996. See also the discussion of branch lending decisions as being "all about relationships" in Parrish Oral History.
[50] Hewitt, Janet Reilley, "The Will to Wynn," *Mortgage Banking*, Vol. 50, Issue 1, October 1989.
[51] Cline, Kenneth, "CEO Keeps Close Watch over the Family Business," American Banker, February 23, 1994.

Lowder regularly spoke about the strength of the company's loan portfolio and its knowledge of local markets.[52] And when residential mortgage markets embraced products that targeted homeowners with less than stellar credit, such as introductory teaser rates, no-document loans, and high fees, Colonial resolutely steered clear. As late as September 2007, Lowder reflected on Colonial underwriting standards as markets got choppier. "Colonial," he insisted,

> hasn't been willing to sacrifice credit quality for loan growth…Colonial makes loans in the markets…with individuals and companies we know. We avoid speculative projects…and we require strong guarantative support…We have no subprime, no stated income lending, and no exotic products.[53]

The commitment to longstanding principles of careful borrower assessment was reflected in Colonial's low non-performing assets ratios shown in Exhibit 3 below, which financial analysts stressed as a strength of the bank. In a sector characterized by widespread deterioration in credit quality, "Colonial's conservative credit culture [stood] out."[54]

Exhibit 3
Non-Performing Assets Ratio

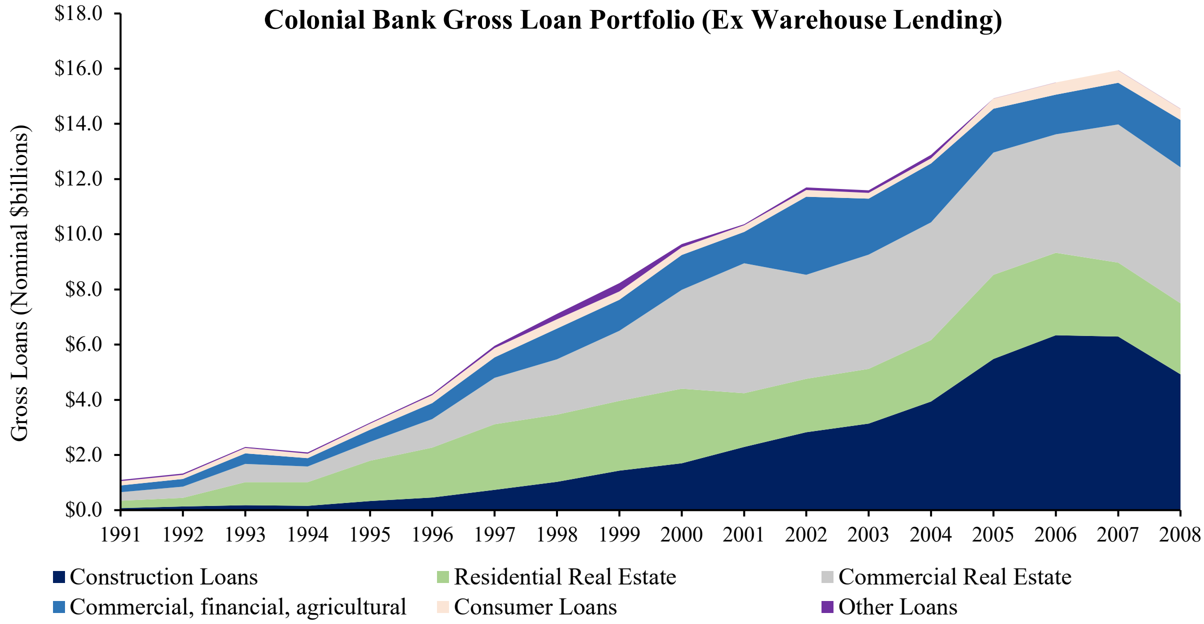


Notes: Data from Colonial SEC filings.

Despite Colonial's assiduous attention to borrower risk, it adopted a very different approach to business cycle risk. The development of strong footholds in Florida and Georgia, complemented by large urban markets in Tennessee, Texas, and Nevada allowed the bank to take full advantage of upswings in the regional and national economies. Exhibit 4 shows Colonial's loan portfolio by loan type. By the turn of the millennium, Colonial's residential real estate business had grown enough to exceed the size of the overall bank fourteen years earlier. Its commercial real estate loan book had expanded even more impressively, as had its construction lending volume, which would go on to more than quadruple in the first six years after 2000.

[52] Rieker, Matthias, "Bankers Say Diversity Key to Avoiding Credit Woes," *American Banker*, December 12, 2000.
[53] Davis, Paul, "Bankers Tout Limited Exposure to Real Estate," *American Banker*, September 12, 2007.
[54] Steven Alexopoulos and Preeti S Dixit, "Colonial BancGroup: A High Quality Management Team is Dealt a Tough Hand to Play; Initiate at Neutral," JPMorgan, December 17, 2007, p. 17.

Exhibit 4
Colonial Bank Gross Loan Portfolio (Ex Warehouse Lending)



Notes**:** Data from 1994 - 2008 are from Capital IQ. Data from 1991 - 1993 are from SEC filings. All data reflect restated filings where applicable. Other loans are grouped into Consumer loans starting from 2005.

Residential and commercial mortgages had long occupied a significant fraction of Colonial's lending.[55] In 1995 Colonial's loan portfolio was comprised of 22% commercial real estate loans and 46% residential real estate loans, many of which were located in Alabama.[56] Each of these lending categories benefited from the bank's move into additional Sunbelt markets. A new focus on construction lending complemented Colonial's expanding residential and commercial real estate lines and accentuated the bank's pro-cyclical strategy. Colonial's earnings report to investors at the end of 1999 stressed that its "increase in construction loans is primarily the result of loan growth in the Georgia, Florida, and Nevada regions. Commercial real estate loan growth also occurred in these regions, as well as the Birmingham and East Central regions in Alabama."[57] As one retail executive recalled, Colonial "got into construction because [the bank was] in high growth markets, [and] there was a lot of construction taking place."[58] As more people moved to the Sunbelt, demand for shopping malls, subdivisions, and condominiums remained strong, and Colonial was well positioned to benefit.[59]

By the early 2000s, some financial analysts voiced concerns about Colonial's exposure to construction, with one noting that the bank made "a huge bet on commercial real estate and construction lending with a level of exposure totaling 6.4x and 8.0x the company's equity and tangible shareholders' equity, respectively, and 47x Colonial's loan loss reserve."[60] By 2007,

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[55] Colonial BancGroup, Inc., Form 10-K for the year ended December 31, 1995, p. 6.
[56] Colonial BancGroup, Inc., Form 10-K for the year ended December 31, 1995, p. 1.
[57] Colonial BancGroup, Inc., Form 10-K for the year ended December 31, 1999, p. 18.
[58] Harlan Parrish Oral History, February 17, 2021.
[59] Freer, Jim, "Colonial Bank to Expand with Condo Group Loans", *Business Journal*, Vol. 24, No. 53, August 6, 2004.
[60] Pringle, N. David, and Daniel P. Foley, "CNB: Meeting With Management, Reiterate SELL Recommendation," Fulcrum Global Partners, September 17, 2003, p. 2.

real estate construction loans composed the largest single chunk of Colonial's business, representing nearly 40% of the company's loan portfolio. At that point, commercial real estate constituted 31% of the bank's lending, and residential mortgages a further 17%.[61]

Geographic expansion underpinned strong growth in every significant business category. As Exhibit 4 also documents, Colonial's gross loan portfolio, which ranged between $3 and $4 billion in the mid-1990s, nearly tripled to nearly $10 billion by 2000 and reached $15 billion by 2005. Consistent high rates of growth in lending, along with conservative underwriting practices with regard to individual borrowers, allowed Colonial to achieve impressive returns for investors.[62] Despite occasional mild recessions, overall national and regional economic growth remained strong between the mid-1980s and the early 2000s, and Colonial had taken steps to benefit from that activity.

Colonial's expansion of its mortgage warehouse lending ("MWL") department during the late 1990s and 2000s represented, in part, an attempt to moderate the bank's business cycle risk. To understand that point, one must grasp the key features of this type of mortgage finance. MWL constitutes a type of bridge financing for mortgage originators, generally mortgage bankers or brokers. An institution like a bank provides temporary funding to the originator to cover the initial funds advanced to a borrower as part of a mortgage origination. Nonbanks operating in the mortgage origination space do not have access to deposits, a traditional source for funding loans, and as such, rely on mortgage warehouse lines as a key source of capital. The warehouse line of credit serves as a short-term bridge until the mortgage originator can sell the mortgage in the secondary market; that sale allows the originator to repay the lender.

Colonial Bancgroup established a formal MWL department in the third quarter of 1998 to provide loans collateralized by residential mortgages to mortgage bankers and brokers predominantly based in the Southeast.[63]

Warehouse lending at Colonial came in three forms. The division provided secured, short-term loans of less than 30 days to mortgage bankers, predicated on collateral of individual prime mortgages whose borrowers had FICO credit scores above 700, and for which Colonial would hold the underlying documentation.[64] Second, Colonial engaged in funding via repo agreements,[65] purchasing securities from mortgage bankers, and on the basis of an agreement that the mortgage bankers would repurchase those securities at a higher price with a matter of days.[66] The markup, known as the repo rate, effectively serves as interest. Finally, Colonial

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[61] Colonial BancGroup, Inc., Form 10-K for the year ended December 31, 2006, p. 34.

[62] Colonial's return on equity typically fluctuated between 15 and 20 percent between 1995 and 2002 before settling into the still lofty 13 percent range through 2005. Net income grew at a compound annual growth rate of over 17 percent between 1995 and 2005.

[63] Colonial BancGroup, Form 10-K for the year ended December 31, 1999, p. 28.

[64] Steven Alexopoulos and Preeti S Dixit, "Colonial BancGroup: A High Quality Management Team is Dealt a Tough Hand to Play; Initiate at Neutral," JPMorgan, December 17, 2007, p. 13.

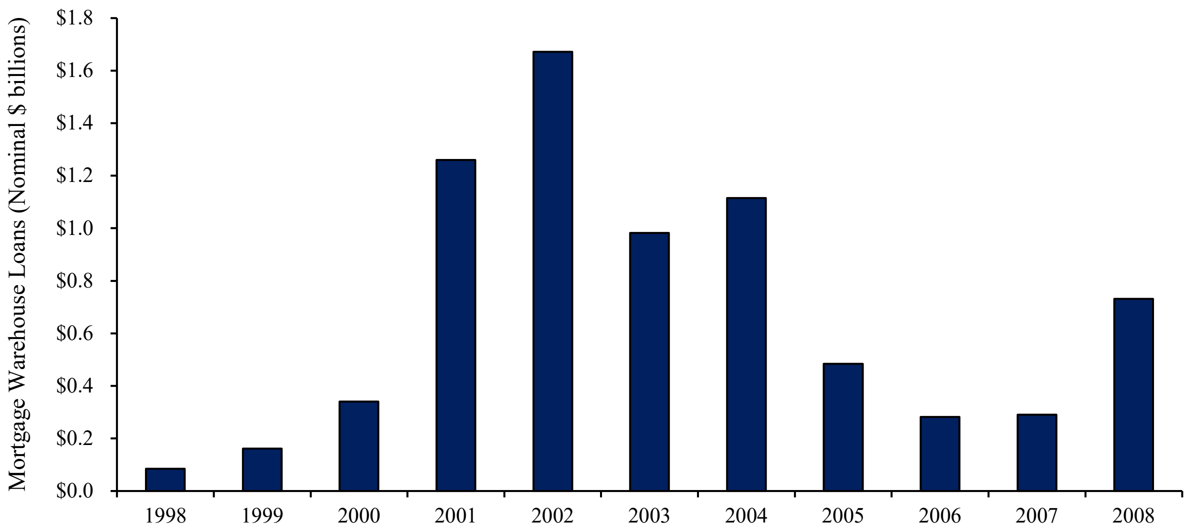
[65] Colonial BancGroup, Form 10-K for the year ended December 31, 2008, p. 50.

[66] Cheng, Jeffrey and David Wessel, "What is the repo market, and why does it matter?", *Brookings,* January 28, 2020, available at https://www.brookings.edu/blog/up-front/2020/01/28/what-is-the-repo-market-and-why-does-it-matter/; Kim, You Suk, Steven M. Laufer, Karen Pence, Richard Stanton, and Nancy Wallace, "Liquidity Crises in the Mortgage Market," Finance and Economics Discussion Series 2018-016, Washington: Board of Governors of the Federal Reserve System, available at https://doi.org/10.17016/FEDS.2018.016.

participated directly in funding mortgage bankers via purchasing short-term participation in the pooled loans originated by mortgage bankers.

As shown in Exhibit 5, warehouse lending grew significantly through 2002, before declining from 2003-2006 and then picking up again thereafter. Warehouse lending volume was a lower margin business for Colonial – as a consequence of the ostensibly lower credit risk – and its volume was driven by, among other things, the fundamentals of the housing market such as interest rates and origination and refinance activity. In periods of lower interest rates, especially periods associated with weaker overall economic activity, balances in the warehouse lending unit grew as mortgage bankers and brokers refinanced more loans.[67] Thus, as long as the warehouse lending business focused on refinancing, it exhibited some countercyclical features, providing Colonial with a partial hedge against declining demand for commercial and construction loans, as well as purchase mortgages.[68] At the same time, Colonial's increased reliance on MWL simultaneously exposed it to heightened counterparty risk, since it depended on the good faith of the many nonbank lenders with which it now conducted hundreds of millions of dollars worth of business.

Exhibit 5
Mortgage Warehouse Loans Outstanding



Notes: Data are year-end from SEC filings. The warehouse lending department was started in Q3 1998.

IV. Colonial Amid the Financial Crisis

Around the mid-2000s, Colonial, much like the economy, was starting to show signs of weakness as more and more market observers began to question whether housing prices were rising unsustainably. A growing proportion of business stories contemplated the prospect of the housing bubble bursting, led by headlines like "Steep rise in prices for homes adds to worry

[67] See, for example, "Colonial BancGroup Announces Quarterly Earnings," *BusinessWire*, April 17, 2001, and "Colonial BancGroup Announces Record Earnings," *BusinessWire,* January 17, 2002.
[68] "Colonial BancGroup Announces Record Earnings," *BusinessWire*, January 17, 2002.

about a bubble" and "Sun starts to set on Florida housing boom."[69] Amid the new macroeconomic situation, financial analysts argued, in essence, that Colonial Bank's longstanding strategies to minimize borrower risk and hedge through warehouse lending would not protect it from ever greater business cycle risks.

The *Wall Street Journal*, for example, ran a story in March 2007 that covered the acute real estate risks faced by regional lenders and signaled out Colonial as "among the banks most heavily exposed to the once-hot Florida construction market," having "lent far more to construction borrowers as a percentage of its […] core capital than recommended by [FDIC] guidelines."[70] Such guidance reflected concerns about the overheating economy, as regulatory officials advised banks to limit their commercial real estate exposure to within certain pre-determined parameters.[71] By late 2007, Credit Suisse analysts noted that Colonial's "growth outlook and Florida real estate exposure are risks" and emphasized that loan growth was slowing. The analysts further pointed out Colonial's heavy weighting to commercial real estate and construction loans, which raised concerns amid softening regional markets.[72]At the very end of that year, JPMorgan analysts noted that Colonial's high Florida loan concentration had begun to weigh on earnings.[73] Exhibit 6 shows the uptick in Florida residential mortgage delinquencies from the beginning of 2008, and so conveys the dramatic macroeconomic headwinds faced by Colonial at that time.

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[69] Leonhardt, David, "Steep Rise in Prices for Homes Adds to Worry About a Bubble," *NYTimes,* May 25, 2005; Ward, Andrew, "Sun starts to set on Florida housing boom," *Financial Times*, July 15, 2005.

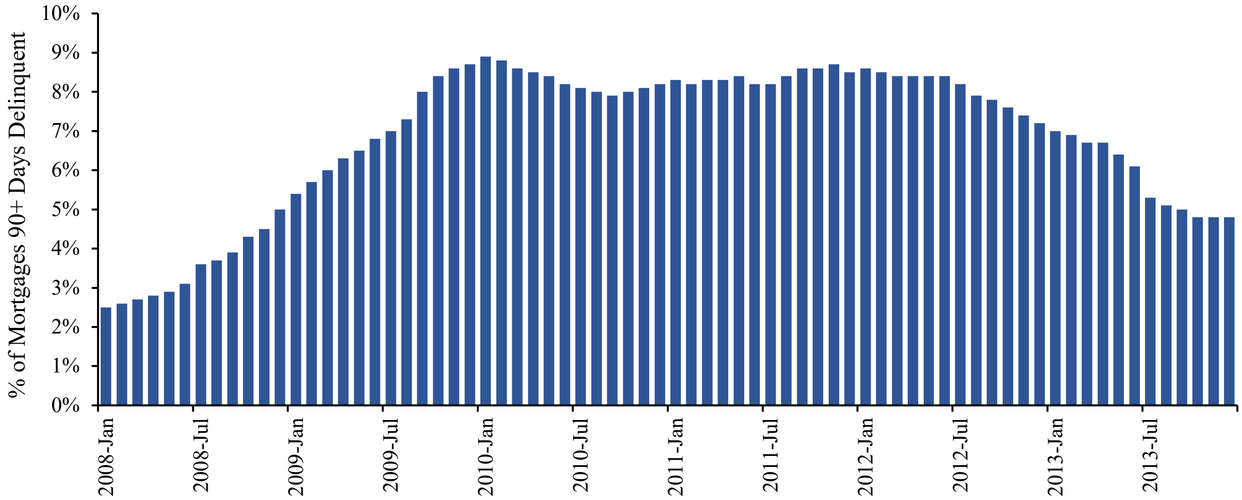
[70] Richardson, Karen and Valerie Bauerlein, "Moving The Market -- Heard on the Street: Shaky Construction Market Exposes Midsize Banks --- Weakness in Florida May Weigh on Colonial BancGroup's Loan Portfolio," *WSJ*, March 22, 2007.

[71] "Managing Commercial Real Estate Concentrations," FDIC, available at https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin07/article02_real_estate.html.

[72] Hagerman, Todd L. and Jill Glaser, "Initiating Coverage with an Outperform Rating," Credit Suisse, September 11, 2007, p. 2.

[73] Steven Alexopoulos and Preeti S Dixit, "Colonial BancGroup: A High Quality Management Team is Dealt a Tough Hand to Play; Initiate at Neutral," JPMorgan, December 17, 2007.

Exhibit 6
Percent of Florida Mortgages 90 + Days Delinquent



Notes: Data are from the CFPB. Data is a 5 percent sample of all outstanding, closed-end, first-lien, 1 - 4 family residential mortgages. See, https://www.consumerfinance.gov/data-research/mortgage-performance-trends/about-the-data/.

As with all U.S. banks, Colonial's history was profoundly shaped by the contours of American banking regulation. There were multiple regulators that interacted with and supervised Colonial, reflecting the disparate character of the U.S. bank supervisory system. Since banks can seek a charter at either the state or federal level, Colonial had to make that fundamental choice. If it possessed a national charter, it would be supervised by the Office of the Comptroller of the Currency (OCC).[74] If Colonial opted for a state charter, then it would be supervised primarily by the state banking agency (for Colonial, the Alabama State Banking Department) and either the Federal Reserve[75]—should it join the Federal Reserve system as a "member bank"— or the Federal Deposit Insurance Corporation[76]—should it choose to be a "non-member bank."

Bank regulatory agencies engage in both regulation and supervision of banks, and confront a mix of policy objectives. In the decades before Colonial came into existence, banking authorities primarily focused on safety and soundness as key goals. In the aftermath of the dramatic bank failures of the early 1930s, banking officials at regulatory agencies such as the OCC, FDIC, and Federal Reserve viewed the maintenance of systemic stability as their chief aim, along with facilitating the flow of capital through the economy. They set rules and parameters for banks to follow, such as capital adequacy levels.[77] In their role as supervisors, however, regulatory

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[74] The OCC serves as the primary regulator for nationally chartered banks.

[75] The Federal Reserve regulates bank holding companies, banks that apply for state charters who choose to be members of the Federal Reserve system, and the US operations of foreign banks. *See* "Preliminary staff report: The role of the federal reserve in banking supervision and regulation," Financial Crisis Inquiry Commission, April 7, 2010, available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-Preliminary_Staff_Report_-_Role_of_Federal_Reserve_in_Bank_Supervision_and_Regulation.pdf.

[76] The FDIC serves as the primary federal regulator of state-chartered banks that do not join the Federal Reserve system. The deposit insurance function of the FDIC makes it unique in comparison to its peer regulatory agencies, *See,* "What We Do," FDIC, May 15, 2020, https://www.fdic.gov/about/what-we-do/.

[77] Starting in the 1960s, Congress and state legislatures added several new regulations on banks, including protections for consumers and prohibitions against racial or gender discrimination in credit provision. All of these complicated oversight of banks by regulatory agencies.

agencies have focused at least as much on facilitating credit as looking to forestall risky practices. Bank supervisors will offer a bank like Colonial guidance on a host of matters, issuing warnings if it is engaging in overly risky businesses, and offering advice about activities such as lending and risk exposure to clients and sectors.

The regulatory postures of different agencies also vary, reflecting their different missions and priorities. The OCC has historically worried the most about sustaining flows of credit; the FDIC has prioritized analysis of solvency and protection of the deposit insurance fund; and state banking agencies almost always focus on access to capital within their states. The existence of multiple regulatory actors has given banks like Colonial the chance to choose between them.

Colonial was a state-chartered entity through 2003, but then converted to a national bank, consequently having the OCC as its primary regulator from 2003 to 2008. Banking agencies use a ratings system to rate banks on their compliance with safety and soundness standards. This rating system goes by the acronym CAMELS: Capital adequacy; Asset quality; Management; Earnings; Liquidity; and Sensitivity to market risk. Regulators rate banks on each component from 1-5—with 1 being strong and 5 being critically deficient—and give banks a composite score based on the six components. CAMELS ratings typically remain confidential, with supervisors only sharing them with senior management and the bank's board of directors.[78]

As a result of Colonial's eventual failure in 2009 however, a post-bankruptcy report by the FDIC disclosed Colonial's ratings from the mid-2000s until its collapse, shown in Exhibit 7.[79]

Exhibit 7		
Rating Date/Rating Period	**Supervising Agency**	**Supervisory Rating (CAMELS + Composite Score)**
August 2004 – August 2005	OCC	222222 (2)
August 2005 – August 2006	OCC	212222 (2)
August 2006 – August 2007	OCC	222222 (2)
February 2008	OCC	232222 (2)
August 2007 – June 2008	OCC	243332 (3)
September 2008	FDIC/ASBD	343433 (3)
June 2008 – June 2009	FDIC/ASBD	444443 (4)
August 2009	FDIC/ASBD	555555 (5)

As the deterioration in Sunbelt housing markets exposed Colonial's financial weaknesses, the supervisory ratings tracked the bank's growing problems. The CAMELS ratings, however,

78 Stackhouse, Julie, "The ABCs of CAMELS," Federal Reserve Bank of St. Louis, July 24, 2018, available at https://www.stlouisfed.org/on-the-economy/2018/july/abcs-camels.
79 FDIC Office of Inspector General, "Material Loss Review of Colonial Bank, Montgomery, Alabama", April 2010, p. 15.

represented more a barometer of current conditions than a forecast. Only in the second half of 2007 did the OCC move Colonial's overall rating to a 3. At this point, banking regulators initiated more aggressive action to rein in Colonial's activities and to attempt to shore up the bank before it experienced more significant problems and required government intervention and a corresponding cost to the FDIC's deposit insurance fund. The first action came from the OCC, which drafted a cease & desist ("C&D") order in 2008 that reflected concerns raised by an August 2007 examination, particularly about the bank's mortgage warehouse lending operation.[80]

At this juncture, Colonial took advantage of the dual banking system, applying to the Alabama State Banking Department to switch back to being a state-chartered bank in Alabama, very likely in an attempt to sidestep, or at least delay growing regulatory scrutiny (Colonial elected state non-member status, as a result of which the FDIC became its primary federal supervisor). Colonial's CEO Bobby Lowder said in a 2008 press release that changing the bank's charter "allow[ed] Colonial to continue to evolve in order to remain competitive as we strive to balance our safety and soundness with innovation, both of which are important to our customers."[81] In June 2008, the FDIC approved Colonial's request, which did slow the process of corrective supervisory action, since the OCC did not have time to issue the C&D order. However, the FDIC and the Alabama State Banking Department (ASBD) met with the OCC to discuss concerns with the bank, especially around its mortgage warehouse lending operation, leading to immediate reviews by those regulators.[82]

As a result, Colonial's reprieve proved short-lived. The examinations by the FDIC and the ASBD raised even more concerns than the OCC examination the previous year. In December 2008, The FDIC and ASBD agreed to a memorandum of understanding (MOU) with Colonial that contained 20 provisions about management, asset quality, capital and more. Notably, the regulators required Colonial to name a chief lending officer with authority over the bank's entire lending practice.[83] Six months later, FDIC and ASBD officials issued their own cease & desist order in June 2009, overriding the MOU from the prior December. The cease & desist order's 14 provisions included requirements to retain qualified management and reduce credit concentrations.[84] By August, the FDIC had concluded that Colonial could not stave off bankruptcy, so it officially closed the bank and sold its assets to BB&T.

The FDIC post-failure report outlined three major problems confronting Colonial as its financial position worsened after 2006: poor risk management practices in its high-risk investments in

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[80] FDIC Office of Inspector General, "Material Loss Review of Colonial Bank, Montgomery, Alabama", April 2010, p. 15. Regulators will issue C&D orders if a bank engages in unsafe or unsound practices or if it breaks the law. C&D orders bind banks into both stopping certain practices and taking certain positive actions to remedy the situation, *See* "RMS Manual of Examination Policies—Formal Administrative Actions," FDIC, July 2016, https://www.fdic.gov/regulations/safety/manual/section15-1.pdf.

[81] Anonymous, "Colonial Bank Announces Change to State Chartered Bank," *BusinessWire,* June 10, 2008.

[82] FDIC Office of Inspector General, "Material Loss Review of Colonial Bank, Montgomery, Alabama", April 2010, p. 14.

[83] A MOU is issued when a regulator steps in to get a bank's board of directors to commit to solving moderate, fixable organizational issues. MOUs are considered a common informal action, with the aim of avoiding harsher, formal actions like a cease & desist order. An MOU is neither available to the public nor legally enforceable; "RMS Manual of Examination Policies—Informal Actions", FDIC, April 2016, https://www.fdic.gov/regulations/safety/manual/section13-1.pdf.

[84] FDIC Office of Inspector General, "Material Loss Review of Colonial Bank, Montgomery, Alabama", April 2010, p. 16.

Acquisition, Development and Construction (ADC) mortgages and securities; weak loan underwriting and risk analysis; and alleged fraud in its mortgage warehouse lending operation with mortgage lender Taylor, Bean, & Whitaker ("TBW").[85] When the real estate market in the South sharply declined in 2007 and 2008, Colonial's pro-cyclical growth strategy exposed it to sharp declines in loan income, as a growing fraction of residential mortgages and construction loans went into default. As of June 2009, 25% of the bank's ADC loans had not been paid on time. Overall weakness in residential real estate simultaneously devastated Colonial's MWL division, which incurred growing losses as its non-bank lenders ran into difficulties. These losses eventually totaled roughly $1.7 billion.[86] In regulator comments, the ASBD took the strong view that Colonial's losses from its real estate and ADC loans would have taken down the bank on their own, even without the MWL losses.[87] The weaknesses in Colonial were apparent in several capital adequacy measures of concern to regulators. By the end of Q1 2009, Colonial's Tier 1 Capital Ratio had declined to 7.3 percent from 10 percent only two quarters earlier.[88]

Colonial's demise, then, predominantly reflected the broader collapse in real estate markets during the financial crisis. Bobby Lowder and the rest of the bank's top leadership had chosen to tack close to the wind of Sunbelt expansion, leaving Colonial badly exposed when that wind died down, subjecting it to a classic bank solvency crisis and to some extent a liquidity crisis.

Insufficient attention to counterparty risk in the MWL division compounded Colonial's woes, saddling it with additional losses that resulted from a large-scale fraud. The key counterparty that perpetrated the fraud was a non-bank mortgage lender, Taylor, Bean, and Whitaker ("TBW"), which relied heavily on Colonial's MWL division to supply it with capital.

TBW was owned and led by Lee Farkas, later sentenced to significant time in prison for perpetrating the Colonial fraud in what one prosecutor called the "largest bank fraud scheme in [U.S.] history."[89] According to mid-level managers at TBW, Farkas set the tone for the firm's culture, and retained a strong grip on the firm's decision-making, along with a small circle of senior leaders. The tight knit group of insiders perpetrated a series of deceptions throughout the 2000s.[90] The first examples of misrepresentations by TBW and Lee Farkas were not against Colonial, but instead against Fannie Mae, the government sponsored enterprise. In the early 2000s, Fannie Mae became aware that TBW had sold loans to Fannie Mae that it characterized as high quality, but that actually were non-performing, fake, or lacking critical features such as mortgage insurance. The Fannie Mae episode ended with a private resolution, with few serious

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[85] "FDIC Office of Inspector General, "Material Loss Review of Colonial Bank, Montgomery, Alabama", April 2010, p. 3; Eaglesham, Jean, "A Prison Life: Ex-Banker Struggles," *WSJ,* March 18, 2014, available at https://www.wsj.com/articles/SB10001424052702303287804579445813343137266.

[86] FDIC Office of Inspector General, "Material Loss Review of Colonial Bank, Montgomery, Alabama", April 2010, p. 3.

[87] FDIC Office of Inspector General, "Material Loss Review of Colonial Bank, Montgomery, Alabama", April 2010, p. 24.

[88] Data from S&P Capital IQ.

[89] U.S. Department of Justice, "Former Chairman of Taylor, Bean & Whitaker Convicted for $2.9 Billion Fraud Scheme That Contributed to the Failure of Colonial Bank," Press Release dated April 19, 2011, available at https://www.justice.gov/opa/pr/former-chairman-taylor-bean-whitaker-convicted-29-billion-fraud-scheme-contributed-failure.

[90] Michael Azzarello Oral History, dated December 28, 2020, pp. 6 – 7; Sherry Gallitz Oral History, dated December 21, 2020, pp. 8 – 9.

penalties for TBW and little if any impact on its ability to operate as a going concern.[91] Like many victims of fraud, Fannie Mae preferred a private settlement that minimized its losses to a public process that would have tarnished its own reputation. This episode foreshadowed the much larger, more damaging, and highly public fraud by TBW and Lee Farkas against Colonial.

Complex, multifaceted, and unfolding over several years, TBW's frauds against Colonial were executed by Mr. Farkas and TBW employees in conjunction with a small set of Colonial's warehouse lending employees. The core MWL employees had come over as a group from SunTrust and reportedly operated in a cultural silo within the bank.[92] As with all its other counterparties, Colonial's warehouse lending arm provided capital to TBW for its business activities, which included the origination, purchasing, pooling, and selling of mortgage loans. Once TBW sold those loans to either Fannie Mae, Freddie Mac, or private-label sellers of mortgage-backed securities, it would repay Colonial's MWL division with interest and the process would start anew. Like other non-bank lenders, TBW's revenues from these activities included the fees from mortgage origination and sales, and fees generated from retained servicing rights on mortgages sold to other entities. Colonial generated revenue from the interest it charged TBW on the mortgage warehouse lending facility.

Fraudulent activity began in 2002, when TBW experienced liquidity problems due to its rapid growth in origination and mortgage sales activities amid the early phases of the housing boom.[93] In order to maximize its profits amid strong housing demand, TBW began to conduct "more business than the size of [its] warehouse lines allowed."[94] As former mid-level TBW executive Michael Azzarello explained,

> We were almost begging management to slow down the volume because we weren't able to purchase those loans as quickly as we needed to. A lot of our correspondents who were selling us those loans were waiting to get our funding to buy the loans that they closed with their warehouse lines. [For] the whole liquidity issue it [was] very important that they use the warehouse line to close the loans, they wanted to get those loans reviewed and purchased by their investor within a couple of weeks, so they can pay off their warehouse lines.[95]

Among top management, TBW presumed that rising markets would solve any operational problems posed by managing rapid growth. "[T]here was so much faith, Azzarello recalled, "that the real estate values would maintain and continue appreciating."[96] Needing additional

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[91] Schoenberg, Tom, "Fannie Mae silence on Taylor Bean led to US $3B fraud," *Bloomberg News*, June 30, 2011; Norris, Floyd, "After Years of Red Flags, A Conviction," *The New York Times*, April 21, 2011.
[92] Harlan Parrish Oral History, dated February 17, 2021.
[93] *See, for example,* Swann, Christopher, "Alarm Sounds for Overheated Housing Market," *The New York Times*, June 29, 2004.
[94] Michael Azzarello Oral History, dated December 28, 2020, p. 7.
[95] Michael Azzarello Oral History, dated December 28, 2020, p. 7; Correspondent lenders are retail lenders who originate and fund a mortgage and then sell the mortgage to a larger mortgage banker or depository institution which becomes the servicer. A correspondent lender will fund a loan using a warehouse line of credit, just the same way TBW funds their originated loans using a warehouse line of credit. Mr. Azzarello is indicating that TBW's correspondents were originating loans at a very quick pace and selling those loans to TBW. For the correspondent lenders, they needed to quickly sell a loan to TBW in order to pay off their warehouse line, originate more loans, and accrue the origination fees. TBW did not have enough capital outright to buy all those loans from its correspondents, thereby driving its liquidity struggles.
[96] Michael Azzarello Oral History, dated December 28, 2020, p. 7.

funding, TBW started to overdraw pre-set credit limits with Colonial's warehouse lending division.

Initially, TBW overdrew its warehouse lending facility at Colonial by approximately $15 million per day. Roughly one year later, the daily overdrawn amount had more than sextupled, exceeding $100 million per day.[97] This development would have been impossible without the collusion of key Colonial executives in the warehouse division. In early 2002, Catherine Kissick, the head of Colonial's MWL department, first learned about the overdrafts that TBW had on its primary account with Colonial. Kissick had joined Colonial from a previous position at SunTrust, with the specific goal of expanding its business with TBW. Thus, she had strong incentives to accommodate TBW management, even after becoming aware of the overdrafts. Lee Farkas persuaded her to conceal the situation by manually moving or sweeping money into TBW's account to hide the overdrawn funds. Kissick later testified that she designed this sweeping activity as a temporary solution to aid TBW and Mr. Farkas, with the hopes that TBW would turn around its performance and in the future remain within its credit limits.[98] As often occurs with corporate fraud, initial acts of misrepresentation that key figures hoped would be temporary created powerful incentives to extend the fraud when that optimism proved to be misplaced.[99]

The pattern of misrepresentation accordingly deepened in the years after 2003. TBW, in collaboration with Colonial's Kissick, went on to engage in a larger corporate scheme to conceal the breaches in the lending relationship from more senior Colonial management. Kissick worked with TBW to submit reports of fictitious, valueless loans that provided an ostensibly legitimate reason for the extra funding that Colonial was providing to TBW. These reports justified expansion of both Colonial's repo arrangements with TBW and its participation in TBW's supposed pooled loans for sale.[100]

Colonial's MWL department employed both internal and external auditors, which amplified the need for additional fabrications. When internal auditors probed documentary irregularities

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[97] Securities and Exchange Commission v. Catherine L. Kissick, Complaint for Injunctive and Other Relief, March 2, 2011, pp. 7 - 8. These overdrafts were initially concealed by TBW and cooperating Colonial Bank employees in the MWLD department through "sweeping" funds into the overdrawn accounts to conceal the presence of any overdraw at all. See, United States of America v. Catherine Kissick, Statement of Facts, March 2, 2011, p. 2.

[98] The Colonial BancGroup vs. PWC, Order on the Liability Phase of the PwC Bench Trial, December 28, 2017, p. 68.

[99] Barakat, Matthew, "Business: Bank Exec at Trial: I Was In Too Deep – Over a Decade, Fraud Grew to $2 Billion Scheme," *Detroit Legal News*, April 11, 2011.

[100] Securities and Exchange Commission v. Catherine L. Kissick, Complaint for Injunctive and Other Relief, March 2, 2011, pp. 5 – 10. Specifically, the first fraud was executed in what was called the COLB account which was an account for TBW at the Colonial MWL department. Through the COLB account, Colonial purchased interests in residential mortgage loans pending resale of those loans to third-party investors. TBW included fictitious or duplicate loans in the COLB account to execute its fraud. Specifically, insiders referred to submitting "Plan B" and "Crap" loans. The "Plan B" loans were fictitious loans that did not exist at all. The "Crap" loans were impaired loans that did not meet the quality standards set in the agreements between Colonial and TBW. The "Crap" loans were still real mortgages, but they were worth very little to Colonial. The second fraud was executed in an Assignment of Trade (AOT) facility. The fraud in the AOT account involved bundling the problematic loans TBW had previously submitted to the COLB account into trades. Once these loans were packaged into trades, identifying information on individual mortgages would stop being tracked, allowing them to stay hidden for longer. See, United States of America v. Catherine Kissick, Statement of Facts, March 2, 2011.

created by Kissick's efforts to conceal the ongoing fraud, she provided false explanations.[101] PwC was engaged as Colonial's external auditor during the period of fraudulent activity, but failed to identify the falsified mortgages, allowing them to pass under the radar for years.[102] As global financial markets seized up in 2008, the scale of deception became even grander, since TBW and Kissick had to hide ever larger losses.

The details surrounding TBW's fraudulent activities eventually came to light as a result of oversight related to the United States government's bailout of the financial industry. On December 2, 2008, Colonial announced that it had obtained preliminary approval to receive $550 million in Troubled Asset Relief Program (TARP) funding from the U.S. Treasury.[103] This TARP capital was predicated on Colonial's ability to raise an additional $300 million in equity capital.[104] In an attempt to fend off closer scrutiny of Colonial's books, Farkas offered to organize an investment group to raise all $300 million of the capital infusion for Colonial and consistently communicated to Colonial officers that TBW had secured funding, when it had not. By July 31, 2009, regulators announced that the equity infusion had failed and Colonial would not receive any TARP funds. The FBI raided Colonial and TBW's offices shortly thereafter, and the FDIC subsequently seized Colonial Bank on August 14, 2009.[105]

While the warehouse lending fraud significantly extended the eventual losses incurred by Colonial's shareholders and the FDIC, as insurer of its deposits, there were also features of the collapse that, as noted, represented a classic bank solvency and liquidity crisis.[106]

By the second quarter of 2009, Colonial reported a net loss in excess of $600 million following a loss one quarter earlier of nearly $170 million. Neither of these figures included the losses from the TBW frauds, and represented the bank's huge exposure to business cycle risk. By that point, Colonial struggled to raise additional equity funding. The bank's Tier 1 capital ratio had fallen to 6.5 percent – below the level required under relevant regulatory statutes and Colonial's prior agreements with regulators. Despite frantic efforts to identify sufficient injections of credit to allow it to weather the storm, Colonial found itself without options.[107] The frauds in the warehouse division may have accelerated the timing of Colonial's demise, in addition to extending the economic damage to investors and the FDIC. But its failure probably would have ensued anyway.

V. Conclusion

Colonial's rise and fall reflects the challenges of risk management for financial institutions that took advantage of banking deregulation to grow rapidly in the Sunbelt. In its early days, financial

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[101] Securities and Exchange Commission v. Catherine L. Kissick, Complaint for Injunctive and Other Relief, March 2, 2011, pp. 9 – 10.
[102] The Colonial BancGroup vs. PWC, Order on the Liability Phase of the PwC Bench Trial, December 28, 2017.
[103] SEC v. Lee B. Farkas, Complaint for Injunctive and Other Relief, pp. 14-15.
[104] SEC v. Lee B. Farkas, Complaint for Injunctive and Other Relief, p. 15.
[105] SEC v. Lee B. Farkas, Complaint for Injunctive and Other Relief, p. 19.
[106] Banks experience solvency crises when their liabilities exceed their assets. Under this scenario, a bank's inability to repay their liabilities in full forces creditors to take a haircut. Banks can also experience liquidity crises, in which their assets remain sufficient to pay off its liabilities so long as they have time to turn their illiquid assets into cash, but do not have sufficient cash on hand to meet requests of depositors for withdrawals or maturing obligations to creditors.
[107] Colonial BancGroup, Press Release dated July 31, 2009, "Colonial BancGroup Reports Second Quarter 2009 Results."

observers depicted it as a conservative and diligent hometown lender with a keen eye for individual borrower risk. Its tagline was "Alabama's hometown bank," reflecting its close relationship with borrowers and its strong underwriting standards. Gradually, the bank's eyes wandered outside of its Montgomery base. Colonial began acquiring small regional banks in Alabama and then across the Southeast until it had built a multistate empire. Moreover, it capitalized on rapid demand growth in construction, commercial real estate, and residential loans.

Even though Colonial sustained many dimensions of community banking amid this rapid ascent, including close management of credit risk for any one individual borrower, it poorly managed the much broader and larger business cycle risk that came with its growth across the Sunbelt. It also fell disastrously short in managing counterparty risk within its large but more siloed mortgage warehouse lending operation. Thus, Colonial illustrates both the widespread fraud that occurred during the housing boom of the 2000s, as well as the ongoing exposure of financial institutions to sharp macroeconomic downdrafts.