Office of Inspector General

Office of Audits
Audit Report No. AUD-11-006

In-Depth Review of the Failure of The Gordon Bank, Gordon, Georgia

This report includes an addendum with management's June 7, 2011 revised response to the final report and the Office of Inspector General's evaluation of management's revised response.

May 2011

Office of Inspector General

Executive Summary

In-Depth Review of the Failure of The Gordon Bank, Gordon, Georgia

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Why We Did The Audit

On October 22, 2010, the Georgia Department of Banking and Finance (DBF) closed The Gordon Bank (Gordon), Gordon, Georgia, and the FDIC was appointed receiver. On November 18, 2010, the FDIC notified the Office of Inspector General (OIG) that Gordon's total assets at closing were $30.5 million and the estimated loss to the Deposit Insurance Fund (DIF) was $8.6 million. As of January 31, 2011, the estimated loss had increased to $8.9 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the material loss review (MLR) threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Although the estimated loss for Gordon does not meet the amended threshold requiring an MLR, we determined that unusual circumstances exist because examinations of the institution between 2006 and 2008 did not satisfy the minimum frequency requirements defined in the FDI Act. Accordingly, we initiated an In-Depth Review as authorized by the Financial Reform Act.

The objectives of the review were to (1) determine the causes of Gordon's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Gordon, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. A primary area of focus during the review was the frequency of on-site risk management examinations in the several years preceding the bank's failure.

Background

Gordon was established in 1946 as a state-chartered nonmember bank. At the time of its closing, the institution operated a single office in the small rural community of Gordon, which is located approximately 100 miles southeast of Atlanta, Georgia. Gordon's lending activities focused primarily on real estate, including commercial real estate (CRE) and acquisition, development, and construction (ADC). Because local loan demand was low in 2005 and 2006, management purchased loan participations from other institutions. The majority of these loan participations pertained to out-of-area ADC projects. Gordon also maintained a securities portfolio that included preferred shares in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

Audit Results

Causes of Failure and Loss

According to supervisory records and institution data that we reviewed, Gordon failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the bank's concentration in ADC loans. Between 2004 and 2007, the bank increased its ADC loans from $3.8 million (or 17 percent of total loans) to $11.1 million (or 40 percent of total loans). Much of this growth resulted from purchasing loan participations from other financial institutions. However, Gordon did not perform adequate due diligence before it acquired the loan participations, and many of the participations were not adequately underwritten or properly administered thereafter.

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Report No. AUD-11-006
May 2011

After the Georgia real estate market weakened in 2007, the quality of Gordon's loan portfolio deteriorated. Adding to Gordon's financial problems were losses of approximately $1.8 million pertaining to the bank's preferred shares in Fannie Mae and Freddie Mac. Gordon's financial condition continued to deteriorate during 2009 and 2010, with the majority of problems centered in ADC loans. The losses and provisions associated with Gordon's loan portfolio and securities investments eliminated the bank's earnings and depleted its capital. The DBF closed Gordon on October 22, 2010 because the institution was unable to raise sufficient capital to support its operations, and its condition was deemed to be unsafe and unsound.

The FDIC's Supervision of Gordon

The FDIC, in coordination with the DBF, provided supervisory oversight of Gordon through on-site risk management examinations, visitations, and various off-site monitoring activities. The FDIC determined that Gordon's overall condition was satisfactory until the October 2008 examination, at which time the FDIC identified significant financial deterioration and downgraded the bank's supervisory composite rating from a "2" to a "5." Based on the results of the examination, the FDIC and the DBF issued a cease and desist order on May 11, 2009 that, among other things, required Gordon to have and retain qualified management, improve its lending and collection policies, and strengthen its capital position. At that time, the bank's lending markets were deteriorating, making remedial efforts difficult. The FDIC and the DBF also conducted visitations in May 2009 and July 2010. These visitations found the bank's financial condition to be critically deficient.

Examinations of Gordon between 2006 and 2008 did not satisfy the minimum frequency requirements defined in the FDI Act. Specifically, the length of time between the June 2006 examination and the October 2008 examination was approximately 8 months longer than permitted by the statute. The FDIC made a risk-based decision to postpone an examination of Gordon in 2008 based on limited resources and higher priority concerns pertaining to other institutions that were experiencing significant financial deterioration. An earlier examination of Gordon would likely have identified deterioration in the bank's financial condition, potentially resulting in earlier supervisory actions. However, the majority of assets that caused Gordon to fail had been acquired prior to 2008. In this regard, FDIC officials with whom we spoke indicated that it is unlikely that an earlier examination or supervisory actions would have materially affected the course of the bank's financial decline or the cost to the DIF.

With respect to PCA, the FDIC implemented supervisory actions that were consistent with relevant provisions of section 38. As discussed in the report, the FDIC did not request a capital restoration plan from Gordon when it became *Critically Undercapitalized*. Doing so would have been consistent with FDIC policy and would have provided an additional avenue for ensuring the Board's awareness of its responsibility under section 38 to submit an acceptable capital restoration plan. The FDIC implemented various supervisory activities that served to mitigate the effect of Gordon's failure to submit a capital restoration plan.

Management Response

On May 5, 2011, the Director of the FDIC's Division of Risk Management Supervision provided a written response to a draft of this report. In the response, the Director reiterated the OIG's conclusions regarding the causes of Gordon's failure and described key supervisory actions that the FDIC and the DBF took to address the bank's deteriorating financial condition. The response also referenced guidance that had been issued in 2006 and 2008 re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. The response did not specifically address the issue described in the report pertaining to examinations that did not satisfy the minimum frequency requirements defined in the FDI Act.

Contents

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits
Office of Inspector General

DATE: May 11, 2011

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

/Signed/

FROM: Mark F. Mulholland
Deputy Assistant Inspector General for Audits

SUBJECT: *In-Depth Review of the Failure of The Gordon Bank, Gordon, Georgia* (Report No. AUD-11-006)

On October 22, 2010, the Georgia Department of Banking and Finance (DBF) closed The Gordon Bank (Gordon), Gordon, Georgia and the Federal Deposit Insurance Corporation (FDIC) was appointed receiver. On November 18, 2010, the FDIC notified the Office of Inspector General (OIG) that the bank's total assets at closing were $30.5 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $8.6 million. As of January 31, 2011, the estimated loss had increased to $8.9 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (the FDI Act) by increasing the threshold for a material loss review (MLR) from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that may warrant an in-depth review (IDR) of the loss. Although the estimated loss for Gordon does not meet the amended threshold requiring an MLR, we determined that unusual circumstances exist because examinations of the institution between 2006 and 2008 did not satisfy the minimum frequency requirements defined in the FDI Act. Accordingly, we initiated an IDR as authorized by the Financial Reform Act.

The objectives of the review were to (1) determine the causes of Gordon's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Gordon, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. A primary area of focus during the review was the frequency of on-site risk management examinations in the several years preceding the bank's failure.

This report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss and in-depth reviews, we will communicate those to FDIC management for its consideration.

As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted. This report includes several appendixes. Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of key terms; Appendix 3 contains a list of acronyms; and Appendix 4 contains management's written comments on a draft of this report.

We note that, in conjunction with other organizational changes made to enhance the FDIC's ability to carry out its new and enhanced responsibilities under the Financial Reform Act, the Division of Supervision and Consumer Protection (DSC) became the Division of Risk Management Supervision effective February 13, 2011. As a result of the timing of our review and draft report issuance, we refer to DSC throughout this report.

Background

Gordon was established in 1946 as a state-chartered nonmember bank. In 1994, the institution converted to a federally chartered savings and loan association to facilitate an expansion into Florida. However, Gordon's entry into Florida was poorly executed, and by 2002 the bank was operating under a supervisory agreement with the Office of Thrift Supervision. In an effort to improve its financial condition, Gordon exited the Florida market in 2003. In 2004, the institution converted back to a state charter and its financial condition improved.

Gordon's lending activities focused primarily on real estate, including commercial real estate (CRE) and acquisition, development, and construction (ADC). Because local loan demand was low in 2005 and 2006, management purchased loan participations from other institutions, including FirstCity Bank of Stockbridge, Georgia, which failed on March 20, 2009. The majority of loan participations purchased by Gordon pertained to out-of-area ADC projects. In addition to its lending activities, Gordon maintained a securities portfolio that included preferred shares in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).[1]

At the time of its closing, Gordon operated a single office in the small rural community of Gordon, which is located approximately 100 miles southeast of Atlanta, Georgia. The bank was one of two institutions in a chain banking organization controlled by the family of an individual who served as both a Director and the Chief Executive Officer of Gordon. The other institution in the chain organization did not fail. Table 1 summarizes select financial information pertaining to Gordon for the calendar year ended 2009 and for the preceding 5 calendar years.

[1] Fannie Mae and Freddie Mac are Government Sponsored Enterprises (GSE). See the glossary for more information on Fannie Mae and Freddie Mac.

Table 1: Select Financial Information for Gordon, 2004-2009

Financial Measures ($000s)	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets	30,620	34,988	39,271	39,676	40,327	38,068
Total Deposits	26,577	29,239	30,869	31,677	31,119	31,077
Total Loans	16,142	22,657	27,041	28,370	28,713	21,055
CRE to Total Capital	547%	555%	324%	346%	282%	182%
ADC to Total Capital	277%	3077%	175%	182%	133%	56%
Net Income (Loss)	-1,191	-3,145	412 45	0	345	133

Source: Uniform Bank Performance Reports (UBPR) for Gordon.

Causes of Failure and Loss

According to supervisory records and institution data that we reviewed, Gordon failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the bank's concentration in ADC loans.[2] Between 2004 and 2007, the bank increased its ADC loans from $3.8 million (or 17 percent of total loans) to $11.1 million (or 40 percent of total loans). Much of this growth resulted from purchasing out-of-area loan participations from other financial institutions. However, Gordon did not perform adequate due diligence before it acquired the loan participations, and many of the participations were not adequately underwritten or properly administered thereafter. For example, the institution did not conduct sufficient global cash flow analyses of borrowers, verify borrower cash positions, or inspect construction sites before disbursing funds. Further, Gordon did not adequately monitor conditions in its ADC lending markets or perform stress testing of its loan portfolio to assess the impact of a sustained downturn in the real estate market.

After the Georgia real estate market began to weaken in 2007, the quality of Gordon's loan portfolio deteriorated. By the close of 2008, nearly 30 percent of the institution's loan portfolio was in a non-accrual status. Adding to Gordon's financial problems were losses of approximately $1.8 million pertaining to the bank's preferred shares in Fannie Mae and Freddie Mac.[3] Gordon's financial condition continued to deteriorate during 2009 and 2010, with the majority of problems centered in ADC loans. The losses and provisions associated with Gordon's loan portfolio and securities investments eliminated the bank's earnings and depleted its capital. The DBF closed Gordon on October 22, 2010 because the institution was unable to raise sufficient capital to support its operations, and its condition was deemed to be unsafe and unsound.

[2] In analyzing the causes of Gordon's failure and loss to the DIF, we relied primarily on examination and visitation reports, an August 9, 2010 *Supervisory History* for Gordon prepared by DSC, and institution data in Consolidated Reports of Condition and Income (Call Report), UBPRs, and the FDIC's Virtual Supervisory Information on the Net system.

[3] On September 7, 2008, the Director of the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship, eliminating much of the market value of the GSE's preferred shares.

The FDIC's Supervision of Gordon

The FDIC, in coordination with the DBF, provided supervisory oversight of Gordon through on-site risk management examinations, visitations, and various off-site monitoring activities.[4] As described later, on-site examinations of the institution between 2006 and 2008 did not satisfy the minimum frequency requirements defined in the FDI Act. The FDIC made a risk-based decision to postpone an examination of Gordon during 2008 based on limited resources and higher priority concerns pertaining to other institutions that were experiencing significant financial deterioration. Table 2 summarizes key supervisory information pertaining to Gordon in the years preceding its failure.

Table 2: On-site Examinations and Visitations of Gordon

Start Date	Examination or Visitation	Regulator(s)	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken*
07/12/2010	Visitation	FDIC and DBF	-	C&D Remained in Effect
11/19/2009	Examination	FDIC and DBF	555544/5	C&D Remained in Effect
05/18/2009	Visitation	FDIC and DBF	554533/5	C&D Remained in Effect
10/06/2008	Examination	FDIC	554543/5	C&D Effective May 11, 2009
06/29/2006	Examination	DBF	122222/2	None
12/06/2004	Examination	FDIC	122312/2	BBR Remained in Effect**

Source: OIG analysis of examination and visitation reports and the May 2009 C&D.
*Informal enforcement actions often take the form of Bank Board Resolutions (BBR) or Memoranda of Understanding. Formal enforcement actions often take the form of Cease and Desist Orders (C&D), but under severe circumstances, can also take the form of insurance termination proceedings.
** Gordon entered into a BBR in July 2004 to address regulatory concerns cited during a May 2004 charter conversion examination.

Gordon's overall financial and operational condition was considered satisfactory until the October 2008 examination, which was based on financial information as of June 30, 2008. During that examination, the FDIC identified significant financial deterioration and downgraded the bank's supervisory composite rating from a "2" to a "5." The FDIC advised Gordon's Board and management of the concerns identified during the examination, including the bank's significant exposure to ADC loans in a weakening real estate market, poor loan underwriting and credit administration practices (particularly with respect to loan participations), and weak investment management practices. Based on the results of the examination, the FDIC and the DBF issued a C&D on May 11, 2009 that included requirements for Gordon to:

- Have and retain qualified management.

[4] The FDIC's off-site monitoring activities generally consisted of contacting the bank's management from time to time to discuss current and emerging business issues and using automated tools to analyze information in Gordon's Call Reports to identify potential supervisory concerns.

- Maintain Tier 1 Capital and Total Risk-based Capital ratios of at least 8 percent and 10 percent, respectively.

- Reduce the amount of its classified assets.

- Improve its lending and collection policies.

- Revise its investment policy.

At the time the C&D was issued, the bank's lending markets had already experienced a significant deterioration, making remedial efforts difficult. The FDIC and DBF conducted a visitation in May 2009 to follow up on the issues identified during the October 2008 examination. The FDIC and DBF also conducted a visitation in July 2010 to assess the condition of the bank and management's efforts to comply with the May 2009 C&D. Both visitations found that the bank's financial condition was critically deficient. As previously stated, the DBF closed Gordon in October 2010.

Frequency of Examinations for Gordon

On-site examinations are considered one of the most important aspects of the bank supervisory process. In that regard, Section 10(d) of the FDI Act states that the appropriate Federal banking agency shall, not less than once during each 12-month period, conduct a full-scope, on-site examination of each insured depository institution. According to the Act, the annual examination interval may be increased to 18 months for small institutions that meet certain conditions.[5] Because Gordon was considered a small institution and met the conditions defined in the FDI Act, the institution was on an 18-month examination cycle prior to October 2008.

For purposes of measuring compliance with the examination frequency requirements of the FDI Act, Section 1.1 of the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) defines how the 12- and 18-month examination cycles should be measured. Specifically, the Examination Manual states that the length of time between the end of one examination and the start of the next examination should not exceed 12 (or 18) months, regardless of whether one or both of the examinations are conducted by a state supervisory agency or the FDIC. The Examination Manual defines the end of an examination as the earlier of (1) the date that the examination report is submitted for FDIC review or (2) 60 calendar days from the examination start date. The FDIC's *Report of Examination Instructions* defines the examination start date as the date when the examination team begins the formal on-site examination of the institution.

[5] The examination interval may be extended to 18 months for institutions that: (1) have total assets of less than $500 million; (2) are *Well Capitalized* as defined in section 38; (3) are determined to be well-managed during the most recent examination; (4) have an outstanding composite condition (or an outstanding or good composite condition in the case of institutions with total assets of $100 million or less); (5) are not subject to a formal enforcement proceeding or order; and (6) have not experienced a change in control during the preceding 12-month period in which a full-scope, on-site examination would have been required but for the above noted exceptions. (See Section 10(d)(4) of the FDI Act, 12 U.S.C. § 1820(d)(4).)

Using the criteria in the Examination Manual, the June 2006 examination of Gordon ended on July 26, 2006. Therefore, the next examination should have started no later than January 26, 2008. However, the actual start date for the next examination was October 6, 2008, approximately 8 months later than permitted by the Examination Manual and the FDI Act. The Atlanta Regional Office documented the decision to postpone the examination of Gordon in quarterly examination delinquency reports[6] submitted to DSC's Washington, D.C., Office.

DSC officials in the Atlanta Regional Office and the Atlanta Field Office advised us that they made a risk-based decision to postpone the examination of Gordon based on limited resources and higher priority concerns pertaining to other institutions that were experiencing significant financial deterioration. DSC officials explained that several factors supported their decision to postpone the examination. Specifically, Gordon had a satisfactory composite rating, was *Well Capitalized* for purposes of PCA, and was not showing signs of significant financial deterioration based on off-site monitoring. In addition, Gordon was among the smallest institutions in terms of total assets that the Atlanta Regional Office supervised and, therefore, posed lesser risk to the DIF than other institutions.

DSC took a number of steps during 2008 to better align examination resources in the Atlanta Regional Office with the rapid deterioration in the banking sector. Among other things, the division hired additional examiners, assigned examiners from other regional offices to assist with the examination workload, and coordinated with the DBF to leverage limited examination resources.

As previously stated, the FDIC identified significant financial deterioration during the October 2008 examination of Gordon and downgraded the bank's supervisory composite rating from a "2" to a "5." An earlier examination of Gordon would likely have identified deterioration in the bank's financial condition, potentially resulting in earlier supervisory actions that may have mitigated, to some extent, the problems experienced by the bank. However, the majority of assets that caused Gordon to fail had been acquired prior to 2008. Notably, many of the ADC loans classified by examiners during the October 2008 examination had been purchased by Gordon in 2006. In this regard, FDIC officials with whom we spoke indicated that it is unlikely that an earlier examination or supervisory actions would have materially affected the course of the bank's financial decline or the cost to the DIF.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and

[6] The examination delinquency reports identified institutions in the Atlanta Regional Office that were past due for a required examination. The reports were submitted to the Washington, D.C., Office on a quarterly basis until September 30, 2008. Beginning in October 2008, the reports were submitted on a monthly basis.

Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

The FDIC implemented supervisory actions with respect to Gordon that were consistent with the PCA provisions of section 38. Among other things, the FDIC notified the institution's Board when the bank became *Critically Undercapitalized*, monitored the bank's capital position, and held discussions with management regarding its efforts to raise needed capital. However, as discussed below, the FDIC did not request a capital restoration plan from Gordon when it became *Critically Undercapitalized*. Doing so would have been consistent with FDIC policy in this area and would have provided an additional avenue for ensuring the Board's awareness of its responsibility under section 38 to submit an acceptable capital restoration plan. Table 3 illustrates Gordon's capital levels relative to the PCA thresholds for *Well Capitalized* institutions between December 2005 and September 2010.

Table 3: Gordon's Capital Levels, 2005-2010

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well Capitalized Thresholds	**5% or more**	**6% or more**	**10% or more**	
Gordon's Capital Levels				
Dec-2005	16.64%	23.00%	24.27%	*Well Capitalized*
Dec-2006	13.60%	18.96%	20.23%	*Well Capitalized*
Dec-2007	15.08%	20.11%	21.38%	*Well Capitalized*
Dec-2008	8.12%	11.39%	12.72%	*Well Capitalized*
Dec-2009	5.32%	8.83%	10.12%	*Adequately Capitalized**
Mar-2010	5.26%	8.62%	9.92%	*Adequately Capitalized*
Jun-2010	1.05%	2.05%	3.35%	*Critically Undercapitalized*
Sep-2010	-0.14%	-0.28%	-0.28%	*Critically Undercapitalized*

Source: OIG analysis of UBPRs for Gordon.
*As described in the narrative below, Gordon was considered *Adequately Capitalized* for purposes of PCA at the end of 2009 because the institution was operating under a C&D with a capital maintenance provision.

Gordon was considered *Well Capitalized* until May 11, 2009, at which time the FDIC and DBF implemented a C&D against the bank. Although Gordon's capital ratios were above the PCA thresholds for *Well Capitalized* institutions at that time, the C&D had the effect of lowering the bank's PCA capital category to *Adequately Capitalized* because the order contained a capital maintenance provision. The FDIC and DBF included a capital maintenance provision in the C&D based on the results of the October 2008 examination, which found the bank's capital adequacy to be critically deficient. The October 2008 examination report stated that Gordon's Board needed to immediately develop a capital policy to ensure that the bank maintained a satisfactory capital position. The report added that the capital policy needed to include, among other things, contingency plans for raising additional capital.

Examiners noted during the November 2009 examination that Gordon had developed a capital contingency plan. However, the plan was not considered adequate because it was limited to increasing capital through internal means, such as shrinking assets and increasing earnings through tighter expense control. The November 2009 examination report stated that the bank needed to immediately revise its capital contingency plan to address outside sources of capital, such as shareholders. During the July 2010 visitation, examiners noted that the institution had not implemented a plan to obtain additional capital and was not in compliance with the capital maintenance provision of the C&D.

In a letter dated August 2, 2010, the FDIC notified Gordon's Board that, based on its June 30, 2010 Call Report, the bank had fallen to a *Critically Undercapitalized* position. The notification letter referenced a number of the restrictions imposed on *Critically Undercapitalized* institutions and advised the Board to develop policies and procedures to ensure compliance. Due to an oversight, the FDIC did not request a capital restoration plan from Gordon as prescribed by FDIC policy.[7] In addition, Gordon never submitted a capital restoration plan to the FDIC. Requesting a capital restoration plan from Gordon would have provided an additional avenue for ensuring the Board's awareness of its responsibilities under section 38.

The FDIC implemented various supervisory activities that served to mitigate the effect of Gordon's failure to submit a capital restoration plan under section 38. As discussed above, the FDIC monitored and assessed the bank's plans and efforts to improve its capital position through on-site examinations and visitations. In addition, the FDIC held discussions with the bank's Board and management regarding their efforts to raise needed capital and reviewed quarterly progress reports submitted by Gordon pursuant to the May 2009 C&D that described the bank's efforts to comply with the order's capital maintenance provision. Gordon's efforts to raise needed capital were unsuccessful, and on October 22, 2010, the institution was closed.

Corporation Comments

On May 5, 2011, the Director, DSC, provided a written response to a draft of this report. That response is provided in its entirety as Appendix 4 of this report.

In its response, DSC reiterated the OIG's conclusions regarding the causes of Gordon's failure and described key supervisory actions that the FDIC and the DBF took to address the bank's deteriorating financial condition. The response also referenced guidance that had been issued in 2006 and 2008 re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. The response did not specifically address the issue

[7] Regional Directors Memorandum 96-090, *Use of Notification and Reconfirmation Letters Under Prompt Corrective Action ("PCA"),* states that PCA notification letters should request that the institution file a capital restoration plan with the appropriate FDIC Regional Office.

described in the report pertaining to examinations that did not satisfy the minimum frequency requirements defined in the FDI Act.

Objectives, Scope, and Methodology

Objectives

Consistent with the Financial Reform Act and the FDI Act, the objectives of the review were to (1) determine the causes of Gordon's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of Gordon, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. A key area of focus during the review was the frequency of on-site risk management examinations for Gordon.

We conducted this performance audit from January 2011 to March 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

To achieve the objectives, we performed the following audit procedures:

- Analyzed key documentation pertaining to the supervision and failure of Gordon, including:
  - Examination and visitation reports issued by the FDIC and DBF between 2004 and 2010.
  - Institution data in Call Reports, UBPRs, and the FDIC's Virtual Supervisory Information on the Net system.
  - FDIC and DBF correspondence.
  - DSC's Supervisory History for Gordon, dated August 9, 2010.
  - The failing bank case for Gordon presented to the FDIC's Board of Directors.
  - Pertinent FDIC regulations, policies, procedures, and guidance.
- Spoke with selected DSC examination staff in the Washington, D.C., Office; the Atlanta Regional Office; and the Atlanta Field Office.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems and reports and

Objectives, Scope, and Methodology

discussions with examination staff to understand Gordon's management controls pertaining to the causes of failure and loss as discussed in the body of this report.

We obtained data from various FDIC systems, but determined that information system controls were not significant to the audit objectives. Therefore, we did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. We did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations, particularly with respect to examination frequency. The results of our tests are discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum indicated that the OIG planned to provide more in-depth coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR and IDR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. In addition, the OIG issued an audit report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

Further, with respect to more in-depth coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *Prompt Corrective Action*, and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE that provide funding for acquiring and developing land for future construction, and that provide interim financing for residential or commercial structures.
Bank Board Resolution (BBR)	A BBR is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C., section 1818, to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 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.
Fannie Mae and Freddie Mac	Fannie Mae and Freddie Mac are shareholder-owned corporations with government charters. The organizations play a critical role in the U.S. home mortgage market by purchasing home mortgages from original lenders, repackaging them as mortgage-backed securities, and either selling or holding them in their investment portfolios. Fannie Mae and Freddie Mac purchased about 80 percent of all new home mortgages in the United States during 2008, and their combined investment portfolios held mortgage assets valued at $1.5 trillion as of June 30, 2008.

Glossary of Terms

Nonaccrual Status	The status of an asset, often a loan, that is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.
Preferred Shares	Preferred shares (or stock) are special-equity securities having characteristics of both equity and debt instruments. Preferred shares are senior in priority to common shares, but subordinate to bonds. Preferred shares typically do not have voting rights, but the shares often have priority over common shares in the payment of dividends and upon liquidation. Preferred shares may carry a dividend that is paid prior to any dividends to common stockholders.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. Seq. implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C., section 1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three undercapitalized categories.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from data in Call Reports submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Acronyms

ADC	Acquisition, Development, and Construction
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DBF	Georgia Department of Banking and Finance
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
IDR	In-depth Review
MLR	Material Loss Review
OIG	Office of Inspector General
PCA	Prompt Corrective Action
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Risk Management Supervision

May 5, 2011

TO: Mark Mulholland
Deputy Assistant Inspector General for Audits

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: Response to Draft Audit Report Entitled, In-Depth Review of the Gordon Bank, Gordon, Georgia (Assignment 2011-029)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted an In-Depth Review of The Gordon Bank (Gordon), which failed on October 22, 2010. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on March 23, 2011.

Gordon failed due to the Board's and management's ineffective oversight of the risk associated with the high concentration of acquisition, development and construction (ADC) loans. From 2004 to 2007 Gordon substantially increased its ADC loan portfolio in part with the purchase of out-of-area loan participations that were not adequately underwritten. Loan provisions and losses in securities investments eliminated earnings and depleted capital. Gordon was unable to raise sufficient capital to operate in a safe and sound condition.

From 2004 through 2010, the FDIC and the Georgia Department of Banking and Finance conducted four risk management examinations, two on-site visitations and off-site reviews. The 2008 FDIC examination found that Gordon's overall condition had rapidly deteriorated, earnings performance was critically deficient and capital did not support Gordon's risk profile. As a result, Gordon was downgraded and a Cease and Desist order was issued.

DSC issued *Interagency Guidance on CRE Monitoring* in 2006 and a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* in 2008 that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

Thank you for the opportunity to review and comment on the Report.

Addendum

Events Leading to Management Providing a Revised Response to the Final Report

On May 11, 2011, the OIG issued its final report on the *In-Depth Review of the Failure of The Gordon Bank, Gordon, Georgia*. The review was conducted in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act. Although the estimated loss for the institution did not meet the amended threshold requiring a material loss review, the OIG determined that circumstances existed warranting an in-depth review of the loss as authorized by the Financial Reform Act. Specifically, the OIG determined that examinations of Gordon between 2006 and 2008 did not satisfy the minimum frequency requirements defined in the FDI Act.

The OIG presented its final report on Gordon to the FDIC Audit Committee on May 20, 2011. During that presentation, it was noted that RMS' written response to the report did not specifically address the issue described in the report pertaining to the frequency of Gordon's examinations. As a result, members of the Audit Committee requested that RMS provide the OIG with a revised response to the final report addressing this issue.

Management's revised response, along with our evaluation of the response, follows.

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Risk Management Supervision

June 7, 2011

TO: Mark Mulholland
Deputy Assistant Inspector General for Audits

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: Response to Draft Audit Report Entitled, In-Depth Review of the Gordon Bank, Gordon, Georgia (Assignment 2011-029)

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From 2004 through 2010, the FDIC and the Georgia Department of Banking and Finance conducted four risk management examinations, two on-site visitations and off-site reviews. The 2008 FDIC examination found that Gordon's overall condition had rapidly deteriorated, earnings performance was critically deficient and capital did not support Gordon's risk profile. As a result, Gordon was downgraded and a \ Cease and Desist order was issued.

Regarding examination scheduling, the FDIC has a longstanding policy of allowing some limited administrative discretion to vary from prescribed examination timeframes in appropriate circumstances. The FDIC's Legal Division has previously reviewed these policies and opined that the policies are a reasonable and permissible interpretation of the FDI Act by the FDIC. This "managed delinquency" process is tightly controlled, changes are tracked, and changes are reported to the RMS Director. As the OIG noted, the RMS Director was notified of the delayed examination schedule in the case of Gordon Bank. That delay largely reflected a determination by the Atlanta Regional Office that other institutions posed greater risks that needed to be addressed before Gordon Bank was examined.

DSC issued *Interagency Guidance on CRE Monitoring* in 2006 and a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* in 2008 that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

Thank you for the opportunity to review and comment on the Report.

OIG Evaluation of Management's Revised Response

As shown on the prior page, on June 7, 2011, the Director, RMS, provided a written response to our final report.

In its response, RMS reiterated the OIG's conclusions regarding the causes of Gordon's failure and described key supervisory actions that the FDIC and the Georgia Department of Banking and Finance took to address the bank's deteriorating financial condition. The response also referenced guidance that had been issued in 2006 and 2008 re-emphasizing the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

With respect to the frequency of Gordon's examinations, the response stated that the FDIC has a longstanding policy of allowing some limited administrative discretion to vary from prescribed examination timeframes in appropriate circumstances. According to the response, the FDIC's Legal Division has opined that this interpretation of the FDI Act is reasonable and permissible. The response added that this "managed delinquency" process is tightly controlled, and that changes are tracked and reported to the RMS Director. Further, the response noted that the delay in examining Gordon largely reflected a determination by the Atlanta Regional Office that other institutions posed greater risks that needed to be addressed.

Management's response adequately addresses our findings and conclusions.