Office of Inspector General

Office of Audits and Evaluations
Report No. AUD-12-013

Material Loss Review of The First State Bank, Stockbridge, Georgia

September 2012

Office of Inspector General

Executive Summary

Material Loss Review of The First State Bank, Stockbridge, Georgia

Report No. AUD-12-013
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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the Deposit Insurance Fund (DIF) incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. Section 38(k) establishes a material loss review (MLR) threshold of $150 million for losses that occur for the period January 1, 2012 through December 31, 2013. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

On January 20, 2012, the Georgia Department of Banking and Finance (GDBF) closed The First State Bank (FSB) and the FDIC was appointed receiver. On March 13, 2012, the FDIC notified the Office of Inspector General (OIG) that FSB's total assets at closing were $528.7 million and that the estimated loss to the DIF was $216.2 million. The FDIC OIG engaged BDO USA, LLP (BDO) to conduct an MLR of FSB. The performance audit objectives were to (1) determine the causes of FSB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of FSB, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

Established on October 8, 1964, FSB was a commercial bank based in Stockbridge, Georgia, which is located about 20 miles south of Atlanta. The institution maintained seven branches in its primary market area of Henry County, Georgia, and the surrounding counties in the Atlanta metropolitan area. The bank was wholly owned by a one-bank holding company, the Henry County Bancshares, Inc., Stockbridge, Georgia. FSB's lending strategy focused primarily on commercial real estate (CRE), particularly residential acquisition, development, and construction (ADC) projects.

Audit Results

Causes of Failure and Material Loss

FSB failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the bank's heavy concentrations in CRE and ADC loans. Among other things, the Board and management did not establish prudent ADC loan concentration limits or maintain capital at levels that were commensurate with the risk in the bank's loan portfolio. Lax lending practices also contributed to the asset quality problems that developed when economic conditions in FSB's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. In addition, FSB's management was slow to recognize the deterioration in its loan portfolio and was unable to successfully address the depth and breadth of the bank's financial problems.

FSB's significant exposure to ADC loans, coupled with weak risk management practices, made the bank vulnerable to a sustained downturn in the Georgia real estate market. In late 2007, conditions in FSB's primary lending areas began to deteriorate, resulting in a decline in the quality of the loan portfolio. Much of this decline was centered in ADC loans. FSB's financial condition continued to deteriorate between 2008 and 2011. The associated provisions for loan losses depleted FSB's earnings, eroded its capital, and strained its liquidity. The GDBF closed FSB on January 20, 2012 due to the institution's inability to raise sufficient capital to support safe and sound banking operations.

The FDIC's Supervision of FSB

The FDIC, in coordination with the GDBF, provided ongoing supervisory oversight of FSB through onsite risk management examinations, visitations, and offsite monitoring activities. Through its supervisory efforts, the FDIC identified key risks in FSB's operations and brought these risks to the attention of the institution's Board and management. Such risks included the bank's significant concentrations in CRE and ADC loans and weak loan underwriting, credit administration, and related monitoring practices. The FDIC and GDBF also made numerous recommendations for improvement and implemented enforcement actions in the form of a Memorandum of Understanding, Consent Order, and Supervisory PCA Directive.

Like other institutions that failed in recent years, FSB developed a significant exposure to ADC loans at a time when the bank's financial condition and lending markets were favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market. Such an exposure would have been subject to a more critical risk assessment under the FDIC's current approach to supervision, which involves greater emphasis on risk management practices for institutions with elevated risk profiles, such as FSB, and a stronger supervisory response—including accelerated examinations or visitations, lower ratings, and/or supervisory actions—when risks are not being properly managed. However, it is uncertain whether an alternative supervisory approach and response would have been effective in limiting FSB's financial deterioration or the loss to the DIF. Examiners became sharply critical of FSB's risk management practices beginning with the FDIC's November 2007 examination and issued supervisory enforcement actions in 2009 and 2010, respectively. By that time, the bank's lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. Such actions include instituting a training initiative for examiners that emphasizes risk management practices for institutions with high-risk profiles and issuing additional supervisory guidance on CRE and ADC concentrations.

With respect to PCA, the FDIC implemented supervisory actions that were consistent with relevant provisions of section 38.

Management Response

Subsequent to the issuance of BDO's draft report, officials in the FDIC's Division of Risk Management Supervision (RMS) provided additional information for BDO's consideration, and BDO revised its report to reflect this information, as appropriate. On September 10, 2012, the Director, RMS, provided a written response to a draft of this report. In the response, the Director reiterated the causes of failure and supervisory activities described in the report. Further, the response stated that RMS recognized the threat that institutions with high-risk profiles, such as FSB, pose to the DIF and issued to FDIC-supervised institutions a 2008 Financial Institution Letter (FIL), entitled, M*anaging Commercial Real Estate Concentrations in a Challenging Environment.* The FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

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

Office of Audits and Evaluations
Office of Inspector General

DATE: September 13, 2012

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

/Signed/

FROM: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

SUBJECT: *Material Loss Review of The First State Bank, Stockbridge, Georgia* (Report No. AUD-12-013)

The subject final report is provided for your information and use. The report does not contain recommendations, thus a response was not required. However, the Division of Risk Management Supervision provided a written response on September 10, 2012. We incorporated the response into Part II of the final report.

If you have questions concerning this report, please contact me at (703) 562-6352 or Mark Mulholland, Assistant Inspector General for Audits, at (703) 562-6316. We appreciate the courtesies extended to the Office of Inspector General and contractor staff.

Attachment

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Part I

Report by BDO USA, LLP

Audit Report
Material Loss Review

The First State Bank, Stockbridge, Georgia

September 12, 2012

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7101 Wisconsin Ave, Suite 800
Bethesda, MD 20814

September 12, 2012

Stephen M. Beard
Deputy Inspector General for Audits and Evaluations
Federal Deposit Insurance Corporation
3501 Fairfax Drive
Arlington, VA 22226

Re: Transmittal of Results of the Material Loss Review Report of The First State Bank, Stockbridge, Georgia

Dear Mr. Beard:

This letter submits our final report representing the Material Loss Review of The First State Bank, Stockbridge, Georgia, in accordance with Contract Number CORHQ-09-G-0341, dated December 4, 2009. The audit objectives were to (1) determine the causes of The First State Bank's failure and resulting material loss to the Deposit Insurance Fund and (2) evaluate the FDIC's supervision of The First State Bank, including the FDIC's implementation of the Prompt Corrective Action provisions of section 38 of the Federal Deposit Insurance Act. As part of our work, we (1) interviewed key examination and supervisory personnel at the FDIC and the Georgia Department of Banking and Finance, and (2) reviewed examination and supervisory records, including supporting examination workpapers.

We conducted our performance audit 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.

The information included in this report was obtained during our fieldwork, which occurred during the period March 2012 through August 2012.

Please contact Thomas Cooper at 301-654-4900 if you have any questions or comments regarding this report.

Very truly yours,

BDO USA, LLP

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Why We Did the Audit

Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), provides, in general, that if the Deposit Insurance Fund (DIF) incurs a material loss[1] with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. Section 38(k) establishes a material loss review (MLR) threshold of $150 million for losses that occur for the period January 1, 2012 through December 31, 2013. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

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Background

Established on October 8, 1964, FSB was a commercial bank based in Stockbridge, Georgia, which is located about 20 miles south of Atlanta. The institution maintained seven branches in its primary market area of Henry County, Georgia, and the surrounding counties in the Atlanta metropolitan area. The bank was wholly owned by a one-bank holding company, the Henry County Bancshares, Inc., Stockbridge, Georgia.

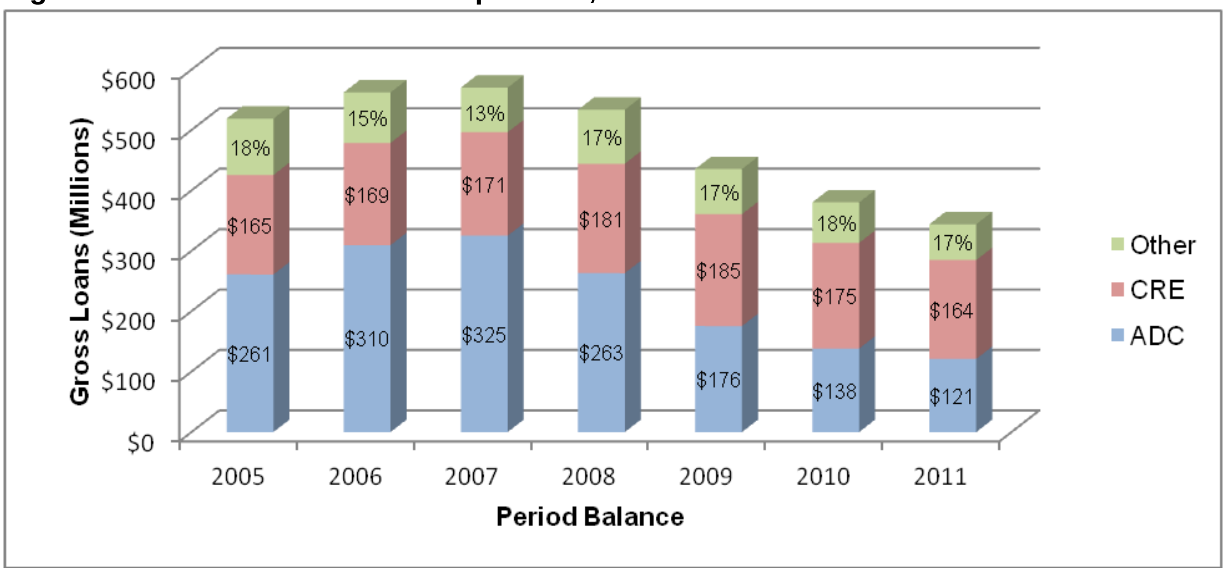
The state of Georgia experienced a total of 74 bank failures from the beginning of 2008 through January 19, 2012. The large number of failures in Georgia was due in large part to depressed real estate values, an oversupply of housing, and an elevated unemployment rate. The deterioration in the Georgia real estate market had a particularly hard impact on banks with

[1] Certain terms that are underlined when first used in this report are defined in Appendix 3, *Glossary of Terms*.

significant exposure to real estate lending in the Atlanta metropolitan area. After peaking in April 2007, home prices in Atlanta had fallen by almost 24 percent through May 2011.[2]

FSB's lending strategy focused primarily on commercial real estate (CRE), particularly residential acquisition, development, and construction (ADC) projects, for an extended period. Specifically, as of December 31, 2002, the bank had CRE and ADC concentration levels of 439 and 210 percent of total capital, respectively. These CRE and ADC concentrations levels increased to 634 percent and 410 percent of total capital, respectively, as of December 31, 2006. As illustrated in Figure 1, these concentrations also made up the vast majority of FSB's loan portfolio in the years preceding its failure.

Figure 1: FSB Loan Portfolio Composition, 2005-2011



Source: BDO Analysis of Consolidated Reports of Conditions and Income (Call Reports) for FSB.

Table 1 presents FSB's financial condition as of December 31, 2011, and for the six preceding years ended December 31.

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[2] Statement of the FDIC on *Potential Mixed Messages: Is Guidance from Washington Being Implemented By Federal Bank Examiners?* before the Subcommittee on Financial Institutions and Consumer Credit Committee on Financial Services House of Representatives; Newnan, Georgia on August 16, 2011.

Table 1: Select Financial Information for FSB, 2005-2011

Financial Measure ($000s) Omitted	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
Total Assets	630,873	694,157	718,831	655,717	614,406	563,746	516,760
Total Loans	518,114	561,646	569,388	533,608	434,891	380,242	344,134
Total Deposits	545,957	595,827	626,068	590,566	586,043	544,707	509,065
Brokered Deposits / Total Liabilities	4%	3%	2%	8%	11%	7%	3%
Time Deposits	300,247	361,657	406,307	389,762	402,355	358,767	312,199
Federal Home Loan Bank Advance / Total Liabilities	2%	3%	1%	0%	0%	0%	0%
Return on Average Assets	1.68%	1.84%	1.19%	(2.06%)	(5.60%)	(1.05%)	(2.06%)
Net Interest Margin	3.90%	4.31%	3.79%	2.48%	1.08%	1.89%	2.04%
Noncurrent Loans / Gross Loans	0.95%	0.25%	6.57%	18.34%	23.43%	23.27%	26.47%
ADC Loans / Total Capital	388%	410%	394%	401%	638%	655%	1,804%
CRE Loans / Total Capital	633%	634%	602%	678%	1,311%	1,484%	4,243%
Tier I Leverage Capital Ratio	9.59%	9.70%	9.85%	8.39%	3.27%	2.65%	0.60%
Total Risk-Based Capital Ratio	12.28%	12.59%	13.32%	11.55%	5.40%	4.35%	1.50%

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

Causes of Failure and Material Loss

FSB failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the bank's heavy concentrations in CRE and ADC loans. Among other things, the Board and management did not establish prudent ADC loan concentration limits or maintain capital at levels that were commensurate with the risk in the bank's loan portfolio. Lax lending practices also contributed to the asset quality problems that developed when economic conditions in FSB's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. In addition, FSB's management was slow to recognize the deterioration in its loan portfolio and was unable to successfully address the depth and breadth of the bank's financial problems.

FSB's significant exposure to ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the Georgia real estate market. In late 2007, conditions in FSB's primary lending areas began to deteriorate, resulting in a decline in the quality of the bank's loan portfolio. Much of the deterioration in the loan portfolio was centered in ADC loans. FSB's financial condition continued to deteriorate between 2008 and 2011. The associated provisions for loan losses depleted FSB's earnings, eroded its capital, and strained its liquidity. On January 20, 2012, the GDBF closed FSB due to the institution's inability to raise sufficient capital to support safe and sound banking operations.

Concentrations in ADC Loans

FSB maintained a large concentration in ADC loans throughout its history. The bank increased its ADC lending activities in response to a strong real estate market in the Atlanta metropolitan area between 2002 and 2007. However, as described below, FSB's Board and management did not effectively manage the risks associated with the institution's significant concentrations in ADC loans.

Loan Growth. During the 6-year period ended December 31, 2007, FSB grew its loan portfolio by 61 percent. Contributing to this growth was an increase in CRE loans (including ADC loans) from $215 million at year-end 2002 to $496 million at year-end 2007. By December 31, 2007, ADC loans represented 66 percent of FSB's $496 million CRE portfolio. FSB's ADC loans included speculative construction[3] and land development projects in Georgia.

Concentrations in CRE/ADC Loans. In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The purpose of the Joint Guidance was to reinforce existing regulations and guidelines for real estate lending and safety and soundness. The Joint Guidance states that the federal banking agencies have observed an increasing trend in the number of institutions with concentrations in CRE loans and noted that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the CRE market.

Although the Joint Guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint Guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

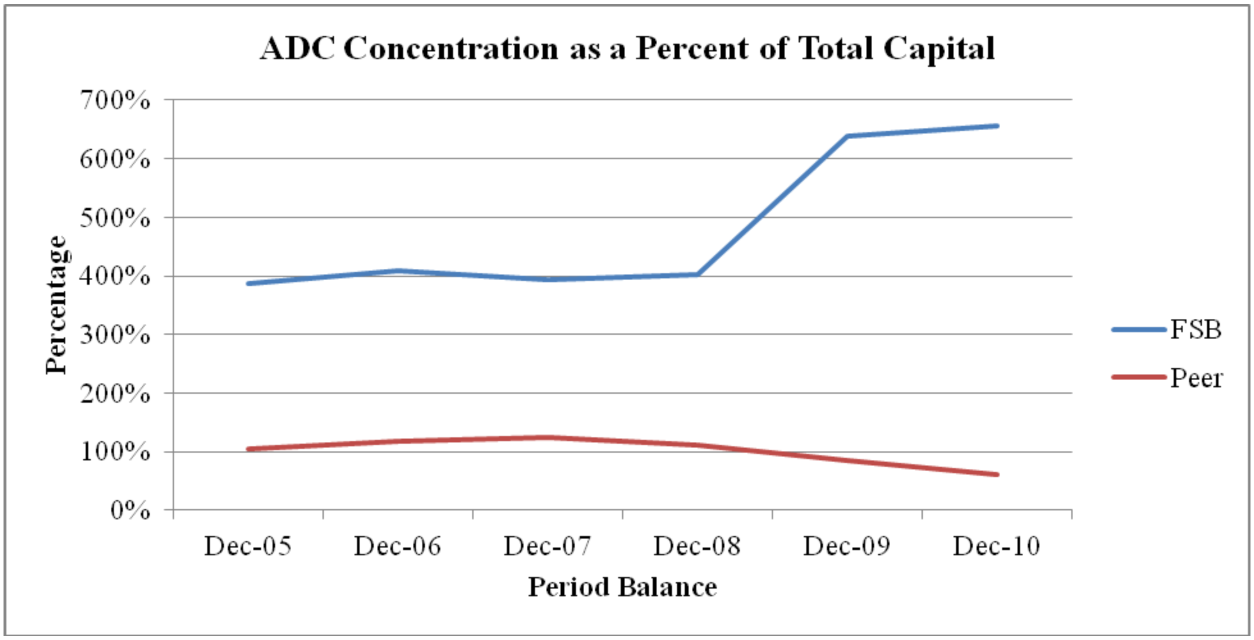
- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

- Total loans for construction, land development, and other land (referred to in this report as ADC loans) representing 100 percent or more of total capital.

[3] Speculative construction lending involves the financing of projects for which a buyer has not yet been identified.

FSB's ADC concentrations significantly exceeded the levels defined in the Joint Guidance as possibly warranting further supervisory analysis. As reflected in the following figure, FSB's ADC loan concentration also significantly exceeded the bank's peer group[4] average throughout the life of the bank. FSB was in the ninety-sixth percentile or higher when compared to their peer group for the period 2005 through 2010.

Figure 2: FSB's ADC Concentrations as a Percent of Total Capital, 2005-2010



Source: BDO analysis of UBPRs for FSB.

ADC lending generally involves a greater degree of risk than permanent financing for finished residences or commercial buildings. Associated risks include adverse changes in market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. The life cycle of these types of projects can vary in length due to consumer demand, which makes financing for such projects susceptible to increased risks during an extended economic downturn. Due to these and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans.

Although FSB had implemented certain controls for managing its ADC loan concentrations, its concentration risk management practices were not adequate. Among other things, the institution's loan policy established limits by category for the acquisition and development loans in relation to total loans. However, examiners noted in the 2007 examination report that FSB did

[4] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. FSB's peer group included all insured institutions with assets between $300 million and $1 billion.

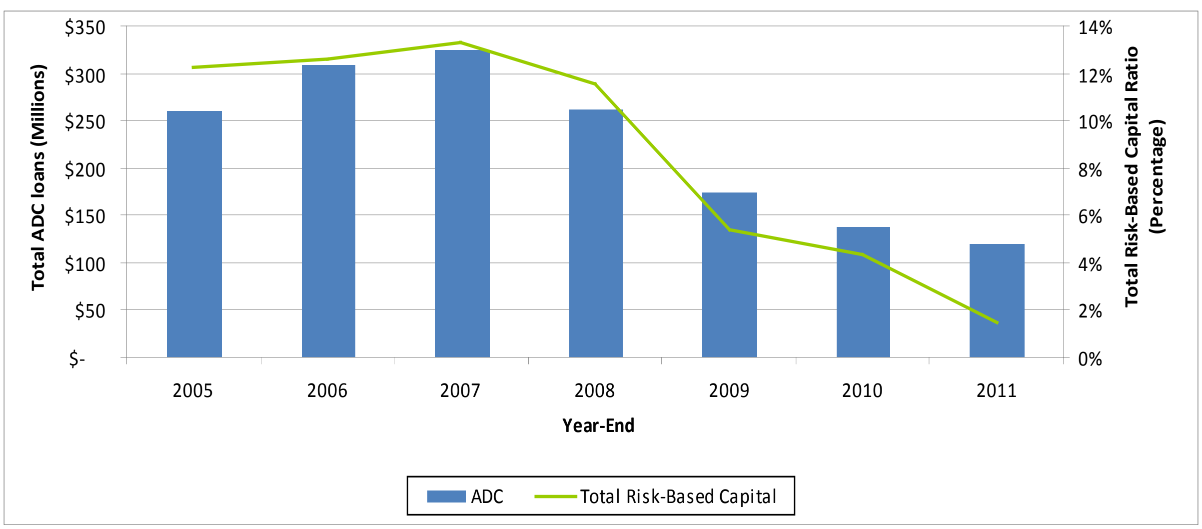
not follow the bank's internal guidelines limiting ADC concentrations, exposing the institution to potential adverse market conditions. In addition, GDBF examiners conveyed to management that the institution had not conducted stress tests on its ADC loan portfolio and had not adequately monitored the global debt or cash flows of its larger borrowers. Further, the bank did not develop a feasible contingency funding plan to mitigate the risks associated with its ADC loan concentration in the event of adverse market conditions until January 8, 2009.

Capital Levels

The Joint Guidance states that institutions with high levels of CRE concentrations should hold capital exceeding regulatory minimums and commensurate with the level of risk in the CRE lending portfolio. In addition, the FDIC's *Risk Management Manual of Examination Policies* states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed. Further, the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for purposes of PCA.

Figure 3 illustrates the trend in FSB's Total Risk-Based Capital ratios relative to the amount of ADC loans in the bank's loan portfolio during the years preceding the bank's failure. The bank's capital ratios were about the same as its peer group average despite having ADC loan concentrations that were significantly higher than peer. The bank's capital levels declined significantly during 2009, due in large part to ADC loan losses. Had FSB maintained higher capital ratios, loan growth may have been constrained and losses to the DIF may have been mitigated to some extent.

Figure 3: Trend in FSB's Total Risk-Based Capital Ratios Relative to ADC Loans, 2005-2011



Source: BDO analysis of UBPRs for FSB.

Lending Practices

Ineffective Board and management oversight of the lending function contributed to the asset quality problems that developed when the economy and FSB's local real estate market declined. References to weak loan underwriting, credit administration, and related monitoring practices were particularly prevalent in examination and visitation reports issued between 2007 and 2011. Some of FSB's risk management practices had the effect of delaying recognition of the growing deterioration in the bank's loan portfolio. The more salient weaknesses identified in examination and visitation reports related to FSB's lending practices follow. In addition, Appendix 1 describes FSB's risk management weaknesses and apparent violations of laws and regulations and contraventions of policy by examination and visitation for the period 2005 through 2011.

Loan Underwriting.

- **Global Cash Flow Analyses.** FDIC Financial Institution Letter (FIL)-22-2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, emphasizes the importance of performing global financial analyses for obligors. Such analyses can provide early indications of problems and are essential in determining whether it is prudent to continue working with a problem borrower or pursue an exit strategy. FSB did not routinely perform global cash flow analyses and did not consider the impact of larger borrowers' contingent liabilities.

- **Use of Interest Reserve Accounts -** Regional Directors Memorandum 2008-021, *Supervising Institutions with Commercial Real Estate Concentrations*, issued by the FDIC's Division of Risk Management Supervision (RMS), describes risks associated with the use of interest reserve accounts. The memorandum states that if a project experiences delays or has diminished feasibility resulting from a weak local real estate market, interest reserves can inappropriately disguise a problem credit relationship from appearing on delinquency reports. Accordingly, the effectiveness of a bank's control over interest reserve accounts and its internal reporting on the use of such reserves is important to institutions with ADC loan concentrations. In some instances, management's use of interest reserves was not acceptable. Specifically, examiners identified loans where interest reserves were used to fund principal or interest payments to keep loans current.

- **Legal Lending Limit -** Section 7-1-285 of the Financial Institutions Code of Georgia imposes limitations on the amount of loans to one borrower. The Section states, in part, that a bank shall not directly or indirectly make loans to any one person or corporation which, in aggregate, exceed 15 percent of the statutory capital base of the bank, unless the entire amount of such loans is secured by good collateral or other ample security and does not exceed 25 percent of the statutory capital base. FSB had certain lending relationships that exceeded these limitations.

- **Real Estate Loan-to-Value Limits -** Guidelines for real estate lending are set forth in Part 365 of the FDIC Rules and Regulations. Appendix A of Part 365 sets forth specific guidelines related to the maximum loan-to-value (LTV) ratios that should be maintained regarding various categories of real estate loans. The guidelines allow for individual exceptions to the LTV limits based on the support provided by other credit factors. LTV exceptions should be identified in the institution's records and their aggregate amount reported at least quarterly to the institution's Board. According to the guidelines, the aggregate amount of all loans in excess of the supervisory LTV limits should not exceed 100 percent of total capital. Institutions receive increased supervisory scrutiny as the total of such loans approaches this level. FSB had several loans in its portfolio that collectively exceeded these regulatory guidelines.

Credit Administration and Loan Monitoring.

- **Appraisals -** Part 323, *Appraisals*, of the FDIC Rules and Regulations, identifies real estate financial transactions, including loan renewals, requiring the services of an appraiser. In addition, the *Statement of Policy on Interagency Appraisal and Evaluation Guidelines* provides expectations for prudent appraisal and evaluation policies, procedures, and practices. FSB management renewed loans after a significant change occurred in the bank's real estate lending markets, but did not obtain updated evaluations or appraisals.

- **Borrower Financial Information –** The *Risk Management Manual of Examination Policies* discusses the importance of maintaining current loan documentation, such as borrower financial statements and cash flow statements. FSB did not consistently obtain updated financial information.

- **Loan Review –** According to the *Risk Management Manual of Examination Policies*, it is essential that all institutions have an effective loan review system. Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. FSB did not have an effective loan review and internal grading system as management failed to recognize problem credits in a timely and appropriate manner.

- **Underfunded ALLL-** According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, the Allowance for Loan and Lease Losses (ALLL) represents one of the most significant estimates in an institution's financial statements and regulatory reports. As a result, institutions are responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently-applied process for determining the ALLL. During the April 2009 examination, examiners noted the ALLL was underfunded by $6.0 million due to the level of adverse classifications and modifications made to the bank's methodology for calculating ALLL. In the subsequent October 2009 visitation, examiners discovered a mathematical error with the reserve percentages used in the calculation of the ALLL. This error, along with the use of stale asset values used for impairment testing, resulted in the need to increase the ALLL by approximately $10 million. Examiners also noted underfunding of the ALLL of $2.1 and $8.9 million in the June 2010 and February 2011 examinations, respectively. The cause of the underfunding was additional loan losses and downgrades of several loan relationships identified during the examinations.

Adversely Classified Assets.[5] FSB's adversely classified assets increased from 65 percent of Tier 1 Capital plus the ALLL as of the November 2007 examination, to 1,077 percent of Tier 1 Capital plus the ALLL as of the August 2011 examination. At the time of the August 2011 examination, the bank's adversely classified assets totaled $232 million. Approximately $153 million of this amount consisted of loans, the majority of which were ADC loans, and almost $77 million was other real estate owned (OREO). Table 2 summarizes the increase in FSB's adversely classified assets as a percentage of Tier 1 Capital plus the ALLL during examinations and visitations conducted between 2006 and 2011.

Table 2: FSB's Adversely Classified Assets as a Percent of Tier 1 Capital Plus the ALLL by Examination and Visitation

Examination/Visitation Date	Exam/Visitation as of Date	Composite Ratings[6]	Adversely Classified Assets as a percent of Tier 1 Capital plus the ALLL
August 14, 2006	June 30, 2006	1	3.70%
November 13, 2007	September 30, 2007	3	65.13%
April 30, 2009	March 31, 2009	5	250.04%
October 26, 2009[V]	September 30, 2009	5	330.89%
June 28, 2010	March 31, 2010	5	562.76%
February 14, 2011[V]	December 31, 2010	5	802.00%
August 8, 2011	June 30, 2011	5	1,077.66%

V – Denotes Visitation

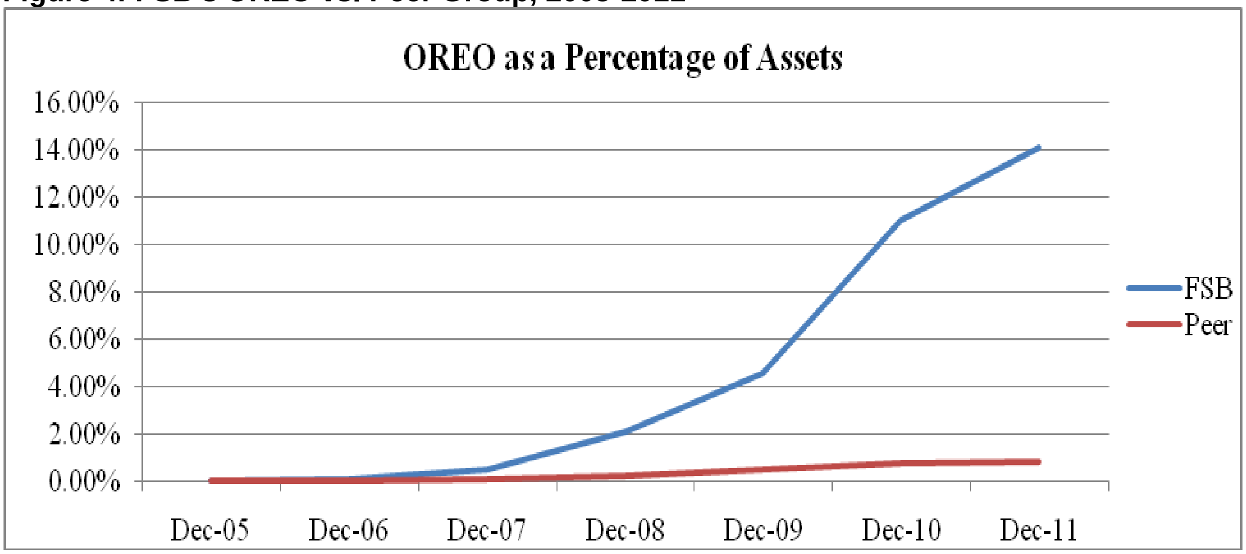
Source: BDO analysis of Reports of Examination and Visitation for FSB.

[5] Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.

[6] Composite ratings are developed using the Uniform Financial Institutions Rating System (UFIRS), which is an internal rating system used by the federal and state regulators for assessing the soundness of financial institutions. Each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. The six component areas are Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk, forming the acronym CAMELS.

As borrowers defaulted on their loans, FSB's OREO increased from $200,000 in 2005 to over $78 million (or over fourteen percent of total assets) in 2011. OREO assets are non-earning assets that require additional oversight and expense to manage and dispose of through sale. When a bank forecloses on an asset and takes possession of property, the property is valued at a reduced fair value, less the cost to sell. This creates additional losses for banks during times of depressed real-estate markets, as was the case for FSB. The following figure illustrates the increasing trend in FSB's OREO portfolio relative to its peer group during the years preceding the bank's failure.

Figure 4: FSB's OREO vs. Peer Group, 2005-2011



Source: BDO analysis of UBPRs for FSB.

The FDIC's Supervision of The First State Bank

The FDIC, in coordination with the GDBF, provided ongoing supervisory oversight of FSB through onsite risk management examinations, visitations, and offsite monitoring activities. Through its supervisory efforts, the FDIC identified key risks in FSB's operations and brought these risks to the attention of the institution's Board and management. Such risks included the bank's significant concentrations in CRE and ADC loans and weak loan underwriting, credit administration, and related monitoring practices. The FDIC and the GDBF also made numerous recommendations for improvement and took supervisory actions in the form of a Memorandum of Understanding (MOU), Consent Order (CO), and Supervisory PCA Directive.

Supervisory History

Between 2005 and 2011, the FDIC and GDBF conducted six onsite examinations and two visitations of FSB. Table 3 presents the supervisory history for FSB from 2005 through 2011.

Table 3: Supervisory History of FSB, 2005-2011

Examination or Visitation Start Date	Report Date	Regulatory Agency	Supervisory Ratings	Violations and/or Contraventions*	Supervisory Action
July 11, 2005	August 1, 2005	FDIC examination	111121/1	1	None
August 14, 2006	September 14, 2006	State examination	111122/1	None	None
November 13, 2007	November 21, 2008	FDIC examination	233222/3	6	MOU effective January 6, 2009
April 30, 2009	March 1, 2010	Joint examination	454544/5	2	CO effective May 14, 2010
October 26, 2009	November 2, 2009	FDIC visitation	555545/5	1	CO still in effect
June 28, 2010	September 30, 2010	Joint examination	555545/5	4	CO still in effect
February 14, 2011	March 1, 2011	FDIC visitation	555545/5	None	CO still in effect
August 8, 2011	November 1, 2011	Joint examination	555555/5	3	PCA Directive effective December 22, 2011

Source: BDO analysis of FSB's Reports of Examination and RMS Supervisory Documents.

* See Appendix 1 for a description of FSB's apparent violations of laws and regulations and contraventions of policy.

Frequency of Onsite Examinations. 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, onsite 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, such as having total assets of less than $500 million. FSB did not meet the conditions to be considered a small institution and, therefore, was required to be examined on a 12-month examination cycle. Except as described below, the frequency of FSB's examinations were consistent with relevant provisions of the FDI Act.

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* defines how the 12- and 18-month examination cycles should be measured. Using the criteria in the Manual, we determined that the April 30, 2009 examination should have started no later than January 12, 2009. The GDBF examiners indicated that GDBF delayed the 2009 Joint Examination due to several factors, including staffing constraints, the bank's adequate capital rating at that time, and the state's desire to allow FSB time to comply with the MOU that went into effect on January 6, 2009. However, the majority of asset growth that contributed to FSB's failure occurred prior to 2009 and as a result, it appears unlikely that an earlier examination would have materially affected the course of the bank's financial decline or the cost to the DIF.

Enforcement Actions. Based on the results of the November 2007 examination, the FDIC entered into a MOU with FSB's Board on January 6, 2009 to address a number of risk management issues. Under the terms of the MOU, the Board agreed to (among other things):

- Submit a written plan to the FDIC for the reduction and improvement of all borrowers with total borrowings, including unfunded loan commitments, which were adversely classified or listed for special mention in the November 2007 Report of Examination which aggregated to $500,000 or more.

- Submit revised loan policies and procedures to the FDIC that address the deficiencies identified during the examination.

- Submit a written Capital Plan to the FDIC that included a requirement for the bank to maintain a Tier 1 Leverage Capital ratio and Total Risk-Based Capital ratio equal to or greater than 8 percent and 10 percent, respectively.

- Maintain an adequate ALLL level in accordance with generally accepted accounting principles (GAAP).

- Refrain from paying any cash dividends without the prior written consent of its Supervisory Authorities.

- Submit a written comprehensive business/strategic plan covering at least an operating period of 3 years. The plan was to contain an assessment of the bank's current financial condition and market area, and a description of the operating assumptions that form the basis for major projected income and expense components.

- Eliminate from the bank's books, by charge-off or collection, all assets or portions of assets classified as "loss" during the examination that had not been previously collected in full or charged-off.

During the April 2009 joint examination, examiners determined that FSB's management had taken a number of actions to address the provisions of the MOU. However, actions taken in several critical areas were not adequate considering the bank's risk profile and large concentrations of credit. These included such things as improving management, the loan review program, loan underwriting and credit administration, budget projections, and compliance with apparent violations. Based on the results of the April 2009 joint examination, the FDIC and

GDBF entered into a CO with FSB's Board on May 14, 2010. The CO remained in effect until the bank was closed in January 2012. The CO required, among other things, that the institution:

- Increase the Board's participation in the affairs of the bank.

- Analyze the bank's credit concentrations and develop a plan to reduce such concentrations.

- Establish an independent loan review program that provides for a periodic review of the bank's loan portfolio and the identification and categorization of problem credits.

- Review and maintain an adequate ALLL.

- Adopt and implement a policy, consistent with regulatory guidance, limiting the use of interest reserves.

- Submit to the FDIC and GDBF a written plan detailing appropriate strategies for managing ADC and CRE concentrations levels, including a contingency funding plan to reduce or mitigate concentrations given adverse market conditions.

- Raise and maintain Tier 1 Capital and Total Risk-Based Capital to equal or exceed 8 percent of total assets and 10 percent of total risk-weighted assets, respectively, in addition to a fully funded ALLL.

- Implement a written plan to address liquidity, contingent funding, interest rate risk, and asset/liability management.

- Eliminate and/or correct all violations of laws and/or regulations or contraventions of statements and policy cited during the April 2009 examination.

The bank made some progress in addressing the requirements of the CO. However, due to the rapid deterioration of the bank, compliance with key provisions was not accomplished, including provisions pertaining to achieving and maintaining minimum capital requirements and reducing adversely classified assets and concentrations.

Supervisory Response to Key Risks

In the years preceding FSB's failure, the FDIC and GDBF identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination reports and letters summarizing the results of the visitations, correspondence, and recommendations. In addition, the FDIC issued both formal and informal enforcement actions, as described earlier. A summary of the supervisory activities related to the bank's key risks follows.

<u>July 11, 2005 FDIC Examination (CAMELS Rating 111121/1)</u>

Examiners determined during the July 2005 examination that FSB's overall condition remained sound. At that time, management was considered sound, with the level and quality of oversight cited as being strong. Examiners determined that the bank's asset quality was strong, with generally sound credit administration practices. However, examiners considered the bank's CRE concentration representing 811 percent of Tier 1 Capital, and ADC concentration representing 464 percent of Tier 1 Capital, high. In addition, examiners identified apparent violations of Part 323 of the FDIC Rules and Regulations related to obtaining real estate appraisals. Specifically, the bank had extended several loans to fund the purchase of residential lots and construction of 1-4 family houses. The files did not contain an appraisal or evaluation of the lots, which is an apparent violation of the regulation. Examiners made recommendations to bank management to enhance problem loan documentation, financial statement analysis consistency, and concentration monitoring.

<u>August 14, 2006 State Examination (CAMELS Rating 111122/1)</u>

Examiners determined during the August 2006 State examination that the overall condition of the bank was strong, with asset quality, capital, earnings, and management considered strong. The examiners continued to note the bank's high concentration in ADC loans, with the funded portion representing 433 percent of Tier 1 Capital and total commitments representing 574 percent of Tier 1 Capital. As identified in Figure 2, these concentration levels were far above FSB's peer group average. However, at the time of the August 2006 examination, examiners considered the bank's management of concentrations to be satisfactory. Examiners encouraged management to continue to closely monitor the real estate market in the bank's trade area. Management was also encouraged to review the Asset/Liability Policy to ensure that all parameters reflected the Board's risk tolerances for the institution.

<u>November 13, 2007 FDIC Examination (CAMELS Rating 233222/3)</u>

Examiners determined during the November 2007 examination that FSB's overall condition had deteriorated and needed improvement and assigned the bank a composite "3" rating. The examiners identified weaknesses in loan underwriting and credit administration that contributed to a significant increase in the volume of adversely classified items, which increased from a modest $2.7 million at the previous examination to $53.6 million at the November 2007 examination. The majority of adversely classified items consisted of ADC loans. Examiners noted that capital was satisfactory and that the bank was *Well Capitalized*, although the significant increase in adversely classified items and the sizeable CRE concentration presented additional risks.

During the examination, examiners noted that the bank continued to have large CRE and ADC concentrations of 575 and 441 percent of examiner adjusted Tier 1 Capital, respectively. Such concentrations were substantially higher than the bank's peer group average, and examiners noted that concentrations were in contravention of the Joint Guidance. Further, examiners determined that the risk exposure attributed to ADC loans was not appropriately monitored and controlled. Examiners recommended that management obtain and review reports that stratify the CRE portfolio by geographic market, developer, subdivision, price range, and risk rating.

Moreover, examiners noted additional weaknesses pertaining to the bank's monitoring of adherence to established ADC limits. The Loan Policy established limits by category of ADC loans in relation to total loans, such as a 10 percent limit for acquisition and development (A&D) loans. The bank's September 30, 2007 monitoring report indicated that A&D loans represented 36 percent of total loans, 250 percent in excess of the bank's internally established limit. Examiners noted the recent downturn in the residential real estate market heightened risk associated with A&D loans. However, examiners did not find any Board discussion regarding the fact that the bank had exceeded its internally established A&D loan limits. Examiners recommended that management ensure that internal policy limits be appropriately monitored, that documentation be maintained to support decisions to exceed those limits, or that management develop a plan to achieve compliance with established limits.

Examiners also noted that the bank needed to improve its loan review system, loan underwriting, credit administration, and loan policy. Examiners noted that approximately 60 percent of adversely classified items in the examination report represented loans downgraded by examiners that were not internally identified on the bank's watch list. Among the other weaknesses, examiners identified inappropriate and liberal use of interest reserves and a lack of global cash flow analyses and updated financial information before loan renewals. In addition, the capitalization and use of interest reserves was not in the loan policy. Further, examiners identified numerous apparent violations of laws and regulations that are contained in Appendix 1 of this report.

During the January 7, 2008 exit meeting, FSB's management disagreed with the tentative composite rating and management rating of "3." As a result of this disagreement, the examiners reviewed their examination results and allowed management more time to receive updated appraisals for certain assets that were adversely classified during the examination. After these reviews and updated appraisals were obtained, the examiners maintained the same ratings and issued the report in November 2008. As discussed earlier in this report, the delay in issuing the November 2007 examination and starting the next examination does not appear to have materially affected the course of the bank's financial decline or the cost to the DIF. Based on the results of examination, the regulators executed an MOU to address the deficiencies identified by the examiners. The MOU became effective on January 6, 2009, one year after the exit meeting.

<u>April 30, 2009 Joint State/FDIC Examination (CAMELS Rating 454544/5)</u>

Examiners determined that the major downturn in the residential real estate market had led to serious deterioration in the bank's financial condition. Examiners noted significant increases in adversely classified assets, which threatened the viability of the bank. The primary cause of the rapid decline in asset quality was the large ADC concentration that the Board permitted the bank to maintain and the collapse of the real estate market during 2007. FSB's ADC concentration was 476 percent of Tier 1 Capital, almost four times that of the bank's peer group average and well in excess of the bank's internal risk limits for concentrations. Management stated that the market collapse had limited the bank's options for reducing this concentration. Foreclosures and sales appeared to be a primary method to achieve immediate reductions in real estate concentrations. However, the bank's OREO was already at an excessive level of 3.71 percent of total assets, with almost $25 million being adversely classified at the examination.

Examiners attributed the decline in asset quality to a failure of management to diversify the loan portfolio, effectively control lending risk and insufficient analysis in the loan underwriting process. Additionally, examiners identified multiple apparent appraisal violations for loans that were renewed without obtaining or performing an appropriate evaluation of the bank's real estate collateral despite an apparent change in the condition of the real estate market. These deficiencies were corrected, although inspection information was not consistently maintained in the loan files. Additionally, examiners determined that loan underwriting did not identify which borrowers would be unable to perform in a stressed economic environment. The bank did not consider that certain borrowers were overly reliant upon real estate for both net worth and sources of income. Examiners found that global cash flow analyses were not routinely performed, nor was the impact of larger borrowers' contingent liabilities considered. In addition, examiners found that the bank was focused on work-out plans that concentrated on the payment of interest, rather than on principal, and extending a large volume of loans for the purpose of servicing interest due on the borrowers' debts at the bank. These practices served to mask problem loans, which were subsequently adversely classified at the examination.

Examiner's determined that the level of adversely classified assets was at a critically deficient level, which contributed to a $14 million operating loss in 2008. Further, the ALLL was underfunded by almost $6 million and the bank had improperly accrued interest on non-performing loans through interest reserves, resulting in identified accrued interest reversals of

$2.3 million. Examiners noted that poor asset quality and operating losses were likely to continue to erode the bank's capital position, which had historically been higher than other community banks in the south Atlanta market. Notwithstanding this mitigating factor, the bank's Total Risk-Based Capital ratio of 10.02 percent as of March 30, 2009, was just above the *Well Capitalized* threshold for PCA. The bank suffered continued declines in its capital throughout 2009, and by year-end the bank had fallen to *Significantly Undercapitalized.*

As described earlier in this report, the examiners performed a review of the institution's compliance with the January 2009 MOU during the April 2009 examination. Examiners found that the bank was not in compliance with 1 of 13 requirements to, within 60 days of the MOU, take steps necessary and consistent with sound banking practices to correct all violations of laws, rules, and regulations, and contraventions of policy statements cited during the prior exam. One material violation was noted due to weaknesses in the bank's appraisal review and evaluation process, which was corrected during the examination. Examiners also noted that the bank was in partial compliance with 3 of the 13 requirements and compliant with the remaining 9 requirements. Examiners determined that the MOU had not been effective in restoring the bank to an overall satisfactory financial condition and recommended that a formal program of corrective action be implemented to correct the condition of the institution.

We spoke with examiners to determine why the April 2009 Report of Examination was not issued until March 2010. Examiners informed us that the delay was due to several factors, including but not limited to, resolving disagreements with management regarding the ratings assigned to the bank and pursuing a CO with FSB between the start of the examination and the issuance of the report.

<u>October 26, 2009 FDIC Visitation (CAMELS Rating 555545/5)</u>

While the examiners were resolving disputes with management about the rating downgrade from a "3" to "5" in the April 2009 examination and were pursuing a CO, a visitation of the bank was conducted on October 26, 2009 to, among other things, confirm the April 2009 examination ratings and evaluate compliance with the MOU. The visitation confirmed the composite bank rating of a "5" and noted further deterioration in the bank's financial condition. The visitation also identified three areas of non-compliance with the MOU related to maintaining capital and the ALLL, and reducing volatile funding. The visitation was completed on November 2, 2009 and the final report of examination was issued on March 1, 2010. The CO became effective on May 14, 2010.

<u>June 28, 2010 Joint State/FDIC Examination (CAMELS Rating 555545/5)</u>

Examiners noted that the overall condition of the bank continued to deteriorate. The asset quality was critically deficient due to the high levels of adversely classified assets, primarily

ADC loans and OREO, which totaled $217 million, or 563 percent of Tier 1 Capital and the ALLL. As of June 30, 2010, funded ADC loans totaled $161 million, or 755 percent of Tier 1 Capital. Examiners determined that the ADC loans lacked sufficient support from borrowers and from the current value of the collateral. Additionally, appropriate Board oversight of the excessive ADC concentration was lacking. Examiners determined that management invested heavily in ADC lending without evaluating the feasibility of certain projects or formulating sufficient risk reduction and/or exit strategies to protect the bank in the event of a downturn in the real estate market.

Examiners identified weaknesses in the oversight of underwriting and credit administration. Specifically, documentation deficiencies were noted in over 42 percent of the loans reviewed and primarily focused on appraisals, financial statements, and tax returns. Examiners found that management and the Board had not demonstrated the ability to correct problems and implement appropriate risk management practices. In addition, the bank's loan policy needed to be modified to define the authority levels required for changing loan grades and to include economic and certain loan type information in the ALLL calculation. The bank also had numerous violations of laws and regulations and contraventions of interagency guidelines as identified in Appendix 1 of this report.

Finally, FSB's capital was critically deficient given the additional losses in the ADC portfolio. Tier 1 Leverage and Total Risk-Based Capital ratios declined to 3.45 and 5.52 percent, respectively. The bank was considered *Significantly Undercapitalized* for PCA purposes and examiners questioned the viability of the institution without the addition of capital. Although the bank was able to satisfy 14 or the 19 provisions of the CO, the bank was unable to satisfy 5 of the provisions, 1 of which related to capital. Those five provisions were (1) write-off all adversely classified loss assets, (2) not extend any additional credit to a borrower that has charged-off or classified assets, (3) maintain an adequate ALLL, (4) maintain Tier 1 Capital of not less than 8 percent and (5) eliminate all apparent violations of regulations and contravention of policy.

<u>February 14, 2011 FDIC Visitation (CAMELS Rating 555545/5)</u>

A routine visitation was conducted at the bank on February 14, 2011 to assess, among other things, compliance with the CO, the ALLL methodology, and capital. Examiners noted that as of December 31, 2010, the overall condition of the bank was critically deficient. Asset quality was critically deficient due to $207 million in adversely classified assets, and poor credit administration practices. Management made progress in reducing classified assets and ADC concentrations. In addition, the ALLL methodology appeared appropriate for the overall risk profile of the institution. However, loans continued to deteriorate and the risk cushion formerly afforded by capital had been nearly eliminated. Examiners noted that the bank had not maintained capital at required levels, eliminated apparent appraisal violations, prepared an adequate Liquidity Plan, and obtained Board approval for the OREO reduction plan.

August 8, 2011 Joint Examination (CAMELS Rating 555555/5)

Examiners determined that the bank had experienced significant deterioration and was in imminent danger of failing. Examiners found that the bank's poor condition was characterized by critically deficient asset quality. Adversely classified items increased since the last examination to $232 million, or 1,078 percent of Tier 1 Capital and the ALLL. Examiners determined that the primary cause of the bank's asset quality deterioration was an excessive and poorly controlled ADC concentration, exacerbated by the extended economic downturn. As of June 30, 2011, ADC loans totaled $141 million, or 25 percent of total assets, while other CRE loans totaled $104 million, or 18 percent of total assets. Moreover, the bank's OREO was an excessive 14 percent of total assets. Examiners noted that the Board and senior management had improved the overall level of credit administration, but had been unable to reduce the volume of nonperforming assets and restore asset quality to a satisfactory level. Examiners also noted that the bank continued to have apparent violations for appraisal evaluations and legal lending limits, and contraventions of regulations related to interest rate risk.

During the examination, examiners found that capital levels remained critically deficient due to losses created by poor asset quality. The ALLL was found to be underfunded by at least $8.9 million. The Tier 1 Capital level, adjusted for examination findings, had fallen to 0.63 which is considered *Critically Undercapitalized* for PCA purposes. Earnings performance remained negative and operating losses were projected to continue, which would further erode the bank's capital position. Examiners noted that the bank needed an immediate and substantial capital injection, without which failure was likely. Such an injection was also required for the bank to comply with the outstanding CO. Examiners found that the bank was not in compliance with numerous provisions of the CO, such as reducing adversely classified assets, not extending additional credit to borrowers with charged-off or classified loans, eliminating apparent violations, maintaining adequate capital, reducing the ADC concentration, and maintaining an adequate ALLL. Management acknowledged the threat of insolvency and the FDIC Atlanta Regional Office recommended that FSB continue to remain on the formal problem bank list.

Supervisory Lessons Learned

The perspectives gained from the failure of FSB are not unique. Like other institutions that failed in recent years, FSB developed a significant exposure to ADC loans at a time when the bank's financial condition and lending markets were favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market.

At the time of the August 2006 GDBF examination, FSB had a nominal amount of adversely classified assets. However, the bank also had a significant concentration in ADC loans that was much higher than its peer group average. The FDIC's current approach to supervision involves greater emphasis on risk management practices for institutions with high-risk profiles, such as FSB, and a stronger supervisory response—including accelerated examinations or visitations, lower ratings, and/or supervisory actions—when risks are not being properly managed. At the time of the August 2006 GDBF examination, however, given the institution's financial condition, examiners assigned FSB a composite "1" rating. A more critical assessment of the risk exposure and closer scrutiny of risk management practices may have produced a different outcome and supervisory response, and prompted earlier action on the part of FSB to limit its vulnerability to a downturn in the real estate market. However, we cannot determine with certainty the degree to which an alternative supervisory approach and response would have been effective in limiting FSB's financial deterioration or the loss to the DIF.

Examiners did become sharply critical of FSB's risk management practices beginning with the FDIC's 2007 examination, resulting in the issuance of an MOU following the examination. Regulators also issued enforcement actions in 2009 and 2010; however, the bank's lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons learned from failures during the financial crisis. Such actions include instituting a training initiative for examiners that focuses on placing greater emphasis on risk management practices for institutions with high risk profiles and issuing additional supervisory guidance on CRE and ADC concentrations.

Implementation of PCA

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions pertaining to institutions at various capital levels. 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 the problems of insured depository institutions at the least possible cost to the DIF. Part 325 of the FDIC Rules and Regulations, *Capital Maintenance,* 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 (CRP), 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 CRP, 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 that were consistent with relevant provisions of PCA. Among other things, the FDIC notified the bank when its capital levels fell into PCA capital categories below *Adequately Capitalized*, reviewed and monitored the institution's Call Report information, and conducted discussions with FSB's management regarding its efforts to raise needed capital.

Table 4 illustrates FSB's capital levels relative to the PCA thresholds for *Well Capitalized* institutions as reported in the bank's Call Reports. A chronological description of the changes in FSB's capital categories and the FDIC's implementation of PCA follow the table.

Table 4: FSB's Capital Levels, 2005-2011

Date	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		
	Bank	Peer	Bank	Peer	Bank	Peer	
December 31, 2005	9.59%	8.88%	11.37%	11.78%	12.28%	12.95%	Well Capitalized
December 31, 2006	9.70%	9.02%	11.72%	11.75%	12.59%	12.89%	Well Capitalized
December 31, 2007	9.85%	9.06%	12.08%	11.62%	13.32%	12.73%	Well Capitalized
December 31, 2008	8.39%	8.75%	10.27%	11.40%	11.55%	12.60%	Well Capitalized
December 31, 2009	3.27%	8.66%	4.16%	11.90%	5.40%	13.17%	Significantly Under-Capitalized
December 31, 2010	2.65%	9.02%	3.09%	13.00%	4.35%	14.27%	Significantly Under-Capitalized
December 31, 2011	0.60%	9.42%	0.75%	13.95%	1.50%	15.20%	Critically Under-Capitalized

Source: BDO analysis of UBPRs for FSB.

FSB was considered *Well Capitalized* for PCA purposes until the institution filed its June 30, 2009 Call Report reflecting an *Adequately Capitalized* position. Although not required by statute or policy, the FDIC notified FSB's Board of its *Adequately Capitalized* position in a letter dated August 7, 2009.[7] Pursuant to Section 29 of the FDI Act and Section 337.6 of the FDIC Rules and Regulations, an *Adequately Capitalized* institution may not accept, renew, or roll over brokered deposits unless it has applied for and been granted a waiver by the FDIC. FSB did not request or receive FDIC's approval to accept, renew, or roll over brokered deposits.

In a letter dated February 10, 2010, the FDIC notified FSB's Board that, based on its December 30, 2009 Call Report, the bank had fallen to *Significantly Undercapitalized*. The letter referenced a number of restrictions imposed on *Significantly Undercapitalized* institutions and advised the Board to develop policies and procedures to ensure compliance. The letter also requested that the bank submit a CRP within 45 days of receipt of the letter. FSB submitted a

[7] FDIC policy requires that institutions be notified in writing when they fall to *Undercapitalized*, *Significantly Undercapitalized*, or *Critically Undercapitalized*. The policy does not require notification to institutions that fall to an *Adequately Capitalized* position.

CRP dated March 28, 2010. On May 27, 2010, the FDIC notified FSB that it would receive a letter by June 2, 2010 stating that the CRP was not acceptable. However, FSB did not receive such a letter until August 12, 2010, beyond the 60 day timeframe allowed for notifying institutions about the acceptability of their CRPs. Section 325.104(c) of the FDIC Rules and Regulation states that the FDIC shall provide written notice to a bank as to whether its CRP, as required under PCA, has been approved within 60 days of receiving the plan. However, FSB became subject to a CO with a capital maintenance provision within 60 days of submitting the CRP. In addition, the FDIC had regular communication with FSB's management regarding the bank's ongoing efforts to improve its capital position. As a result, in our view, the lack of a timely written notice was inconsequential to the supervision or failure of the bank.

The August 12, 2010 letter required that FSB submit a revised CRP within 45 days, or by September 27, 2010. On October 5, 2010, FSB provided the FDIC with a revised CRP. In a letter dated November 26, 2010, the FDIC notified the bank that the revised CRP was essentially the same as the prior CRP and remained unacceptable. FSB never submitted an acceptable CRP. The bank attempted a private placement offering during January 2011. However, there was not sufficient interest to raise the required capital to bring FSB's capital levels back to a *Well Capitalized* status. In addition, the bank was required to provide the FDIC and GDBF with quarterly status reports on its efforts to improve capital pursuant to the CO. Further, examiners assessed the bank's efforts to improve its capital position through examinations, visitations, and other communications. Due to the bank's inability to raise additional capital, the bank's capital levels continued to fall throughout 2011 due to the recognition of additional operating losses.

In a letter dated November 3, 2011, the FDIC notified FSB's Board that, based on its September 30, 2011 Call Report, the bank had fallen to *Critically Undercapitalized*. The letter included reminders regarding the requirements imposed on *Critically Undercapitalized* institutions. On December 22, 2011, the FDIC issued a Supervisory PCA Directive in response to the bank's ratio of tangible equity to total assets falling below two percent. Among other things, the Directive required the bank to submit an acceptable CRP and take appropriate action to increase its capital to a level sufficient to restore the bank to an *Adequately Capitalized* category.

FSB explored a number of strategic alternatives for raising capital, such as a private placement offering, conversion of existing bank liabilities to capital (e.g., deferred compensation plans), sale of bank-owned fixed assets (non OREO) at a price in excess of book value, and bulk sales of OREO and nonperforming loans in conjunction with capital injections. However, these efforts were ultimately not successful and the institution was closed on January 20, 2012.

FSB's Risk Management Weaknesses and Apparent Violations and Contraventions by Examination and Visitation, 2005-2011

Reports of Examination Dates	**2005**	**2006**	**2007**	**2009**	**2009v**	**2010**	**2011v**	**2011**
Examination/Visitation Composite Ratings	**1**	**1**	**3**	**5**	**5**	**5**	**5**	**5**
Excessive concentrations in CRE and ADC loans	✔	✔	✔	✔	✔	✔	✔	✔
Loan Underwriting								
Inappropriate use of interest reserves			✔	✔				
Improper disbursement of construction loan funds			✔					
Inadequate appraisals and evaluations	✔		✔	✔		✔		✔
Credit Administration								
Loan policy did not establish risk limits for loan concentrations as a percentage of capital.					✔	✔		✔
Lack of risk management practices to monitor and control ADC and CRE concentrations			✔		✔	✔		✔
Inadequate or lack of analysis of global cash flows, financial statements, credit memoranda, contingent liabilities, project feasibility and debt service capacity			✔	✔		✔		
Lack of adherence to the loan policy			✔	✔				
Inadequate loan review and problem loan identification/grading/ALLL methodology			✔	✔	✔	✔		
Apparent Violations and Contraventions								
Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices			✔		✔	✔		
Part 323/Statement of Policy – Appraisals	✔		✔	✔		✔		✔
Part 365/ Statement of Policy – LTV limits			✔			✔		
Part 364/ Interagency Guidance Establishing Standards for Safety and Soundness						✔		
Statement of Policy on Interagency Appraisal and Evaluation Guidelines			✔					
Interagency Statement of Policy on ALLL			✔					
Section 7-1-285(b) of the Financial Institution Code of Georgia regarding legal lending limits			✔					✔
Joint Agency Policy Statement for Interest Rate Risk				✔				✔

V – Denotes Report of Visitation

Source: Report of Examinations for FSB

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the DIF incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The Financial Reform Act amends section 38(k) by increasing the MLR threshold from $25 million to $150 million for losses that occur for the period January 1, 2012 through December 31, 2012. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Consistent with the Financial Reform and FDI Act provisions described above, the objectives of this MLR were to (1) determine the causes of FSB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

Our report contains no recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in MLRs, the FDIC OIG communicates those to FDIC management for its consideration. As resources allow, the FDIC OIG conducts more comprehensive reviews of specific aspects of the FDIC's supervision program and makes recommendations as warranted.

We conducted this performance audit from April 2012 to July 2012 in accordance with Generally Accepted Government Auditing Standards (GAGAS). 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

The scope of the audit focused primarily on FSB's operations from July 2005 until its failure in January 2012. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period. In addition, we analyzed information pertaining to certain other matters that occurred prior to 2005 that we considered relevant to the audit. To achieve the objectives, we performed the following audit procedures:

- Analyzed examination and visitation reports prepared by the FDIC and GDBF from 2005 to 2011.

Objectives, Scope, and Methodology

- Reviewed key documentation, including:

    - Selected examination work papers prepared by the FDIC and GDBF from 2005 to 2011, as provided to BDO by RMS and the GDBF.
    - Institution data in Call Reports, UBPRs, and other reports.
    - FDIC and GDBF correspondence, as provided to BDO by RMS.
    - Other relevant documents prepared by the FDIC relating to the institution.
    - Information in the FDIC's Virtual Supervisory Information On the Net system.
    - Pertinent FDIC regulations, policies, procedures, and guidance.

- Interviewed RMS examination staff in the Washington, DC office and in the Atlanta, Georgia Regional and Field Offices.

- Interviewed State examination staff to obtain their perspectives on the failure and to discuss their role in the supervision of the institution.

BDO relied primarily upon material provided by the FDIC OIG and RMS, including information and other data collected during interviews. BDO did not perform specific audit procedures to ensure the information and data were complete and accurate. BDO is, however, aware that Circular 12000.1, *Cooperation with the Office of Inspector General*, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

> (1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.
>
> (2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

In addition, BDO did not evaluate RMS's compliance with offsite monitoring policies and procedures for FSB.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in the examination reports and other relevant supervisory correspondence between the FDIC, GDBF, and the bank. BDO relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

Objectives, Scope, and Methodology

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

Consistent with the audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in RMS systems, reports, and interviews of examiners to understand FSB's management controls pertaining to the causes of failure and material 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 and, 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. For this MLR, we did not assess the strengths and weaknesses of RMS' annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. RMS compliance with the Results Act is reviewed in OIG's program audits of RMS' 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's Rules and Regulations. 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

The FDIC provided us with a memorandum issued by the OIG on May 1, 2009. The memorandum 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 also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. As discussed earlier in this report, the OIG issued an audit report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), dated December 2010). The objectives of the audit were to (1) determine the actions that

Objectives, Scope, and Methodology

the FDIC has taken to enhance its supervision program since May 2009, including those specifically in responses 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, the OIGs of the FDIC, the Department of the Treasury, and the Board of Governors of the Federal Reserve System issued an evaluation report in September 2011, entitled *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which assessed the role and Federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, PCA, and section 39, Standards for Safety and Soundness) in the banking crisis.

Additionally, the FDIC OIG has informed us that it began an evaluation in July 2011 to study the characteristics and related supervisory approaches that may have prevented FDIC-supervised institutions with significant ADC loan concentrations from being designated as problem banks or failing during the recent financial crisis. Most recently, in January 2012, the President signed Public Law 112-88 (formerly known as H.R. 2056, as amended), which requires the Inspector General of the FDIC to conduct a comprehensive study on the impact of the failure of insured depository institutions. In connection with this study, the FDIC OIG has initiated work in the following areas of bank supervision:

- evaluation and use of appraisals,
- implementation of the FDIC's policy statement on CRE loan workouts,
- risk management enforcement actions, and
- examiner assessment of capital.

The Inspector General is required to submit a report on the results of the study and any related recommendations to Congress by January 3, 2013.

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.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
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.
Capital Restoration Plan (CRP)	Section 325.104(a)(1) of the FDIC Rules and Regulations requires a bank to file a written capital restoration plan with the appropriate FDIC regional director within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is Undercapitalized, Significantly Undercapitalized, or Critically Undercapitalized, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.
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.

Glossary of Terms

Term	Definition
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.
Consent Order (CO)	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A CO may be terminated by the regulators when they have determined that the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Contingency Funding (or Liquidity) Plan	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency funding plans should be regularly tested and updated to ensure that they are operationally sound. RMS uses the terms contingency funding plan and contingency liquidity plan interchangeably.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's RMS (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all relevant factors including: guarantor's related debt at other financial institutions, current and complete operating statements of all related entities, and future economic conditions. In addition, global cash flow analysis should be routinely conducted as part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.

Glossary of Terms

Term	Definition
Interest Reserve Account	An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. Frequently, ADC loan budgets will include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sell out or lease-up period.
Loan-to-Value (LTV)	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Financial Reform Act, for the period beginning January 1, 2012 and ending December 31, 2012, a material loss is defined as any estimated loss to the DIF in excess of $150 million.
Memorandum of Understanding (MOU)	An MOU is an informal agreement between the institution and the FDIC, signed by both parties. The state authority may also be a party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Other Real Estate Owned (OREO)	Property taken over by a bank through loan foreclosures.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
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.

Glossary of Terms

Term	Definition
Risked-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risked-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Special Mention Assets	A Special Mention Asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or the institutions credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
Tier 1 (Core) Capital	In general, this term is defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations (C.F.R.), section 325.2(v), as: **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for- sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial 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 reported in Reports of Condition and Income submitted by banks.

Glossary of Terms

Term	Definition
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: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity 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

Acronym	Explanation
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BDO	BDO USA, LLP
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CO	Consent Order
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FIL	Financial Institution Letter
FSB	The First State Bank, Stockbridge, Georgia
GAAP	Generally Accepted Accounting Principles
GAGAS	Generally Accepted Government Auditing Standards
GDBF	Georgia Department of Banking and Finance
LTV	Loan-to-Value
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
RMS	Division of Risk Management Supervision
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

Corporation Comments and OIG Evaluation

Corporation Comments and OIG Evaluation

Subsequent to the issuance of BDO's draft report, RMS officials provided additional information for BDO's consideration, and BDO revised its report to reflect this information, as appropriate. On September 10, 2012, the RMS Director provided a written response to a draft of this report. That response is provided in its entirety on page II-2 of this report.

In the response, the Director, RMS, reiterated the causes of FSB's failure and the supervisory activities described in the report. Further, the response stated that RMS recognized the threat that institutions with high-risk profiles, such as FSB, pose to the DIF and issued to FDIC-supervised institutions a 2008 FIL, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*. The FIL re-emphasized the importance of robust credit risk management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

CORPORATION COMMENTS

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

September 10, 2012

TO: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

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

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of The First State Bank, Stockbridge, Georgia (Assignment No. 20 12-050)

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 (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of The First State Bank, (FSB) which failed on January 20, 2012. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on August 9, 2012.

FSB failed due to the Board's and management's ineffective oversight of the risk associated with the high concentration of commercial real estate (CRE) and acquisition, development and construction (ADC) loans. The Board and management did not establish appropriate loan concentration limits resulting in significant exposure in the CRE/ ADC portfolio. Lax lending practices such as weak ADC loan underwriting, administration, and monitoring also contributed to the decline in asset quality resulting in loan losses. The increase of the provision for loan losses depleted earnings, eroded capital and strained liquidity. Unable to raise sufficient capital to sustain safe and sound operations, FSB closed.

From 2005 to 2011, the FDIC and the Georgia Department of Banking and Finance (GDBF) conducted six onsite risk management examinations, onsite visitations, and offsite monitoring. Examiners identified key risks in FSB's operations, brought these to the attention of the Board and management, and made recommendations. The 2007 FDIC examination noted weaknesses in loan underwriting and administration, and a significant increase in adversely classified loans. Examiners downgraded FSB and executed a Memorandum of Understanding to address identified deficiencies. At the joint 2009 examination examiners found asset quality had declined significantly. In addition, earnings were critically deficient. FDIC and GDBF proposed the issuance of a Consent Order to address unsafe and unsound banking practices that became effective on May 14, 2010.

RMS has recognized the threat that institutions with high risk profiles, such as FSB, pose to the Deposit Insurance Fund and issued to FDIC-supervised institutions a 2008 Financial Institution Letter (FIL) entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasizes 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.