Office of Inspector General

Office of Audits
Report No. AUD-12-003

Material Loss Review of Atlantic Southern Bank, Macon, Georgia

December 2011

Office of Inspector General

Executive Summary

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Why We Did The Audit

On May 20, 2011, the Georgia Department of Banking and Finance (GDBF) closed Atlantic Southern Bank (ASB), Macon, Georgia. On June 17, 2011, the FDIC notified the Office of Inspector General (OIG) that ASB's total assets at closing were $726 million and the estimated loss to the Deposit Insurance Fund (DIF) was $273.5 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of ASB.

The objectives of the review were to (1) determine the causes of ASB's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of ASB, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

ASB was established in December 2001 as a state nonmember institution called New Southern Bank. In 2005, the bank changed its name to ASB. The bank was wholly owned by the Atlantic Southern Financial Group, Inc., a publicly-traded, one-bank holding company. As of June 2010, ASB's directorate owned or controlled 19.5 percent of the holding company's outstanding stock, with the remainder of the stock widely held.

In 2006 and 2007, ASB expanded its geographic presence in central and southern Georgia to the growing markets of coastal Georgia and northern Florida. The bank's expansion was facilitated by the acquisition of three institutions: Sapelo National Bank (with total assets of $64 million), First Community Bank of Georgia (with total assets of $70 million), and CenterState Bank Mid Florida (with total assets of $100 million). ASB's lending strategy focused on acquisition, development, and construction (ADC) and other commercial real estate (CRE) projects. At the time of its closure, ASB operated a main office in Macon, Georgia, and 15 branches in central, southern, and coastal Georgia. The bank also operated one branch in Jacksonville, Florida.

Audit Results

Causes of Failure and Material Loss

ASB failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the institution's aggressive growth and heavy concentration in CRE loans, particularly ADC loans. Notably, ASB did not maintain capital at levels that were commensurate with the increasing risk in its loan portfolio, reducing the institution's ability to absorb losses due to unforeseen circumstances. Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in ASB's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. Further, ASB relied on non-core funding sources, especially brokered deposits, to support its lending activities and maintain adequate liquidity. These funding sources became restricted when ASB's credit risk profile deteriorated, straining the institution's liquidity position.

ASB's heavy concentration in ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the real estate market. During 2007, conditions in ASB's primary lending areas began to decline, but notably, ASB's assets increased by $96 million (or 14 percent) during the first 6 months of 2008. By year-end 2008, the quality of ASB's loan portfolio had deteriorated significantly, with the majority of problems centered in ADC loans. Further deterioration occurred in 2009. The associated provisions for loan losses depleted ASB's earnings, eroded its capital, and strained its liquidity. GDBF closed ASB on May 20, 2011 because the institution was unable to raise sufficient capital to support its operations.

The FDIC's Supervision of ASB

The FDIC, in coordination with the GDBF, provided ongoing regulatory supervision of ASB through on-site risk management examinations, visitations, and off-site monitoring activities. The regulators also reviewed and approved ASB's previously discussed acquisition of three institutions that were part of the bank's expansion efforts. Through its supervisory efforts, the FDIC identified key risks in ASB'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 ADC and other CRE loans, lack of adequate capital, weak loan underwriting and credit administration practices, and reliance on non-core funding sources. The FDIC and GDBF made numerous recommendations for improvement. In November 2008, ASB's Board adopted a Bank Board Resolution to address concerns identified during the November 2008 visitation. Further, in September 2009, the FDIC, in coordination with the GDBF, issued a Cease and Desist Order against ASB to address the safety and soundness concerns identified during the February 2009 joint examination.

A more forward-looking assessment of ASB's risk profile during earlier examinations, particularly during the GDBF's November 2007 examination, may have been prudent. Such an assessment may have resulted in lower supervisory ratings and a supervisory action and established a strong supervisory tenor at a critical time. This approach may have influenced ASB to curb its growth appetite sooner than it did, potentially mitigating, to some extent, the financial problems experienced by the bank and the losses incurred by the DIF. FDIC examiners became sharply critical of ASB's risk management practices during the November 2008 visitation, and FDIC and GDBF examiners reported significant weaknesses in subsequent examinations and visitations. However, by that time, the institution's financial condition and lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC has taken a number of actions to increase its supervisory attention to banks with risk profiles similar to ASB. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.

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

Management Response

The Director, RMS, provided a written response, dated December 16, 2011, to a draft of this report. In the response, RMS reiterated the causes of failure and the supervisory activities described in the report. The response noted that the FDIC issued a Financial Institution Letter (FIL) in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, the response referenced a 2009 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*, issued by RMS to heighten its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources. The response also stated that RMS is committed to ensuring that institutions meet all PCA requirements.

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

Office of Audits and Evaluations
Office of Inspector General

DATE: December 16, 2011

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 Atlantic Southern Bank, Macon, Georgia* (Report No. AUD-12-003)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Atlantic Southern Bank (ASB), Macon, Georgia. The Georgia Department of Banking and Finance (GDBF) closed the bank on May 20, 2011, and the FDIC was appointed receiver. On June 17, 2011, the FDIC notified the OIG that ASB's total assets at closing were $726 million, and that the estimated loss to the Deposit Insurance Fund (DIF) was $273.5 million. The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate Federal banking agency shall make a written report to that agency. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA), a determination as to why the institution's problems resulted in a material loss to the DIF, and recommendations to prevent future losses.

The objectives of this material loss review were to (1) determine the causes of ASB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of ASB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our MLRs, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

[1] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of this report.

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of key terms, Appendix 3 contains a list of acronyms, and Appendix 4 contains the Corporation's comments on this report.

Background

ASB was established in December 2001 as a state nonmember institution called New Southern Bank. In 2005, the bank changed its name to ASB. The bank was wholly owned by the Atlantic Southern Financial Group, Inc., a publicly-traded, one-bank holding company. As of June 2010, ASB's directorate owned or controlled 19.5 percent of the holding company's outstanding stock, with the remainder of the stock widely held.

In 2006 and 2007, ASB expanded its geographic presence in central and southern Georgia to the growing markets of coastal Georgia and northern Florida. The bank's expansion was facilitated by the acquisition of three institutions: Sapelo National Bank (with total assets of $64 million), First Community Bank of Georgia (with total assets of $70 million), and CenterState Bank Mid Florida (with total assets of $100 million). Part of ASB's strategy in acquiring these institutions was to obtain core deposits in order to decrease its reliance on non-core funding sources. During that period, the bank relied heavily on non-core funding, including brokered deposits and Federal Home Loan Bank (FHLB) borrowings, to support its lending activities and maintain adequate liquidity. ASB's lending strategy focused on acquisition, development, and construction (ADC) and other commercial real estate (CRE) projects.

At the time of its closure, ASB operated a main office in Macon, Georgia, and 15 branches in central, southern, and coastal Georgia. The bank also operated one branch in Jacksonville, Florida. Table 1 summarizes selected financial information pertaining to ASB as of March 31, 2011 and for the 5 preceding years.

Table 1: Selected Financial Data for ASB, 2006-2011

Financial Data ($000s)	Dec - 06	Dec - 07	Dec 08	Dec - 09	Dec - 10	Mar - 11
Total Assets	$670,292	$851,465	$989,728	$948,477	$772,655	$741,855
Total Loans	$534,660	$697,825	$794,175	$719,396	$576,644	$544,068
Total Investments	$87,377	$86,251	$101,738	$155,341	$86,981	$84,857
Total Deposits	$557,236	$707,067	$837,173	$862,046	$726,435	$707,643
Brokered Deposits	$242,033	$272,904	$384,372	$236,249	$117,025	$111,957
FHLB Borrowings	$31,700	$40,500	$47,500	$39,000	$29,000	$19,000
Net Income (Loss)	$6,357	$8,341	($137)	($58,523)	($26,216)	($2,524)

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

Causes of Failure and Material Loss

ASB failed primarily because its Board of Directors (Board) and management did not effectively manage the risks associated with the institution's aggressive growth and heavy concentration in CRE loans, particularly ADC loans. Notably, ASB did not maintain capital at levels that were commensurate with the increasing risk in its loan portfolio, reducing the institution's ability to absorb losses due to unforeseen circumstances. Lax oversight of the lending function also contributed to the asset quality problems that developed when economic conditions in ASB's lending markets deteriorated. Specifically, the bank exhibited weak ADC loan underwriting, credit administration, and related monitoring practices. Further, ASB relied on non-core funding sources, especially brokered deposits, to support its lending activities and maintain adequate liquidity. These funding sources became restricted when ASB's credit risk profile deteriorated, straining the institution's liquidity position.

ASB's heavy concentration in ADC loans, coupled with weak risk management practices, made the institution vulnerable to a sustained downturn in the real estate market. During 2007, economic conditions in ASB's primary lending areas began to decline, but notably, ASB's assets increased by $96 million (or 14 percent) during the first 6 months of 2008. By year-end 2008, the quality of ASB's loan portfolio had deteriorated significantly, with the majority of problems centered in ADC loans. Further deterioration occurred in 2009. The associated provisions for loan losses depleted ASB's earnings, eroded its capital, and strained its liquidity. GDBF closed ASB on May 20, 2011 because the institution was unable to raise sufficient capital to support its operations.

Growth in CRE and ADC Loans

Soon after it was established, ASB embarked on an aggressive growth strategy centered in CRE, particularly ADC, loans in response to a strong real estate market. The bank's target lending areas were in central and coastal Georgia, northern Florida, Tennessee, and Alabama. However, ASB's Board and management did not effectively manage the risks associated with the institution's rapid growth and ensuing concentrations in CRE and ADC loans. A description of the institution's lending strategy and risk management practices in this area follows.

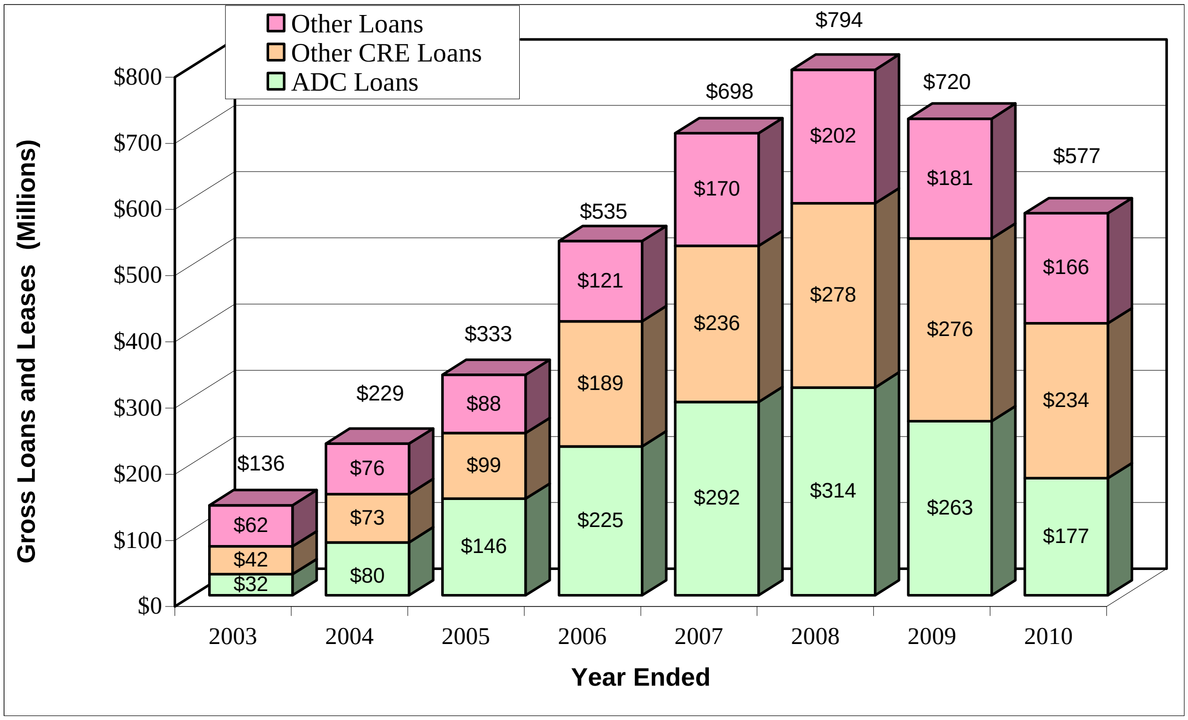
Aggressive Growth

From December 31, 2003 to December 31, 2008, ASB's loan portfolio grew from $136 million to $794 million (or 484 percent).[2] Contributing to this growth was an increase in total CRE loans (including ADC loans) from $74 million at year-end 2003 to $592 million at year-end 2008. During this same period, ADC loans grew from $32 million to $314 million (an increase of 881 percent). ASB's ADC lending included speculative construction and land development projects.[3] Figure 1 illustrates the general

[2] The three bank acquisitions contributed $167 million (or 25 percent) of ASB's $658 million in loan growth.
[3] Speculative lending involves the financing of projects for which a buyer has not yet been identified.

composition and growth of ASB's loan portfolio in the years preceding the institution's failure.

Figure 1: Composition and Growth of ASB's Loan Portfolio, 2003-2010



Source: OIG Analysis of Consolidated Reports of Condition and Income (Call Reports) for ASB.

<u>CRE and ADC Concentrations</u>

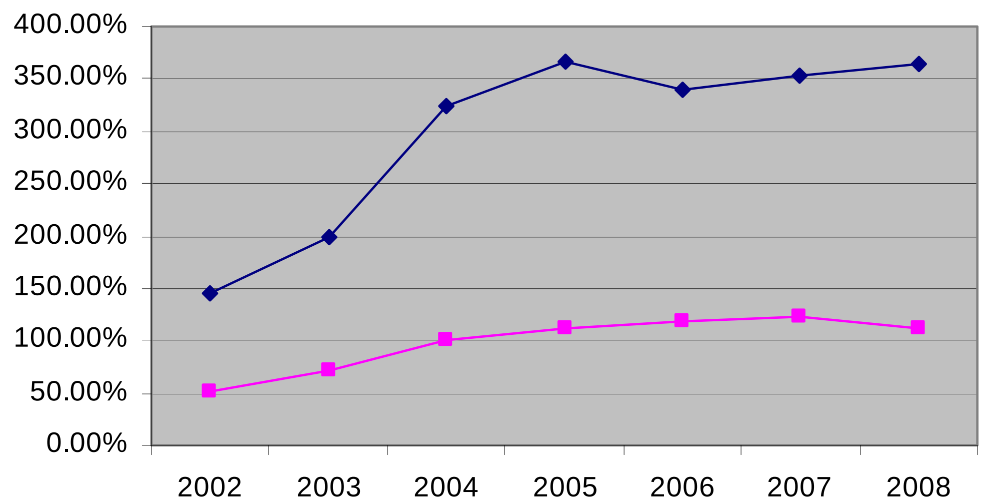
In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). Although the Joint Guidance does not 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 loans (referred to in this report as ADC loans) representing 100 percent or more of total capital.

As of December 31, 2007, ASB's non-owner-occupied CRE loans represented 723 percent of the institution's total capital. Further, the bank's ADC loan concentration at year-end 2007 represented 354 percent of total capital. Both of these concentrations significantly exceeded the levels defined in the Joint Guidance as possibly warranting further supervisory analysis. Further, as reflected in Figure 2, ASB's ADC loan concentration significantly exceeded the bank's peer group[4] average throughout the life of the bank.

Figure 2: ASB's ADC Loan Concentration Compared to Peer Group



	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08
ASB	145.90%	199.41%	323.43%	365.44%	339.27%	353.95%	364.82%
Peer	52.48%	71.84%	99.55%	112.83%	117.42%	123.58%	111.47%

Source: UBPRs for ASB.

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. Due to these and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans.

Although ASB had implemented certain controls for managing its CRE and ADC loan concentrations, its concentration risk management practices were not adequate. Among other things, the institution's ADC loan concentration limits were high. Specifically, ASB's internal guidelines allowed ADC concentrations of up to 400 percent of the bank's risk-based capital, exposing the institution to potential adverse market conditions. In

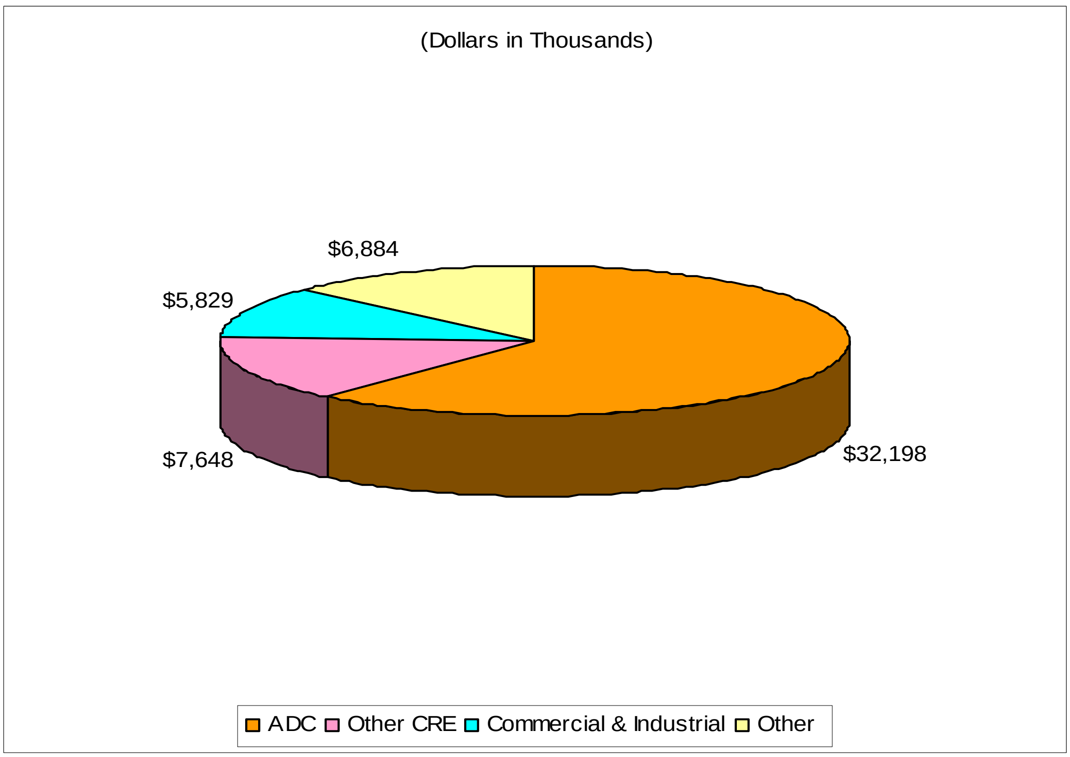
[4] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. ASB's peer group included all insured institutions with assets between $300 million and $1 billion.

addition, the institution did not stress-test its CRE and ADC loan portfolios to assess the impact that various economic scenarios might have on the institution's asset quality, capital, earnings, and liquidity as described in the Joint Guidance. The bank had also not developed a feasible contingency plan to mitigate the risks associated with its ADC loan concentration in the event of adverse market conditions.

ADC Loan Losses

At the time of the February 2009 examination, ASB's adversely classified assets totaled $81 million (or 94 percent of Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL)). This amount included $70 million in classified loans. By the February 2010 examination, adversely classified assets had increased to $180 million (or 271 percent of Tier 1 Capital plus the ALLL). In its Call Report for the year ended December 31, 2010, ASB reported that nearly 20 percent of its total loan portfolio was in a nonaccrual status. Further, about 40 percent of the bank's ADC loan portfolio was not performing at that time. As reflected in Figure 3, the majority of ASB's loan charge-offs pertained to ADC loans.

Figure 3: ASB's Net Loan Charge-offs through December 31, 2010



Source: Call Reports for ASB.

Additionally, as borrowers defaulted on loans, ASB's other real estate owned (OREO)[5] increased from $759,000 in 2007 to over $21 million in 2009. As the real estate market and economy continued to decline, the bank's OREO increased to over $72 million by year end 2010.

[5] OREO is property taken over by a bank through loan foreclosures.

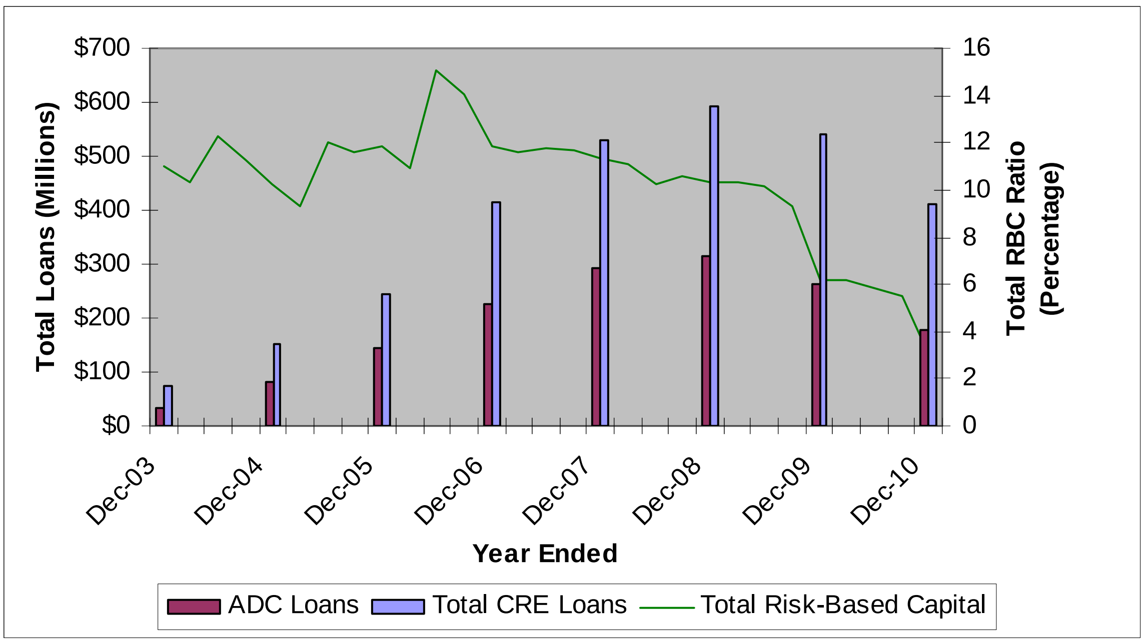
Individual Concentrations of Credit

Adding to the risk in the loan portfolio were individual concentrations of credit. Generally, these relationships consisted of an individual or group of real estate developers that had borrowed funds from ASB to finance numerous real estate projects. From 2006 to 2009, individual concentrations of credit ranged from 25 percent to 32 percent of Tier 1 Capital. Four of the individual concentrations of credit were cited by examiners as violations of state legal lending limits. Notably, the February 2009 and February 2010 joint examination reports identified approximately $6 million and $23 million, respectively, of these concentrations as being adversely classified. ASB's individual concentrations of credit increased the bank's exposure to a sustained downturn in the real estate market.

Capital Levels Relative to CRE and ADC Loan Growth

While risk in the loan portfolio increased due to ASB's growing ADC loan exposure, capital ratios remained relatively constant or declined. This trend limited the bank's ability to absorb losses due to unforeseen circumstances and contributed to the losses incurred by the DIF when the institution failed. Figure 4 illustrates the trend in ASB's Total Risk-Based Capital relative to CRE and ADC loans.

Figure 4: Trend in ASB's Total Risk-Based Capital Ratio Relative to CRE and ADC Loans



Source: UBPRs for ASB.

Although ASB's exposure to ADC loans was much higher than the bank's peer group average, ASB's capital levels were consistently below its peer group average. Table 2 reflects ASB's Total Risk-Based Capital ratios compared to the bank's peer group from 2003 to 2008.

Table 2: ASB's Total Risk-Based Capital Ratios Compared to Peer Group

	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08
	(Percent)					
ASB	11.03	10.21	11.88	11.81	11.32	10.33
Peer	16.01	14.57	13.98	12.89	12.73	12.60

Source: UBPRs for ASB.

The FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed. In addition, 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. Had ASB maintained higher capital ratios commensurate with its risk profile, the institution's loan growth may have been constrained, and losses to the DIF may have been mitigated to some extent.

Oversight of the Lending Function

Ineffective Board and management oversight of the lending function contributed to the asset quality problems that developed when the economy and local real estate market declined. Examiners identified areas for improvement in ASB's credit risk management practices in examination and visitation reports from 2006 to 2010. References to weaknesses in loan underwriting, credit administration, and related monitoring practices were most prevalent in the February 2009 and February 2010 examination reports. Some of the more salient weaknesses are briefly described below.

- **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. Examiners noted that loan underwriting needed to be enhanced for large, complex lending relationships. Specifically, it was difficult to determine the global financial condition or ability of borrowers to repay without consolidated financial statements and eliminations of intercompany transactions documented in loan files.

- **Use of Interest Reserves.** 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 reserves.[6] The memorandum states that if a

[6] 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 sellout or lease-up period.

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 reserves and its internal reporting on the use of reserves is important to institutions with construction and development loan concentrations. Examiners noted instances in which management's use of interest reserves was not acceptable. Specifically, examiners identified loans referred to as "working capital" loans or "investment" lines of credit that were used to pay interest on other loans, but were not properly identified as interest reserves. Examiners also noted that ASB had established interest reserves for some loans that were no longer (or never were) in the development or construction phase.

- **Appraisals.** Part 323, *Appraisals*, of the FDIC Rules and Regulations, identifies real estate financial transactions, including loan renewals, requiring the services of an appraiser. Examiners noted instances in which loans were renewed after a significant change in the real estate market, but evaluations or appraisals had not been obtained.

- **Legal Lending Limit.** Section 7-1-285 of the Financial Institutions Code of Georgia imposes limitations on the amount of loans to one borrower and 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. Examiners reported three lending relationships that exceeded these limitations, two of which were cited at more than one examination.

- **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. At the 2006 and 2009 examinations, examiners identified several loans that collectively exceeded these regulatory guidelines.

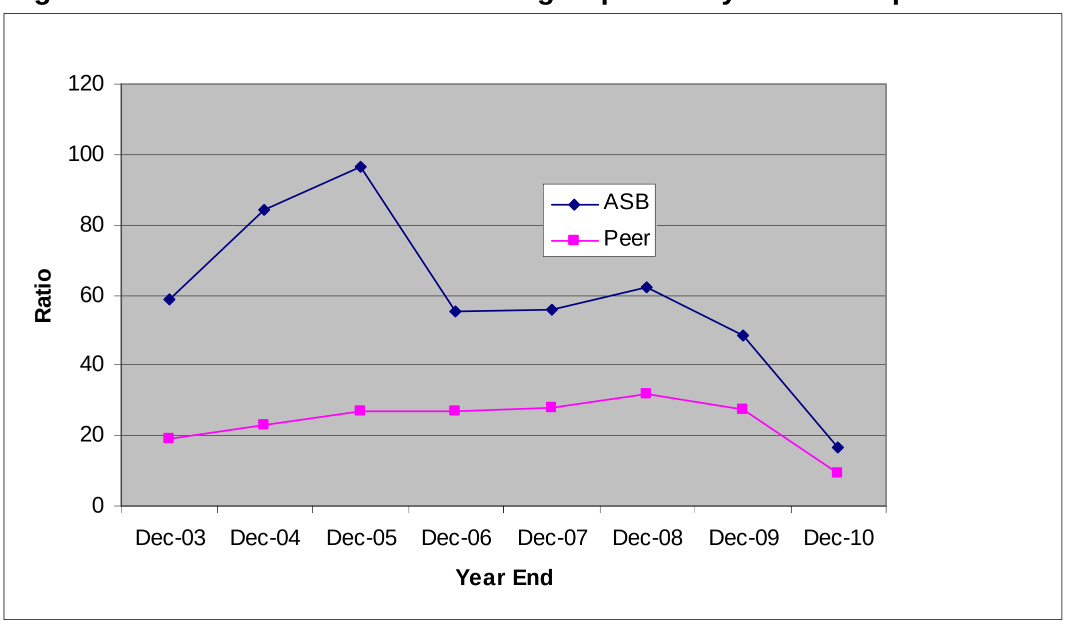
- **Underfunded ALLL**. According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (Policy Statement on ALLL), the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. As a result, institutions are responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently-applied process for determining the ALLL. The February 2010 examination and August 2010 visitation reports stated that ASB's ALLL was underfunded by $15 million and $102,000, respectively.

Funding Strategy

In the years preceding its failure, ASB became increasingly dependent on non-core funding sources to support loan growth and maintain adequate liquidity. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. According to the Examination Manual, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

A bank's net non-core funding dependency ratio is a key measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). As shown in Figure 5, ASB's net non-core funding dependency ratio was consistently higher than its peer group, ranking in the 90th to 93rd percentile from 2007 to 2009. ASB's net non-core funding dependency ratio was elevated due to the bank's heavy reliance on aggressively priced deposits, brokered deposits, FHLB borrowings, and Federal Funds purchased.

Figure 5: ASB's Net Non-Core Funding Dependency Ratio Compared to Peer



Source: UBPRs for ASB.

During the November 2008 visitation, examiners determined that ASB's poor asset quality and deficient earnings had weakened the bank's liquidity position, presenting a risk that the bank would not be able to attract funds in the open market on reasonable terms. Examiners noted that the need to replace brokered deposits, fund deposit withdrawals, and meet previously established loan commitments presented risk to the bank's liquidity profile. To address these concerns, ASB's Board adopted a Bank Board Resolution (BBR) that included a provision intended to prevent any further increase in the bank's brokered deposits holdings and eliminate its reliance on brokered deposits.

By the February 2009 examination, ASB's liquidity position had become less than satisfactory. Although the Board had adopted a brokered deposit reduction plan and made some progress in reducing its brokered deposits, the bank's brokered deposits still represented almost half of total deposits. In addition, ASB's net non-core funding dependency ratio remained excessively high at 62 percent. Examiners noted that the Board-approved policy limit of less than 65 percent for net non-core funding dependency appeared excessive given the level of risk in the bank's loan portfolio.

Based on the results of the February 2009 examination, the FDIC, in conjunction with the GDBF, initiated a Cease and Desist Order (C&D) against ASB, effective September 11, 2009, which included a provision to eliminate the bank's reliance on brokered deposits. In response, ASB adopted a brokered deposit plan effective September 11, 2009 and began liquidating its investment portfolio to increase cash reserves and maintain liquidity. As a result, the bank's investment portfolio decreased from $155 million at year-end 2009 to $85 million by the quarter-ending March 31, 2011. By the time of the 2010 examination and visitation, the bank's liquidity position had become critically deficient, and access to outside funding sources was strained.

The FDIC's Supervision of ASB

The FDIC, in coordination with the GDBF, provided ongoing supervisory oversight of ASB through on-site risk management examinations, visitations, and off-site monitoring activities. The regulators also reviewed and approved ASB's previously discussed acquisition of three institutions that were part of the bank's expansion efforts. Through its supervisory efforts, the FDIC identified key risks in ASB'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 ADC and other CRE loans, lack of adequate capital, weak loan underwriting and credit administration practices, and heavy reliance on non-core funding sources. The FDIC and the GDBF also made numerous recommendations for improvement. In November 2008, ASB's Board adopted a BBR to address concerns identified during the November 2008 visitation. Further, in September 2009, the FDIC, in coordination with the GDBF, issued a C&D against ASB to address the safety and soundness concerns identified during the February 2009 joint examination.

As discussed below, a more forward-looking assessment of ASB's risk profile during earlier examinations, particularly during the GDBF's November 2007 examination, may have been prudent. Such an assessment may have resulted in lower supervisory ratings and a supervisory action and established a strong supervisory tenor at a critical time. This approach may have influenced ASB to curb its growth appetite sooner than it did, mitigating, to some extent, the financial problems experienced by the bank and the losses incurred by the DIF. FDIC examiners became sharply critical of ASB's risk management practices during the November 2008 visitation, and FDIC and GDBF examiners reported significant weaknesses in subsequent examinations and visitations. However, by that time, the institution's financial condition and lending markets were rapidly deteriorating, making remedial efforts difficult.

The FDIC has taken a number of actions to increase its supervisory attention to banks with risk profiles similar to ASB. Such actions include instituting a training initiative for examiners on forward-looking supervision and issuing additional supervisory guidance on CRE and ADC concentrations and funds management practices.

Supervisory History

From 2006 to 2010, the FDIC and the GDBF conducted four on-site examinations and three visitations of ASB. The frequency of this on-site examination activity was generally consistent with relevant statutory and regulatory requirements.[7] The scope of our work focused on the FDIC's supervision of ASB from 2006 until the bank's closure in May 2011. Table 3 summarizes key supervisory information pertaining to ASB's examinations and visitations.

[7] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, on-site examinations of every state non-member bank at least once every 12-month period and allows for 18-month intervals for certain small institutions (i.e., total assets of less than $500 million) if certain conditions are satisfied. ASB was not considered a small institution during the period covered by our review. We noted that the length of time between the November 2007 examination and February 2009 examination was approximately 1 month longer than permitted by FDIC policies for implementing the regulations and statute. However, the FDIC completed a visitation in November 2008, which we determined mitigated the effect of the delay.

Table 3: On-site Examinations and Visitations of ASB, 2006-2010

Examination or Visitation Start Date	Examination or Visitation	Regulator(s)	Supervisory Ratings (UFIRS*)	Number of Violations and/or Contraventions	Informal or Formal Action Taken***
11/20/06	Examination	FDIC	212122/2	4	None
11/26/07	Examination	GDBF	222222/2	4	None
11/12/08	Visitation	FDIC	333443/3	Not Applicable**	BBR effective November 17, 2008
02/17/09	Examination	FDIC/GDBF	444343/4	5	C&D effective September 11, 2009
10/13/09	Visitation	FDIC/GDBF	No change in the ratings	Not Applicable**	C&D still in effect
02/01/10	Examination	FDIC/GDBF	555555/5	7	C&D still in effect
08/16/10	Visitation	FDIC	No change in the ratings	Not Applicable**	C&D still in effect

Source: OIG analysis of examination reports and visitation memorandums for ASB.
* See the report Glossary for a definition of UFIRS, which establishes the CAMELS rating system.
** The visitations did not assess the bank's compliance with laws and regulations.
*** Informal actions often take the form of a BBR or Memorandum of Understanding. Formal enforcement actions often take the form of a C&D or a Supervisory Directive.

Off-site Monitoring

The FDIC's off-site monitoring procedures generally consisted of contacting the bank's management from time to time to discuss current and emerging business issues and using automated tools[8] to identify potential supervisory concerns. Although ASB had high CRE and ADC concentrations, the FDIC's automated bank monitoring programs did not trigger any offsite reviews prior to 2009. However, according to an RMS official, the FDIC conducted a visitation of ASB in November 2008 based on an internal RMS monitoring program to assess the risks posed by institutions with a significant level of CRE and ADC concentrations.

ASB became subject to an off-site review that was triggered by the bank's significant provisions made to the ALLL during the third quarter of 2009. The FDIC contacted the bank's president, who stated that he anticipated a loss for the third quarter of between $5 and $6 million because of problem assets centered in the CRE portfolio. At the time, ASB was subject to a C&D, so the FDIC continued to monitor the bank.

[8] The FDIC uses various off-site monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating system and the Growth Monitoring System. Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions with a composite CAMELS rating of 1 or 2 that are likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

Enforcement Actions

Following the November 2008 FDIC visitation, ASB's Board drafted and adopted a BBR containing nine provisions intended to address examiner concerns. The BBR addressed such matters as the: (1) development and adoption of a capital plan; (2) review and revision of the bank's loan underwriting and administration procedures for ADC loans; (3) reduction of classified items and concentrations; and (4) review and assessment of the adequacy of the bank's contingency funding plan. Based on the results of the February 2009 examination, the FDIC, working in conjunction with the GDBF, issued a C&D on September 11, 2009. The C&D required, among other things, that the institution:

- Increase Board participation in the affairs of the bank.

- Analyze credit concentrations and develop a plan to reduce such concentrations.

- Submit a written plan to reduce ADC loan concentrations.

- 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 written lending, underwriting, and collection policies to provide effective guidance and control over the lending function.

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

- Discontinue accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC.

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

Supervisory Response to Key Risks

In the years preceding ASB's failure, the FDIC and the GDBF identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination and visitation reports, correspondence, and recommendations. In addition, the FDIC issued a C&D in September 2009. A summary of supervisory activities related to the bank's key risks follows.

2006 Supervisory Activities

Examiners determined during the November 2006 examination that ASB's overall condition was satisfactory and that management operated the bank in a satisfactory manner through effective operating policies and sufficient practices. In addition, the Board was active and well-informed. Asset quality and earnings were considered strong, and capital was considered adequate. Examiners identified ASB's CRE and ADC industry and individual concentrations, but determined that the bank's monitoring practices were adequate. Examiners also noted ASB's increasing reliance on non-core funding sources to support growth, but considered liquidity to be adequate. A contravention of *Interagency Guidelines for Real Estate Lending Policies* contained in Appendix A of part 365 of the FDIC Rules and Regulations was also identified.

<u>2007 Supervisory Activities</u>

During the November 2007 examination, examiners determined that the overall condition of the bank remained satisfactory. However, the slowdown in the economy and depressed real estate markets were negatively affecting the bank's financial performance and asset quality. Specifically, earnings had declined following the prior examination and adversely classified assets had increased from 4 percent to 33 percent of Tier 1 Capital plus the ALLL. As a result, examiners lowered the bank's Asset Quality and Earnings component ratings from a "1" to a "2."

Examiners noted that ASB had experienced tremendous growth following its opening in 2001, fueled by local business, an expansion in its branch system, and recent acquisitions. The bank's annual asset growth rate was 73 percent in 2006 and was 23 percent as of the 2007 examination. In addition, CRE and ADC loan concentrations represented 697 percent and 349 percent,[9] respectively, of risk-based capital, posing significant risk to the institution. Examiners made numerous recommendations in the report of examination for management to improve its risk management practices. Notably, examiners recommended that management:

- Improve the manner in which risk exposure is measured and the policies and procedures governing that risk.

- Formalize the appraisal review process, particularly for large loans.

- Modify the loan policy to address the *Interagency Guidelines for Real Estate Lending Policies*.

Examiners also recommended that the Board establish limits on the bank's aggregate exposure to CRE, including sub-limits by loan type, property type, geographic market, or any other relevant segmentation.

To keep pace with the asset growth, the holding company injected capital totaling $30 million during 2005 and 2006. Nevertheless, the bank's Tier 1 Leverage Capital ratio was 9.32 percent, down from 11.76 percent at the prior examination. In addition, the bank's Total Risk-Based Capital ratio was 10.46 percent, slightly above the minimum requirement for maintaining a *Well Capitalized* position for PCA purposes. Examiners

[9] ASB's management had established an internal guideline of 400 percent of risk-based capital for total ADC loans outstanding.

also noted that ASB's net non-core dependency ratio had fallen 4 percent (to 54 percent) from the prior examination.

2008 Supervisory Activities

During the November 2008 visitation, examiners identified significant deterioration in ASB's loan portfolio that was adversely affecting other areas of the bank's operating performance and downgraded the bank to a composite "3." Adversely classified assets had more than doubled since the prior examination, comprising 70 percent of Tier 1 Capital and the ALLL. In addition, problems had developed in a significant volume of the bank's speculative ADC projects, which lacked proper monitoring and risk reduction strategies. Examiners noted that ASB's management had aggressively pursued loan growth at the expense of prudent lending standards and that the Board and management had not appropriately supervised the bank's activities.

An October 20, 2008 external loan review performed on behalf of the bank identified numerous deficiencies in loan underwriting and credit administration. Among other things, the review found that:

- management had failed to fully document the financial condition of borrowers and obtain current real estate appraisals, when appropriate;

- global cash flow calculations had not been consistently prepared using current financial information during underwriting; and

- borrower financial information was often not current or complete.

Examiners also determined that the ALLL was inadequate due to management not charging off deficient balances on collateral-dependent loans. Further, capital was considered to be less than satisfactory given the risks associated with the bank's poor asset quality, deficient earnings performance, and moderate market risk exposure. Additionally, examiners found that liquidity had weakened and that associated monitoring practices needed improvement. Notably, ASB's net non-core dependency ratio of 61 percent was considered excessively high. Examiners cautioned ASB's management that the need to replace brokered deposits, fund other deposit withdrawals, and meet previously established loan commitments could impair the bank's liquidity position. As stated earlier, ASB's Board initiated a BBR to address examiner concerns.

2009 Supervisory Activities

Examiners determined during the February 2009 joint examination that the overall condition of the bank was unsatisfactory and downgraded the bank to a composite "4." Examiners noted that "the Board and senior management had embarked on a rapid growth strategy over the past few years, without implementing sound risk management practices." Problems were attributed to rapid growth funded by the aggressive use of non-core deposits and deteriorating market conditions coupled with the Board not ensuring that the bank maintained sufficient capital throughout the growth period. Adversely classified assets had increased to 94 percent of Tier 1 Capital and the ALLL, posing significant risk to the institution. The majority of asset quality problems were centered in ADC loans, which represented 385 percent of Tier 1 Capital. Notably, the bank had a CRE concentration of 695 percent, which exceeded the bank's newly established internal guideline of 500 percent. Additionally, ASB had five individual concentrations of credit that represented 25 percent or more of Tier 1 Capital, posing added risk.

The examination report identified numerous loan underwriting, credit administration, and monitoring weaknesses related to CRE (and ADC) concentrations, including a: (1) liberal use of interest reserves, (2) failure to perform global cash flow analysis on complex credits, (3) significant volume of loan documentation exceptions, and (4) lack of implementation of recent loan policy revisions.

The FDIC, in coordination with the GDBF, pursued a C&D to address the risks identified during the examination. The examination report was issued in July 2009 and the C&D in September 2009. FDIC and GDBF officials stated that, due to resource constraints, it took longer than anticipated to issue the final examination report. Both the FDIC and GDBF have since implemented internal goals of issuing final examination reports within 90 days of the start of examinations.

In October 2009, a joint visitation was conducted to review ASB's internal classifications and asset quality, capital, earnings, liquidity, and changes in management or strategic plans. Examiners noted that adversely classified assets had increased to 165 percent of Tier 1 Capital and the ALLL, and past-due and nonaccrual loans had increased to over 9 percent of total loans. Further, there was a high probability that the ALLL was underfunded. There were no positive factors impacting capital adequacy, since adversely classified assets in relation to capital had increased considerably, and earnings were rapidly declining. Further, ASB's liquidity position remained risky with management relying heavily on brokered deposits. Further, the bank's contingency funding plan lacked specific strategies since bank management had not addressed two key variables—possible deposit reductions and loan payoffs. Examiners cautioned management that a runoff of non-brokered deposits could threaten the bank's short-term viability. Examiners advised management to strengthen contingency planning and cash flow projections.

Examiners also noted noncompliance with four of the nine provisions in the bank's BBR and that further enhancements were needed in the bank's ADC administration procedures. In addition, the bank's strategy for reducing concentrations had not been fully implemented, and the bank's contingency funding plan did not adequately address key areas.

2010 and 2011 Supervisory Activities

Examiners determined during the February 2010 joint examination that the overall condition of the bank was critically deficient, resulting in a composite "5" rating. All financial components had deteriorated since the previous examination and were considered critically deficient. Adversely classified items had increased to 271 percent of Tier 1 Capital and the ALLL, and the bank was *Undercapitalized* for PCA purposes. An

August 2010 FDIC visitation found that the overall condition of the bank remained critically deficient, despite management's efforts to improve the bank's condition. At that time, ASB's capital position had declined to *Significantly Undercapitalized* for PCA purposes. By the close of 2010, the bank had fallen to *Critically Undercapitalized*, and prospects for meaningful improvement were minimal.

For the remainder of 2010 until the bank's closing in May 2011, the FDIC continued to monitor the bank's liquidity, efforts to raise capital, and compliance with the C&D.

Supervisory Lessons Learned

In retrospect, a more forward-looking assessment of ASB's risk profile and management practices during earlier examinations, particularly during the GDBF's November 2007 examination, may have been prudent. At the time of the November 2007 examination, ASB had a significant exposure to ADC loans, its lending markets were beginning to experience a slowdown, and adversely classified assets had increased to 33 percent of Tier 1 Capital plus the ALLL. In addition, although ASB's ADC loan exposure was much higher than the bank's peer group average, ASB's capital ratios were below peer group averages. Further, ASB was heavily reliant on non-core funding sources, including potentially volatile brokered deposits, to support loan growth and maintain liquidity.

A more critical assessment of the ASB's risk management practices during the GDBF's November 2007 examination may have resulted in lower component ratings and a lower composite rating, which could have led to a supervisory action. Such an approach would have established a strong supervisory tenor that may have influenced ASB to curb its appetite for loan growth sooner than it did, potentially mitigating, to some extent, the financial problems experienced by the bank and the losses incurred by the DIF. FDIC examiners became sharply critical of ASB's risk management practices during the November 2008 visitation, and FDIC and GDBF examiners reported significant weaknesses in subsequent examinations and visitations. In addition, the FDIC, working with the GDBF, issued a C&D in September 2009. However, by that time, the institution's financial condition and lending markets were rapidly deteriorating, making remedial efforts difficult.

The perspectives gained from the failure of ASB are not unique. Like many other institutions that failed in recent years, ASB developed a significant exposure to CRE and ADC loans at a time when the bank's financial condition and lending markets were generally favorable. This exposure made the bank vulnerable to a sustained downturn in the real estate market. The FDIC has taken a number of actions to increase its supervisory attention to banks with risk profiles similar to ASB. With respect to the issues discussed in this report, the FDIC has, among other things, provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized. The training addressed the importance of considering management practices, as well as current financial performance or trends, when assigning ratings, consistent with existing examination guidance.

The FDIC has also issued supervisory guidance addressing the risks associated with ADC lending and funds management practices. For example, the FDIC issued FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices. It also articulated the FDIC's concerns regarding the need for proper controls over interest reserves used for ADC loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

With respect to funds management practices, the FDIC has issued FIL-84-2008, entitled, *Liquidity Risk Management*, which highlights the importance of contingency funding plans in addressing relevant stress events and states that FDIC requirements governing the acceptance, renewal, or roll-over of brokered deposits should be incorporated in those plans.

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 generally 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 ASB's management regarding its efforts to raise needed capital. However, as discussed below, the FDIC could have better addressed ASB's failure to submit required capital restoration plans.

Table 4 illustrates ASB'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 ASB's capital categories and the FDIC's implementation of PCA follow the table.

Table 4: ASB's Capital Levels Relative to PCA Thresholds, 2009-2011

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well-Capitalized Thresholds	**5 percent or more**	**6 percent or more**	**10 percent or more**	
ASB's Capital Levels				
06/30/09	6.56	8.69	10.12	*Well Capitalized*
09/30/09	5.69	7.91	9.34	*Adequately Capitalized*
12/31/09	3.37	4.73	6.19	*Undercapitalized*
03/31/10	3.65	4.70	6.16	*Undercapitalized*
06/30/10	3.27	4.36	5.83	*Undercapitalized*
09/30/10	3.14	4.02	5.49	*Significantly Undercapitalized*
12/31/10	1.24	1.53	3.03	*Critically Undercapitalized*
03/31/11	0.99	1.21	2.42	*Critically Undercapitalized*

Source: Call Reports for ASB.

ASB was considered *Well Capitalized* until the issuance of the joint C&D on September 11, 2009. At that time, ASB fell to *Adequately Capitalized* because the C&D contained a provision that required the bank to maintain a Tier 1 Capital ratio equal to or greater than 8 percent of total assets and a Total Risk-Based Capital ratio equal to or greater than 10 percent of total risk-weighted assets. As a result, pursuant to section 29 of the FDIC Act, ASB could not accept, renew, or rollover any brokered deposits unless it applied for, and the FDIC granted, a waiver. ASB's management applied for a brokered deposit waiver on September 8, 2009, but subsequently withdrew the application on February 11, 2010.

Although not required by the C&D or PCA, ASB's management submitted a Capital Plan to the FDIC on December 11, 2009. The Capital Plan provided a chronological history of the bank's efforts to raise capital and included a 2-year capital projection based upon a reduction in ASB's total assets. The FDIC reviewed the plan and determined that it did not establish a reasonable approach for reaching the minimum capital levels defined in the C&D. The Capital Plan was never approved by the FDIC.

In a letter dated March 26, 2010, the FDIC notified ASB's Board that the bank had fallen to *Undercapitalized* based on the results of the February 8, 2010 examination. The letter reminded the Board of restrictions imposed on *Undercapitalized* institutions, including restrictions on capital distributions, management fees, asset growth, and acquisitions. The letter also noted that the bank was required to file a CRP with the Regional Director within 45 days of the date of receipt of the letter. However, ASB did not submit a CRP, and we found no indication that the FDIC contacted ASB's management regarding its failure to submit a CRP.

Section 325.104(e) of the FDIC Rules and Regulations states that an *Undercapitalized* bank that fails to submit a written CRP within 45 days shall be subject to all of the provisions of section 38 and the corresponding FDIC PCA regulations that are applicable to *Significantly Undercapitalized* institutions. Although the FDIC's internal records indicate that ASB was reclassified to *Significantly Undercapitalized*, the bank was not formally notified of this change in its capital category at that time as prescribed by FDIC policy.

In a letter dated November 8, 2010, the FDIC notified ASB's Board that, based on the September 30, 2010 Call Report, the bank was considered *Significantly Undercapitalized*. In a letter dated March 3, 2011, the FDIC notified ASB's Board that the bank was considered *Critically Undercapitalized* based on the institution's March 1, 2011 Call Report filing for the quarter ended December 31, 2010. Neither of these letters requested that the bank submit a CRP as prescribed by FDIC policy.

Additional notifications and follow-up with the bank would have provided another avenue for ensuring the Board's awareness of its responsibilities under section 38 to submit an acceptable CRP. The FDIC did, however, implement various supervisory activities that served to substantially mitigate the effect of ASB's failure to submit a CRP. For example, the FDIC reviewed the status of ASB's capital-raising efforts described in the bank's quarterly progress reports required by the C&D. The FDIC also assessed the bank's capital position in examinations and visitations and corresponded with bank officials regarding their capital-raising efforts.

ASB explored strategic alternatives for improving its capital position, such as: (1) merging with another bank, (2) seeking new investors, and (3) selling its retail branches. ASB's management also applied for funds under the Capital Purchase Program, but subsequently withdrew the application. ASB's efforts to raise capital were ultimately unsuccessful. The GDBF closed the bank on May 20, 2011 because ASB was unable to raise sufficient capital to support its operations.

OIG Evaluation of Corporation Comments

The Director, RMS, provided a written response, dated December 16, 2011, to a draft of this report. That response is provided in its entirety as Appendix 4 of this report. In the response, RMS reiterated the causes of failure and the supervisory activities described in the report. The response noted that the FDIC issued a FIL in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment,* that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, the response referenced a 2009 FIL, entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*, issued by RMS to heighten its supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources. The response also stated that RMS is committed to ensuring that institutions meet all PCA requirements.

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 $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of ASB's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of ASB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

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

Scope and Methodology

The scope of this audit included an analysis of ASB's operations from January 2006 until its failure in May 2011. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the FDIC and the GDBF from November 2006 to August 2010.

- Reviewed the following:

    - Selected examination work papers prepared by the FDIC from 2006 to 2010.

    - Bank data contained in UBPRs and Call Reports.

    - Correspondence in the Atlanta Regional Office and the Atlanta Field Office.

Objectives, Scope, and Methodology

  - Various other records prepared by the Division of Resolutions and Receiverships (DRR) and RMS relating to the bank's closure.

  - Information in the FDIC's Virtual Supervisory Information On the Net System.

  - Pertinent RMS policies, procedures, and guidelines, as well as applicable laws and regulations.

- Interviewed the following FDIC officials:

  - RMS regional managers from the Atlanta Regional Office.

  - RMS examiners from the Atlanta Field Office.

  - GDBF officials.

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

Consistent with our audit objectives, we did not assess RMS's overall internal control or management control structure. We relied on information in the FDIC's systems and reports, and interviews of RMS and GDBF examiners, to obtain an understanding of ASB'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, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination and visitation reports, correspondence files, and testimonial evidence to corroborate data obtained from systems, which was 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's annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. RMS's compliance with the Results Act is reviewed in OIG 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 Rules and

Objectives, Scope, and Methodology

Regulations. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum 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. In addition, the OIG issued an audit report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

Further, with respect to more in-depth coverage of specific issues, 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 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. Finally, in September 2011, the FDIC OIG initiated two evaluations related to the (1) issuance, termination, and impact of risk management enforcement actions; and (2) policies and procedures examiners use for evaluating appraisals and the adequacy of an institution's ALLL.

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.
Bank Board Resolution (BBR)	A BBR is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Capital Restoration Plan (CRP)	Section 325.104(a)(1) of the FDIC Rules and Regulations requires a bank to file a written CRP 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.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

Glossary of Terms

Commercial Real Estate (CRE) Loans	CRE loans 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. CRE loans also include are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans.
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.
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.
Federal Home Loan Bank (FHLB) Borrowings	The FHLB System provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to its members. Advances (referred to as FHLB borrowings in this report) are funds that are available to members with a wide variety of terms to maturity, from overnight to long term, and are collateralized. Advances are designed to prevent any possible loss to FHLBs, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail.
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 other 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 a 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.
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 sellout or lease-up period.

Glossary of Terms

Loan-to-Value	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 Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.
Off-site Review Program	The FDIC's Off-site Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Off-site reviews are performed quarterly for each bank that appears on the Off-site Review List. Regional management is responsible for implementing procedures to ensure that off-site review findings are factored into examination schedules and other supervisory activities.
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 United States Code 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*.

Glossary of Terms

Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-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).
Risk-Based Capital Rules	Appendix A to Part 325—*Statement of Policy on Risk-Based Capital*—defines the FDIC's risk-based capital rules. Appendix A states that an institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together, and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution's qualifying total capital base is the numerator of the ratio.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, 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 CALL Reports submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ASB	Atlantic Southern Bank
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
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

Corporation Comments

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

December 16, 2011

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

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

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Atlantic Southern Bank, Macon, Georgia (Assignment No. 2011-081)

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 Atlantic Southern Bank (ASB), which failed on May 20, 2011. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on November 15, 2011.

ASB failed due to the Board's and management's inability to manage risks associated with its growth strategy centered on high concentrations of commercial real estate (CRE) and acquisition, development and construction (ADC) loans. ASB's weak CRE/ADC underwriting and lax credit administration practices and monitoring also contributed to the deterioration in the quality of its loan portfolio resulting in substantial losses, negative earnings and depleted capital. ASB was unable to raise additional capital to maintain operations.

From 2006 to 2010, the FDIC and the Georgia Department of Banking and Finance conducted four onsite risk management examinations, three onsite visitations and ongoing offsite monitoring. At the 2008 onsite visitation, examiners informed ASB Board members and executives that the increased level of classified loans and deficient earnings weakened ASB's liquidity position. The visitation also revealed deterioration in all component ratings and ASB was downgraded. The 2009 examination noted further deterioration of CRE and ADC loans, and ASB's heavy reliance on non-core funding, including brokered deposits and Federal Home Loan Bank borrowings. Examiners downgraded ASB and issued a Cease and Desist Order. In 2010 examiners noted continued deteriorating conditions characterized by critically deficient asset quality, significant losses and an erosion of capital and further downgraded ASB.

RMS has recognized the threat that institutions with high risk profiles, such as ASB, pose to the Deposit Insurance Fund and issued to FDIC-supervised institutions in 2008 Financial Institution Letter (FIL)-22-2008 entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*. This FIL re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations. Additionally, RMS issued in 2009 FIL-13-2009 entitled, *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition.* This FIL heightened our supervision of institutions with aggressive growth strategies or excessive reliance on volatile funding sources. With respect to our responsibilities under Prompt Corrective Action (PCA), RMS is committed to ensuring that institutions meet all PCA requirements.

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