Board of Governors of the Federal Reserve System

Material Loss Review of First Georgia Community Bank

Office of Inspector General

June 2009

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

OFFICE OF INSPECTOR GENERAL

June 29, 2009

The Honorable Daniel K. Tarullo
Chairman
Committee on Supervisory and Regulatory Affairs
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act, (FDI Act) as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of First Georgia Community Bank. The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

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

First Georgia Community Bank (First Georgia) was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and the Georgia Department of Banking and Finance (State). The State closed First Georgia in December 2008, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $72 million loss to the DIF, or 31.5 percent of the bank's $229 million in total assets.

First Georgia failed because its Board of Directors and management did not adequately control the risks associated with its (1) high concentration of acquisition, development, and construction loans made to home builders and developers; and (2) reliance on non-core funding, particularly brokered deposits. Weakening demand for housing in the local real estate market led to significant loan losses that eroded the bank's capital. The bank's deteriorating capital position triggered regulatory restrictions on renewing brokered deposits, thereby significantly impeding liquidity and ultimately leading to First Georgia's insolvency.

With respect to supervision, FRB Atlanta complied with regulatory guidance concerning the frequency of safety and soundness examinations, and conducted regular off-site monitoring commensurate with concerns and risks identified during examinations. FRB Atlanta rated First Georgia as a CAMELS composite 3 or lower during every safety and soundness examination

since 2002, when the institution became a state-chartered member bank of the Federal Reserve System.[1] In addition to FRB Atlanta's frequent criticisms of First Georgia's high loan concentrations, risk management, credit administration, and reliance on volatile non-core deposits, regulators entered into four enforcement actions designed to address the bank's deficiencies.

Nevertheless, First Georgia failed despite FRB Atlanta's close supervision. Fulfilling our mandate under section 38(k) provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to decrease the likelihood of the bank's failure or to reduce the loss to the DIF. Our review of FRB Atlanta's supervision of First Georgia found that an asset concentration in speculative acquisition, development, and construction loans contributed to the bank's failure. We believe that the significant and growing risk associated with this sizeable concentration in speculative construction loans, coupled with deficiencies in credit administration and risk management, warranted a more forceful supervisory response from FRB Atlanta during its 2006 safety and soundness examination.

First Georgia's supervisory history reveals a similar situation in 2003, when FRB Atlanta did require the bank to reduce its high convenience store loan concentration because of increasing credit risk and weaknesses in credit administration, loan underwriting, and management oversight. While it is not possible to determine the degree to which a stronger regulatory response in 2006 would have altered First Georgia's subsequent decline, it is reasonable to conclude that an earlier decrease in the speculative construction loan portfolio could have reduced the loss to the DIF.

We note that First Georgia's financial performance was strong in 2006, the time frame during which we believe FRB Atlanta could have directed the bank to reduce its speculative construction lending exposure. However, recent statements made by Board officials emphasize that supervisors must have an even firmer resolve and provide clear and very forceful communication in "good times," when risks appear low, losses or write downs have not yet been recognized, and "optimism abounds."

The failure of a single community bank does not provide sufficient evidence to draw broad-based conclusions. Nonetheless, First Georgia's failure points to a valuable "lesson learned" that Federal Reserve examiners and managers may find useful in planning and conducting future examinations of community banks with similar characteristics. Accordingly, First Georgia's failure demonstrates that a forceful supervisory response is warranted, even in the presence of strong financial performance, when community banks with weaknesses in risk management, credit administration, and loan underwriting accumulate a high concentration in a risky asset class.

During the course of our review, we also found that FRB Atlanta did not fully comply with supervisory guidance that addresses disagreements with CAMELS ratings assigned by state regulators. FRB Atlanta disagreed with the CAMELS composite upgrade assigned after a 2007 examination conducted by the State. According to supervisory guidance, when a Federal Reserve Bank disagrees with the rating assigned by a state regulator, the Reserve Bank should,

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[1] The CAMELS rating system is described in Appendix 3.

among other things, (1) formally assign a separate CAMELS rating, and (2) record the separate rating in a Federal Reserve examination database. While FRB Atlanta discussed their disagreement with the State, and informed the bank's Board of Directors that the institution would continue to be monitored as though it had not been upgraded, the Reserve Bank did not formally issue or record a separate CAMELS rating. Our report contains a recommendation designed to address this issue.

We provided our draft report for review and comment to the Director of the Division of Banking Supervision and Regulation. The Director agreed with our recommendation and said that he plans to send a reminder to ensure that Reserve Banks follow supervisory guidance pertaining to formally assigning and recording a separate CAMELS composite rating when the Reserve Bank disagrees with a rating assigned by a state supervisory agency. We plan to follow-up on this and any other action taken to implement our recommendation. The Director's response is included as Appendix 4.

We appreciate the cooperation we received from FRB Atlanta and Board staff during our review. The principal contributors to this report are listed in Appendix 5. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

/signed/

Elizabeth A. Coleman
Inspector General

cc: Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Mr. Roger T. Cole
Mr. William B. Estes

Board of Governors of the Federal Reserve System

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Background

First Georgia Community Bank (First Georgia)—a small community bank in Jackson, Georgia that opened in 1997—had three branches and two loan production offices serving residents and businesses in several counties south of metropolitan Atlanta. First Georgia became a state-chartered member bank of the Federal Reserve System (SMB) on October 1, 2002. The bank was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and the Georgia Department of Banking and Finance (State).

The State closed First Georgia on December 5, 2008, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. In a letter dated December 30, 2008, the FDIC Inspector General advised us that First Georgia's failure would result in a material loss to the Deposit Insurance Fund (DIF). The FDIC estimated that the bank's failure would result in a $72.2 million loss to the DIF, or 31.5 percent of the bank's $229 million in total assets. Under section 38(k) of the Federal Deposit Insurance Improvement Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

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

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

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

Cause of the Failure

First Georgia failed because its Board of Directors and management did not adequately control the risks associated with its (1) high concentration of acquisition, development, and construction

(ADC) loans made to home builders and developers; and (2) reliance on non-core funding, particularly brokered deposits. Weakening demand for housing in the local real estate market led to significant loan losses that eroded the bank's capital. The bank's deteriorating capital position triggered regulatory restrictions on renewing brokered deposits, thereby significantly impeding liquidity and ultimately leading to First Georgia's insolvency.

High-Risk Business Strategy Featured Loan Concentrations

Historically, First Georgia's business strategy centered on developing high loan concentrations. When FRB Atlanta began its first full scope examination in June 2003, First Georgia already had a high concentration of convenience store loans, representing 46 percent of its total loan portfolio and 419 percent of tier-1 capital. In general, concentrations of credit increase financial institutions' vulnerability to cyclical changes in the market place, and compound the risks inherent in individual loans. Therefore, concentrations may present a substantial risk to the safety and soundness of the institution.

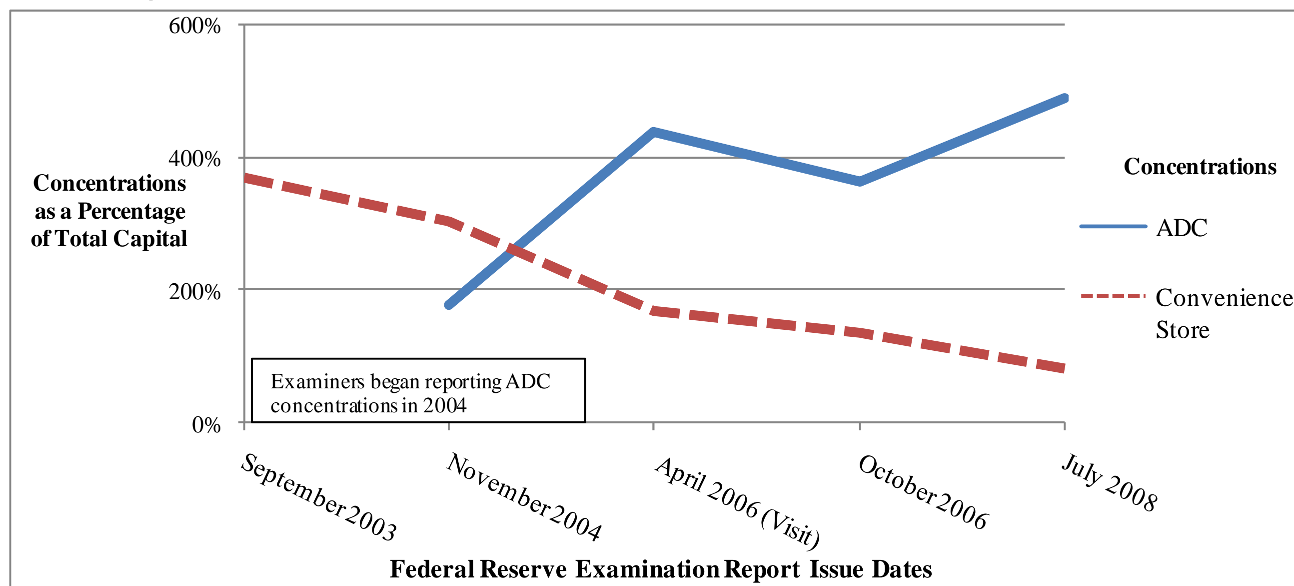
Risk management practices for controlling First Georgia's convenience store loan exposure were insufficient because of weak credit underwriting and significant loan policy deficiencies. For example,

- loan agreements often did not reference important financial information, or include key financial statements; and
- examiners found no evidence that appraisals for underlying collateral were reviewed to determine if assumptions were reasonable.

These deficiencies and the bank's less than satisfactory financial condition resulted in a 2003 supervisory enforcement action. Among other things, the enforcement action precluded First Georgia from making additional convenience store loans, and required periodic detailed reporting to regulators. In response, First Georgia's management decided to reduce the convenience store exposure, and moved aggressively into the commercial real estate market, particularly ADC lending to residential builders and developers. First Georgia's 2004 strategic plan stated that, "The Bank plans to move as quickly as possible, without a loss in profitability, from a concentration in convenience store loans to becoming a factor in the acquisition, development, and construction loan driven market . . . ."

To implement their new strategic objective, the bank hired a Chief Credit Officer to improve credit administration and to develop an ADC loan portfolio. Even though this executive and the lending staff that he recruited left First Georgia within two years, their efforts contributed to an ADC concentration that eventually peaked at almost 500 percent of total capital in 2008. Chart 1 illustrates that First Georgia essentially substituted a concentration in convenience store loans for a concentration in high-risk ADC lending.

Chart 1
First Georgia's Concentrations



By 2006, First Georgia's ADC concentration totaled $103 million, including $63 million in residential construction loans. The risks associated with the ADC portfolio were magnified by the speculative nature of the residential construction loan component; 93 percent of these loans were made to builders for constructing homes that were not pre-sold. This level of speculative lending violated First Georgia's internal policy, which limited such loans to 60 percent of the residential construction loan portfolio.

Regulatory criticisms directed at First Georgia's controls over the ADC concentration were similar to those expressed when convenience store lending was a concern. However, First Georgia's Board of Directors and management made what, at times, appeared to be notable improvements in response to recommendations and enforcement actions from regulators. Ultimately, First Georgia did not establish a sustainable credit administration infrastructure based on sound underwriting and loan administration practices. Accordingly, the systems and controls in place were not sufficiently robust to identify, monitor, and appropriately manage the bank's ADC concentration risks, especially in changing market conditions. Examples of First Georgia's credit administration deficiencies included

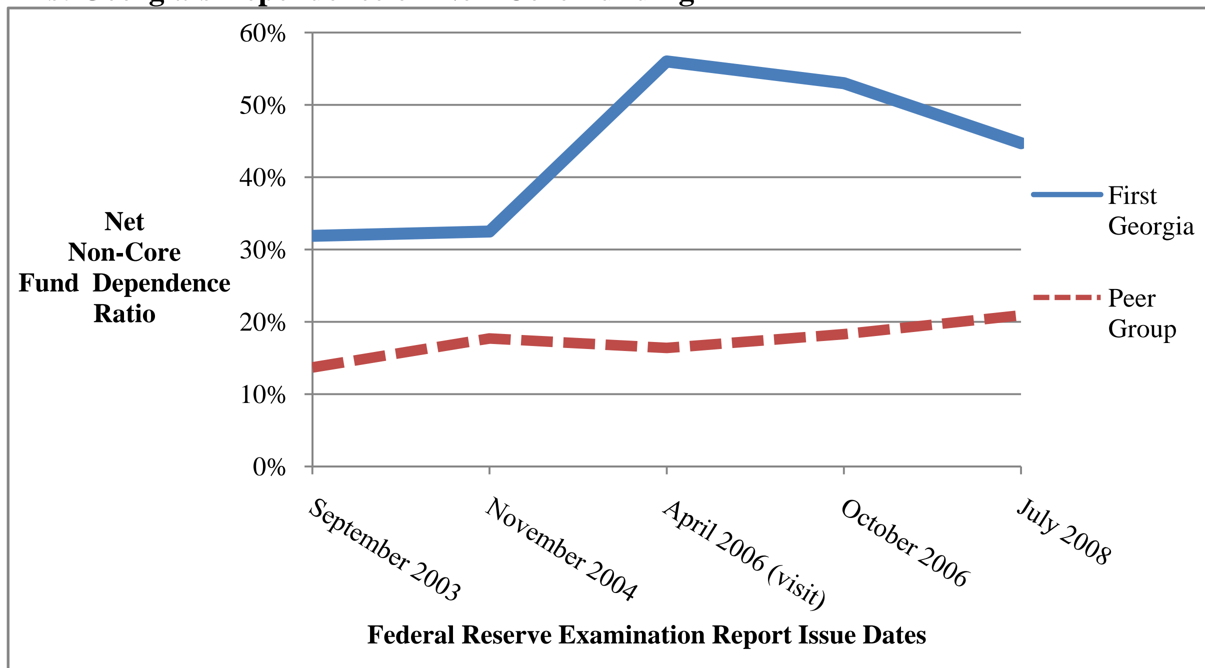
- lack of current financial information and credit reviews of significant lending relationships;
- insufficient monitoring of problem loans identified by the internal grading system; and
- inadequate documentation (during underwriting) of builders' profitability, experience, liquidity, historical performance, and global exposure to other lenders.

Sustained improvement in credit administration and risk management was hampered, at least in part, by turnover of key leadership and staff. For example, the Chief Credit Officer left First Georgia in 2005, and his loan production office staff also resigned. During the period covering 2005 to 2008, First Georgia was led by three different Presidents and experienced turnover of other key staff, and members of the Board of Directors.

Heavy Reliance on Non-Core Funding

Attracting local core deposits posed significant challenges for First Georgia because of high competition in its market. As a result, the bank was highly dependent on non-core funding sources, such as brokered deposits, Federal Home Loan Bank (FHLB) borrowing, high-rate deposits, and deposits concentrated in a few large customers. Reliance on non-core funding sources, particularly brokered deposits, is considered a risky strategy. Brokered deposit investors typically have no other relationship with or loyalty to the bank, and are only seeking the highest return possible. As illustrated in Chart 2, First Georgia's dependence on non-core funding sources was considerably higher than its peers. For example, in 2006, First Georgia's dependence on non-core deposits reached 56 percent, compared to the peer average of only 16 percent.

Chart 2
First Georgia's Dependence on Non-Core Funding



Deteriorating Local Real Estate Market Leads to Dramatic Increase in Problem Assets

First Georgia's asset quality deteriorated significantly as the economy slowed and the demand for residential housing declined. By the fourth quarter of 2007, the market areas served by First Georgia had an inventory of vacant developed lots that ranged from 52 to 116 months, far exceeding the eighteen to twenty-four months that is considered an acceptable level. As shown

in Table 1, classified assets almost doubled from $6 million in October 2006; to $11 million six months later; and then increased ten-fold, to $114 million, in the ensuing fourteen months. The dramatic increase in classified assets could be attributed to the worsening economic conditions and falling demand for residential real estate. According to examiners, by 2008, the high level of classified assets were primarily composed of speculative residential ADC loans. However, First Georgia's management was not proactive in recognizing and downgrading the loans that examiners cited as obviously distressed.

Table 1
First Georgia's Classified Assets and Allowance for Loan and Lease Losses (ALLL) History
($000's omitted)

Examination Report Issue Date	Total Loans	Classified Assets	ALLL
September 2003	106,091	6,506	2,098
March 2004	105,905	7,002	2,044
November 2004	123,681[a]	6,206	2,087 [a]
September 2005	167,233	4,476	2,174
October 2006	205,084	6,486	2,494
April 2007	230,380	11,038	3,130
December 2007	236,645	43,165	3,200
July 2008	209,471	114,166	6,700 / 14,000[b]

[a] Uniform Bank Performance Report as of 6/30/2004
[b] FRB Atlanta required First Georgia to increase the ALLL to $14 million from $6.7 million after reviewing First Georgia's loan portfolio.

The growth in classified assets prompted a corresponding increase in the allowance for loan and lease losses (ALLL). According to supervisory guidance, the ALLL should cover estimated losses on loans that are determined to be impaired, as well as estimated losses inherent in the remainder of the portfolio. In 2008, examiners noted weaknesses in the bank's ALLL methodology because it did not reflect the bank's recent experience with increasing losses or the devaluation of certain collateral in the current market. Accordingly, First Georgia's management was required to (1) raise the bank's $6.7 million ALLL balance to $14 million (see Table 1), and (2) re-file regulatory reports to reflect this change. Complying with the regulator's requirement to increase the ALLL by $7.3 million affected the bank's financial condition, ultimately eroding capital.

Decline in Capital Leads to Funding Crisis and Insolvency

First Georgia's deteriorating capital position invoked the Prompt Corrective Action (PCA) provisions of the FDI Act. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled depository institutions. The $7.3 million increase in the ALLL, in effect, resulted in First Georgia falling below the *well capitalized* PCA threshold to *adequately capitalized*. Under section 29 of the FDI Act, banks that are deemed *adequately capitalized* cannot accept, renew, or roll over brokered deposits, unless a waiver is obtained from the FDIC.

First Georgia received a brokered deposit waiver in June 2008. However, as losses continued to mount, the bank's PCA capital position declined to *undercapitalized* one month later. As soon as the bank became *undercapitalized*, the waiver expired because the FDI Act prohibits less than *adequately capitalized* banks from accepting brokered deposits. By August 2008, First Georgia had few prospects for funding $25 million of brokered deposits set to mature over the next four months. Alternative funding sources, such as secondary lines of credit, FHLB borrowings, and the Federal Reserve Discount Window, were not available because of the bank's precarious financial condition.

The weakening market conditions and resulting losses exposed the Board of Directors' and management's failure to establish, implement, and sustain a strong credit administration infrastructure. As the financial situation continued to deteriorate, the Board of Directors and bank management failed to understand the severity of the bank's problems, and did not acknowledge the continuing instability of the ADC market. According to regulators, this lack of understanding may have contributed to the Board of Directors' and management's failure to take timely and decisive corrective action to stem further large losses.

A full scope examination began in October 2008 and revealed that First Georgia's financial condition was continuing to deteriorate while the volume of classified assets was increasing. Examiners noted that the increase in the ALLL required to cover projected losses would lead to insolvency. Efforts by First Georgia Board members to recapitalize the bank or identify a viable acquisition or merger candidate were unsuccessful and, by late November, the bank's PCA capital position had dropped to *critically undercapitalized*. At that time, daily cash flow calculations revealed significant outflows from maturing brokered deposits that could not be replaced. On December 3, 2008, First Georgia's Board of Directors returned the bank's charter to the State. The State closed First Georgia on December 5, 2008, and appointed the FDIC as receiver.

Supervision of First Georgia Community Bank

As shown in Table 2, First Georgia was examined nine times between 2003 and 2008, five times by FRB Atlanta and four times by the State. Regulators performed on-site supervision at least once every ten months after FRB Atlanta completed its first examination in 2003. A twelve to eighteen month examination interval would have been permissible after the September 2005 and April 2007 State examinations, when the bank was upgraded to a CAMELS composite 2 rating. Nonetheless, after the upgrades, FRB Atlanta conducted a visitation or an examination within seven months. A synopsis of key Federal Reserve supervisory activities follows, including full scope and targeted examinations, a visitation, and four enforcement actions.

Table 2
First Georgia Supervisory Overview

Examination Start Date	Examination Report Issue Date	Supervisory Agency Conducting or Leading the Examination	Scope of Examination	CAMELS Composite Rating	Enforcement Actions
June 2003	September 2003	FRB Atlanta	Full	3	MOU
January 2004	March 2004	State	Full	3	
August 2004	November 2004	FRB Atlanta	Full	3	
June 2005	September 2005	State	Full	2	MOU Lifted Board Resolution Issued
February 2006 [a]	April 2006	FRB Atlanta	Visitation	n/a	
July 2006	October 2006	FRB Atlanta	Full and CRE Target	3	
February 2007	April 2007	State	Full	2	Board Resolution Lifted
November 2007	December 2007	FRB Atlanta (Joint with State)	Target	4	MOU
March 2008	July 2008	FRB Atlanta	Full	5	Written Agreement
October 2008 [b]	n/a	State (Joint with FRB Atlanta)	Full	n/a	

[a] This on-site visit was prompted by a change in senior bank management, and included a review of asset quality, liquidity, and management. The visitation is not counted as an examination.
[b] A final report was not issued because First Georgia was closed before examination work was completed.

FRB Atlanta's First Examination Resulted in a CAMELS Composite 3 Rating and an Enforcement Action

FRB Atlanta began its first full scope examination of First Georgia in June 2003, and downgraded the bank to a CAMELS composite 3 from the CAMELS composite 2 assigned by the State in the previous examination. Examiners rated asset quality, management, earnings, and liquidity as less than satisfactory, citing weaknesses in risk management, credit administration, and loan underwriting. In addition, the examination report noted that an increasing trend in problem loans exposed First Georgia to an unacceptable level of risk.

Examiners cited First Georgia's concentration in convenience store loans as their greatest concern, and recommended that the concentration be reduced to a more manageable level. In addition, issues were raised regarding the near-term liquidity risks associated with the bank's heavy reliance on volatile funding, particularly brokered deposits. Examiners also pointed to a need for stronger strategic planning and Board of Director oversight.

Based on the bank's deteriorating financial condition and the significance of the deficiencies noted during the 2003 examination, FRB Atlanta and the State promulgated an informal supervisory action; specifically, a Memorandum of Understanding (MOU). The MOU required that the Board of Directors address a wide range of deficiencies and take actions to improve the

financial condition of the bank. The bank was directed to stop making new convenience store loans, improve monitoring and management of the convenience store loan concentration, and prepare a detailed strategic plan to address the bank's problems and define its future direction. In addition, the MOU required that the bank reduce the level of classified loans, and assess the adequacy of senior and support staff.

Subsequent Examinations Cited Concerns Regarding Loan Concentrations, Credit Administration, Risk Management, and Non-Core Funding

FRB Atlanta completed another full scope examination in November 2004. The MOU was kept in place, despite improvements in risk management, internal controls, and staffing. First Georgia once again received a CAMELS composite 3 rating because asset quality and earnings continued to be less than satisfactory. Examiners noted that the bank was reducing its convenience store loan concentration and redirecting lending towards the ADC market. Based on concerns with internal loan monitoring and grading, examiners made a number of recommendations to enhance loan administration. In addition, liquidity was reported as "stretched," primarily because management continued to rely on non-core funding.

FRB Atlanta performed an on-site visit in February 2006. The on-site visit followed a State examination (begun in June 2005) that upgraded First Georgia to a CAMELS composite 2, and replaced the MOU with a Board Resolution. Prompted by senior management and lending staff changes that occurred in 2005, the visitation focused on asset quality, management, liquidity, and strategic planning. An April 2006 letter summarizing FRB Atlanta's observations noted that bank management made progress in certain areas, particularly loan administration. However, examiners expressed concern that First Georgia's commercial real estate concentration had reached four times the bank's capital base, and speculative real estate construction lending constituted approximately 250 percent of total capital. Liquidity risk remained a major issue because of the significant level of brokered deposits. Examiners commented that alternative sources of funding appeared to be limited, and that the bank's contingency funding plan lacked specificity regarding what funding sources might be available in the event of a liquidity crisis.

In July 2006, FRB Atlanta returned to perform another full scope examination that also included a targeted examination of First Georgia's commercial real estate portfolio. Examiners reported that earnings were strong based on yields from real estate loans, and asset quality and capital were at satisfactory levels. Nevertheless, the bank was downgraded to a CAMELS composite 3 from the CAMELS composite 2 rating assigned by the State during the previous examination. The examination report indicates that First Georgia's downgrade was attributed to (1) the high level of speculative lending in residential construction; (2) deficiencies in risk management, credit administration, and loan underwriting; and (3) an extreme reliance on non-core funding and weaknesses in funding-related risk management. Examiners also commented that the Board of Directors and management had not taken "explicit corrective action" on prior examination comments, and that further improvement was needed to correct deficiencies and establish a firm infrastructure for future growth.

FRB Atlanta sustained the Board Resolution that was put into place after the MOU was lifted in 2005. Although the bank made progress in fulfilling the Board Resolution, examiners noted that

First Georgia had not yet complied with requirements pertaining to funding policies and practices. The bank had also not complied with items requiring more comprehensive financial analysis of large loans, and detailed reports on the bank's commercial real estate lending exposure.

FRB Atlanta Disagreed with the CAMELS Rating Assigned by the State in February 2007

The State began a full scope examination in February 2007 that resulted in lifting the Board Resolution and upgrading First Georgia's CAMELS composite rating to a 2. FRB Atlanta had concerns about the bank's liquidity position and management weaknesses and, as a result, disagreed with the State's CAMELS composite 2 rating. FRB Atlanta expressed their disagreement to the State, and told First Georgia's Board members that the Federal Reserve would supervise the bank as though it were rated a CAMELS composite 3. In a July 2007 letter to First Georgia's President, an FRB Atlanta officer reiterated that asset quality was less than satisfactory, and that the bank's risk profile warranted more frequent reporting and communications with supervisory authorities. By September 2007, First Georgia's reports and FRB Atlanta's surveillance process revealed an alarming trend in delinquent loans and internal classifications.

FRB Atlanta Downgraded First Georgia to a CAMELS Composite 4 Rating in December 2007

A significant increase in non-performing assets prompted FRB Atlanta and the State to conduct a joint target examination in November 2007. Examiners reviewed loan files to evaluate credit quality, loan documentation, and borrower's capacity to continue loan payments. They also reviewed the adequacy of recent appraisals and First Georgia's strategy to manage and resolve problem assets.

First Georgia was downgraded to a CAMELS composite 4, or "troubled condition." Asset quality was cited as poor due to a significant level of problem assets—particularly in the commercial real estate portfolio—and credit administration and loan underwriting practices were deemed inadequate. The December 2007 letter summarizing the results of the target examination stated that the level of First Georgia's classified assets and delinquent loans severely impaired the bank's overall financial condition, and could threaten the bank's long-term viability if immediate corrective measures were not taken. Examiners also noted that earnings were marginal; management did not properly identify, measure, monitor, or control risks in the commercial real estate portfolio; and there were weaknesses in the real estate appraisal process. In addition, the Board of Directors was criticized for not establishing appropriate limits for overall commercial real estate exposure, as suggested in the January 2007, *Interagency Guidance on Concentrations in Commercial Real Estate*.[2]

[2] The Federal Reserve and the other federal banking regulatory agencies issued interagency guidance that addressed concentrations in commercial real estate (CRE) lending and sound risk management practices. The guidance does not establish specific CRE lending limits; rather, it sets forth sound risk management practices that an institution should employ when it has CRE concentration risk.

MOU Executed in January 2008

Regulators and First Georgia entered into an MOU in January 2008 as a result of the unsafe and unsound practices related to asset quality, credit administration, and risk management identified during the target examination. In communicating the target examination results, FRB Atlanta stated that a future formal enforcement action would likely be taken based on a more thorough analysis to be conducted during the full scope examination scheduled for March 2008. Among the nine specific provisions included in the MOU were requirements to provide an acceptable plan for improving classified assets, manage and mitigate commercial real estate concentrations in light of the adverse market conditions, assess the adequacy of staffing, and outline the bank's current and future capital requirements. The MOU also compelled the bank to submit acceptable written loan policies and procedures to address a wide range of credit and loan administration issues. In addition, the bank was precluded from declaring or paying dividends without prior approval from the regulators.

First Georgia Downgraded to a CAMELS Composite 5 Rating as a Result of the March 2008 Examination

FRB Atlanta's full scope examination that began in March 2008 resulted in First Georgia being downgraded to a CAMELS composite 5 rating. Banks in this group exhibit extremely unsafe and unsound practices or conditions, and pose a significant risk to the DIF because failure is highly probable. Examiners noted that the adverse rating was driven by the poor and weakening condition of the bank's loan portfolio, and its negative impact on earnings, capital, and liquidity. Deterioration in the commercial real estate market was cited as jeopardizing the bank's ongoing viability. Asset quality was labeled as poor because of mounting levels of classified and non-performing assets primarily composed of speculative ADC loans. Examiners noted that unsatisfactory management and risk management practices were responsible for allowing the growth of loan concentrations without prudent safeguards to control the associated risks.

Liquidity was also cited as unsatisfactory, and examiners criticized the bank's continued dependence on non-core funding, particularly brokered deposits. Examiners cautioned that the bank was not likely to obtain a sufficient volume of funds on reasonable terms to cover loan commitments or to meet unexpected cash needs. Furthermore, the ALLL methodology was evaluated and deemed inadequate, due in part to weaknesses in problem loan identification. First Georgia was required to increase the ALLL to $14 million, and re-file regulatory financial reports to reflect the adjustment. Finally, examiners concluded that First Georgia was not in full compliance with seven of the nine provisions included in the MOU.

Written Agreement Executed

As a result of the examination, in July 2008, FRB Atlanta requested that the Board prepare a formal enforcement action—a Written Agreement—to replace the MOU. The draft document prepared by the Board was reviewed by FRB Atlanta and the State in August, but First Georgia's Board of Directors was unable to convene until September 11, 2008, when the Written Agreement was executed. The Written Agreement, which was posted on the Board's public web site, contained over twenty specific items requiring action on capital, earnings, liquidity, credit

administration, credit risk management, and asset improvement. Most of the items included in the Written Agreement were also in the MOU; however, earnings and liquidity were added because of the bank's rapidly deteriorating financial condition.

FRB Atlanta Implemented Prompt Corrective Action Provisions

On May 5, 2008, FRB Atlanta notified First Georgia that the bank's capital position, as defined under PCA, had declined to *adequately capitalized* after the Board of Directors failed to make a capital injection that was required under the January 2008 MOU. The *adequately capitalized* category prohibits renewing or obtaining brokered deposits, unless a waiver is granted by the FDIC. On May 13, 2008, First Georgia requested a waiver, and the FDIC approved the bank's request on June 20, 2008. As part of the approval, the FDIC stipulated that brokered deposits must be reduced by 5 percent, and that the bank must remain above the *undercapitalized* PCA category.

In late July 2008, First Georgia's President notified regulators that the bank's capital had decreased further and had fallen below PCA's *undercapitalized* threshold. FRB Atlanta issued a PCA letter on August 1, 2008, and made the bank aware that additional restrictions were being imposed. These restrictions included immediate expiration of the FDIC brokered deposit waiver, and limits on the bank's asset growth and dividend payments. In addition, First Georgia was required to submit an acceptable capital restoration plan to FRB Atlanta by September 15, 2008. The capital restoration plan First Georgia submitted in mid-September was deemed "not acceptable" by the Federal Reserve, and the bank was asked to submit a revised capital restoration plan by November 1, 2008. On November 25, 2008, FRB Atlanta notified First Georgia's Board of Directors that the preliminary results from a joint, full scope examination determined that the bank had reached the *critically undercapitalized* PCA category. Less than two weeks later, First Georgia was closed and placed into receivership.

Conclusions, Lesson Learned, and Recommendation

First Georgia failed because its Board of Directors and management did not adequately control the risks associated with its (1) high concentration of speculative acquisition, development, and construction loans made to home builders and developers; and (2) reliance on non-core funding, particularly brokered deposits. Weakening demand for housing in the local real estate market led to significant loan losses that eroded the bank's capital. The bank's deteriorating capital position triggered regulatory restrictions on renewing brokered deposits, thereby significantly impeding liquidity and ultimately leading to First Georgia's insolvency.

With respect to supervision, FRB Atlanta complied with the frequency of safety and soundness examinations prescribed in regulatory guidance, and conducted regular off-site monitoring commensurate with concerns and risks identified during examinations. Although a twelve to eighteen month examination interval would have been permissible after the State upgraded First Georgia to a CAMELS composite 2 rating on two occasions, FRB Atlanta conducted a visitation or an examination within seven months. As shown in Table 3, every examination conducted by FRB Atlanta rated First Georgia as CAMELS composite 3 or lower. Our analysis of FRB

Atlanta's examination reports revealed frequent criticisms of First Georgia's high loan concentrations, risk management, credit administration, and reliance on volatile non-core deposits. In addition, regulators entered into four enforcement actions designed to address deficiencies found during safety and soundness examinations.

Table 3
CAMELS Ratings by Examination

Examination		Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions
Start Date	Report Issue Date			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
June 2003	September 2003	FRB Atlanta	3	2	3	3	3	3	2	MOU
January 2004	March 2004	State	3	2	3	3	3	2	2	
August 2004	November 2004	FRB Atlanta	3	2	3	3	3	3	2	
June 2005	September 2005	State	2	2	2	2	2	2	2	MOU Lifted Board Resolution Issued
February 2006	April 2006	FRB Atlanta	*a*							
July 2006	October 2006	FRB Atlanta	3	2	2	3	1	2	3	
February 2007	April 2007	State	2	2	3	2	2	2	2	Board Resolution Lifted
November 2007	December 2007	FRB Atlanta (Joint with State)	4	3	4	4	5	2	2	MOU
March 2008	July 2008	FRB Atlanta	5	5	5	5	5	5	4	Written Agreement

[a] Examination work conducted during the April 2006 visitation included reviews of certain high-dollar value loans and liquidity; no CAMELS rating was issued.
Note: The State-led joint examination begun in October 2008 is not included above because First Georgia was closed before examination work was completed.

Nevertheless, First Georgia failed despite FRB Atlanta's close supervision. Fulfilling our mandate under section 38(k) provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or the loss to the DIF. Our analysis of FRB Atlanta's supervision of First Georgia indicates that a more direct and forceful action may have served to reduce an asset concentration—namely, speculative ADC loans for residential construction—that eventually contributed to First Georgia's failure. Specifically, in the 2006 safety and soundness examination, FRB Atlanta stated that credit risks remained high from the prior examination, and were increasing because of concerns related to speculative ADC residential construction loans, and continuing weaknesses in credit administration and risk management.

In commenting on First Georgia's ADC exposure, examiners noted that 93 percent of the bank's $63 million residential construction loan portfolio was "speculative" because credit extensions were made to builders for constructing homes that were not pre-sold. Examiners stated that the level of speculative lending exceeded First Georgia's 60 percent internal policy limit, as well as the industry standard of 30 to 35 percent. FRB Atlanta responded to the identified risks and policy breach by stating that management should determine what measures were necessary to ensure policy compliance, and reevaluate the appropriateness of the 60 percent policy limit because it "reflects a very high tolerance for risk."

We believe that the significant and growing risk associated with the sizeable concentration in speculative residential construction loans, coupled with deficiencies in credit administration and risk management, warranted a more forceful supervisory response compelling First Georgia to reduce the speculative ADC exposure, as opposed to merely asking management to develop steps to comply with the speculative lending policy. First Georgia's supervisory history reveals a similar situation in which examiners responded more aggressively. FRB Atlanta put First Georgia under an MOU in 2003 that required the bank to reduce its high convenience store loan concentration because of increasing credit risk, and notable deficiencies in credit administration, loan underwriting, and management oversight. While it is not possible to determine the degree to which a stronger regulatory response in 2006 would have altered First Georgia's subsequent decline, it is reasonable to conclude that an earlier decrease in the speculative construction loan portfolio could have reduced the loss to the DIF.

We note that First Georgia's financial performance was strong in 2006, the time frame during which we believe FRB Atlanta could have directed the bank to reduce its speculative construction lending exposure. The 2006 examination report stated that First Georgia's earnings were strong as a result of loan yields from the construction portfolio; asset quality was satisfactory due to the low levels of classified assets, past due loans, and loan losses; and a new management team had recently taken over. However, recent statements by Board officials provide a valuable perspective that we believe is relevant to the timing and forcefulness of supervisory efforts. These officials acknowledged that supervisors must have an even firmer resolve and provide clear and very forceful communication in "good times," when risks appear low, losses or write downs have not yet been recognized, and "optimism abounds."

Lesson Learned

The failure of one small community bank does not provide sufficient evidence to draw broad-based conclusions. Nevertheless, First Georgia's failure points to a valuable lesson learned that Federal Reserve examiners and managers may find useful in planning and conducting future examinations of community banks with similar characteristics. Accordingly, First Georgia's failure demonstrates that a forceful supervisory response is warranted—even in the presence of strong financial performance—when community banks with weaknesses in risk management, credit administration, and loan underwriting, accumulate a high concentration in risky assets.

Recommendation: We recommend that the Director of the Division of Banking Supervision and Regulation ensure that Reserve Banks follow supervisory guidance to formally assign and properly record a separate CAMELS composite rating when the Reserve Bank disagrees with the rating assigned by a state supervisory agency.

As noted earlier, FRB Atlanta disagreed with the CAMELS composite 2 rating issued by the State after the 2007 examination. FRB Atlanta told State officials that a CAMELS composite 3 rating was more appropriate because of concerns with the bank's liquidity position and management weaknesses. In addition, during a First Georgia Board of Directors meeting, FRB Atlanta noted that the bank would be supervised as though it were a CAMELS composite 3, and that bank-provided reports on non-performing loans, real estate concentrations, and liquidity would continue to be closely monitored.

We found that FRB Atlanta did not fully comply with supervisory guidance that addresses disagreements with CAMELS ratings assigned by state regulators.[3] According to the guidance, a Federal Reserve Bank should, among other things, (1) formally assign a separate CAMELS rating when there is a disagreement with the rating assigned by the State, and (2) record the separate rating in the Federal Reserve's National Examination Database.[4] While FRB Atlanta continued to monitor First Georgia as though it were a CAMELS composite 3, it did not formally issue or record a separate CAMELS rating.

Analysis of Comments

We provided a copy of this report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response, included as Appendix 4, indicates agreement with the report findings and recommendation. The Director agreed that a more aggressive supervisory response to force a reduction in the high concentration of risky assets at an earlier stage, even in the presence of strong financial performance, may have averted some loss ultimately incurred as a result of the bank's failure. He plans to implement our recommendation by sending a reminder to ensure that Reserve Banks follow supervisory guidance pertaining to formally assigning and recording a separate CAMELS composite rating when the Reserve Bank disagrees with the rating assigned by a state supervisory agency. We plan to follow-up on this and any other action taken to implement our recommendation.

The Director welcomed the report's observations and contribution to understanding the reasons for First Georgia's failure. He noted that the events described in the report are a vivid reminder to all supervisors of the critical importance of the early detection of issues and close supervision. The Director also cited the dangers of high concentrations in risky assets that are subject to dramatic and swift market swings that may ultimately be beyond the bank's ability to overcome.

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[3] Supervision and Regulation Letter 99-17, *Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System*.

[4] The National Examination Database enables Federal Reserve supervisory staff, as well as state and other federal banking authorities to access supervisory documents, as well as financial and banking structure data.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Acquisition, Development, and Construction (ADC) Loans
ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and providing interim financing for residential or commercial structures.

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

Board Resolution
A Board Resolution is an informal enforcement action involving commitments made by the bank's Board of Directors that are incorporated into the bank's corporate minutes.

Brokered Deposits
Brokered Deposits are deposits that are placed in a savings institution by a broker who gathers funds from others and packages the funds in batches of $100,000. The broker then shops for financial institutions paying the highest rates and invests in multiple $100,000 certificates of deposit, which typically pay the highest rates of interest and are federally insured.

Classified Assets
Classified assets are loans that exhibit well-defined weaknesses and a distinct possibility of loss. The term ''classified'' is divided into more specific subcategories ranging from least to most severe: ''substandard,'' ''doubtful,'' and ''loss.'' An asset classified as ''substandard" is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. An asset classified ''doubtful" has all the weaknesses inherent in one classified as "substandard," with the added characteristic that the weaknesses make collection or liquidation in full, highly questionable and improbable. Assets classified "loss" are considered uncollectible and of such little value that their continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE)
CRE loans are land development and construction loans (including one-to-four family residential and commercial construction loans), and other land loans. CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property, or the proceeds of the sale, refinancing, or permanent financing of the property.

Appendix 1 (continued)

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.

Core Deposits
Core deposits are small denomination time deposits and checking accounts acquired in a bank's natural market area, counted as a stable source of funds for lending. These deposits have a predictable cost, imply a degree of customer loyalty, and are less interest rate sensitive than short-term certificates of deposit and money market deposit accounts.

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

Liquidity
Liquidity is the ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

Memorandum of Understanding (MOU)
An MOU is a highly structured written, but informal, enforcement action that is signed by both the Reserve Bank and the member bank's Board of Directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management.

Net Non-Core Funding Dependence Ratio
The Net Non-Core Funding Dependence ratio measures the extent to which banks fund assets with non-core funding. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Non-Core Deposits
Non-core deposits include federal funds purchased, Federal Home Loan Bank advances, subordinated notes and debentures, CDs of more than $100,000, and brokered deposits.

Nonperforming loans
The sum of total loans and lease financing receivables past due 90 or more days and still accruing interest, total nonaccrual loans and lease financing receivables, and other real estate owned.

Appendix 1 (continued)

Prompt Corrective Action (PCA)
PCA is a framework of supervisory actions, set forth in 12 U.S.C. 1831o, for insured depository institutions whose capital position has declined below certain threshold levels. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or to minimize resulting losses to the Deposit Insurance Fund. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

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

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

Underwriting
Underwriting is part of a bank's lending policies and procedures that enable the bank's lending staff to evaluate all relevant credit factors. These factors include the capacity of the borrower or income from the underlying property to adequately service the debt; the market value of the underlying real estate collateral; the overall creditworthiness of the borrower; the level of the borrower's equity invested in the property; any secondary sources of repayment; and any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

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

Appendix 2 – Key Events Timeline

Date	Key Event
03/11/2002	FRB Atlanta conducted a pre-membership assessment in conjunction with a State examination.
10/01/2002	First Georgia became a state member bank.
06/16/2003	FRB Atlanta began its first full-scope examination. Examination report issued September 2003 assigned a CAMELS composite 3 rating.
09/20/2003	FRB Atlanta placed First Georgia under an MOU.
01/13/2004	State began a full scope examination. Examination report issued March 2004, assigned a CAMELS composite 3 rating. MOU remained in effect. Examination report noted that First Georgia hired a Chief Credit Officer to develop an ADC loan portfolio.
08/23/2004	FRB Atlanta began a full scope examination. Examination report issued in November 2004 assigned a CAMELS composite 3 rating. MOU remained in effect.
05/18/2005	First Georgia added a full service branch as a strategy to increase core deposits.
06/15/2005	State began a full scope examination. Examination report issued September 2005 upgraded First Georgia to a CAMELS composite 2 rating. MOU is replaced with a Board Resolution.
10/19/2005	Both the President and the Chief Executive Officer (CEO) of First Georgia resigned. An experienced bank executive was hired as President and CEO before the end of the month.
02/27/2006	FRB Atlanta conducted a visitation because of significant changes in bank management and lending personnel, and issued a summary letter in April 2006.
07/17/2006	FRB Atlanta began a full scope examination. Examination report issued October 2006 downgraded First Georgia to a CAMELS composite 3 rating. Board Resolution remained in place. FRB Atlanta also began a target examination focusing on commercial real estate.
02/23/2007	State began a full scope examination. Examination report issued in April 2007 upgraded First Georgia to a CAMELS composite 2 rating. Board Resolution lifted.

Appendix 2 (continued)

Date	Key Event
05/2007	FRB Atlanta granted approval for opening another branch office.
07/2007 to 09/2007	FRB Atlanta communicated with First Georgia because ongoing surveillance revealed alarming trends in delinquent loans and internal classifications, as well as a substantial increase in unsold homes and lots.
10/22/2007	FRB Atlanta and State officials attended a First Georgia Board meeting to discuss issues related to asset deterioration.
11/13/2007	FRB Atlanta and State began a joint examination. Examination report issued December 2007 downgraded First Georgia to a CAMELS composite 4 rating reflecting the bank's troubled condition.
01/17/2008	Regulators and First Georgia enter into an MOU.
03/04/2008	FRB Atlanta and State officials met with First Georgia senior management and Directors to discuss the bank's declining financial condition and the continued weakening real estate market. First Georgia Directors commit to inject the necessary capital.
03/31/2008	FRB Atlanta began a full scope examination. Examination report issued July 2008 downgraded First Georgia to a CAMELS composite 5 rating. MOU remained in place.
05/08/2008	FRB Atlanta, State, and FDIC visited First Georgia to discuss the bank's condition, and required First Georgia's Board of Directors to provide weekly liquidity reports.
05/19/2008	First Georgia fell to the *adequately capitalized* PCA category, which jeopardized the bank's ability to attract brokered deposits; First Georgia submitted brokered deposit waiver request to FDIC.
06/20/2008	FDIC granted First Georgia a 90-day brokered deposit waiver.
06/25/2008 to 07/27/2008	Ongoing discussions and correspondence between First Georgia and FRB Atlanta continued to focus on the bank's troubled financial condition.

Appendix 2 (continued)

Date	Key Event
08/01/2008	FRB Atlanta issued a PCA letter affirming that the bank was *undercapitalized*. The FDIC brokered deposit waiver immediately expired and additional restrictions were imposed.
08/05/2008	FRB Atlanta, State, and FDIC made another visit to discuss the bank's deteriorating financial condition.
09/11/2008	Federal Reserve Board placed First Georgia under a Written Agreement.
10/10/2008	FRB Atlanta and the State began a joint examination.
11/25/2008	FRB Atlanta notified First Georgia that it was *critically undercapitalized* for PCA purposes based on the preliminary results of the joint examination.
12/05/2008	State closed First Georgia and appointed FDIC as receiver.

Appendix 3 – CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of *capital*, the quality of *assets*, the capability of *management*, the quality and level of *earnings*, the adequacy of *liquidity*, and the *sensitivity* to market risk (CAMELS). Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A "1" indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a "5" indicates the lowest rating, weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern.

Composite Rating Definition

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the Board of Directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the Board of Directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Appendix 3 (continued)

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the Board of Directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the Deposit Insurance Fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the Deposit Insurance Fund and failure is highly probable.

Appendix 4 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: June 26, 2009

To: Elizabeth A. Coleman, Inspector General

From: Roger T. Cole, Director, Banking Supervision & Regulation ***/signed/***

Subject: Material Loss Review of First Georgia Community Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Report on the Failure of First Georgia Community Bank (FGCB) prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that FGCB failed because its Board of Directors and management did not adequately control the risks associated with its (1) high concentration of speculative acquisition, development, and construction (ADC) loans made to home builders and developers, and (2) reliance on non-core funding, particularly brokered deposits.

We concur with the findings of the report that the Federal Reserve Bank of Atlanta had this bank under close supervision from the outset. The Reserve Bank identified key weaknesses in risk management at the very first examination of the bank after it became a member of the Federal Reserve System, and assigned a less than satisfactory rating. Moreover, the Federal Reserve Bank of Atlanta persisted in criticizing the bank management for failing to address weaknesses and continued to assign less than satisfactory ratings, notwithstanding interim rating upgrades by the State of Georgia. We also agree that a more aggressive supervisory response to force a reduction in the high concentration of risky assets at an earlier stage, even in the presence of strong financial performance, may have averted some loss ultimately incurred as a result of the bank's failure. This observation benefits from the hindsight of observing the subsequent speed of deterioration in ADC portfolios across the industry and particularly in this region.

We note that the Federal Reserve Bank of Atlanta strongly disagreed with the 2006 composite "2" rating assigned FGCB by the State of Georgia, and appropriately conveyed to the bank that it would be supervised by the Federal Reserve as a composite "3," and that the Reserve Bank did so. However, we also note the requirements of SR Letter 99-17, which call for the Reserve Bank to formally assign a separate rating in the case of a disagreement with a state rating, and to reflect that rating change in the National Information Center database. The Division concurs with the recommendation contained in the IG report, and will be sending a reminder to the Reserve Banks to adhere to the guidance contained in SR Letter 99-17.

Board staff very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for FGCB's failure. The events described in the report are a vivid reminder to all supervisors of the critical importance of

the early detection of issues and close supervision, but also the dangers of high concentrations in risky assets that are subject to dramatic and swift market swings that may ultimately be beyond the bank's ability to overcome.

Appendix 5 – Principal Contributors to this Report

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