Board of Governors of the Federal Reserve System

Material Loss Review of Neighborhood Community Bank

Office of Inspector General

January 2010

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

OFFICE OF INSPECTOR GENERAL

January 28, 2010

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 Neighborhood Community Bank (Neighborhood). 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.

Neighborhood 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 by the Georgia Department of Banking and Finance (State). The State closed Neighborhood in June 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On July 28, 2009, the FDIC Inspector General notified us that Neighborhood's failure would result in an estimated loss to the DIF of $66.6 million, or about 31.7 percent of the bank's $210.4 million in total assets.

Neighborhood failed because its Board of Directors and management did not properly manage the risks associated with the bank's concentration in acquisition, development, and construction (ADC) loans tied to the residential real estate market. Neighborhood expanded its ADC loan portfolio when the areas served by the bank experienced rapid growth. A declining residential real estate market—coupled with management's failure to recognize and act upon weakening market conditions—led to deteriorating asset quality and significant losses, particularly in the ADC loan portfolio. Mounting losses eliminated earnings and depleted

capital, which ultimately caused the State to close Neighborhood on June 26, 2009, and appoint FDIC as receiver.

With respect to supervision, FRB Atlanta complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular offsite monitoring commensurate with concerns and risks identified during examinations. Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken earlier to reduce the likelihood of a bank's failure or loss to the DIF. Accordingly, in our opinion, the conditions examiners observed during a 2007 examination provided FRB Atlanta with an opportunity to be more aggressive in addressing Neighborhood's high ADC loan concentration as part of its October 2007 informal enforcement action (Board Resolution).

FRB Atlanta accelerated the start of its 2007 examination by three months because ongoing surveillance revealed an increased inventory of completed but unsold homes in the bank's market area. Examiners downgraded Neighborhood to a CAMELS composite 3 rating and noted that staff turnover at Neighborhood during the prior six to twelve months had a negative effect on the bank's ability to manage its loan portfolio. The 2007 examination report stressed the importance of effective Board of Directors and senior management oversight given the lending staff's inexperience and the "uncertain outlook for residential real estate." Examiners noted an increase in classified assets and commented that most of the loans downgraded during the examination were tied to residential land development and construction. Bank management was criticized for being slow to recognize loan deterioration. In addition, examiners stated that the signs of a potential housing oversupply were evident twelve to fifteen months earlier. Separately, examiners noted that management had continued to originate new ADC loans after other local banks had begun to reduce their commercial real estate exposure.

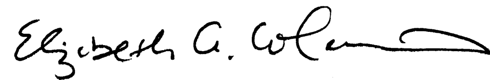
We believe that in 2007, FRB Atlanta had an opportunity to take stronger supervisory action regarding Neighborhood. Specifically, in our opinion, the conditions observed during the 2007 examination that led to a Board Resolution also warranted compelling Neighborhood to reduce its ADC loan concentration. However, in light of the subsequent rapid deterioration in the local real estate market, it is not possible to determine the degree to which any such action would have affected the bank's subsequent decline or the failure's cost to the DIF.

Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that the Neighborhood Community Bank failure points to a valuable lesson learned that Federal Reserve examiners and managers may find useful in planning and conducting future examinations of banks with similar characteristics. Accordingly, in our opinion, Neighborhood's failure demonstrates that an aggressive and immediate supervisory response—including an enforcement action compelling a bank to reduce its concentration in ADC loans—may be warranted when a financial institution experiences significant staff turnover and management is slow to recognize or act upon early signs of loan portfolio deterioration and weakening market conditions.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director agreed with our conclusion and lesson learned. His response is included as Appendix 3.

We appreciate the cooperation that we received from FRB Atlanta and Board staff during our review. The principal contributors to this report are listed in Appendix 4. 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,



Elizabeth A. Coleman
Inspector General

cc: Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Mr. Patrick M. Parkinson
Mr. Michael Johnson

Board of Governors of the Federal Reserve System

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Table of Contents

Page

Background 9

Objectives, Scope, and Methodology 9

Cause of the Failure 10

Supervision of Neighborhood Community Bank 12

Supervision History from 2004 through 2006 13

A 2007 Examination Resulted in a CAMELS Composite 3 Rating and an Informal Enforcement Action 14

A February 2008 State Examination Resulted in a Downgrade to a CAMELS Composite 4 Rating and a Written Agreement 15

An August 2008 Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating 15

A March 2009 Examination Resulted in Another CAMELS Composite 5 Rating 16

Conclusion and Lesson Learned 16

Lesson Learned 17

Analysis of Comments 17

Appendixes 19

Appendix 1 – Glossary of Banking and Regulatory Terms 21

Appendix 2 – CAMELS Rating System 23

Appendix 3 – Division Director's Comments 25

Appendix 4 – Principal Contributors to this Report 27

Background

Neighborhood Community Bank (Neighborhood)—a community bank in Newnan, Georgia—opened on April 20, 2000, as a state non-member bank serving metropolitan Atlanta.[1] Neighborhood became a state member bank (SMB) of the Federal Reserve System on April 13, 2001. 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 by the Georgia Department of Banking and Finance (State).

The State closed Neighborhood on June 26, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $66.6 million loss to the Deposit Insurance Fund (DIF), or 31.7 percent of the bank's $210.4 million in total assets. Under section 38(k) of the Federal Deposit Insurance 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 the failed institution and

- 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.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed FRB Atlanta and State staff, and collected relevant FRB Atlanta examination data. We also reviewed correspondence, Call Reports, e-mails, surveillance reports, Uniform Bank Performance Reports, Reports of Examination (examination reports) issued between 2004 and 2009, and examination work papers prepared by FRB Atlanta. Appendixes at the end of this report include a glossary that defines key banking and regulatory terms and a description of the CAMELS rating system.[2] We conducted our fieldwork from August 2009 through October 2009 in accordance with the *Quality Standards for Inspections* issued by the Council of Inspectors General on Integrity and Efficiency.

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[1] The bank changed its name from Newnan Coweta Bank to Neighborhood Community Bank in 2005.

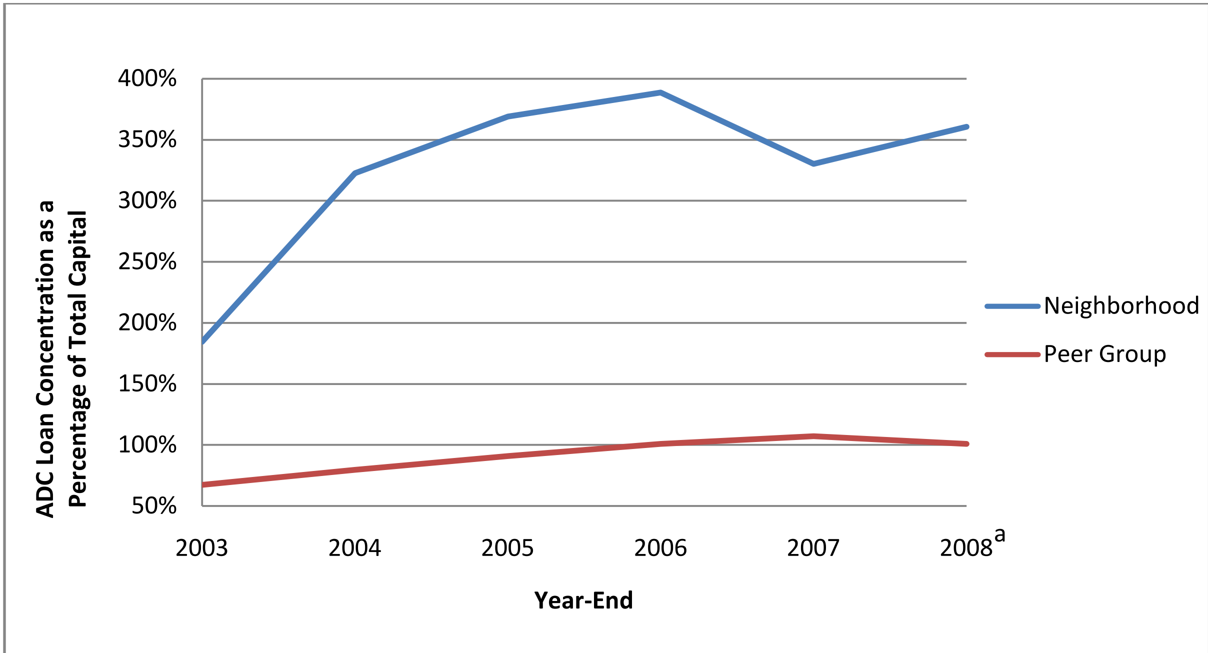
[2] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Cause of the Failure

Neighborhood failed because its Board of Directors and management did not properly manage the risks associated with the bank's concentration in acquisition, development, and construction (ADC) loans tied to the residential real estate market. Neighborhood expanded its ADC loan portfolio when the areas served by the bank experienced rapid growth. A declining residential real estate market—coupled with management's failure to recognize and act upon weakening market conditions—led to deteriorating asset quality and significant losses, particularly in the ADC loan portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately caused the State to close Neighborhood on June 26, 2009, and appoint FDIC as receiver.

Neighborhood largely focused on real estate lending that featured significant growth and a high concentration in the ADC component of the bank's commercial real estate (CRE) portfolio. The bank's ADC loans almost doubled from $41.6 million in 2004 to $82.3 million by 2007. As shown in Chart 1 below, Neighborhood's ADC loan concentration reached 389 percent of total capital by 2006 and subsequently remained well above 300 percent. In addition, the bank's ADC loan concentration was significantly higher than its peers.[3] In general, concentrations of credit increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. Therefore, concentrations may represent a substantial risk to the safety and soundness of the institution.

Chart 1: Neighborhood's ADC Loan Concentration Compared to Peers

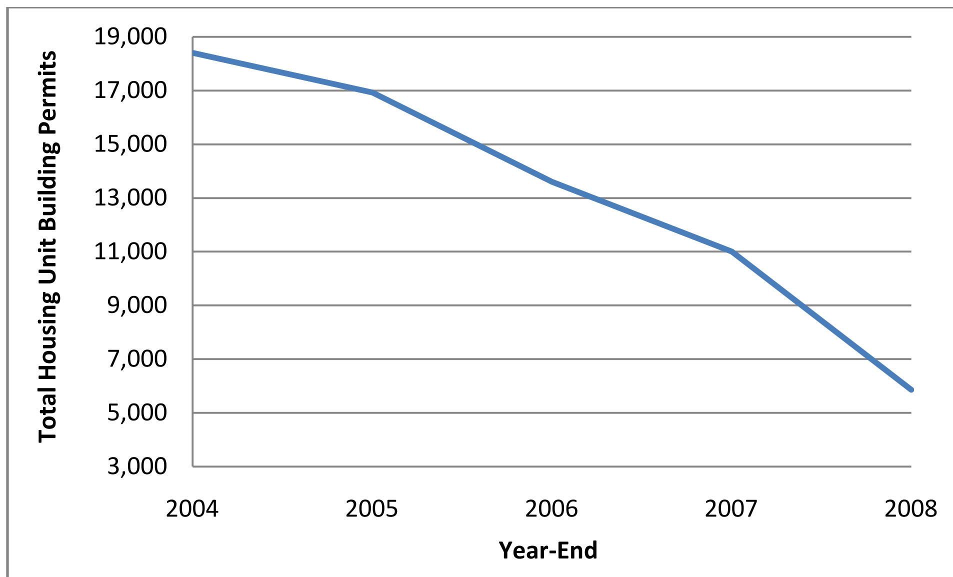


[a] Data as of 9/30/2008

[3] Neighborhood's peer group consisted of all insured commercial banks having assets between $100 million and $300 million in a metro area, and having three or more full-service offices.

Neighborhood's asset quality deteriorated significantly as the economy slowed and the demand for residential housing declined. As shown in Chart 2, the number of housing unit building permits issued in Neighborhood's service area decreased 26 percent from 18,403 in 2004, to 13,605 in 2006, and dropped another 57 percent to 5,861 by 2008. In addition, the inventory of vacant developed lots in the Atlanta metropolitan area increased from 20.6 months by the end of 2005 to 126 months by the end of 2008. Eighteen to twenty-four months is considered an acceptable inventory for vacant developed lots. Correspondingly, Neighborhood's classified assets increased from $346,000 in 2005, to $69.6 million in 2008. Examiners noted that Neighborhood's classified loans were mostly contained in the ADC portfolio.

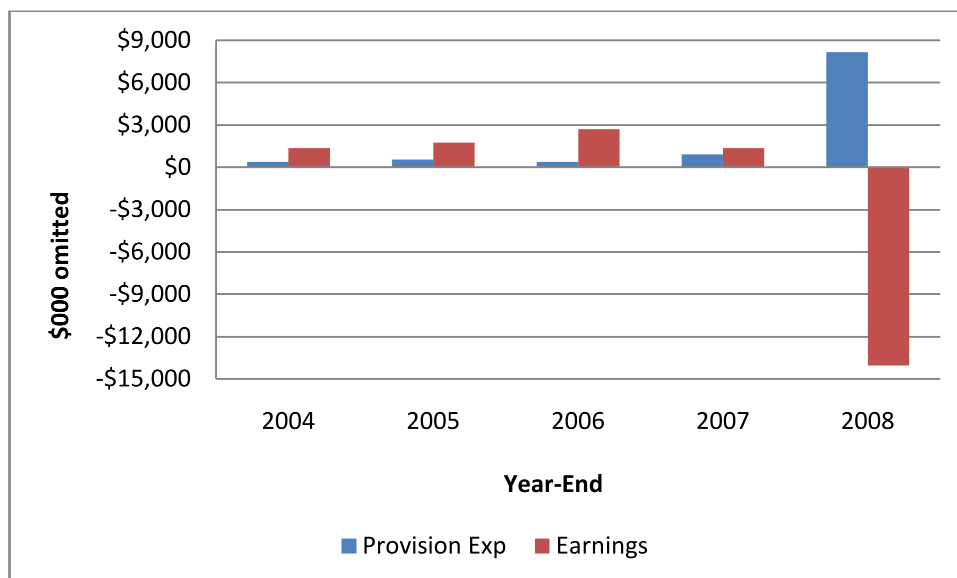
Chart 2: Building Permits Issued in Neighborhood's Service Area



Neighborhood's Board of Directors and management failed to understand the severity of the bank's problems and to take timely action as the loan portfolio deteriorated. According to an FRB Atlanta internal surveillance report, management was slow to recognize the signs of weakening market conditions and continued to originate new ADC loans after other local banks began to reduce their exposure. Examiners also noted that, ultimately, Neighborhood pursued a concentration in ADC loans without fully mitigating the risk.

The growth in classified assets prompted corresponding increases in Neighborhood's Allowance for Loan and Lease Losses (ALLL) and loan loss provision expense (provision). As shown in Chart 3 (see page 12), the provision for the year ending December 31, 2007, totaled $906,000. By the end of the following year, the provision increased 805 percent to $8.2 million, contributing to the bank's 2008 net loss of $14 million. The loss eliminated retained earnings and significantly reduced Neighborhood's capital.

Chart 3: Impact of Provision Expense on Earnings



Neighborhood'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. FRB Atlanta implemented PCA and made timely notifications when the bank reached various PCA capital categories. In November 2008, Neighborhood dropped below the *well capitalized* category to *adequately capitalized*. The bank's financial condition continued to deteriorate, and Neighborhood was deemed *undercapitalized* as of February 2009. A joint full scope examination that began in March 2009 revealed further financial decline, and Neighborhood was declared *significantly undercapitalized* on April 21, 2009.

By May 2009, the bank's capital position was *critically undercapitalized,* and the Federal Reserve issued a PCA Directive on May 27, 2009, that, among other things, required Neighborhood to (1) raise additional capital to achieve the *adequately capitalized* PCA designation or (2) be acquired by or merge with another depository institution. At that juncture, the bank had no prospects for raising capital, finding an acquirer, or merging with another institution, and the State closed Neighborhood on June 26, 2009.

Supervision of Neighborhood Community Bank

As shown in Table 1, FRB Atlanta and the State conducted six full scope examinations in the five and one-half-year period preceding Neighborhood's failure in June 2009. In addition, FRB Atlanta conducted a CRE target examination and two visitations. Neighborhood was also included in an FRB Atlanta district-wide CRE Review Program of twenty-five state member community banks. The bank was rated CAMELS composite 2 (satisfactory) until August 2007, when an FRB Atlanta examination resulted in a CAMELS composite 3 (fair) rating and an informal enforcement action. A subsequent FRB Atlanta visitation in January 2008 revealed an

accelerating decline in asset quality, prompting a February 2008 examination by a State-led team that included three experienced FRB Atlanta examiners. As a result of this examination, Neighborhood was downgraded to a composite 4 rating and a Written Agreement was executed. Neighborhood was rated a CAMELS composite 5 in two subsequent examinations, reflecting the bank's critically depleted capital position and high probability of failure.

Table 1: Neighborhood Supervisory Overview

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions/PCA notifications
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
February 2004	April 2004	Full	FRB Atlanta	2	1	1	2	2	2	2	
April 2005	June 2005	CRE Review	FRB Atlanta	n/a							
September 2005	February 2006	Full	State	2	2	1	2	2	3	2	
October 2005	November 2005	CRE Target	FRB Atlanta	n/a							
April 2006	April 2006	Visitation	FRB Atlanta	n/a							
May 2007	August 2007	Full	FRB Atlanta	3	2	3	3	2	2	2	Board Resolution
January 2008	January 2008	Visitation	FRB Atlanta	n/a							
February 2008	July 2008	Full	State (with three FRB Atlanta examiners)	4	3	5	4	4	3	3	Written Agreement, PCA Letter
August 2008	November 2008	Full	FRB Atlanta	5	4	5	5	5	4	3	PCA Letter
March 2009	June 2009	Full	Joint FRB Atlanta-State	5	5	5	5	5	5	4	PCA Directive

Supervision History from 2004 through 2006

FRB Atlanta's 2004 examination resulted in a CAMELS composite 2 (satisfactory) rating. The capital and asset quality components both were rated 1 (strong), while management, earnings, and liquidity were rated 2 (satisfactory). Examiners noted that the bank had a concentration in ADC loans tied to residential construction, but commented that the credit quality of the loan portfolio was sound. Examiners also cited the healthy economic conditions in the local market and Neighborhood's ability to attract and retain financially strong borrowers.

In April 2005, because of its high CRE concentration, FRB Atlanta included Neighborhood as one of twenty-five SMBs being evaluated as part of a district-wide CRE Review Program. The resulting June 2005 report prepared by FRB Atlanta noted that Neighborhood's CRE portfolio appeared to be sound. Loan underwriting, policies and procedures, and the appraisal process were all deemed satisfactory. A June 2005 letter to Neighborhood's President following up on the CRE review included suggestions for the bank's consideration, such as stress testing certain CRE loans and addressing CRE concentration risk in strategic and capital planning. The letter also suggested that bank management include further stratification of the CRE loans by (1) property type and geographic location and (2) the number of pre-sold and non-pre-sold homes in the residential construction portfolio.

A State examination that began in September 2005, with a report issued in February 2006, also resulted in a CAMELS composite 2 rating, with asset quality again rated 1 (strong). Past due and non-accrual loans were cited as minimal. During the same time period, FRB Atlanta began a CRE concentration target examination. Examiners cited Neighborhood's considerable CRE concentration risk and noted that management and the Board of Directors were expected to "be attentive to any changes in market conditions and borrowers' financial conditions that could expose the bank's capital, earnings, and asset quality to undue risk." Examiners made several recommendations that included establishing sub-limits for certain categories within the CRE portfolio, expanding management information and reporting on the loan portfolio, and considering concentration risk in preparing the ALLL calculation.

FRB Atlanta returned to Neighborhood in April 2006 to conduct a visitation that, among other things, followed up on suggestions made in the 2005 CRE review. Examiners noted that the CRE risk profile was very high, but cited several actions that management had taken to address prior suggestions. These actions included enhancing the bank's loan policy, having CRE reporting evaluated as part of the loan review process, and factoring CRE concentration risk into the ALLL.

A 2007 Examination Resulted in a CAMELS Composite 3 Rating and an Informal Enforcement Action

FRB Atlanta began a full scope examination in May 2007, three months before it was required to do so, because ongoing surveillance revealed that the inventory of completed but unsold homes had increased in Neighborhood's market area. The examination report, issued in August 2007, downgraded Neighborhood to a CAMELS composite 3 (fair) rating. The asset quality and management components were rated 3, while capital, earnings, and liquidity were rated 2. Examiners noted deteriorating market conditions and an increased level of classified assets. According to examiners, most of the loans downgraded during the examination were tied to residential land development and construction, which was being negatively affected by the slowdown in housing sales.

Examiners also cited bank staff turnover in the prior six to twelve months as having a negative effect on "client knowledge and portfolio management" and criticized management for being slow to recognize deterioration in the loan portfolio. Neighborhood's management attributed examiner-required loan downgrades to market deterioration occurring in the prior sixty to ninety

days, but examiners disagreed and noted that many signs of a potential oversupply were evident at least twelve to fifteen months earlier.

Credit risk management weaknesses noted during the examination were attributed to the bank's Board of Directors' and senior management's lack of active participation in, and oversight of, key processes, such as the loan committee and loan grading. The examination report stressed that effective oversight and guidance were particularly important in light of the low experience of the lending staff due to turnover, and the "uncertain outlook for residential real estate." As a result of the bank's decline and the deficiencies noted during the examination, Neighborhood's Board of Directors adopted a Board Resolution, which is an informal enforcement action, in October 2007.

The Board Resolution focused on what examiners described as "certain issues that if left unattended could lead to further deterioration of the bank." Specific resolution provisions included requiring the bank to prepare (1) a written plan for improving credit administration and credit underwriting weaknesses, (2) a strategic plan detailing the bank's short- and long-term direction, and (3) a written capital plan addressing earnings retention and capital. The resolution did not specifically address Neighborhood's ADC loan concentration.

A February 2008 State Examination Resulted in a Downgrade to a CAMELS Composite 4 Rating and a Written Agreement

The State, with the assistance of three experienced FRB Atlanta examiners, began an examination in February 2008 and issued a report in July 2008 that resulted in Neighborhood being downgraded to a CAMELS composite 4 rating. According to supervisory guidance, institutions in this group pose a risk to the DIF, and failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved. Examiners noted "serious deterioration" in the bank's condition since the prior Federal Reserve examination. According to examiners, the bank's critically deficient asset quality resulted from a dramatic decline in the ADC market coupled with management's failure to diversify the bank's loan portfolio. Classified assets had reached an excessively high level, and the significant volume of problem assets resulted in unsatisfactory earnings along with weakened capital and liquidity.

In response to the bank's troubled condition, a formal enforcement action in the form of a Written Agreement was executed in September 2008. The Written Agreement required the Board of Directors to submit a written plan to strengthen board oversight of bank management and operations and improve the bank's condition. Neighborhood was also required to submit written plans to address a variety of issues, including capital, lending practices, credit administration, credit concentrations, asset improvement, and strategic planning.

An August 2008 Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating

FRB Atlanta started a full scope examination in August 2008 and issued its report in November 2008. The examination resulted in Neighborhood 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

cited the rising level of classified loans and $26.5 million in examiner-initiated downgrades of ADC loans as indicative of continued deterioration in Neighborhood's asset quality. According to examiners, the severe decline in asset quality and weaknesses in credit administration had a negative effect on financial performance that threatened capital adequacy. Examiners criticized the Board of Directors' lack of oversight with regard to the high level of nonperforming assets, inaccurate risk rating of problem loans, and failure to take timely action to increase capital.

A March 2009 Examination Resulted in Another CAMELS Composite 5 Rating

A joint full scope examination that was started in March 2009, with a report issued in June 2009, resulted in another CAMELS composite 5 rating. Examiners concluded that Neighborhood's condition continued to deteriorate and that the bank's deficient asset quality, capital, earnings, and liquidity posed a direct threat to the institution's viability. According to examiners, continued asset quality deterioration was driven by the bank's excessive concentration in residential ADC loans and the severe market downturn in residential real estate. Examiners commented that the bank's deteriorating condition was due in part to the Board of Directors' initial delay in implementing corrective measures. With the additional losses cited in the examination report, the bank's capital level was expected to drop to *critically undercapitalized.*

In May 2009, the Board issued a PCA Directive that, among other things, required Neighborhood to (1) restore itself to *adequately capitalized* by raising additional capital or (2) merge with or be acquired by another depository institution. With no prospects for recapitalizing, merging, or being acquired, the State closed Neighborhood on June 26, 2009.

Conclusion and Lesson Learned

Neighborhood failed because its Board of Directors and management did not properly manage the risks associated with the bank's concentration in ADC loans tied to the residential real estate market. Neighborhood expanded its ADC loan portfolio when the areas served by the bank experienced rapid growth. A declining residential real estate market—coupled with management's failure to recognize and act upon weakening market conditions—led to deteriorating asset quality and significant losses, particularly in the ADC loan portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately caused the State to close Neighborhood on June 26, 2009, and appoint FDIC as receiver.

With respect to supervision, FRB Atlanta complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular offsite monitoring commensurate with concerns and risks identified during examinations. In addition, FRB Atlanta included Neighborhood in a district-wide CRE Review Program in April 2005 and conducted a CRE target examination in October 2005. The bank was rated CAMELS composite 2 (satisfactory) until August 2007, when an FRB Atlanta examination resulted in a CAMELS composite 3 (fair) rating and an informal enforcement action. A February 2008 State-led examination that included three experienced FRB Atlanta examiners resulted in a downgrade to a composite 4 rating and the execution of a Written Agreement. Neighborhood was rated a CAMELS composite 5 in two subsequent examinations, reflecting the bank's critically depleted capital position and high probability of failure.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken earlier to reduce the likelihood of a bank's failure or loss to the DIF. Accordingly, in our opinion, the conditions examiners observed during the 2007 examination provided FRB Atlanta with an opportunity to be more aggressive in addressing Neighborhood's high ADC loan concentration as part of its informal enforcement action (Board Resolution).

FRB Atlanta accelerated the start of its 2007 examination by three months because ongoing surveillance revealed an increased inventory of built homes that remained unsold in the bank's market area. Examiners downgraded Neighborhood to a CAMELS composite 3 rating and noted that staff turnover at Neighborhood during the prior six to twelve months had a negative effect on the bank's ability to manage its loan portfolio. The 2007 examination report stressed the importance of effective Board of Directors and senior management oversight given the lending staff's inexperience and the "uncertain outlook for residential real estate." Examiners noted an increase in classified assets and commented that most of the loans downgraded during the examination were tied to residential land development and construction. Bank management was criticized for being slow to recognize loan deterioration, and examiners stated that the signs of a potential housing oversupply were evident twelve to fifteen months earlier. Separately, examiners noted that management continued to originate new ADC loans after other local banks began to reduce their CRE exposure.

We believe the conditions observed during the 2007 examination that led FRB Atlanta to execute a Board Resolution also warranted compelling Neighborhood to reduce its ADC loan concentration. However, in light of the subsequent rapid deterioration in the local real estate market, it is not possible to determine the degree to which any such action would have affected the bank's subsequent decline or the failure's cost to the DIF.

Lesson Learned

Although the failure of one community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe the failure of Neighborhood points to a valuable lesson learned that Federal Reserve examiners and managers may find useful in planning and conducting future examinations of banks with similar characteristics. Accordingly, in our opinion, Neighborhood's failure demonstrates that an aggressive and immediate supervisory response, including an enforcement action compelling a bank to reduce its concentration in ADC loans, may be warranted when a financial institution experiences significant staff turnover and management is slow to recognize or act upon early signs of loan portfolio deterioration and weakening market conditions.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response is included as Appendix 3. The Director concurred with the report's conclusion and lesson learned. He also noted that FRB Atlanta expended considerable time and resources examining and supervising Neighborhood and urging its management and Board of Directors to exercise greater oversight in key processes, such as the

loan committee and loan grading. The Director commented that our report highlighted an important lesson learned. Specifically, he stated that an aggressive and immediate supervisory response, including an enforcement action compelling a bank to reduce its concentration in ADC loans, may be warranted when a financial institution experiences significant staff turnover and management is slow to recognize or act upon early signs of loan portfolio deterioration and weakening market conditions.

The Director welcomed the report's observations and contribution to understanding the reasons for Neighborhood's failure. He noted that the events described in the report (1) highlight the critical importance of the early detection of issues by both bank management and bank supervisors and (2) serve as a reminder of the dangers of high concentrations in risky assets that are subject to dramatic and swift market swings.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Acquisition, Development, and Construction (ADC) Loans
ADC loans are a component of commercial real estate loans that provide funding for acquiring and developing land for future construction and 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.

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 as "doubtful" has all the weaknesses inherent in one classified as "substandard," with the added characteristic that the weaknesses make full collection or liquidation highly questionable and improbable. Assets classified as "loss" are considered uncollectible and of such little value that their continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE) Loans
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.

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.

Appendix 1 (continued)

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

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

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 DIF. The capital categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

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 based upon quarterly data submitted by banks and is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public.

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 – 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 the 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 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 institutions' size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For financial institutions 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 institutions' size, complexity, and risk profile. There are no material supervisory concerns; and, as a result, the supervisory response is informal and limited.

Appendix 2 (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 institutions' 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 institutions' 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 DIF. 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 institutions' 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 DIF, and failure is highly probable.

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: January 26, 2010

To: Elizabeth A. Coleman, Inspector General

From: Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***

Subject: Draft "Material Loss Review of Neighborhood Community Bank"

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Neighborhood Community Bank ("Neighborhood"), Newnan, Georgia that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that Neighborhood failed because its Board of Directors and management did not properly manage and control the risk associated with the bank's highly concentrated acquisition, development, and construction (ADC) loan portfolio. The bank was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta) under delegated authority from the Board.

We concur with the conclusions and lesson learned contained in the report. FRB Atlanta complied with examination frequency guidelines, and appropriately accelerated the 2007 examination when declining market conditions became evident. FRB Atlanta expended considerable time and resources examining and supervising Neighborhood and urging its management and Board of Directors to exercise greater oversight in key processes, such as the loan committee and loan grading. Stronger management oversight was particularly critical given bank staff turnover. Oversight remained deficient, however, and this in combination with the bank's high concentration in ADC in a declining real estate market resulted in rapid deterioration in Neighborhood's loan portfolio and financial condition. We concur that in hindsight more aggressive supervisory action at an earlier stage was warranted, but also that we cannot determine whether such would have averted the ultimate failure of the bank or altered the Deposit Insurance Fund's cost of resolution. The report highlights an important lesson learned in that an aggressive and immediate supervisory response, including an enforcement action compelling a bank to reduce its concentration in ADC loans, may be warranted when a financial institution experiences significant staff turnover and management is slow to recognize or act upon early signs of loan portfolio deterioration and weakening market conditions.

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 Neighborhood's failure. The events described in the report highlight the critical importance of the early detection of issues by both bank management and bank supervisors, and serve as a reminder to both of the dangers of high concentrations in risky assets that are subject to dramatic and swift market swings.

Appendix 4 – Principal Contributors to this Report

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