Board of Governors of the Federal Reserve System

Material Loss Review of Community Bank of West Georgia

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 Community Bank of West Georgia (West Georgia). 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.

West 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 by the Georgia Department of Banking and Finance (State). The State closed West Georgia in June 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On July 28, 2009, the FDIC Inspector General notified us that West Georgia's failure would result in an estimated loss to the DIF of $85.1 million, or 42.6 percent of the bank's $200 million in total assets.

West Georgia 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. West Georgia expanded its ADC lending when the metropolitan Atlanta area was experiencing rapid growth. However, a declining real estate market coupled with credit administration and loan underwriting weaknesses led to deteriorating asset quality and significant losses, particularly in the ADC portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately led to the State closing West Georgia and appointing the FDIC as receiver on June 26, 2009.

After West Georgia became a state member bank in March 2004, FRB Atlanta and the State conducted a total of six safety and soundness examinations, two visitations, and a commercial real estate review. We found that FRB Atlanta did not perform a required examination and, therefore, did not fully comply with the Federal Reserve's supervisory guidance regarding examination frequency for de novo banks. However, our analysis revealed that the missed examination likely did not have a material effect on West Georgia's supervision. In addition, we found that discrete Federal Reserve guidance pertaining to de novo bank examinations is contained in two separate documents that are not cross-referenced, which could result in the guidance being overlooked or misinterpreted. Our report includes additional details on the noncompliance issue and offers a recommendation to clarify supervisory guidance related to de novo banks.

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. Our analysis of FRB Atlanta's supervision of West Georgia indicated that emerging problems that became apparent in early 2007 warranted a more forceful supervisory response compelling West Georgia's management to (1) address credit administration and loan underwriting deficiencies and (2) maintain capital commensurate with the bank's high concentration in speculative ADC loans.

By early 2007, it was apparent that West Georgia's credit risk was high due to (1) a large concentration in ADC loans, especially speculative construction loans for homes that were not pre-sold; and (2) weaknesses in credit administration and loan underwriting. Although West Georgia received a CAMELS composite 2 rating, examiners cited credit management problems, including insufficient information contained in memoranda supporting ADC loans and a lack of independent appraisal reviews. In addition, examiners noted a declining trend in capital and expressed concerns about West Georgia's capital in light of the bank's high ADC concentration. Examiners specifically cautioned that West Georgia's capital level might not be sufficient to absorb unexpected losses arising from the bank's ADC concentration.

The case for a stronger supervisory response in early 2007 is supported by the results of FRB Atlanta's November 2007 visitation, when examiners noted that the bank's credit risk analysis and monitoring of commercial real estate loans still needed further improvement and that there were continued weaknesses in credit administration. In addition, Federal Reserve guidance on de novo bank supervision states, "Given the rapid deterioration experienced by some de novo banks, a timely supervisory response to address problem areas is particularly important." The guidance also advises that prompt supervisory action should be taken when weaknesses are first detected. We believe that the circumstances FRB Atlanta observed during the early 2007 time period warranted a more forceful supervisory response; however, in light of the rapidly declining real estate market, it is not possible to assess the degree to which any such action would have affected West Georgia's subsequent decline or the ensuing failure's cost to the DIF.

Although the failure of one de novo community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, West 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 de novo banks with similar characteristics. West Georgia's failure illustrates that de novo banks with a growth strategy that results in a concentration of ADC loans can be highly vulnerable to changes in the real estate market. Accordingly, de novo banks with ADC concentrations require immediate and forceful supervisory action compelling management to (1) correct credit administration and loan underwriting deficiencies as soon as they begin to appear, and (2) maintain capital levels that are commensurate with emerging risks.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director concurred with our conclusions, lesson learned, and recommendation. The Director said that he plans to implement our recommendation by revising the *Commercial Bank Examination Manual* to include a cross-reference to Supervision and Regulation Letter 91-17, which provides the examination frequency requirements for de novo banks. We will follow up on the action taken to implement the recommendation. The Director's 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

Elizabeth A. Coleman
Inspector General

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

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Background

Community Bank of West Georgia (West Georgia)—a community bank in Villa Rica, Georgia, with two branch offices—opened on March 25, 2003, as a state non-member institution, serving residents and businesses in a four-county suburban area west of metropolitan Atlanta. West Georgia became a state member bank (SMB) of the Federal Reserve System on March 9, 2004. 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). As a de novo bank, West Georgia was subject to additional regulatory requirements following its approval as an SMB, including more frequent examinations and higher capital standards.[1]

The State closed West Georgia 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 an $85.1 million loss to the Deposit Insurance Fund (DIF), or 42.6 percent of the bank's $200 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* (CBEM) and relevant supervisory guidance. We interviewed FRB Atlanta and State staff and collected relevant FRB Atlanta examination data. We also reviewed correspondence, regulatory reports filed by West Georgia, surveillance 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] Federal Reserve supervisory guidance defines a de novo bank as an SMB that has been in operation for five years or less.

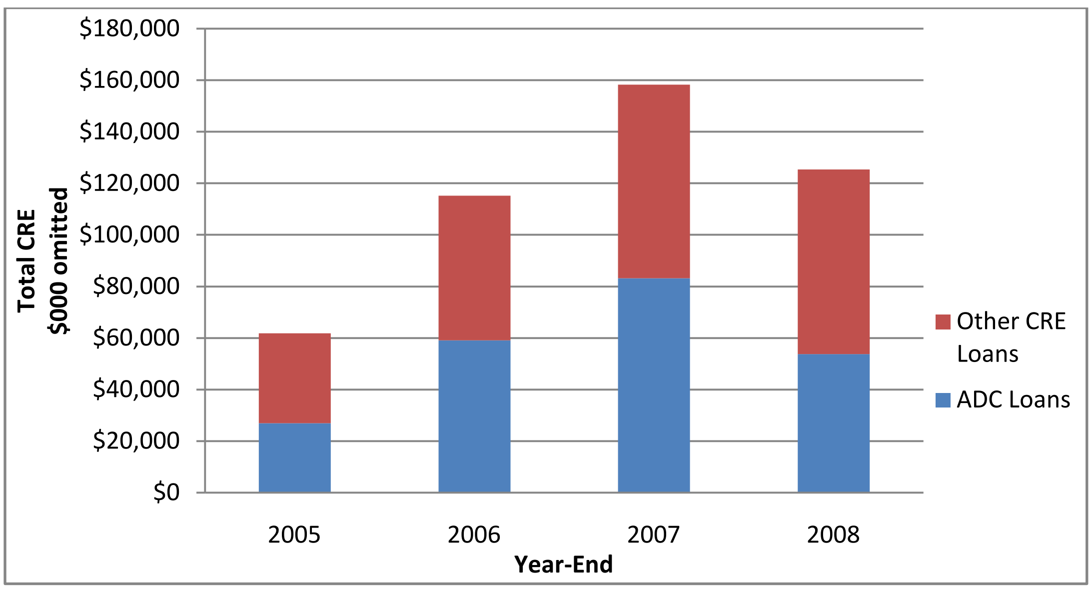
[2] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the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

Cause of the Failure

West Georgia 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. West Georgia expanded its ADC lending when the metropolitan Atlanta area was experiencing rapid growth. However, a declining real estate market—coupled with credit administration and loan underwriting weaknesses—led to deteriorating asset quality and significant losses, particularly in the ADC portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately led to the State closing West Georgia and appointing the FDIC as receiver on June 26, 2009.

Initially, West Georgia focused its business strategy on gradually developing the ADC loan component of its commercial real estate (CRE) portfolio within its service area. In 2005, however, the bank adopted a more aggressive ADC loan growth strategy. As shown in Chart 1, the ADC component of the bank's CRE portfolio more than tripled from 2005 to 2007, peaking at $83.1 million. West Georgia funded its ADC portfolio growth with non-core funding, including brokered deposits, because it had not yet established a solid core deposit base.[3]

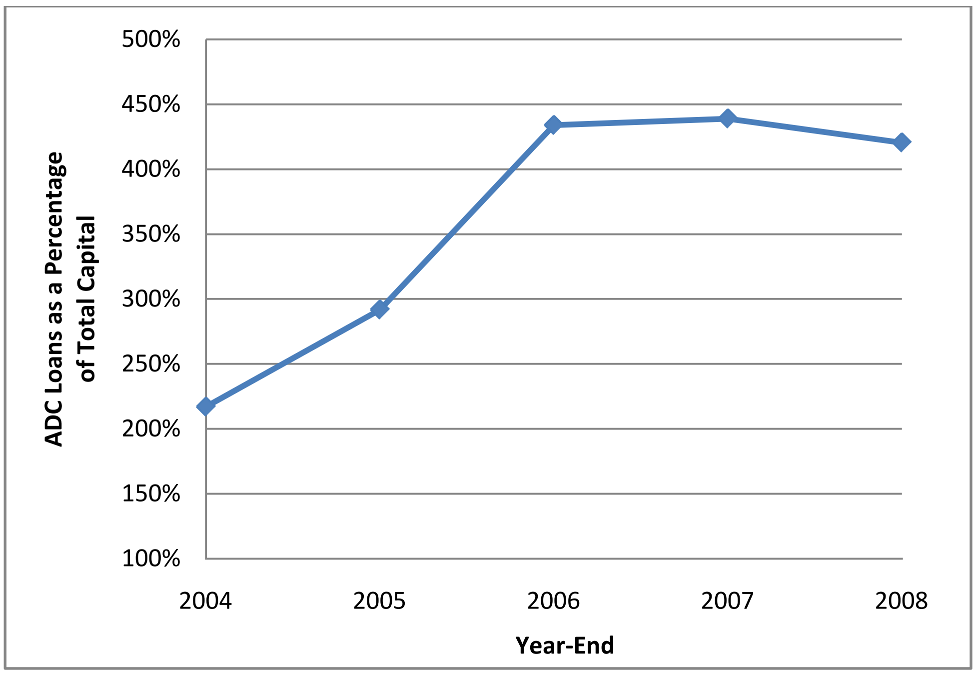
Chart 1: Growth in ADC Loans



[3] Brokered deposits can have a significant negative effect on liquidity because these funds may not be available in times of financial stress or adverse changes in market conditions. Although West Georgia's use of non-core funding was a concern for examiners, liquidity was not a primary factor in West Georgia's failure.

West Georgia's growth strategy led to a high concentration in ADC loans. As shown in Chart 2, West Georgia's ADC concentration grew from 217 percent of total capital in 2004, to 420 percent in 2008. In contrast, according to regulatory reports, financial institutions in West Georgia's peer group had a year-end 2008 ADC concentration of 90 percent.[4] In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. West Georgia's ADC portfolio included an additional risk dimension because it contained what examiners described as a substantial amount of "speculative residential construction loans" to developers for constructing homes that were not pre-sold.

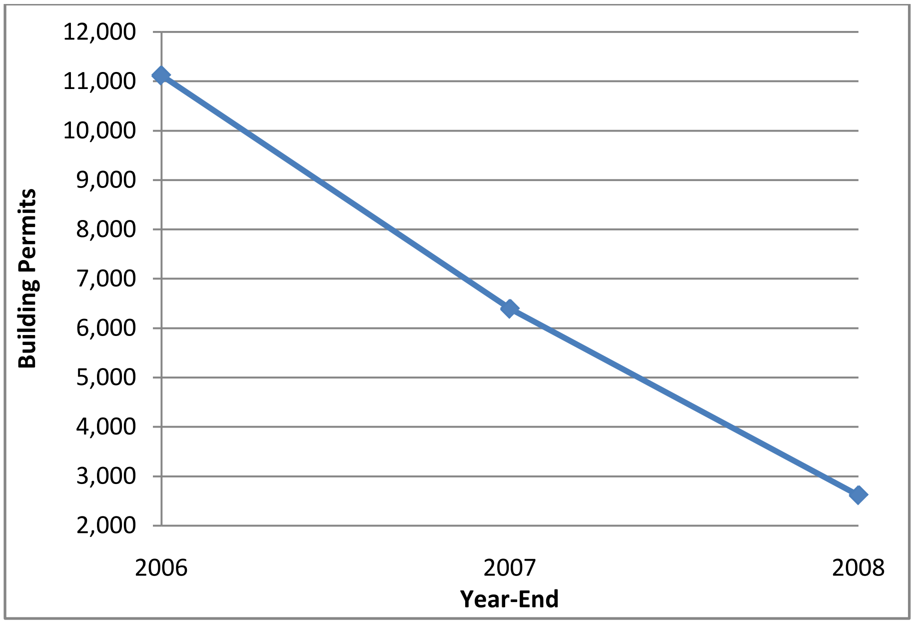
Chart 2: West Georgia's ADC Loan Concentration



West Georgia's asset quality deteriorated significantly as the economy slowed and the demand for residential housing declined. As shown in Chart 3 (see page 12), the number of housing unit building permits issued in West Georgia's service area dropped from 11,121 in 2006, to 2,614 in 2008, a 76 percent decline over a two-year period. In addition, the inventory of vacant developed lots in the Atlanta metropolitan area increased from 47 months at the end of 2007 to 125 months at the end of 2008. Eighteen to twenty-four months is considered an acceptable vacant developed lot inventory.

[4] West Georgia's peer group consisted of all insured commercial banks having assets between $100 million and $300 million in a metro area and having two or fewer full service offices.

Chart 3: Building Permits Issued in West Georgia's Service Area

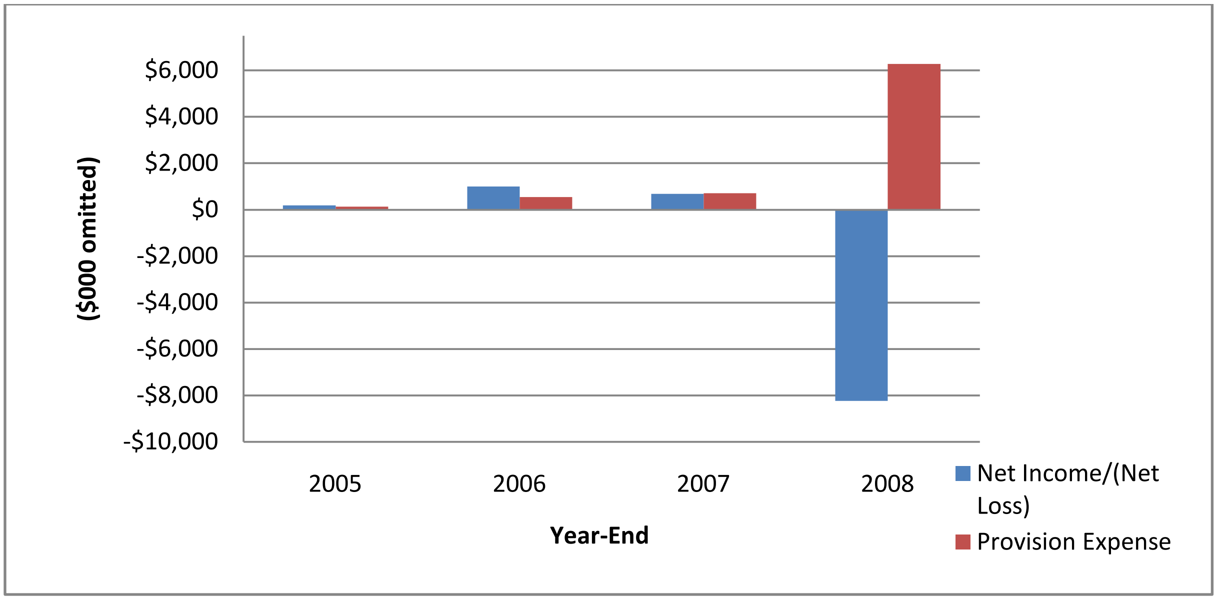


Furthermore, West Georgia's Board of Directors and management failed to establish a sound credit administration and loan underwriting infrastructure. Accordingly, the bank lacked sufficient controls to identify, monitor, and appropriately manage the bank's ADC concentration risks, especially in changing market conditions. With respect to loan underwriting, examiners cited specific deficiencies, including insufficient financial information to support loan decisions, a lack of independent real estate appraisal reviews, and inadequate liquidity analysis of builders responsible for ADC loans.

West Georgia's asset quality declined as deteriorating real estate market conditions substantially reduced the appraised value of collateral supporting the ADC portfolio. The bank's classified assets jumped from $2.7 million at the end of 2006 to $63.5 million at year-end 2008. Examiners noted that the substantial concentration in ADC loans was the "primary factor" in the bank's asset quality deterioration.

The growth in classified assets prompted corresponding increases in West Georgia's Allowance for Loan and Lease Losses (ALLL) and loan loss provision expense (provision). As shown in Chart 4 (see page 13), the provision for year-end 2007 totaled $712,000. By the end of the following year, the provision increased 783 percent to $6.3 million, contributing to the bank's 2008 net loss of $8.2 million. The loss eliminated retained earnings and significantly reduced West Georgia's capital.

Chart 4: Impact of Provision Expense on Earnings



West 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. FRB Atlanta implemented PCA and made timely notifications when the bank reached various PCA capital categories. The bank's capital category dropped from *well capitalized* to *adequately capitalized* in November 2008. Ongoing efforts to raise capital were unsuccessful, West Georgia's financial condition continued to deteriorate, and FRB Atlanta notified the bank that it had fallen to the *undercapitalized* level in March 2009.

A full scope examination that began in April 2009 revealed further financial decline, and on May 13, 2009, FRB Atlanta notified West Georgia that its capital position had dropped to *critically undercapitalized.* The Federal Reserve issued a PCA Directive on May 19, 2009, that, among other things, required the bank to (1) restore the bank to *adequately capitalized* by raising additional capital, or (2) be acquired by or merge with another depository institution. When prospects for recapitalizing the bank did not materialize, West Georgia's Board of Directors executed a resolution to surrender the bank's charter, and the State closed West Georgia on June 26, 2009.

Supervision of Community Bank of West Georgia

FRB Atlanta and the State conducted six safety and soundness examinations, two visitations, and a CRE review during the five-year period preceding West Georgia's failure in June 2009. As shown in Table 1 (see page 14), the bank's condition through 2007 was rated a CAMELS composite 2, which is considered satisfactory. Ongoing supervisory activities indicated a significant increase in West Georgia's non-performing assets, which resulted from declines in the real estate market. These circumstances prompted FRB Atlanta to begin an asset quality target examination in March 2008. The target examination resulted in a double downgrade to a CAMELS composite 4 rating based on deteriorating asset quality and its adverse effect on earnings, capital, and liquidity. The target examination also led to a formal enforcement action. Four months after the target examination report was issued, FRB Atlanta and the State began a joint examination that resulted in a CAMELS composite 5 rating. A subsequent joint examination that began in April 2009 also assigned a CAMELS composite 5 rating.

During the course of our review, we found that FRB Atlanta did not fully comply with Federal Reserve examination frequency guidelines for de novo banks. These guidelines are found in Supervision and Regulation Letter (SR Letter) 91-17, *Application and Supervision Standards for De Novo State Member Banks*, and the CBEM. We address this issue in more detail and make a recommendation in the Conclusions, Lesson Learned, and Recommendation section of this report (see page 17).

Table 1: West Georgia Supervisory Overview

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
5/3/2004	8/5/2004	Full	FRB Atlanta	2	1	1	2	3	2	2	
6/13/2005	7/22/2005	Full	State	2	2	1	2	3	2	2	
6/13/2005	7/31/2005	CRE Review	FRB Atlanta	n/a							
4/11/2006	n/a	Visitation	FRB Atlanta	n/a							
1/22/2007	3/29/2007	Full	FRB Atlanta	2	3	2	2	3	2	2	
11/13/2007	n/a	Visitation	FRB Atlanta	n/a							
3/10/2008	5/22/2008	Target	FRB Atlanta	4	4	5	4	5	4	4	Written Agreement
9/22/2008	1/30/2009	Full	Joint FRB Atlanta-State	5	5	5	5	5	5	4	PCA notifications
4/20/2009	6/23/2009	Full	Joint FRB Atlanta-State	5	5	5	5	5	5	4	PCA notification; PCA Directive

Supervision History from 2004 through 2006

FRB Atlanta conducted its first safety and soundness examination of West Georgia in May 2004. During this full scope review, examiners rated the bank a CAMELS composite 2. The earnings component was rated 3 (fair), which examiners noted was typical for a de novo bank. The examination report noted that bank management was experienced, with a sound background in credit administration and local markets. Examiners also noted that West Georgia's loan underwriting practices, credit administration procedures, and loan policies were sound.

The State began a full scope examination in June 2005, ten months after the Federal Reserve issued its August 2004 examination report, and West Georgia again received a CAMELS composite 2 rating. Examiners cited the bank's strong asset quality and noted that the bank had no adversely classified loans or loans past due over thirty days and that underwriting practices and credit administration appeared to be operating effectively. In addition, capital, management, and liquidity were all deemed satisfactory (rated 2). Earnings were once again rated 3 (fair), but examiners stated that such a situation was to be expected for a bank that had only been operating for two years.

During the same time period, FRB Atlanta visited West Georgia as part of a district-wide CRE Review Program involving twenty-five state member community banks with high CRE concentrations. The purpose of the program was to assess the level of risk associated with West Georgia's increasing exposure to CRE loans and to determine if proper risk management tools and practices were in place to manage the CRE concentration. An FRB Atlanta August 9, 2005, letter to West Georgia's President made several suggestions for the bank's consideration, such as stress testing certain CRE loans, addressing CRE concentrations when analyzing the adequacy of the ALLL, and enhancing information available to management and the Board of Directors by further stratifying the CRE loan portfolio by property type and geographic location.

FRB Atlanta conducted a visitation in April 2006 and noted that management had begun implementing suggestions included in the August 2005 letter. Examiners noted that bank management was working on stratifying the loan portfolio and was doing "some" stress testing. However, examiners indicated that the credit policy as it related to the ALLL needed improvement. They stated that management seemed receptive to the examiners' suggestions.

FRB Atlanta Conducted a Full Scope Examination and a Visitation in 2007

FRB Atlanta conducted a full scope examination in January 2007 that resulted in a composite 2 rating. While asset quality was rated 2 with a "moderate" level of classified assets, examiners cautioned that ongoing attention was needed to prevent loans from deteriorating. Examiners rated capital as 3, noting a declining trend, and stated that earnings were not adequate to support capital growth and the bank's "immense CRE concentration risk." Examiners cautioned that even though the bank was *well capitalized* for regulatory purposes, capital may not be sufficient to absorb unexpected losses that could arise from loan concentrations. Bank management was asked to evaluate capital adequacy in light of asset growth and CRE concentrations and ensure that capital levels were commensurate with the risks.

The bank's liquidity was rated 2; however, examiners labeled credit risk as "high" because of high loan growth rates, the CRE concentration in speculative construction lending, and weak risk management practices. Senior bank management was directed to give immediate attention to credit administration issues related to underwriting and ongoing monitoring of CRE loans. According to examiners, loan administration and credit management deficiencies included insufficient information in ADC loan documentation and a lack of independent real estate appraisal reviews. The examination report noted that ADC loans comprised 42 percent of West

Georgia's overall loan portfolio and represented a concentration that exceeded 400 percent of risk-based capital. In addition, examiners stated that over 90 percent of the bank's $20 million portfolio of single family residential construction loans were speculative because the homes that were being constructed were not pre-sold. Examiners stated that monitoring and controls related to speculative residential construction loans needed improvement.

FRB Atlanta performed a visitation in November 2007 to assess management's progress in implementing the corrective actions outlined in the report from the January examination, specifically those related to credit risk management processes and procedures. Examiners focused their review on credit files and supporting loan documentation and material changes in processes and procedures. While some progress was made, examiners stated that credit risk analysis and monitoring of CRE loans continued to need improvement.

West Georgia Was Downgraded to a CAMELS Composite 4 Rating as a Result of a March 2008 Target Examination, and a Written Agreement Was Executed

FRB Atlanta conducted a March 2008 target examination of West Georgia after ongoing supervisory activities indicated a significant increase in the level of non-performing assets due to a decline in the real estate market. Issues addressed during the target examination included West Georgia's deteriorating loan portfolio, credit risk management weaknesses, and capital adequacy. Examiners also revisited West Georgia's CAMELS ratings and lowered the composite rating and all the component ratings.

The examination report noted that classified assets had increased substantially since the last examination because of the weak residential real estate market and West Georgia's inability to correct previously identified credit administration and underwriting weaknesses. According to examiners, capital levels were not sufficient to support the bank's risk profile despite two capital injections made in 2007, and earnings were critically deficient due to increasing levels of classified assets and the need for additional provision expenses to fully fund the ALLL. Liquidity was a concern because of the bank's deteriorating asset quality and a reliance on the use of brokered deposits. West Georgia was downgraded to a CAMELS composite 4, "troubled condition."

A Written Agreement subsequently was executed in September 2008. It required West Georgia's Board of Directors to address a variety of specific issues within sixty days. These issues included credit risk management, lending and credit administration, loan review, asset improvement, capital, earnings, and liquidity. West Georgia was required to submit written plans for improving credit risk management and to assess bank management and staffing needs, along with the performance of all senior bank management.

Subsequent 2008 Full Scope Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating

FRB Atlanta and State examiners downgraded West Georgia to a CAMELS composite 5 rating after completing a joint full scope examination that began in September 2008. Composite 5 rated banks exhibit extremely unsafe and unsound practices or conditions and pose a significant risk to the DIF because failure is highly probable. Examiners noted that serious deterioration in the local ADC market left builders and developers with high inventories of properties that were not selling. Classified assets continued to increase and were at unacceptably high levels. Capital, earnings, and liquidity were cited as critically deficient, and the bank was considered to be *undercapitalized* for PCA purposes.

West Georgia Received Another CAMELS Composite 5 Rating after an April 2009 Examination, and a PCA Directive Was Issued

FRB Atlanta and State examiners conducted another joint full scope examination on April 20, 2009, and assigned another CAMELS composite 5 rating. Examiners noted that adversely classified assets had increased significantly since the prior examination and that loan losses associated with the ADC portfolio eroded the bank's capital. The bank was deemed *critically undercapitalized* as a result of the examination, and examiners stated that the bank would fail without an immediate and substantial injection of capital.

The Board issued a PCA Directive in May 2009 that, among other things, required the bank to (1) restore the bank to *adequately capitalized* by raising additional capital, or (2) be acquired by or merge with another depository institution. When prospects for recapitalizing the bank did not materialize, West Georgia's Board of Directors executed a resolution to surrender its charter, and the State closed West Georgia on June 26, 2009.

Conclusions, Lesson Learned, and Recommendation

West Georgia failed because its Board of Directors and management did not properly manage and control the risk associated with the bank's highly concentrated ADC loan portfolio. West Georgia expanded its ADC lending when the metropolitan Atlanta area was experiencing rapid growth. However, a declining real estate market—coupled with credit administration and loan underwriting weaknesses—led to deteriorating asset quality and significant losses, particularly in the ADC portfolio. Mounting losses eliminated earnings and depleted capital, which ultimately led the State to close West Georgia and appoint the FDIC as receiver on June 26, 2009.

FRB Atlanta and the State conducted six safety and soundness examinations, two visitations, and a CRE review during the five-year period preceding West Georgia's failure in June 2009. We found that FRB Atlanta did not fully comply with the Board's supervisory guidance regarding examination frequency for de novo banks. Specifically, FRB Atlanta should have followed its May 2004 examination with a full scope examination by December 30, 2004. However, our analysis revealed that the missed examination likely did not have a material effect on West Georgia's supervision. An examination performed by the State in June 2005—six months after the Federal Reserve examination should have begun—resulted in a CAMELS composite 2 rating. This examination indicated that West Georgia did not have any classified or past due loans or any material financial or operational problems. In addition, West Georgia's quarterly financial regulatory report revealed the same financial position, with no classified or past due loans at year-end 2004, the time period during which the Federal Reserve should have conducted a full scope examination. We also found, however, that discrete Federal Reserve guidance pertaining to de novo bank examinations is contained in two separate documents that are not cross-referenced, which could result in the guidance being overlooked or misinterpreted. Below we provide additional details on the noncompliance issue and offer a recommendation to clarify supervisory guidance related to de novo banks.

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. Our analysis of FRB Atlanta's supervision of West Georgia indicated that emerging problems that became apparent in early 2007 warranted a more forceful supervisory response compelling West Georgia's management to (1) address credit administration and loan underwriting deficiencies and (2) maintain capital commensurate with the bank's high concentration in speculative ADC loans.

By early 2007, it was apparent that West Georgia's credit risk was high due to (1) a large concentration in ADC loans, especially speculative construction loans for homes that were not pre-sold; and (2) weaknesses in credit administration and loan underwriting. Although West Georgia received a CAMELS composite 2 rating, examiners cited credit management problems, including insufficient information contained in memoranda supporting ADC loans and a lack of independent appraisal reviews. In addition, examiners noted a declining trend in capital and expressed concerns about West Georgia's capital in light of the bank's high ADC concentration. Examiners specifically cautioned that West Georgia's capital level might not be sufficient to absorb unexpected losses arising from the bank's ADC concentration.

The case for a stronger supervisory response in early 2007 is supported by the results of FRB Atlanta's November 2007 visitation, when examiners noted that credit risk analysis and monitoring of CRE loans still needed further improvement and that there continued to be weaknesses in credit administration. In addition, Federal Reserve guidance on de novo bank supervision states, "Given the rapid deterioration experienced by some de novo banks, a timely supervisory response to address problem areas is particularly important." The guidance also advises that prompt supervisory action should be taken when weaknesses are first detected. We believe that the circumstances FRB Atlanta observed during the early 2007 time period warranted a more forceful supervisory response; however, in light of the rapidly declining real estate market, it is not possible to assess the degree to which any such action would have affected West Georgia's subsequent decline or the ensuing failure's cost to the DIF.

Lesson Learned

Although the failure of one de novo community bank does not necessarily provide sufficient evidence to draw broad-based conclusions, West 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 de novo banks with similar characteristics. West Georgia's failure illustrates that de novo banks with a growth strategy that results in a concentration of ADC loans can be highly vulnerable to changes in the real estate market. Accordingly, de novo banks with ADC concentrations require immediate and forceful supervisory action compelling management to (1) correct credit administration and loan underwriting deficiencies as soon as they begin to appear, and (2) maintain capital levels that are commensurate with emerging risks.

Recommendation

We recommend that the Director of the Division of Banking Supervision and Regulation revise the *Commercial Bank Examination Manual* to include (a) the examination frequency requirements for de novo banks, and (b) a cross-reference to Supervision and Regulation Letter 91-17.

Our analysis of West Georgia's supervisory history revealed that FRB Atlanta did not fully comply with the Board's supervisory guidance regarding the examination frequency for de novo banks. Discrete guidance is found in two documents: (1) SR Letter 91-17, which provides the examination frequency requirements for de novo banks; and (2) the CBEM, which includes the rules for determining when the Reserve Banks and the State may alternate their examination responsibilities for de novo banks.

The guidance contained in SR Letter 91-17 requires each Reserve Bank to comply with the following examination schedule for de novo banks:

- a limited scope examination should be conducted after a newly-converted SMB completes its first quarter of operations,
- a full scope examination should be conducted six months after the end of the first quarter of operations, and
- a full scope examination should be conducted for each six-month interval thereafter.

According to SR Letter 91-17, a de novo bank is subject to this examination schedule until it receives two consecutive CAMELS composite ratings of 1 or 2 and, in the judgment of the Reserve Bank, can be expected to continue operating on a sound basis. Once these criteria are met, a de novo bank is eligible for the standard examination schedule.

The CBEM does not specifically address de novo bank examination frequency. In fact, it only states that a de novo bank is ineligible for alternate-year examinations by the applicable Reserve Bank and state until the de novo bank is rated 1 or 2 for two consecutive examinations after it has commenced operations.

During the first quarter of operations after West Georgia became an SMB, FRB Atlanta conducted a full scope examination (although only a limited scope examination was required), and it resulted in a CAMELS composite 2 rating. The examination report issued in August 2004 noted that bank management was experienced, had sound credit backgrounds, and was familiar with local markets. Examiners also noted that West Georgia's loan underwriting practices, credit administration procedures, and loan policies were sound. Earnings were rated a composite 3 (fair), which, according to examiners, was typical for a de novo bank.

Pursuant to SR Letter 91-17, FRB Atlanta should have begun another examination (full scope) by December 30, 2004, six months after West Georgia completed its first quarter operating as an SMB. However, FRB Atlanta did not conduct a full scope examination by this date. An FRB Atlanta officer stated that the Reserve Bank staff did not conduct an examination by December 30, 2004, because they believed that the CAMELS composite 2 ratings from (1) a

State examination begun in September 2003 before the bank converted to an SMB, and (2) the Federal Reserve's May 2004 examination qualified West Georgia for the standard examination cycle and alternating examinations with the State. Counting the State examination was inconsistent with the CBEM requirement that de novo banks are ineligible for alternate examinations by the State until they are rated a CAMELS composite 1 or 2 for two consecutive Federal Reserve examinations.

However, our analysis determined that the missed examination likely did not have a material effect on West Georgia's supervision. An examination performed by the State in June 2005—six months after the Federal Reserve examination should have begun—resulted in a CAMELS composite 2 rating and also revealed that West Georgia did not have any classified or past due loans or any material financial or operational problems. In addition, West Georgia's quarterly financial regulatory report revealed the same financial position with no past due or nonaccrual loans at year-end 2004, the time period during which the Federal Reserve should have conducted a full scope examination. Further, FRB Atlanta's full scope examination in January 2007 also resulted in a CAMELS composite 2 rating. Based on the above, we believe it is likely that a Federal Reserve examination of West Georgia in the December 2004 timeframe would have resulted in a CAMELS composite 2 rating, which would have permitted West Georgia to be subject to the standard examination schedule and alternating examination cycles by the Reserve Bank and the State.

As noted above, SR Letter 91-17 and the CBEM each contain discrete guidance pertaining to de novo bank examinations. However, the CBEM only addresses the conditions a de novo bank must meet to be eligible for alternating examinations and does not cross-reference or cite the examination frequency guidance outlined in SR Letter 91-17. As a result, an examiner could overlook one or the other document and, thus, misinterpret the de novo bank examination requirements. Therefore, we recommend that the Director of the Division of Banking Supervision and Regulation revise the CBEM to include the examination frequency guidelines for de novo banks and to cross-reference SR Letter 91-17.

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, included as Appendix 3, indicates concurrence with the report's conclusion, lesson learned, and recommendation. The Director agreed that a more aggressive supervisory action at an earlier stage was warranted. He noted that FRB Atlanta expended considerable time and resources examining and supervising West Georgia and urging its management and Board of Directors to (1) maintain capital commensurate with risks, and (2) address credit administration and loan underwriting weaknesses.

With respect to our recommendation, the Director agreed that having guidance regarding de novo bank examinations in two discrete documents, without any cross-references, could result in an examiner misinterpreting the requirements. He plans to implement our recommendation by revising the CBEM to include a cross-reference to SR Letter 91-17, which provides the examination frequency requirements for de novo banks. We will follow up on action taken to implement the recommendation.

The Director welcomed the report’s observations and contribution to understanding the reasons for West 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 of de novo banks. 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.

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.

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 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.

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 may be taken, typically 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.

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, certificates of deposit of more than $100,000, and brokered deposits.

Nonperforming Loans
Nonperforming loans are the sum of total loans and lease financing receivables past due ninety 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 DIF. 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 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 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 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 Deposit Insurance Fund 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 Community Bank of West Georgia"

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Community Bank of West Georgia (“West Georgia), Villa Rica, 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 West Georgia 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, lesson learned, and recommendation contained in the report. FRB Atlanta expended considerable time and resources examining and supervising West Georgia and urging its management and Board of Directors to address weaknesses in credit administration and loan underwriting and the need for the bank to maintain capital commensurate with the risk. However the rapid growth and concentration in speculative ADC loans followed by rapidly declining real estate market conditions proved to be insurmountable. 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. We also agree with the lesson learned that de novo banks with an aggressive growth strategy that results in a concentration of ADC loans that are highly vulnerable to changes in the real estate market require immediate and forceful action compelling management to (1) correct credit administration and loan underwriting deficiencies as soon as they begin to appear; and (2) maintain capital levels commensurate with emerging risks.

Consistent with the report’s recommendation, the Division will revise the Commercial Bank Examination Manual, which provides the rules for determining when the Reserve Banks and the State may alternate their examination responsibilities for de novo banks, to include a cross-reference to SR Letter 91-17, which provides the examination frequency requirements for de novo banks. We agree that having this information in two discrete documents without any cross reference could lead to an examiner overlooking one or the other document, and thus misinterpret the de novo bank examination requirements.

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 West Georgia’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 of de novo banks, 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 4 – Principal Contributors to this Report

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