Office of Inspector General

May 2009
Report No. AUD-09-010

Material Loss Review of Alpha Bank and Trust, Alpharetta, Georgia

AUDIT REPORT

Federal Deposit Insurance Corporation

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Alpha Bank and Trust (Alpha), Alpharetta, Georgia. On October 24, 2008, the Georgia Department of Banking and Finance (DBF) closed Alpha and named the FDIC as receiver. On November 6, 2008, the FDIC notified the OIG that Alpha's total assets at closing were $334 million and the estimated loss to the Deposit Insurance Fund (DIF) was $158 million.

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

Background

Alpha was a state-chartered nonmember bank insured on May 8, 2006. As a de novo bank, for its first 3 years in operation, Alpha was subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan. Further, Alpha, as a de novo institution, was in operation only 29 months. With one branch office, Alpha engaged principally in traditional banking activities within its local marketplace, which experienced a significant economic downturn starting in 2007. Alpha had no holding company, subsidiaries, or affiliates.

Alpha's assets consisted principally of commercial real estate (CRE) loans, including a significant concentration in residential acquisition, development, and construction (ADC) loans. The FDIC has recognized the increased risk that CRE loans present to financial institutions and has issued guidance that describes a risk management framework to effectively identify, measure, monitor, and control CRE concentration risk. That framework includes effective oversight by bank management, including the board of directors (BOD) and senior executives, and sound loan underwriting, administration, and portfolio management practices.

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Material Loss Review of Alpha Bank and Trust, Alpharetta, Georgia

Audit Results

Alpha failed primarily due to management's aggressive pursuit of asset growth concentrated in high-risk ADC loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls. Also, Alpha's compensation policies excessively rewarded loan production without sufficient focus on asset quality. The quality of loans suffered due to the bank's aggressive growth model. Resulting losses severely eroded Alpha's earnings and capital, leading to the bank's failure and a material loss to the DIF.

Management. Alpha's BOD did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. Although Alpha developed a business plan governing its activities, the plan was not kept current or followed. After 11 months in operation, total asset growth was nearly double the planned projections. The bank operated under a nonregulatory-approved compensation plan that rewarded loan production without emphasis on the quality of the loans. Additionally, Alpha did not comply with regulatory orders/conditions, including a state (1) limitation on the payment of bonuses during the first 3 years of operation and (2) requirement for sufficient asset quality controls in compensation policies. Further, Alpha rapidly expanded lending operations without sufficient attention to associated risk management controls.

Asset Quality. Alpha's ADC loans were concentrated in a rapidly growing local marketplace. The bank used interest reserves for many of the loans in its portfolio, which masked deterioration in asset quality. Additionally, Alpha did not follow sound loan underwriting standards and administration practices, including those pertaining to: (1) legal lending limits, (2) loan-to-value limits, and (3) recognition of problem assets. Alpha's underwriting process failed to fully capture the financial condition of borrowers. Asset quality was also adversely impacted by compensation policies that focused on loan growth. As asset quality declined and losses were recognized, Alpha's liquidity position became critical, and earnings and capital were eroded.

Liquidity. Alpha relied on high-cost sources of funding such as time deposits of more than $100,000; brokered deposits; and Federal Home Loan Bank advances, to support its asset growth. The increased interest expense associated with these funding sources reduced earnings. Rapid asset growth, declining asset quality, and poor earnings strained liquidity. The overall deterioration in the bank's condition impacted access to alternative sources of funding, including brokered deposits. As capital levels dropped, liquidity became a major problem contributing to the bank's failure.

Supervision. The FDIC and DBF conducted timely examinations of Alpha. The FDIC provided additional oversight through its off-site monitoring process and site visits. The April 2008 DBF examination found significant deterioration in asset quality, resulting in increased losses and further depletion of capital. As a result of the April 2008 examination, the DBF, in conjunction with the FDIC, issued a Cease and Desist Order in July 2008 in response to examination concerns. Those concerns included, but were not limited to, inadequate management oversight, deficient capital levels, high levels of classified assets, a prohibition on additional advances to classified borrowers, weak lending and loan review practices, and earnings and liquidity deficiencies. In October 2008, the FDIC used its authority under the PCA provisions of the FDI Act to issue a PCA Directive when Alpha became critically undercapitalized. The FDIC has authority to take a wide range of supervisory actions. In the case of Alpha, however, supervisory actions were not timely and effective in addressing the bank's most significant problems.

The FDIC has taken steps to improve its supervisory review of business plans, oversight of financial institutions that have CRE loan concentrations, and identification and analysis of interest reserves at risk management examinations. Alpha's significant growth was noted as a potential problem during the 2007 examination. The risks associated with weak loan underwriting and administration and compensation policies should have warranted greater concern. The extent of loan deterioration did not become evident to examiners until 2008. Greater concern regarding Alpha's compliance with regulatory orders, loan underwriting administration, and ADC concentrations could have led to earlier supervisory action, particularly given the bank's de novo status.

The FDIC OIG plans to issue a series of summary reports on the material loss reviews it is conducting and will make appropriate recommendations related to the failure of Alpha and other FDIC-supervised banks at that time.

Management Response

DSC agreed with the OIG's conclusions regarding the causes of Alpha's failure and the resulting material loss. DSC stated that when real estate sales slowed, inventories rose and values in the bank's marketplace experienced a significant downturn, the real estate construction industry and the ability of the bank's borrowers to make payments were both negatively impacted. DSC noted that at the 2007 examination, Alpha exhibited a high-risk profile and that examiners appropriately expanded their loan coverage of Alpha's portfolio. DSC stated that the supervisory concern expressed in the 2007 Report of Examination was appropriate. However, in our view, greater concern regarding Alpha's adherence to its approved business plan, compliance with regulatory orders, loan underwriting, credit administration, and ADC concentrations could have led to earlier supervisory action, particularly given the bank's de novo status.

To view the full report, go to www.fdicig.gov/2009reports.asp

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Alpha's Key CAMELS Ratings 3

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

Office of Audits
Office of Inspector General

DATE: May 1, 2009

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/Signed/

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Alpha Bank and Trust, Alpharetta, Georgia* (Report No. AUD-09-010)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Alpha Bank and Trust (Alpha), Alpharetta, Georgia. On October 24, 2008, the State of Georgia, Department of Banking and Finance (DBF), closed Alpha and named the FDIC as receiver. On November 6, 2008, the FDIC notified the OIG that Alpha's total assets at closing were $334.5 million, and the estimated loss to the Deposit Insurance Fund (DIF) was $158.1 million.

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

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of terms. Acronyms used in the report are listed in Appendix 4.

This report presents the FDIC OIG's analysis of Alpha's failure and the FDIC's efforts to require Alpha's management to operate the bank in a safe and sound manner. The FDIC

[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices, including internal control systems; and compliance with applicable laws and regulations; and (2) issues related guidance to institutions and examiners.

OIG is performing similar analyses regarding the failure of other FDIC-supervised financial institutions. The FDIC OIG plans to issue a series of summary reports on our observations on the major causes, trends, and common characteristics of financial institution failures resulting in a material loss to the DIF. Recommendations in the summary reports will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

Alpha was a state-chartered nonmember bank, established on May 8, 2006 by the DBF, and insured by the FDIC the same day. Alpha was closed October 24, 2008, making it the fastest failure of a financial institution out of the 136 failures between 1993 and 2008. In the 29 months Alpha was in operation, the bank:

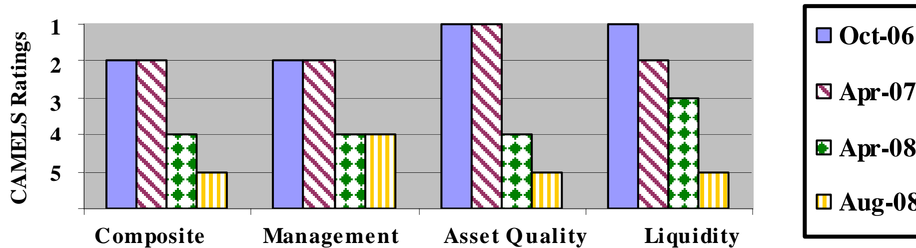
- established its headquarters in Alpharetta, Georgia;
- opened a branch office in Marietta, Georgia;
- provided full service commercial banking activities, specializing in acquisition, development, and construction (ADC) loans; and
- used jumbo certificates of deposit (CD), brokered deposits, Internet deposits, and Federal Home Loan Bank (FHLB) borrowings as funding sources, in addition to core deposits, to fund asset growth.

Alpha did not have a holding company, subsidiaries, or affiliates. Alpha's local marketplace was, at one time, characterized by rapidly appreciating real estate values. However, real estate values experienced a significant downturn that negatively impacted the real estate construction industry and borrowers' ability to make payments.

DSC's Atlanta Regional Office (ARO) and DBF alternated safety and soundness examinations of Alpha, conducting three examinations from May 2006 through October 2008. Alpha's composite rating remained a 2 until the April 2008 DBF examination when it was downgraded to 4,[3] indicating unsafe and unsound practices or conditions and a distinct possibility of failure if such conditions and practices were not satisfactorily addressed and resolved. After an off-site review of Consolidated Report of Condition and Income (Call Report) information, the FDIC downgraded Alpha's composite rating to 5 in August 2008, indicating extremely unsafe and unsound practices or conditions; critically deficient performance, often with inadequate risk management practices; and great supervisory concern. Institutions in this category pose a significant risk to the DIF and have a high probability of failure.

[3] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Further, with respect to selected component ratings, as indicated in Figure 1 below, at the April 2008 DBF examination, Alpha's management rating was downgraded from 2 to 4, and its asset quality rating was downgraded from 1 to 4. As a result of the August 2008 FDIC off-site review, officials downgraded Alpha's asset quality and liquidity ratings to 5.



To address examination concerns, including apparent violations of laws and regulations, inadequate risk management controls, and other safety and soundness issues, the DBF, in consultation with the FDIC, issued a Cease and Desist Order (C&D) effective on July 27, 2008, and the FDIC issued a PCA Directive to Alpha on October 10, 2008.

Details on Alpha's financial condition, as of June 2008, and for the four preceding report periods follow in Table 1.

Table 1: Financial Condition of Alpha

	30-June-08	31-Dec-07	30-June-07	31-Dec-06	30-June-06
Total Assets ($000s)	$383,235	$363,894	$278,197	$168,030	$44,032
Total Deposits ($000)	$359,911	$321,643	$235,928	$133,658	$10,016
Total Loans ($000s)	$321,235	$322,355	$238,350	$136,462	$12,817
Annualized Net Loan Growth Rate	35%	136%	1760%	N/A	N/A
Net Income (Loss) ($000s)	($6,833)	($7,851)	$243	($1,494)	($580)
Loan Mix (% of Avg. Gross Loans):					
All Loans Secured by Real Estate	**88.36%**	**90.99%**	**91.57%**	**91.84%**	**95.85%**
Construction and Development	76.48%	77.14%	75.74%	74.52%	66.32%
CRE - Nonfarm/ nonresidential	10.12%	11.82%	13.04%	13.53%	22.88%
Multifamily Residential Real Estate	1.55%	1.79%	2.35%	3.06%	5.82%
1-4 Family Residential – excluding Home Equity Lines of Credit	0.87%	0.08%	0.09%	0.15%	0.00%
Home Equity Loans	0.05%	0.17%	0.34%	0.58%	0.85%
Construction and Industrial Loans	6.97%	4.40%	2.65%	1.65%	4.15%
Adverse Classifications Ratio	N/A	129%	N/A	0%	0%

Source: Uniform Bank Performance Report (UBPR) and Reports of Examination (ROE) for Alpha.

RESULTS IN BRIEF

Alpha failed primarily due to management's aggressive pursuit of asset growth concentrated in high-risk ADC loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls. Also, Alpha's compensation policies excessively rewarded loan production without sufficient focus on asset quality. The quality of loans suffered due to the bank's aggressive growth model. Resulting losses severely eroded Alpha's earnings and capital, leading to the bank's failure and a material loss to the DIF.

Management. Alpha's board of directors (BOD) did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. Although Alpha developed a business plan governing its activities, the plan was not kept current or followed. After 11 months in operation, total asset growth was nearly double the planned projections. The bank operated under a nonregulatory-approved compensation plan that rewarded loan production without emphasis on the quality of the loans. Additionally, Alpha did not comply with regulatory orders/conditions, including a state (1) limitation on the payment of bonuses during the first 3 years of operation and (2) requirement for sufficient asset quality controls in compensation policies. Further, Alpha rapidly expanded lending operations without sufficient attention to associated risk management controls.

Asset Quality. Alpha's ADC loans were concentrated in a rapidly growing local marketplace. The bank used interest reserves for many of the loans in its portfolio, which masked deterioration in asset quality. Additionally, Alpha did not follow sound loan underwriting standards and administration practices, including those pertaining to: (1) legal lending limits, (2) loan-to-value limits, and (3) recognition of problem assets. Alpha's underwriting process failed to fully capture the financial condition of borrowers. Asset quality was also adversely impacted by compensation policies that focused on loan growth. As asset quality declined and losses were recognized, Alpha's liquidity position became critical, and earnings and capital were eroded.

Liquidity. Alpha relied on high-cost sources of funding such as time deposits of more than $100,000, brokered deposits, and Federal Home Loan Bank advances to support its asset growth. The increased interest expense associated with these funding sources reduced earnings. Rapid asset growth, declining asset quality, and poor earnings strained liquidity. The overall deterioration in the bank's condition impacted access to alternative sources of funding, including brokered deposits. As capital levels dropped, liquidity became a major problem contributing to the bank's failure.

Supervision. The FDIC and DBF conducted timely examinations of Alpha. The FDIC provided additional oversight through its off-site monitoring process and site visits. As a result of the April 2007 examination, the FDIC advised bank management to resubmit its business plan with revised financial projections and strategies for obtaining additional equity capital. The April 2008 DBF examination found significant deterioration in asset quality, resulting in increased losses and further depletion of capital. As a result of the April 2008 examination, the DBF, in conjunction with the FDIC, issued a C&D in July

2008. Examination concerns included, but were not limited to, inadequate management oversight, deficient capital levels, high levels of classified assets, a prohibition on additional advances to classified borrowers, weak lending and loan review practices, and earnings and liquidity deficiencies. In October 2008, the FDIC used its authority under the PCA provisions of the FDI Act to issue a PCA Directive when Alpha became critically undercapitalized. The FDIC has authority to take a wide range of supervisory actions. In the case of Alpha, however, supervisory actions were not timely and effective in addressing the bank's most significant problems.

The FDIC has taken steps to improve its supervisory review of business plans, oversight of financial institutions that have CRE loan concentrations, and identification and analysis of interest reserves at risk management examinations. Alpha's significant growth was noted as a potential problem during the 2007 examination. However, the risks associated with weak loan underwriting and administration and compensation policies should have warranted greater concern. The extent of loan deterioration did not become evident to examiners until 2008. Greater concern regarding Alpha's compliance with regulatory orders, loan underwriting administration, and ADC concentrations could have led to earlier supervisory action, particularly given the bank's de novo status.

MANAGEMENT

Examinations in 2006 and 2007[4] resulted in a 2 rating for Alpha management. At the subsequent 2008 examination, examiners found significant deterioration in asset quality, resulting in increased losses and depletion of capital during the de novo period of the bank.[5] Management's rating was then downgraded to a 4, indicating deficient BOD and management performance, risk management practices that were inadequate, and excessive risk exposure. The bank's problems and significant risks had been inadequately identified, measured, monitored, or controlled and required immediate action by BOD and management to preserve the safety and soundness of the institution.

Ineffective BOD and Management

The first examination occurred in October 2006 when the examiners noted concerns with director absences from meetings, exceptions to loan policy credit extension limits, and needed enhancements to the wire transfer policy. The April 2007 examination noted that total loans had increased from the projected $93 million within the 5 years of operation to $182 million after the first 11 months of operation. Examiners attributed the significant increase in loan growth to the fact that lending officers were able to generate more loans than originally anticipated. Alpha's business results had exceeded the projections in the original business plan, and examiners reminded management that significant changes to

[4] Initially, the draft ROE contained a 1 rating for management. However, in the ROE review process, the Case Manager downgraded this component to a 2 as a result of the examination findings and the lack of revised business projections from the bank which were required by the FDIC's Final Order of Approval for Deposit Insurance.

[5] De novo institutions are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency.

the bank's business plan must be presented to regulators for approval before implementation. Also, examiners noted that the bank should monitor the risk exposure of large developers/guarantors on an ongoing basis to ensure the amount of debt does not exceed the developers/guarantors' repayment capacity. Examiners made recommendations to enhance and further strengthen credit administration procedures, Bank Secrecy Act (BSA) programs, and information technology policies. The 2007 ROE did not address violations of banking laws and regulations, because the examiners' criticisms of management practices were thought to be in areas management could handle and correct in the normal course of business.

The April 2008 examination found the overall management of the institution to be inadequate and resulted in a 4 management rating. Problems in the loan portfolio surfaced in late 2007 and early 2008 as loans matured and the Atlanta real estate market declined. The BOD terminated the Chief Executive Officer (CEO) in February 2008, and new management began identifying more problems with loan operations. Loan delinquencies vaulted with abrupt increases in past-due and nonaccrual loans attributed to the maturity of single-pay loans[6] and depletion of interest reserves on ADC loans. Management had not established a loan review structure that was effective and adequate. Further, Alpha did not comply with laws and regulatory orders (details are in Table 3). Examiners determined that management had pursued an aggressive growth model through concentration in ADC loans without fully mitigating the risk. Table 2, which follows, provides examples of examiner concerns, comments, and recommendations related to Alpha's BOD and management.

Table 2: Examples of Examiner Comments and Recommendations Regarding Alpha's BOD and Management Performance

Examiner Comments	Examination Dates		
	Oct 2006	**April 2007**	**April 2008**
Overall conclusion on BOD and management performance			
• Satisfactory	✓	✓	
• Unsatisfactory			✓
• Improvement needed and failure to adequately identify, measure, monitor, and control risks			✓
BOD and management supervision of the bank has been ineffective in managing asset quality			✓
Compliance with laws and regulations			
• Three apparent violations: legal lending limits, real estate loan-to-value ratios, and appraisals			✓
• Noncompliance with DBF Final Order or FDIC Final Order of Approval for Deposit Insurance		✓	✓
Growth of operations			
• Loan growth was aggressive, significant, or faster than anticipated		✓	✓
• Loan portfolio was concentrated in high-risk ADC loans		✓	✓
Loan documentation and administration			
• Significant increase in loan staff		✓	
• Weaknesses in loan administration and loan underwriting			✓

[6] Such loans require a large single payment at the end of the loan term after a series of low monthly payments.

Examiner Comments	Examination Dates		
	Oct 2006	April 2007	April 2008
• Inadequate risk management controls			✓
Examiner suggestions and/or recommendations			
• Enhance loan policy regarding wire transfers	✓		
• Director attendance at meetings is important in a de novo bank	✓		
• Significant changes to the business plan must be presented and approved	✓		
• Improve credit administration procedures, BSA programs, and information technology policies		✓	
• If growth continues at current pace, additional equity capital will be necessary		✓	
• Review policies and procedures regarding ADC lending to determine if any mitigating action could have been taken to reduce the risk associated with ADC lending			✓
• Evaluate ADC loan portfolio in consideration of changes in the current real estate market			✓
• Continue to review the appraised values on collateral held to identify possible loss exposure			✓
• Implement an effective loan review program			✓

Source: ROEs issued by the DBF and the FDIC.

Risk Management. Alpha did not ensure that adequate risk management controls were implemented and did not adequately address deficiencies identified by examiners and auditors related to the bank's risk management controls for loan documentation, administration, and monitoring.

The BOD and senior management focused on a strategy of aggressively growing the bank's assets, consisting primarily of high-risk ADC loans. Total assets from June 2006 through June 2008 grew, on a cumulative basis, from $44 million to over $383 million. However, given Alpha's BOD and senior management decisions to pursue such growth, the bank did not adequately identify measure, monitor, and report on a regular basis to the BOD on these concentrations, speculative lending, and interest reserves.

The April 2007 ROE noted that ADC concentrations were adequately monitored. No adversely classified assets were identified, and past-dues loans were minimal. Internal controls were generally adequate, and the risk management processes were adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities. However, the examination included recommendations to monitor the global risk exposure of large developers/guarantors and fully document and explain upward adjustments to collateral values.

By 2008, asset quality was negatively affected by a declining Atlanta real estate market. DBF's April 2008 examination indicated the bank's condition as critical, with significant deterioration noted in various areas. The amount of adversely classified assets was excessive. Capital was deficient, and losses continued to erode that position. The bank's Tier 1 Leverage Capital ratio of 6.94 percent was significantly below the DBF- and FDIC-approved conditions requiring a minimum 8 percent Tier 1 Leverage Capital ratio during the bank's de novo period. The asset-sensitive nature of the balance sheet and the volume of higher-cost deposits used as a funding source exposed the bank to continued declines in its net interest margin and earnings performance. The bank's liquidity

position was marginal, and secondary sources of funding diminished, which resulted in a relatively volatile, unstable liquidity situation. Examiners determined the current loan review structure to be ineffective and inadequate and mentioned that a weak loan underwriting process failed to fully capture the global financial condition of the borrower and current market conditions.

We consider inadequate risk management controls and the lack of management action to address control deficiencies to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Noncompliance with Regulatory Orders. According to the DSC *Risk Management Manual of Examination Policies* (Examination Manual), an institution's BOD and management should implement appropriate policies and procedures to effect compliance, detect instances of noncompliance, institute corrective measures, and provide adequate training and retraining of officers and employees to prevent future infractions. Further, the Examination Manual states that it is important that correction of all apparent violations of laws and regulations be instituted promptly, regardless of their perceived importance.

With respect to the regulatory orders, Alpha did not comply with specific conditions included in the FDIC's Final Order of Approval for Deposit Insurance and the Articles of Incorporation for Alpha. For example, Alpha did not operate within the parameters of its business plan as required by the FDIC and DBF. This was noted in the 2007 examination and was a repeat condition in the 2008 examination.

We address the apparent violation of laws and regulations in the *Asset Quality* section of this report. Table 3, which follows, summarizes the bank's noncompliance with conditions as articulated in the FDIC's Final Order of Approval for Deposit Insurance and the Articles of Incorporation for Alpha.[7]

[7] The 2007 FDIC examination, as reflected in the respective sections of the ROE, addresses the FDIC's order/conditions but does not specifically address DBF's conditions.

Table 3: Alpha's Noncompliance with Regulatory Orders[a]

DBF Conditions in Articles of Incorporation for Alpha	FDIC Final Order of Approval for Deposit Insurance/Conditions	Compliance Comments
Tier 1 Leverage Capital ratio - No less than 8 percent throughout first 3 years of operation.	Tier 1 Leverage Capital ratio - No less than 8 percent throughout first 3 years of operation.	Noncompliance identified in the 2008 examination. As of March 31, 2008, the Tier 1 Leverage Capital ratio was 6.94 percent.[b]
Business Plan - Bank shall operate within the parameters of the business plan and both notify and obtain approval of any proposed major deviation prior to implementation during the first 3 years of operation.	Business Plan - Bank shall operate within the parameters of the business plan and both notify and obtain approval of any proposed major deviation prior to implementation during the first 3 years of operation.	Noncompliance identified in the 2007 and 2008 examinations. The regulators had not approved a revised business plan.
Executive Management Committee – The BOD must establish an Executive Management Committee to guide the CEO through the formative years of the bank.	Not addressed	The committee had not met. Noncompliance was not addressed in the FDIC's 2007 examination. Noncompliance was identified in the 2008 examination.
Dividends and Incentive Bonuses - No dividends or incentive bonuses paid and/or accrued without prior approval during the first 3 years of operation.	Not addressed	Bonuses paid in 2007 and 2008. Noncompliance was not addressed in the 2007 examination but was a major issue in the 2008 examination.
Liquidity Ratio - No less than 10 percent throughout the first 3 years of operation, and the bank shall forward to DBF quarterly internal liquidity calculation reports.	Not addressed	Liquidity ratio met in all examinations. However, quarterly internal reports were not submitted to the DBF in 2007 and 2008. Noncompliance was reported by the DBF in correspondence to the bank.
Brokered and Internet Deposit Reports - Quarterly reports on the total amount of brokered and Internet deposits during the first 3 years of operation.	Not addressed	DBF correspondence indicated the bank was in noncompliance, but the noncompliance was not a reportable condition in either the 2007 or 2008 examinations.
Income and Expenses Statement - Monthly statements of income and expenses required during the first 3 years of operation.	Not addressed	DBF correspondence indicated the bank was in noncompliance, but the noncompliance was not a reportable condition in either the 2007 or 2008 examinations.

Source: OIG review of the FDIC Deposit Insurance Order, Articles of Incorporation for Alpha, and ROEs.
[a] The FDIC order has 14 conditions, whereas the DBF order has 32 conditions. Only those conditions the examiners identified as not in compliance are reflected in the table.
[b] Compliance with Tier 1 Leverage Capital ratio requirements is addressed in the *Implementation of PCA* section of this report.

We consider noncompliance with regulatory orders to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Deviations from the Business Plan. Contrary to both the FDIC's and DBF's regulatory final orders approving Alpha's deposit insurance, Alpha did not operate within the parameters of the submitted business plan and failed to notify the regulators of any proposed major deviation or material change before making the change.

Proposed financial institutions are required to submit business plans with their initial applications for federal deposit insurance. According to the *FDIC Statement of Policy on Applications for Deposit Insurance*, and in compliance with sections 5 and 6 of the FDI Act, the FDIC must be assured that the proposed institution does not present an undue risk to the DIF. The FDIC expects that proposed institutions will submit a business plan commensurate with the capabilities of its management and the financial commitment of the incorporators. Any significant deviation from the business plan within the first 3 years of operation, the de novo phase, must be reported by the insured depository institution to the primary federal regulator before making the change. Business plans that rely on high-risk lending, a special-purpose market, or significant funding from sources other than core deposits, or that otherwise diverge from conventional bank-related financial services, require specific documentation as to the suitability of the proposed activities for an insured institution. Similarly, additional documentation of a business plan is required where markets to be entered are intensely competitive or economic conditions are marginal. Although not required, business plans are expected to include information on projected financial data for a 3-year period.

Soon after the bank opened, examiners concluded that Alpha had significantly deviated from its business plan by quickly exceeding financial projections and loan originations. In particular, total loans increased from the projected $93 million to $182 million after the first 11 months of operation. The examiners attributed the significant increase in loan growth to the fact that lending officers were able to generate more loans than originally anticipated. Growth of this magnitude significantly exceeded original planned projections and required the bank to submit revised financial projections. Based on Alpha's rapid growth and examiner questions as to whether it would maintain an 8 percent Tier 1 Leverage Capital ratio through the de novo period, the FDIC notified Alpha in June 2007 that the bank had materially deviated from its original business plan and required management to submit a revised plan. However, these deficiencies warranted greater supervisory concern.

On August 2, 2007, Alpha submitted a revised plan that included the formation of a holding company, the issuance of trust preferred stock, and a curtailment of its trust activities. On August 29, 2007, the FDIC and DBF met with Alpha regarding the proposed changes, informing Alpha that the Federal Reserve Bank of Atlanta would have to approve the request for a holding company. Additionally, FDIC and DBF examiners expressed concerns about the use of trust preferred securities by a new bank.
On October 24, 2007, Alpha submitted a second revised business plan that removed the trust preferred securities, proposed a $10 million sale of Alpha common stock, and expanded trust activities. Regulators requested a third revision due to regulatory questions regarding the trust department and inconsistencies in the revised financial statements and the bank's 2008 budget.

The third plan, received on December 28, 2007, contained revised financial projections that incorporated increased trust activities, which reconciled to the 2008 budget, and provided for a $10 million capital injection by February 15, 2008. The FDIC expressed no objection to the revisions in the business plan subject to the bank providing

$10 million in additional capital, maintaining a well capitalized position, and maintaining the previously committed 8 percent Tier 1 Leverage Capital ratio and 10 percent liquidity ratio. Alpha's performance began deteriorating in early 2008, and the bank was unable to raise the additional capital.

We consider deviations from the business plan to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Compensation Policy. As part of the approval of new institutions, DBF requires institutions to have a compensation policy that addresses core compensation; signing bonuses; other bonuses or incentive compensation features; and other forms of compensation, including deferred compensation provided to a bank's officers. The DBF 2008 ROE stated that Alpha operated under a nonregulatory-approved compensation policy that excessively rewarded loan production. DBF specifically established a condition in its approval of the Articles of Incorporation for Alpha that commission-based compensation plans must include asset quality controls. In 2007, DBF questioned Alpha's draft compensation policy, particularly the production-based incentive compensation for the chief lending officer. DBF did not find sufficient asset quality guidelines that addressed, for example, past-due loans, classifications, charge-offs, and technical exceptions for the chief lending officer as part of the compensation policy.

Also, according to the conditions contained in the DBF approval of the Articles of Incorporation for Alpha, "… during the first three years of operation, no dividends or incentives [will] be paid and/or accrued without the prior approval of the Department." For new charter approvals issued by the DBF, part of the standard condition states that "any revision to the compensation policy that represents a material increase in the compensation for senior officers during the first three years of the bank's operations shall require DBF approval." A material increase is defined as any increase in any form of compensation that is 5 percent or greater per year and is not in the compensation policy the DBF approved. Bank management submitted a compensation policy on several occasions for DBF review and approval; however, numerous revisions were required, and the policy was not formally approved. For example, in May 2007, Alpha's compensation policy proposal stated that salary increases can be awarded in the range of 0-20 percent. In reviewing this version of the compensation policy, DBF took the position that, based on other banks' approved policies, an annual salary increase of 20 percent of the base salary appeared excessive. DBF asked Alpha management for an explanation of the bank's salary proposal. The bank president's December 2007 letter to DBF stated that "the management team and [BOD] have been quite occupied with the task of revising the bank's business plan and other significant projects. We have substantially completed our higher priority projects and recently turned attention back to the executive incentive plan project."

Meanwhile, Alpha paid bonuses in 2007 and 2008 without an approved policy. For example, as of March 31, 2007, a senior vice president had received a $50,000 bonus. The DBF April 2008 examination showed that one senior vice president loan officer had

received a base salary of $154,000 and a bonus/commission of $206,000, totaling $360,000 for 2007. DBF examiners deemed this to be excessive. On July 25, 2008, Alpha responded to the DBF regarding the finding on the loan officer's salary, stating the BOD:

> … was not aware of the magnitude of the bonus/commission paid to the identified lender referred to in the finding. The Board agrees that it was excessive. In response to the finding and the bank's current financial condition, all salary incentives have been terminated for lenders within the bank. Bank management is currently in negotiations with said lender to substantially reform his contract and compensation package. It is management's intention that all lenders will comply with the Bank's new compensation policy already submitted to the Georgia Department for approval.

The DBF issued a C&D to Alpha's BOD on July 16, 2008 stating, among other things, unsafe and unsound practices by engaging in violations of applicable federal state laws and regulations. Specifically, item number 16 of the order states,"the Bank shall not pay cash dividends or bonuses without the prior written consent of the Supervisory Authorities."

The conditions in the FDIC's Final Order of Approval for Deposit Insurance for Alpha state,"That any proposed stock compensation plans (including stock options, warrants, or other stock based compensation plans) to be granted to organizers, directors or executive officers of the bank during the first three years of operation require prior notice and letter of non-objection from the Atlanta regional Director." Unlike DBF's conditions, the FDIC's conditions do not address overall compensation policies; other forms of compensation (i.e., salaries, bonuses, and/or commissions); and compensation for officers below the executive level. However, the FDIC may sometimes review the reasonableness of the compensation plans for senior executive officers.

The FDIC and the other federal regulators have increased their focus on compensation policies. A November 12, 2008 joint release statement by the federal regulatory agencies states:

> … poorly-designed management compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization … Management compensation policies should be aligned with the long-term prudential interests of the institution, should provide appropriate incentives for safe and sound behavior, and should structure compensation to prevent short-term payments for transactions with long-term horizons.

The agencies expect banking organizations to regularly review their management compensation policies to ensure they are consistent with the long-term objectives of the organization and sound lending and risk management practices. We consider performance bonus programs that do not address asset quality objectives to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Management

DSC's Examination Manual states that the quality of management is probably the single most important element in the successful operation of a bank. The BOD is responsible for the formulation of sound policies and objectives for the bank, effective supervision of its affairs, and promotion of its welfare, while the primary responsibility of senior management is implementing the BOD's policies and objectives in the bank's day-to-day operations. DSC's Examination Manual also states that the capability and performance of management and the BOD is rated based upon, but not limited to, an assessment of compliance with laws and regulations. In addition, according to the DSC's *Case Manager Procedures Manual*, the risk posed by any particular institution is a function of the business plan pursued, management's competency in administering the institution's affairs, and the quality and implementation of risk management programs.

Based on the results of the 2007 examination, DSC's review of Alpha's business plan focused on the bank's financial projections. DSC's review included a limited assessment of Alpha's risk management controls compared to the bank's actual practices. Although DSC required Alpha to provide updated financial and budget data, DSC did not require Alpha to provide a revised business plan that addressed high-risk lending in ADC loans, the bank's concentration in such loans, and how the bank planned to mitigate such risk through appropriate loan documentation, administration, and lending strategies.

The FDIC's April 2007 examination addressed compliance with the conditions in the FDIC's Final Order of Approval for Deposit Insurance and the business plan; however, the examination did not address Alpha's noncompliance with the DBF's conditions in the Articles of Incorporation for Alpha. Most noticeably, the examination mentioned significant growth but did not address Alpha's compensation practices, monthly income expense statements, and quarterly liquidity reports.

DSC's examiner guidance related to business plans did not provide a definition of significant deviations. In June 2008, DSC's ARO issued examiner guidance for determining what constitutes a major deviation or material change in business plans for de novo institutions during the first 3 years of operation. That guidance states that examiners should consider whether changes have occurred in growth levels, asset and liability mix or products offered, and plans for branch offices.

The FDIC provided additional oversight through its off-site monitoring process. From October 2007 through March 2008, DSC conducted three off-site reviews. The October 2007 off-site review discussed loan growth, the need for business plan revisions, and the possibility that a reduction in the Tier 1 Leverage Capital ratio might call for an additional stock issuance to support loan growth. The January 2008 off-site review showed that the bank remained profitable. Finally, the March 2008 off-site review showed that the bank's financial condition had deteriorated and that the bank had delayed the stock offering of $10 million due to its recent poor financial performance. As a result, DBF accelerated the date of its third-year safety and soundness examination from May 2008 to April 2008.

ASSET QUALITY

Alpha's asset quality was rated 1 at its 2006 and 2007 examinations. At the 2007 examination, asset quality was characterized as strong with no adversely classified assets and minimal past-due loans. However, the examiner made recommendations to enhance loan underwriting and credit administration. In addition, examiners stated that the allowance for loan and lease losses (ALLL) appropriately reflected the risk in the portfolio.

At the 2008 examination, Alpha's asset quality rating was downgraded to a 4, indicating that the bank's risk level and problem assets were significant and inadequately controlled. The examiners concluded that Alpha's focus on asset growth had resulted in weaknesses in loan administration and loan underwriting.

Alpha's asset quality deteriorated as loan classifications significantly increased, from zero in 2006 and 2007 to over $49 million in 2008. Corresponding increases in the bank's ALLL were also significant (see Table 4). At the April 2008 examination, adversely classified loans represented 129 percent of capital.

Table 4: Alpha's Loan Classifications and ALLL

	Asset Quality (Dollars in Thousands)					
	Loan Classifications				**Analysis of ALLL**	
Examination Date	**Substandard**	**Doubtful**	**Loss**	**Total Classified Items**	**ALLL Computed by Alpha**	**Increase in ALLL Required by Examiners**
Oct 06	0	0	0	0	$129	0
April 07	0	0	0	0	$1,370	0
April 08	$46,189	$3,421	0	$49,610	$11,922	0

Source: ROEs for Alpha.

Examiner Concerns and Recommendations Regarding Asset Quality

Examiner concerns regarding Alpha's asset quality related to the bank's concentration in high-risk ADC loans, its inappropriate replenishment of interest reserves, and its poor loan underwriting and administration (see Table 5, which follows). These loan underwriting deficiencies should have been detected and addressed as part of an adequate loan approval process.

Table 5: Examples of Examiner Comments and Recommendations Regarding Alpha's Asset Quality

Examiner Comments	Examination Dates		
	Oct 2006	**April 2007**	**April 2008**
Overall conclusion on asset quality			
• Strong	✓	✓	
• Asset quality deficient, and criticized assets have reached a critical level			✓
CRE and ADC concentrations			
• Concentration already developed	✓	✓	✓
• Concentration is adequately monitored by management	✓	✓	
• Overall exposure to this industry has caused a significant decline in asset quality, and management should review its policies and procedures regarding ADC lending			✓
Adverse classifications			
• No adverse classifications	✓	✓	
• Level of adverse classifications is considered excessive			✓
Assessment of risk management practices			
• Risk management, monitoring, and reporting practices ineffective or inadequate			✓
• Loan documentation and underwriting standards satisfactory	✓	✓	
• Loan documentation and underwriting standards need improvement			✓
• ALLL amount and methodology adequate	✓	✓	✓
• Incomplete and unsigned appraisal reviews			✓
• Incorrectly recorded interest rates on the loan system			✓
Recommendations			
• Bank management should monitor the global risk exposure of large developers/guarantors to ensure amount of debt does not exceed repayment capacity		✓	✓
• Bank management should determine that upward adjustments to collateral values by the appraiser are fully explained and documented in the appraisal report		✓	
• Bank management should strengthen the loan review process by having at least a quarterly external loan review			✓
• Bank management should expand the quarterly concentration report to include all concentrations of credit to individuals			✓

Source: ROEs for Alpha.

Concentration in ADC Loans. Alpha focused its loan portfolio in high-risk ADC loans and did not ensure that adequate risk management controls were developed and implemented. Alpha's concentration in ADC loans was noted in each of the examination reports. This ADC loan concentration steadily increased as a percentage of Tier 1 Capital as indicated in Table 6, which follows.

Table 6: Alpha's ADC Concentrations

ROE Date	ADC Amount Funded as a Percent of Tier 1 Capital	Total ADC Commitments as a Percent of Tier 1 Capital
October 30, 2006	156%	330%
April 23, 2007	266%	509%
April 14, 2008	684%	860%

Source: OIG review of ROEs.

On December 12, 2006, the FDIC issued interagency guidance on CRE lending entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, which also addresses ADC lending. According to the guidance, the FDIC and the other federal regulatory agencies have acknowledged that a concentration in CRE loans, coupled with weak loan underwriting and depressed markets, has contributed to significant loan losses.[8] However, Alpha's management did not implement timely actions to address its ADC concentration risk. Further, in the April 2008 examination, examiners identified a high level of adverse classifications. As asset quality declined and losses were recognized, Alpha's earnings and capital were eroded. We consider loan concentrations without adequate risk management controls to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Interest Reserves. Alpha did not have appropriate controls related to the use and tracking of interest reserves. Alpha's loan policy stated that the bank should not capitalize accrued interest when renewing or rewriting an existing loan unless the repayment of the capitalized interest is tied to an identifiable source of repayment in the near term. The policy also stated that any device that avoids the recognition of loan delinquency is prohibited. However, Alpha did not follow this policy and used interest reserves to mask the deterioration of loans. Based on a schedule of loans with interest reserves that Alpha prepared in January 2008, the OIG determined that Alpha used about $11.1 million in interest reserves to fund loans. Of that amount, $4.4 million (about 40 percent) was associated with loans that were adversely classified, as noted in the April 2008 ROE, because borrower payments were past due, and collateral values were insufficient. Additionally, the schedule showed two instances where the amount of used interest reserve exceeded the total amount of interest reserve set aside for the loan. We consider inadequate controls over the use and tracking of interest reserves to be a significant concern, which we will address in our summary reports covering multiple bank failures.

DSC has issued examiner guidance on the use of interest reserves. In November 2007, the ARO issued regional examiner guidance entitled, *Identification and Analysis of Interest Reserves at Risk Management Examinations*. In April 2008, DSC issued FDIC-

[8] The FDIC also issued Financial Institution Letter (FIL) 22-2008 on March 17, 2008, entitled, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, which re-emphasized the importance of strong capital and ALLL and loan risk-management practices for state nonmember institutions with significant CRE and ADC loan concentrations.

wide examiner guidance reiterating the November 2007 ARO guidance. In addition, in July 2008, DSC issued guidance to examiners and FDIC-supervised financial institutions on the use of interest reserves in ADC lending, the risk this underwriting practice could present, and "red flags" that should alert lenders to potential problems at each stage of the ADC cycle.

Loan Underwriting and Administration. Alpha did not follow sound loan underwriting standards and administration practices, including those relating to: (1) legal lending limits to individuals, (2) loan-to-value limits, and (3) recognition of problem assets. These weaknesses contributed to a decline in asset quality.

Alpha did not follow a state legal lending limit designed to help banks avoid concentrations of lending to an individual. Alpha was cited in the 2008 examination report for a violation of section 7-1-285 of the Financial Institutions Code of Georgia, which states that a bank shall not directly or indirectly make loans to any one person or corporation which, in the aggregate, exceed 25 percent of Tier 1 Leverage Capital. The 2008 examination report listed nine borrowing relationships in which the amount of loans for each borrower exceeded 25 percent of Tier 1 Leverage Capital. Examiners noted loans to one specific borrower that totaled over $10.3 million, or 39 percent of Tier 1 Leverage Capital and were in excess of the statutory limit by 14 percent, based on the bank's capital position. Additionally, this concentration of credit issue was acknowledged and discussed by Alpha's Directors Loan Committee in May 2007 at the time the bank made the final loan advance to this borrower. These concentrations of credit to individual borrowers increased Alpha's risk profile. However, the 2007 ROE addressed only Alpha's industry concentration and made no mention of concentrations to individuals or loans that exceeded loan-to-value limits.

Alpha made loans that exceeded regulatory loan-to-value limits. The ROE for the 2008 examination describes Alpha's violations of the loan-to-value limits for real estate loans prescribed in Part 365 of the FDIC's Rules and Regulations. Part 365 establishes loan-to-value limits ranging from 65 to 90 percent of value based on the type of collateral. Part 365 also specifies that value means the lesser of the actual acquisition cost or the estimate of value. Alpha's loan policy established the same loan-to-value limits as in Part 365; however, the bank did not follow these limits. The ROE identified two instances in which the amount of the loan exceeded the loan-to-value limits in Alpha's loan policy and Part 365. In both cases, the amount of the loan exceeded 100 percent of the acquisition cost of existing property. Failure to follow loan-to-value limits can increase the amount of loss for an institution in cases where the borrower defaults and the collateral is the only source of repayment.

Alpha's recognition of problem assets was not timely. Alpha's loan policy describes a process to maintain an ongoing review of asset quality. The policy states that the review process shall consist of a complete file review and shall result in each credit being verified for a proper risk rating. However, Alpha did not proactively adjust the internal risk ratings it assigned to its problem loans. For example, an external loan review

conducted in February 2008 noted that the bank had assigned internal risk ratings above the substandard category for four loans with a total value of approximately $14.5 million. However, the external loan review firm recommended that each of these loans be classified as substandard because of cash flow problems with guarantors and uncertain collateral value. DBF's April 2008 examination also concluded that these loans should be classified as substandard. Earlier recognition of problem assets by Alpha management may have led to earlier corrective action by the bank.

Alpha's underwriting processes, including internal loan approvals, failed to fully capture the weak financial condition of some borrowers. Alpha's loan policy, dated April 2006, contained provisions covering approval of loans based on dollar amount and type of loans, and these approvals were obtained. However, underwriting weaknesses, such as incomplete appraisals, were not detected or addressed as part of this process. We consider loan underwriting and administration weaknesses to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Asset Quality

Alpha's loan administration deficiencies, particularly its risk management of an ADC concentration, should have warranted greater concern during the 2007 examination. DSC's Examination Manual states that the examiner's evaluation of a bank's lending policies, credit administration, and the quality of the loan portfolio is among the most important aspects of the examination process. In 2007, examiners recognized that Alpha had an ADC concentration. They reviewed a sample of 43 percent of total loans, including ADC loans. Based on this review, examiners made recommendations to monitor borrower repayment capacity and document upward adjustments to collateral values by appraisers. However, the examiners did not identify weaknesses (for example, the 2007 ROE noted incomplete appraisals, replenished interest reserves, capitalized interest, and interest rates on notes that were not consistent with the rates booked in the system) in Alpha's risk management practices that, when combined with a downturn in the residential real estate market, would result in severe asset quality deterioration.

Examiners did not determine whether Alpha was following its loan policy guidelines on ADC concentrations. DSC's Examination Manual states that there are certain broad areas of consideration and concern that should be addressed in the lending policies of all banks regardless of size or location. The bank's lending policy should include guidelines, which, at a minimum, address the goals for portfolio mix and risk diversification and cover the bank's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist. Although Alpha's loan policy addressed goals for portfolio mix and risk diversification, the BOD and management did not ensure that the bank implemented the policy guidelines for ADC concentrations. On June 30, 2006, Alpha's percentage of ADC loans to total assets was 19 percent. This percentage did not exceed the 20-40 percent range recommended in the bank's loan policy. However, the bank's percentage of ADC loans to total assets increased to 60 percent by December 31, 2006, which was significantly higher than the

range recommended in the bank's loan policy. The April 2007 examination identified that the bank had an ADC loan concentration; however, examiners did not report that the level exceeded the range in Alpha's loan policy or make recommendations for the bank to diversify its portfolio. In fact, the percentage of ADC loans to total assets further increased to 70 percent by December 31, 2007.

The examiners' conclusions on Alpha's ability to control the risk of its ADC concentration varied. In the October 2006 ROE, examiners concluded that the bank had adequate procedures in place to monitor and control this concentration. Likewise, in the April 2007 ROE, examiners concluded that the ADC concentration was adequately monitored through various reports. Greater supervisory concern in 2007 regarding Alpha's loan documentation and administration deficiencies could have led to elevated supervisory attention and earlier supervisory action.

The April 2008 ROE stated that while management actively monitored the ADC concentration, the overall exposure to this industry resulted in a significant decline in asset quality. The ROE recommended that management review policies and procedures regarding ADC lending to determine if any mitigating action should be taken to reduce the risk associated with ADC lending.

On July 17, 2008, the DBF, in consultation with the FDIC, issued a C&D to Alpha. The C&D, among other things, required Alpha to:

- submit specific plans and proposals to:
  - address loan underwriting weaknesses;
  - strengthen management of loan operations;
  - strengthen collections;
  - address the appropriate use of interest reserves;
  - control loan disbursements; and
  - ensure proper financial analysis of potential and existing credit relationships, including the documentation of cash flow for the primary and secondary sources of repayment.

- Adopt a written lending policy to provide for a planned material reduction in the volume of funded and unfunded ADC loans as a percentage of Tier 1 Capital.

- Adopt an effective system of loan review and grading to promptly identify loans with well-defined credit weaknesses so that timely action can be taken to minimize credit loss.

The C&D addressed issues related to Alpha's asset quality—some of these issues were apparent during the 2007 examination and warranted additional supervisory concern at that time. Additionally, while the C&D restricted cash dividends and bonuses, it did not address deficiencies in Alpha's overall compensation policy.

LIQUIDITY

Liquidity represents the ability to fund assets and meet obligations as they become due. Liquidity is essential in all banks to compensate for expected and unexpected balance sheet fluctuations and provide for growth. Alpha relied on high-cost sources of funding to support its asset growth. The increased interest expense associated with these funding sources reduced earnings. Rapid asset growth, declining asset quality, and poor earnings eventually strained liquidity and impacted access to alternative sources of funding. As capital levels dropped, liquidity or the lack thereof, became a major problem, contributing to the bank's failure.

Alpha's liquidity rating steadily declined from a 1 in the October 2006 examination, to a 2 in the April 2007 examination, to a 3 in the April 2008 examination. The overall deterioration in the bank's condition impacted access to secondary sources of liquidity, including brokered deposits. Alpha submitted a brokered deposit waiver application to the FDIC in May 2008, but withdrew the application in July 2008 when bank management disclosed the bank would fall into an undercapitalized position. Liquidity was downgraded to a 5 in the August 2008 examination.

A bank's net non-core dependency ratio indicates the degree to which the bank is relying on non-core/volatile liabilities such as time deposits of more the $100,000; brokered deposits; and FHLB advances to fund long-term earning assets. Generally, the lower the ratio, the less risk exposure there is for the bank. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. Alpha's reliance on non-core/volatile liabilities increased from mid-2006 through the end of 2007 and exceeded its peer group during this time. However, as Alpha began to recognize losses in its loan portfolio in 2008, it also decreased its dependency on non-core funding. Table 7, which follows, provides a synopsis of Alpha's deposits and other funding sources and net non-core dependency ratios.

Table 7: Alpha's Non-Core Funding Sources and Net Non-Core Dependency Ratios

Date	**Non-Core Funding Sources** (Dollars in Thousands)			**Net Non-Core Dependency Ratios** (Percent)	
	Time Deposits $100,000 or More*	**Brokered Deposits**	**FHLB**	**Alpha**	**Peer Group**
June 30, 2006	$885	$0	$0	-220.07%	-353.53%
Dec 31, 2006	$37,491	$22,589	$0	11.09%	-113.74%
June 30, 2007	$64,589	$26,848	$0	19.22%	-7.97%
Dec 31, 2007	$74,299	$45,882	$2,000	22.34%	16.45%
June 30, 2008	$63,294	$35,055	$0	11.25%	26.75%

Source: Review of Alpha's UBPR and ROEs.
* Time deposits of $100,000 or more include the amounts shown for brokered deposits.

Examiner Concerns and Recommendations Regarding Liquidity

Due to competition for local deposits, brokered and Internet deposits had become an alternative source to fund Alpha's loan growth. Sources of liquidity consisted of federal funds sold, interest-bearing deposits with banks, investment securities, and unsecured federal fund lines. Alpha relied on high-cost and volatile sources of funding such as time deposits of more than $100,000; brokered deposits; and FHLB advances to support its asset growth. Liquidity risk is the risk of not being able to obtain funds at a reasonable price within a reasonable period to meet obligations as they become due. In Alpha's case, the increased interest expense associated with these funding sources reduced earnings and increased liquidity risk.

According to the ROEs, Alpha's liquidity position started strong with a liquidity ratio of 37.82 percent as of September 30, 2006. The non-core dependency ratio of 12.12 percent at that date indicated that the bank was not heavily dependent on volatile liabilities to fund asset growth. As a de novo bank, Alpha generally had ample liquid assets as core deposits grew. However, by April 2007, the significant loan growth had prompted management to augment the core deposit growth with brokered deposits and Internet CDs, resulting in the high non-core funding dependency ratio of 19.76 percent as of March 31, 2007. According to examiners, back-up borrowing lines were in place, and examiners deemed liquidity and funds management practices to be satisfactory.

Subsequently, the net non-core funding dependency ratio increased from 18.56 percent as of December 31, 2007 to 23.69 percent as of March 31, 2008. The change was primarily attributed to an increase in non-core funding by $28 million in the first quarter of 2008. As of March 31, 2008, these potentially volatile liabilities primarily included:

- $38.5 million for non-core jumbo CDs;
- $36.8 million for brokered deposits;
- $8 million for the purchase of federal funds;
- $9 million for FHLB borrowings;
- $5.1 million for QwickRate[9] CDs; and
- $15.1 million for the Certificate of Deposit Account Registry Service (CDARS)[10]

As of March 31, 2008, the bank's liquidity ratio was 11.58 percent. The liquidity position was deemed marginal considering the deteriorating asset quality shown by adversely classified items coverage of 128.99 percent, the increase in net losses, and the diminishing secondary sources of funding. The bank's core liquidity was derived from federal funds sold at $11,894,000; interest bearing CDs at $16,228,000; and unpledged securities at $7,344,000. At the same time, total assets were $385 million, and core deposits totaled $259 million, or 67 percent of assets.

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[9] QwickRate, a private network, is a rate listing service, providing subscriber access to the entire funding and investing process.

[10] CDARS is a deposit-placement service. When a depositor places a large deposit with a network member, that institution may use CDARS to place the depositor's funds into CDs issued by the other banks in the network. The premise is that this occurs in increments of less than $100,000 to ensure that both principal and interest are eligible for full FDIC deposit insurance.

Secondary sources of funding became limited because the federal fund lines of credit required collateral in order to draw on the lines. The bank had only one remaining unsecured federal funds line, which was with another bank for $8.5 million, and an FHLB borrowing limit of $17.3 million, of which $9 million had already been utilized.

By August 2008, liquidity was strained. The overall deterioration in the bank's condition impacted access to alternative sources of funding, including brokered deposits. The liquidity ratio was 15 percent and centered in federal funds sold and unpledged securities. Although liquidity improved, it remained susceptible to deposit outflows due to negative publicity about the bank. Based on a DSC off-site review, earnings did not support operations or capital due to a high level of non-performing assets and high-provision expenses. Tier 1 Leverage Capital had decreased to 5.27 percent, below the 8 percent minimum required by both the FDIC order granting deposit insurance and the July 17, 2008 DBF C&D. Growth in excess of initial projections and sizeable operating losses were primary contributors to an inadequate capital position.

Regulatory Supervision Related to Liquidity

In the early examinations, examiners did not make recommendations related to Alpha's liquidity position. In the first examination, examiners found Alpha's liquidity position to be strong. Capital levels were sufficient to protect the bank against normal losses and allow for future growth. In the second examination, examiners commented that liquidity and funds management practices were satisfactory. The bank had a contingency funding plan for a "liquidity crisis." However, significant loan growth had prompted management to augment core deposit growth with brokered deposits and Internet CDs. Examiners warned bank management that while the use of brokered deposits can be a cost-effective method of funding loan growth on a temporary basis, the long-term use of brokered deposits is not considered a cost-effective alternative to establishing and retaining a strong core deposit base.

Our review of DBF correspondence files showed that the state examiners had notified Alpha management on February 2, 2007 and again on May 7, 2008 that management was not complying with the DBF's conditions in Articles of Incorporation for Alpha, dated February 7, 2006, requiring quarterly reports on (1) the bank's internal liquidity calculation and (2) total dollar amount of deposits not considered brokered, raised through an Internet rate listing service. Also lacking were the bank's month-end Statements of Condition and Statements of Income and Expense.

In the April 2008 DBF examination, the bank's liquidity position was fair but did not fully support the bank's risk profile. The bank's liquidity ratio was 11.58 percent, higher than the regulatory condition that it be at least 10 percent during the first 3 years of operation. The ROE stated that liquidity was above the required 10 percent but that liquidity was an ongoing concern, considering the overall risk profile, resulting from deteriorating asset quality and diminishing secondary sources of funding.

On July 17, 2008, DBF issued a C&D to Alpha. Included in the order were instructions that within 60 days from the effective date of the order, the bank shall review and revise its written liquidity policy. The revision shall include, at a minimum:

- an assessment of the bank's liquidity needs and plans for ensuring that such needs are met on an ongoing basis;
- goals and strategies for managing and/or improving the bank's interest rate risk exposure and for returning the bank to a position which is within policy guidelines;
- coordination of the bank's loan, investment, operating, and budget policies with the written liquidity policy; and
- a contingency funding plan.

According to DSC and DBF officials, liquidity became an issue as the overall deterioration in the bank's condition impacted access to alternative sources of funding, including brokered deposits. In fact, during the last 4 months that the bank was operational, DSC was monitoring Alpha's liquidity position on a daily basis. DBF officials stated that when Alpha was immersed in loan problems, the Federal Reserve Bank reduced Alpha's line of credit. Due to the drop in Alpha's PCA category to undercapitalized in July 2008, Alpha was unable to obtain a brokered deposit waiver, and the bank suffered about $300,000 in prepayment penalties when it was forced to liquidate bank-owned CDs in order to fund the withdrawal of consumer deposits. The bank had many CDs with other banks but did not want to renew or renegotiate them under less-than-favorable conditions. As capital levels dropped, liquidity became a major problem, contributing to the bank's failure.

IMPLEMENTATION OF PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory supervisory actions that are to be triggered by an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized.

The FDIC and DBF evaluated Alpha's capital position; assigned capital component ratings; included capital-related provisions in a formal action, including a PCA Directive, in accordance with regulatory guidelines; and provided PCA notification letters. The DBF's April 2008 examination concluded that Alpha's capital levels had declined due to extensive earnings losses resulting from asset quality deterioration. Alpha's rapid asset growth since its inception in May 2006 was supported by an initial stock issuance that raised $34 million in capital. However, this asset growth had eroded the Tier 1 Leverage Capital ratio to 6.94 percent—below the 8-percent threshold required by FDIC and DBF conditions.

In its Call Report dated December 31, 2007, Alpha reported that it held brokered deposits totaling $45.9 million (14 percent of total deposits). On May 15, 2008, Alpha submitted an application for a brokered deposit waiver. However, the FDIC determined, through discussions with Alpha's Chief Financial Officer, that the bank's capital position would likely fall below adequately capitalized. Thus, Alpha withdrew its application for a brokered deposit waiver on July 2, 2008.

On July 17, 2008, the DBF issued a C&D, acknowledged by the FDIC and effective July 27, 2008, that included provisions related to capital and required Alpha to:

- Attain, within 90 days, a Tier 1 Capital ratio of no less than 8 percent. The level of capital was to be maintained in addition to a fully funded ALLL determined to be satisfactory by the DBF and FDIC at subsequent examinations or visitations.

- Develop, within 30 days, a written capital plan acceptable to the DBF and FDIC to enable the bank to meet the minimum capital requirements set forth in the C&D.

In response, Alpha submitted a plan on August 22, 2008 to meet the minimum capital requirements set forth in the C&D. The plan included steps for reducing the level of non-performing assets, reducing total assets, reducing the level of concentration in CRE loans, improving operations to make the institution profitable, maintaining an aggressive ALLL, and raising additional capital.

On October 10, 2008, the FDIC notified Alpha that based on financial information provided by the institution, Alpha was considered to be critically undercapitalized for PCA purposes. The FDIC required Alpha to file a written capital restoration plan within 45 days. However, Alpha failed on October 24, 2008, shortly after this notification.

PCA's focus is on capital, and capital can be a lagging indicator of an institution's financial health. In addition, the use of PCA directives depends on the accuracy of capital ratios in a financial institution's Call Reports. Alpha's capital remained in the well capitalized to adequately capitalized range long after its operations had begun to deteriorate because of problems related to management, asset quality, risk management controls, and net losses. Further, by the time Alpha's capital levels fell below the required thresholds necessary to implement PCA, the bank's condition had deteriorated to the point at which the institution could not raise additional needed capital, estimated to be at least $10 million, through its BOD or find other investors to assist in recapitalizing the bank.

CORPORATION COMMENTS AND OIG EVALUATION

On March 27, 2009, the Director, DSC, provided a written response to the draft of this report. DSC's response is presented in its entirety in Appendix 3. In its response, DSC agreed with the OIG's assessment that Alpha failed primarily due to bank management's

aggressive pursuit of asset growth concentrated in high-risk ADC loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls.

DSC agreed that at the time of the 2007 examination, Alpha exhibited a high-risk profile, given its level of ADC concentration. DSC indicated that examiners stated that management monitored the concentration through various reports and described management's monitoring as adequate. Further, DSC noted that examiners appropriately expanded their loan review coverage to include 43 percent of the loan portfolio. At the time of the April 2007 examination, Alpha had been in operation for 11 months. Its loan portfolio showed no delinquencies and no charge-offs, and examiners identified no adversely classified or criticized assets. Examiners made recommendations for bank management (1) to ensure that the amount of debt extended to given developers or guarantors, on a global basis, did not exceed their repayment capacity and (2) to determine that appraisal adjustments were fully documented in the appraisal report to ensure adequate collateral protection. DSC indicated that these recommendations were not characterized as criticisms of a deficient program. Finally, DSC stated that examiners required Alpha management to submit a revised business plan in light of its growth, which exceeded original projections, and advised management that additional capital would be necessary to support the growth. DSC concluded that the level of supervisory concern expressed in the 2007 examination was appropriate.

The OIG recognizes that examiner recommendations (in 2007) to address repayment capacity and collateral protection and require an updated business plan and capital were positive. However, examiner actions as part of the 2007 examination did not effectively address Alpha's business strategy of aggressive growth of the institution or risk in its loan operations. Alpha was a de novo institution subject to increased regulatory supervision particularly during its first 3 years of operation. Virtually from its inception, the institution did not fully adhere to its approved business plan or loan policy, pursuing high ADC loan growth without adequate diversification or sound controls and risk management practices. For example, Alpha's (1) compensation policy was production-based and therefore encouraged excessive loan origination without quality controls, (2) use of interest reserves masked asset quality problems, and (3) underwriting did not capture the full financial condition of borrowers and, at times, exceeded loan-to-value limits. The risks associated with this business strategy and Alpha's loan operations were present even though the reported financial condition did not deteriorate right away. Additional supervisory focus on managing risk and strengthening controls was warranted as the loan portfolio had not matured in the 11 months that Alpha was in operation.

By the time of the 2007 examination, Alpha's ADC commitments, as a percent of Tier 1 Capital, exceeded 500 percent. Alpha's loan portfolio exceeded the supervisory criteria established in the December 2006 interagency guidance for CRE concentration risk. The 2006 interagency guidance emphasizes (1) the importance of a successful track record in managing the risks of CRE concentrations and (2) that recent, significant growth in CRE lending will receive closer supervisory review. Also, Alpha exhibited many of the risk characteristics identified by DSC's 2004 *De Novo Banks Study* with regard to rapid asset

growth. These guidelines further support that Alpha's business strategy and loan operations should have received greater supervisory attention in 2007.

As part of the 2007 financial statement audit, Alpha's independent public accountant expressed concern in January 2008 that interest reserves were masking loan problems on ADC loans where the project development was not progressing in accordance with original loan terms. The accountant recommended a significant increase in the ALLL for 2007. Alpha's BOD also identified problems with loan operations that resulted in the BOD's termination of the CEO in February 2008. Examiners rated asset quality a 1 in April 2007 and a 4 a year later—a triple downgrade, after the actions by Alpha's BOD to address asset quality problems. This decline in the rating was based, in part, on (1) a loan review structure that was inadequate, (2) significant increases in past-due and nonaccrual loans, including risky single-pay loans, and (3) depletion of interest reserves on ADC loans. However, subsequent supervisory actions, including a C&D issued by the DBF based on the 2008 examination, and corrective measures by the institution were too late to prevent the failure of Alpha.

Alpha failed 29 months after it opened and resulted in a loss to the DIF that approached 50 percent of the bank's total assets. This timeframe is the shortest amount of time between the granting of approval for deposit insurance and failure of an institution and the highest loss rate of any of the failures requiring a material loss review over the last 3 years. In our view, the extraordinary risk associated with Alpha's business strategy and loan operations warranted additional examiner concern and action in 2007 even though the examiners did not identify adversely classified or criticized assets.

DSC's response also noted that, in light of the economic deterioration and its impact on Alpha and other similarly situated institutions, the division has undertaken a number of initiatives, listed in its response, related to the supervision of such institutions.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency, reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

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

We conducted the audit from November 2008 to February 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it was not feasible to address certain aspects of the standards as described in the sections that follow.

Scope and Methodology

The scope of this audit included an analysis of Alpha's operations, which began on May 8, 2006, until the bank's failure on October 24, 2008. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by the FDIC and DBF examiners from 2006 to 2008.

- Reviewed the following:

    - Bank data and correspondence maintained at the DSC's ARO and Atlanta Field Office.

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

    - Records of the bank's external auditor, Mauldin & Jenkins, at the offices of Carlock, Copeland & Stair, LLP in Atlanta, Georgia.

  - Bank records maintained by DRR in Dallas, Texas.

  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C., and DSC's ARO in Atlanta, Georgia.

  - DRR officials at the Dallas Regional Office.

  - FDIC examiners from the DSC ARO and DSC Atlanta Field Office who participated in examinations or reviews of examinations of Alpha.

- Met with officials from DBF in Atlanta, Georgia, to discuss their historical perspective of the institution, its examinations, state banking laws, and other activities regarding the state's supervision of the bank.

- Researched various banking laws and regulations, including State of Georgia banking laws.

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

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of Alpha's management controls pertaining to its operations as discussed in the finding section of this report. For purposes of the audit, we did not rely on computer-processed data to support our significant findings or conclusions. Our review centered on interviews, ROEs, and correspondence and other evidence to support our audit.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

GLOSSARY OF TERMS

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Cease and Desist Order (C&D)	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
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.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq. implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
Trust Preferred Security	A trust preferred security, generally issued by bank holding companies, is a security possessing characteristics of both equity and debt issues. Trust preferred securities have an advantage over other types of hybrid securities, which is that if they are issued by a bank holding company, they will be treated as capital (equity/own funds) rather than as debt for regulatory purposes.
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

March 27, 2009

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, *Material Loss Review of Alpha Bank and Trust* (Assignment No. 2009-004)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Alpha Bank and Trust (Alpha), Alpharetta, Georgia, which failed on October 24, 2008. This memorandum represents the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received March 3, 2009.

The OIG found that the FDIC and the State of Georgia, Department of Banking and Finance conducted timely examinations of Alpha; and the FDIC provided additional oversight through its off-site monitoring process and site visitations. Further, the OIG found that the DSC used its authority under the Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Act to issue a PCA Directive, in accordance with regulatory guidelines.

We agree with the OIG's assessment that Alpha failed primarily due to management's aggressive pursuit of asset growth concentrated in high-risk Acquisition, Development, and Construction (ADC) loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls. When real estate sales slowed, inventories rose and values in the bank's marketplace experienced a significant downturn. The real estate construction industry and the ability of the bank's borrowers to make payments were both negatively impacted. The resulting loan losses severely eroded Alpha's earnings and capital, leading to the bank's failure and a material loss to the Deposit Insurance Fund.

The Draft Report states that greater supervisory concern in 2007 regarding Alpha's loan documentation and administration deficiencies could have led to elevated supervisory attention and earlier supervisory action. We agree that at the time of the 2007 examination Alpha exhibited a high risk profile, given its level of ADC concentration. Examiners stated that management monitored the concentration through various reports and described management's monitoring as adequate. We further note that examiners appropriately expanded their loan review coverage to include 43 percent of the loan portfolio. At the time of the April 2007 examination, Alpha had been in operation for 11 months. Its loan portfolio showed no delinquencies and no charge-offs, and examiners identified no adversely classified or criticized assets.

Examiners made recommendations for Alpha's management to ensure that the amount of debt extended to a given developer/guarantor on a global basis did not exceed their repayment capacity and to ensure that appraisal adjustments were fully documented in the appraisal report to ensure adequate collateral protection. These recommendations were not characterized as criticisms of a deficient program. Examiners additionally required management to submit a revised business plan in light of the growth in excess of original projections and advised management that additional capital would be necessary to support the growth.

As the OIG notes on page 15 of the Draft Report, examiners characterized the bank's loan underwriting and documentation as satisfactory. Problems in the loan portfolio did not surface until late 2007 and early 2008 as loans matured amidst a rapid decline in the Atlanta real estate market. Loan delinquencies then jumped, with abrupt increases in past-due and nonaccrual loans attributed to the maturity of single-pay loans and the depletion of interest reserves on ADC loans. While the concentration in ADC loans was noted at the 2007 examination and ultimately contributed to the bank's failure, we believe that the supervisory concern expressed in the Report of Examination was appropriate; however, DSC will continue to evaluate existing and emerging risks in the banking industry. The OIG notes the FDIC has taken special steps to review de novo bank business plans and to supervise financial institutions that have concentrations in ADC loans and use interest reserves. Further, in light of the economic deterioration and its impact on Alpha and other similarly situated institutions, DSC has undertaken a number of initiatives:

- In May 2007, DSC launched a call program for institutions with significant residential construction, subprime mortgage, or other higher-risk lending activities. A goal of the program was to identify problems early and initiate appropriate supervisory responses.

- DSC examiners authored an article titled *Managing Commercial Real Estate (CRE) Concentrations* in the Winter 2007 edition of *Supervisory Insights*. This article was prompted by rapid CRE loan growth in the banking industry and elaborates on the authors' field examination experience with the principles set forth in the 2006 CRE Guidance, issued by the FDIC, the Federal Reserve Board, and the Office of the Comptroller of the Currency on December 6, 2006, titled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (2006 CRE Guidance).

- In January 2008, DSC conducted a horizontal review of CRE lending practices; outcomes include changes to the current supervisory approaches, such as an acceleration of the next scheduled examination or downgrades to composite ratings, where warranted.

- The FDIC issued a Financial Institution Letter on March 17, 2008, titled *Managing Commercial Real Estate Concentrations in a Challenging Environment* (2008 CRE FIL). The 2008 CRE FIL re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices and recommended several risk management processes to help institutions manage CRE and ADC concentrations. This FIL also articulated the FDIC's concern about interest reserves for ADC loans,

CORPORATION COMMENTS

stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

- In July 2008, DSC developed a comprehensive CRE guidance repository in a Regional Director memorandum which updates and re-emphasizes CRE loan examination procedures in view of more challenging market conditions, particularly in ADC lending.

- DSC examiners authored an article titled *A Primer on the Use of Interest Reserves* in the Summer 2008 edition of *Supervisory Insights*. This article focuses on the use of interest reserves in ADC lending, examines the risks this underwriting practice presents, and reviews regulatory guidance on the use of interest reserves. The article identifies "red flags" that should alert lenders to potential problems at each stage of the ADC cycle and reinforces the importance of evaluating the appropriateness of interest reserves when ADC projects become troubled.

- In August 2008, DSC issued revised examination instructions to collect information on market conditions and practices at banks potentially exposed to significant CRE concentration risk. These data will provide real-time information relating to CRE markets across the country and FDIC-supervised institutions operating in those markets and will be available for supervisory purposes.

- In September 2008, DSC made available to examiners a resource that provides for more detailed information on commercial and residential real estate markets and transactions. These data, which include estimated property values, comparable sales, leasing rates, capitalization rates, vacancy rates, title/deed documents, and other related information, may aid examiner analysis of market conditions during examinations of banks with significant CRE concentrations.

- The FDIC issued a Financial Institution Letter on November 12, 2008, titled *Interagency Statement on Responsible Lending* (FIL-128-2008). The FIL encourages FDIC-supervised institutions to lend prudently and responsibly to creditworthy borrowers, adjust dividend policies to preserve capital and lending capacity, and implement compensation structures that encourage prudent lending. If further emphasizes that state nonmember institutions' adherence to these expectations will be reflected in examination ratings the FDIC assigns for purposes of assessing safety and soundness, compliance with laws and regulations, and performance in meeting requirements of the Community Reinvestment Act.

- In November and December 2008, examiners conducted on-site visitations of certain banks in Georgia, Florida and California with high ADC concentrations. Ratings were downgraded as appropriate and corrective programs initiated.

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

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ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ARO	Atlanta Regional Office
BOD	Board of Directors
BSA	Bank Secrecy Act
C&D	Cease and Desist Order
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CD	Certificate of Deposit
CDARS	Certificate of Deposit Account Registry Service
CEO	Chief Executive Officer
CRE	Commercial Real Estate
DBF	Department of Banking and Finance
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System