Office of Inspector General

Office of Material Loss Reviews
Report No. IDR-11-006

In-Depth Review of the Failure of First Lowndes Bank, Fort Deposit, Alabama

February 2011

Office of Inspector General

Executive Summary

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Why We Did The Audit

The Alabama State Banking Department (ASBD) closed First Lowndes Bank (First Lowndes), Fort Deposit, Alabama on March 19, 2010, and named the FDIC as receiver. On April 13, 2010, the FDIC notified the Office of Inspector General (OIG) that First Lowndes' total assets at closing were $133.5 million and the estimated loss to the Deposit Insurance Fund (DIF) was $37.1 million. As of December 31, 2010, the estimated loss to the DIF had decreased to $35.3 million. In preparing this report, we relied extensively on work performed by Clifton Gunderson LLP, an independent contractor engaged by the OIG.

This assignment was initiated as a material loss review (MLR). However, on July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), which amends section 38(k) of the Federal Deposit Insurance Act (FDI Act). The Financial Reform Act increases the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Further, the Financial Reform Act calls for the OIG to perform in-depth reviews of failures when losses are not material but they involve unusual circumstances. At the time the Financial Reform Act was enacted, the fieldwork for this review was substantially complete. As a result, although the estimated loss no longer met the threshold requiring an MLR, we decided to complete the audit and issue this report.

Consistent with both Acts, the objectives of this review were to (1) determine the causes of First Lowndes' failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

We note that, in conjunction with other organizational changes made to enhance the FDIC's ability to carry out its new and enhanced responsibilities under the Financial Reform Act, the Division of Supervision and Consumer Protection (DSC) became the Division of Risk Management Supervision effective February 13, 2011. As a result of the timing of our review and draft report issuance, we refer to DSC throughout this executive summary and the body of the report.

Background

First Lowndes commenced operations on February 4, 1984, as a state nonmember bank. The bank was wholly owned by The Fort Bancorp, Inc., a single-bank holding company. First Lowndes' directorate owned 42 percent of the holding company stock. The largest shareholder, the individual appointed as the president and senior lending officer of the bank in 2002, owned 12.86 percent of the holding company stock.

First Lowndes historically operated as a traditional community bank, with four branches serving a predominately rural trade area southwest of Montgomery, Alabama. In 2002, the bank expanded its lending efforts into the Gulf Coast region of Alabama and Florida and began a period of significant growth concentrated in acquisition, development, and construction (ADC) and other commercial real estate (CRE) loans.

Executive Summary

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Audit Results

Causes of Failure and Loss

First Lowndes' failure can be attributed to (1) inadequate management and Board of Directors (Board) oversight, (2) an aggressive growth strategy concentrated in ADC and other CRE loans, (3) deficient underwriting and credit administration policies and procedures, and (4) reliance on non-core funding sources that negatively impacted the bank's net earnings.

In 2002, the bank expanded its lending efforts into the Gulf Coast region of Alabama and Florida, a new market for the institution, and began to pursue an aggressive growth strategy focused on CRE loans. This growth was partially funded with non-core funding sources, including brokered deposits. Relying on higher-cost, non-core sources to fund the bank's growth resulted in a steady decline in the bank's net interest margin and therefore net earnings. The bank's decline was exacerbated by deteriorating economic conditions in the markets served by the institution. From 2007 until First Lowndes failed, loan losses depleted earnings and capital and impaired the bank's liquidity position. ASBD closed First Lowndes because it was unable to raise sufficient capital to avoid failure.

The FDIC's Supervision of First Lowndes

The FDIC, in coordination with ASBD, provided ongoing supervisory oversight of First Lowndes. Through their supervisory efforts, the regulators identified key risks in the bank's operations and made recommendations to improve risk management practices and address areas of concern. The bank's Board and senior management responses to these criticisms and related recommendations repeatedly fell short, and ultimately the financial condition of the bank became critically deficient.

Given the examination findings and First Lowndes' increasing risk profile, a more critical assessment and stronger supervisory tenor at earlier examinations may have been prudent. In this regard, a more stringent supervisory response and related action to address the weak risk management practices identified during the August 2005 and earlier examinations may have been prudent. Earlier supervisory intervention may have better positioned First Lowndes to work through the loan deterioration that developed as its real estate markets deteriorated, mitigating, to some extent, the financial problems experienced by the bank.

Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of FDI Act section 38. First Lowndes was unable to find a suitable acquirer or otherwise raise sufficient capital to support its continued operation and was closed by the ASBD.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008 the FDIC reiterated broad supervisory expectations with regard to managing risk associated with ADC and CRE loan concentrations. Further, the FDIC has completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addresses the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

In-Depth Review of the Failure of First Lowndes Bank, Fort Deposit, Alabama

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Corporation and ASBD Comments

We issued a draft of this report to FDIC management and ASBD on January 7, 2011. After we issued our draft report, DSC management officials provided informal comments for our consideration and we revised our report as appropriate. On February 7, 2011, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

In DSC's response, the Director provided the division's views on the causes of First Lowndes' failure and the regulators' supervision of the bank. The response also stated that DSC issued a Financial Institution Letter (FIL) in 2008 entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, which re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. DSC also pointed out that it had issued a FIL in 2009 entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance the supervision of institutions that rely on volatile non-core funding.

ASBD also provided a written response. ASBD largely agreed with our findings and added that credit administration and underwriting were so poor at First Lowndes that the loans made in the bank's rural trade area would, by themselves, have led to extreme difficulties and possible failure of the bank. In addition, they cited the following lessons learned:

- For banks rated composite 2, regulators were reluctant to require that examiner concerns be addressed, but banks should not be allowed to ignore examiner concerns and recommendations no matter how determined bank management is to do so.

- Regardless of a bank's composite rating, serious repeat criticisms should be addressed with increasingly severe enforcement actions that include limits on growth.

Contents

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

Office of Material Loss Reviews
Office of Inspector General

DATE: February 14, 2011

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

/Signed/

FROM: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *In-Depth Review of the Failure of First Lowndes Bank, Fort Deposit, Alabama* (Report No. IDR-11-006)

The Alabama State Banking Department (ASBD) closed First Lowndes Bank (First Lowndes), Fort Deposit, Alabama on March 19, 2010 and named the FDIC as receiver. On April 13, 2010, the FDIC notified the Office of Inspector General (OIG) that First Lowndes' total assets at closing were $133.5 million and the estimated loss to the Deposit Insurance Fund (DIF) was $37.1 million. As of December 31, 2010, the estimated loss to the DIF had decreased to $35.3 million.

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act). The Financial Reform Act amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the threshold for a material loss review (MLR) from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that may warrant an in-depth review (IDR) of the loss. Although the estimated loss for First Lowndes no longer met the threshold requiring an MLR, the OIG decided to complete the audit as an IDR because fieldwork was substantially complete at the time the Financial Reform Act was enacted.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of First Lowndes' failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. This report presents an analysis of First Lowndes' failure and the FDIC's efforts to promote safe and sound banking operations at the institution. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in material loss and in-depth reviews, we will communicate those to FDIC management for its consideration.

As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

We include several appendices in this report. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System (otherwise known as CAMELS ratings). Appendix 3 contains a list of acronyms. Appendix 4 presents the Corporation's comments on our report.

We note that, in conjunction with other organizational changes made to enhance the FDIC's ability to carry out its new and enhanced responsibilities under the Financial Reform Act, the Division of Supervision and Consumer Protection (DSC) became the Division of Risk Management Supervision effective February 13, 2011. As a result of the timing of our review and draft report issuance, we refer to DSC throughout the executive summary and the body of this report.

Background

First Lowndes commenced operations on February 4, 1984, as a state nonmember bank located in Fort Deposit, Alabama. The bank historically operated as a traditional community bank, with four branches serving a predominately rural trade area southwest of Montgomery, Alabama. In 2002, First Lowndes expanded its lending efforts into the Gulf Coast region of Alabama and Florida and began a period of significant growth concentrated in acquisition, development, and construction (ADC) and other commercial real estate (CRE) loans.

First Lowndes was wholly owned by The Fort Bancorp, Inc., a single-bank holding company. First Lowndes' directorate owned 42 percent of the holding company stock. The largest shareholder, the individual appointed as the president and senior lending officer of the bank in 2002, owned 12.86 percent of the holding company stock.

Table 1 presents a summary of First Lowndes' financial condition as of December 31, 2009, and for the 4 preceding calendar years.

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

Table 1: Financial Condition of First Lowndes

Financial Measure	12/31/09	12/31/08	12/31/07	12/31/06	12/31/05
	($000s omitted)				
Total Assets	$137,175	$156,654	$165,969	$168,735	$155,393
Total Loans	102,654	118,506	120,169	116,784	120,010
Total Deposits	131,117	141,870	149,853	151,916	139,707
Return on Average Assets	(5.44%)	(0.68%)	(0.15%)	0.82%	1.09%
ADC as a percent of Total Capital *	181%	104%	112%	52%	80%
Other CRE as a percent of Total Capital *	1,216%	449%	339%	278%	318%
Tier 1 Leverage Capital Ratio	1.98%	7.04%	6.96%	7.39%	7.13%

Source: Uniform Bank Performance Reports (UBPR) for First Lowndes.

* Increases in the 2009 concentration ratios were attributed to a decline in First Lowndes' capital rather than an increase in loan volumes.

Causes of Failure and Loss

First Lowndes' failure can be attributed to (1) inadequate management and Board of Directors oversight, (2) an aggressive growth strategy concentrated in ADC and other CRE loans, (3) deficient underwriting and credit administration policies and procedures, and (4) reliance on non-core funding sources that negatively impacted the bank's net earnings.

In 2002, the bank expanded its lending efforts into the Gulf Coast region of Alabama and Florida, a new market for the institution, and began to pursue an aggressive growth strategy focused on ADC and other CRE loans. This growth was partially funded with non-core funding sources, including brokered deposits. Relying on higher-cost, non-core sources to fund the bank's growth resulted in a steady decline in the bank's net interest margin and therefore net earnings. The bank's decline was exacerbated by deteriorating economic conditions in the markets served by the institution. From 2007 until First Lowndes failed, loan losses depleted earnings and capital and impaired the bank's liquidity position. ASBD closed First Lowndes because it was unable to raise sufficient capital to avoid failure.

Management and Board of Directors Oversight

First Lowndes management and its Board failed to implement adequate management controls during a period of loan growth focused on ADC and CRE lending in new market areas.

The *DSC Risk Management Manual of Examination Policies* (Examination Manual) states that the quality of an institution's management, including its Board and executive officers, is perhaps the single most important element in the successful operation of an institution. According to the Examination Manual, the Board has overall authority and responsibility for formulating sound policies and objectives for the bank and for effectively supervising its affairs. Executive officers such as the president have primary responsibility for implementing the Board's policies and objectives in the bank's day-to-day operations.

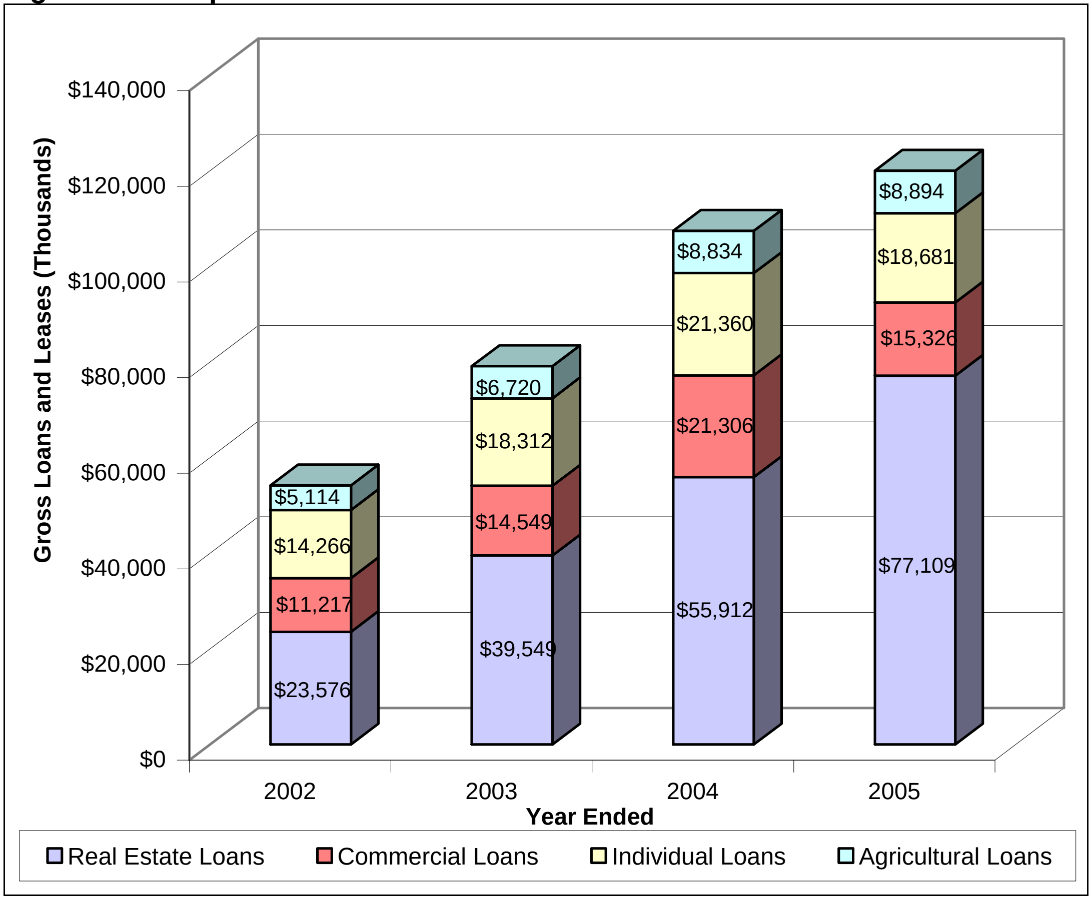
First Lowndes received unsatisfactory ratings for the *Management* component of its CAMELS ratings starting with the 2002 examination and continuing through the last examination in 2009.[2] The examiners' reasons for assigning these ratings included (1) the failure of the bank's president/senior lending officer and Board to provide proper oversight and supervision to the bank's lending function, including appropriate internal audit and loan review programs; and (2) the number and severity of deficiencies noted in the bank's underwriting and credit administration policies and procedures, many of which were repeated at consecutive examinations.

Management Controls During the Growth Period

The bank experienced a period of significant growth and a change in the relative mix of its loan portfolio from year-end 2002 to year-end 2005. During this 3-year time period, total assets increased from $68.8 million to $154.7 million (125 percent); total loans increased from $54.2 million to $120.0 million (121 percent); and its real estate loans, particularly CRE loans, more than tripled. Figure 1 illustrates the composition and growth of the bank's loan portfolio during this time.

[2] From 2002 through 2006, examiners assigned First Lowndes a "less than satisfactory" *Management* rating of "3". In 2007, this rating was downgraded to a "deficient" rating of "4". Examiners raised the *Management* rating back to a "3" in 2008 to acknowledge management's efforts to address the bank's deficiencies but subsequently downgraded *Management* to a "critically deficient" rating of "5" in 2009.

Figure 1: Composition and Growth of First Lowndes' Loan Portfolio



Source: UBPRs for First Lowndes.

During this growth period, First Lowndes' management did not implement adequate management controls, including internal audit and loan review programs. Specific examiner comments on this topic, from Reports of Examination issued in 2003 through 2005, are presented in Table 2.

Table 2: Examiner Comments on Management Controls, 2003-2005

Examination Comments
2003 Examination Report o Management has not performed a number of important duties, such as preparing a budget, instituting an internal audit program, correcting deficiencies noted in external audit and supervisory examination reports, and ensuring that the Board's policies and applicable banking regulations are fully complied with. o The bank has no internal audit program in place and no internal auditor designated. o The bank does not currently have an internal or external loan review process. Management is reminded that a consistent loan review is critical in maintaining high quality credits, and is necessary in light of the extensive loan growth experienced by the bank.
2004 Examination Report o Although efforts have been made to address findings from previous examinations, this examination cites repeat violations, and some previously-criticized deficiencies in operations and loan administration remain uncorrected. o To safely meet growth objectives, the Board must ascertain that a qualified and well-trained staff is furnished with adequate policies and procedures, and that effective review and audit programs ensure those policies and procedures are followed. o The lack of an effective internal loan grading system has been criticized at several examinations. Despite promised correction, the system was again found inadequate.
2005 Examination Report o The bank's continuing problems with regard to the management of the lending function are evidenced by repeat criticisms in loan administration and a considerable increase in adversely classified assets. Although some effort has been made to address previous findings, numerous exceptions remain in the areas of internal routine and controls. o The lack of an effective loan grading system has been criticized at several examinations. Inconsistencies in loan grades between loan officers and inaccuracies in assigned grades remain as a large number of loans reviewed were downgraded from pass grades to adversely classified during this examination. The need for expanded loan review to validate the grading system and identify problem loans is a continuing recommendation. Loan reviews appear to focus primarily on documentation exceptions. o Significant loan administration deficiencies were noted in several areas including credit and cash flow analysis, construction loan draws, and appraisal review.

Source: Reports of Examination, 2003-2005.

Growth and Concentration in CRE Lending

The inherent risk in First Lowndes' loan portfolio increased from 2002 to 2005 when the bank pursued a new strategic direction, focusing on loan growth and changing the relative mix of its loan portfolio from a diversified portfolio to one that was concentrated in ADC and other CRE loans. A significant amount of the loan charge-offs eventually incurred by the bank was from the loans originated during this growth period. The FDIC and ASBD examiners we interviewed generally cited the bank's significant growth and increased concentration in CRE loans during this period as a major contributing factor to the bank's failure.

On December 12, 2006, the federal banking regulatory agencies issued a Financial Institution Letter (FIL) entitled *Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), to reinforce existing regulations and guidelines for real estate lending and safety and soundness.[3] The Joint Guidance states that the agencies had observed an increasing trend in the number of institutions with concentrations in CRE loans and noted that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Further, the Joint Guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land and development, and other land representing 100 percent or more of total capital, or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE had increased by 50 percent or more during the prior 36 months. Additionally, the FDIC issued FIL-22-2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, dated March 17, 2008, to reemphasize the importance of strong capital and loan loss allowance levels, and robust credit risk-management practices for institutions with concentrated CRE exposures.

The bank began pursuing ADC and other CRE lending in the Gulf Coast region in 2002, pursuant to a strategic initiative designed to use non-core funding to expand into credit markets on the Gulf Coast, approximately 100 miles from the bank's core business operations. By 2007, First Lowndes' ADC and CRE concentrations exceeded the levels identified in the Joint Guidance and stayed above those levels until the bank failed. Moreover, a majority of the ADC and CRE loans were out of its primary lending area, making loan monitoring more difficult. Management did not implement appropriate risk management practices for mitigating exposure in the ADC and CRE portfolios and failed to develop appropriate strategies for exiting these markets. These factors, combined with a significant downturn in real estate markets, led to large loan loss provisions, as well as critically deficient earnings and capital levels.

As previously discussed, from year-end 2002 to year-end 2005, First Lowndes' total loans increased by 122 percent, and the annual growth level far exceeded that of its peer group during the first 3 years of that period, as shown in Figure 2.

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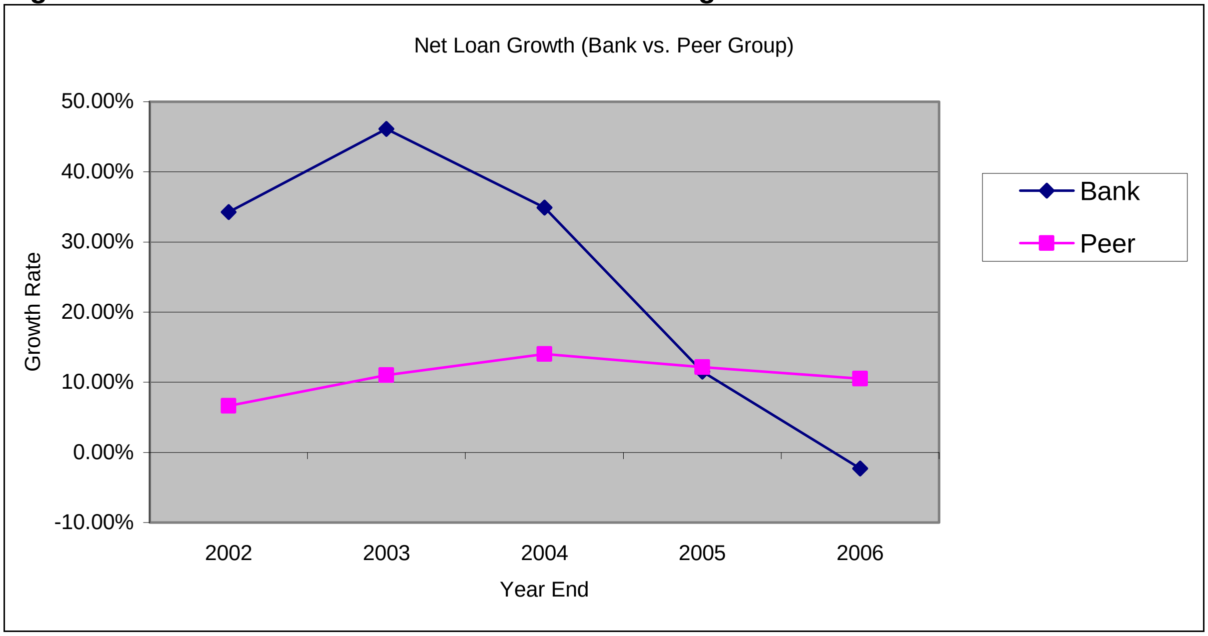
[3] The Joint Guidance (FIL-104-2006) was issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as "the agencies" in the Joint Guidance).

Figure 2: Net Loan Growth Rates from 2002 through 2006



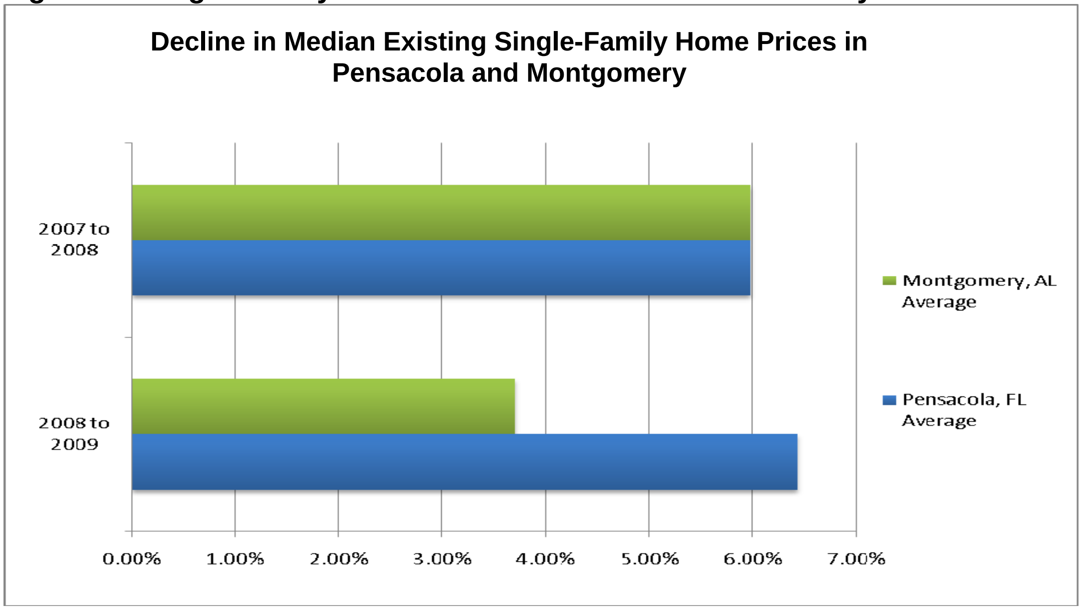
Source: UBPRs for First Lowndes.

First Lowndes began slowing its loan growth from 2005 to 2007. After 2007, the bank tried to shrink its balance sheet to improve the bank's capital position because of a sharp increase in the level of adversely classified loans (as shown later in Table 3 on page 12), which caused both examiners and the bank to become concerned with the adequacy of the bank's capital.

Changing the mix of the bank's loan portfolio to focus more heavily on real estate loans increased the severity of losses incurred by the bank because, starting in 2007, real estate values in the markets served by the bank began to experience significant declines. Figure 3 provides information on the declines in the real estate markets served by the bank from 2007 through 2009. According to this data, for the 2-year period from 2007 to 2009, the median market value for a single-family home declined by over 12 percent in Pensacola, Florida and over 9 percent in Montgomery, Alabama. The Montgomery area included the markets served by First Lowndes' core operations, while the Pensacola area covered the Gulf Coast region where First Lowndes first began making loans in 2002.[4]

[4] We were unable to determine the total losses incurred by First Lowndes in the Gulf Coast region, because neither the bank's records nor examination reports included specific information in that regard. However, there were numerous comments in the 2009 examination report referring to the increasing risk profile of the bank's loan portfolio because the institution ventured into the Gulf Coast region.

Figure 3: Single-Family Home Prices in the Markets Served by First Lowndes



Source: The National Association of Realtors Web site.

Underwriting and Credit Administration

Weak loan underwriting and credit administration practices contributed to the asset quality problems that developed when First Lowndes' lending markets deteriorated. The bank had deficient underwriting and credit administration policies and procedures as evidenced by the number and severity of findings in these areas in examinations from 2003 to 2009. These deficiencies included not having adequate loan policies in place to provide proper guidance to the bank's loan officers when originating loans and inadequate credit administration procedures that would have allowed the bank to (1) properly monitor the borrower and guarantor's ability to service their debt obligations to the bank and (2) evaluate the physical condition and estimated value of the collateral pledged against the loans held by the institution.

First Lowndes' loan policy did not contain adequate commercial and CRE loan guidance for the bank's loan officers. Specifically, the loan policy did not include:

- Provisions requiring site inspections of real estate or any other type of collateral pledged against commercial and CRE loans.

- Procedures for authenticating draw requests for construction loans. Normal and customary procedures include obtaining copies of third-party vendor invoices and lien waivers and performing site inspections before funds are released.

- Guidelines regarding minimum debt service coverage ratios that the borrower needed to qualify for a loan. The policy also did not discuss the preparation of global debt service coverage ratios for more complex borrowers or guarantors who owned multiple properties or entities.

- Guidelines regarding the minimum requirements for the type and frequency of financial information to be obtained on CRE development projects, the borrowing entity, or any guarantors. Such financial information is normally obtained to determine whether a loan should be underwritten and to monitor repayment capability.

Based on comments in examination reports from 2003 through 2007, it did not appear that the bank consistently performed site inspections or analyzed the debt service capacity of the borrowers or guarantors prior to originating loans or on a periodic basis thereafter until the loans were repaid.

The following are some of the specific deficiencies noted in examination reports:

- The bank did not consistently prepare credit presentations and those that were prepared often lacked sufficient analysis of the borrower and guarantor financial statements.

- Several loans were originated with exceptions to the bank's loan policy and the nature of the exceptions was not disclosed to the bank's Board.

- The bank originated a $750,000 loan to the president's sister-in-law for the benefit of the president's nephew, which was an apparent violation of the bank's legal lending limit, and a loan to an executive vice president of the bank which was an apparent violation of section 337.3(c)(2) of the FDIC Rules and Regulations regarding the indebtednesses of an executive officer.

- Examiners suggested several changes to the bank's loan policy, including:
    - adding provisions disallowing the capitalization of interest and when and how modifications were to be granted,
    - establishing guidelines for originating unsecured loans,
    - providing more guidance in terms of the level of documentation needed to properly analyze a credit request,
    - establishing loan officer lending limits, and
    - providing approval requirements and standards by which extensions of credit could be made to executive officers or members of the Board or their relatives.

- The bank was too liberal in granting loan modifications because of customer delinquencies or financial difficulties. Some of the modifications were granted just prior to the end of a quarter, when a Call Report would be due, giving the appearance that management was trying to mask problem loans.

- The bank was not properly applying payments received to the principal balances of certain loans as required by the contractual terms of the note agreements with the borrower. Examples cited included allowing borrowers to make interest only payments well beyond what was allowed in the note agreement or modification agreement and miscoding partial payments as regular payments, resulting in the advancement of due dates.

- The bank's construction inspection procedures were deficient.

- The bank was repeatedly criticized until 2006 for failing to have an appropriate loan review program.

- Starting with the 2006 examination, the bank was criticized for not properly monitoring and identifying its concentrations in CRE and the increased risk associated with loans acquired or originated outside of the bank's normal trade territory.

- In the 2007 examination, about half of the dollar amount of classified loans reported by examiners was identified by the examination team rather than the bank, suggesting that the bank did not have adequate procedures in place to identify and properly risk-rate problem loans. Significant dollar amounts of classified loans were also identified in the 2008 and 2009 examinations.

- Starting with the 2004 examination, the bank was repeatedly criticized for failing to adopt an ALLL methodology that complied with generally accepted accounting principles and regulatory guidelines.

- In each examination report issued from 2003 through 2009, the bank was criticized for having a high number of technical exceptions related to the lending function.

These deficiencies exacerbated the bank's asset quality problems, which first surfaced in the 2007 examination. Examiners reported that First Lowndes had $11.0 million in classified loans, an increase of 150 percent from the $4.4 million in classified loans reported at the 2006 examination. Of the total classified credits, $5.4 million, or almost 50 percent of the total, was identified by examiners, suggesting that the risk rating and problem loan identification procedures at First Lowndes were ineffective. In the 2008 examination, the amount of classified loans increased to $16.4 million, or 13.6 percent of total loans outstanding, and 138.4 percent of the bank's total equity capital. As with the 2007 examination, a large percentage of the 2008 examination classifications were identified by the examiners.

Table 3 includes information on First Lowndes' adversely classified loans as a percentage of both First Lowndes' total equity capital and total loans outstanding as reported in the examination reports issued for First Lowndes from 2002 to 2009.

Table 3: Summary of First Lowndes' Adversely Classified Loans

Financial Measure	Examination "As of" Dates 6/30/09	6/30/08	6/30/07	6/30/06	3/31/05	3/31/04	3/31/03	3/31/02
	($000s omitted)							
Total of Adversely Classified Loans	$32,988	$16,443	$10,979	$4,404	$5,288	$2,439	$2,291	$1,247
Total Outstanding Loans	$116,841	$121,221	$118,983	$117,807	$109,337	$85,419	$57,162	$41,996
Total Equity Capital	$11,223	$11,879	$12,481	$11,700	$9,825	$8,691	$5,165	$4,697
Classified Loans as a Percentage of Outstanding Loans	28.2%	13.6%	9.2%	3.7%	4.8%	2.9%	4.0%	3.0%
Classified Loans as a Percentage of Total Equity Capital	293.9%	138.4%	88.0%	37.6%	53.8%	28.1%	44.4%	26.5%

Source: Examination reports for First Lowndes.

Reliance on Non-Core Funding Sources

The bank relied on non-core funding sources, including brokered deposits, to fund its loan growth. Although the bank's liquidity position was not a major cause of the bank's failure, reliance on high-cost deposits hampered the bank's net earnings and therefore its ability to generate capital.

The 2006 examination indicated that First Lowndes' return on average assets had declined from 1.09 percent in 2005 to 0.75 percent by mid-year 2006, largely as a result of the contraction in the bank's net interest margin (NIM). The decline in NIM was attributed to a significant increase in the cost of First Lowndes' non-core funding sources, upon which the institution was increasingly reliant.

The growth in First Lowndes' loan portfolio from 2002 through 2005 was partially funded with large certificate of deposit accounts, brokered deposits, and advances from the Federal Home Loan Bank. Table 4 shows the dollar amount for each type of non-core funding held by the bank at year-end 2002 through year-end 2009 and the combined percentage to total deposits.

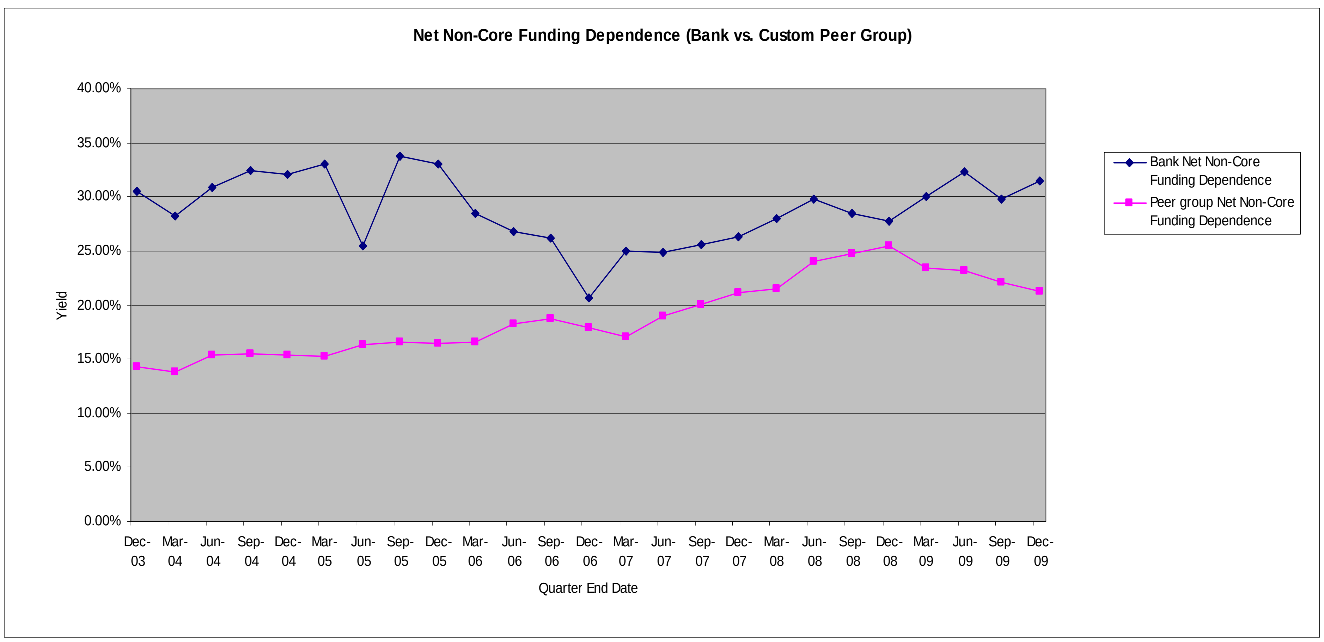
Table 4: First Lowndes' Non-Core Funding Sources by Dollar Amount and Combined as a Percentage of Total Deposits

Financial Measure	12/31/09	12/31/08	12/31/07	12/31/06	12/31/05	12/31/04	12/31/03	12/31/02
				($000s omitted)				
FHLB Borrowing	$2,816	$2,905	$3,489	$3,632	$3,758	$3,888	$718	$770
Certificates of Deposit > $100,000	$40,472	$44,733	$41,542	$40,113	$39,072	$26,880	$24,416	$15,099
Brokered Deposits	$99	$198	$2,671	$6,129	$11,180	$13,349	$5,711	$6,038
Total Deposits	$131,117	$141,870	$149,853	$151,916	$139,707	$120,966	$93,292	$64,749
% of Non-Core/Total Deposits	33.09%	33.71%	31.83%	32.82%	38.65%	36.47%	33.06%	33.83%

Source: Call Reports filed by First Lowndes.

Figure 4 below shows that First Lowndes' non-core funding dependency ratio was consistently above the bank's peer group from year-end 2003 through 2009.

Figure 4: Non-Core Funding Dependency Ratio from 2003 through 2009



Source: UBPRs for First Lowndes.

First Lowndes opened a branch in Greenville, Alabama in 2003. Consistent with the other branch locations, the deposits originated from this branch included large high-cost, non-retail deposits, which are considered non-core funds. Table 5 shows the steady decline in the bank's reported NIM, using the as-of dates for examinations from 2002 to 2009.

Table 5: Trends in First Lowndes' Net Interest Margin

Financial Measure	6/30/09	6/30/08	6/30/07	6/30/06	3/31/05	3/31/04	3/31/03	3/31/02
First Lowndes	2.92%	3.33%	3.80%	4.33%	4.79%	5.37%	5.20%	5.69%
Peer Group	3.79%	3.98%	4.25%	4.26%	4.25%	4.26%	4.42%	4.44%

Source: Examination reports for First Lowndes.

According to DSC, First Lowndes did not have an imminent liquidity crisis at the time it was closed in the first quarter of 2010. However, the bank did have $47.4 million in certificate of deposit accounts, maturing at varying times in 2010, that may have been difficult for the bank to renew given the bank's weakened financial condition. If a significant amount of these deposits could not be renewed when they matured, the bank may have had a liquidity crisis later in 2010.

The FDIC's Supervision of First Lowndes

The FDIC, in coordination with ASBD, provided ongoing supervisory oversight of First Lowndes. Through their supervisory efforts, the regulators identified key risks in the bank's operations and made recommendations to improve risk management practices and address areas of concern. The bank's Board and senior management responses to these criticisms and related recommendations repeatedly fell short and ultimately the financial condition of the bank became critically deficient.

Given the examination findings and First Lowndes' increasing risk profile, a more critical assessment and stronger supervisory tenor at earlier examinations may have been prudent. In this regard, a more stringent supervisory response and related action to address the weak risk management practices identified during the August 2005 and earlier examinations may have been prudent. Earlier supervisory intervention may have better positioned First Lowndes to work through the loan deterioration that developed as its real estate markets deteriorated, mitigating, to some extent, the financial problems experienced by the bank.

Supervisory History

The following table summarizes the supervisory history of First Lowndes, including the CAMELS ratings assigned and regulatory action taken as a result of the examinations performed from 2002 to 2009.

Table 6: Examination History of First Lowndes from 2002 to 2009

Examination Start Date	Regulator	CAMELS Ratings	Informal or Formal Action Taken*
10/5/2009	FDIC/ASBD	555555/5	C&D dated March 7, 2008
10/14/2008	FDIC/ASBD	343433/3	C&D dated March 7, 2008
9/10/2007	FDIC/ASBD	344433/4	C&D dated March 7, 2008
8/28/2006	FDIC/ASBD	223222/2	Compliance MOU dated January 4, 2007
8/1/2005	FDIC/ASBD	223232/2	None
7/6/2004	FDIC	223232/2	IT BBR dated September 22, 2004 and BSA MOU dated December 7, 2004
6/30/2003	ASBD	223222/2	None
6/10/2002	FDIC	223222/2	None

Source: Examination reports for First Lowndes.

* Regulatory actions include Cease and Desist orders (C&D), memoranda of understanding (MOU), and bank board resolutions (BBR), which are defined in Appendix 2, Glossary of Terms. Regulatory actions pursued in 2004 include a BBR for information technology (IT) weaknesses and an MOU for Bank Secrecy Act (BSA) weaknesses. The MOU in 2007 addressed weaknesses in First Lowndes' system for ensuring compliance with consumer protection laws and regulations.

Supervisory Response Related to Key Risks

The FDIC and ASBD identified the key risks and made recommendations to management to address the weaknesses in First Lowndes' operations and risk management functions. The FDIC also pursued regulatory actions against the bank in 2004 and 2007 to address IT, BSA, and compliance management issues. With respect to risk management, the FDIC could have pursued earlier and more stringent regulatory action against the bank when management and the Board failed to implement appropriate corrective actions to address weaknesses identified by the examiners. These weaknesses were first identified as early as the 2003 examination, but the FDIC did not take enforcement action against the bank to address these issues until more than 4 years later, when the FDIC and ASBD jointly issued a C&D on March 7, 2008.

More detailed information on the FDIC's supervisory activities is presented below.

Supervisory Activities from 2002 through 2006

Examiners consistently identified weaknesses in the bank's underwriting and credit administration policies and procedures, risk management functions, and in other key areas or functions of the bank, such as the annual budgeting process, BSA compliance, and IT security controls. Many of these criticisms were repeated in consecutive examinations because management failed to take appropriate corrective action.

Some of the specific examination criticisms from the 2006 examination included:

- the methodology used to calculate the ALLL was deficient,
- the credit presentations prepared by the bank were not always complete,
- the bank's internal risk rating system and risk identification procedures were inadequate,
- the level of documentation exceptions (involving 27 percent of loans reviewed) was considered to be relatively high, and
- the bank's investment policy and loan policy did not include concentration limits.

<u>2007 Supervisory Activities</u>

According to the 2007 examination report, "The overall condition of the Bank has deteriorated significantly since the last examination and is considered unsatisfactory. Management oversight is ineffective and significant work is required to return the Bank to a satisfactory condition." The 2002 strategic initiative, using non-core funding to expand into out-of-area credit markets on the Gulf Coast, approximately 100 miles from the bank's core business operations, was identified as a high-risk activity.

The volume of adversely classified assets rose from $4.4 million at the 2006 examination to $11.0 million at this examination, an increase of 150 percent. The decline in the bank's asset quality was attributed to the bank having liberal lending practices and the deterioration of the financial condition of certain borrowers. Asset classifications totaled 88 percent of the bank's Tier 1 Risk Based Capital and the ALLL. The internal loan grading system was deemed ineffective, as was the methodology used to calculate an adequate ALLL level.

During this examination, regulators noted several apparent violations of laws and regulations, including violations relating to loans in excess of the bank's legal lending limit, issues regarding the calculation and reporting of the bank's legal lending limit, inappropriate extensions of credit to executive officers, and appraisal concerns.

2008 Supervisory Activities

The FDIC and ASBD jointly issued a C&D in March 2008 to address weaknesses identified in the 2007 examination. The C&D provisions addressed asset quality, lending policies, and internal loan review procedures and policies. The C&D also required the bank to prepare a management assessment report. Based on the completed assessment report, the Board replaced the president with an experienced banker who was appointed to the position of CEO. In this capacity, the CEO had overall responsibility for managing and supervising the bank and its staff, including the bank's lending function. The CEO reported directly to the Board. The president was relieved of all lending and management responsibilities, although he was allowed to stay on as an employee.

The October 2008 examination identified some improvement in the area of credit administration, but examiners concluded that new management had not been provided sufficient time to fully address the problems from previous examinations. The bank's new CEO brought in a new Vice President/Credit Administration Officer. The *Management* component and the composite ratings were elevated from a "4" to a "3" based on bank management's actions to improve previous asset classifications and overall bank operations. However, the amount of classified loans increased from $11.0 million to $16.4 million, or 13.6 percent of total loans outstanding, and 138.4 percent of the bank's total equity capital.

Some positive items were noted despite the increase in classified loans. For example, examiners noted that all criticized assets at this point were the result of prior management's unacceptable loan underwriting and administration practices, as well as the deteriorating economic conditions. There were no adversely classified assets underwritten by new management. Furthermore, management had made substantial progress in reducing previously criticized loans.

The examination report also stated that the classified loans were concentrated in a relatively small number of credits. Specifically, $9.6 million or 58.5 percent of the total classified loans were originated with only five borrowers.

One cause for concern was the rising level of loan classifications. Like the 2007 examination, a large percentage of the 2008 examination classifications were identified by the examination team, not by the bank. In addition, the examiners pointed out that the bank's internal auditor had issued several reports that contained repeat criticisms and the Board and the audit committee did not appear to take any action to address them. Additionally, examiners expressed concern regarding whether the bank would be able to renew brokered deposits and large non-retail certificates of deposit accounts when they matured.

2009 Supervisory Activities

The 2009 examination report assigned a “5” to each component and the composite rating. Examiners found that the bank was not in compliance with 15 provisions of the C&D issued in 2008. Asset quality was considered critically deficient. Classified loans totaled $33.0 million, or 28.2 percent of total loans outstanding. In September 2009, the bank charged off $7.2 million of impaired loans in accordance with FAS 114.[5] Additionally, examiners recommended that the bank make another $650,000 provision to the ALLL because the bank’s ALLL methodology was not in compliance with generally accepted accounting principles.

The 2009 examination report also noted that although loan underwriting and administration problems could be traced to former officers of the bank, the Board and management were responsible for approving lending activities. Further, examiners found numerous operational and lending deficiencies and lowered the *Management* rating to a “5”. The bank also received a “5” rating for *Sensitivity to Market Risk* and for *Liquidity*, because of the concern that the bank would likely not be able to retain deposits when they matured, especially large certificate of deposit accounts or brokered deposits, because of the bank’s poor financial condition.

Offsite Monitoring

In addition to onsite examinations, the FDIC has an offsite monitoring program that generally consists of periodic contact with bank management to discuss current or emerging issues, and the use of various offsite monitoring tools, including the Offsite Review List (ORL), to monitor institutions between examinations.

The *Case Manager Procedures Manual* states that the “offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately.” The FDIC generates a quarterly ORL, listing institutions that meet criteria based on three risk measurements:

- The Statistical CAMELS Offsite Rating (SCOR) model uses statistical techniques to measure the likelihood that an institution will receive a ratings downgrade at the next examination.

- SCOR-Lag, a derivation of SCOR, attempts to more accurately assess the financial condition of rapidly growing banks.

[5] FAS 114 addresses accounting by creditors for the impairment of certain loans. It requires that certain impaired loans be measured at the present value of expected future cash flows discounted at the loan’s effective interest rate or at the loan’s observable market price, or the fair value of the collateral if the loan is collateral dependent.

- The Growth Monitoring System (GMS) identifies institutions experiencing rapid growth and/or with a funding structure highly dependent on non-core funding sources.

The ORL consists of institutions with a composite CAMELS rating of 1 or 2 that have been identified by SCOR or SCOR-Lag as having a 35 percent or higher probability of being downgraded to a 3 rating or worse at the next examination, or have been flagged by GMS as being in the 98th or higher growth percentile. Offsite reviews must be completed and approved within 3½ months after each Call Report date.[6]

Three offsite reviews were conducted for First Lowndes as summarized in Table 7.

Table 7: First Lowndes' Offsite Monitoring History

Call Report Date	Completed Date	Level of Risk	Risk Trend	Follow-up
12/31/02	4/8/03	Medium	Increasing	None
12/31/03	4/12/04	Medium	Increasing	Continued monitoring
9/30/09	1/8/10	High	Increasing	None

Source: Offsite review data obtained from FDIC offsite review reports printed from DSC's supervisory information system.

The offsite review completed on April 8, 2003, under "recommendations/corrective action," stated that due to the "3" *Management* rating, First Lowndes was on an annual examination program and, pending the results of the 2003 ASBD examination, no other onsite or offsite FDIC activities were recommended. The offsite review completed on April 12, 2004 also stated under "recommendations/corrective action" that due to the "3" *Management* rating, the bank was on an annual examination program. The bank did not appear on the ORL from 2004 through the 3rd quarter of 2009 due in part to bank management not recognizing loan problems in a timely manner. The January 8, 2010 review stated that the bank was scheduled to fail soon and was being monitored daily by its case manager for liquidity purposes.

The offsite reviews for the bank were conducted in accordance with policy; however, they did not result in any material change to the supervisory approach to the institution.

Implementation of 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 implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered, nonmember banks that are not *Adequately Capitalized*. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e) of the FDI

[6] The FDIC also utilizes other offsite monitoring tools in addition to the ORL.

Act, and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Table 8 shows the bank's capital ratios as of December 31, 2005 through 2008 and at various points during 2009.

Table 8: First Lowndes' Capital Ratios and PCA Categories

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
12/31/05	7.13%	9.53%	10.80%	Well Capitalized
12/31/06	7.39%	10.32%	11.58%	Well Capitalized
12/31/07	6.96%	9.72%	10.98%	Well Capitalized
12/31/08	7.04%	9.37%	10.64%	Well Capitalized
3/31/09	7.11%	9.63%	10.90%	Well Capitalized
6/30/09	7.15%	9.65%	10.92%	Well Capitalized
9/30/09	2.32%	3.30%	4.58%	Significantly Undercapitalized
11/4/09	1.80%	N/A	N/A	Critically Undercapitalized

Source: Call Reports filed by First Lowndes with the FDIC and 2009 Examination Report.

As of June 30, 2009, First Lowndes was considered *Well Capitalized* for PCA purposes. During the 3rd quarter of 2009, the bank made a $7.8 million provision to the ALLL. As a result of the provision, the bank became *Significantly Undercapitalized* under PCA.

Based on the supervisory actions taken with respect to First Lowndes, we determined that the FDIC properly implemented applicable PCA provisions of section 38 as follows:

- Although First Lowndes was *Significantly Undercapitalized* for PCA purposes based on its September 30, 2009 Call Report, that data was in the process of being reported and processed when the 2009 examination found the bank to be *Critically Undercapitalized*.

- On November 13, 2009, the FDIC sent First Lowndes' Board a PCA notification by certified letter. The letter stated that the bank was *Critically Undercapitalized* as of November 4, 2009, based on the 2009 examination findings. In accordance with PCA provisions, the FDIC required First Lowndes to file a written capital restoration plan and notified the bank of other restrictions in place under PCA.

- The capital restoration plan was submitted by the bank to the FDIC on November 23, 2009. This plan outlined steps First Lowndes would take to become *Adequately Capitalized*. The Board determined that it would be necessary to sell all or a majority of the outstanding stock of the holding company to an investor or group of investors. None of the bank's existing shareholders, employees, or Board members would be injecting any additional capital.

> According to the plan, the bank would need to have raised at least $7.25 million in additional capital by January 30, 2010.

Ultimately, First Lowndes was unable to find a suitable acquirer or otherwise raise sufficient capital to support its continued operation and correct its then-*Critically Undercapitalized* position. On March 19, 2010, First Lowndes was closed by the ASBD and the FDIC was named as the receiver for the institution.

Lessons Learned

Based on our review, too much reliance may have been placed on First Lowndes being *Well Capitalized* for PCA purposes and operating at a profit to compensate for the apparent deficiencies in the bank's risk management practices. In light of the examination findings and First Lowndes' increasing risk profile, a more critical assessment and stronger supervisory tenor at earlier examinations may have been prudent. In hindsight, the FDIC may have benefited from pursuing supervisory action as early as 2005, when the bank had repeatedly failed to take corrective action to address criticisms and recommendations made by examiners for the bank to adopt and implement appropriate risk management policies and procedures to address the increased risks the bank was undertaking. Such action may have compelled the bank to (1) bring in new management earlier than 2008 and (2) implement effective internal audit and risk management programs earlier than 2006.

In addition, upgrading the *Management* and composite ratings from a "4" to a "3" at the 2008 examination may not have been warranted, considering that the dollar amount of classified assets actually increased during this examination compared to the prior examination, the bank was continuing to report net losses in its earnings statement, and management and the Board had not fully implemented the corrective actions to address the deficiencies noted in previous examinations.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008 the FDIC reiterated broad supervisory expectations with regard to managing risk associated with ADC and CRE loan concentrations. Further, the FDIC has completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addresses the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

Corporation and ASBD Comments

After we issued our draft report, DSC management officials provided informal comments for our consideration and we revised our report as appropriate. On February 7, 2011, the

Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

In DSC's response, the Director provided the division's views on the causes of First Lowndes' failure and the regulators' supervision of the bank. The response also stated that DSC issued a FIL in 2008 entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, which re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. DSC also pointed out that it had issued a FIL in 2009 entitled *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance the supervision of institutions that rely on volatile non-core funding.

ASBD also provided a written response. ASBD largely agreed with our findings and added that credit administration and underwriting were so poor at First Lowndes that the loans made in the bank's rural trade area would, by themselves, have led to extreme difficulties and possible failure of the bank. In addition, they cited the following lessons learned:

- For banks rated composite 2, regulators were reluctant to require that examiner concerns be addressed, but banks should not be allowed to ignore examiner concerns and recommendations no matter how determined bank management is to do so.

- Regardless of a bank's composite rating, serious repeat criticisms should be addressed with increasingly severe enforcement actions that include limits on growth.

Objectives, Scope, and Methodology

Objectives

This performance audit was conducted to satisfy the requirements of section 38(k) of the FDI Act, as amended by the Financial Reform Act, which was signed into law on July 21, 2010. The Financial Reform Act amended section 38(k) of the FDI Act by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Further, the Financial Reform Act includes provisions that call for the OIG to perform an in-depth review of failures when losses are not material but they involve unusual circumstances. In-depth reviews are required to be performed and reported in a manner consistent with that of an MLR.

At the time the Financial Reform Act was enacted, fieldwork was substantially completed. Although the estimated loss for First Lowndes no longer met the threshold requiring an MLR, the OIG decided to complete the audit and issue this report as an in-depth review. In preparing this report, we relied extensively on work performed by Clifton Gunderson LLP, an independent contractor engaged by the OIG.

Consistent with the Financial Reform Act and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of First Lowndes' failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

This performance audit was conducted from June 2010 to December 2010 in accordance with GAGAS. Those standards require that the audit be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

Scope and Methodology

The scope of this audit included an analysis of First Lowndes' operations from 2002 until its failure on March 19, 2010. The review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, Clifton Gunderson performed the following procedures and techniques:

- Analyzed examination reports prepared by the FDIC and ASBD examiners from 2002 to 2009.

- Reviewed the following:

Objectives, Scope, and Methodology

- Bank data and correspondence maintained on FDIC databases.

- Reports prepared by the Division of Resolutions and Receiverships (DRR) and Division of Supervision and Consumer Protection (DSC) relating to First Lowndes' closure. Clifton Gunderson also reviewed selected failed bank records maintained by DRR in Jacksonville, Florida for information that would provide insight into First Lowndes' failure.

- Audit reports prepared by First Lowndes' internal and external audit firms.

- Pertinent DSC policies and procedures and various banking laws and regulations.

o Interviewed the following FDIC officials:

- Two FDIC Case Managers from the Atlanta Regional Office and one Case Manager from the Chicago Regional Office.

- Two FDIC examiners from the Atlanta Regional Office who participated in examinations or reviews of examinations of First Lowndes.

o Interviewed two officials from the ASBD to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of First Lowndes.

In addition to overseeing the work performed by Clifton Gunderson, the OIG performed other steps deemed necessary in preparing the audit report, which included conducting a comprehensive review of the firm's audit workpapers.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand First Lowndes' management controls pertaining to the causes of failure and loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

Objectives, Scope, and Methodology

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 in-depth 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 is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

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

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. In December 2010, the OIG completed an audit, the objectives of which were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs. That report, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), and additional reports related to the failures of FDIC-supervised institutions, can be found at www.fdicig.gov.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and providing interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Bank Secrecy Act (BSA)	Congress enacted the BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file certain reports, including cash transactions over $10,000, via the Currency Transactions Reports (CTR). These reports are used in criminal, tax, or regulatory investigations or proceedings.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

Glossary of Terms

Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
The FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's 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.
Federal Home Loan Bank (FHLB) Advances	FHLBs provide long-and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Non-Core Funding Sources	Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Glossary of Terms

Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Receiver	When a bank fails the FDIC may be appointed receiver. The receiver will then sell the institution's assets to pay depositors and creditors.
Risk-based Capital Rules	Appendix A to Part 325—*Statement of Policy on Risk-Based Capital*— defines the FDIC's risk-based capital rules. Appendix A states an institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution's qualifying total capital base is the numerator of the ratio.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the 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.

Glossary of Terms

Uniform Financial Institutions Rating System (UFIRS)	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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CEO	Chief Executive Officer
CRE	Commercial Real Estate
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
MOU	Memorandum of Understanding
OIG	Office of Inspector General
ORL	Offsite Review List
PCA	Prompt Corrective Action
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

February 7, 2011

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, In-Depth Review of First Lowndes Bank Fort Deposit, Alabama (Assignment 2010-047)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted an In-Depth Review of First Lowndes Bank (First Lowndes), which failed on March 19, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received on January 7, 2011.

First Lowndes failed due to the Board and management's weak oversight of the commercial real estate (CRE) loan portfolio. Management failed to implement effective risk management practices and strong credit administration and loan underwriting practices commensurate with the portfolio's risk. Further, management expanded its CRE lending growth strategy into the Gulf Coast region, a new out-of-territory market to First Lowndes. This growth was fueled by volatile funding sources that negatively impacted earnings. When market conditions began to decline, capital levels were insufficient to absorb losses and efforts to recapitalize were unsuccessful.

From 2005 through 2009, the FDIC and the Alabama Banking Department conducted five onsite examinations, two visitations and off-site reviews. In 2006, examiners recommended management improve oversight of its credit administration practices, correct deficiencies and ensure that effective policies and procedures were adopted. The 2007 examination noted that First Lowndes' overall condition had significantly deteriorated since the previous examination and resulted in a Cease and Desist Order. First Lowndes made some improvements in credit administration practices in 2008, but by 2009 asset quality had deteriorated. Earnings performance could not support operations and First Lowndes could not maintain adequate capital levels to sustain their losses.

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DSC issued a Financial Institution Letter (FIL) to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. Additionally, DSC issued a FIL in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance the supervision of institutions that rely on volatile non-core funding.

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