

Office of Inspector General



Office of Material Loss Reviews
Report No. MLR-10-046

**Material Loss Review of Community
Bank & Trust, Cornelia, Georgia**

September 2010



Why We Did The Audit

The FDIC Office of Inspector General (OIG) contracted with Crowe Horwath LLP to conduct a material loss review of Community Bank & Trust (CBT), Cornelia, Georgia.

On January 29, 2010, the Georgia Department of Banking and Finance (DBF) closed CBT and named the FDIC as receiver. On March 1, 2010, the FDIC notified the OIG that CBT's total assets at closing were \$1.2 billion and the estimated loss to the Deposit Insurance Fund (DIF) was \$345.4 million. As of August 6, 2010, the estimated loss had declined to \$336.1 million. As required by section 38(k) of the Federal Deposit Insurance Act, and as amended by Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of CBT and retained Crowe Horwath for this purpose.

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

CBT was a state nonmember bank that opened in 1900 and became insured in 1934. CBT's operations were located in northeast Georgia, with a main office in Cornelia, Habersham County, and 36 branches throughout the region. CBT also operated a trust department and printing shop and fully owned two subsidiaries, Financial Supermarkets, Inc. and Financial Properties, Inc. All shares of CBT were owned by its holding company, Community Bankshares, Inc., Cornelia, Georgia, which also owned community banks in LaGrange, Georgia and Union Springs, Alabama.

CBT was a traditional community bank and its lending was concentrated in commercial real estate (CRE) lending, including acquisition, development, and construction (ADC) loans. The bank's CRE and ADC concentrations primarily related to financing speculative residential construction and some residential loans made to rehabilitate depressed properties.

Audit Results

Causes of Failure and Material Loss

CBT's failure can be attributed to inadequate oversight by the Board of Directors (Board) and management. In particular, the bank's control environment was not commensurate with the risk associated with increasing concentrations in CRE and ADC loans. CBT was also negatively impacted by the Board and management relying too heavily for an extended period of time on a senior official's expertise and authority rather than establishing sound practices and controls. The Board and management were also slow to respond to examiner recommendations and supervisory actions and did not implement sound risk management practices, particularly related to loan underwriting and credit administration

activities. Finally, CBT lacked adequate controls over lending operations, which likely contributed to inappropriate lending activities that were associated with substantial losses.

The FDIC's Supervision of CBT

Through its supervisory efforts, the FDIC identified and documented key risks and deficiencies at the bank, including CBT's weak Board and management oversight and inadequate risk management practices. From 2006 to 2009, the FDIC and the DBF conducted four safety and soundness examinations and one visitation of CBT.

In 2006 and 2007, examiners assigned CBT a composite rating of "2", indicating that they considered the institution to be fundamentally sound and there were no material supervisory concerns. The impact of poor Board and management oversight, coupled with weaknesses in risk management practices, was more fully exposed at the October 2008 examination when the economy had weakened, and the bank received a composite rating of "4". However, by the time the FDIC had downgraded the risk management rating and issued a Cease and Desist Order in early 2009, these actions and the bank's responses were insufficient to prevent continued significant losses and the rapid erosion of capital, which led to the eventual insolvency of the institution. Given CBT's increasing level of risk, earlier and greater emphasis on these aspects of the bank's operations may have been prudent.

Based on the supervisory actions taken with respect to CBT, the FDIC properly implemented the applicable PCA provisions of section 38.

Management Response

After we issued our draft report, management officials provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On August 25, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of CBT's failure and the FDIC's supervision of the bank. Additionally, DSC stated that it recognizes the threat that institutions with high-risk profiles, such as CBT, pose to the DIF. According to DSC, it continues to look for and implement improvements to its supervisory program that focus on stabilizing an institution's risk profile and strengthening its financial condition. DSC issued *Interagency Guidance on CRE Monitoring* in 2006 and a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* in 2008 that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.



DATE: September 1, 2010

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

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

SUBJECT: *Material Loss Review of Community Bank & Trust,
Cornelia, Georgia (Report No. MLR-10-046)*

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. The report did not contain recommendations, thus a response was not required. However, the Division of Supervision and Consumer Protection provided a written response on August 25, 2010. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mike Lombardi, Audit Manager, at (703) 562-6328. We appreciate the courtesies extended to the audit staff.

Attachment

cc: Thomas J. Dujenski, Regional Director, DSC
Elaine D. Drapeau, Acting Chief, Office of Internal Control and Review, DSC
James H. Angel, Jr., Director, OERM

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Part I

Report by Crowe Horwath LLP

**Material Loss Review
Community Bank & Trust
Cornelia, GA**

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

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August 31, 2010

EXECUTIVE SUMMARY

Stephen M. Beard
Assistant Inspector General for Material Loss Reviews
Federal Deposit Insurance Corporation
3501 North Fairfax Drive
Arlington, VA 22226

**RE: Transmittal of Results for the Material Loss Review Report for
Community Bank & Trust, Cornelia, Georgia**

Dear Mr. Beard:

This letter is to acknowledge delivery of our performance audit report on the results of the Material Loss Review for Community Bank & Trust (CBT), Cornelia, Georgia, in accordance with Task Order Number 0001 (10-04), dated April 5, 2010. The objectives of this performance audit were to (1) determine the causes of CBT's failure and the resulting material loss to the Deposit Insurance Fund and (2) evaluate the FDIC's supervision of CBT, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Causes of Failure

CBT's failure can be attributed to inadequate oversight by the Board of Directors (Board) and management. In particular, the bank's control environment was not commensurate with the risk associated with excessive concentrations in commercial real estate and acquisition, development, and construction loans. CBT was also negatively impacted by the Board and management relying too heavily for an extended period of time on a senior official's expertise and authority rather than establishing sound practices and controls. The Board and management were also slow to respond to examiner recommendations and supervisory actions and did not implement sound risk management practices, particularly related to loan underwriting and credit administration activities. Finally, CBT lacked adequate controls over lending operations, which likely contributed to inappropriate lending activities that were associated with substantial losses.

Evaluation of Supervision

Through its supervisory efforts, the FDIC identified and documented key risks and deficiencies at the bank, including CBT's weak Board and management oversight and inadequate risk management practices. From 2006 to 2009, the FDIC and the State of Georgia Department of Banking and Finance conducted four safety and soundness examinations and one visitation of CBT.

In 2006 and 2007, examiners assigned CBT a composite rating of "2", indicating that they considered the institution to be fundamentally sound and there were no material supervisory concerns. However, the impact of poor Board and management oversight, coupled with weaknesses in risk management practices, was more fully exposed at the October 2008 examination, when the economy had weakened. Given CBT's increasing level of risk, earlier and greater emphasis on these aspects of the bank's operations may have been prudent.

Prompt Corrective Action

Based on the supervisory actions taken with respect to CBT, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the performance audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Consistent with our contract with the Office of Inspector General (OIG), the report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in the OIG's material loss reviews, the OIG will communicate those to FDIC management for its consideration. As resources allow, the OIG may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted. A further discussion of OIG-related coverage of financial institution failures can be found in the Objectives, Scope, and Methodology section of our report.

The information included in this draft report was obtained during our fieldwork, which occurred during the period from May 2010 through July 2010.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Crow Horvath" followed by a stylized flourish.

Background

On January 29, 2010, the Georgia Department of Banking and Finance (DBF) closed Community Bank & Trust (CBT) and named the FDIC as receiver. The FDIC notified the Office of Inspector General (OIG) on March 1, 2010 that CBT's total assets at closing were \$1.2 billion and the estimated loss to the Deposit Insurance Fund (DIF) was \$345.4 million. The estimated loss exceeds the \$200 million threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), signed into law July 21, 2010. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act, as amended by the Financial Reform Act, to conduct a material loss review of the failure of CBT, and retained Crowe Horwath LLP for this purpose.¹

CBT was a state nonmember bank that opened in 1900 and became insured in 1934. CBT's operations were located in northeast Georgia, with a main office in Cornelia, Habersham County, and 36 branches throughout the region. CBT also operated a trust department and printing shop and fully owned two subsidiaries, Financial Supermarkets, Inc. and Financial Properties, Inc. All shares of CBT were owned by its holding company, Community Bankshares, Inc., Cornelia, Georgia, which also owned community banks in LaGrange, Georgia and Union Springs, Alabama.

CBT was a traditional community bank and its lending was concentrated in commercial real estate (CRE) lending, including acquisition, development, and construction (ADC) loans.

Table 1 provides details on CBT's financial condition as of September 2009, and for the 4 preceding calendar years.

Table 1: Financial Information for CBT

Financial Measure	Sep-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets (\$000s)	1,211,027	1,276,651	1,103,355	921,960	780,257
Total Loans (\$000s)	901,864	992,432	853,474	700,906	598,912
Loan Growth	-9.13%	16.28%	21.77%	18.16%	11.38%
Total Deposits (\$000s)	1,099,308	1,039,356	963,405	785,306	652,989
Net Income (Loss) (\$000s)	(64,484)	(6,313)	10,710	11,478	12,457

Source: Uniform Bank Performance Reports (UBPR).

¹ In conducting this performance audit and preparing this report, Crowe Horwath LLP relied primarily on information provided by the FDIC OIG and Division of Supervision and Consumer Protection (DSC). Appendix 1, Objectives, Scope, and Methodology, describes in greater detail the procedures used by Crowe Horwath LLP.

Causes of Failure and Material Loss

CBT's failure can be attributed to inadequate oversight by the Board and management. In particular, the bank's control environment was not commensurate with the risk associated with increasing concentrations in CRE and ADC loans. CBT was also negatively impacted by the Board and management relying too heavily for an extended period of time on CBT's former Chief Executive Officer's (CEO) expertise and authority rather than establishing sound practices and controls. The Board and management were also slow to respond to examiner recommendations and supervisory actions and did not implement sound risk management practices, particularly related to loan underwriting and credit administration activities. Finally, CBT lacked adequate controls over lending operations, which likely contributed to inappropriate lending activities that were associated with substantial losses.

Board and Management Oversight

CBT's reliance on a former CEO's expertise and authority and later changes in senior management impacted the institution's ability to respond to changing economic conditions and examiner recommendations and contributed to inadequate risk management practices and noncompliance with loan policies.

Changes in Senior Management

CBT's CEO and President exerted primary control over the bank's loan underwriting and credit administration functions for more than 20 years. After his death in 2005, it became apparent that the bank lacked management depth and an effective succession plan, as the Board and management were unable to demonstrate sound management practices and effective internal controls over lending activities.

Our discussions with FDIC examiners revealed that CBT's Board and management had relied on this individual's expertise to make proper decisions for the bank and to deal with any issues that arose. Examiners also indicated that although this individual had the requisite experience and knowledge to lead the bank, other members of management and the Board lacked good leadership and decision-making skills. Further, this reliance apparently led to the bank not sufficiently establishing adequate policies and procedures for governance purposes. For example, the June 2006 Report of Examination (ROE)² noted that CBT had weak mechanisms for monitoring ADC loans, loan renewals were not adequately tracked, and credit approval memoranda were not updated. These types of issues persisted until the bank was closed in January 2010.

² Unless otherwise noted in this report, references to examination dates will refer to the month and year of the examination start dates.

Numerous changes in the bank's senior leadership also occurred from 2006 through CBT's closing. For example:

- In November 2006, the individual who replaced the former CEO and President resigned after holding office for just 1 year.
- A newly elected CEO and President ran the bank until June 2009.
- In June 2009, a new individual was elected as CEO for the bank.
- In July 2009, the Senior Lending Officer resigned.
- In September 2009, the Chief Financial Officer resigned.

Along with other factors, the changes in senior leadership during a period of rapid decline in the economic conditions in the bank's market area likely contributed to examiners stating in the 2008 and 2009 examination and visitation reports that, among other things:

- Board and senior management oversight was deficient;
- Board and management had not complied with numerous provisions contained in a May 2009 Cease and Desist Order (C&D); and
- Board and management did not establish proper risk management practices, effective internal controls, and adequate reporting and monitoring procedures.

Finally, the May 2009 C&D indicated that the bank was operating with less than satisfactory management and Board oversight whose policies and procedures and strategic plan were damaging to the bank and jeopardized its safety and soundness.

Implementation of Examiner Recommendations

CBT's Board and management were slow to respond to examiners' concerns and implement their recommendations. Examiners identified various weaknesses with CBT's loan underwriting and credit administration beginning in 2004, with additional comments and recommendations made to bank management during the 2006 and 2007 examinations. Examiners elevated their concerns and reported continued significant problems in loan underwriting and credit administration during the October 2008 examination and noted that CBT's Board and management had not implemented corrective actions timely. Significant weaknesses identified during the 2004 through 2007 examinations were also evident in the October 2008 examination and included:

- Insufficient borrower financial and cash flow analyses.
- Insufficient appraisal review processes.
- Inadequate monitoring of construction lending.
- Inadequate management tracking systems.
- Inaccurate management reporting systems.

These continued deficiencies and failure to fully respond to examiner recommendations resulted in the issuance of the May 2009 C&D referenced earlier.

Lack of Adequate Lending Controls

For the period covered by our review (2006-2010), the Board and senior management had decentralized the lending function and appointed division presidents to manage all banking operations at branches within their designated counties. The division presidents had lending authority and were authorized to originate loans, as well as manage their own portfolios. Some divisions with larger portfolios and increased activity had multiple lenders. This structure appeared to promote a lack of standard practices, particularly with regard to monitoring construction lending. In addition, compliance with the loan policy was not effectively monitored and approval authorities were not always followed.

The lack of adequate internal controls likely contributed to a former senior lending officer being able to (1) make loans that were inconsistent with prudent lending practices and which resulted in benefits to certain customers of the bank; (2) fund advances and assign loans to other lending officers; and (3) grant a \$500,000 letter of credit to a customer without proper approval and conceal this letter of credit by not recording it on the letter of credit ledger. Additionally, these actions apparently violated provision 6.b of the May 2009 C&D which prohibited CBT from extending, directly or indirectly, any additional credit to, or for the benefit of, any borrower who had a loan or other extension of credit from CBT that had an uncollected balance and was classified substandard. Loan losses associated with this particular senior lender's portfolio were estimated by the bank and the FDIC at no less than \$10 million. Additional instances of questionable lending activity involving other bank officers have been found since CBT was closed.

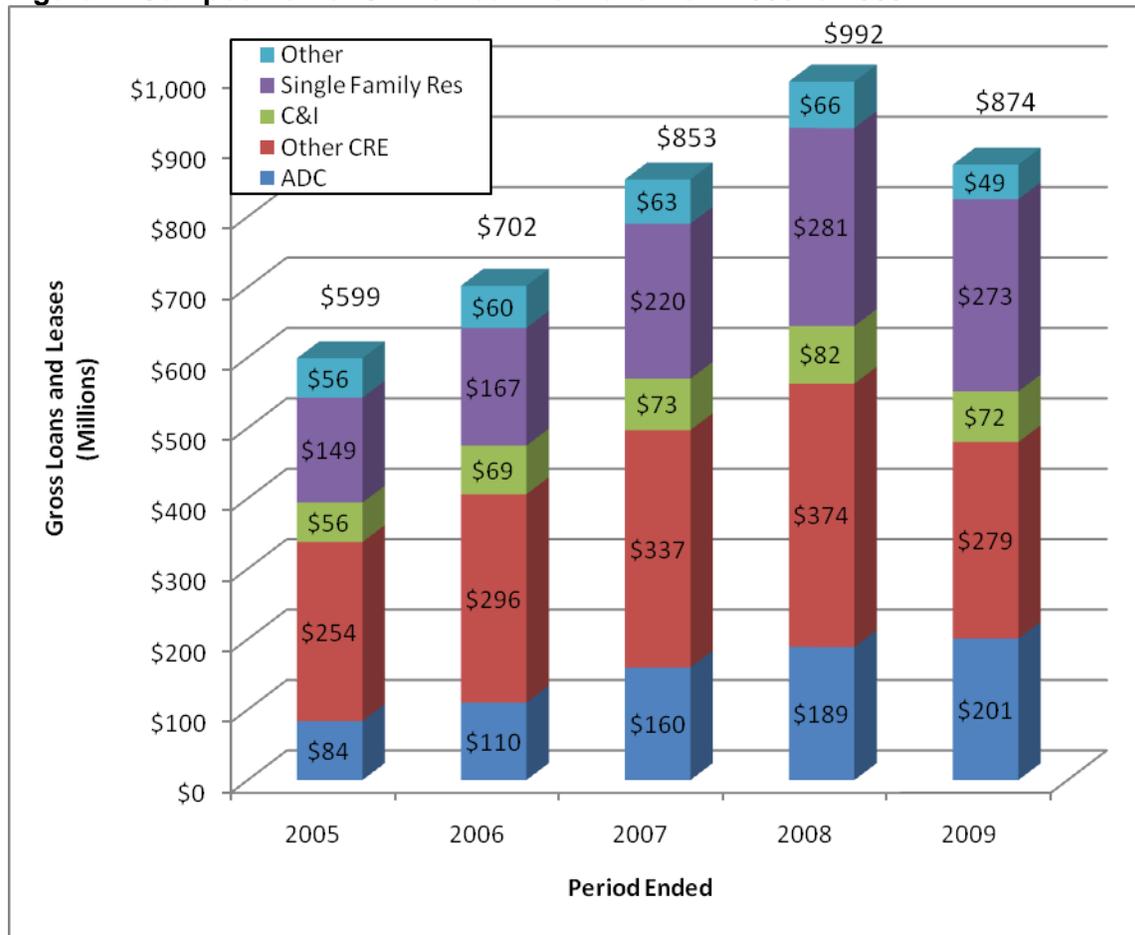
Further, the Board and management did not sufficiently monitor credit quality. As an example, during the October 2008 examination, examiners identified the need for an additional \$16 million to be allocated to the Allowance for Loan and Lease Losses (ALLL) as of September 30, 2008. In addition, the loan review function did not adequately identify issues with problem loans and management reports for loan monitoring were incomplete or inaccurate.

CRE and ADC Concentrations

Management pursued growth in CRE and ADC concentrations without recognizing and controlling risk to the bank if economic conditions deteriorated, which resulted in increasing loan losses. Additionally, CBT grew its CRE and ADC lending without proper loan underwriting and credit administration, as discussed in the next section of this report. The FDIC issued guidance in 1998 on ADC lending emphasizing that management’s ability to identify, measure, monitor, and control portfolio risk through effective underwriting policies, systems, and internal controls was crucial to a sound ADC lending program.³

CBT’s loan portfolio increased from approximately \$599 million at December 31, 2005 to \$992 million at December 31, 2008, with much of the growth centered in CRE and ADC lending. CRE and ADC lending grew from \$338 million at December 31, 2005 to \$563 million at December 31, 2008. Figure 1 shows the composition of CBT’s loan portfolio in the years leading to its failure.

Figure 1: Composition of CBT’s Loan Portfolio from 2005 to 2009



Source: UBPRs for CBT.

³Financial Institution Letter (FIL)-110-98, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, dated October 8, 1998.

At the time of the October 2008 examination, CRE loans represented 657 percent of total capital, including ADC loans that represented 328 percent of total capital. The bank's CRE and ADC concentrations primarily related to speculative residential construction loans and some residential loans made to rehabilitate depressed properties.

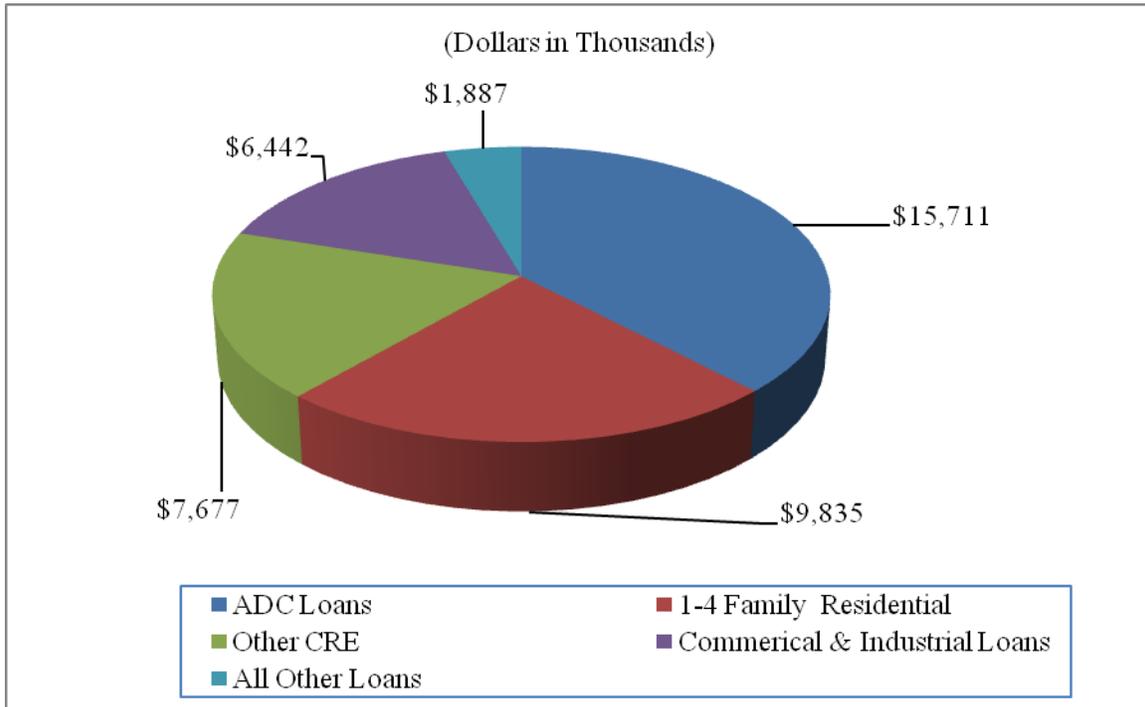
On December 12, 2006, the federal banking regulatory agencies issued *Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), to reinforce existing regulations and guidelines for real estate lending and safety and soundness.⁴ The Joint Guidance focuses on those CRE loans for which cash flow from real estate is the primary source of repayment (i.e., ADC lending). 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. CBT's CRE and ADC concentrations exceeded the levels identified in the Joint Guidance at the time the guidance was issued and continued to increase steadily thereafter.

As noted in CBT's October 2008 examination report, the declining real estate values in CBT's market area resulted in an increase in adversely classified ADC credits. Specifically, while ADC loans represented less than 20 percent of the total loan portfolio at December 31, 2008, these loans accounted for a disproportionate volume of loan losses, including 37.8 percent of charge-offs recorded in 2009. As shown in Figure 2, ADC loans charged off totaled over \$15 million during 2009.

⁴ The guidance (FIL-104-2006) was issued jointly 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 guidance).

Figure 2: CBT's Charge-off on Loans and Leases for the Year Ended December 31, 2009



Source: CBT Call Reports.

Risk Management Practices

FIL-22-2008 also recommended key risk management processes to help institutions with significant ADC and CRE concentrations manage through changes in market conditions. Many of the weaknesses in CBT's credit risk management practices identified in the October 2008 examination report can be associated with one or more of the key risk management processes discussed in this guidance. Those weaknesses included, but were not limited to:

- the failure to place loans on nonaccrual status and recognize problem loans in a timely manner;
- numerous instances in which accrued interest was capitalized into loan balances at renewals;
- insufficient financial and global cash flow analysis;
- insufficient monitoring of construction projects; and
- inadequate appraisal and appraisal review processes.

As the bank's exposure to risk increased commensurate with higher levels of CRE and ADC concentrations in a declining economy, these weaknesses, primarily involving loan underwriting and credit administration, contributed to the asset quality problems that developed and ultimately caused losses and eroded capital.

Loan Underwriting

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), the degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. Undue reliance should not be placed upon a property's appraised value in lieu of an adequate initial assessment of a debtor's repayment ability. CBT's Board and management failed to develop and follow prudent underwriting standards, particularly related to CRE and ADC lending. The October 2008 examination identified a number of issues related to loan underwriting, some of which had been identified in prior examinations.

Loan Underwriting Analysis and Documentation. During the October 2008 examination, examiners found that CBT's credit files generally lacked comprehensive loan underwriting analysis. Loan files, including renewed problem loans, lacked current financial information, adequate global cash flow analysis, and sufficient loan officer commentary to support appropriate credit underwriting decisions. Additional underwriting weaknesses included limited borrower equity and continued advancements of funds to problem borrowers without analysis or support for repayment.

Significant underwriting weaknesses were identified by examiners in the October 2008 examination related to a large mortgage originator, as 19 loans were foreclosed or in the process of being foreclosed and at least two borrowers alleged that they were not party to any loans or recipients of loan proceeds (potential defalcations). Additionally, the entire portfolio of loans referred by the originator and several other loans to related interests and principals of the originator were listed for Special Mention. Examples of underwriting weaknesses in the mortgage originator portfolio included loans with loan-to-value ratios in excess of policy limits, loans originated by a loan officer in excess of his authority without evidence of appropriate authorization, and renovation/construction inspections not on file.

Capitalization of Interest and Frequent Loan Renewals. At the October 2008 examination, numerous instances were identified in which accrued interest was capitalized and added to the loan balance, as part of the loan renewal process, so that principal and accrued interest were not due until the end of the new repayment period. Loan files lacked adequate support and documentation for capitalizing accrued interest. In some instances, the capitalization of interest was not appropriate due to the questionable ability of the borrower to repay the principal on the loan. At least \$2 million in capitalized interest was identified in the loans subject to adverse classification during the October 2008 examination.

Examiners also noted loans originated to provide funds to borrowers or their related interests to pay interest due on existing loans. Additionally, loans were frequently underwritten with a 1-year maturity. The October 2008 examination noted that 24 percent of total loans were underwritten with a single payment of principal and interest at maturity. These practices facilitated multiple loan renewals and masked problems with loans that were not amortizing or paying interest.

Credit Administration

Examiners expressed numerous concerns with the bank's credit administration practices during the October 2008 examination, including inadequate identification of adversely classified assets and nonaccrual loans and real estate appraisal processes that needed improvement.

Nonaccrual Loans. The October 2008 examination identified numerous loans that should have been placed on nonaccrual status prior to the examination. Some of these loans were instead renewed with interest and principal due at maturity. As a result, management overstated income by recognizing interest that most likely would not be collected. In addition, management failed to properly report the level of problem loans within its quarterly Call Report.

Real Estate Appraisals and Review Program. The October 2008 examination reported that CBT's program for obtaining appraisals needed improvement and the appraisal review process was ineffective. The examination identified numerous instances where management did not obtain current appraisals or evaluations of appraisals. In some cases, appraisals were insufficient to comply with regulatory standards. Additionally, examiners noted several loans originated in excess of supervisory loan-to-value limits not captured in management's reports or reported to the Board.

Other Criticisms Related to Credit Administration. Examiners also noted that construction loan practices were weak. There were instances where there were no loan files, no records of inspections, and/or loan information did not agree with inspection reports. There were also instances where information provided by loan officers was not consistent with the results of subsequent inspections of the properties. In addition, examiners noted that loan workout and collection practices needed to be strengthened.

The FDIC's Supervision of CBT

Our review focused on the FDIC's and the DBF's supervisory oversight of CBT from 2006 through 2010. Through its supervisory efforts, the FDIC identified and documented key risks and deficiencies at the bank, including CBT's weak Board and management oversight and risk management deficiencies. However, by the time the FDIC downgraded the CAMELS ratings and issued supervisory actions in early 2009, these

actions and the bank’s responses were insufficient to prevent continued significant losses and the rapid erosion of capital, which led to the eventual insolvency of the institution.

Supervisory History

Between 2006 and 2009, the FDIC and the DBF conducted four examinations and one visitation of CBT. In one case, the October 2008 examination, the FDIC initiated the review 3 months after the statutory examination frequency requirement.⁵ FDIC officials explained that there were a large number of institutions in distress during 2008 that required immediate attention and CBT was considered lower risk based on its prior examinations and offsite monitoring.

CBT was historically a well-rated institution until 2009. Based on the October 2008 FDIC examination, however, CBT was downgraded to a composite “4” rating in early 2009 and became subject to a C&D issued on May 1, 2009. A joint visitation was conducted in September 2009 to follow up on issues noted during the previous examination as well as assess compliance with the May 2009 C&D, and a joint examination was conducted in December 2009. Table 2 summarizes CBT’s examination history during its last 4 years.

Table 2: CBT’s Examination History from 2006 to 2009

Risk Management Activities					
Examination Date	12/22/2009	9/10/2009 (Visitation)	10/27/2008	5/29/2007	6/19/2006
Review Completed	N/A –Bank Closed	11/17/2009	2/26/2009	8/15/2007	7/24/2006
Supervisory Agency	Joint	Joint	FDIC	DBF	FDIC
UFIR	555555/5	555555/5	444432/4	222221/2	222221/2
Classifications/ T1+ALLL	546%	195%	111%	24%	32%
Enforcement Action	Bank was closed 1/29/2010	C&D dated 5/01/2009 still in effect.	C&D dated 5/01/2009	None	None

Sources: 2006 to 2008 ROEs; 2009 FDIC and State Visitation report; Supervisory History; and C&D dated May 1, 2009.

⁵ Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope examinations of every state nonmember bank at least once every 12-month period and allows for 18-month intervals for small institutions (total assets of less than \$500 million) if certain conditions are satisfied.

FDIC offsite monitoring systems also identified CBT for review based on the bank's Call Reports as of June 30, 2008, September 30, 2008, and December 31, 2008. However, each of these offsite reviews indicated that the concerns could be addressed at the October 2008 FDIC examination, which was either about to commence, in process, or recently completed at the time of these offsite reviews. Due to the processing times for Call Report data and the time period provided for review, the offsite review based on the June 30, 2008 Call Report data was completed October 13, 2008—2 weeks before the examination was scheduled to start.

Supervisory Response to Board and Management Oversight

Although examiners noted weaknesses in earlier examinations, the October 2008 examination was the first to emphasize that the Board and management had failed to establish an appropriate risk management program commensurate with the bank's risk profile, business activities, and concentrations of credit. The examination report further indicated that CBT's strategy to pursue loan growth, coupled with loan underwriting and credit administration weaknesses and poor supervision of lending activities, aggravated existing problems stemming from a depressed economy and real estate market.

Based on our interviews, examiners recognized the influence and importance of the prior dominant CEO and President. Examiners noted that, up to and including 2005, the bank did not have a succession plan and the passing of this individual in August 2005 left a leadership void. Although the June 2006 FDIC examination identified the lack of a succession plan, and examiners recommended that management develop one, CBT did not do so at any time prior to its closing. The June 2006 FDIC examination report noted that a management change had occurred due to the death of the previous CEO and President, but new management had made a successful transition. The May 2007 DBF examination report noted management was capable and well suited for the bank, although there had been another change to the CEO and President in November 2006. In fact, the Management component was rated a "2" until the October 2008 examination, when the rating was downgraded to a "4".

In retrospect, examiners should have placed greater emphasis on the extent and significance of inadequate risk management practices when assigning the Management component rating prior to the October 2008 examination. Additionally, although examiners noted concerns with loan underwriting and credit administration as early as 2004, they did not fully recognize the impact of those deficiencies or take supervisory action to address them until the 2008 examination.

In the October 2008 FDIC examination report, management was described as "deficient" and examiners made the following comments:

- The Board and senior management have failed to establish an appropriate risk management program commensurate with the bank's risk profile, business activities, and concentrations of credit.

- Significant loan growth over the past 3 years, coupled with lax loan underwriting, approval, and administration functions, have aggravated existing problems stemming from a depressed economy and real estate market.
- Weak supervision of lending activities has allowed division presidents to operate their branches autonomously without requiring compliance with Board-approved policies and procedures, regulatory requirements, and prudent lending standards.
- The Board should assess the current management team and corporate structure to ensure that sufficient resources are in place to adequately oversee day-to-day affairs.
- The audit function did not provide coverage for the following key areas: construction lending, Regulation O compliance, and the adequacy of the ALLL.

Our review indicated that these weaknesses existed prior to the October 2008 examination and some were CBT's standard operating procedures for a number of years, but it was not apparent that they were fully considered when assigning CAMELS component ratings in prior examinations.

As a result of the October 2008 examination, a C&D was issued in May 2009. During the December 2009 examination, it was noted that the Board and management had not complied with several provisions, as illustrated in Table 3.

Table 3: C&D Provisions Not Complied With by CBT – December 2009

C&D Provision	December 2009 Examination Finding
Provision 2.a: Hire qualified management, including a Chief Executive Officer, a Senior Lending Officer, and a Chief Financial Officer.	The bank was operating without a Chief Executive Officer, Senior Lending Officer, and Chief Financial Officer.
Provision 3.a: Maintain a Leverage Capital ratio of not less than 8 percent.	The Leverage Capital ratio was negative 1.83 percent.
Provision 3.b: Maintain a Total Risk-based Capital ratio of at least 10 percent.	The Total Risk-based Capital ratio was negative 2.61 percent.
Provision 3.f: Capital shall be in addition to a fully-funded ALLL.	After considering examination findings, the ALLL was underfunded by \$34.8 million.
Provision 7: Establish an effective internal loan grading system.	Loan rating downgrades totaled \$106.4 million, representing 42 percent of total examiner classifications.
Provision 8: Revise and implement a written lending and collection policy.	The examination disclosed numerous instances of loan policy contraventions. These issues have been consistently noted by the bank's internal loan review function.
Provision 9: Perform a concentration analysis and establish a plan to reduce concentrations.	Management did not perform a concentration analysis that considered product type, geographic distribution, underlying collateral, or other asset groups. A plan to reduce concentrations was not developed and implemented.
Provision 10: Review the adequacy of the ALLL and establish a policy for determining the adequacy of the ALLL.	There were contraventions of the Interagency Policy Statement on the ALLL.
Provision 12.b: Develop a Liquidity Contingency Plan.	An adequate Liquidity Contingency Plan has not been developed.

Source: December 2009 Joint Examination.

FDIC officials stated that the failure to identify the breadth of the asset quality problems earlier was due, in part, to the fact that loans were performing and the market was strong prior to 2008, and the examiners were following practices in place at the time. The FDIC has since taken steps to issue guidance and instruct examiners to (1) take a more comprehensive, forward-looking approach to addressing risk management deficiencies and (2) consider taking supervisory action earlier for banks with high-risk profiles and/or weak risk management practices.

Supervisory Response to CRE and ADC Concentrations

Examiners first identified a concentration in ADC loans during the June 2006 FDIC examination, as ADC loans were 127 percent of Tier 1 Capital at March 31, 2006.

Although ADC and CRE concentrations had grown to 166 percent and 353 percent of Tier 1 Capital, respectively, as of December 31, 2006, the May 2007 DBF examination report only noted that the concentrations were well monitored and managed.⁶ It was not until the 2008 examination that significant concerns related to the ADC and CRE concentrations were identified and reported by the FDIC. At that time, CRE loans represented 657 percent of total capital and ADC loans represented 328 percent of total capital (as of September 30, 2008).

Examiners recommended in the October 2008 examination report that management review and implement the Joint Guidance, as management had not effectively done so at that point in time. In that report, examiners specifically recommended that management:

- Expand the strategic plan to address CRE levels in relation to growth objectives, financial targets, and the capital plan.
- Develop strategies to manage concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions.
- Provide for strong management information systems for effective portfolio management.
- Expand management reporting to include analyses in response to potential market events that could affect the CRE loan portfolio.
- Expand lending policies to address underwriting standards such as (1) minimum requirements for initial investment and maintenance of hard equity by the borrower; (2) minimum standards for borrower net worth, property cash flow, and debt service coverage; (3) requirements for feasibility studies, sensitivity analysis, or stress testing; (4) loan terms; and (5) pricing structures.
- Implement practices governing loan disbursements to ensure minimum borrower equity requirements are maintained throughout the development and construction periods.
- Perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital.

⁶ The June 2006 FDIC and May 2007 DBF examination reports identified ADC and CRE concentrations as a percentage of Tier 1 Capital. The December 2006 Joint Guidance states that concentrations should be monitored as a percentage of total capital. Per the UBPR for March 31, 2006, ADC loans were 114.76 percent of total capital and CRE loans were 437.32 percent of total capital. The December 31, 2006 UBPR noted ADC loans were 161.68 percent of total capital and CRE loans were 459 percent of total capital.

The May 2009 C&D, issued as a result of the 2008 FDIC examination, also contained the following provisions related to loan concentrations:

- Within 90 days from the effective date of the order, the bank was to perform a risk segmentation analysis with respect to the concentrations of credit noted in the ROE and any other concentration deemed important by the bank. Concentrations were to be identified by product type, geographic distribution, underlying collateral or other asset groups, which are considered economically related and in the aggregate represent a large portion of the bank's capital account.
- A copy of this analysis was to be provided to the Supervisory Authorities and the Board agreed to develop a plan to reduce any segment of the portfolio which the Supervisory Authorities deemed to be an undue concentration of credit in relation to the bank's capital account.

As discussed earlier, the bank had a period of high loan growth during 2007 and 2008, which was concentrated in CRE and ADC loans. In retrospect, given the fact that examiners had cited CBT in 2006 and 2007 for loan underwriting and credit administration weaknesses, increased supervisory attention to the growing concentrations may have been warranted during that same timeframe. Such attention would have been consistent with the December 2006 Joint Guidance and may have helped focus management's attention on developing a contingency plan to reduce concentrations or raise additional capital before the economy began to deteriorate.

Supervisory Response to Risk Management Practices

As discussed earlier in the report, examiners identified various issues with CBT's loan underwriting, credit administration, and risk management practices beginning in 2004, and repeatedly thereafter. The 2006 examination found policies and procedures for the credit function to generally be adequate, but identified several areas in need of immediate improvement, including the lack of an adequate tracking system for loan exceptions. However, examiners first recognized the depth of issues surrounding loan underwriting, credit administration, and risk management practices and pursued a C&D at the 2008 examination. The C&D specifically stated that the bank was operating with lax loan underwriting and weak credit administration practices.

A joint visitation of the FDIC and the DBF was conducted in September 2009 to follow up on CBT's implementation of the C&D provisions. The visitation noted that management did not understand or identify all asset quality issues and was in non-compliance with the C&D.

While the FDIC's supervisory response to these issues prior to the 2008 examination was generally consistent with practices in place at the time, examiners have since been instructed to take a more aggressive, forward-looking approach to addressing risks like those found at CBT. As discussed in earlier sections of this report, that approach would likely involve a greater emphasis on bank management practices, additional and more

affirmative recommendations for improvement, and/or earlier CAMELS rating downgrades and supervisory action.

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

Based on the supervisory actions taken with respect to CBT, the FDIC properly implemented applicable PCA provisions of section 38. Table 4 illustrates that CBT was *Well Capitalized* for PCA purposes until the October 2008 examination when the institution’s condition had already seriously deteriorated.

Table 4: Summary of Capital Categories for CBT

Examination/Visitation Date	As of Date	PCA Capital Category	Informal or Formal Action Taken
June 19, 2006	March 31, 2006	Well Capitalized	None
May 29, 2007	December 31, 2006	Well Capitalized	None
October 27, 2008 *	September 30, 2008 December 31, 2008	Adequately Capitalized	PCA Notification 2/9/2009 C&D 5/1/2009
September 10, 2009	August 31, 2009 September 30, 2009	Significantly Undercapitalized Critically Undercapitalized	PCA Directive 9/21/2009 PCA Directive 11/3/2009

Source: Reports of Examination, Progress Reports for CBT, and FDIC PCA Notifications.

* The examination report was issued February 26, 2009.

CBT was considered *Adequately Capitalized* based on the October 2008 examination and the bank’s December 31, 2008 Call Report. As previously mentioned in this report, the C&D signed on May 1, 2009 included a capital provision that specifically directed CBT to increase and maintain a Leverage Capital ratio above 8 percent and Total Risk-based Capital ratio above 10 percent.

The FDIC’s efforts to monitor CBT’s capital position and the bank’s response to supervisory actions after its capital position fell below *Well Capitalized* included the following:

- The October 27, 2008 examination revealed significant deterioration in the bank's overall performance. CBT's Total Risk-based Capital ratio declined to 8.76 percent, and on February 9, 2009, the FDIC notified the bank that it was *Adequately Capitalized* for PCA purposes. The C&D also followed in May 2009.
- In response to the C&D, on June 10, 2009 CBT submitted a capital plan to the FDIC and the DBF for approval. The FDIC issued a letter on August 24, 2009 noting the bank's capital plan appeared optimistic given CBT's June 30, 2009 performance. The FDIC requested that an updated capital plan be submitted within 30 days. A revised capital plan was adopted by CBT on September 8, 2009 and submitted to the FDIC for approval.
- Once the FDIC started its onsite visitation in September 2009, examiners determined that CBT's capital ratios had further declined. Capital no longer supported the risk profile of the bank. Loan charge-offs, an increasing ALLL, and operating losses had eroded the bank's capital position. The bank was notified that it was *Significantly Undercapitalized* for PCA purposes. A PCA Directive, issued to the bank on September 21, 2009, noted that CBT was subject to restrictions on asset growth, dividends, other capital distributions, and management fees and required CBT to submit a capital restoration plan within 45 days of the receipt of the directive. CBT was further reminded that the bank was not allowed to accept, renew, or rollover any brokered deposits. CBT was also advised that the bank was not allowed to "solicit deposits by offering an effective yield that exceeds by more than 75 basis points the prevailing effective yields on insured deposits of comparable maturity in such institution's normal market area or in the market area in which such deposits are being solicited."
- Based on the September 2009 visitation, the FDIC issued a PCA Directive on November 3, 2009 informing the bank that it was *Critically Undercapitalized* as of September 30, 2009 for PCA purposes. The examiners notified CBT that the bank was immediately subject to the same restrictions associated with asset growth, dividends, other capital distributions, management fees, deposit yields, and brokered deposits that existed as a result of the prior PCA Directive. In addition, CBT was required to file a written capital restoration plan with the FDIC's Regional Director within 30 days. CBT submitted an amended capital restoration plan to the FDIC on December 4, 2009 in response to the November 3, 2009 PCA Directive. Ultimately, regulators concluded that CBT would be unable to raise the level of capital required and, as a result, the bank was closed by the DBF on January 29, 2010.

Objectives, Scope, and Methodology

Objectives

We conducted this performance audit to satisfy the requirements of section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, 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 CBT'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 this performance audit from May 2010 to July 2010 in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained, as described in the Scope and Methodology section, provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of CBT from 2006, until its failure on January 29, 2010. Our work also included an evaluation of the regulatory supervision of the institution over the same period. In some sections of this report, information prior to 2006 is included to provide perspective and context for later actions.

To accomplish our objectives, we performed the following procedures and utilized the following techniques:

- Analyzed examination and visitation reports prepared by FDIC and DBF examiners from 2006 to 2009.
- Reviewed the following documentation:
 - Financial institution data and correspondence maintained at DSC's Atlanta Regional Office and Atlanta Field Office, as provided to Crowe Horwath LLP by DSC.
 - Reports prepared by the Division of Resolutions and Receiverships and DSC relating to the bank's closure.

Objectives, Scope, and Methodology

- Pertinent DSC policies and procedures.
- Interviewed the relevant FDIC officials having supervisory responsibilities pertaining to CBT, which included DSC examination staff.
- Interviewed appropriate officials from the DBF to discuss their historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.
- Researched various banking laws and regulations.

Crowe Horwath LLP relied primarily upon the materials provided by the FDIC OIG and DSC, including information and other data collected during interviews. Crowe Horwath LLP did not perform specific audit procedures to ensure the information and data were complete and accurate. Crowe Horwath LLP is, however, aware that Circular 12000.1, Cooperation with the Office of Inspector General, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the FDIC and the bank. Crowe Horwath LLP relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

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 CBT's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

Objectives, Scope, and Methodology

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 reports of examination, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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 is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG's 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. In that regard, while not consequential to the overall supervision of the institution, we note on page I-12 that the FDIC did not meet statutory examination frequency requirements in 2008.

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. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are 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.

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 institutions 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.
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.
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.

Glossary of 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.
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.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: a guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Financial Reform 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.
Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.

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)	<p>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, <i>Prompt Corrective Action</i>, 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) <i>Well Capitalized</i>, (2) <i>Adequately Capitalized</i>, (3) <i>Undercapitalized</i>, (4) <i>Significantly Undercapitalized</i>, and (5) <i>Critically Undercapitalized</i>.</p> <p>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.</p>
Special Mention Assets	A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institutions credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Glossary of Terms

Tier 1 (Core) Capital	<p>Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as</p> <p>The sum of:</p> <ul style="list-style-type: none"> • Common stockholder’s equity (common stock and related surplus, undivided profits, disclosed capital reserves, and foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; <p>Minus:</p> <ul style="list-style-type: none"> • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Uniform Bank Performance Report (UBPR)	<p>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.</p>
Uniform Financial Institutions Rating System (UFIRS)	<p>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: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity 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.</p>

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity and <u>S</u> ensitivity to Market Risk
CBT	Community Bank & Trust
CEO	Chief Executive Officer
CRE	Commercial Real Estate
DBF	Georgia Department of Banking and Finance
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
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

Part II

OIG Evaluation of Management Response

OIG Evaluation of Management Response

After we issued our draft report, management officials provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On August 25, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of CBT's failure and the FDIC's supervision of the bank. Additionally, DSC stated that it recognizes the threat that institutions with high-risk profiles, such as CBT, pose to the DIF. According to DSC, it continues to look for and implement improvements to its supervisory program that focus on stabilizing an institution's risk profile and strengthening its financial condition. DSC issued *Interagency Guidance on CRE Monitoring* in 2006 and a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* in 2008 that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation

550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

August 25, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: /Signed/
Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Community Bank and Trust, Cornelia, Georgia (Assignment 2010-039)

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 Community Bank and Trust (CBT), which failed on January 29, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on August 12, 2010.

CBT's failure was due to inadequate Board and management oversight, specifically the absence of an internal control environment commensurate with the risks resulting from high concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans. The Board and management relied too heavily on the Chief Executive Officer's decisions and expertise rather than establishing sound practices and controls. CBT experienced substantial losses in the loan portfolio and was unable to raise the capital necessary to remain solvent.

From 2006 to 2009, the FDIC and the Georgia Department of Banking and Finance conducted four on-site risk management examinations and one visitation. The 2006 FDIC examination found that weaknesses persisted in the credit administration area and recommended immediate corrective action. The 2008 FDIC examination noted deterioration of CBT's financial condition, weak risk management practices, deficiencies in loan approval processes, and generally lax lending administration. The examination also found that the concentration in CRE and ADC loans had increased with insufficient Allowances for Loan and Lease Losses and that the Board and management had failed to establish an appropriate risk management program commensurate with CBT's risk profile, business activities, and credit concentrations. As a result, FDIC issued a Cease and Desist Order in 2009.

We recognize the threat that institutions with high risk profiles, such as CBT, pose to the Deposit Insurance Fund. We continue to look for and implement improvements to our supervisory program that focus on stabilizing an institution's risk profile and strengthening its financial condition. DSC issued *Interagency Guidance on CRE Monitoring* in 2006 and a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* in 2008 that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

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