



Office of Inspector General

March 2009
Report No. AUD-09-006

**Material Loss Review of Integrity Bank,
Alpharetta, Georgia**

AUDIT REPORT

Office of Audits



oig



Federal Deposit Insurance Corporation

Material Loss Review of Integrity Bank, Alpharetta, Georgia

Audit Results

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Integrity Bank (Integrity), Alpharetta, Georgia. On August 29, 2008, the Georgia Department of Banking and Finance (DBF) closed the institution and named the FDIC as receiver. On September 17, 2008, the FDIC notified the OIG that Integrity's total assets at closing were \$1.045 billion, with a material loss to the Deposit Insurance Fund (DIF) estimated at \$295 million.

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

Background

Integrity was a state-chartered nonmember bank that was established and insured on November 1, 2000. Integrity was headquartered in Alpharetta, Georgia, and, at closing, had five other branches in Georgia. Integrity was closely held by Integrity Bancshares, Inc., which had no other subsidiaries. Integrity provided full-service commercial banking activities.

Integrity's loan portfolio was concentrated in acquisition, development, and construction (ADC) loans. The federal financial regulatory agencies have recognized the increased risk that ADC loans present to financial institutions and issued guidance in December 2006 on a risk management framework that effectively identifies, measures, monitors, and controls ADC concentration risk. That framework should include effective oversight by bank management, including the board of directors (BOD) and senior executives; and sound loan underwriting; credit administration; and portfolio management practices.

Integrity failed primarily due to management's aggressive pursuit of asset growth concentrating in higher-risk ADC loans without adequate controls. Integrity lacked adequate loan underwriting and other loan portfolio and risk management controls and liquidity management practices to support its growth strategy. Resulting losses severely eroded Integrity's capital, leading to its failure and material loss to the DIF. Specifically:

Management. Integrity's BOD did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. In addition, the BOD did not ensure the implementation of corrective actions in response to bank examinations and audit recommendations. In particular, Integrity did not provide adequate controls over the lending function, including credit underwriting, credit approval, appraisals, loan documentation, and problem loan recognition. By the end of 2007, Integrity's management had been replaced, and new management was making an effort to address the bank's problems; however, new management was not able to correct the condition of the bank sufficiently to prevent failure.

Asset Quality. Integrity concentrated its lending in ADC loans in rapidly growing markets, including out-of-territory markets, and concentrated its loans to individuals to an extent that exceeded state lending limits. While doing so, Integrity did not follow sound loan underwriting standards and administration practices, including: (1) adequately supporting loan presentations, (2) recognizing problem assets in a timely manner, (3) effectively classifying loans, (4) establishing a methodology in compliance with interagency policy for determining the adequacy of the allowance for loan and lease losses, and (5) establishing controls over the use of interest reserves. In addition, Integrity did not perform global cash flow analyses for large borrowers to establish a comprehensive picture of bank debt. As asset quality declined and losses were recognized, earnings and capital were eroded.

Liquidity. Integrity relied on volatile sources of funding, such as brokered deposits and Federal Home Loan Bank advances, to support its asset growth. In 2008, these sources of funding were not readily available as Integrity's condition deteriorated. Although new bank management was closely monitoring liquidity, it was not able to obtain sufficient funds on reasonable terms to meet liquidity needs.

Supervision. The FDIC and DBF conducted timely examinations of Integrity. The FDIC also provided oversight through its off-site monitoring process. In February 2008, the FDIC issued a Cease and Desist Order (C&D) and conducted a visitation to review actions taken as a result of the C&D. Further, in July 2008 and again in August 2008, the FDIC used its authority under the PCA provisions of the FDI Act to issue PCA Directives when Integrity became undercapitalized and then significantly undercapitalized. The FDIC has authority to take a wide range of supervisory actions. In the case of Integrity, however, supervisory actions were not timely and effective in addressing the bank's most significant problems.

The FDIC has taken steps to improve its supervisory oversight of financial institutions that have concentrations in ADC loans and use interest reserves. However, examiners noted deficiencies in Integrity's asset quality in the 2005 and 2006 examinations that should have warranted greater concern. Specifically, these examinations identified significant risks in Integrity's loan portfolio, including a high concentration in ADC and individual loans; out-of-territory lending; and loan administration issues that were not corrected in subsequent examinations as Integrity's risk profile was increasing. Greater concern regarding Integrity's loan administration and declining asset quality could have led to elevated supervisory attention and earlier supervisory action.

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

Management Response

The Division of Supervision and Consumer Protection (DSC) provided a written response to the draft report. DSC agreed with the OIG's conclusions regarding the causes of Integrity's failure and the resulting material loss. DSC noted that facts regarding Integrity's largest borrowing relationship and significant control weaknesses in the loan approval processes did not come to light until the 2007 examination. However, in our view, greater concern for Integrity's loan administration and underwriting weaknesses identified in the 2005 and 2006 examinations could have led to earlier supervisory action regarding Integrity's borrowing relationships.

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FIGURE

Integrity's Key CAMELS Ratings

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DATE: March 17, 2009

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

FROM: /Signed/
Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Integrity Bank
Alpharetta, Georgia
(Report No. AUD-09-006)*

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss¹ review of the failure of Integrity Bank (Integrity), Alpharetta, Georgia. On August 29, 2008, the Georgia Department of Banking and Finance (DBF) closed Integrity and named the FDIC as receiver. On September 17, 2008, the FDIC notified the OIG that Integrity's total assets at closing were \$1.045 billion, and the estimated loss to the Deposit Insurance Fund (DIF) was \$295 million.

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

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision² of the institution, including implementation of the PCA provisions of section 38. Appendix 1 contains details on our objectives, scope, and methodology; and Appendix 2 contains a glossary of terms. Acronyms used in the report are listed in Appendix 4.

¹ As defined by section 38 of the FDI Act, a loss is material if it exceeds the greater of \$25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.

² The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by the 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.

This report presents the FDIC OIG's analysis of Integrity's failure and the FDIC's efforts to require Integrity's management to operate the bank in a safe and sound manner. The FDIC OIG plans to issue a series of summary reports on the material loss reviews it is conducting. These reports will summarize our observations on the major causes, trends, and common characteristics of failures resulting in a material loss to the DIF and will make recommendations applicable to the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

Integrity was a state-chartered nonmember bank, which received approval from the DBF to open for business on November 1, 2000, and was insured by the FDIC effective November 1, 2000. Integrity, which was headquartered in Alpharetta, Georgia:

- had five branches in Alpharetta, Roswell, Smyrna, Duluth, and Cumming, Georgia;
- had a holding company, with no other subsidiaries or affiliates;
- provided traditional banking activities within its marketplace; and
- specialized in commercial lending, with concentrations in acquisition, development, and construction (ADC) loans.

Integrity's local marketplace was, at one time, characterized by rapidly appreciating real estate values. However, real estate values experienced a significant downturn in 2007 that impacted borrowers' ability to make payments, and the real estate construction industry was negatively impacted.

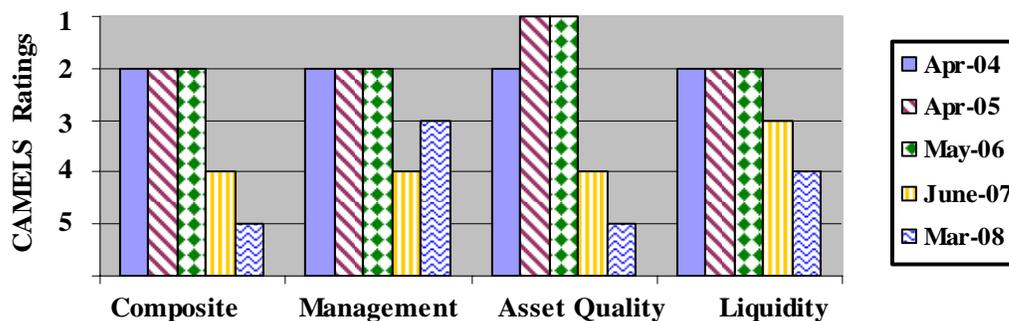
DSC's Atlanta Regional Office (ARO) and DBF alternated safety and soundness examinations of Integrity. For the period that we reviewed, five examinations were conducted, starting in April 2004 and ending in March 2008. DSC also conducted visitations in May 2007 and February 2008. At the June 2007 examination, Integrity's composite rating was downgraded to 4,³ indicating unsafe and unsound practices or conditions and a distinct possibility of failure if such conditions and practices were not satisfactorily addressed and resolved. As a result of the March 2008 examination, Integrity's composite rating was downgraded to 5, indicating extremely unsafe and unsound practices or conditions; critically deficient performance, often with inadequate

³ Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: 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.

risk management practices; and great supervisory concern. Institutions in this category pose a significant risk to the DIF and have a high probability of failure.

Further, with respect to selected component ratings, as indicated in the figure below, at the June 2007 examination, Integrity's management rating was downgraded from 2 to 4, and its asset quality rating was downgraded from 1 to 4. As a result of the March 2008 examination, examiners downgraded Integrity's asset quality to 5 and the liquidity rating to 4.

Integrity's Key CAMELS Ratings



Details on Integrity's financial condition, as of June 2008, and for the 4 preceding calendar years follow in Table 1.

Table 1: Financial Condition of Integrity

	June-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets (\$000s)	\$1,107,514	\$1,209,722	\$1,120,244	\$751,036	\$444,631
Total Deposits (\$000)	\$962,456	\$1,000,245	\$930,776	\$674,499	\$373,500
Total Loans (\$000s)	\$849,800	\$930,628	\$941,580	\$651,778	\$385,906
Net Loan Growth Rate	(19%)	(3%)	44%	69%	63%
Net Income (Loss) (\$000s)	(\$33,563)	(\$45,196)	\$12,010	\$7,512	\$3,694
Loan Mix (% of Avg. Gross Loans):					
All Loans Secured by Real Estate	98%	97%	94%	95%	95%
Construction and Development	79%	75%	67%	57%	52%
Commercial Real Estate (CRE) – Nonfarm/ nonresidential	14%	14%	16%	23%	33%
Multifamily Residential Real Estate	2%	2%	2%	1%	1%
1-4 Family Residential – excluding Home Equity Lines of Credit	2%	2%	2%	2%	3%
Home Equity Loans	1%	2%	2%	1%	1%
Construction and Industrial Loans	2%	3%	5%	5%	5%
Adverse Classifications Ratio	290%	104%	6%	2%	22%
	March 2008 ROE	June 2007 ROE	May 2006 ROE	April 2005 ROE	April 2004 ROE

Source: Uniform Banking Performance Report (UBPR) and Reports of Examinations (ROEs) for Integrity.

RESULTS IN BRIEF

Integrity failed primarily due to management's aggressive pursuit of asset growth concentrating in higher-risk ADC loans without adequate controls. Integrity lacked adequate loan underwriting and other loan portfolio and risk management controls and liquidity management practices to support its growth strategy. Resulting losses severely eroded Integrity's capital, leading to its failure and the material loss to the DIF. Specifically:

Management. Integrity's BOD did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities. In addition, the BOD did not ensure the implementation of corrective actions in response to bank examinations and audit recommendations. In particular, Integrity did not provide adequate controls over the lending function, including credit underwriting, credit approval, appraisals, loan documentation, and problem loan recognition. By the end of 2007, Integrity's management had been replaced, and new management was making an effort to address the bank's problems; however, bank management was not able to correct the condition of the bank sufficiently to prevent failure.

Asset Quality. Integrity concentrated its lending in ADC loans in rapidly growing markets, including out-of-territory markets, and concentrated its loans to individuals to an extent that exceeded state lending limits. While doing so, Integrity did not follow sound loan underwriting standards and administration practices, including: (1) adequately supporting loan presentations, (2) recognizing problem assets in a timely manner, (3) effectively classifying loans, (4) establishing a methodology in compliance with interagency policy for determining the adequacy of the allowance for loan and lease losses (ALLL), and (5) establishing controls over the use of interest reserves. In addition, Integrity did not perform global cash flow analyses for large borrowers to establish a comprehensive picture of bank debt. As asset quality declined and losses were recognized, earnings and capital were eroded.

Liquidity. Integrity relied on volatile sources of funding, such as brokered deposits and Federal Home Loan Bank (FHLB) advances, to support its asset growth. In 2008, these sources of funding were not readily available as Integrity's condition deteriorated. Although new bank management was closely monitoring liquidity, management was not able to obtain sufficient funds on reasonable terms to meet liquidity needs.

Supervision. The FDIC and DBF conducted timely examinations of Integrity. The FDIC also provided oversight through its off-site monitoring process. In February 2008, the FDIC issued a Cease and Desist Order (C&D) and conducted a visitation to review actions taken as a result of the C&D. Further, in July 2008 and again in August 2008, the FDIC used its authority under the PCA provisions of the FDI Act to issue PCA Directives

when Integrity became undercapitalized and then significantly undercapitalized. The FDIC has authority to take a wide range of supervisory actions. In the case of Integrity, however, supervisory actions were not timely and effective in addressing the bank's most significant problems.

The FDIC has taken steps to improve its supervisory oversight of financial institutions that have concentrations in ADC loans and use interest reserves. However, examiners noted deficiencies in Integrity's loan administration and underwriting in the 2005 and 2006 examinations that should have warranted greater concern. Specifically, these examinations identified significant risks in Integrity's loan portfolio, including a high concentration in ADC and individual loans, out-of-territory lending, and loan administration issues that were not corrected in subsequent examinations as Integrity's risk profile was increasing. Greater concern regarding Integrity's loan administration and underwriting weaknesses could have led to elevated supervisory attention and earlier supervisory action.

MANAGEMENT

Examinations in 2005 and 2006 resulted in a 2 management rating for Integrity. At the 2007 examination, the rating was downgraded to a 4, due to concerns about deficient BOD and management performance, inadequate risk management practices, and excessive risk exposure particularly regarding ADC loan concentrations. Significant risks had been inadequately identified, measured, monitored, or controlled and required immediate action by the BOD and management to preserve the safety and soundness of the institution. By year end 2007, Integrity's BOD hired a new senior management team to correct the bank's problems, and the rating was upgraded to a 3 in the 2008 examination. However, new management was not able to sufficiently correct the condition of the bank to prevent failure.

Ineffective BOD and Management

Examiners noted concerns with Integrity's BOD and management in the 2005 examination, including issues related to excessive growth, individual loan and ADC concentrations, ALLL, compliance with laws and regulations, and loan administration. Many of those issues continued throughout the bank's existence. Integrity examinations showed a continuing pattern of inadequate risk management for ADC loans, inadequate loan presentations, and inadequate loan administration, resulting in an increasing risk profile for the institution. The loan administration deficiencies were repeated and compounded as noted in the 2006 through 2008 examinations and led to asset quality deterioration. Table 2, which follows, provides examples of examiner comments and recommendations related to Integrity's BOD and management.

Table 2: Examples of Examiner Comments and Recommendations Regarding Integrity’s BOD and Management Performance

Examiner Comments	Examination and Visitation Dates						
	April 2004	April 2005	May 2006	May 2007 ^(a)	June 2007	Feb 2008 ^(b)	March 2008
Overall conclusion on BOD and management performance							
• Satisfactory	✓	✓	✓				
• Failure to maintain proper policies, processes, and controls to assure bank’s long-term success					✓		✓
Compliance with laws and regulations							
• Apparent violations of appraisal practices		✓	✓		✓		✓
• Apparent violations of state legal lending limits					✓		✓
• Noncompliance with real estate loan-to-value ratios		✓	✓		✓		✓
• Inadequately maintaining and funding the ALLL		✓		✓	✓		
Growth of operations							
• Loan growth was aggressive and significant	✓	✓			✓		
• Loan portfolio was concentrated in individual borrowers and CRE and ADC high-risk loans	✓	✓	✓		✓		✓
• Significant out-of-territory lending	✓	✓	✓	✓	✓		
Loan documentation and administration							
• Deterioration of asset quality, including increases in adversely classified items	✓			✓	✓	✓	✓
• Inadequate ALLL methodology		✓			✓		
• Deficiencies in loan underwriting and administration		✓			✓		
• Asset quality negatively affected by economic downturn						✓	✓
Examiner recommendations							
• Address noncompliance with applicable laws and regulations		✓	✓		✓		✓
• Improve practices and procedures in loan administration and internal routines and controls	✓		✓		✓		✓

Source: Integrity ROEs, issued by DBF and the FDIC, and FDIC visitation reports.

^(a) FDIC Visitation.

^(b) In February 2008, the FDIC conducted a visitation that identified substantial deterioration in Integrity’s condition. By February 2008, the prior president, senior lending officer, chief operating officer, and executive vice president of risk management had been replaced, and since June 2007, only three original directors remained.

Risk Management. Integrity management did not ensure that adequate risk management controls were implemented and followed. Furthermore, Integrity’s management did not implement corrective actions in a timely manner to adequately address deficiencies identified by examiners and auditors related to the bank’s inadequate risk management controls for loan documentation, administration, and monitoring.

The bank did not adequately identify, measure, monitor, and report on a regular basis to the BOD on ADC concentrations, overall portfolio performance, and use of interest reserves. Integrity's loan policy did not adequately establish limits for concentrations in ADC loans or provide for tracking the total volume of ADC loans. The ADC concentration was 931 percent and 1,025 percent of Tier 1 Capital at the June 2007 and March 2008 examinations, respectively. Given such growth and the increased risk profile that accompanied the decision by Integrity's BOD and management to pursue this lending activity, the BOD needed to provide a clear framework of controls for risk management.

The June 2007 ROE noted that the bank's overall portfolio risk identification, measuring, monitoring, and reporting practices were ineffective and contributed to the bank's poor condition. Prior management did not provide adequate oversight, policies, and controls to ensure Integrity's continued viability. New management, hired in 2007 along with a new bank president, was unable to correct the loan deficiencies, loan administration risks, and liquidity risks, and those issues were not adequately addressed at the last examination in March 2008. Specifically, the FDIC's March 2008 examination concluded that while new management had aggressively identified risks within the bank, excessive risk-taking practices of the former management team caused a severe deterioration in the condition of the institution.

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

Inadequate Actions for Apparent Violations of Regulatory Requirements. Beginning with the bank's April 2005 examination, examiners cited Integrity for apparent violations of laws and regulations related to, for example, appraisals and real estate lending policies; contraventions of interagency policies on interest rate risk, supervisory loan-to-value limits, and ALLL; and the Financial Institutions Code of Georgia legal lending limits. These violations represented increased risk and should have warranted greater concern due to Integrity's rapid growth. According to Appendix A of Part 365, *Interagency Guidelines for Real Estate Lending Policies*, the real estate lending policy should be appropriate to the size of the institution. In addition, the *DSC Risk Management Manual of Examination Policies* (Examination Manual) states that an institution's BOD and management should implement appropriate policies and procedures to effect compliance, detect instances of noncompliance, institute corrective measures, and provide adequate training and retraining of officers and employees to prevent future infractions. Further, the Examination Manual states that it is important that correction of all apparent violations of laws and regulations be instituted promptly, regardless of their perceived importance.

Integrity's BOD and management failed to implement adequate controls to ensure compliance with laws, regulations, and other regulatory requirements, with apparent violations being reported in each of its last four examinations.

We consider the inadequate actions for addressing apparent violations of laws and regulations and contraventions of interagency policies to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Management

According to the Examination Manual, the quality of management is probably the single most important element in the successful operation of a bank. The BOD is responsible for formulating sound policies and objectives for the bank, effective supervision of its affairs, and promotion of its welfare, while the primary responsibility of senior management is implementing the BOD's policies and objectives in the bank's day-to-day operations. Also according to the manual, the capability and performance of management and the BOD is rated based upon, but not limited to, an assessment of compliance with laws and regulations.

The FDIC's 2005 examination rated management a 2, which indicates satisfactory management and BOD performance and risk management practices. This rating indicates that minor weaknesses may exist and significant risks are effectively identified, measured, monitored, and controlled. However, the examination cited as risks, items that ultimately caused the institution to fail. Specifically, the examiners expressed concern that the risk profile was characterized by the following elements: rapid loan growth; large individual concentrations; ADC concentrations; out-of-territory lending; and a marginal ALLL, including contravention of FIL-63-2001, *Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Associations*, dated July 25, 2001. Examiners also noted appraisal deficiencies and minor deficiencies in loan underwriting and administration. The examiners reasoned that management satisfactorily managed the risk as evidenced by strong asset quality and earnings. The DBF's 2006 examination of Integrity stated that the risk profile remained unchanged, and management was again rated a 2. However, repeat violations of laws and regulations were identified relevant to appraisals, lending policies, and contraventions of interagency policies regarding supervisory loan-to-value limits, while Integrity's loans increased by another 44 percent.

As a result of the 2007 examination, examiners downgraded Integrity's management rating from 2 to 4. The FDIC stated that the performance of senior management and the BOD was deficient primarily as a result of inadequate oversight and supervision of the lending function. The BOD had not provided effective oversight of the lending function as evidenced by weaknesses related to credit underwriting, credit approval processes, appraisal practices, loan documentation, credit administration, and problem loan recognition. The examination criticized management's contravention of policy statements regarding the adequacy of ALLL, the appraisal review program, real estate loan-to-value limits, and the interest rate risk management program. The examination also noted repeat deficiencies regarding large individual concentrations, ADC concentrations, and out-of-territory lending. Following this examination, the BOD replaced most of Integrity's senior management as noted earlier.

Generally, Integrity provided written responses to each examination and promised corrective actions, and examiners generally followed up on any recommendations at the next examination. However, Integrity disputed the 2005 and 2006 examination ratings while agreeing to resolve any concerns before the next examination. Although the FDIC accepted Integrity’s responses, Integrity failed to implement actions to sufficiently address the 2005, 2006, and 2007 examination results, which contributed to the continued deterioration of Integrity’s financial condition.

ASSET QUALITY

Integrity’s asset quality rating fluctuated between 1 and 2 from April 2004 through its May 2006 examination. Integrity’s asset quality was downgraded to a 4 rating in its June 2007 examination and to a 5 rating in its March 2008 examination as a result of continued loan classifications. These significant downgrades indicated that the bank’s level of risk and problem assets was excessive and inadequately controlled and subjected the bank to potential losses that threatened the viability of the institution.

Integrity’s loan classifications significantly increased, from \$0.9 million in 2005 to over \$313.9 million in 2008. At the April 2005 examination, adversely classified loans represented 1.78 percent of capital and, by March 2008, adversely classified loans totaled more than 290 percent of capital. Corresponding increases in Integrity’s ALLL were also significant (see Table 3).

Table 3: Integrity’s Asset Classifications and ALLL (Dollars in Thousands)

Examination Date	Asset Classifications				Analysis of ALLL
	Substandard	Doubtful	Loss	Total Classified Items	ALLL Computed by Integrity
April 2001	0	0	0	0	\$56
Oct 2001	0	0	0	0	\$234
July 2002	0	0	0	0	\$545
May 2003	\$1,764	0	0	\$1,764	\$1,417
April 2004	\$3,334	\$2,319	\$550	\$6,203	\$3,572
April 2005	\$917	0	0	\$917	\$3,433
May 2006	\$5,930	0	\$142	\$6,072	\$6,743
June 2007	\$92,484	0	\$37,175	\$129,659	\$10,898
March 2008	\$293,715	\$20,073	\$157	\$313,945	\$38,489

Source: ROEs for Integrity.

In addition to the \$6.1 million in adversely classified assets at the 2006 examination, examiners identified one \$18.1 million loan as “Special Mention,” which refers to loans that have potential weaknesses that deserve management’s close attention and, if left uncorrected, could result in a deterioration of the status of those assets. By the 2007

examination, examiners reported a total of more than \$160 million in Special Mention loans for six individual loan concentrations.

Examiner Concerns and Recommendations Regarding Asset Quality

Examiner concerns regarding Integrity’s asset quality related to its concentration in high-risk CRE/ADC loans in rapidly growing markets, including out-of-territory markets, as well as the extent of Integrity’s concentration of loans to individuals which exceeded state lending limits (see Table 4). Specifically, Integrity did not follow sound loan underwriting standards and administration practices.

Table 4: Examples of Examiner Comments and Recommendations Regarding Integrity’s Asset Quality

Examiner Comments	Examination and Visitation Dates						
	April 2004	April 2005	May 2006	May 2007*	June 2007	Feb 2008*	Mar 2008
Overall conclusion on Integrity’s asset quality							
• Strong or satisfactory	✓	✓	✓				
• Required the BOD to actively oversee operations					✓		✓
CRE and ADC concentrations							
• Concentration developing or already developed	✓	✓	✓		✓		✓
• Concern of excessive use of interest reserve component in ADC loans			✓		✓		
• Increasing risk profile based on loan portfolio affected by an economic downturn				✓		✓	✓
Adverse classifications							
• Noticeable loan quality deterioration				✓	✓	✓	✓
• Significant increases in adverse classifications	✓				✓		✓
Assessment of risk management practices							
• Risk management, monitoring, and reporting practices adequate	✓	✓	✓				
• Loan documentation and/or underwriting standards satisfactory	✓	✓	✓				
• ALLL methodology inadequate		✓			✓		
• ALLL not adequately funded		✓			✓	✓	
• Significant increase in ALLL					✓		✓
Examiner recommendations							
• Establish an effective real estate appraisal and evaluation program					✓		✓
• Conform with Uniform Standards of Professional Appraisal Practice		✓	✓		✓		✓
• Develop commercial ADC underwriting and administration guidelines	✓						
• Establish individual and aggregate limits for loan concentrations			✓		✓		
• Comply with legal lending limit					✓		✓
• Document and improve the ALLL methodology and allowance		✓			✓		

Examiner Comments	Examination and Visitation Dates						
	April 2004	April 2005	May 2006	May 2007*	June 2007	Feb 2008*	Mar 2008
<ul style="list-style-type: none"> Identify and report real estate loans exceeding the supervisory loan-to-value guidelines to the BOD 			✓		✓		✓

Source: ROEs and visitation reports for Integrity.

* FDIC visitation.

Concentration in CRE and ADC Loans

Integrity's concentrations in individual and CRE loans, including ADC loans, was first noted during DBF's April 2001 examination when those loans comprised 81.6 percent of the loan portfolio and 150 percent of Tier 1 Capital. Steady and rapid increases in individual and CRE-related risk exposure followed, as indicated in Table 5 below.

Table 5: Integrity's Loan Concentrations and Classifications

Examination Date	Percent of Tier 1 Capital Funded	Percent of Tier 1 Capital Committed	Total Classified Loans ^(a)	ALLL ^(a)
April 2001	150.0	Not Provided	0	\$56
Oct 2001	141.4	288.3	0	\$234
July 2002	472.6	502.7 ^(b)	0	\$545
May 2003	647.7	918.8	\$1,764	\$1,417
April 2004	540.9	736.5	\$6,203	\$3,572
April 2005	643.5	857.0	\$917	\$3,433
May 2006	629.2	818.5	\$6,072	\$6,743
June 2007	1,296.5	1,645.5	\$129,659	\$10,898
March 2008	1,474.7	1,674.8	\$313,945	\$38,489

Source: The ROEs for Integrity.

^(a) Dollars in thousands.

^(b) No details were available for total loans committed to industry concentrations.

Integrity's loan commitments steadily grew even though at the 2004 and 2006 examinations, lending levels decreased as a percentage of Tier 1 Capital. The decrease in the 2004 ratio was attributed to over \$6.8 million in stock offerings and a high earnings performance that increased capital. The 2006 decrease in the ratio was partially attributed to an injection of \$25 million in capital by Integrity's holding company. However, by 2008, the holding company was no longer a source of funding to improve the capital level. In June 2007, Integrity was adequately capitalized although individual and CRE loans represented 1,296.5 percent of Tier 1 Capital, and total classified loans had increased over 2,000 percent since May 2006. By March 2008, total classified loans had increased another 142 percent, and Integrity's capital level was deemed critically deficient by the FDIC.

On December 12, 2006, the banking agencies, which includes the FDIC, Board of Governors of the Federal Reserve System, and Comptroller of the Currency, issued joint guidance on CRE lending entitled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. The guidance acknowledged that a concentration in CRE/ADC loans, coupled with weak loan underwriting and depressed

CRE markets, has contributed to significant loan losses.⁴ However, Integrity focused its loan portfolio in high-risk CRE/ADC loans and failed to ensure that adequate risk management controls were developed and implemented. For example, financial and repayment analyses were inadequate because Integrity did not perform global cash flow analyses for individual borrowers to establish a comprehensive picture of bank debt. In addition, Integrity did not effectively classify these loans and adequately support loan presentations with appropriate documentation. Examiners recommended several actions to mitigate the bank’s CRE risk—such as enhanced monitoring of concentrations and improvements to loan underwriting and administration. However, bank management failed to implement actions to adequately address those recommendations, and asset quality continued to decline. Beginning with the June 2007 examination, and continuing through the March 2008 examination, examiners identified a high level of adverse classifications along with significant increases of classified and Special Mention loans and an inadequate ALLL. As asset quality declined and losses were recognized, Integrity’s liquidity position became critical, and earnings and capital were eroded. We consider loan concentrations to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Interest Reserves. Integrity did not have adequate controls related to the use and reporting of interest reserves. Integrity’s management extended or refunded the interest reserves for some loans. However, Integrity did not maintain complete records on the extent and number of loans funded with interest reserves, or have sufficient guidance for the use of interest reserves, such as provisions in loan agreements that provide for the discontinuation of funding of the interest reserve in the event a project falls behind projected performance goals. At the 2007 examination, examiners identified a total of about \$15 million in interest reserves on the loans sampled. Of that amount, \$2.7 million was adversely classified as “loss” in the ROE. Integrity’s liberal use of interest reserves masked the deterioration of these loans and resulted in overstated interest income. We consider inadequate controls over the use and reporting of interest reserves to be a significant concern, which we will address in our summary reports covering multiple bank failures.

DSC has issued guidance on the use of interest reserves. In November 2007, the ARO issued guidance entitled, *Identification and Analysis of Interest Reserves at Risk Management Examinations*. In April 2008, DSC issued corporate-wide guidance reiterating the November 2007 ARO guidance. In addition, in June 2008, DSC issued guidance to examiners and FDIC-supervised financial institutions on the use of interest reserves. The guidance describes the use of interest reserves in ADC lending, examines the risk this underwriting practice could present, and identifies “red flags” that should alert lenders to potential problems at each stage of the ADC cycle.

⁴ The FDIC also issued Financial Institution Letter (FIL) 22-2008 on March 17, 2008, entitled, *Managing Commercial Real Estate Concentrations In a Challenging Environment*, which re-emphasized the importance of strong capital, ALLL and loan risk-management practices for state nonmember institutions with significant CRE and construction and development loan concentrations.

Allowance for Loan and Lease Losses. Integrity's methodology for determining the ALLL did not comply with interagency policy. According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, (FIL-105-2006), dated December 13, 2006, each institution must analyze the collectibility of its loans and maintain an ALLL at a level that is appropriate and determined to be in accordance with Generally Accepted Accounting Principles (GAAP).⁵ An appropriate ALLL covers estimated loan losses on individually evaluated loans that are determined to be impaired as well as the estimated loan losses inherent in the remainder of the loan and lease portfolio.

The ROE for the April 2005 examination reported that Integrity's ALLL methodology was in contravention of the FIL-63-2001, *Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Associations*, dated July 25, 2001. Integrity's ALLL was marginally adequate because Integrity did not include unfunded lending commitments in its methodology for determining ALLL. Although examiners made no reference to Integrity's ALLL methodology in the May 2006 examination, FDIC examiners reported in the June 2007 ROE that Integrity was again not conforming to the interagency policy. Examiners deemed the ALLL inadequate due to Integrity's ineffective risk rating system and untimely recognition of problem credits. As a result of its ineffective ALLL methodology, Integrity understated the ALLL and overstated capital and earnings. As a result of additional problem credits the examiners identified during this examination, Integrity added another \$34 million to the ALLL. Integrity's new management team completed a review of the entire loan portfolio by August 31, 2007 and increased the ALLL by an additional \$14 million.

In compliance with the C&D issued in February 2008, Integrity's BOD approved an ALLL policy that outlined the methodology for analyzing the adequacy of the ALLL and established an ALLL committee that was responsible for maintaining the ALLL methodology and maintaining documentation to support the quarterly analysis.

We consider an inadequate methodology for determining the ALLL to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Asset Quality

Greater examination attention to weaknesses in loan underwriting and administration practices could have led to elevated supervisory concern when deficiencies were first identified and to more timely enforcement action. Between 2004 and 2006, Integrity's loan portfolio more than doubled with high concentrations in ADC lending. As the loan

⁵ The interagency policy statement reiterates key concepts and requirements pertaining to the ALLL included in GAAP and existing supervisory guidance. In addition, it describes the nature and purpose of the ALLL; the responsibilities of BODs, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound loan grading system.

portfolio seasoned and the economy weakened, the loan underwriting deficiencies identified by examiners became apparent in the form of adversely classified loans. Examiners assigned a 1 rating for asset quality in the 2005 and 2006 examinations. The rating was largely based on the low level of adversely classified assets in the portfolio. However, examiners noted deficiencies in Integrity's asset quality in the 2005 and 2006 examinations that should have warranted greater concern. These examinations identified significant risks in Integrity's loan portfolio, including a high concentration in ADC and individual loans, out-of-territory lending, and loan administration issues that had not been corrected in subsequent examinations as Integrity's risk profile was increasing. Additionally, the actual condition of these loans was, in part, masked by the use of interest reserves, as identified by examiners in 2007 and 2008.

At the April 2005 examination, Integrity had six individual borrower concentrations that totaled 256 percent of Tier 1 Capital as of March 31, 2005. Examiners reported that Integrity's management was appropriately monitoring these concentrations. Although three of the concentrations exceeded Integrity's loan policy limit, examiners noted that the exceptions had been approved by Integrity's BOD. In addition, funded ADC loans represented 385 percent of Tier 1 Capital, and out-of-territory loans represented 141 percent of Tier 1 Capital as of March 31, 2005.

At the DBF May 2006 examination, examiners identified four individual borrower concentrations. As discussed earlier, an \$18.1 million loan to one of these borrowers was identified as Special Mention because management funded \$6.1 million in loan proceeds without appropriate documentation prior to funding the request. Out-of-territory loans represented 146 percent of Tier 1 Capital, a slight increase from 2005. At the 2006 examination, examiners first reported that the CRE/ADC loans, representing 35 percent of Integrity's loan portfolio, had an interest reserve component that could mask the deterioration of the loans. Although examiners concluded that Integrity's risk management policies and practices for credit were adequate, examiners recommended that the bank establish both individual and aggregate limits for individual borrower concentrations. The ROE for this examination also reported that Integrity was in violation of Part 365, Appendix A, *Real Estate Lending*, of the FDIC Rules and Regulations.⁶ Because Integrity had not developed an effective method to identify its loan-to-value exceptions, it did not provide quarterly reports of these exceptions to its BOD. Bank management disagreed with many of the reported exceptions based on the experience of its management team and conservative practices to mitigate risks; however, management agreed to report any Part 365 exceptions to its BOD.

In a press release of its first quarter earnings for 2007, Integrity explained that a dramatic increase in past due loans was due to a group of loans, totaling approximately \$83 million in the aggregate, to entities controlled by one guarantor. The FDIC conducted a visitation in May 2007 to investigate this guarantor's lending relationship. The examiners

⁶ Part 365, Appendix A, charges each bank to establish its own internal loan-to-value limits for real estate loans, provided such limits do not exceed the supervisory limits in Appendix A. If the bank grants loans in excess of the Appendix A limits, management must identify such loans on the bank's records and report the aggregate amount to the BOD as least quarterly.

estimated a possible loss of \$20 to \$40 million to Integrity if the guarantor was unable to meet its obligation and defaulted on these past-due loans.

FDIC examiners reviewed the lending relationship further during the June 2007 examination. The team for the 2007 examination was instrumental in identifying the extent of Integrity's asset quality issues. By the June 2007 examination, examiners identified significant asset quality deterioration due to a significant increase in adversely classified assets and numerous loan underwriting and administration deficiencies, such as:

- Ineffective appraisal practices and inaccurate and inadequately supported loan presentations.
- Untimely recognition of problem assets due to an ineffective internal loan grading system and questionable loan review program.
- Inadequate method for determining the adequacy of the ALLL.
- Liberal use of interest reserves that masked the deterioration of assets.
- Liberal lending limits to borrowers that circumvented legal lending limits through the use of limited liability corporations and a lack of cash flow analyses for large borrowers in order to establish a comprehensive picture of bank debt.
- Risky concentrations of credit in CRE/ADC loans as well as individual concentrations.
- Inadequately controlled loan disbursements, as well as loan officers and directors operating outside of Integrity's loan policy guidelines.

As discussed earlier, the FDIC issued a C&D to Integrity in February 2008 due to Integrity's unsafe and unsound banking practices and violations of regulations reported in the FDIC's June 2007 ROE. The FDIC and DBF issued the C&D on February 20, 2008. A visitation had been conducted by the FDIC on February 11, 2008 to review information pertaining to asset quality and liquidity and the processes that management was implementing to conform to the C&D. As a result of the visitation, asset quality and earnings ratings were downgraded due to the increase in adversely classified assets and inadequate provisions to the ALLL.

By the March 2008 examination, examiners reported critically deficient asset quality due to another significant increase in adversely classified assets, former management's excessive risk taking, and loan underwriting and administration deficiencies. FDIC examiners expressed concern about Integrity's high ADC concentration, at 1,025 percent of Tier 1 Capital, because Integrity's residential real estate construction portfolio was over 90 percent speculative, and there was an oversupply of houses in the Atlanta market. However, Integrity's new management was in full or partial compliance with the C&D. Despite new management's efforts to address the high-risk practices of the previous management team and to comply with the C&D, asset quality continued to decline, and Integrity was not able to obtain funding to remain viable. Elevated and timely criticism of the bank's loan administration and underwriting deficiencies identified in earlier examinations might have led to earlier corrective action by bank management and earlier supervisory action that may have prevented these difficulties.

LIQUIDITY

Examiners for the April 2004, April 2005, and May 2006 risk management examinations assigned a 2 rating to Liquidity. By the June 2007 examination, liquidity was downgraded to a 3 rating, and by the March 2008 examination, liquidity was further downgraded to a 4 rating, indicating that Integrity had deficient liquidity levels or inadequate funds management practices. Integrity also may not have been able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

A bank's net non-core funding dependency ratio (dependency ratio) indicates the degree to which the bank is relying on non-core/volatile liabilities,⁷ such as time deposits of more than \$100,000; brokered deposits; and FHLB advances to fund long-term earning assets. Generally, the lower the ratio, the less risk exposure there is for the bank. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. Integrity's reliance on non-core/volatile liabilities began in 2005 and continually increased through 2008. Table 6, which follows, provides a synopsis of Integrity's net non-core dependency ratios and non-core funding sources, including CDs over \$100,000; brokered deposits; and FHLB advances that were comparable to its peer group.

Table 6: Integrity's Non-Core Funding Sources

Period Ending	Non-Core Funding Sources (Dollars in Thousands)			Net Non-Core Dependency Ratios (Percent)	
	Time Deposits \$100,000 or More	Brokered Deposits	FHLB	Integrity	Peer Group
December 31, 2004	\$54,779	0	\$15,000	17.18%	21.30%
December 31, 2005	\$135,473	\$150,011	0	17.96%	22.29%
December 31, 2006	\$169,615	\$247,988	\$5,000	20.77%	27.27%
December 31, 2007	\$202,035	\$233,238	\$65,000	23.12%	29.32%
June 30, 2008	\$155,687	\$170,145	\$65,000	20.94%	33.96%

Source: Review of Integrity's UBPR and ROEs.

Examiner Concerns and Recommendations Regarding Liquidity

Examiner concerns over Integrity's liquidity position were noted throughout its existence. From the institution's inception, examiners noted that Integrity's management had implemented an aggressive funds management strategy that placed reliance on volatile sources of funds to support asset growth. In the April 2004 examination, DBF examiners described Integrity's liquidity position as "marginally satisfactory," referencing Integrity's continued reliance on non-core funding to support significant growth in the bank's loan portfolio. DBF examiners also noted that Integrity did not include all volatile sources of funds in its dependency ratio calculation. This resulted in Integrity reporting

⁷ Volatile sources of funds include: Certificates of Deposit (CD) acquired through the Internet; QuickRate Internet Deposits; Brokered CDs and Jumbo CDs (greater than \$100,000); FHLB advances; and Repurchase Agreements.

a more favorable dependency ratio. However, when examiners recalculated the dependency ratio, including the Internet CDs, for example, Integrity’s dependency ratio changed from 16.59 percent to 25 percent at the April 2004 examination. Examiners described the condition in three separate ROEs (see Table 7) and recommended the discontinuance of this practice.

Table 7: Dependency Ratios as Calculated by Integrity and Examiners

Examination Date	Integrity’s Calculation	Examiners’ Calculation
April 2004	16.59%	25%
May 2006	27.63%	42.89%
March 2008	22.27%	26.5%

Source: Review of Integrity’s UBPR and ROEs.

At the 2008 examination, examiners noted that the interest Integrity paid on aggressive funding sources was higher than the interest Integrity earned on its investments, resulting in reduced earnings. Examiners also noted that past rapid asset growth, declining asset quality, and poor earnings were indications of increasing liquidity risk that could compromise Integrity and cause a liquidity crisis. Although Integrity’s BOD reviewed liquidity reports and ratios, bank management did not implement adequate controls to ensure the bank had sufficient sources of funds for a liquidity crisis. Examiners’ comments and recommendations related to liquidity are summarized in Table 8, which follows.

Table 8: Examples of Examiner Comments and Recommendations Regarding Integrity’s Liquidity

Examiner Comments	Examination Dates				
	April 2004	April 2005	May 2006	June 2007	March 2008
Overall conclusion on Integrity’s liquidity					
• Marginally Satisfactory – Continued reliance on non-core funding	✓				
• Satisfactory – Non-core funding steadily grown to meet demands		✓			
• Adequate – However, Integrity did not include all volatile funding sources in its dependency ratio calculation			✓		
• Tight Liquidity Position – Deterioration in asset quality and weak earnings may reduce Integrity’s ability to attract funding on reasonable terms				✓	
• Weak – Due to the inability to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs					✓
Funding sources					
• Increasing reliance on non-core funding sources	✓	✓	✓	✓	✓
• Lines of credit established with national banks and/or the FHLB	✓		✓	✓	✓
• Additional collateral required for lines of credit with FHLB				✓	✓
• Inadequate sources for funding due to the bank’s troubled financial condition, negative publicity, and potential for a run on deposits				✓	✓
Level of liquidity risk					
• Liquidity risk increasing	✓	✓	✓	✓	✓
• Potential liquidity strain for the bank				✓	✓
• Net non-core funding dependency ratio increasing	✓	✓	✓	✓	✓
• Non-core funding dependency ratio calculated to show more favorable ratio	✓		✓		✓
Examiner recommendations					
• Due to Integrity’s reliance on non-core funding sources, management should establish individual and aggregate risk tolerances for these funding sources	✓		✓		
• The Funds Management Policy should include parameters for a dependency ratio that includes all potentially volatile liabilities, in addition to separate parameters for a dependency ratio that includes potentially volatile liabilities that mature in less than 1 year			✓		✓
• Management must continue to reduce dependence on non-core funding to comply with dependency ratio requirements of the C&D and the brokered deposit limitation imposed by the brokered deposit waiver					✓

Source: ROEs for Integrity.

In response to examiner comments in 2004, Integrity’s management stated that the bank would continue to utilize non-core liabilities to fund the bank’s asset growth in the event of a shortfall in core deposit growth. To address the April 2004 examination recommendation to establish individual and aggregate risk tolerances for non-core funding sources, Integrity revised its Funds Management Policy, dated January 2005. The revised policy stated that Integrity would maintain a minimum liquidity ratio of 10 percent, excluding available lines of credit, and 15 percent including available lines of credit. Furthermore, the policy established a dependency ratio target of less than 40 percent. The policy stated that Integrity would rely on cash and cash equivalents to satisfy its routine liquidity needs. However, should the occasion

arise when the bank was unable to meet its liquidity requirements, any combination of the following actions could be taken, depending on funding availability and market conditions:

- advertise for local Money Market Deposit Accounts,
- advertise and try to attract local 6-12 month CDs,
- advertise and try to attract 6-12 month QuickRate deposits,
- obtain FHLB advances,
- place 30-90 day repurchase agreements through the Bankers Bank,
- purchase federal funds (on established lines),
- sell shorter-term investments,
- sell short-term loan participations, and
- purchase brokered deposits.

Finally, the revised policy stated that non-core funding sources should have an individual and aggregate limit of 100 percent of core deposits and that the composition of the non-core funding sources should be determined based on availability, pricing, and the funding needs of the bank at a given point in time.

By the May 2006 examination, Integrity increased its dependency ratio target to 50 percent. Examiners reported that brokered deposits along with time deposits greater than \$100,000 represented 47 percent of total deposits. Examiners assigned liquidity a 2 rating and recommended again that Integrity establish individual and aggregate limits on non-core funding. Additionally, examiners noted the 50-percent dependency ratio target and that Integrity did not define a timeframe used in the calculation. Therefore, examiners recommended that the policy include parameters for the dependency ratio that includes all potentially volatile liabilities, in addition to separate parameters for a dependency ratio that includes potentially volatile liabilities that mature in less than 1 year.

Lack of an Adequate CLP. Integrity did not implement sound liquidity risk management controls that included a comprehensive Contingency Liquidity Plan (CLP). According to DSC, Integrity's new management team was effective in procuring sufficient liquidity to provide time to market the institution to a variety of investors and provide DRR with time to complete resolution activities. However, when Integrity's liquidity position became severely critical, bank management could not provide sufficient liquidity for the institution.

According to the Examination Manual, CLPs should be in force and should include strategies for handling liquidity crises and procedures for addressing cash flow shortfalls in emergency situations. The manual also states that financial institutions should have an adequate CLP in place to manage and monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources.

Integrity developed a CLP and incorporated it into its Funds Management Policy; however, the CLP was not comprehensive. The June 2007 examination disclosed a worsening condition for Integrity, with non-core deposits increasing to 54 percent of total deposits and brokered deposits totaling 24 percent of total deposits. Examiners downgraded liquidity to a 3 rating. To incorporate more conservative non-core funding parameters, Integrity's BOD approved a revised funds management policy on September 5, 2007. The funds management policy was again updated in January 2008 and contained revisions that further strengthened the bank's liquidity policy. Integrity's new management implemented the guidelines and closely monitored liquidity. However, new management was not able to obtain sufficient funds on reasonable terms to meet liquidity needs.

The FDIC issued FIL-59-2003, *Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management*, dated July 23, 2003, which provides interagency guidance on the need for financial institutions to develop CLPs, in addition to other liquidity risk management controls, and informs depository institutions that a contingency plan should be part of the bank's liquidity management program. According to the Examination Manual, a bank's funds management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. The Examination Manual also includes 13 suggested elements for inclusion in a CLP. However, Integrity's January 2007 CLP did not adequately address these elements. Integrity's CLP listed general options to investigate—rather than specific plans—to monitor risk, maintain liquid assets, measure and project funding requirements during various scenarios, and manage access to funding sources as suggested in the Examination Manual. Integrity's 2008 CLP included 8 of the 13 elements from the Examination Manual. The five elements not in the CLP were a method of computing cost of funds, investment strategies, a system of internal controls, tax planning, and authority/procedures to access wholesale funding sources. We consider the lack of an adequate CLP be a significant concern, which we will address in our summary reports covering multiple bank failures.

Integrity's BOD and previous management had failed to implement adequate controls to monitor the bank's liquidity risk. The June 2007 examination identified significant deterioration in Integrity's loan portfolio, a high level of adverse classifications, significant downgrades in loans from the bank's internal watch list, and an inadequate ALLL. Although new management was monitoring and planning for Integrity's liquidity needs after the 2007 examination, the bank's financial condition was severely deteriorating. By the 2008 examination, Integrity's liquidity position was weak due to the inability to obtain funds on reasonable terms. As Integrity's financial position continued to deteriorate, Integrity's net interest margin declined, the bank's earnings and capital position were adversely affected, and the bank lacked potential sources to address liquidity shortfalls and resultant crises.

Regulatory Supervision Related to Liquidity

Examiners assessed Integrity's liquidity position and made recommendations to address cash flow and liquidity reports and deviations from, and updates to, the liquidity policy. Further, examiners discussed various options for funding sources with Integrity's new management. However, DSC did not assess the adequacy of Integrity's CLP and take supervisory action related to liquidity or take steps to limit the use of volatile funds until September 2007, when the FDIC granted the first of three brokered deposit waivers to Integrity as listed below in Table 9. Until July 2007, the bank was well capitalized which allowed Integrity to accept, renew, and roll over brokered deposits without regulatory approval.

Table 9: Brokered Deposit Waiver Requests Submitted by Integrity

Application Number	Date Submitted by Integrity	Action Taken and Date
20072356	08/21/07	Approved by the FDIC 09/28/07
20073304	12/04/07	Approved by the FDIC 12/17/07
20080512	03/03/08	Approved by the FDIC 03/18/08
20081330	05/29/08	Withdrawn by Integrity 06/06/08
20081506	06/11/08	Withdrawn by Integrity 07/17/08

Source: The ViSION Application Tracking System.

The FDIC subsequently issued a C&D in February 2008 that included liquidity provisions. Before the brokered deposit waivers and C&D were issued, the FDIC and Integrity held numerous discussions, during late 2007 and early 2008, regarding actions implemented by Integrity's new management to address examiner concerns, including those related to asset quality and liquidity.

The Examination Manual states that examiners should not wait for the PCA-based brokered deposits restrictions to be triggered, or the viability of an institution to be in question, before raising relevant safety and soundness issues with regard to the use of volatile funding sources. The manual also describes red flags related to the use of such funding sources. If examiners determine that the bank's use of these funding sources is not safe and sound, that risks are excessive, or that risks adversely affect the bank's condition, then appropriate supervisory action should be taken immediately.

Several red flags should have indicated to examiners that Integrity needed to ensure that the risks associated with brokered or other rate-sensitive funding sources were managed appropriately before the restrictions on the use of brokered deposits were implemented based on the C&D. Those red flags included:

- ineffective management and the absence of appropriate expertise,
- an aggressive growth strategy,
- inadequate information systems and controls,
- the absence of adequate policy limitations on non-core funding sources,
- high delinquency rate or deterioration in other asset quality indicators, and
- deterioration in the general financial condition of the institution.

DSC stated that while examinations prior to 2007 made recommendations with respect to liquidity and funds management, these examinations did not determine that existing policies, controls, and information systems, as a whole, were inadequate. DSC further stated that the bank did not report high levels of loan delinquencies or general deterioration in its financial condition until 2007.

At the March 2008 examination, examiners reviewed Integrity's corrective actions on the C&D provisions that required Integrity to review and amend the bank's liquidity policy. Examiners determined that Integrity was in partial compliance with the C&D provisions in that the bank had revised its funds management policy to address the concerns highlighted in the previous FDIC examination; however, examiners found that the policy guidelines were not consistent with actual practices. For example, the policy required a Sheshunoff model⁸ for cash flow analysis, which was not employed. Liquidity was calculated instead on a weekly basis by Integrity's Chief Financial Officer (CFO). Additionally, the policy established an Asset/Liability Management Committee, which had not met since the previous examination. Finally, the policy required an independent party to test the interest rate risk model annually in March, but such testing had not been completed. Examiners recommended that the contingency funding plan be expanded to provide additional sources of liquidity.

The availability of brokered deposits assisted Integrity in its rapid, aggressive growth and its funding of high-risk ADC loans. DSC approved the first brokered deposit waiver in September 2007 after Integrity had fallen to an adequately capitalized position for PCA purposes. DSC's implementation of PCA provisions is discussed in detail in the next section of this report. According to DSC, brokered deposit waivers were granted to Integrity to allow time for Integrity's new management team to actively pursue a private market solution. This also provided the Division of Resolutions and Receiverships (DRR) sufficient marketing time to ensure an orderly resolution of Integrity.

Finally, at the June 2007 examination, examiners did not recommend that the bank review and revise its CLP to adequately address the 13 plan elements listed in the Examination Manual—Integrity subsequently developed a more comprehensive CLP in September 2007 and updated it in January 2008. Prior to September 2007, Integrity had not developed controls that could have identified the specific circumstances under which secondary sources of funds should be used and the manner in which those funds would be used to provide liquidity for the bank.

After Integrity's failure, DSC issued additional guidance related to liquidity risk and CLPs. The FDIC's *Liquidity Risk Management* guidance, dated August 26, 2008, urged the BODs for financial institutions to establish a formal CLP that establishes quantitative liquidity risk guidelines. The guidance also states that CLPs should identify an institution's liquidity risk profile and the types of stress events that may be faced including, but not limited to, a deterioration in asset quality, becoming less than well capitalized, the need to fund unplanned asset growth, loss of access to market funding

⁸ The Sheshunoff model of cash flow analysis is the study of the movement of cash through a bank's business cycle. The goal is to maintain sufficient cash for bank operations from month to month.

sources, and the impact of negative press coverage. The guidance also reiterates many of the CLP elements that Integrity’s CLP did not include, as suggested by the Examination Manual.

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. PCA establishes a system of restrictions and mandatory supervisory actions that are to be triggered by an institution’s capital levels. Part 325 of the FDIC’s Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized.

At each examination, the FDIC evaluated Integrity’s capital position; assigned capital component ratings; and later included capital-related provisions in informal and formal actions, including a C&D with capital provisions; and provided PCA notification letters. The FDIC’s April 2005 examination noted that in order to remain well capitalized given its significant growth rate, Integrity had to raise additional capital through the issuance of holding company stock, primarily to existing stockholders. In fact, Integrity’s rapid growth from 2004 to 2006 was supported by significant stock issuances to raise more than \$60 million in capital, as shown in Table 10 below.

Table 10: Integrity Capital Stock Issuances

	2004	2005	2006	2007	2008
	(Dollars in Thousands)				
Common Stock Issued	\$20,000	\$15,600	\$25,000	\$3,000	\$300
Cumulative Total	\$20,000	\$35,600	\$60,600	\$63,600	\$63,900

Source: UBPR.

In 2007, Integrity failed to maintain its well capitalized position after adding \$34 million, which was attributed to one guarantor relationship, to the ALLL. At the June 2007 examination, Integrity fell to an adequately capitalized position with Tier 1 Total Risk Based Capital of 9.68 percent and, following the examination, recorded an additional \$14 million to the ALLL, which further decreased the Tier 1 Capital ratio; however, the institution remained adequately capitalized. On February 11, 2008, the FDIC issued a C&D that included provisions related to capital and required Integrity to:

- Submit, within 30 days, a capital plan for maintaining a Tier 1 Capital ratio of no less than 8 percent and to achieve that ratio within 120 days.
- Address how the bank would meet the minimum risk-based capital requirements for a well capitalized bank, as well as to have a fully funded ALLL, and develop plans to reduce its volatile liability dependency ratio below 20 percent by March 2008 and below 15 percent by June 2008.

The bank submitted plans as required in response to the C&D on March 25, 2008. In addition, Integrity withdrew applications for brokered deposit waivers submitted in May and June 2008 due to the C&D restrictions on brokered deposits. In June and August 2008, Integrity submitted progress reports, which notified the FDIC that it was not able to reduce its volatile dependency ratio below 20 percent as required by the C&D.

On July 30, 2008, the FDIC notified Integrity that, based on its June 30, 2008 Call Report data, the institution was considered to be undercapitalized for PCA purposes. The FDIC required Integrity to develop and submit a capital restoration plan (CRP) within 45 days of that letter. This requirement was reiterated in the August 12, 2008 PCA letter notifying Integrity that it had fallen to significantly undercapitalized. However, Integrity had not responded with a CRP as required by the PCA letters by the time the state closed the institution on August 29, 2008.

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

CORPORATION COMMENTS

On March 12, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 3 of this report. In its response, DSC agreed with the OIG's conclusions regarding the causes of Integrity's failure and the resulting material loss. DSC noted that facts regarding Integrity's largest borrowing relationship and significant control weaknesses in the loan approval processes did not come to light until the 2007 examination. However, in our view, greater concern for Integrity's loan administration and underwriting weaknesses identified in the 2005 and 2006 examinations could have led to earlier supervisory action regarding Integrity's borrowing relationships.

Finally, DSC stated that it has undertaken a number of initiatives related to the supervision of financial institutions that have high-risk lending activities, including concentrations in CRE loans and the use of interest reserves.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

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

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

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

Scope and Methodology

The scope of this audit included an analysis of Integrity's operations, from DBF's 2004 examination, until the bank's failure on August 29, 2008. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period. For an historical perspective of the bank, our review also included data regarding Integrity's asset and loan classifications, ALLL, and loan concentrations from the April 2001 through May 2003 examinations.

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

- Analyzed examination and visitation reports prepared by FDIC and DBF examiners from 2004 to 2008.
- Reviewed the following:
 - Bank data and correspondence maintained at DSC's ARO and Atlanta Field Office (AFO).
 - Reports prepared by DRR relating to the bank's closure.
 - Records of the bank's external auditors at the offices of Mauldin & Jenkins, in Atlanta, Georgia; and Carr, Riggs & Ingram, in Enterprise, Alabama.

- Records of the bank’s internal auditors at the offices of Porter Keadle Moore, LLP in Atlanta, Georgia; and Crowe Chizek and Company, LLC in Atlanta, Georgia.
- Bank records maintained by DRR in Dallas, Texas.
- Pertinent DSC policies and procedures.
- Interviewed or contacted the following FDIC officials:
 - DSC management in Washington, D.C., and DSC’s ARO and AFO in Atlanta, Georgia.
 - DRR officials at the Dallas Regional Office and in Alpharetta, Georgia.
 - FDIC examiners from the DSC AFO who participated in examinations or reviews of examinations of Integrity.
- Met with officials from the State of Georgia’s DBF in Atlanta, Georgia, to discuss their historical perspective of the institution, its examinations, state banking laws, and other activities regarding the states supervision of the bank.
- Researched various banking laws and regulations, including State of Georgia banking laws.

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

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

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

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

GLOSSARY OF TERMS

TERM	DEFINITION
Adversely Classified Assets	Assets subject to criticism and/or comment in an ROE. Adversely classified assets are allocated on the basis of risk (lowest to highest) to three categories: <ul style="list-style-type: none"> • Substandard, • Doubtful, and • Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL level that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of loan.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, <i>Prompt Corrective Action</i> , of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS


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

Division of Supervision and Consumer Protection

March 11, 2009

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

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, *Material Loss Review of Integrity Bank* (Assignment No. 2008-045)

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 Integrity Bank (Integrity), Alpharetta, Georgia, which failed on August 29, 2008. This memorandum represents the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received February 13, 2009.

We are pleased the OIG found that the FDIC and the Georgia Department of Banking and Finance conducted timely examinations of Integrity. Further, the OIG found that DSC used its authority responsibilities under Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Act to issue PCA Directives when Integrity became both undercapitalized and significantly undercapitalized.

We agree with the OIG's assessment that Integrity failed primarily due to management's aggressive pursuit of asset growth concentrated in higher-risk acquisition, development, and construction (ADC) loans with inadequate loan administration practices and risk management controls. For example, a lending relationship that far exceeded Integrity's legal lending limit was cited as an apparent violation of law at the March 2008 examination. This concentration of credit alone resulted in a significant loss of over \$44 million being suffered by Integrity. Cumulative loan losses, not only from this large lending relationship, severely eroded Integrity's capital, led to the bank's failure and a material loss to the Deposit Insurance Fund.

We are also pleased that the OIG notes the FDIC has taken steps to improve its supervisory oversight of financial institutions that have concentrations in ADC loans and use interest reserves. The report also notes that examiners identified deficiencies at Integrity in the 2005 and 2006 examinations that should have warranted greater concern. Facts regarding Integrity's largest borrowing relationship and other significant internal control weaknesses in the loan approval processes did not come to light until the 2007 FDIC examination. As noted by the OIG, the FDIC's 2007 examination team was instrumental in identifying the extent of Integrity's asset quality issues. The identified weaknesses were then exacerbated by rapidly deteriorating economic conditions, most notably in the Construction and Development (C&D) sector.

Lastly, with respect to the bank's regular use of brokered deposits as a funding source, FDIC regulations allow an insured bank that is "Well Capitalized" pursuant to PCA to obtain, renew, and roll over brokered deposits without limitation. Prior to 2007, Integrity operated as a Composite "2" rated, "Well Capitalized" institution. When the bank's financial condition began to deteriorate in 2007, DSC took action to address brokered deposit reliance as outlined in FDIC regulations. Brokered deposit waivers were granted within the parameters of a comprehensive supervisory strategy designed to allow for a pending market resolution. However, subsequent events, including a failed asset sale, caused the pending market resolution to fall through.

In light of the economic deterioration and its impact on Integrity and other similarly situated institutions, DSC has undertaken a number of initiatives:

- In May 2007, DSC launched a call program for institutions with significant residential construction, subprime mortgage, or other higher-risk lending activities. A goal of the program was to identify problems early and initiate appropriate supervisory responses.
- DSC examiners authored an article titled *Managing Commercial Real Estate Concentrations* in the Winter 2007 edition of *Supervisory Insights*. This article was prompted by rapid commercial real estate (CRE) loan growth in the banking industry and elaborates on the authors' field examination experience with the principles set forth in the 2006 CRE Guidance, issued by the FDIC, the Federal Reserve Board, and the Office of the Comptroller of the Currency on December 6, 2006, titled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (2006 CRE Guidance).
- In January 2008, DSC conducted a horizontal review of CRE lending practices; outcomes include changes to the current supervisory approaches, such as an acceleration of the next scheduled examination or downgrades to composite ratings, where warranted.
- The FDIC issued a Financial Institution Letter (FIL) on March 17, 2008, titled *Managing Commercial Real Estate Concentrations in a Challenging Environment* (2008 CRE FIL). The 2008 CRE FIL re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices and recommended several risk management processes to help institutions manage CRE and C&D concentrations. This FIL also articulated the FDIC's concern about interest reserves for C&D loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.
- In July 2008, DSC developed a comprehensive CRE guidance repository in a Regional Director memorandum which updates and re-emphasizes CRE loan examination procedures in view of more challenging market conditions, particularly in C&D lending.

- DSC examiners authored an article titled *A Primer on the Use of Interest Reserves* in the Summer 2008 edition of *Supervisory Insights*.
- In August 2008, DSC issued revised examination instructions to collect information on market conditions and practices at banks potentially exposed to significant CRE concentration risk. These data will provide real-time information relating to CRE markets across the country and FDIC-supervised institutions operating in those markets and will be available for supervisory purposes.
- In September 2008, DSC made available to examiners a resource that provides for more detailed information on commercial and residential real estate markets and transactions. These data, which include estimated property values, comparable sales, leasing rates, capitalization rates, vacancy rates, title/deed documents, and other related information, may aid examiner analysis of market conditions during examinations of banks with significant CRE concentrations.
- In November and December 2008, examiners conducted on-site visitations of certain banks in Georgia, Florida and California with high C&D concentrations. Ratings were downgraded as appropriate and corrective programs initiated.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
AFO	Atlanta Field Office
ALLL	Allowance for Loan and Lease Losses
ARO	Atlanta Regional Office
BOD	Board of Directors
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
CD	Certificate of Deposit
C&D	Cease and Desist Order
CFO	Chief Financial Officer
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
DBF	Department of Banking and Finance
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
MLR	Material Loss Review
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System