Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-020

Material Loss Review of the Six Bank Subsidiaries of Security Bank Corporation, Macon, Georgia

February 2010

Office of Inspector General

Executive Summary

Material Loss Review of the Six Bank Subsidiaries of Security Bank Corporation, Macon, Georgia

Report No. MLR-10-020
February 2010

Why We Did The Audit

On July 24, 2009, the Georgia Department of Banking and Finance (DBF) closed the six bank subsidiaries (Security Banks) of Security Bank Corporation (SBC), Macon, Georgia and named the FDIC as receiver. On August 12, 2009, the FDIC notified the Office of Inspector General (OIG) of the estimated losses that each of the Security Banks had caused to the Deposit Insurance Fund (DIF). The total assets at closing for the Security Banks were $2.4 billion and the estimated losses to the DIF were approximately $807 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failures.

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

Background

The Security Banks were state nonmember banks wholly-owned by SBC, a six-bank holding company headquartered in Macon, Georgia that was initially established in September 1994 as a one bank-holding company. SBC expanded its presence in Georgia through a number of acquisitions between 1994 and 2006, eventually providing community banking services in the central, coastal, and north Georgia markets through its six subsidiary banks. The six banks operated autonomously, each with its own Board and management team. SBC provided oversight and assistance in areas of budgeting, marketing, human resource management, credit administration, operations, and funding. The banks provided traditional banking services within their local markets and focused on Commercial Real Estate (CRE) lending with an emphasis on Acquisition, Development, and Construction (ADC) lending. Since 2005, much of the banks' loan growth was generated by the parent bank's subsidiary, Security Real Estate Services (SRES). SRES-originated loans were purchased by all but one of the Security Banks as well as other banks in Georgia. Although each of the Security Banks was independently chartered with separate Boards, SBC significantly influenced the business strategies of the banks, particularly with regard to the purchase of ADC loans from SRES. The Security Banks are considered affiliates based on section 23A of the Federal Reserve Act, made applicable to insured nonmember banks by section 18(j) of the FDI Act, which establishes certain requirements, restrictions, and prohibitions with regard to transactions among the banks.

Audit Results

Causes of Failures and Material Losses

The failures of the Security Banks can be attributed to the strategy promoted by SBC and followed by each of the banks' Boards and management, which centered on growing their ADC loan portfolios. Further, SBC's expansion into the Atlanta metropolitan market was ill-timed, as it

occurred at the peak of that market. Although initially profitable, the banks' pursuit of growth and increased ADC concentrations, without regard for prudent underwriting and credit administration, made the banks vulnerable to depressed economic conditions. As economic conditions, particularly in housing markets, began to deteriorate in 2007, the weaknesses in the Security Banks' management and Board oversight and loan underwriting and credit administration practices were exposed, and the performance of the banks' ADC portfolios began to deteriorate. Asset quality became critically deficient and earnings were insufficient to support operations and maintain adequate capital. In addition, the banks relied on non-core funding sources, including brokered deposits, to fund growth. As the banks' capital levels declined as a result of the mounting loan losses, the banks could no longer rely on those funding sources and liquidity became strained. Collectively, these factors led to the DBF's closure of the banks.

The FDIC's Supervision of the Security Banks

Recognizing that each bank's supervisory history is unique, our conclusion regarding the FDIC's supervision of these institutions is the same. The FDIC and the DBF examinations prior to 2007 identified the ADC concentrations but generally concluded that the institutions were fundamentally sound. Further, examinations and Federal Reserve inspections of the holding company did not identify any significant concerns related to affiliate transactions. FDIC officials stated that prior to 2007, concerns regarding the Security Banks' high concentrations in ADC loans were mitigated by the banks' respective strong earnings and low levels of adversely classified assets. Examiners, nevertheless, cautioned the Boards and management of the Security Banks to be mindful of the inherent risks of the high ADC concentrations. In hindsight, examiners could have been more emphatic in advising the banks' Boards and management to maintain strong risk management practices before 2007—prior to the economic downturn—taking into consideration the following factors:

- the vulnerability of significant ADC concentrations to economic cycles,
- the importance of strong underwriting and credit administration practices in order to mitigate the risk associated with the significant concentrations, and
- growth that was being fueled by non-core funding sources.

Once problems were identified, the FDIC and the DBF pursued supervisory actions. However, by the time those actions became effective, the financial condition of the banks had become critically deficient.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. SBC and the Security Banks were unsuccessful in raising needed capital and the banks were subsequently closed on July 24, 2009.

Material Loss Review of the Six Bank Subsidiaries of Security Bank Corporation, Macon, Georgia

Report No. MLR-10-020
February 2010

Management Response

On February 12, 2010, the Director, Division of Supervision and Consumer Protection, provided a written response to the draft report. DSC's response reiterates the OIG's conclusions regarding the causes of failures and describes market conditions prior to the economic downturn that led Atlanta-area financial institutions to increase ADC lending to unprecedented levels and encouraged out-of-area institutions to begin lending in the marketplace.

With respect to our assessment of the FDIC's supervision of the Security Banks, DSC's response also reiterated the supervisory actions taken with regard to the ADC concentrations presented in the report, including examiners encouraging the banks to implement stronger risk management practices. The response indicates, however, that in DSC's view, the extent of the ADC concentration at the Security Banks, together with the sudden collapse of demand for vacant building lots, resulted in a situation that could not have been overcome by even the strongest risk management practices.

Finally, DSC's response describes supervisory guidance issued in 2006 and 2008 that re-emphasizes the importance of robust credit risk-management practices and sets broad supervisory expectations, in recognition that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources.

Contents

	Page
Background	2
Causes of Failures and Material Losses	5
Excessive Concentrations in ADC Loans	6
Weak Loan Underwriting and Credit Administration	8
Reliance on Non-Core Funding	11
The FDIC's Supervision of the Security Banks	12
Supervisory History	13
Examination of Transactions with Affiliates	15
Supervisory Concerns Related to ADC Concentrations	16
Supervisory Concerns Related to Loan Underwriting and Credit Administration	17
Supervisory Concerns Related to Non-Core Funding	18
Implementation of PCA	19
Corporation Comments	21
Appendices	
1. Objectives, Scope, and Methodology	22
2. Glossary of Terms	24
3. Acronyms	26
4. Corporation Comments	27
Tables	
1. Estimated Losses to the DIF for the Security Banks	1
2. Acquisition History of the Security Banks, 1988 to 2006	4
3. Selected Financial Information for the Security Banks, 2006 to 2009	5
4. Security Banks' Asset Growth Rates, 2005 and 2006	6
5. Loan Losses at the Security Banks from SRES-Originated Loans	9
6. Security Banks' Net Non-Core Funding Sources, 2006 to 2009	11
7. Security Banks' Net Non-Core Funding Dependence Ratio Compared to Peer Groups, 2006 to 2009	12
8. Examinations and Visitations of the Security Banks, 2006 to 2009	15
9. Security Banks' ADC Loans to Total Capital as of March 31, 2007	17
10. Security Banks' Capital Levels Relative to PCA Thresholds for *Well Capitalized* Institutions	19
11. Security Banks' Decline in Capital Levels Between 2008 and 2009 in Examinations and/or Visitations	20

Contents

Page

Figures

1. Structure of the Security Banks Under SBC 3
2. Security Banks' ADC Loans to Total Capital as of December 31, 2007 7
3. Security Banks' Adversely Classified Items Coverage Ratios, Reported in Examinations Conducted from 2006 to 2008 8

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

Office of Material Loss Reviews
Office of Inspector General

DATE: February 12, 2010

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

/Signed/

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

SUBJECT: *Material Loss Review of the Six Bank Subsidiaries of Security Bank Corporation, Macon, Georgia* (Report No. MLR-10-020)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failures of the six bank subsidiaries of Security Bank Corporation (SBC), Macon, Georgia, which are collectively referred to in this report as the Security Banks. The Georgia Department of Banking and Finance (DBF) closed the institutions on July 24, 2009, and named the FDIC as receiver. On August 12, 2009, the FDIC notified the OIG that the total assets at closing for the Security Banks were $2.4 billion and the estimated losses to the Deposit Insurance Fund (DIF) were approximately $807 million. Table 1 details the estimated loss to the DIF for each of the Security Banks.

Table 1: Estimated Losses to the DIF for the Security Banks

Bank Subsidiary	Total Assets	Total Estimated Losses to the DIF	Total Estimated Losses as a Percentage of Total Assets
Security Bank of Bibb County (Bibb)	$1,013,327,220	$429,494,000	42.3%
Security Bank of Jones County (Jones)	$409,496,934	$59,574,000	14.5%
Security Bank of Houston County (Houston)	$365,722,429	$54,909,000	15.0%
Security Bank of Gwinnett County (Gwinnett)	$280,647,395	$152,742,000	54.4%
Security Bank of North Fulton (N. Fulton)	$193,187,062	$37,684,000	19.5%
Security Bank of North Metro (N. Metro)	$184,900,219	$72,453,000	39.1%
Total	**$2,447,281,259**	**$806,856,000**	**32.9%**

Source: The FDIC's Division of Finance.

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

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. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review were to (1) determine the causes of the Security Banks' failures and the resulting material losses to the DIF and (2) evaluate the FDIC's supervision[2] of the Security Banks, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of the Security Banks' failures and the FDIC's efforts to ensure that the Security Banks' Boards of Directors (Boards) and management operated the institutions in a safe and sound manner.

The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our material loss reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of DSC's supervision program and make recommendations as warranted. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of terms and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

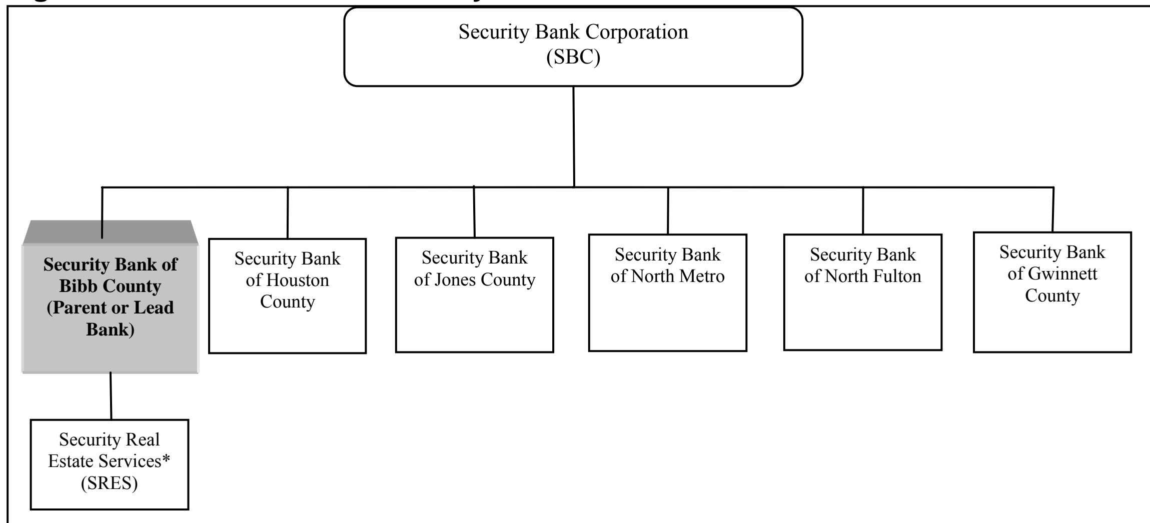
The Security Banks were state nonmember banks wholly-owned by SBC, a six-bank holding company headquartered in Macon, Georgia that was initially established in September 1994 as a one bank-holding company. SBC expanded its presence in Georgia through a number of acquisitions between 1994 and 2006, eventually providing community banking services in the central, coastal, and north Georgia markets through its six subsidiary banks. The Security Banks are considered affiliates based on section 23A of the Federal Reserve Act, made applicable to insured nonmember banks by section 18(j) of the FDI Act. As discussed later in this report, section 23A regulates loans or extensions of credit to affiliated organizations and investments in affiliates by restricting amounts of loans, extensions of credit, and investments, and requiring that loans or extensions of credit meet certain collateral requirements.

---

[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.

At the time of failure, the Security Banks operated 20 branches located near Atlanta and Macon, Georgia. The six banks operated autonomously, each with its own Board and management team. Each of the banks had a reciprocal agreement with one another to perform various services, including receiving deposits, renewing time deposits, closing loans, servicing loans, receiving payments on loans and other obligations, and performing other services approved by regulatory authorities. SBC provided oversight and assistance in areas of budgeting, marketing, human resource management, credit administration, operations, and funding. Over time, management became more centralized, and in January 2009, SBC initiated an application to the FDIC and the DBF for approval to consolidate the banks into a single charter. The objective of the consolidation was to improve the credit process, reduce credit risk, and increase operational efficiency. However, SBC withdrew the application prior to the banks' failure. Figure 1 illustrates the structure of the six banks under SBC, noting Bibb as the parent or lead bank.

Figure 1: Structure of the Security Banks Under SBC



Source: OIG
* Until 2008, SRES was known as Fairfield Financial Services, Inc.

Table 2 on the following page summarizes the history and acquisitions of the Security Banks by SBC.

Table 2: Acquisition History of the Security Banks, 1988 to 2006

Date	Bank
1988	Bibb commences operations as Security National Bank.
1994	Bibb forms SNB Bankshares, Inc. (the predecessor of SBC), a one-bank holding company.
1998	SBC acquires Houston.
2000	SBC acquires Fairfield Financial Services (hereafter referred to as SRES), a financial services company specializing in residential mortgage originations.
2003	SBC acquires Jones.
2005	SBC acquires N. Metro.
2005/2006	SBC acquires Rivoli Bancorp, Inc. and merges its subsidiary bank, Rivoli Bank & Trust, into Bibb.
2006	SBC acquires N. Fulton.
2006	SBC acquires Gwinnett.

Source: Supervisory documents for the Security Banks.

The banks provided traditional banking services within their local markets and focused on commercial real estate (CRE) lending with an emphasis on acquisition, development, and construction (ADC)[3] lending. Since 2004, except for Gwinnett, which did not purchase loans from SRES, much of the banks' loan growth was generated by SRES. As noted in Table 2, SRES originally specialized in residential mortgage originations but in 2004 transitioned to ADC lending primarily in Georgia and Florida. Eventually, SRES began generating loans outside of the banks' traditional lending areas, including South Carolina, North Carolina, and Alabama. SRES-originated loans were purchased by the Security Banks as well as other banks in Georgia. Although each of the Security Banks was independently chartered with separate Boards, SBC's Board influenced the business strategies of the Security Banks, particularly with regard to the purchase of ADC loans from SRES. Table 3 on the following page summarizes selected financial information for the Security Banks.

[3] ADC lending involves loans on construction and development projects which may often be speculative because the loan repayment is based on the successful completion and leasing or sale of the construction project.

Table 3: Selected Financial Information for the Security Banks, 2006 to 2009

Financial Measure	Bank	06/30/2009	12/31/2008	12/31/2007	12/31/2006
Total Assets ($000s)	Bibb	943,744	1,231,751	1,289,830	1,089,742
	Houston	371,624	383,678	336,807	304,053
	Jones	432,712	442,269	378,848	344,479
	Gwinnett	259,182	346,763	403,656	345,392
	N. Metro	184,184	237,526	221,709	221,349
	N. Fulton	190,564	200,685	191,378	190,177
Total Loans ($000s)	Bibb	784,518	945,429	995,384	869,782
	Houston	206,257	231,051	255,994	229,600
	Jones	277,787	283,427	287,979	230,621
	Gwinnett	178,963	226,576	314,490	272,089
	N. Metro	151,266	161,553	172,889	164,042
	N. Fulton	109,857	125,606	139,989	134,966
Total Deposits ($000s)	Bibb	831,437	1,038,170	1,060,012	856,346
	Houston	313,155	316,363	300,413	267,161
	Jones	375,238	378,294	306,087	263,243
	Gwinnett	256,578	310,767	312,040	263,703
	N. Metro	182,413	219,722	175,942	183,440
	N. Fulton	179,523	180,086	148,206	151,320
Total Brokered Deposits ($000s)	Bibb	300,514	403,404	389,391	211,576
	Houston	28,603	27,770	31,959	32,030
	Jones	120,716	112,978	82,183	54,116
	Gwinnett	90,650	118,383	77,020	29,202
	N. Metro	64,627	95,068	78,021	60,241
	N. Fulton	36,412	40,574	19,454	29,073
Net Income (Loss) ($000s)	Bibb	(37,634)	(103,943)	2,317	14,601
	Houston	(5,227)	(2,538)	2,798	4,267
	Jones	(7,042)	(21,508)	5,101	4,416
	Gwinnett	(33,189)	(57,028)	2,483	1,780
	N. Metro	(15,179)	(28,242)	(1,282)	2,128
	N. Fulton	(7,523)	(29,526)	503	1,429

Source: Uniform Bank Performance Reports (UBPR) and Reports of Examination (ROE) for the Security Banks.

SBC was historically a source of strength to each of the banks. During 2008, as the financial conditions of each of the banks deteriorated, SBC raised a significant amount of capital to address the economic uncertainty facing the organization and distributed the funds to the banks to help maintain capital levels. However, as conditions worsened, SBC was unable to raise sufficient capital to keep the banks viable.

Causes of Failures and Material Losses

The failures of the Security Banks can be attributed to the strategy promoted by SBC and followed by each of the banks' Boards and management, which centered on growing their ADC loan portfolios. Further, SBC's expansion into the Atlanta metropolitan market was

ill-timed, as it occurred at the peak of that market. Although initially profitable, the banks' pursuit of growth and increased ADC concentrations, without regard for prudent underwriting and credit administration, made the banks vulnerable to depressed economic conditions. As economic conditions, particularly in housing markets, began to deteriorate in 2007, the weaknesses in the Security Banks' management and Board oversight and loan underwriting and credit administration practices were exposed, and the performance of the banks' ADC portfolios began to deteriorate. Asset quality became critically deficient and earnings were insufficient to support operations and maintain adequate capital. In addition, the banks relied on non-core funding sources, including brokered deposits, to fund growth. As the banks' capital levels declined as a result of the mounting loan losses, the banks could no longer rely on those funding sources and liquidity became strained. Collectively, these factors led to the DBF's closure of the banks.

Excessive Concentrations in ADC Loans

SBC pursued a strategy of growth in 2005 and 2006, acquiring Gwinnett, N. Metro, and N. Fulton, to expand its organization outside of middle Georgia into the developing Atlanta metropolitan real estate market. Although unknown at the time, FDIC officials stated SBC expansion into the Atlanta metropolitan area occurred as growth in the area was peaking.

Table 4 summarizes the asset growth at the Security Banks during this period, particularly among the three banks in the Atlanta metropolitan area, with much of this growth concentrated in ADC loans. From the time of their acquisition by SBC, all of the Security Banks maintained high ADC lending concentrations.

Table 4: Security Banks' Asset Growth Rates, 2005 and 2006

Year	Bibb	Jones	Houston	Gwinnett	N. Metro	N. Fulton
2005	18.11%	8.52%	23.33%	85.68%	62.00%	102.11%
2006	57.63%	20.53%	15.49%	54.36%	20.09%	65.74%

Source: UBPRs for Security Banks.

Gwinnett had a large volume of ADC loans in its portfolio when it was acquired by SBC in 2006. The other banks' growth was fueled in large part by loans purchased from SRES. The banks purchased loans from SRES to meet ADC lending targets directed by SBC, as well as to remain within regulatory lending limits. Loans purchased from SRES during 2005 and 2006, as well as an increase in ADC loans originated by the banks themselves, increased each of the banks' ADC loan concentrations. Initially, SBC's overarching growth strategy centered on ADC lending was profitable because the real estate market was strong. As of December 31, 2007, four of the banks had concentrations in ADC lending over 400 percent of Total Capital.

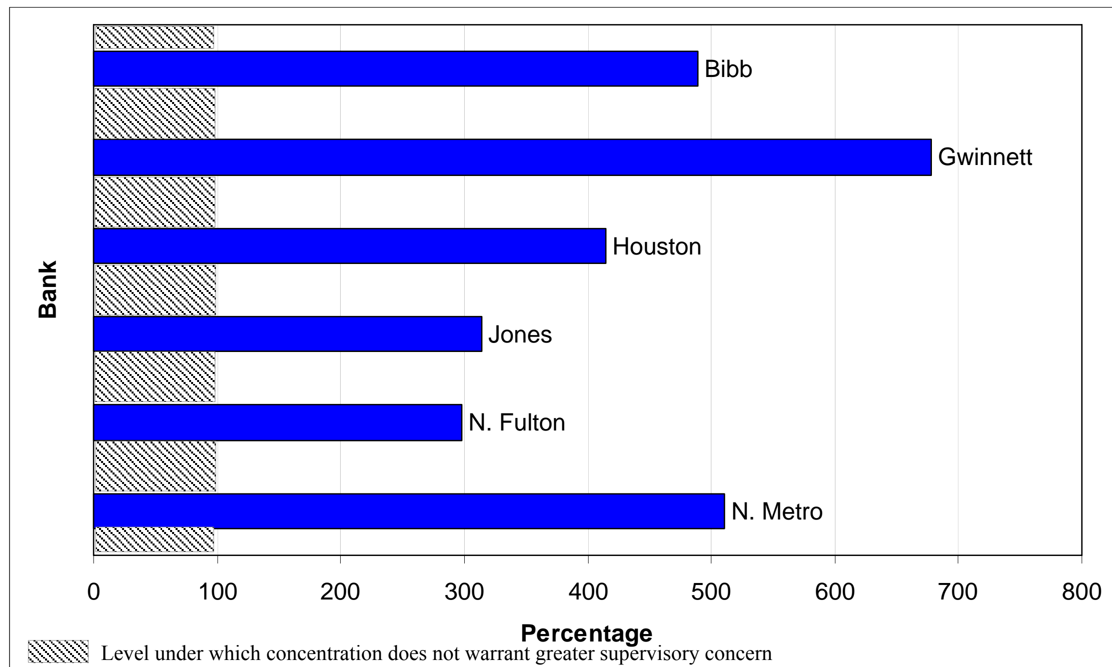
Federal banking regulatory agencies issued guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (*Interagency Guidance*) on December 12, 2006 to remind institutions that strong risk management practices and appropriate levels of capital are essential elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans. The Interagency Guidance focuses on those CRE loans for which cash flow from the real estate is the

primary source of repayment (i.e., ADC lending). The *Interagency Guidance* does not define specific CRE lending limits but establishes supervisory criteria to identify institutions that are exposed to significant CRE concentration risk that may warrant greater supervisory scrutiny as follows:

1. Total reported loans for construction, land development, and other land (i.e., ADC) representing 100 percent or more of total capital; or
2. Total CRE loans representing 300 percent or more of total capital where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months.

As shown in Figure 2, as of December 31, 2007, each of the Security Banks had ADC concentrations well beyond the levels defined in the 2006 guidance.

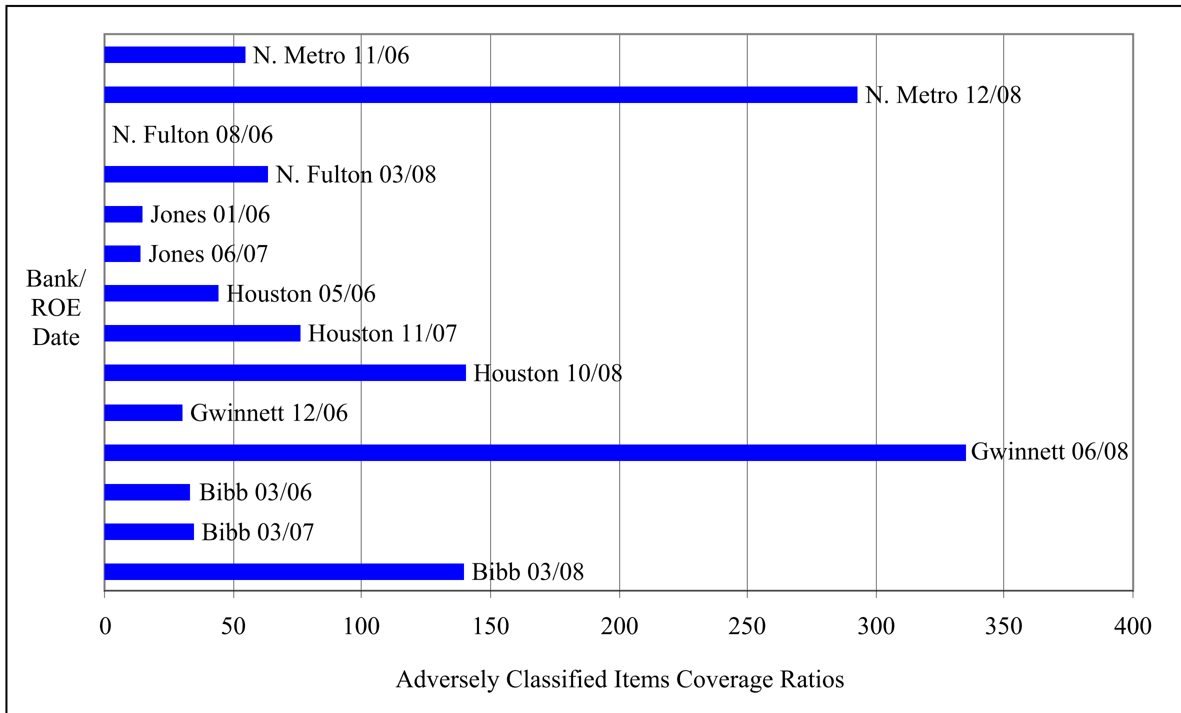
Figure 2: Security Banks' ADC Loans to Total Capital as of December 31, 2007



Source: December 31, 2007 UBPRs for Security Banks.

Each of the examinations at the Security Banks conducted after January 1, 2008 found that the bank's asset quality had significantly deteriorated from the previous examinations. The 2008 examinations concluded that the asset quality deterioration was centered in the excessive concentrations in ADC lending adversely affected by the downturn in the real estate markets in the banks' lending areas. Figure 3 shows the increase in adversely classified loans to Tier 1 Capital (Adversely Classified Items Coverage Ratio) from 2006 to 2008. This ratio is a measure of the level of asset risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor-quality assets and less ability for the bank's capital to absorb any losses associated with those assets.

Figure 3: Security Banks' Adversely Classified Items Coverage Ratios, Reported in Examinations Conducted from 2006 to 2008



Source: OIG analysis of the ROEs of the Security Banks.

Weak Loan Underwriting and Credit Administration

According to the *Interagency Guidance*, concentrations in CRE lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the past. The *Interagency Guidance* reinforced and enhanced existing regulations and guidelines and promotes sound risk management practices and appropriate levels of capital to enable institutions to pursue CRE lending in a safe and sound manner. For instance, earlier guidance on ADC lending[4] emphasized 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. Counter to regulatory guidance and fundamental sound business practices, the banks' Boards and management focused on growth and income and failed to implement adequate risk management practices, including loan underwriting and credit administration controls, which ultimately led to significant asset quality problems.

---

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

Loan Underwriting

Loan underwriting weaknesses were identified in each of the 2008 Security Bank examinations reports but generally had not been identified as a significant concern in prior examinations. FDIC officials told us that the Security Banks may have relaxed their underwriting standards due to the competition among banks, particularly in the Atlanta market, to obtain deposits, fund loans, and develop business relations. Although the degree of weaknesses reported varied among the Security Banks, examination comments indicated that underwriting practices:

- Allowed high residential speculative construction loan limits and high loan-to-value (LTV) financing on lot development. In several cases, examiners concluded that these practices were in contravention of the *Interagency Guidance*.

- Lacked adequate global cash flow analysis. Examination reports for three of the six Security Banks (Bibb, Jones, and Gwinnett) commented that the banks did not conduct adequate global cash flow analysis on the borrowers prior to extending credit. Information such as comparative financial statements, income statements, cash flow statements, and other pertinent statistical support, including the borrowers' list of contingent liabilities, was not properly obtained.

Underwriting deficiencies in SRES-originated loans were cited as a primary cause of the asset quality deterioration at the Security Banks. Both FDIC and DBF regulators told us that one of the first warning signs of potential deterioration at the Security Banks was the loan problems identified in participations from SRES found during examinations at other non-affiliated banks in Georgia. SRES-originated loans proved to be a significant cause of loan losses for the Security Banks, as shown in Table 5. The exception was Gwinnett, where unlike the other Security Banks, the majority of its problem loans were generated internally.

Table 5: Loan Losses at the Security Banks from SRES-Originated Loans

Bank	Bibb	Houston	Jones	N. Metro	N. Fulton
SRES-Originated Loan Losses from 2006 to 2009	91 Percent	67 Percent	73 Percent	77 Percent	36 Percent

Source: DSC Supervisory Histories.

Problems with SRES loan underwriting were first reported in the November 2007 Houston examination when examiners reported that loans originated by SRES made up approximately 50 percent of adversely classified items. The examination report noted that SRES utilized a loosely controlled, fee-based compensation structure that emphasized fee generation at the expense of credit quality. Also, SRES-originated loans throughout Georgia, Florida, South Carolina, North Carolina, and Alabama. In addition to the poor underwriting by SRES, the geographic dispersion of these credits, outside the bank's traditional lending area, was difficult for the bank to monitor and presented heightened risk due to the type of ADC projects being pursued.

According to the DSC *Risk Management Manual of Examination Policies,* institutions purchasing participations must make a thorough, independent evaluation of the transaction and risks involved before committing any funds. Institutions should also apply the same standard of prudence, credit assessment, approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. However, it is apparent, based on examiners' comments on the lack of adequate underwriting identified in SRES-originated loans, that the Security Banks did not conduct this type of evaluation.

Similar comments were also reported in the March 2008 Bibb examination. Specifically, examiner concern with Bibb's asset quality was due to approximately 87 percent of its adversely classified loans having been originated by SRES. The examination report also noted that SRES was not properly controlled internally and that its lenders produced a significant number of loans that lacked adequate underwriting, and cited the SRES lender compensation plan as a cause of the poor loan quality. The SRES lender compensation plan was solely based upon growth and lacked any consideration of the underlying quality of the asset being booked. As a result, according to the examiners, lenders at SRES originated an exorbitant number of loans that lacked adequate underwriting.

Credit Administration Practices

Examination reports noted credit administration weaknesses as a contributing factor in the asset quality problems at each of the Security Banks. Common weaknesses reported included:

Improper Use of Interest Reserves. Beginning in November 2007, examinations reported that each of the banks allowed borrowers to continue using interest reserves, despite problems with the project being financed (e.g., a delay or total cessation of the project). This practice masked weaknesses in the ADC portfolio by showing credits as current and performing. Loans would not be reported as delinquent or non-performing until all interest reserves were depleted or the loan matured and the borrower did not have the ability to make the interest payment. The banks also masked ADC delinquencies by requiring interest-only payments for troubled ADC projects with extended repayment terms.

Failure to Obtain Updated Appraisals. Each of the Security Banks was found to be in contravention of *Part 323 of the FDIC Rules and Regulations* regarding appraisals. This finding involved the failure of the banks to obtain updated appraisals on properties that reflected current market conditions. Prior appraisals were found to be weak and contained stale comparable information, particularly when considering current market conditions. Prior evaluations also contained unrealistic absorption rates, holding periods, sales prices, and discount rates. Other weaknesses noted included the failure to (1) obtain new appraisals or evaluations prior to the renewal of construction or development projects that were either stalled, or were completed but had not met their original sales projections and (2) obtain new appraisals or evaluations despite significant changes in market conditions.

Lack of Property Inspections. The Security Banks' ADC lending program did not adequately ensure that loan disbursements and inspections were appropriately monitored or documented. The Security Banks' management did not require general contractors to consistently provide invoices to support draw requests, and did not obtain lien waivers from subcontractors to illustrate that the individual or company completed the assigned project and that payment was received from the general contractor. Additionally, although inspections were performed by third-party companies, they were not contracted to review an assigned project as a whole, but rather review the current disbursement requested to determine if the work had been completed for that specific draw. As a result, management was unable to determine the degree of completion of an entire project.

Reliance on Non-Core Funding

Liquidity management of the Security Banks was performed at the holding company level and was heavily dependent on non-core funding sources such as brokered deposits and Federal Home Loan Bank borrowings. In the years preceding their failure, the Security Banks became increasingly dependent on non-core funding sources, particularly brokered deposits, to fund growth in their loan portfolio and maintain adequate liquidity. Table 6 provides details regarding the Security Banks' non-core funding sources during the years prior to their failure. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. According to the *DSC Risk Management Manual of Examination Policies*, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

Table 6: Security Banks' Net Non-Core Funding Sources, 2006 to 2009

Period Ending	Total Deposits ($000s)	Time Deposits of $100,000 or More ($000s)	Brokered Deposits ($000s)	Federal Home Loan Bank Borrowings ($000s)
March 2009	2,138,344	870,464	641,522	163,510
December 2008	2,443,402	1,085,976	798,177	190,695
December 2007	2,302,700	1,042,540	678,028	77,200
December 2006	1,985,213	745,150	416,238	83,450

Source: UBPRs for the Security Banks.

Table 7 illustrates the Security Banks' net non-core funding dependence ratios[5] between December 2006 and the institutions' failures. During this period, except for Houston, the Security Banks' net non-core funding dependence ratio was most often higher than its peer group. Such rankings indicate that the institution's potential volatile funding dependence was higher than the average of the banks' respective peer groups.

Table 7: Security Banks' Net-Core Funding Dependence Ratio Compared to Peer Groups, 2006 to 2009

	June 2009	Dec 2008	Dec 2007	Dec 2006
Bibb	50.23	52.71	52.30	39.41
Peer Group	30.90	35.29	29.31	27.27
Gwinnett	58.92	55.31	54.38	44.23
Peer Group	27.63	30.37	26.18	20.11
Houston	16.65	25.24	17.57	17.51
Peer Group	27.70	30.37	25.68	17.85
Jones	38.24	37.63	41.87	25.02
Peer Group	27.70	30.37	25.68	24.46
N. Fulton	38.84	30.03	38.98	39.88
Peer Group	27.63	30.16	26.18	20.11
N. Metro	50.68	49.12	58.36	42.62
Peer Group	27.63	30.16	23.72	24.85

Source: UBPRs for Security Banks.

The FDIC's Supervision of the Security Banks

Recognizing that each bank's supervisory history is unique, our conclusion regarding the FDIC's supervision of these institutions is the same. The FDIC and the DBF examinations prior to 2007 identified the ADC concentrations but generally concluded that the institutions were fundamentally sound. Further, examinations and Federal Reserve inspections of the holding company did not identify any significant concerns related to affiliate transactions. FDIC officials stated that prior to 2007, concerns regarding the Security Banks' high concentrations in ADC loans were mitigated by the banks' respective strong earnings and low levels of adversely classified assets. Examiners, nevertheless, cautioned the Boards and management of the Security Banks to be mindful of the inherent risks of the high ADC concentrations. In hindsight, examiners could have been more emphatic in advising the banks' Boards and management to maintain strong risk management practices before 2007—prior to the economic downturn—taking into consideration the following factors:

[5] The net non-core funding dependence ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources that may not be available in times of financial stress.

- the vulnerability of significant ADC concentrations to economic cycles,
- the importance of strong underwriting and credit administration practices in order to mitigate the risk associated with the significant concentrations, and
- growth that was being fueled by non-core funding sources.

Once problems were identified, the FDIC and the DBF pursued supervisory actions. However, by the time those actions became effective, the financial condition of the banks had become critically deficient.

Supervisory History

Our review focused on supervisory oversight from 2006 and 2009. Until 2009, the examinations of the Security Banks were not conducted concurrently. FDIC officials stated that it is a good practice to coordinate the timing of examinations for affiliated banks, but not always practically possible. For example, in this case, the timing of SBC's bank acquisitions made it challenging for the FDIC to synchronize the banks' examination cycles. Accordingly, absent supervisory concerns, such as those that existed in 2009, the examination cycles were based on the date of the individual institution's charter. However, examiners covered relationships and transactions between the affiliated banks during the individual bank examinations.

Except in one instance, the FDIC and the DBF conducted alternating examinations of the Security Banks on a regular basis, as required, between 2006 and 2008.[6] Examinations conducted in 2009 were conducted jointly, except for the FDIC's examination of Houston. The banks were also subject to offsite monitoring. In the case of N. Metro, there was a 22-month interval between the 2006 and 2008 on-site examinations. FDIC officials stated that the N. Metro examination was delayed because of resource constraints during that period. However, N. Metro received an interim visitation 9 months after the 2006 examination that confirmed the 2006 examination rating. Also, the FDIC used Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) examination procedures[7] during the 2006 examinations of Bibb and Gwinnett.

Prior to 2006, each of the Security Banks was considered a well-performing institution and consistently received "1" or "2" CAMELS composite ratings.[8] Regulators first

[6] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full scope, on-site examinations of every state nonmember bank at least once every 12-month period and allows for 18-month intervals for certain small institutions (total assets of less than $500 million) if certain conditions are satisfied. Houston, Jones, Gwinnett, N. Fulton, and N. Metro qualified for the 18-month examination cycle.
[7] In 2002, DSC implemented MERIT guidelines to assist examiners in risk-focusing examination procedures in institutions with lower risk profiles. Under this program, the loan penetration ratio range was guided by the asset quality rating at the last examination. In March 2008, DSC eliminated MERIT examination procedures.
[8] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

observed a decline in the asset quality of the Security Banks in the June 30, 2007 offsite monitoring reports of Bibb and Gwinnett. Also, during 2007 examinations ongoing at other banks in Georgia not affiliated with the Security Banks, SRES-originated loans were showing signs of weaknesses. As a result, the FDIC increased the budgeted hours planned for the November 2007 Houston examination and accelerated its planned examination of Bibb to the first quarter of 2008.

In November 2007, examiners assigned Houston a "3" CAMELS composite rating and placed the bank under a Memorandum of Understanding (MOU) to address identified weaknesses. The 2008 examinations conducted by the FDIC and the DBF identified significant deterioration in all of the Security Banks and resulted in the pursuit of Cease and Desist Orders (C&Ds) at each one, except N. Fulton.[9] The FDIC notified Bibb management that a C&D would be pursued in a letter dated December 19, 2008 that transmitted the 2008 examination results. However, the C&Ds did not become effective until April 2009 due to competing priorities resulting from problem banks in the Atlanta Regional Office.

Although it took several months to finalize the C&Ds, DSC Atlanta Regional Office and DBF officials were communicating with bank management during that timeframe, and the banks were already attempting to address issues ultimately included in the C&Ds. The C&Ds included provisions for bank management to reduce ADC concentrations and correct underwriting and credit administration weaknesses, and take other steps necessary to improve the banks' asset quality, capital levels, and liquidity. Table 8 summarizes the results of each of the examinations and visitations conducted from 2006 to 2009 and related supervisory actions, if any.

[9] N. Fulton was subject to a Bank Board Resolution (BBR), an informal enforcement action, based on the 2008 DBF examination.

Table 8: Examinations and Visitations of the Security Banks, 2006 to 2009

Bank	Start Date	As of Date	Agency	Supervisory Ratings	Supervisory Action
Bibb	05/01/06	03/31/06	FDIC	222122/2	None
	05/01/07	03/31/07	State	222121/2	None
	03/10/08	03/31/08	FDIC	344543/4	Proposed C&D
	03/23/09*	03/31/09	Joint	555555/5	C&D Issued
Houston	05/22/06	03/31/06	State	222121/2	None
	11/13/07	09/30/07	FDIC	343332/3	MOU
	10/21/08	09/30/08	State	443433/4	Proposed C&D
	04/13/09*	03/31/09	FDIC	555544/5	C&D Issued
Jones	01/03/06	09/30/05	FDIC	111122/1	None
	06/18/07	03/31/07	State	111122/1	None
	03/17/08 (CRE Visit)	03/31/08	FDIC	N/A	None
	11/24/08 (CRE Visit)	09/30/08	Joint	443543/4	Proposed C&D
	04/13/09*	03/31/09	Joint	555555/5	C&D Issued
Gwinnett	02/24/06	12/31/05	FDIC	222222/2	None
	04/16/07	12/31/06	State	122121/2	None
	05/05/08	06/30/08	FDIC	454544/5	Proposed C&D
	04/13/09*	03/31/09	Joint	555555/5	C&D Issued
N. Metro	11/13/06	09/30/06	State	232222/2	None
	08/23/07 Visitation	06/30/07	State	232322/2	None
	12/01/08	09/30/08	FDIC	554544/5	Proposed C&D
	03/23/09*	03/31/09	Joint	555555/5	C&D Issued
N. Fulton	08/28/06	06/30/06	FDIC	212222/2	None
	03/31/08	12/31/07	State	232323/3	BBR Adopted
	04/13/09*	03/31/09	Joint	555555/5	PCA Directive

Source: FDIC ViSION system and ROEs for the Security Banks.
*Coordinated examinations were commenced at each of the Security Banks in 2009. While the banks were closed prior to issuance of the final ROEs, results were communicated to the banks through examination memorandums. Preliminary CAMELS ratings indicated a composite "5" was planned for each bank. As discussed in the 2008 examinations, Capital continued to decline as a result of the extensive loan losses incurred in the banks' ADC lending portfolios.

Examination of Transactions with Affiliates

As noted in the Background section of the report, the Security Banks were considered to be affiliates for purposes of Section 23A of the Federal Reserve Act. Due to the commonality of ownership or management between financial institutions and affiliated organizations, regulators recognize that transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties due to the influence of common ownership or management between the parties. As such, the respective examinations of the Security Banks were required to determine whether

each bank's transactions with its affiliates were in regulatory compliance and not detrimental to the safety and soundness of the financial institution. In this case, understanding and evaluating the transactions and relationships among the banks, including participations purchased from SRES, was important to evaluating the condition of each of the banks.

Each FDIC examination report included a section on relationships with affiliates and the holding company that contained financial data of the overall relationships, affiliated transactions, and a description of the affiliated relationship in accordance with the FDI Act and DSC examination procedures. In some examinations, violations related to covered transactions with affiliates were reported; however, these violations were corrected by bank management in the course of the examination and none required further administrative action. DSC officials told us that although it was not required, in hindsight, it may have been more efficient and effective to conduct the examinations of the Security Banks on a consolidated basis. They suggested that this sort of examination may have helped examiners obtain a more comprehensive understanding of the banks' affiliated transactions and better identify operational weaknesses, including those related to loan participations purchased from SRES.

Further, examiners reviewed annual Federal Reserve Bank (FRB) Inspection Reports of SBC from 2006 to 2008. The inspection reports provide an assessment of the financial condition of SBC similar to the individual bank examinations conducted by the FDIC and the DBF. The inspection reports also include coverage of intercompany transactions. None of the FRB inspection reports noted serious concerns with intercompany transactions.

Supervisory Concerns Related to ADC Concentrations

Examiners consistently identified that the Security Banks' loan portfolios included concentrations in ADC lending and noted that the concentrations warranted continued monitoring by management. Examiners did not downgrade the institutions' capital or management ratings or issue enforcement actions for the banks to reduce these concentrations until after the economic downturn began affecting asset quality. Based on our review of examinations conducted in 2006 and early 2007, and discussions with examiners, supervisory concern about the level of concentrations was generally not warranted for a number of reasons: (1) the apparent strong protection of collateral; (2) low levels of classified assets; (3) management involvement; (4) strong capital levels; and (5) effective programs to measure, monitor, and control the inherent risks in the banks' highly concentrated ADC lending. However, the 2006 N. Metro examination reported that ADC monitoring needed improvement.

The 2007 examinations identified ADC concentrations at levels above those described in the *Interagency Guidance* on CRE lending that may require a greater level of supervisory oversight. Specifically, as discussed earlier in the report, the guidance states that an institution may be identified for further supervisory analysis of the level and nature of the risk if it has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria: (1) total

reported loans for construction, land development, and other land (ADC) representing 100 percent or more of the institution's total capital or (2) total commercial real estate loans representing 300 percent or more of the institution's total capital and the outstanding balance of the institution's CRE loan portfolio has increased 50 percent or more during the prior 36 months. Table 9 shows that all of the Security Banks had ADC concentrations significantly above the CRE guidance and well above peer banks as of March 31, 2007.

Table 9: Security Banks' ADC Loans to Total Capital as of March 31, 2007

Bank Name	Bank	Peer
Bibb	486.69	137.18
Gwinnett	649.77	149.91
Houston	417.81	104.26
Jones	284.71	120.90
N. Fulton	272.51	149.91
N. Metro	474.46	105.35

Source: UBPR for the Security Banks.

These high ADC concentration levels, coupled with the poor underwriting that was uncovered during the late 2007 and 2008 examinations, left the banks vulnerable to the real estate market decline, and the FDIC and the DBF began to initiate supervisory actions. However, asset quality began to rapidly deteriorate and by the time the supervisory actions were effective, the financial conditions of the banks were critically deficient.

Supervisory Concerns Related to Loan Underwriting and Credit Administration

With the exception of the N. Metro examination conducted in November 2006, the 2006 examinations reported that underwriting and credit administration practices at the Security Banks were satisfactory. The 2006 N. Metro examination cited the bank for contraventions of policy related to appraisal practices and loan-to-value limits. As discussed earlier in this report, MERIT examination procedures were used for the 2006 examinations of Bibb and Jones. Consistent with these procedures, examiners reviewed 30 percent and 17 percent of the loan portfolios, respectively. DSC officials told us that the use of MERIT procedures during the 2006 examinations did not impact their assessment of the Bibb and Jones loan portfolios because adversely classified assets were low and problems with the loan underwriting and credit administration practices had not yet materialized.

Of the four examinations conducted at the Security Banks in 2007 (Bibb, Gwinnett, Jones, and Houston), three reported that although a concentration in ADC lending existed, bank management was adequately monitoring the concentration and no weaknesses were reported related to loan underwriting or credit administration practices. However, the Houston examination, conducted later in the year (November 2007) than the other 2007 Security Bank examinations, identified weaknesses in loan underwriting.

Loan underwriting and credit administration weaknesses were consistently reported during examinations at each of the Security Banks in 2008. For example, examiners concluded in the 2008 Gwinnett examination that loan deterioration was primarily the result of (1) liberal loan underwriting and credit administration practices associated with uncontrolled ADC lending, (2) a lack of appropriate safeguards, and (3) a downturn in the economy. Similarly, the 2008 Bibb examination concluded that loan deterioration was primarily the result of (1) deficient underwriting and loan administration practices, (2) significant lending outside of the geographic area, (3) poor controls over volume-based compensation packages of SRES executives, and (4) the subsequent decline in the real estate market. Although the SRES lending function was included in the scope of each Bibb examination, no significant weaknesses were reported related to SRES during the Bibb examinations until 2008.

Absent the identification of significant underwriting problems prior to 2008, the examiners' ratings and approach to the banks' practices in this area and overall risk profiles were consistent with prevailing guidance and practices at the time. However, the FDIC's examination procedures caution that banks may compromise sound credit principles in a highly competitive market similar to what existed in the Atlanta metropolitan area during 2006 and 2007. In that regard, going forward, it would be prudent for examiners to place earlier and greater emphasis on the significance of sustaining proper underwriting in examination reports when high concentrations elevate a bank's risk profile.

Supervisory Concerns Related to Non-Core Funding

During the 2006 to 2008 examinations, examiners noted the heavy use of brokered deposits as a funding source but concluded that the risk of the Security Banks' heavy dependence on non-core funding sources was mitigated, in part, by a well-developed funds management process and SBC's Asset Liability Management Committee that was actively engaged in monitoring and measuring liquidity. By the 2008 examinations, however, regulators had determined that liquidity was less than satisfactory. As of December 31, 2008, 32.66 percent of the institutions' deposit base consisted of brokered deposits (up from 20.97 percent as of December 31, 2006).

FDIC's Rules and Regulations Part 337, *Unsafe and Unsound Banking Practices,* states that any *Well Capitalized* insured depository institution may solicit and accept, renew, or roll over any brokered deposits without restriction. Under FDIC's Rules and Regulations, restrictions on brokered deposits are imposed when an institution falls below *Well Capitalized*.[10] As a result of declining capital levels, the institutions became subject to certain restrictions related to brokered deposits, including the prohibition on the acceptance, renewal, or roll-over of brokered deposits without a waiver from the FDIC. This restriction was applicable to Houston, Gwinnett, and N. Metro. Bibb was restricted in increasing the amount of its brokered deposits above its current amount outstanding as

[10] Under Part 337, *Undercapitalized* and *Adequately Capitalized* institutions are prohibited from obtaining or rolling over brokered deposits; however, *Adequately Capitalized* institutions may request a waiver of the prohibition.

of the C&D's effective date. N. Fulton consented in its BBR to decrease its reliance on brokered deposits.

By 2009, regulators determined that the Security Banks' liquidity position had become critically deficient. By that time, the institutions' access to external funding sources was limited and their earnings were not sufficient to augment capital, straining liquidity.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. *Part 325 of the FDIC's Rules and Regulations* implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken with respect to the Security Banks, the FDIC properly implemented applicable PCA provisions of section 38. However, PCA's effectiveness in mitigating losses to the DIF was limited because PCA did not require action until the institutions were at serious risk of failure.

In the case of the Security Banks, capital was a lagging indicator of the institutions' financial health. At the time of the banks' 2008 examinations, four of the six Security Banks were considered *Well or Adequately Capitalized* for PCA purposes. However, examiners concluded that the overall financial conditions of the institutions had deteriorated significantly and weakened to a point where viability was threatened. Table 10 illustrates the Security Banks' capital levels relative to the PCA thresholds for *Well Capitalized* institutions as of the 2008 examinations and visitation.

Table 10: Security Banks' Capital Levels Relative to PCA Thresholds for *Well Capitalized* Institutions

Bank/ Examination Date	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based	Capital Classification
Threshold for *Well Capitalized* Institutions	≥ 5%	≥ 6%	≥ 10%	
Bibb/March 2008	8.00	9.04	9.44	*Adequately Capitalized*
Gwinnett/May 2008	3.43	4.51	5.80	*Significantly Undercapitalized*
Houston/October 2008	6.67	9.27	10.36	*Well Capitalized*
Jones/November 2008 Visitation	5.52	Not Provided	10.18	*Well Capitalized*
N. Fulton/March 2008	8.98	9.33	10.51	*Well Capitalized*
N. Metro/December 2008	4.74	5.76	7.03	*Undercapitalized*

Source: OIG analysis of results of ROEs and visitations and section 38 of the FDI Act.

Based on the results of the 2008 examinations and visitation, the FDIC and the DBF issued joint C&Ds to all of the Security Banks except N. Fulton that included, among other things, a capital provision. The capital provision of the C&D directed these five banks to increase and maintain a Tier 1 Leverage Capital ratio of 8 percent – an amount

that is greater than required by PCA for *Well Capitalized* institutions. In 2009, the FDIC issued a PCA directive to N. Fulton because it had not been subjected to the C&D.

Based on the FDIC's analysis of the Security Banks' Call Reports and the results of 2009 examinations, the FDIC and the DBF determined that the quality of the Security Banks' assets had deteriorated to the point that the institutions were either *Undercapitalized or Critically Undercapitalize*d for PCA purposes. Table 11 illustrates the significant decline in the Security Banks' capital levels between 2008 and 2009.

Table 11: Security Banks' Decline in Capital Levels Between 2008 and 2009 in Examinations and/or Visitations

Bank/Exam	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based
Bibb/March 2008	8.00	9.04	9.44
Bibb/March 2009	1.82	2.29	3.57
Gwinnett/May 2008	3.43	4.51	5.80
Gwinnett/April 2009	(3.96)	(5.43)	(5.43)
Houston/October 2008	6.67	9.27	10.36
Houston/April 2009	4.08	7.02	8.28
Jones/November 2008 Visitation	5.52	Not Provided	10.18
Jones/April 2009	4.13	6.63	7.88
N. Fulton/March 2008	8.98	9.33	10.51
N. Fulton/April 2009	1.50	2.48	3.79
N. Metro/December 2008	4.74	5.76	7.03
N. Metro/March 2009	(0.25)	(0.35)	(0.35)

Source: OIG analysis of results of ROEs and visitations.

SBC had submitted an application for the Troubled Asset Relief Program (TARP)[11] on October 27, 2008 for funding of $65 million. SBC subsequently withdrew its application in April 2009. The Security Banks were unsuccessful in other efforts to raise needed capital and were subsequently closed on July 24, 2009.

[11]TARP was established under the Emergency Economic Stabilization Act of 2008. The Act established the Office of Financial Stability within the Department of the Treasury. Under TARP, Treasury will purchase up to $250 billion of preferred shares from qualifying institutions as part of the Capital Purchase Program.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On February 12, 2010, the Director, DSC provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC's response reiterates the OIG's conclusions regarding the causes of failures and describes market conditions prior to the economic downturn that led Atlanta-area financial institutions to increase ADC lending to unprecedented levels and encouraged out-of-area institutions to begin lending in the marketplace.

With respect to our assessment of the FDIC's supervision of the Security Banks, DSC's response also reiterated the supervisory actions taken with regard to the ADC concentrations presented in the report, including examiners encouraging the banks to implement stronger risk management practices. The response indicates, however, that in DSC's view, the extent of the ADC concentration at the Security Banks, together with the sudden collapse of demand for vacant building lots, resulted in a situation that could not have been overcome by even the strongest risk management practices.

Finally, DSC's response describes supervisory guidance issued in 2006 and 2008 that re-emphasizes the importance of robust credit risk-management practices and sets broad supervisory expectations, in recognition that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, 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 Security Banks' failures and the resulting material losses to the DIF and (2) evaluate the FDIC's supervision of the Security Banks, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from October 2009 to February 2009 in accordance with generally accepted government auditing standards. 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 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 the Security Banks' operations from 2006 until their failures on July 24, 2009. Our review also entailed an evaluation of the regulatory supervision of the institutions over the same period.

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

- Analyzed examination reports prepared by the FDIC and the DBF from 2006 through 2009.
- Reviewed the following:
    - Bank data and correspondence received from DSC's Regional Office and the Atlanta and Albany, Georgia Field Offices.
    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the banks' closures. We also reviewed records maintained by DRR for information that would provide insight into the banks' failures.
    - Pertinent FDIC policies and procedures.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:
    - DSC management from the Washington, D.C. and Atlanta Regional Offices.
    - DSC examiners from the Atlanta and Albany, Georgia Field Offices.
    - DRR personnel from the Dallas Regional Office.
- Interviewed DBF officials to discuss the historical perspective of the institutions, DBF examinations, and other activities related to the state's supervision of the institutions.

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, ROEs, and interviews of examiners to understand the Security Banks' management controls pertaining to causes of failures and material losses as discussed in the body of this report.

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

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 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 were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Bank Board Resolution (BBR)	Informal commitments adopted by a financial institution's Board directing the institution's personnel to take corrective action regarding specific noted deficiencies.
Call Report	The report filed by a bank pursuant to 12 U.S.C. 1817(a)(1), which requires each insured State nonmember bank and each foreign bank having an insured branch which is not a Federal branch to make to the Corporation reports of condition in a form and shall containing such information as the Board of Directors may require. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator 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.
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.
Memorandum of Understanding (MOU)	An informal corrective administrative action for institutions considered to be of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, an MOU is to be considered for all institutions rated a composite 3.
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, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq, implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action of compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.

Glossary of Terms

Troubled Asset Relief Program (TARP)	TARP is a program of the United States Treasury Department to purchase assets and equity from financial institutions to strengthen the financial sector.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from data reported in Reports of Condition and Income submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DBF	Department of Banking and Finance
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
FRB	Federal Reserve Bank
LTV	Loan-to-Value
MERIT	Maximum Efficiency, Risk-focused, Institution Targeted
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SBC	Security Bank Corporation
SRES	Security Real Estate Services
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

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

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of the Six Bank Subsidiaries of Security Bank Corporation, Macon, Georgia (Assignment No. 2009-067)

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 the six bank subsidiaries (Security Banks) of Security Bank Corporation (SBC) which failed on July 24, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on January 25, 2010.

The Report concludes that the Security Banks failed because of the strategy promoted by SBC, and followed by each of the Security Banks' boards and management, to pursue aggressive growth centered in acquisition, development, and construction (ADC) lending. Further, SCB's expansion into the Atlanta metropolitan market was ill-timed, as it occurred at the peak of the real estate market. Although the Security Banks' aggressive growth was initially profitable, weaknesses in Board and management oversight related to loan underwriting and risk management practices were exposed as the economy contracted. The Security Banks' strategy of relying on wholesale funding, such as brokered deposits, was unsustainable once its financial condition began to deteriorate. Ultimately, the Security Banks' capital and liquidity became strained.

The Report indicates that examiners cautioned the Board of Directors and management of the Security Banks of the inherent risks associated with high ADC concentrations, and encouraged stronger risk management practices. However, the level of the ADC concentration at the Security Banks at the time of the sudden collapse of demand for vacant building lots resulted in a situation that could not have been overcome by even the strongest risk management practices.

At the time of the economic downturn, financial institutions in the Atlanta metropolitan market had experienced more than 20 years of profitable ADC lending at concentration levels higher than the national average due to some of the strongest population growth in the country. The availability of subprime and nontraditional mortgage credit inflated housing demand between 2002 and 2007, which led Atlanta-area financial institutions to increase ADC lending to unprecedented levels and encouraged out-of-area institutions to begin lending in the marketplace.

In recognition that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, 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 to re-emphasize the importance of robust credit risk-management practices and set forth broad supervisory expectations. Thank you for the opportunity to review and comment on the Report.