Office of Inspector General

Office of Material Loss Reviews
Report No. IDR-11-002

In-Depth Review of the Failure of the Bank of Hiawassee, Hiawassee, Georgia

November 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On March 19, 2010, the Georgia Department of Banking and Finance (GDBF) closed the Bank of Hiawassee and named the FDIC as receiver. On April 1, 2010, the FDIC notified the Office of Inspector General (OIG) that the Bank of Hiawassee's total assets at closing were $372.5 million and the estimated loss to the Deposit Insurance Fund (DIF) was $135.8 million. As of August 27, 2010, the estimated loss to the DIF had decreased to $129.7 million (or 35 percent of the Bank of Hiawassee's total assets).

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), which amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the threshold for a material loss review (MLR) from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that might warrant an in-depth review of the loss. At the time the Financial Reform Act was enacted, our fieldwork and a draft of this report were substantially complete. As a result, we decided to complete the audit as an in-depth review and issue this report.

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

Background

The Bank of Hiawassee, headquartered in Hiawassee, Georgia, was a state nonmember bank that opened for business on July 21, 1909 and was insured by the FDIC on January 1, 1934. The bank was wholly-owned by Chatuge Bank Shares, Inc., a one-bank holding company. The directorate owned 26 percent of the company, and Stoinoff Investments, a local family-held interest, owned 33 percent. The bank operated five offices in Towns, Fannin, and Union Counties, Georgia. The Fannin County location operated under the business name of Bank of Blue Ridge, and the Union County location operated under the name of Bank of Blairsville.

The Bank of Hiawassee historically operated as a traditional community bank. Beginning in 2001, the bank's management began pursuing growth centered in commercial real estate (CRE) with a focus on acquisition, development, and construction (ADC) lending, with the ADC portfolio growing from 14 percent of total loans in 2000 to 48 percent in 2007. The majority of the ADC loan growth occurred in 2005 and 2006 and was funded with non-core funding sources, including brokered deposits and Federal Home Loan Bank advances.

Audit Results

Causes of Failure and Material Loss

The Bank of Hiawassee's deterioration was attributed primarily to weak Board and management oversight of its increasing CRE, and in particular, ADC loan concentrations. Specifically, the Board and management did not establish effective risk management practices commensurate with the risks associated with this lending, which included speculative construction lending for vacation homes in southern North Carolina and northern Georgia. Further, although the bank was considered *Well Capitalized* until June 30, 2009, capital levels did not support the risks associated with its high CRE and ADC concentrations. As the economy and real estate market started to decline, the bank's loan losses and increases in the allowance for loan and lease losses (ALLL) eroded capital, weakened liquidity, and led to negative earnings. Although the holding company injected $8 million in capital in 2005 to support loan growth, it was unable to provide additional financial support for the bank or raise additional capital through other sources once the economy and real estate market declined. In addition, the bank increasingly relied upon the use of potentially volatile non-core funding to support its loan growth. The GDBF closed the Bank of Hiawassee on March 19, 2010 because the institution was unable to raise sufficient capital to support its operations.

The FDIC's Supervision of the Bank of Hiawassee

The FDIC, in coordination with the GDBF, provided ongoing supervisory oversight of the Bank of Hiawassee through regular onsite risk management examinations and two visitations. Through its supervisory efforts, the FDIC identified key risks in the Bank of Hiawassee's operations and brought these risks to the attention of the bank's Board and management through examination and visitation reports. Such risks included the institution's significant CRE and ADC concentrations, weak credit administration and loan underwriting practices, and reliance on potentially volatile funding sources. Examiners also reported apparent violations of laws and regulations and contraventions of interagency policy and guidance associated with the institution's lending practices. As a result of the 2006 examination, the Bank of Hiawassee's Board adopted a Bank Board Resolution. In addition, based on the results of a 2008 visitation, the FDIC and the GDBF issued a Cease and Desist Order.

In hindsight, a more critical assessment of the bank's risks and performance and additional supervisory action to address high concentrations in CRE and ADC loans, increased reliance on non-core funding to support growth, and weak credit administration and loan underwriting practices, may have been warranted from 2005 to 2007. Such actions could have included lowering key supervisory ratings, obtaining an earlier commitment from the Board to diversify the bank's loan portfolio and requiring progress reports on those efforts, and/or requiring the bank to maintain higher capital levels commensurate with those risks associated with high CRE and ADC concentrations. The FDIC's supervision of the bank may have also benefited from taking additional supervisory action at the 2007 examination to address emerging risks and declining trends that were identified in several aspects of the bank's operations.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons it has learned from institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, reiterated broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations to its supervised institutions and examiners. The FDIC has also recently provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

With respect to PCA, based on the supervisory actions taken, we determined that the FDIC properly implemented applicable PCA provisions of section 38. The Bank of Hiawassee was unsuccessful in raising needed capital and was subsequently closed on March 19, 2010.

In-Depth Review of the Failure of the Bank of Hiawassee, Hiawassee, Georgia

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Management Response

On October 21, 2010, the Director, DSC, provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of the Bank of Hiawassee's failure. With respect to our assessment of the FDIC's supervision of the Bank of Hiawassee, DSC summarized supervisory activities from 2005 to 2010 described in our report, including onsite examinations, offsite monitoring, and the issuance of a formal enforcement action in 2008. In recognition of the threat that institutions with high risk profiles, such as the Bank of Hiawassee, pose to the DIF, DSC stated it has issued guidance to financial institutions that reemphasizes the importance of robust credit risk management practices for institutions with concentrated CRE exposures. DSC also stated that it has issued guidance to enhance the supervision of institutions that rely on volatile non-core funding.

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

Office of Material Loss Reviews
Office of Inspector General

DATE:	November 2, 2010
MEMORANDUM TO:	Sandra L. Thompson, Director Division of Supervision and Consumer Protection
FROM:	**/Signed/** Stephen M. Beard Assistant Inspector General for Material Loss Reviews
SUBJECT:	*In-Depth Review of the Failure of the Bank of Hiawassee, Hiawassee, Georgia* (Report No. IDR-11-002)

The Georgia Department of Banking and Finance (GDBF) closed the Bank of Hiawassee on March 19, 2010, and named the FDIC as receiver. On April 1, 2010, the FDIC notified the Office of Inspector General (OIG) that the Bank of Hiawassee's total assets at closing were $372.5 million and the estimated loss to the Deposit Insurance Fund (DIF) was $135.8 million. As of September 3, 2010, the estimated loss to the DIF had decreased to $128 million (or 34 percent of the Bank of Hiawassee's total assets).

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), which amends section 38(k) of the Federal Deposit Insurance Act (FDI Act) by increasing the threshold for a material loss review (MLR) from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that might warrant an in-depth review of the loss. At the time the Financial Reform Act was enacted, our fieldwork and a draft of this report were substantially complete. As a result, we decided to complete the audit as an in-depth review and issue this report.

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

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

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

Background

The Bank of Hiawassee, headquartered in Hiawassee, Georgia, was a state nonmember bank that opened for business on July 21, 1909 and was insured by the FDIC on January 1, 1934. The bank was wholly-owned by Chatuge Bank Shares, Inc., a one-bank holding company. The bank's directorate owned 26 percent of the holding company, and Stoinoff Investments, a local family-held interest, owned 33 percent. The bank operated five offices in Towns, Fannin, and Union Counties, Georgia. The Fannin County location operated under the business name of Bank of Blue Ridge, and the Union County location operated under the name of Bank of Blairsville.

The Bank of Hiawassee historically operated as a traditional community bank. Beginning in 2001, the bank's management began pursuing growth centered in commercial real estate (CRE) with a focus on acquisition, development, and construction (ADC) lending, with the ADC portfolio growing from 14 percent of total loans in 2000 to 48 percent of total loans in 2007. The majority of the ADC loan growth occurred in 2005 and 2006 and was funded with non-core funding sources, including brokered deposits and Federal Home Loan Bank (FHLB) advances. Table 1 summarizes selected financial information pertaining to the Bank of Hiawassee for the year ended 2009 and for the 4 preceding calendar years.

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

Table 1: Selected Financial Information for the Bank of Hiawassee, 2005 - 2009

Financial Measure	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	$377,779	$434,284	$435,593	$422,862	$368,827
Total Loans ($000s)	$281,939	$338,692	$359,730	$358,373	$309,142
Total Deposits ($000s)	$339,597	$366,890	$354,186	$343,794	$289,569
Net Income (Loss) ($000s)	($30,665)	($6,834)	$5,287	$4,920	$3,023
FHLB Advances ($000s)	$30,000	$32,000	$38,000	$38,500	$45,000
Brokered Deposits ($000s)	$45,168	$90,823	$59,156	$33,210	$35,120
Past Due Ratio	35.82%	22.63%	.85%	.82%	1.77%
Total Risk-Based Capital/Risk Weighted Assets	3.03%	10.32%	11.76%	10.83%	11.20%

Source: Uniform Bank Performance Reports (UBPR) for the Bank of Hiawassee.

Causes of Failure and Loss

The Bank of Hiawassee's failure was attributed primarily to weak Board and management oversight of its high CRE and ADC loan concentrations. Specifically, the Board and management did not establish risk management practices commensurate with the risks associated with this lending, which included speculative construction lending for vacation homes in southern North Carolina and northern Georgia.[2] Weak loan underwriting and credit administration practices contributed to the asset quality problems that developed when the bank's real estate lending markets deteriorated. Further, although the bank was considered *Well Capitalized* until June 30, 2009, capital levels did not support the risks associated with its high CRE and ADC concentrations.

As the economy and real estate market started to decline, the bank's loan losses and increases in the allowance for loan and lease losses (ALLL) eroded capital, weakened liquidity, and led to negative earnings. Despite the fact that the holding company injected $8 million in capital during 2005 to support loan growth, it was unable to provide additional financial support for the bank or raise additional capital through other sources once the economy and real estate market declined. In addition, the bank increasingly relied upon the use of potentially volatile non-core funding sources to support its loan growth. The GDBF closed the Bank of Hiawassee on March 19, 2010 because the institution was unable to raise sufficient capital to support its operations.

[2] Speculative construction lending involves the financing of projects for which a buyer has not yet been identified.

Board and Management Oversight and Risk Management Practices

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

As discussed more fully in subsequent sections of this report, the Bank of Hiawassee's Board and management did not effectively manage the risks associated with the institution's CRE and ADC loan concentrations, including increased speculative lending for vacation homes in North Carolina and Georgia. Specifically, examiners determined that the Bank of Hiawassee had credit administration deficiencies at each examination from 2005 to 2009; loan underwriting weaknesses in 2006, 2008, and 2009; and various violations of laws and regulations and contraventions of statements of policy in 2005, 2006, and 2009. Notably, examiners cited the bank for loans that exceeded the loan-to-value limits at three examinations and appraisal violations at two examinations.

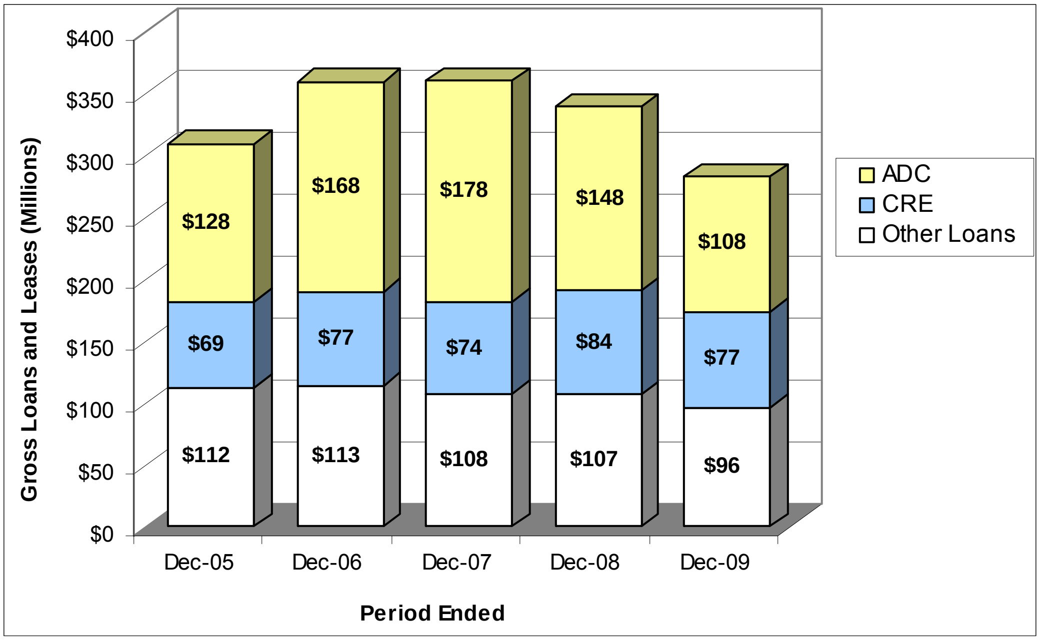
According to examiners, turnover in senior management positions was a cause for regulatory concern. Specifically, a new management team was hired in 2005 that included a President/Director, Senior Vice President/Chief Financial Officer, and Senior Vice President/Chief Credit Officer. These individuals represented the bank's third management team since 2001.

CRE and ADC Concentrations

The Bank of Hiawassee's growth strategy led to concentrations in CRE and ADC loans, which, coupled with inadequate credit administration and loan underwriting practices, ultimately caused the bank to fail. The Bank of Hiawassee experienced significant asset growth—increasing from $155 million at year-end 1999 to over $435 million at year-end 2007. To fund the growth, the bank became increasingly reliant on non-core funding sources, especially brokered deposits, which increased from zero in 2002 to $19 million in 2005 to over $90 million in 2008.

The figure on the next page illustrates the general composition and growth of the Bank of Hiawassee's loan portfolio in the years preceding the institution's failure.

Figure: Composition of the Bank of Hiawassee's Loan Portfolio



Source: OIG analysis of Consolidated Reports of Condition and Income (Call Reports) for the Bank of Hiawassee.

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). Although the Joint Guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint Guidance, an institution that 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 may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

- Total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

As of December 31, 2005, the Bank of Hiawassee's non-owner occupied CRE loans and ADC loans represented 602 percent and 360 percent, respectively, of the institution's total capital. This trend continued through December 2008 when non-owner occupied CRE loans and ADC loans represented 662 percent and 391 percent, respectively, of the institution's total capital. These levels are significantly higher than the criteria defined in the Joint Guidance as possibly warranting further supervisory analysis.

In addition, the Bank of Hiawassee's concentrations in ADC and CRE loans were well above the institution's peer group[3] averages. Table 2 and Table 3 illustrate the trend in the bank's ADC and CRE loan concentrations, respectively, relative to total capital and total loans as compared to the institution's peer group.

Table 2: The Bank of Hiawassee's ADC Concentrations Compared to Peer Group

Period Ended	ADC Loans as a Percent of Total Capital			ADC Loans as a Percent of Total Loans		
	Bank of Hiawassee	Peer Group	Bank of Hiawassee Percentile	Bank of Hiawassee	Peer Group	Bank of Hiawassee Percentile
Dec 2005	360%	104%	96	41%	14%	94
Dec 2006	415%	117%	97	47%	16%	95
Dec 2007	398%	124%	97	49%	16%	97
Dec 2008	391%	111%	97	44%	14%	97
Dec 2009	1,151%*	85%	99	38%	11%	98

Source: UBPR data for the Bank of Hiawassee.
*The ADC concentration percentage was high because capital had declined to an extremely low level, rather than because of asset growth.

Table 3: The Bank of Hiawassee's CRE Concentrations Compared to Peer Group

Period Ended	CRE Loans as a Percent of Total Capital			CRE Loans as a Percent of Total Loans		
	Bank of Hiawassee	Peer Group	Bank of Hiawassee Percentile	Bank of Hiawassee	Peer Group	Bank of Hiawassee Percentile
Dec 2005	603%	358%	91	69%	49%	85
Dec 2006	660%	372%	95	75%	50%	88
Dec 2007	608%	377%	89	76%	51%	89
Dec 2008	662%	380%	92	74%	50%	90
Dec 2009	1,975%**	356%	99	66%	48%	83

Source: UBPR data for the Bank of Hiawassee.
* Percentages for the Bank of Hiawassee and peers include owner-occupied CRE.
**The CRE concentration percentage was high because capital had declined to an extremely low level, rather than because of asset growth.

From 2005 to 2007, the Bank of Hiawassee's adversely classified assets ranged from approximately 18 percent to 31 percent of Tier 1 Capital and reserves, and past due and nonaccrual loans were 1 percent to 3 percent of total loans. Regulators considered both of these levels to be manageable and of limited supervisory concern.

However, ADC lending involves a greater degree of risk than permanent financing for finished residences or commercial buildings. These risks generally include adverse changes in market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these

[3] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. The Bank of Hiawassee's peer group included insured commercial banks having assets between $300 million and $1 billion.

and other risk factors, ADC loans generally require greater effort to effectively evaluate and monitor than other types of loans.

Indeed, during 2008, the depressed housing market began to negatively impact the quality of the Bank of Hiawassee's assets, particularly its ADC loan portfolio. By 2009, the bank's asset quality had become critically deficient, with problems centered in ADC loans secured by homes and real estate in northern Georgia and southern North Carolina. As borrowers defaulted on loans, the bank's other real estate owned (OREO)[4] increased from $1.3 million at year-end 2005 to more than $15 million by year-end 2009. Further, as shown in Table 4, the bank's adversely classified assets and past due and nonaccrual loans percentages significantly increased in 2008 and 2009.

Table 4: The Bank of Hiawassee's Adversely Classified Assets

Examination Year	Adversely Classified Assets*	Past-Due and Nonaccrual Loans**
2005	25%	2%
2006	18%	1%
2007	31%	3%
2008 (Visitation)	115%	12%
2009	233%	20%
2009 (Visitation)	318%	26%

Source: ROEs for the Bank of Hiawassee.
*Ratio is a percentage of Tier 1 Capital and reserves.
**Ratio is a percentage of total loans.

Examiners noted in the May 2009 examination report that the bank's viability had become contingent on the recovery of secondary home markets. Examiners also indicated that, in an attempt to keep loans current, bank management had converted an inordinate number of loans to interest-only payments even though the development of underlying projects had ceased in most cases. Examiners found further deterioration in the bank's loan portfolio at the final visitation in December 2009.

Capital Levels Compared to Risk Profile

From 2005 to 2008, the Bank of Hiawassee's ADC concentration was at least triple that of its peer group, and the CRE concentrations were significantly higher than its peer group. However, the bank's capital ratios were near or below those of its peer group. In addition, the Bank of Hiawassee's Total Risk-Based Capital only exceeded *Well Capitalized* levels by a slight margin. Table 5 shows the Bank of Hiawassee's capital ratios compared to its peer group.

[4] OREO is property taken over by a bank through loan foreclosures.

Table 5: The Bank of Hiawassee's Capital Ratios Compared to Peer Group

Period Ended	Tier 1 Leverage Capital Hiawassee	Tier 1 Leverage Capital Peer	Tier 1 Risk-Based Capital Hiawassee	Tier 1 Risk-Based Capital Peer	Total Risk-Based Capital Hiawassee	Total Risk-Based Capital Peer
12/31/04	8.22	9.31	9.94	13.71	11.13	14.86
12/31/05	9.11	8.88	10.23	11.78	11.20	12.95
12/31/06	8.67	9.02	9.68	11.75	10.83	12.89
12/31/07*	9.38	9.06	10.62	11.62	11.76	12.73
12/31/08	7.78	8.75	9.08	11.4	10.32	12.60
12/31/09	1.35	8.67	1.75	11.91	3.03	13.19

Source: UBPRs for the Bank of Hiawassee.
*Ratios increased due to slower asset growth and improved earnings.

The Examination Manual states that institutions should maintain capital commensurate with the level and nature of risks to which they are exposed. In addition, the amount of capital necessary for safety and soundness purposes may differ significantly from the amount needed to maintain a *Well Capitalized* or *Adequately Capitalized* position for purposes of PCA.

While risk in the Bank of Hiawassee's ADC loan portfolio increased significantly between 2005 and 2008, the institution's capital ratios did not increase proportionally to that risk. By 2008, examiners were reporting that the bank's capital position was less than satisfactory to provide for the risks inherent in the bank's loan portfolio and deficient earnings. Had the Bank of Hiawassee maintained higher capital ratios commensurate with its risk profile, the bank would have been better positioned to absorb losses in its loan portfolio and limit the loss to the DIF.[5]

Non-Core Funding

In the years preceding its failure, the Bank of Hiawassee became increasingly dependent on non-core funding sources to support loan growth and maintain adequate liquidity. 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 Examination Manual, 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.

Beginning in 2004, the Bank of Hiawassee began to increasingly rely on non-core potentially volatile funding sources, including large time deposits, brokered deposits, and FHLB borrowings to fund strong loan growth that had outpaced core deposits. In

[5] The Bank of Hiawassee's estimated loss rate of 35 percent is higher than the average estimated loss rate of 24 percent for all insured institutions that failed between January 1, 2008 and July 31, 2010. (The average loss rate does not include the failure of Washington Mutual.) The Bank of Hiawassee's loss rate also exceeds the average estimated loss rate of 28 percent for institutions in the state of Georgia that failed between January 1, 2008 and July 31, 2010.

addition, the bank relied on volatile Internet certificates of deposit (CDs). Table 6 provides details on the bank's core and non-core funding sources during the years prior to its failure.

Table 6: The Bank of Hiawassee's Funding Sources

Period Ended	Core Deposits ($000s)*	Time Deposits $100,000 or More ($000s)	Brokered Deposits ($000s)	FHLB Borrowings ($000s)
December 2003	153,456	32,023	0	34,227
December 2004	175,110	41,599	6,588	40,453
December 2005	200,733	88,836	35,120	45,000
December 2006	218,867	124,927	33,210	38,500
December 2007	274,169	80,016	59,156	38,000
December 2008	299,910	66,981	90,823	32,000
December 2009	258,387	81,210	45,168	30,000

Source: UBPR data for the Bank of Hiawassee.
*Core deposits may include some deposits of less than $100,000 obtained through the bank's use of an Internet listing service and brokered deposits representing time deposits of less than $100,000.

In 2006, examiners first noted that the bank's liquidity posture was strained because of a high dependence on non-core funding. Further, the bank continued to be in apparent violation of the State of Georgia's regulation regarding the statutory limit on borrowings, a repeat finding from the 2005 examination. By 2008, the bank's liquidity position had weakened because of the significant decrease in asset quality and deficient earnings, and examiners were concerned that the bank's strained financial condition and asset quality concerns might impede the institution's ability to attract funds in the open market on reasonable terms. Finally, in 2009, bank management's decision to rely on non-core funding negatively impacted the bank's liquidity position because the bank was no longer able to accept, renew, or roll over brokered deposits without a waiver from the FDIC. The bank's unsecured lines of credit were also canceled.

The FDIC's Supervision of the Bank of Hiawassee

The FDIC, in coordination with the GDBF, provided ongoing supervisory oversight of the Bank of Hiawassee through regular onsite risk management examinations and two visitations. Through its supervisory efforts, the FDIC identified key risks in the Bank of Hiawassee's operations and brought these risks to the attention of the bank's Board and management through examination and visitation reports. Such risks included the institution's significant CRE and ADC concentrations, weak credit administration and loan underwriting practices, and reliance on potentially volatile funding sources. Examiners also reported apparent violations of laws and regulations and contraventions of interagency policy and guidance associated with the institution's lending practices. As a result of the 2006 examination, the Bank of Hiawassee's Board adopted a Bank Board Resolution (BBR). In addition, based on the results of a 2008 visitation, the GDBF and the FDIC issued a Cease and Desist Order (C&D).

In hindsight, a more proactive assessment of the bank's risks and performance and additional supervisory action to address high concentrations in CRE and ADC loans, increased reliance on non-core funding to support growth, and weak credit administration and loan underwriting practices, may have been warranted from 2005 to 2007. Such actions could have included lowering key supervisory ratings, obtaining an earlier commitment from the Board to diversify the bank's loan portfolio and requiring progress reports on those efforts, and/or requiring the bank to maintain higher capital levels commensurate with the risks associated with high CRE and ADC concentrations. The FDIC's supervision of the bank may have also benefited from taking additional supervisory action at the 2007 examination to address emerging risks and declining trends that were identified in several aspects of the bank's operations.

The FDIC has taken a number of actions to enhance its supervision program based on the lessons it has learned from institution failures during the financial crisis. With respect to the issues discussed in this report, the FDIC has, among other things, reiterated broad supervisory expectations for managing risks associated with CRE and ADC loan concentrations to its supervised institutions and examiners. The FDIC has also recently provided training to its examination workforce wherein the importance of assessing an institution's risk management practices on a forward-looking basis was emphasized.

Supervisory History

From 2005 to 2009, the FDIC and the GDBF conducted three examinations of the Bank of Hiawassee. In addition, the FDIC and the GDBF conducted a joint visitation in November 2008, and the FDIC conducted a final visitation in December 2009. The FDIC and the GDBF also pursued enforcement actions, including a BBR and a C&D. Table 7 summarizes key supervisory information pertaining to these examinations, visitations, and enforcement actions.

Table 7: The Bank of Hiawassee's Examination History, 2005 to 2009

Examination Start Date	Agency	Supervisory Ratings (UFIRS)	Contraventions and/or Violations	Supervisory Action
10/17/05	GDBF	222222/2	✓	None
10/30/06	FDIC	223232/2	✓	BBR** Effective 1/17/2007
10/29/07	GDBF	222122/2	None	Monitored compliance with the BBR.***
11/17/08	FDIC-GDBF Visitation	443443/4	Not Applicable*	C&D.** Effective 3/2/2009
5/11/09	FDIC-GDBF	555544/5	✓	Monitored compliance with the C&D
12/14/09	FDIC Visitation	554544/5	Not Applicable*	Continued to monitor compliance with the C&D

Source: The FDIC's Virtual Supervisory Information on the Net and ROEs for the Bank of Hiawassee.
*The scope of the visitations did not include reviewing the bank's compliance with laws and regulations.
**Informal enforcement actions often take the form of BBRs or Memoranda of Understanding (MOU). Formal enforcement actions often take the form of C&Ds but under severe circumstances can also take the form of insurance termination proceedings.
***The bank was released from the BBR by the GDBF on December 17, 2007 and by the FDIC on January 16, 2008.

At the 2006 examination, examiners determined that (1) management's responses to deficiencies from prior regulatory examination reports and external audits were unsatisfactory; (2) risk management practices needed improvement, particularly in the areas of loan administration, audits, and funds management; and (3) liquidity was strained, with a significant increase in dependence on non-core funding to support rapid growth. As a result, the bank's Management and Liquidity components were each downgraded to a "3", and the Board agreed to adopt a BBR.

The FDIC also conducted offsite monitoring of the Bank of Hiawassee in 2008.[6] Specifically, the Bank of Hiawassee first appeared on the FDIC's offsite review list in March 2008 because the bank's risk profile involved high concentrations, an increased past-due ratio, a high percentage of brokered deposits to total assets, and significant ALLL provisions. For the first two quarters of 2008, the bank's risk was considered medium and increasing, but the FDIC did not contact bank management. However, the FDIC did schedule a visitation in November 2008 to assess the bank's risks.

[6] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating system and the Growth Monitoring System. Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

Based on the significant decline in the bank's condition at the November 2008 visitation, the bank was downgraded in all CAMELS components, and the GDBF, in consultation with the FDIC, began pursuing a C&D for unsafe and unsound banking practices. The C&D became effective on March 2, 2009. Among other things, the C&D required the institution to:

- increase Board participation in the affairs of the bank, assuming full responsibility for approval of sound policies and objectives and for the supervision of all of the bank's activities;

- maintain a Tier 1 Leverage Capital ratio of not less than 8 percent and a Total Risk-Based Capital ratio of at least 10 percent;

- reduce adversely classified assets;

- reduce concentrations of credit; and

- establish a comprehensive policy for determining the adequacy of the ALLL.

The May 2009 examination found further deterioration in the bank's condition, and the December 2009 visitation confirmed that the bank's condition was continuing to deteriorate. The bank was closed 3 months later.

Supervisory Response to Key Risks

Historically, the Bank of Hiawassee had been considered a well-performing institution and received composite "2" supervisory ratings from 2005 through 2007. Examiners identified key risks and made recommendations to address certain of those risks at each examination. Bank management provided written responses to examiner recommendations and, as a result, follow-up occurred at the next regularly-scheduled examination. In hindsight, however, a more proactive approach to the bank's risks and performance during this time frame may have been prudent.

<u>October 2005 GDBF Examination</u>

Examiners reported that the bank's overall condition was satisfactory and assigned a "2" rating to all CAMELS components and the overall composite score. A "2" rating indicates satisfactory board and management performance and satisfactory capital levels relative to the bank's risk profile. In contrast with that definition, the Bank of Hiawassee's risks included the following:

- The bank's liquidity and capital positions continued to be hampered due to strong asset growth.

- There was improper monitoring of CRE and ADC concentrations.

- Credit administration deficiencies were noted.

- Thirteen recommendations were made for improvements to the Loan Policy.

- The bank was operating with its third senior management team since 2001.[7]

- There was increased reliance on brokered deposits and Internet CDs.

- Violations of laws and regulations were noted.

- The bank lacked a written budget and strategic plan and needed to develop a written Capital Plan and to improve investment and asset and liability management policies.

In addition, we noted that, since the 2004 examination, loan growth went from approximately $207 million to over $285 million (a 38-percent increase), with ADC loans increasing from approximately $59 million to over $103 million (a 76-percent increase).

October 2006 FDIC Examination

As a result of this examination, the FDIC downgraded the Management and Liquidity components to a "3" and asked the Bank of Hiawassee's management to adopt a BBR, which it did, effective January 17, 2007. However, the bank's Capital and composite ratings remained a "2". Given the following risks that existed at the time of this examination, the bank's capital and overall performance may have warranted greater supervisory concern.

- **Rapid Growth.** From June 30, 2005, to June 30, 2006, the bank's ADC loan portfolio had grown by 75 percent, amounting to approximately 618 percent of Tier 1 Capital. The net non-core dependence ratio had increased from 38 percent to 43 percent. In that regard, brokered deposits increased from $19 million to over $46 million.

- **Capital Ratios.** The bank's capital ratios had changed from an overall upward trend at year-end 2005 to an overall declining trend at the quarter ending June 2006.

In addition, examiners identified several deficiencies related to the bank's lending, which included: (1) loan underwriting, (2) a high volume of loans with technical exceptions (a repeat finding from the prior two examinations), and (3) no limits for ADC lending in the loan policy.

[7] FDIC officials stated that significant management turnover is cause for regulatory concern.

In connection with the bank's high CRE and ADC concentrations, the Board and management agreed in the BBR to (1) implement a sufficient system for tracking and monitoring the volume of residential ADC commitments by risk categories, including segments of speculative, pre-sold, and owner-occupied projects; (2) provide loan concentration reports and "aging" reports to the Board at least quarterly; (3) amend the loan policy to prohibit over-funding construction loans and require routine inspections on construction projects before loan draws are approved; (4) institute a program for reducing the volume of loan-to-value exceptions in order to comply with the aggregate limitations contained in Appendix A of Part 365 of the FDIC Rules and Regulations; and (5) implement appropriate processes to reduce the volume of loan documentation exceptions. Although the lack of an ADC lending limit was identified as a deficiency in the loan policy, the BBR did not include a provision to revise the loan policy to include such a limit. At the time the BBR was being developed, the Bank of Hiawassee's CRE and ADC concentrations (as of September 30, 2006) were 700 percent and 445 percent of total capital, respectively.

<u>October 2007 GDBF Examination</u>

Examiners reported that the bank's overall condition was satisfactory and upgraded the Management and Liquidity components each to a "2" and assigned the bank an overall composite rating of "2". Further, examiners concluded that the bank was in compliance with 11 of the 14 provisions contained in the BBR and had taken some action to address the remaining three. As a result, the GDBF and the FDIC released the bank from the BBR. A "2" rating for Management indicates that management's and the Board's performance and risk management practices are satisfactory. A component rating of "2" for Asset Quality also indicates satisfactory asset quality and credit administration practices. The risks identified by examiners at the 2007 examination, which appear to be greater than those contemplated by a "2" rating, included the following:

- Asset quality had declined, with adversely classified assets increasing from approximately 18 percent to approximately 31 percent. Further, the past-due ratio had increased from less than 1 percent to over 3 percent.

- CRE and ADC concentrations were 687 percent and 414 percent, respectively.

- Credit administration needed improvement, with the level of documentation exceptions still excessive. Further, management was not tracking loans that had interest reserves, and implementation of ADC disbursement and inspection procedures were needed.

- The bank remained *Well Capitalized*; however, the capital ratios were still not commensurate with risks associated in the loan portfolio and were lower than the bank's peer group.

- Brokered deposits had increased from $47 million to over $62 million since the last examination.

- Liquidity and dependency monitoring needed improvement.
    - Examiners recommended that management establish reasonable targets for the aggregate non-core funding ratio, a repeat recommendation.
    - Examiners noted that the dependency ratio represented approximately 47 percent of total funding.

The GDBF's ROE provided a detailed explanation supporting the termination of the BBR. However, greater emphasis on the newly identified risks and deficient practices at this examination may have been appropriate when assigning the bank's ratings and determining whether a new informal action was needed.

November 2008 Joint Visitation

A joint visitation targeted to assess the bank's overall financial condition was conducted because offsite analysis had identified declining trends in performance ratios. Negative core earnings, increasing levels of OREO and nonaccrual loans, continued large dividends, and a tightening liquidity position coupled with an increasing dependence on non-core and potentially volatile liabilities all raised supervisory concern. ADC activity had been adversely affected by the depressed housing market, and banks with large ADC exposure had been negatively impacted. Examiners concluded that declining asset quality was the primary threat facing the bank, resulting in weakened earnings, capital, and liquidity positions. An immediate provision to the ALLL, which would erode capital and reserves, was recommended given the asset quality and loan underwriting concerns.

As a result of the visitation findings, the bank's component and composite ratings were downgraded, and the GDBF, in consultation with the FDIC, initiated efforts to impose a C&D. The C&D became effective on March 2, 2009.

May 2009 Joint Examination

Examiners found that the overall condition of the bank was critically deficient and continued viability of the institution was threatened. Asset quality was poor, with past-due loans, nonperforming assets, loan losses, and adversely classified assets at excessive levels. In addition, the ALLL was underfunded by at least $2 million. Earnings were critically deficient, due largely to high loan loss provisions and other expenses related to excessive and increasing problem loans, and OREO, which had increased by over 112 percent from the November 2008 visitation. Capital was critically deficient in relation to the risk profile and negative earnings. Liquidity was deficient as secondary funding sources became restricted with management seeking to replace a significant amount of maturing brokered deposits. As a result, the Capital, Asset Quality, and Earnings components were downgraded to "5"; the Management component was double-downgraded to a "5"; and a composite rating of "5" was assigned. Further, the March 2009 C&D remained in effect.

December 2009 FDIC Visitation

The visitation was conducted to assess the overall financial condition of the institution and confirm the assigned component and composite ratings. Examiners found that the bank's condition continued to deteriorate as losses on impaired loans were recognized, with an additional provision of approximately $7 million needed to the ALLL. Imminent failure was evident unless the bank was able to recapitalize through its proposed $35 million stock offering. The composite rating and all component ratings remained the same, with the exception of the Management rating, which was upgraded to a "4" to recognize the initiatives undertaken by bank management since the May 2009 examination. The bank failed 3 months later.

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 Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved. Based on the supervisory actions taken with respect to the Bank of Hiawassee, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

The Bank of Hiawassee was considered *Well Capitalized* for PCA purposes until June 30, 2009. Table 8 illustrates the Bank of Hiwassee's capital levels relative to the PCA thresholds for *Well Capitalized* institutions for the quarter ending December 31, 2009, and for the 4 preceding calendar years.

Table 8: The Bank of Hiawassee's Capital Levels

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well-Capitalized Thresholds	**5 percent or more**	**6 percent or more**	**10 percent or more**	
Bank of Hiawassee's Capital Levels				
Dec-05	9.11	10.23	11.2	*Well Capitalized*
Dec-06	8.67	9.68	10.83	*Well Capitalized*
Dec-07	9.38	10.62	11.76	*Well Capitalized*
Dec-08	7.78	9.08	10.32	*Well Capitalized*
Dec-09	1.35	1.75	3.03	*Critically Undercapitalized*

Source: UBPRs for the Bank of Hiawassee.

The FDIC's efforts to monitor the Bank of Hiawassee's capital position and the institution's response to supervisory actions included the following:

- On August 5, 2009 and again on October 22, 2009, the FDIC issued a letter informing the bank that it was considered *Adequately Capitalized*. Based on the institution's June 30, 2009 Call Report, its Tier 1 Leverage Ratio, Tier 1 Risk-Based Capital Ratio and Total Risk-Based Capital Ratio were 5.76 percent, 7.08 percent, and 8.36 percent, respectively. The FDIC also informed the bank's management that it could not accept, renew, or roll over brokered deposits unless it applied for and obtained a waiver by the FDIC.[8]

- On November 17, 2009, a letter from the FDIC informed the bank that it had fallen to *Undercapitalized*. Based on the institution's September 30, 2009 Call Report, its Tier 1 Leverage Ratio, Tier 1 Risk-Based Capital Ratio, and Total Risk-Based Capital Ratio were 4.23 percent, 5.14 percent, and 6.42 percent, respectively. The FDIC reminded the bank's management that the bank could not accept, renew or roll over any brokered deposit. The FDIC also informed the bank that, effective immediately, the bank was subject to restrictions on asset growth, dividends, other capital distributions, and management fees and that it was required to file a written capital restoration plan within 45 days.

- On December 28, 2009, the FDIC received the bank's capital restoration plan, which indicated that the bank was trying to raise capital through a stock offering but needed to wait until April 2010 to provide the offering circular to prospective investors. On January 20, 2010, the FDIC notified the bank that the plan was not acceptable because of the length of time before the offering circular could be provided to prospective investors. The bank did not submit another plan before it failed.

- On February 1, 2010, the FDIC notified the bank that it was *Critically Undercapitalized*. Based on information provided to the FDIC in an email dated January 20, 2010, the bank's key capital ratios as of January 15, 2010 were, as follows:

    - Tangible Equity Capital Ratio 1.37%
    - Tier 1 Leverage Ratio 1.37%
    - Tier 1 Risk-Based Capital Ratio 1.80%
    - Total Risk-Based Capital Ratio 3.09%

  The FDIC also informed the bank that it was subject to the mandatory requirements of Section 38, which included restrictions on asset growth, dividends, other capital distributions, certain activities, and management fees.

[8] FDIC officials stated that the bank's management did not apply for a brokered deposit waiver at any time.

On November 13, 2008, the bank applied for funds under the Troubled Asset Relief Program (TARP)[9] but subsequently withdrew the application on February 26, 2009. On March 19, 2010, the GDBF closed the Bank of Hiawassee.

Corporation Comments

On October 21, 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. In its response, DSC reiterated the OIG's conclusions regarding the causes of the Bank of Hiawassee's failure. With regard to our assessment of the FDIC's supervision of the Bank of Hiawassee, DSC summarized supervisory activities from 2005 to 2010 described in our report, including onsite examinations, offsite monitoring, and the issuance of a formal enforcement action in 2008. In recognition of the threat that institutions with high risk profiles, such as the Bank of Hiawassee, pose to the DIF, DSC stated that it has issued guidance to financial institutions that reemphasizes the importance of robust credit risk management practices for institutions with concentrated CRE exposures. DSC also stated that it has issued guidance to enhance the supervision of institutions that rely on volatile non-core funding.

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

Objectives, Scope, and Methodology

Objectives

The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The Financial Reform Act also requires the OIG to review all other losses incurred by the DIF to determine (a) the grounds identified by the state or Federal banking agency for appointing the Corporation as receiver and (b) whether any unusual circumstances exist that might warrant an in-depth review of the loss. At the time the Financial Reform Act was enacted, our fieldwork and a draft of this report were substantially complete. Although the estimated loss for the Bank of Hiawassee no longer met the threshold requiring an MLR, the OIG decided to complete the audit and issue this report as an in-depth review.

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

We conducted this performance audit from June 2010 to August 2010, 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 Bank of Hiawassee's operations from 2005 until it failed on March 19, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution during the same period. To accomplish the objectives, we performed the following procedures and techniques:

- Analyzed examination reports and other supervisory documents prepared by the FDIC and the GDBF from 2005 through December 2009.

- Reviewed the following:

    - Institution data in Call Reports, UBPRs, and other reports.

    - FDIC and GDBF correspondence, including correspondence maintained in DSC's Atlanta Regional Office.

Objectives, Scope, and Methodology

- Relevant reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the institution's closure, including records maintained by DRR in the Jacksonville, FL office.

- Pertinent FDIC regulations, policies, procedures, and guidance.

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, and interviews of examiners to understand the Bank of Hiawassee's management controls pertaining to the causes of failure 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 was 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 the provisions of PCA. We performed limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations. The results of our tests are 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.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional material loss review reports related to failures of FDIC-supervised institutions and these

Objectives, Scope, and Methodology

reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent material loss reviews.

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

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and providing interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Call Report	The report filed by a bank pursuant to 12 United States Code (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 that shall contain 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 pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.

Glossary of Terms

Loan-to-Value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Memorandum of Understanding (MOU)	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, this action is to be considered for all institutions rated a composite "3".
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.

Glossary of Terms

Tier 1 (Core) Capital	In general, this term is defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Uniform Bank Performance Report (UBPR)	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.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Acronyms

ADC	Acquisition, Development, and Construction
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
CD	Certificate of Deposit
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
GDBF	Georgia Department of Banking and Finance
MLR	Material Loss Review
MOU	Memorandum of Understanding
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
ROE	Report of Examination
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

October 21, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, In-Depth Review of Bank of Hiawassee, Hiawassee, Georgia (Assignment No. 2010-041)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted an In-Depth Review of the Bank of Hiawassee (Hiawassee), which failed on March 19, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on September 20, 2010.

Hiawassee failed due to ineffective oversight of its high concentrations of commercial real estate (CRE) and acquisition, development and construction (ADC) loans, which included speculative construction lending for vacation homes in southern North Carolina and northern Georgia. Specifically, the Board and management failed to implement effective risk management practices and strong credit administration and loan underwriting practices, commensurate with Hiawassee's risk profile. As a result, asset quality deteriorated and capital levels were insufficient to support a safe and sound operation.

From 2005 to 2010, the FDIC and Georgia Department of Banking and finance (DBF) provided ongoing supervisory oversight of Hiawassee with four risk management examinations supplemented by on-site visitations. As early as 2006 the FDIC examiners noted that liquidity was strained as a result of asset growth and Hiawassee's increasing dependence on volatile non-core funding. In 2007 examiners noted a decline in asset quality and recommended improving documentation deficiencies. In the 2008 joint visitation Hiawassee was assigned a composite "4" rating, and a Cease and Desist order was issued. Hiawassee was further downgraded to a composite "5" rating in the 2009 examination due to further deterioration of asset quality, poor earnings performance, and capital levels that were critically deficient.

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

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