Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-012

Material Loss Review of Southern Community Bank, Fayetteville, Georgia

January 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On June 19, 2009, the Georgia Department of Banking and Finance (DBF) closed Southern Community Bank (Southern Community), Fayetteville, Georgia, and named the FDIC as receiver. On July 6, 2009, the FDIC notified the Office of Inspector General (OIG) that Southern Community's total assets at closing were $380.6 million and the estimated loss to the Deposit Insurance Fund (DIF) was $112.8 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Southern Community.

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

Background

Southern Community was chartered as a state nonmember bank on June 2, 2000 and was headquartered in Fayetteville, Georgia, a southern suburb in the Atlanta metropolitan area. In addition to its main office, Southern Community operated six full-service branch offices in various locations around the southern Atlanta area. The majority of Southern Community's lending was in commercial real estate (CRE), with a particular focus on residential acquisition, development, and construction (ADC) loans. Southern Community historically relied upon aggressively priced deposits, brokered deposits, and Federal Home Loan Bank (FHLB) borrowings to fund loan growth. Southern Community was wholly owned by Southern Community Bancshares, Inc., of Fayetteville, Georgia.

Audit Results

Causes of Failure and Material Loss

Southern Community failed because of a rapid deterioration in asset quality that led to loan and operational losses that quickly eroded the bank's capital. Specifically, Southern Community's excessive ADC concentrations, coupled with poor Board oversight and risk management practices, led to rapidly increasing levels of nonperforming loans and foreclosed properties when economic conditions began to deteriorate in 2007. Despite actions taken by the Board in 2007, 2008, and 2009, including steps to diversify its loan portfolio, replace the management team, and secure additional capital, the bank's condition continued to deteriorate, and in 2009, the bank's liquidity levels became critically deficient. DBF closed Southern Community because of its core unprofitability, inability to raise sufficient capital to support its operations, and weak liquidity position.

The FDIC's Supervision of Southern Community

The FDIC and DBF conducted annual on-site examinations of Southern Community consistent with requirements and monitored its condition through the use of various offsite monitoring mechanisms. Examiners consistently identified and reported on Southern Community's ADC concentrations and reliance on non-core funding. However, the bank's asset quality, liquidity, and overall financial condition were considered satisfactory until the 2008 examination. By then, asset quality had rapidly declined due to the severe economic downturn. In hindsight, greater supervisory emphasis on the risk profile created by the ADC concentrations reported in the 2005 examination would have been prudent, in light of the historical vulnerability of ADC concentrations to economic cycles. In addition, although it is not necessarily indicative of supervisory concern, one of the FDIC's offsite monitoring tools used in planning examinations indicated that Southern Community had a high exposure to a potential economic downturn because of its ADC concentrations. Accordingly, the 2005 examination report could have emphasized to the bank the fundamental importance of risk diversification, as was done in the 2008 examination, even though few risk management problems were identified in the on-site examination. Doing so may not have been effective in persuading management to diversify its portfolio at that time, but such emphasis would have served to establish a supervisory tenor and expectations regarding the Board's basic risk management responsibility that was found to be lacking in 2008.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. The bank was unsuccessful in raising needed capital and was subsequently closed on June 19, 2009.

Management Response

On January 6, 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 reiterated the OIG's conclusions regarding the cause of Southern Community's failure. With regard to our assessment of the FDIC's supervision of Southern Community, DSC noted that examiners consistently identified the sizable ADC concentrations, yet judged the overall financial condition to be satisfactory despite Southern Community's high risk profile through the 2006 examination. The 2008 examination reported significant deterioration in credit administration and underwriting. DSC agreed that emphasis of the fundamental importance of risk diversification might have better established supervisory expectations regarding the Board's basic risk management responsibility.

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FDIC
Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226
Office of Inspector General

DATE: January 6, 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 Southern Community Bank, Fayetteville, Georgia* (Report No. MLR-10-012)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the FDIC Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Southern Community Bank (Southern Community), Fayetteville, Georgia. The Georgia Department of Banking and Finance (DBF) closed Southern Community on June 19, 2009 and named the FDIC as receiver. On July 6, 2009, the FDIC notified the OIG that Southern Community's total assets at closing were $380.6 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $112.8 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency. 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 Southern Community's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of Southern Community, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Southern Community's failure and the FDIC's efforts to ensure that Southern Community's 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 financial institution failures are

[1] As defined by section 38 of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by 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.

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 key terms and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

Southern Community was chartered as a state nonmember bank on June 2, 2000 and was headquartered in Fayetteville, Georgia, a southern suburb in the Atlanta metropolitan area. In addition to its main office, Southern Community operated six full-service branch offices in various locations around the southern Atlanta area. The majority of Southern Community's lending was in commercial real estate (CRE), with a particular focus on residential acquisition, development, and construction (ADC) loans. Southern Community historically relied upon aggressively priced deposits, brokered deposits, and Federal Home Loan Bank (FHLB) borrowings to fund loan growth. Table 1 provides details on Southern Community's financial condition as of March 31, 2009 and for the 4 preceding calendar years.

Table 1: Financial Information for Southern Community, 2005 to 2009

Financial Measure	3-31-09	12-31-08	12-31-07	12-31-06	12-31-05
Total Assets ($000s)	$371,695	$381,791	$407,740	$385,813	$333,661
Total Deposits ($000s)	$297,962	$305,724	$303,255	$295,033	$263,095
Total Loans ($000s)	$223,680	$240,134	$290,796	$293,223	$253,954
Brokered Deposits ($000s)	$101,083	$101,083	$35,094	$39,607	$36,110
FHLB Funds ($000s)	$50,000	$50,000	$57,500	$44,500	$30,000
Net Income ($000s)	($4,369)	($17,598)	($1,197)	$3,064	$2,210

Source: Uniform Bank Performance Reports (UBPR) for Southern Community.

Southern Community was wholly owned by Southern Community Bancshares, Inc., (SCBI) of Fayetteville, Georgia. SCBI provided capital to support the bank's growth, totaling approximately $4.2 million in 2008 to keep Southern Community *Well Capitalized*. However, as the financial condition of the bank deteriorated, SCBI was not able to provide additional support to the bank.

Causes of Failure and Material Loss

Southern Community failed because of a rapid deterioration in asset quality that led to loan and operational losses that quickly eroded the bank's capital. Specifically, Southern Community's excessive ADC concentrations, coupled with poor Board oversight and risk management practices, led to rapidly increasing levels of nonperforming loans and foreclosed properties when economic conditions began to deteriorate in 2007. Despite actions taken by the Board in 2007, 2008, and 2009, including steps to diversify its loan portfolio, replace the management team, and secure additional capital, the bank's condition continued to deteriorate, and in 2009, the bank's liquidity levels became critically deficient. DBF closed Southern Community because of its core unprofitability, inability to raise sufficient capital to support its operations, and weak liquidity position.

Concentration in ADC Loans

Southern Community's strategy was centered on funding residential ADC loans in its local lending area. Southern Community was located in an area that was considered to be more affluent than the average market and had experienced significant growth. Accordingly, Southern Community was able to grow its assets from $86 million at the end of 2001 to $382 million by the end of 2006. ADC loans comprised over half of Southern Community's average gross loans by the end of 2008. In addition, Southern Community's ADC loans, as a percentage of total capital, increased from 217 percent as of December 31, 2001 to 563 percent as of December 31, 2008,[3] more than five times greater than its peer group. As the level of its concentrations grew, the bank's risk profile increased. Table 2 summarizes Southern Community's ADC concentrations in comparison to its peer group.

Table 2: Southern Community's ADC Concentrations Compared to Peer Group

	ADC Loans as a Percentage of Total Capital		ADC Loans as a Percentage of Average Gross Loans	
Year Ended	Southern Community	Peer Group	Southern Community	Peer Group
2001	217%	51%	32.23%	7.09%
2002	225%	56%	30.85%	7.72%
2003	243%	67%	29.60%	8.67%
2004	266%	81%	28.94%	10.43%
2005	457%	104%	37.73%	12.72%
2006	480%	117%	54.81%	14.96%
2007	484%	124%	57.26%	16.31%
2008	563%	111%	51.68%	15.26%

Source: UBPRs for Southern Community.

Supervisory guidance emphasizes that an institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk. Further, Interagency Guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, dated December 12, 2006, stipulates that institutions with CRE concentrations should manage not only the risk of individual loans but also portfolio risk and should develop appropriate strategies for managing concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse market conditions. According to the 2008 examination report, Southern Community did not have such a plan. In mid-2007, Southern Community recognized the need to diversify its portfolio because of changes to the economic landscape. The bank planned to move into the equipment financing arena and established specific portfolio mix targets and a plan for growth in

[3] The increase in risk exposure from ADC loans in 2008 was due primarily to the decline in the bank's capital level.

that sector. However, the bank's plans to diversify the portfolio did not materialize due to the financial impact of the significant deterioration of the ADC portfolio in 2008 and into 2009. The 2008 examination report stated that indicators of a decline in the ADC market had been on the horizon for some time, yet management did not take appropriate action until loan quality began to deteriorate. By then, asset quality had declined to an unacceptable level, and examiners considered actions taken by the Board and management to identify problem loans and pursue foreclosure and collection reactionary.

Oversight and Risk Management Practices

Notwithstanding the steps taken by the Board to replace key management in 2008 and correct weaknesses, the 2009 examination report stated that Board and management supervision were severely lacking at the onset of the bank's problems. Further, the report stated that the poor condition of the bank preempted substantial improvement and despite positive actions taken by the new management team, it could not effectively correct the bank's problems. The Interagency Guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* reiterated that concentrations in CRE lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the past. 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. Further, Part 365 of the *FDIC Rules and Regulations* requires FDIC-supervised institutions to adopt and maintain written policies that establish appropriate limits and standards for all real estate loans, including ADC loans. In the case of Southern Community, the bank lacked an adequate loan policy, and there were deficiencies in its loan underwriting and credit administration practices and allowance for loan and lease losses (ALLL) methodology.

Loan Policy

Southern Community's Board did not establish effective risk management practices sufficient to limit the bank's exposure to its ADC concentrations. Southern Community's *Loan Policy and Procedure Manual* was silent regarding limits on total exposure to the acquisition and development market in relation to capital and did not provide loan mix guidelines, according to the 2008 examination. Specifically, while the loan policy did address limitations for the number of speculative construction units and for acquisition and development loans as a percent of the portfolio, there was no limit for total exposure to the market as a percent of capital. The bank had begun to update its loan policy in 2007 and it was submitted to the Board for review and approval in 2008, but the new policy was not in place at the time of the 2008 examination.

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

Loan Underwriting and Credit Administration Weaknesses

Southern Community did not implement sound loan underwriting and credit administration practices, which contributed to the asset quality problems that developed in the institution's ADC portfolio. Specifically, the 2008 examination noted the following weaknesses and violations:

- inadequate financial and cash flow analysis,
- lack of feasibility analysis to support development projects,
- infrequent formal inspections of large development projects,
- improper handling or liberal use of interest reserves, and
- documentation exceptions.

FIL-22-2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, issued March 17, 2008, provides key risk management processes for institutions with CRE concentrations, one of which is to maintain updated financial and analytical information for borrowers and states that global financial analysis[5] of obligors should be emphasized. The guidance also states that inappropriately adding extra interest reserves on loans where the underlying real estate project is not performing as expected can erode collateral protection and mask loans that would otherwise be reported as delinquent.

The 2008 examination also noted that internal loan grading needed to be strengthened because approximately 28 percent of the adverse loan classifications were downgraded by examiners. Additionally, the 2008 examination reported that Southern Community was in contravention of Appendix A to Part 365 of the FDIC Rules and Regulations (*Interagency Guidelines for Real Estate Lending Policies*). Appendix A specifies that loans in excess of the supervisory loan-to-value (LTV) limits should be identified in the bank's records and their aggregate amount reported to the Board at least quarterly. Southern Community's management did not implement a process to report these loans to its Board. Five loans were found to exceed the supervisory LTV.

Allowance for Loan and Lease Losses

According to the 2008 examination report, the bank's ALLL methodology needed to be improved. Consistent with longstanding supervisory guidance, an institution's ALLL methodology must comply with accounting standards, and the ALLL must be maintained at a level that is appropriate to cover estimated credit losses on individually evaluated loans determined to be impaired, as well as estimated credit losses inherent in the remainder of the portfolio. According to the 2008 examination, the bank was using loan grades to calculate the allocation under Financial Accounting Standard No. 5 (FAS 5),[6] but needed to further segment the ADC pool to fully comply with accounting standards.

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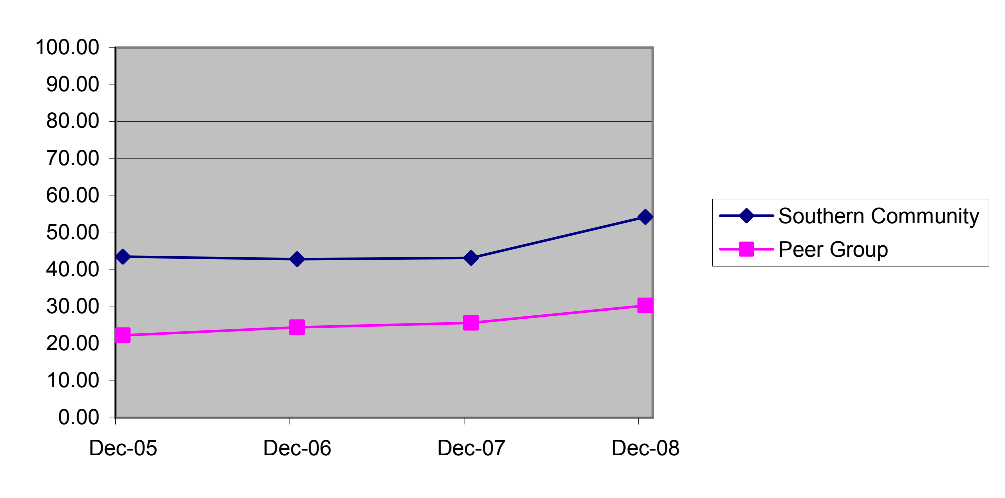
[5] Global financial analysis involves analyzing a borrower's complete financial obligations.
[6] Under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans.

The 2009 examination also reported that the ALLL was underfunded and the methodology was not in compliance with accounting standards.

Reliance on Volatile Funding Sources

Historically, Southern Community relied heavily on potentially volatile liabilities, including large time deposits, brokered deposits, FHLB borrowings, and federal funds purchased to fund loan growth. As shown in Figure 1, Southern Community's net non-core funding dependence ratio[7] was consistently higher than its peer group from 2005 through 2008, and increased in 2008 when the bank purchased over $100 million in brokered deposits. Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Figure 1: Southern Community's Net Non-Core Funding Dependence Ratio



Source: UBPRs for Southern Community.

Further, the 2005 and 2008 examinations reported that Southern Community's net non-core dependence ratios exceeded the bank's policy parameters. The 2008 examination also noted that Southern Community needed to develop a better tool to monitor its liquidity position to enable management to more accurately forecast funding needs and recommended that management evaluate its liquidity contingency plan.

[7] The net non-core funding dependence ratio is defined as non-core liabilities less short-term investments divided by long-term assets. Non-core liabilities include total time deposits of $100,000 or more, insured brokered deposits issued in denominations of less than $100,000, federal funds purchased, and other borrowed money.

The FDIC's Supervision of Southern Community

The FDIC and DBF conducted annual on-site examinations of Southern Community consistent with requirements[8] and monitored its condition through the use of various offsite monitoring mechanisms. Examiners consistently identified and reported on Southern Community's ADC concentrations and reliance on non-core funding. However, the bank's asset quality, liquidity, and overall financial condition were considered satisfactory until the 2008 examination. By then, asset quality had rapidly declined due to the severe economic downturn. In hindsight, greater supervisory emphasis on the risk profile created by the ADC concentrations reported in the 2005 examination would have been prudent, in light of the historical vulnerability of ADC concentrations to economic cycles. In addition, although it is not necessarily indicative of supervisory concern, one of the FDIC's offsite monitoring tools used in planning examinations indicated that Southern Community had a high exposure to a potential economic downturn because of its ADC concentrations. Accordingly, the 2005 examination report could have emphasized to the bank the fundamental importance of risk diversification, as was done in the 2008 examination, even though few risk management problems were identified in the on-site examination. Doing so may not have been effective in persuading management to diversify its portfolio at that time, but such emphasis would have served to establish a supervisory tenor and expectations regarding the Board's basic risk management responsibility that was found to be lacking in 2008.

Supervisory History

Historically, Southern Community was considered a well-performing institution and consistently received composite "2" CAMELS ratings.[9] Our review focused on supervisory oversight between 2005 and 2009. During that period, the FDIC and the DBF conducted four safety and soundness examinations of Southern Community, alternating these examinations with the exception of a final joint examination.

In the 2005 examination, the FDIC used Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) examination procedures.[10] By the 2006 examination, examiners identified Bank Secrecy Act (BSA) deficiencies and Information Technology (IT)

[8] 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. Southern Community did not meet the conditions for the 18-month examination cycle.

[9] 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.

[10] 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.

weaknesses and assigned the bank a composite "3" rating.[11] Southern Community was placed under a Memorandum of Understanding (MOU) to address the weaknesses. In 2007, the DBF and FDIC conducted separate visitations to follow up on the progress related to the BSA and IT deficiencies. During 2007, the FDIC also monitored the impact of the economic slowdown on the bank.

In the 2008 examination, examiners found that the overall condition of the bank had deteriorated significantly and assigned it a composite "4" rating. Subsequently, in September 2008, a Cease and Desist Order (C&D) effective October 6, 2008, was issued. The C&D required the bank, among other things, to:

- Increase Board participation in the affairs of the bank;
- Adopt a plan for achieving and maintaining its Tier 1 Capital at or above 8 percent of the bank's total assets and maintaining minimum risk-based capital requirements for a *Well Capitalized* bank;
- Submit specific plans and proposals to effect the correction of all loan underwriting, loan administration, and loan portfolio management weaknesses;
- Develop an effective system of independent loan review to appropriately assess and grade the overall quality of the loan portfolio;
- Review the adequacy of the ALLL;
- Review its liquidity position at least monthly and develop or revise, adopt, and implement a written contingency liquidity plan; and
- Implement an asset/liability management policy that established an acceptable range for the bank's non-core funding dependency ratio.

Despite efforts by the bank to address its problems during 2007, 2008, and 2009, the condition of the bank continued to deteriorate, and Southern Community received a composite "5" rating in 2009. Table 3 summarizes Southern Community's supervisory history during this period, including the supervisory actions taken.

[11] As a result of the state's composite downgrade, risk management oversight responsibilities were transferred from the field office to the regional office, and a case manager at the regional office level was assigned.

Table 3: Examinations and Visitations of Southern Community, 2005 to 2009

Start Date	As of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
09/27/05	06/30/05	FDIC	222222/2	N/A
11/07/06	09/30/06	State	223222/3	Issued an MOU related to IT weaknesses and BSA deficiencies.
6/18/07	N/A	State	N/A	Reviewed steps taken to improve IT function and BSA compliance.
09/10/07 Visitation	N/A	FDIC	N/A	Reviewed steps taken in response to BSA provisions in the MOU.
01/31/08	12/31/07	FDIC	454533/4	Issued Cease and Desist Order (C&D).
01/26/09	12/31/08	FDIC/State	554555/5	Continued to monitor compliance with the C&D.

Source: Reports of Examination (ROE) for Southern Community.

Supervisory Concerns Related to ADC Concentrations

The 2005 and 2006 examinations reported ADC concentrations of 306 percent and 302 percent of Tier 1 Capital, respectively, and concluded that management adequately monitored and reported the concentrations to the Board. Further, the 2005 and 2006 examination reports concluded that asset quality was satisfactory, risk management policies and practices for the credit function were adequate, and past due and nonaccrual loans were nominal and adequately monitored. As discussed earlier in this report, MERIT examination procedures were used for the 2005 examination. Consistent with these procedures, examiners reviewed 29 percent of the loan portfolio. DSC officials told us that the use of MERIT procedures during the 2005 examination did not impact their assessment of Southern Community's loan portfolio because problems with the loan underwriting and credit administration practices had not yet materialized. Notably, 89 percent of the loans classified as nonperforming in the 2009 examination were originated after January 1, 2007.

The Interagency Guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* provides supervisory criteria for identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny, as follows:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
- total commercial real estate loans that represent 300 percent or more of the institution's total capital, and the outstanding balance of an institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Southern Community's ADC concentration far exceeded 100 percent of total capital. Recognizing that the 2006 guidance was not in place at the time of the 2005 examination, the FDIC could have emphasized to the Board and management that the bank's risk profile was increasing because the lack of diversity in its loan portfolio and growth in ADC concentrations was making it vulnerable to an economic downturn.

The 2008 examination reported that risk management weaknesses related to concentrations were a primary concern, as the majority of adversely classified loans were related to the residential ADC market. The adversely classified items ratio had reached an excessive level of 231 percent and further increased to 396 percent at the 2009 examination.

Supervisory Concerns Related to ALLL

Examiner conclusions on the appropriateness of Southern Community's ALLL methodology and level varied. According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses,* examiners should assess the credit quality of an institution's portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of the reported ALLL in the institution's regulatory reports. The 2005 FDIC examination stated that Southern Community's ALLL methodology needed improvement, but the 2006 state examination reported that management had revised the methodology and that it was appropriate for the size and risk associated with the loan portfolio. However, both the FDIC's 2008 and the joint 2009 examinations indicated that Southern Community's ALLL methodology did not comply with accounting standards and its ALLL reserve was inadequately funded. Table 4 illustrates the significant growth in the bank's adversely classified assets and the ALLL increases identified by examiners in 2008 and 2009.

Table 4: Southern Community's Adversely Classified Assets and ALLL

Asset Quality (Dollars in Thousands)						
Examination Date	Examiner Adversely Classified Asset Amounts				ALLL Amounts	
	Substandard	Doubtful	Loss	Total Adversely Classified Items	ALLL Computed by Southern Community	Increase in ALLL Computed by Examiners
09/27/05	$5,081	$0	$39	$5,120	$2,358	$0
11/07/06	$4,229	$198	$1,989	$6,416	$4,246	$0
01/31/08	$84,072	$0	$4,982	$89,054	$6,244	$3,700
01/26/09	$103,466	$0	$5,155	$108,621	$9,872	$2,600

Source: ROEs for Southern Community.

Offsite Review Program

The offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. The FDIC generates an offsite review list each quarter and performs offsite reviews for each bank that appears on the list. The findings of these reviews are factored into examination schedules and other supervisory activities. The system-generated offsite review list includes only institutions rated "1" and "2" that are either:

- identified by the Statistical CAMELS Offsite Rating (SCOR) system as having a 35 percent or higher probability of downgrade to "3" or worse,[12] or
- identified in the Growth Monitoring System (GMS) as having a growth percentile of 98 or 99.[13]

Southern Community did not appear on the system-generated offsite review list because it did not meet the criteria. Specifically, from 2004 through 2006, the bank was rated a "2", but its probability of a downgrade only reached 16 percent and its highest GMS percentile was 97. In 2007, the bank would have met the criteria for inclusion on the offsite review list based on its December 31, 2007 Call Report data; however, the bank did not appear on the system-generated offsite review list because the bank had a composite "3" CAMELS rating at that time. Notwithstanding, by the time the December 31, 2007 offsite review list was generated in February 2008, the on-site examination had already started.

The FDIC's model that measures a bank's exposure to concentrations, the Real Estate Stress Test (REST),[14] indicated that Southern Community had a REST score of "5" in 2005, 2006, and 2007. According to FDIC information about the REST model, a high REST score does not necessarily mean that the institution is a supervisory concern but indicates a high exposure to a potential economic downturn because of the concentrations in construction and development loans. The REST model was designed to help focus examination activities on risky areas before a downturn, and the reasons behind the REST score need to be investigated before drawing conclusions about a particular institution. The FDIC has not established formal requirements related to the use of REST because of the varying nature of real estate exposures and localized market activities. Based on pre-examination planning documents, the REST score was taken into consideration in planning for Southern Community on-site reviews.

During 2007, the FDIC took steps to monitor institutions with high ADC concentrations, including Southern Community. For example, in June 2007, the FDIC contacted

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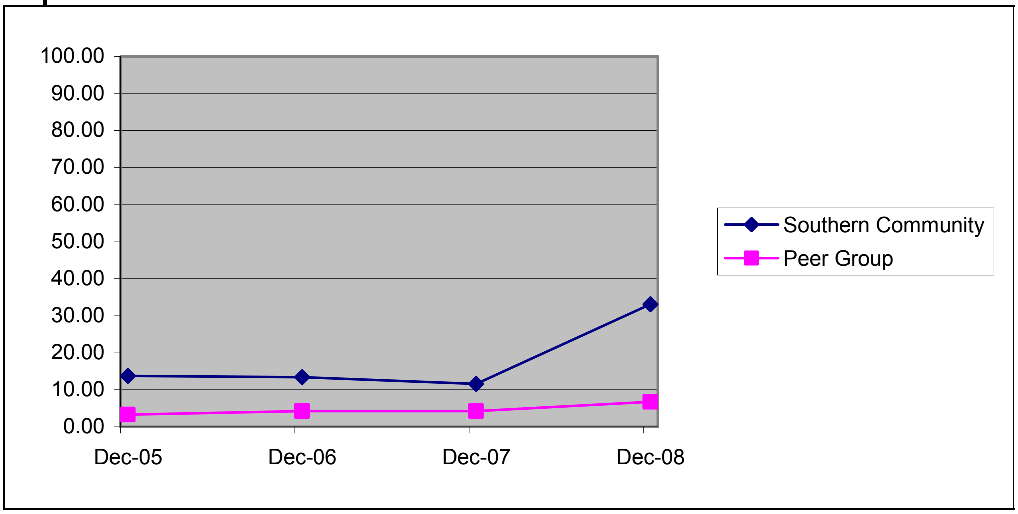
[12] SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
[13] GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.
[14] REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. REST uses statistical techniques to forecast an institution's condition over a 3- to 5-year horizon and provides a single rating from 1 to 5 in descending order of performance quality.

Southern Community officials to discuss the impact of the residential lending market on the bank. Southern Community stated that the residential construction market was saturated, that a large loan had been placed in nonaccrual after the borrower had filed bankruptcy, that past due loans were up, and that the bank's 2007 income would be well below budget due to increased provisions for loan and lease losses. Using Call Report data, the Atlanta Field Office Supervisor analyzed Southern Community's ADC exposure relative to other institutions supervised by that office in September 2007. This analysis indicated that Southern Community had a relatively high risk exposure. The examination start date was not accelerated because the next examination was scheduled to start in the first quarter of 2008.

Supervisory Concerns Related to Volatile Funding

FDIC's Rules and Regulations Part 337 states that any *Well Capitalized* insured depository institution may solicit and accept, renew, or roll over any brokered deposit without restriction. Southern Community had briefly dropped below a *Well Capitalized* position at the end of 2007, but its holding company injected enough capital to return the bank to *Well Capitalized.* Accordingly, during the 6-month period between March 31, 2008 and September 30, 2008, the bank was able to increase brokered deposits from $22 million to $116 million to bolster its liquidity position. The majority of this increase occurred after the issuance of the FDIC's 2008 examination report, which discussed Southern Community's weakening condition. Specifically, Southern Community purchased $82 million in brokered deposits during July and August 2008. The FDIC did not begin weekly monitoring of the bank's liquidity until after Southern Community had purchased these brokered deposits. Figure 2 illustrates the percentage of brokered deposits to total deposits between 2004 and 2008.

Figure 2: Southern Community's Percentage of Brokered Deposits to Total Deposits



Source: OIG analysis of UBPRs for Southern Community.

The C&D imposed by the FDIC, effective in October 2008, prohibited the bank from accepting, renewing, or rolling over brokered deposits without obtaining a waiver from the FDIC. After the issuance of the C&D, Southern Community did not request a waiver and had no further purchases of brokered deposits.

In March 2009, the FDIC took steps to address increases in wholesale funding by institutions that are in a weakened condition. The FDIC issued FIL 13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions that are in a Weakened Condition*. This guidance states, among other things, that:

- Institutions rated "3", "4", or "5" are expected to implement a plan to stabilize or reduce risk exposure and limit growth. This plan should not include the use of volatile liabilities to fund aggressive asset growth or materially increase the institution's risk profile.

- Corrective programs may include requirements that institutions notify the FDIC before undertaking asset growth or material changes in asset or liability composition.

This guidance should enable the FDIC to subject institutions that rely excessively on a volatile funding mix to more extensive offsite monitoring and on-site examination to ensure management is taking appropriate steps to stabilize the bank's risk profile and strengthen its financial condition.

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. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-charted nonmember banks that are not *Adequately Capitalized.* As stated previously in the report, Southern Community briefly fell to *Adequately Capitalized* based on amended December 31, 2007 Call Report information, but its holding company injected capital to return it to a *Well Capitalized* position. In addition to including provisions in the C&D on minimum capital requirements, the FDIC followed PCA guidance and appropriately notified the bank of its capital position and corresponding requirements, as follows:

- On November 17, 2008, the FDIC notified Southern Community that it was *Adequately Capitalized* based on September 30, 2008 Call Report data and reaffirmed the brokered deposit restrictions that were included in the C&D.
- On February 17, 2009, the FDIC notified Southern Community that the bank was *Undercapitalized* and was required to submit a capital restoration plan within 45 days.
- On May 26, 2009, the FDIC notified Southern Community that the bank was *Significantly Undercapitalized* and that its capital restoration plan submitted was not acceptable. Southern Community failed less than a month later on June 19, 2009.

Southern Community had submitted an application for the Troubled Asset Relief Program (TARP)[15] on November 14, 2008 for funding of $9 million. Southern Community subsequently withdrew its application in February 2009.

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 January 6, 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 reiterated the OIG's conclusions regarding the cause of Southern Community's failure. With regard to our assessment of the FDIC's supervision of Southern Community, DSC noted that examiners consistently identified the sizable ADC concentrations, yet judged the overall financial condition to be satisfactory despite Southern Community's high risk profile through the 2006 examination. The 2008 examination reported significant deterioration in credit administration and underwriting. DSC agreed that emphasis of the fundamental importance of risk diversification might have better established supervisory expectations regarding the Board's basic risk management responsibility.

[15] 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.

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.

The objectives of this material loss review were to (1) determine the causes of Southern Community's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Southern Community, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted the audit from October 2009 to December 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

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

- Analyzed examination reports prepared by the FDIC and the DBF from 2005 to 2009.

- Analyzed available examination work papers prepared by the FDIC from 2008 to 2009.

- Reviewed the following:

    - Bank data contained in UBPRs and Call Reports.
    - Correspondence maintained at DSC's Atlanta Regional and Field Offices.
    - DSC's Virtual Supervisory Information on the Net (ViSION) Modules, including Supervisory Tracking & Reporting.
    - Reports from the bank's internal auditors, Porter Keadle Moore, LLP, as of September 21, 2007 and external auditors, Mauldin & Jenkins, LLC, for the year ended 2006.
    - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

Objectives, Scope, and Methodology

- DSC regional management in Atlanta.
- DSC examiners in the Atlanta Field Office.

- Interviewed DBF officials from Atlanta to discuss their perspective of the institution, its examinations, and other activities regarding the DBF's supervision of the bank.

We performed our audit field work at the OIG offices in Arlington, Virginia.

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

Consistent with our audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC's systems, reports, ROEs, and interviews of DSC and DBF examiners to obtain an understanding of Southern Community's management controls pertaining to the causes of failure and material loss as discussed in the body of this report. Although we obtained information from various FDIC systems, we determined that the controls pertaining to these systems were not significant to the audit objectives, and therefore, did not evaluate the effectiveness of information system controls. We relied on information from various sources, including ROEs, 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 was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. 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.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Bank Secrecy Act (BSA)	Congress enacted BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file certain reports used in criminal, tax, or regulatory investigations or proceedings.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
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.
Federal Home Loan Bank (FHLB)	The Federal Home Loan Bank System provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to its members. Advances are available to members with a wide variety of terms to maturity, from overnight to long term, and are collateralized. Advances are designed to prevent any possible loss to FHLBs, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail. To protect their position, FHLBs have a claim on any of the additional eligible collateral in the failed bank. In addition, the FDIC has a regulation that reaffirms FHLB priority, and FHLBs can demand prepayment of advances when institutions fail.
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.

Glossary of Terms

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.
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
ALLL	Allowance for Loan and Lease Losses
BSA	Bank Secrecy Act
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
DSC	Division of Supervision and Consumer Protection
FAS	Financial Accounting Standard
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GMS	Growth Monitoring System
IT	Information Technology
LTV	Loan-to-Value
MERIT	Maximum Efficiency, Risk-focused, Institution Targeted
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
REST	Real Estate Stress Test
ROE	Report of Examination
SCBI	Southern Community Bancshares, Inc.
SCOR	Statistical CAMELS Offsite Rating
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

FDIC

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

January 6, 2010

MEMORANDUM TO:	Stephen Beard Assistant Inspector General for Material Loss Reviews
FROM:	Sandra L. Thompson Director
SUBJECT:	Draft Audit Report Entitled, Material Loss Review of Southern Community Bank, Fayetteville, Georgia (Assignment No. 2009-061)

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 Southern Community Bank (SCB) which failed on June 19, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on December 14, 2009.

SCB failed due to a rapid deterioration in asset quality, which led to loan and operational losses that quickly eroded SCB's capital and liquidity. Weakened loan underwriting standards and poor credit administration practices contributed to deterioration in SCB's acquisition, development, and construction (ADC) loan portfolio. The high ADC concentration relative to capital magnified the negative impact of the economic downturn on SCB. SCB's rapidly deteriorating condition ultimately resulted in critically deficient liquidity levels. The Georgia Department of Banking and Finance (GDBF) closed SCB due to negative earnings, insufficient capital, and weak liquidity position.

The Report indicates that DSC and GDBF conducted annual on-site examinations of SCB consistent with statutory requirements and further analyzed its condition utilizing various offsite monitoring tools. Examiners consistently identified and reported SCB's sizable ADC concentrations and volatile funding reliance, yet judged SCB's asset quality, liquidity, and overall financial condition to be satisfactory despite its high risk profile through the November 2006 examination. The FDIC examination in January 2008, reported significant deterioration in credit administration and underwriting. Notably, 89% of the non-performing loans listed in SCB's final examination report were originated after January 1, 2007. We agree that emphasis of the fundamental importance of risk diversification might have better established supervisory expectations regarding the Board's basic risk management responsibility.

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