Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-11-001

Material Loss Review of Appalachian Community Bank, Ellijay, Georgia

October 2010

Office of Inspector General

Executive Summary

Material Loss Review of Appalachian Community Bank, Ellijay, Georgia

Report No. MLR-11-001
October 2011

Why We Did The Audit

On March 19, 2010, the Georgia Department of Banking and Finance (DBF) closed Appalachian Community Bank (Appalachian), Ellijay, Georgia and named the FDIC as receiver. On April 1, 2010, the FDIC notified the Office of Inspector General (OIG) that Appalachian's total assets at closing were $1.04 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $415 million. As of September 3, 2010, the estimated loss to the DIF had increased to $420 million. As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of Appalachian.

The audit objectives were to (1) determine the causes of Appalachian's failure and the 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

Appalachian was a state nonmember bank established on March 3, 1995, and was wholly-owned by Appalachian Bancshares, Inc., Ellijay, Georgia (ABI), a two-bank holding company. Appalachian was headquartered in Ellijay, Georgia, which is located approximately 80 miles north of Atlanta in the foothills of the Blue Ridge Mountains. The bank's main office was located in Gilmer County and held 41 percent of the institution's total deposits. Appalachian's business strategy focused on growth in commercial real estate (CRE), in particular, acquisition, development, and construction (ADC) lending that was supported, in part, by wholesale funding, including brokered deposits and Federal Home Loan Bank (FHLB) borrowings.

Audit Results

Causes of Failure and Material Loss

Appalachian's failure can be attributed to losses associated with its ADC loan concentrations that were the center of the Board's and management's growth strategy. Although initially profitable, Appalachian's Board and management failed to provide appropriate oversight of its ADC lending activities, especially when economic conditions began to decline. Inadequate underwriting and credit administration led to the rapid deterioration of asset quality, which eroded the bank's capital. DBF closed after capital declined to unsafe and unsound levels and prospects for recapitalization or sale of the bank failed to materialize.

The FDIC's Supervision of Appalachian

Our review focused on FDIC and DBF supervisory oversight of Appalachian between 2006 and 2010. The FDIC and DBF conducted timely and regular examinations of Appalachian and monitored its condition through the use of offsite monitoring mechanisms. Through its supervisory efforts, the FDIC and DBF identified risks in Appalachian's operations and brought these to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's growth, significant concentrations in CRE and ADC loans, and poor Board and management oversight of risk management processes. Regulators imposed a formal enforcement action following the 2008 examination; however, Appalachian's response fell short and the financial condition of the bank became critically deficient.

In retrospect, a more critical supervisory assessment of Management and Asset Quality based on Appalachian's increasing risk profile during the 2006 and 2007 examinations may have been prudent. Such an approach could have helped to establish supervisory expectations with regard to ADC concentrations and the bank's responsibilities for mitigating risks at a critical point in time. Further, this approach may have led to lower CAMELS ratings in 2006 or 2007 and possibly an informal supervisory action, which would have increased supervisory attention to Appalachian's performance and risks earlier.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008 the FDIC reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Further, the FDIC completed a training initiative in March 2010 for its supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addresses the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

Management Response

On October 1, 2010, the Director, DSC, provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of Appalachian's failure. With regard to our assessment of the FDIC's supervision of Appalachian, DSC summarized supervisory activities between 2006 and 2009 described in our report, including onsite examinations, offsite monitoring, and the issuance of a formal enforcement action in 2009. DSC agreed that greater emphasis could have been placed on Appalachian's increasing risk profile. Further, in recognition of the threat that institutions with high risk profiles, such as Appalachian, pose to the DIF, DSC stated it has issued guidance to financial institutions that re-emphasizes the importance of robust credit risk management practices for institutions with concentrated CRE exposures and sets forth broad supervisory expectations.

Contents

	Page
Background	2
Causes of Failure and Material Loss	2
ADC Concentrations	3
Board and Management Oversight	6
The FDIC's Supervision of Appalachian	9
Supervisory History	10
Supervisory Response to Key Risks	11
Supervisory Lessons Learned	14
Implementation of PCA	15
Corporation Comments	17
Appendices	
1. Objectives, Scope, and Methodology	18
2. Glossary of Terms	21
3. Acronyms	25
4. Corporation Comments	26
Tables	
1. Financial Information for Appalachian, 2005 to 2009	2
2. Appalachian's ADC Concentrations Compared to Peer Group	5
3. Appalachian's Examination History, 2006 to 2009	10
4. Appalachian's Capital Levels	15
Figures	
1. Overview Map of Appalachian's Market Area	3
2. Appalachian's Loan Composition, 2005 to 2009	4
3. Appalachian's Loan and Lease Charge-offs, 2008 and 2009	6

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

Office of Material Loss Reviews
Office of Inspector General

DATE: October 1, 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 Appalachian Community Bank, Ellijay, Georgia* (Report No. MLR-11-001)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Appalachian Community Bank (Appalachian), Ellijay, Georgia. The Georgia Department of Banking and Finance (DBF) closed the institution on March 19, 2010, and named the FDIC as receiver. On April 1, 2010, the FDIC notified the OIG that Appalachian's total assets at closing were $1.04 billion and the estimated loss to the Deposit Insurance Fund (DIF) was $415 million. As of September 3, 2010, the estimated loss to the DIF had increased to $420 million. The estimated loss exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

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 Appalachian's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Appalachian, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Appalachian'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 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

Appalachian was a state nonmember bank established on March 3, 1995, and was wholly-owned by Appalachian Bancshares, Inc., Ellijay, Georgia (ABI), a two-bank holding company.[2] Appalachian was headquartered in Ellijay, Georgia, which is located approximately 80 miles north of Atlanta in the foothills of the Blue Ridge Mountains. The bank's main office was located in Gilmer County and held 41 percent of the institution's total deposits. Appalachian's business strategy focused on growth in commercial real estate (CRE), in particular, acquisition, development, and construction (ADC) lending that was supported, in part, by wholesale funding, including brokered deposits and Federal Home Loan Bank (FHLB) borrowings. Table 1 provides details on Appalachian's financial condition as of December 2009 and for the 4 preceding calendar years.

Table 1: Financial Information for Appalachian, 2005 to 2009

Financial Measure ($000)	Dec 2009	Dec 2008	Dec 2007	Dec 2006	Dec 2005
Total Assets	1,010,075	1,101,608	940,203	757,652	592,329
Total Loans	663,348	812,111	762,970	631,786	457,418
Total Deposits	917,575	939,223	785,629	661,632	490,600
Brokered Deposits	4,612	69,733	146,483	123,982	52,588
Federal Home Loan Bank (FHLB) Borrowings	67,000	72,000	57,350	25,050	38,950
Net Income (Loss)	(59,346)	(2,323)	6,753	7,134	6,027

Source: UBPR and ROEs for Appalachian Community Bank.

Causes of Failure and Material Loss

Appalachian's failure can be attributed to losses associated with its ADC loan concentrations that were the center of the Board's and management's growth strategy.

[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.
[2] Appalachian was considered an affiliate with the other institution held by ABI.

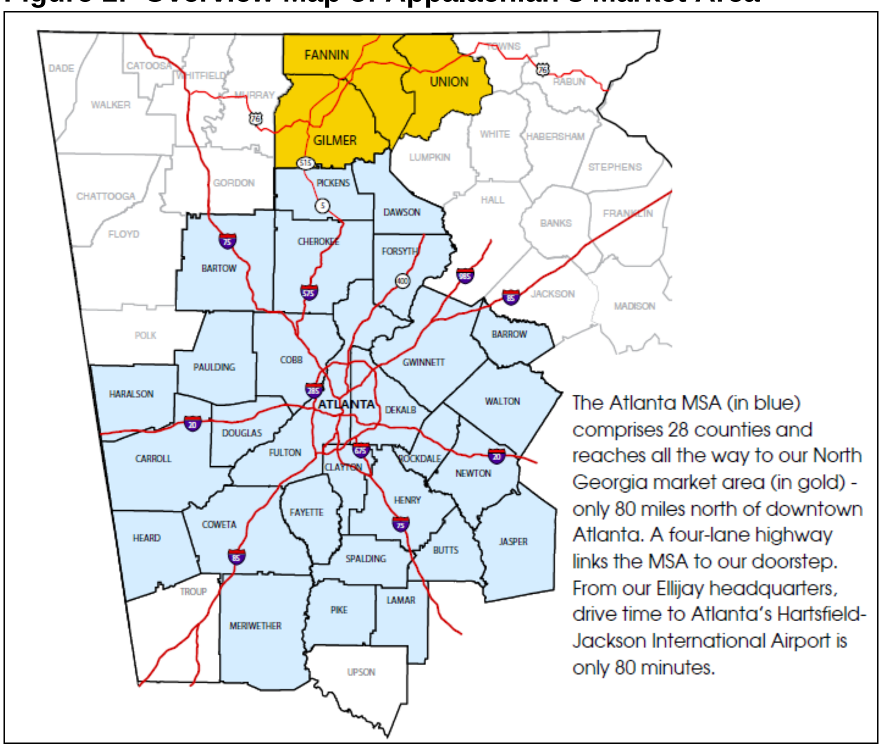
Although initially profitable, Appalachian's Board and management failed to provide appropriate oversight of its ADC lending activities, especially when economic conditions began to decline. Inadequate underwriting and credit administration led to the rapid deterioration of asset quality, which eroded the bank's capital. DBF closed after capital declined to unsafe and unsound levels and prospects for recapitalization or sale of the bank failed to materialize.

ADC Concentrations

Historically, Appalachian relied on ADC lending to propel asset and earnings growth. Appalachian's lending strategy was initially profitable, but as the bank expanded, its earnings performance began to weaken. Weak earnings and the losses associated with its ADC portfolio as the economy declined proved to be financially disastrous for the bank.

Appalachian's growth strategy was reflective of the population surge in Northern Georgia. According to ABI's 2005 annual report, the U.S. Census Bureau identified Appalachian's primary market area, Fannin, Union, and Gilmer counties, to be among the 100 fastest growing counties in the United States, based on housing unit estimates from 2000-2004. The proximity to the Atlanta, Georgia area combined with the natural recreational features of the Northern Georgia landscape (mountains, lakes, and waterfalls) fueled significant growth and development in the area. Population growth was driven by an influx of retirees and individuals purchasing second homes or vacation homes in the area. Figure 1 is a map from ABI's 2005 annual report that illustrates where Appalachian was located.

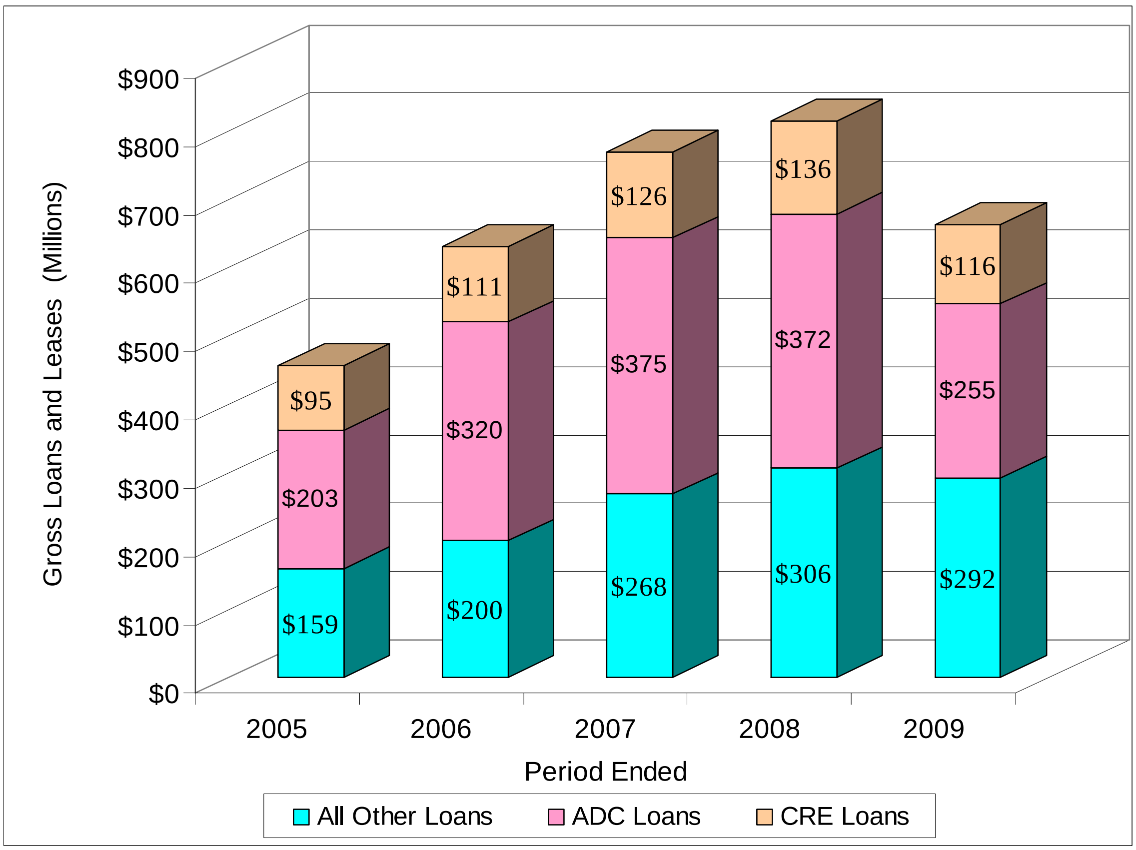
Figure 1: Overview Map of Appalachian's Market Area



Source: ABI's 2005 Annual Report.

During 2006 and 2007, in response to loan demand in the region and to sustain market share, Appalachian's Board and management expanded the bank's operations by increasing the number of branch offices in adjoining counties. By mid-2009, Appalachian operated 10 offices in seven Georgia counties and held the second largest market share among the institutions operating within its market. Total loans grew from $457 million at the end of 2005 to $812 million by the end of 2008. Figure 2 illustrates Appalachian's loan composition, which primarily consisted of CRE and ADC loans.

Figure 2: Appalachian's Loan Composition, 2005 to 2009



Source: Reports of Condition and Income (Call Reports) for Appalachian.

Management relied on wholesale funding to support asset growth. According to the 2006 examination report, brokered deposits increased significantly because the bank was able to obtain brokered deposits at a lower cost than local deposits. The 2008 examination report noted that the bank's use of brokered deposits had decreased, but management had significantly increased the bank's reliance on Internet deposits and time deposits greater than $100,000 – both of which are volatile funding sources.

In December 2006, Federal banking regulatory agencies issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) that reinforces existing regulations and guidelines for real estate lending and safety and soundness.[3] The guidance was issued because the agencies had observed that CRE concentrations had been rising and could create safety and soundness concerns in the event of a significant downturn. The guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. Due to the risks associated with CRE and ADC lending, regulators consider institutions with significant CRE and ADC concentrations to be of greater supervisory concern. Table 2 illustrates Appalachian's ADC concentrations, which significantly exceeded the criteria established in the guidance as well as the bank's peer group levels.[4]

Table 2: Appalachian's ADC Concentrations Compared to Peer Group

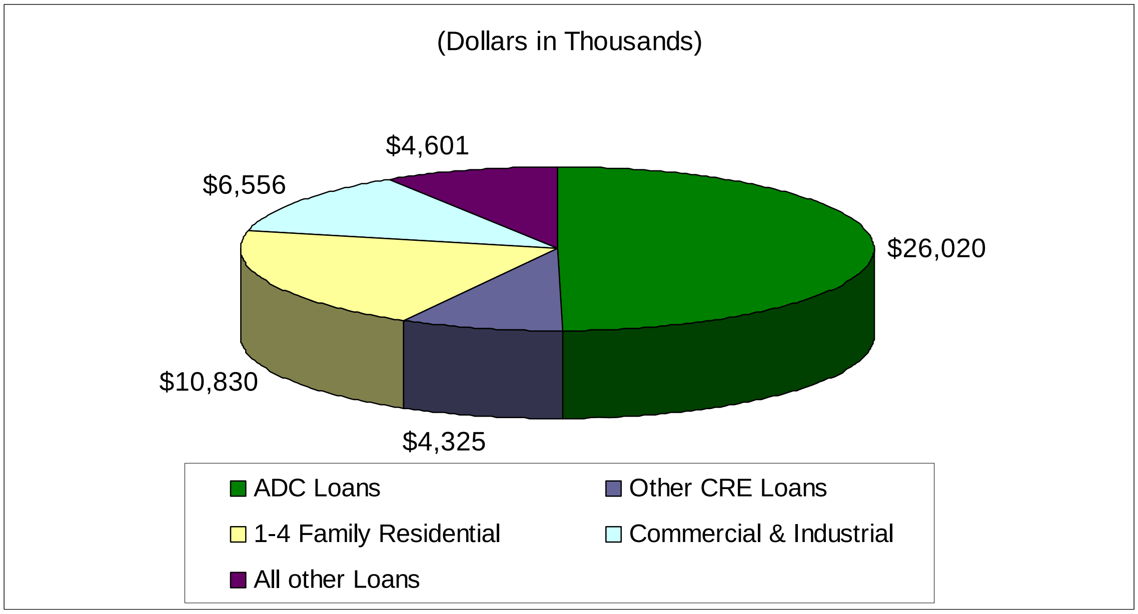
	ADC Loans as a Percentage of Total Capital		ADC Loans as a Percentage of Total Loans	
Year Ending	Appalachian	Peer Group	Appalachian	Peer Group
2005	385%	104%	45%	14%
2006	476%	117%	51%	16%
2007	458%	124%	49%	16%
2008	430%	139%	46%	17%
2009	847%*	97%	38%	13%

Source: UBPRs for Appalachian.
* The increase in risk exposure from ADC loans in 2009 was due primarily to the decline in the bank's capital level.

According to the Joint Guidance, risks posed by CRE concentrations, especially ADC concentrations, include unanticipated earnings and capital volatility during a sustained downturn in the real estate market. The housing market in northern Georgia began to decline at the end of 2007, and Appalachian's Adversely Classified Items Coverage Ratio increased from 33 percent as of June 30, 2007 to 168 percent as of June 30, 2008. This ratio is a measure of the asset risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor-quality assets and less ability for the bank's capital to absorb any losses associated with those assets. By June 30, 2009, the bank's Adversely Classified Items Coverage ratio had increased to 736 percent. As shown in Figure 3, about $30 million of $52 million (approximately 58 percent) in loan and lease charge-offs involved CRE and ADC loans during 2008 and 2009.

[3] The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).
[4] 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. Appalachian's peer group included institutions with assets between $1 billion and $3 billion.

Figure 3: Appalachian's Loan and Lease Charge-offs, 2008 and 2009



Source: Call Reports for Appalachian.

Board and Management Oversight

Supervisory guidance states 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.[5] The guidance further states that management's ability to identify, measure, monitor, and control portfolio risk through effective underwriting policies, systems, and internal controls is crucial to a sound ADC lending program. Appalachian's risk management practices did not evolve sufficiently to mitigate the risks associated with its increasing ADC concentration. Examiners commented that as the bank grew larger and more risky, management continued to run the bank like a smaller, less complex institution.

Loan underwriting and credit administration weaknesses identified by examiners were not adequately addressed by the Board and management. Appalachian was also cited for being in contravention or in violation of regulatory requirements, which is a further indication of poor Board and management oversight. According to the *DSC Risk Management Manual of Examination Policies* (Examination Manual), it is important for a financial institution's Board to ensure that bank management is cognizant of applicable laws and regulations, develops a system to effect and monitor compliance and, when violations do occur, makes corrections as quickly as possible. Ultimately, the economic downturn exposed Appalachian risk management weaknesses and contributed to the rapid deterioration of asset quality.

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

The Board and management attempted to improve risk management practices as a result of the 2008 examination, but the 2009 examination report noted that risk management practices had not been implemented in a timely fashion and the viability of the bank was in jeopardy. Further, the Board's outside directors initiated an investigation of possible bank policy violations related to insider transactions. This investigation led to separation agreements with three senior bank officers in December 2009.

Loan Underwriting and Credit Administration Practices

Examiners identified a number of weak loan underwriting and credit administration practices that impaired the quality of the institution's ADC loans. For example:

- **Global Cash Flow Analysis**. Examiners noted in the 2006 examination that the bank appeared to have satisfactory knowledge of borrowers; however, recommendations to enhance Appalachian's global cash flow analysis were made and this issue was repeated in subsequent examinations. Fundamentally, global cash flow analysis helps a lender assess a borrower's repayment capacity. Given the composition of Appalachian's portfolio, examiners emphasized the importance of management understanding a builder's or developer's capacity to repay.

- **Credit Memoranda**. Credit memoranda, which are prepared by bank officials, are an integral step in the lending function, especially on larger, complex, or problem credits. Credit memoranda basically serve as documentation of a loan request and should, therefore, include details pertaining to (1) the borrower, including sources of repayment capacity; (2) the project, including background and feasibility analysis; and (3) the collateral value, including both market value and liquidation value. In the 2006, 2007, and 2008 examinations, examiners indicated that Appalachian's credit memoranda generally lacked sufficient detail to affirm the borrower's creditworthiness, guarantor financial strength and experience, and the likelihood of a project's success.

- **Interest Reserves**. According to the 2007 examination report, the bank did not have a formal way to track the dollar amount of interest reserves, or the percentage of the loan portfolio that had embedded interest reserves. The report recommended that Appalachian begin tracking the use of interest reserves. Further, Appalachian's loan policy did not adequately address interest reserves. For the 2008 examination, Appalachian provided examiners with a spreadsheet that identified $51.8 million in loans with $6.2 million in documented interest reserves, but this document did not take into account loans for which interest reserves may have been funded but not formally documented. The 2008 examination report recommended that Appalachian's loan policy should clearly discourage the use of interest reserves for projects that had experienced significant development or construction delays, cost overruns, sales or leasing shortages, or were otherwise not performing according to the original loan agreement.

Apparent Violations and Contraventions of Interagency Policy Statements

Appalachian also failed to comply with various regulatory requirements, including those designed to ensure that institutions have adequate collateral protection for real estate loans.

- **Loan-to-value (LTV) Limits.** The 2006 and 2007 examinations cited Appalachian for being in apparent contravention of Appendix A of Part 365, *Interagency Guidelines for Real Estate Lending Policies*. These guidelines are intended to assist institutions in the formulation and maintenance of real estate lending policy and establish supervisory LTV limits for loans secured by real estate. The aggregate amount of all loans in excess of supervisory limits should not exceed 100 percent of total capital. The total of all loans in excess of supervisory LTV limits represented 110 percent and 107 percent in 2006 and 2007, respectively.

- **Appraisals.** In 2008, examiners noted numerous deficiencies regarding real estate appraisals and cited Appalachian for being in apparent violation of Part 323 of the FDIC's Rules and Regulations, *Real Estate Appraisals,* and apparent contravention of *Interagency Appraisal and Evaluation Guidelines.* According to the third quarter 2008 external loan review performed for Appalachian, numerous ADC loans were supported by outdated appraisals. Specifically, appraisals performed during 2005 and 2006 were likely to inaccurately reflect the project's current value. The external loan review report further noted that as existing loans were considered for renewal, the age and quality of the existing appraisal should be evaluated. Consistent with this external loan review, examiners found that appraisals had not been updated to reflect significant market deterioration.

  In 2009, management proactively identified problem credits and attempted to reduce the volume of these credits by aggressively charging down loan balances to the appraised value. This effort resulted in approximately 50 percent of the bank's loans having lower internal ratings for ALLL calculations prior to the 2009 examination. During 2009, the bank ordered over 1,000 new appraisals. However, in 2009, examiners found that many comparable sales used in the new appraisals pre-dated the economic downturn. Aside from impacting decisions being made with regard to loan renewals, the poor quality appraisals affected the calculation of the ALLL, as discussed below.

- **Allowance for Loan and Lease Losses (ALLL).** The 2008 and 2009 examinations cited Appalachian for being in apparent contravention of *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL Policy Statement), which reiterates key concepts and requirements related to generally accepted accounting principles and existing supervisory guidance.[6] Examiners found that

[6] Statement of Financial Accounting Standards (FAS) No. 5, *Accounting for Contingencies,* and FAS No. 114, *Accounting by Creditors for Impairment of a Loan*, provide accounting guidance for loss contingencies on a pool basis and impairment of loans on an individual basis, respectively.

Appalachian needed to better support and document its methodology for estimating credit losses on groups of loans with similar characteristics under FAS 5.

With regard to FAS 114, the bank individually evaluated all internally criticized and classified loans using the fair value of collateral method. When measuring impaired loans under the fair value of collateral method, management used the most recent "as is" appraised value. Under this method, the "as is" appraised value of the collateral is considered the starting point for determining its fair value. Appalachian applied a discount based on the age of the appraisal. However, among other concerns, examiners found that the "new" appraisals completed in 2009 used sale comparables that pre-dated the economic downturn. For example, the bank applied a 10 percent discount to an appraisal that was 6 months old even though the sale comparables used for the appraisal were 2 years old. As a result, the level of incurred losses was not fully reflected in the ALLL.

- **Risk Management Practices for CRE (and ADC) Concentrations.** Examiners determined that a number of Appalachian's concentration risk management practices were not consistent with those called for in the Joint Guidance. For example:

  (1) Management had not established acceptable risk exposure limits and appropriate sub-limits for CRE and ADC loans as a percentage of gross loans and total assets.
  (2) There was no evidence of documentation supporting management's periodic market analysis of loan types and geographic markets.
  (3) Management had not developed a contingency plan to reduce or mitigate concentrations.
  (4) There was no evidence of documentation showing performance of portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital.

The FDIC's Supervision of Appalachian

Our review focused on FDIC and DBF supervisory oversight of Appalachian between 2006 and 2010. The FDIC and DBF conducted timely and regular examinations of Appalachian and monitored its condition through the use of offsite monitoring mechanisms. Through its supervisory efforts, the FDIC and DBF identified risks in Appalachian's operations and brought these to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's growth, significant concentrations in CRE and ADC loans, and poor Board and management oversight of risk management processes. Regulators imposed a formal enforcement action following the 2008 examination; however, Appalachian's response fell short, and the financial condition of the bank became critically deficient.

In retrospect, a more critical supervisory assessment of Management and Asset Quality based on Appalachian's increasing risk profile during the 2006 and 2007 examinations may have been prudent. Such an approach could have helped to establish supervisory expectations with regard to ADC concentrations and the bank's responsibilities for mitigating the associated risks at a critical point in time. Further, this approach may have led to lower CAMELS ratings in 2006 and 2007 and possibly an informal supervisory action, which would have increased supervisory attention to Appalachian's performance and risks earlier.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008, the FDIC reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Further, the FDIC completed a training initiative in March 2010 for its supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addresses the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

Supervisory History

The FDIC and the DBF conducted four onsite examinations of Appalachian between August 2006 and the bank's failure. Table 3 summarizes key supervisory information.

Table 3: Appalachian's Examination History, 2006 to 2009

Start Date	As of Date	Agency	Supervisory Ratings (UFIRS)*	Supervisory Action	Apparent Violation of Law or Contravention of Policy Reported
10/2/2006	6/30/2006	FDIC	222222/2	None	✓
8/24/2007	6/30/2007	DBF	222222/2	None	✓
9/29/2008	6/30/2008	FDIC	444433/4	Cease & Desist (C&D)*	✓
9/15/2009	9/30/2009	Joint	555555/5	(C&D)	✓

Source: ROEs for Appalachian.
*In September 2008, Appalachian adopted a Bank Board Resolution (BBR). FDIC officials explained that the bank was attempting to demonstrate it was proactively trying to address issues to preempt pursuit of a formal action (i.e., the C&D).

In addition, the FDIC monitored the condition of the bank through its offsite review process. For example, as described later in this report, the FDIC made interim contact with the bank to discuss the bank's exposure to the declining housing market in 2007. The FDIC's Offsite Review List (ORL) flagged Appalachian for review based on September 30, 2008 and December 31, 2008 Call Report data. The September 2008 onsite examination had already recommended downgrading the bank's overall composite rating and pursuit of a C&D by the time these two offsite reviews were complete. Offsite monitoring continued during 2009, and Appalachian was added to the ORL based on June 2009 data because of concerns related to its ALLL. Accordingly, the FDIC targeted the ALLL as part of its September 2009 onsite examination.

Supervisory Response to Key Risks

Examiners identified Appalachian's ADC concentrations and made recommendations to improve loan underwriting and credit administration in both 2006 and 2007. However, Appalachian was rated a composite "2", meaning the bank was considered to be fundamentally sound with only moderate weaknesses that were well within the Board's and management's capabilities and willingness to correct. In retrospect, a more critical supervisory assessment of Management and Asset Quality in light of Appalachian's growth, loan underwriting and credit administration weaknesses, and declining capital levels in 2006 and 2007 would have been prudent for reasons discussed more fully below.

2006 Supervisory Activities

Supervisory activity in 2006 primarily consisted of the FDIC's onsite examination. The pre-examination planning memorandum noted that the bank had experienced rapid growth over the last 3 years, mainly from ADC loans. Further, the memorandum noted that the bank had increased its reliance on brokered deposits to fund that growth, in part, because brokered deposits were less costly than deposits in the local market. Interestingly, a bank official who was interviewed as part of the pre-examination planning process acknowledged that the economy had a "substantial" impact on the bank. At the time, the bank official noted that housing trends across the nation were showing signs of slowing but viewed growth in the bank's trade area as remaining good.

The 2006 examination report stated that the overall condition of the bank was satisfactory. The examination also stated that asset quality was satisfactory with a manageable volume of classified assets and past due loans. However, examiners noted a number of concerns related to loan documentation, monitoring of loan concentrations, loan underwriting, and credit administration. Examiners made a recommendation to enhance the process for monitoring the ADC concentration and a series of recommendations to enhance loan underwriting and credit administration issues. Further, the report cited Appalachian for being in contravention of Appendix A of Part 365, *Interagency Guidelines for Real Estate Lending Policies*, which was a repeat finding. Although these issues were identified, examiners concluded at the time that senior management and the Board continued to effectively operate the bank. One factor considered by examiners in making that assessment was the fact that management had been responsive in the past in addressing weaknesses identified by examiners.

Capital levels were also viewed to be satisfactory based on adequate earnings retention, satisfactory asset quality, and the demonstrated ability of ABI – its holding company – to provide capital injections. However, as discussed in the PCA section of this report, in June 2006, the bank fell slightly below *Well Capitalized* for a brief period because funds available from the holding company were not promptly downstreamed to the bank. Notably, although management immediately arranged for a capital injection in order to reinstate the bank's capital status and attributed the error to management oversight, the examination report does not discuss restrictions on brokered deposits that are imposed when an institution falls below *Well Capitalized*. Under the FDIC's Rules and

Regulations Part 337, *Unsafe and Unsound Banking Practices, Undercapitalized* and *Adequately Capitalized* institutions are prohibited from obtaining or rolling over brokered deposits. However, *Adequately Capitalized* institutions may request a waiver of the prohibition. The examination pre-planning memorandum discussed the need to provide the bank with guidance about brokered deposit waivers.

In hindsight, a more critical assessment of Appalachian's Management component based on identified weaknesses and the bank's capital levels in relationship to its growing ADC portfolio may have been prudent. Such an approach would have been consistent with supervisory guidance in place at that time and later strengthened by the Joint Guidance that emphasizes the Board's and management's responsibility to properly control and manage risks associated with ADC lending.

2007 Supervisory Activities

As part of its offsite monitoring process, the FDIC made interim contact with the bank in June 2007 to discuss the bank's exposure to the slowing housing market. DBF's onsite examination began in August.

Interim Contact. According to the bank official interviewed by examiners, the housing market in the bank's trade area was relatively good and the local economy was seen as stable. The official stated a further slow down could adversely impact the bank but viewed capital and earnings to be sufficient to mitigate the impact. Further, the bank official stated that management had taken steps to address 2006 examiner recommendations and was planning to gradually reduce the bank's ADC concentrations. The financial condition of the bank was satisfactory at the time contact was made based on March 31, 2007 Call Report data.

August 2007 Examination. Despite a decline in asset quality, the examination report stated that the risk profile of the bank had not changed from the prior examination, noting that management continued to pursue strong loan growth with the portfolio centered in ADC. The bank's Adversely Classified Items Coverage Ratio had increased from 20.69 percent to 33.12 percent, but the report stated that the classifications were generally consistent with the bank's internal watch list and the overall level of problem loans was manageable.

Examiners also viewed capital as satisfactory, attributing downward trends in capital and earnings to Appalachian's rapid asset growth and expansion efforts. Although these were potentially troubling trends in a softening real estate market, examiners concluded that earnings were sufficient and ABI served as a source of strength for the bank. Indeed, ABI provided a $3 million capital injection during 2007, which kept Appalachian's capital levels above regulatory minimums.

In hindsight, heightened concern related to Appalachian's risk profile in light of a softening real estate market may have been prudent. Specifically, downgrading the Management and/or Asset Quality component ratings may have been called for considering the following:

- As of June 30, 2007, Appalachian's ADC concentrations represented approximately 371 percent of Tier 1 Capital. This level of concentrations left Appalachian vulnerable to a slowing real estate market absent a sound contingency plan to reduce or mitigate concentrations.

- Despite management's assertion that it had addressed prior examination recommendations, the 2007 examination report made a number of repeat recommendations related to loan underwriting and credit administration, and Appalachian remained in apparent contravention of LTV limitations. In addition, the report was clear that Appalachian's credit underwriting culture needed to improve.

Downgrading one or both of these component ratings could have led to an informal supervisory action that would have required the Board and management to develop a more formal plan with affirmative actions for correcting deficiencies and allowed the FDIC and DBF to more closely monitor Appalachian's progress. We recognize that rating determinations are a matter of judgment and the severe economic downturn that ensued after the examination was not foreseen. Further, while it was possible for examiners to downgrade the Management component, it may have been difficult for them to support a lower Asset Quality rating in 2007 based on weak practices because the bank's earnings and capital were considered to be satisfactory at that time.

2008 and 2009 Supervisory Activities

As Appalachian's condition deteriorated, supervisory oversight increased. In 2008, examiners downgraded the composite CAMELS rating from a "2" to a "4". Examiners attributed the bank's overall poor condition and substantial deterioration to Appalachian's excessive concentrations in CRE and ADC lending, coupled with lax underwriting and credit administration practices, and the economic downturn. Examiners also concluded that capital was deficient relative to the bank's risk profile, deteriorating condition, and poor earnings performance. Details about Appalachian's capital levels and the impact of two capital infusions made by ABI during 2008 are discussed in the *Implementation of PCA* section of this report. Although the Board adopted a BBR during the examination to demonstrate its commitment and willingness to address issues, examiners pursued a C&D which became effective April 24, 2009. The C&D included 17 provisions aimed at addressing Board oversight, management qualifications, the levels of concentrations, credit practices, capital levels and plans, funding issues, and violations of law and contraventions of statements of policy.

During 2009, the FDIC and DBF monitored Appalachian's compliance with the C&D through quarterly progress reports. The 2009 examination report stated that management had achieved compliance with many of the provisions but was not in full compliance with critical provisions related to management qualifications, ALLL methodology, capital adequacy, brokered deposits, and earnings performance. Although management had tried to correct weaknesses and proactively write down problem assets, the 2009 examination report stated that the overall condition of the bank remained poor and the viability of the bank was a significant concern without a capital injection. The bank received a “5” composite rating. The report stated the volume of problem assets was overwhelming in comparison with the available personnel and capital. Further, capital levels had decreased significantly from the prior examination and reached a critically deficient level.

Supervisory Lessons Learned

According to the Examination Manual, the quality of an institution’s management, including its Board of Directors and executive officers, is perhaps the single most important element in the successful operation of a bank. The Board has overall responsibility and authority for formulating sound policies and objectives for the bank and for effectively supervising the institution’s affairs. The Examination Manual further states that

> …to effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking…when corrective action is not taken until conditions have deteriorated it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

In hindsight, Appalachian’s risk profile may have warranted greater supervisory concern and earlier and stronger supervisory action. Such actions may have involved component and/or composite rating downgrades and pursuit of an informal supervisory action, such as a BBR or memorandum of understanding, to ensure the bank more promptly and effectively corrected its operational deficiencies and focused on mitigating risks.

The FDIC has taken steps to increase supervisory attention to banks that have risk profiles similar to Appalachian. On January 26, 2010, the FDIC issued guidance to its examiners that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed. Specifically, the guidance defines a standard approach for communicating matters requiring Board attention (e.g., examiner concerns and recommendations) in examination reports. The guidance also states that examination staff should request a response from the institution regarding the actions that it will take to mitigate the risks identified during the examination and correct noted deficiencies.

Finally, the FDIC completed a training initiative in March 2010 for its entire supervisory workforce that emphasizes the need to assess a bank’s risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as the financial institution’s current financial performance or trends in assigning ratings as allowable under existing examination guidance.

Implementation of PCA

Section 38, *Prompt Corrective Action,* of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe action, known as "prompt corrective actions," as an institution's capital levels deteriorate. The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. 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 supervisory actions taken with respect to Appalachian, the FDIC properly implemented applicable PCA provisions of section 38. Table 4 illustrates Appalachian's capital levels relative to the PCA thresholds for *Well Capitalized* Institutions.

Table 4: Appalachian's Capital Levels

Period Ending	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based	Capital Classification
Well-Capitalized Threshold	5% or more	6% or more	10% or more	
June 2006	8.29	8.70	9.82	*Adequately Capitalized*
June 2007	8.01	9.01	10.08	*Well Capitalized*
June 2008	7.63	8.88	9.92	*Adequately Capitalized*
September 2008	7.15	8.71	10.69	*Well Capitalized*
December 2008	6.73	8.09	10.08	*Well Capitalized*
March 2009	5.99	8.06	10.08	*Well Capitalized*
June 2009	3.74	5.22	7.26	*Undercapitalized*
September 2009	2.14	2.91	4.97	*Significantly Undercapitalized*
December 2009	1.73	2.26	3.62	*Critically Undercapitalized*

Source: UBPRs and ROEs for Appalachian and Part 325 of the FDIC Rules and Regulations.

As discussed earlier in this report, Appalachian was cited in the 2006 examination as being *Adequately Capitalized* for the quarter ending June 30, 2006. Management immediately arranged for a capital injection to return the bank to a *Well Capitalized* position, which was sustained until June 30, 2008. Specifically, during the 2008 examination, Appalachian fell to *Adequately Capitalized* based on June 30, 2008 Call Report data and again ABI provided two capital injections to return the bank to a *Well Capitalized* position for PCA purposes.

However, the 2008 examination report advised management to maintain capital levels that were commensurate with the bank's complexity, size, and risk profile and also reminded management under FDIC's Rules and Regulations Part 337, *Unsafe and Unsound Banking Practices,* that restrictions on brokered deposits are imposed when an institution falls below *Well Capitalized*. In addition, as discussed earlier, the FDIC issued a C&D, effective on April 24, 2009, that included a capital provision requiring Appalachian to (1) within 90 days of the effective date of the order maintain Tier 1 Capital at 8 percent and Total Risk-Based Capital at 10 percent and (2) within 30 days of the effective date of the order develop and adopt a capital plan for meeting minimum risk-based capital requirements for a *Well Capitalized* institution.

On May 22, 2009, Appalachian submitted a capital plan to the FDIC as part of its first progress report that was also required by another C&D provision. Appalachian's capital plan described various scenarios it planned to pursue to ensure that it had sufficient capital to meet regulatory requirements based on financial forecasts for a 2-year planning horizon, 2009-2011. On July 1, 2009, FDIC and DBF officials met with Appalachian to discuss capital options the bank was pursuing.

Subsequently, on August 26, 2009, the FDIC notified Appalachian that it had fallen to *Undercapitalized* based on the June 30, 2009 Call Report capital ratios. The FDIC's PCA notification letter outlined restrictions pursuant to Part 325 of the FDIC Rules and Regulations, including restrictions on asset growth, dividends, and other capital distributions. The letter also stated that Appalachian was required to submit a capital restoration plan within 45 days of receipt of the letter, or by October 10, 2009. The FDIC also met with bank officials on August 26, 2009, as part of its pre-planning examination process, to discuss ABI's ongoing efforts to raise capital. The onsite examination commenced on September 29, 2009 and focused on compliance with the C&D, including the capital-related provision.

On October 30, 2009, as part of its third quarter progress report, Appalachian submitted an updated capital plan that it considered to be its capital restoration plan.[7] Although the plan was not submitted within 45 days as required, examiners were in the midst of an onsite examination and were aware of Appalachian's plans and ongoing efforts to raise capital. Appalachian's revised capital plan was updated to reflect financial forecasts based on September 30, 2009 data. The progress report also summarized the actions Appalachian had taken since July 2009 to increase capital.

Section 38 requires that the FDIC act on capital restoration plans expeditiously, and generally not later than 60 days after a plan is submitted. On October 29, 2009, the FDIC documented its determination that the bank had not submitted an acceptable capital plan in accordance with the C&D or in response to the August 26, 2009 written PCA notification in its information system and also noted that a failing bank case was being prepared. Further, FDIC officials told us that they orally informed Appalachian that the capital plans submitted were not acceptable. Although FDIC procedures for processing a capital restoration plan include providing a written notice to the bank advising of the approval or disapproval of the plan, in our view, given ongoing examination activities

[7] Appalachian also submitted an application for the Troubled Asset Relief Program on October 30, 2008 for funding of $27.26 million. The bank subsequently withdrew its application on January 7, 2009.

during this period, the lack of a written notification to the bank was an apparent oversight and inconsequential to the supervision and failure of the bank.

Under PCA, provisions applicable to *Significantly Undercapitalized* institutions apply to institutions that fail to provide an acceptable capital restoration plan. In this case, those provisions already applied because Appalachian was considered *Significantly Undercapitalized* as of September 30, 2009. Specifically, on November 23, 2009 the FDIC notified Appalachian that it was *Significantly Undercapitalized* based on September 30, 2009 Call Report data. The FDIC's PCA notification letter outlined restrictions imposed pursuant to Part 325 in the PCA notification letter. Further, on January 20, 2010, the FDIC notified Appalachian that it was *Critically Undercapitalized* based on interim financial information that the bank provided to the FDIC. The PCA notification letter outlined the mandatory and discretionary actions permitted by the FDIC pursuant to Part 325. Ultimately, the bank was unsuccessful in efforts to raise capital and was closed by DBF on March 19, 2010.

Corporation Comments

On October 1, 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 causes of Appalachian's failure. With regard to our assessment of the FDIC's supervision of Appalachian, DSC summarized supervisory activities between 2006 and 2009 described in our report, including onsite examinations, offsite monitoring, and the issuance of a formal enforcement action in 2009. DSC agreed that greater emphasis could have been placed on Appalachian's increasing risk profile. Further, in recognition of the threat that institutions with high risk profiles, such as Appalachian, pose to the DIF, DSC stated it has issued guidance to financial institutions that re-emphasizes the importance of robust credit risk management practices for institutions with concentrated CRE exposures and sets forth broad supervisory expectations.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), which provides, in general, that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

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

We conducted this performance audit from May 2010 to September 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 Appalachian's operations from 2006 until its failure on March 19, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination reports prepared by the FDIC and the DBF examiners from 2006 to 2010.

- Reviewed the following:

    - Bank data and correspondence maintained at the DSC's Atlanta Regional Office and Atlanta Metro Field Office,

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

    - Pertinent DSC policies and procedures and various banking laws and regulations.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C., and the Atlanta Regional Office and Atlanta Metro Field Office.

  - FDIC examiners from the DSC Atlanta Metro Field Office, who participated in examinations or reviews of examinations of Appalachian.

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

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, ROEs, and interviews of examiners to understand Appalachian's management controls pertaining to causes of failure and material loss 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 ROEs, 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 provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC's Rules and Regulations. 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.

Objectives, Scope, and Methodology

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

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

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and providing interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Affiliate	Under section 23A of the Federal Reserve Act (12 U.S.C. section 371c), an affiliate generally includes, among other things, a bank subsidiary, or a company that (1) controls the bank and any other company that is controlled by the company that controls the bank, (2) is sponsored and advised on a contractual basis by the bank, or (3) is controlled by or for the benefit of shareholders who control the bank or in which a majority of directors hold similar positions in the bank.
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	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

Glossary of Terms

Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Interest Reserve Account	An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. Frequently, ADC loan budgets will include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sellout or lease-up period.
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

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.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Prompt Corrective Action (PCA)	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.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).

Glossary of Terms

Tier 1 (Core) Capital	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).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data 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.
Wholesale Funding	Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DBF	Georgia Department of Banking and Finance
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
LTV	Loan-to-Value
OIG	Office of Inspector General
ORL	Offsite Review List
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

FDIC

Federal Deposit Insurance Corporation

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

October 1, 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, Material Loss Review of Appalachian Community Bank, Ellijay, Georgia (Assignment 2010-044)

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 Appalachian Community Bank (Appalachian), 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 8, 2010.

Appalachian failed due to the Board's and management growth strategy centered on a high concentration of acquisition, development and construction (ADC) loans which lacked adequate oversight, coupled with the failure to develop risk management practices commensurate with the size and complexity of the loan portfolio. A rapid deterioration of the asset quality due to inadequate underwriting and credit administration led to losses and the decline of Appalachian's capital. The Georgia Department of Banking and Finance (DBF) closed Appalachian when recapitalization efforts failed and sale of the institution did not materialize.

The FDIC and DBF provided ongoing supervisory oversight of Appalachian, with four on-site risk management examinations supplemented by offsite monitoring. As early as 2006, examiners noted concerns with documentation, the monitoring of loan concentrations, credit underwriting and loan administration. They made several recommendations to enhance monitoring. In 2007, examiners noted the deterioration in asset quality since the previous FDIC examination and requested that management proactively address this issue. The 2008 examination concluded that asset quality was continuing to significantly decline, earnings performance was poor, and capital levels were deficient. As a result, Appalachian was downgraded to a composite "4" rating, and a Cease and Desist order was issued in April 2009.

We agree that greater emphasis could have been placed on Appalachian's increasing risk profile, and we recognize the threat that institutions with high risk profiles, such as Appalachian, pose to the Deposit Insurance Fund. DSC has issued a Financial Institution Letter 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 and sets forth broad supervisory expectations.

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