Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-022

Material Loss Review of Integrity Bank, Jupiter, Florida

February 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On July 31, 2009, the Florida Office of Financial Regulation (OFR) closed Integrity Bank, Jupiter, Florida (Integrity-Jupiter) and named the FDIC as receiver. On August 28, 2009, the FDIC notified the Office of Inspector General (OIG) that Integrity-Jupiter's total assets at closing were $110.3 million and the estimated loss to the Deposit Insurance Fund (DIF) was $45.5 million. As of December 31, 2009, the estimated loss to the DIF had decreased to $36.9 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure.

The objectives were to (1) determine the causes of failure for Integrity-Jupiter and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Integrity-Jupiter, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

Integrity-Jupiter was chartered as a state nonmember institution on July 12, 2004. The institution operated a single office in Jupiter, which is a coastal community located in Palm Beach County, Florida. Integrity-Jupiter's lending activities focused primarily on commercial real estate, with an emphasis on acquisition, development, and construction (ADC) in Florida and Georgia. A significant portion of the institution's loan portfolio consisted of out-of-territory loan participations acquired from the Integrity Bank of Alpharetta, Georgia (Integrity-Alpharetta), which failed on August 29, 2008. Integrity-Jupiter was privately held and its Board directors collectively controlled approximately 15 percent of the institution's outstanding stock as of June 30, 2008. No individual shareholder controlled more than 9 percent of Integrity-Jupiter's stock, and the institution's shares were widely held.

Integrity-Jupiter had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act. However, the institution did have a significant relationship with Integrity-Alpharetta. Specifically, some of Integrity-Jupiter's shareholders and directors were also shareholders, directors, and/or officers of Integrity-Alpharetta and/or its parent bank holding company, Integrity Bancshares, Inc. In addition, certain directors of Integrity Bancshares, Inc. played an instrumental role in establishing Integrity-Jupiter and modeled the institution's business strategy, policies, and practices after Integrity-Alpharetta. Integrity-Alpharetta also provided significant managerial and operational assistance to Integrity-Jupiter during its initial years of operation, and an eventual merger between the two institutions was envisioned.

Audit Results

Causes of Failure and Material Loss

Integrity-Jupiter failed primarily because of ineffective oversight by the institution's Board and management. Turnover and extended vacancies in the positions of President and Chief Executive Officer and Senior Lending Officer during the short life of the institution contributed to the weak oversight. In addition, the Board and management did not effectively manage the risks associated with the institution's heavy concentration in ADC loans. Weak ADC loan underwriting and administration, particularly with respect to out-of-territory loan participations acquired from Integrity-Alpharetta, were contributing factors in Integrity-Jupiter's failure.

The lack of effective Board and management oversight, together with a significant concentration in risky ADC loans, made the institution vulnerable when the Florida and Georgia real estate markets began to decline in 2007. Notably, a Board dispute that began in 2007 over control of the institution presented a significant distraction when the Board's undivided attention was needed on the institution's deteriorating financial condition. By 2008, the quality of Integrity-Jupiter's loan portfolio had become critically deficient, with additional deterioration continuing into 2009. The associated losses and provisions depleted Integrity-Jupiter's capital, rendering the institution insolvent. OFR closed Integrity-Jupiter on July 31, 2009 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

The FDIC's Supervision of Integrity-Jupiter

The FDIC, in coordination with OFR, provided ongoing supervisory oversight of Integrity-Jupiter through regular on-site risk management examinations, visitations, and offsite monitoring activities. In addition, because Integrity-Jupiter was a newly chartered institution, it was subject to higher capital requirements and more frequent examinations during its first 3 years of operation. Through its supervisory efforts, the FDIC identified key risks in Integrity-Jupiter's operations and brought these risks to the attention of the institution's Board and management.

Although examiners raised concerns about Integrity-Jupiter's management in the years preceding the failure, the FDIC determined that the institution's management was generally satisfactory prior to the July 2008 examination, as reflected in the supervisory component ratings of "2" for management. In retrospect, a stronger supervisory response to the risks associated with Integrity-Jupiter's management practices at earlier examinations may have been prudent. Such a response could have included lowering the institution's supervisory component rating for management and requiring the institution to develop a management succession plan. The FDIC's supervisory approach for addressing Integrity-Jupiter's ADC concentration was generally reasonable. However, a lesson learned with respect to ADC concentrations is that early supervisory intervention is prudent, even when an institution has significant capital and few or no classified assets. Finally, while examiners noted that Integrity-Jupiter had materially deviated from its business plan during the June 2007 examination, the deviation should have been noted and been the subject of corrective action in earlier examinations.

In recognition of the elevated risk that newly-chartered institutions pose to the DIF, the FDIC recently extended their de novo periods from 3 to 7 years for purposes of on-site examinations, capital maintenance, and other requirements, including that institutions obtain prior approval from the FDIC before making material changes in their business plans. The FDIC also established procedures to better communicate and follow up on risks and deficiencies identified during examinations.

Based on the supervisory actions taken with respect to Integrity-Jupiter, the FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act. However, PCA's role in the failure of Integrity-Jupiter was limited because capital was a lagging indicator of the institution's financial health.

Management Response

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response to a draft of this report on February 24, 2010. In the response, DSC reiterated the OIG's conclusions regarding the causes of Integrity-Jupiter's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. DSC also noted that it had recently issued guidance to institutions and examiners extending the de novo period for newly-chartered institutions from 3 to 7 years and had established procedures to more formally communicate and follow up on risks and deficiencies identified during examinations.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: February 26, 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 Integrity Bank, Jupiter, Florida* (Report No. MLR-10-022)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Integrity Bank, Jupiter, Florida (Integrity-Jupiter). The Florida Office of Financial Regulation (OFR) closed the institution on July 31, 2009, and named the FDIC as receiver. On August 28, 2009, the FDIC notified the OIG that Integrity-Jupiter's total assets at closing were $110.3 million and that the estimated loss to the Deposit Insurance Fund (DIF) was $45.5 million. As of December 31, 2009, the estimated loss to the DIF had decreased to $36.9 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 Integrity-Jupiter's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of Integrity-Jupiter, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents the FDIC OIG's analysis of Integrity-Jupiter'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

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

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 in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted. Appendix 1 contains a timeline of key management events pertaining to Integrity-Jupiter; Appendix 2 contains details on our objectives, scope, and methodology; Appendix 3 contains a glossary of terms; and Appendix 4 contains a list of acronyms. Appendix 5 contains the Corporation's comments on this report.

Background

Integrity-Jupiter was chartered as a state nonmember institution on July 12, 2004. The institution operated a single office in Jupiter, which is a coastal community located in Palm Beach County, Florida. Integrity-Jupiter's lending activities focused primarily on commercial real estate (CRE), with an emphasis on acquisition, development, and construction (ADC) in Florida and Georgia. A significant portion of the institution's loan portfolio consisted of out-of-territory loan participations acquired from the Integrity Bank of Alpharetta, Georgia (Integrity-Alpharetta), which failed on August 29, 2008. Integrity-Jupiter was privately held and its Board directors collectively controlled approximately 15 percent of the institution's outstanding stock as of June 30, 2008. No individual shareholder controlled more than 9 percent of Integrity-Jupiter's stock, and the institution's shares were widely held.

Integrity-Jupiter had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act.[3] However, the institution did have a significant relationship with Integrity-Alpharetta. Specifically, some of Integrity-Jupiter's shareholders and directors were also shareholders, directors, and/or officers of Integrity-Alpharetta and/or its parent bank holding company, Integrity Bancshares, Inc. In addition, certain directors of Integrity Bancshares, Inc. played an instrumental role in establishing Integrity-Jupiter and modeled the institution's business strategy, policies, and practices after Integrity-Alpharetta. Integrity-Alpharetta also provided significant managerial and operational assistance to Integrity-Jupiter during its initial years of operation, and an eventual merger between the two institutions was envisioned. Table 1 summarizes selected financial information for Integrity-Jupiter for the quarter ended June 30, 2009 and for the 4 preceding calendar years.

[3] See the glossary of terms for more information about affiliates.

Table 1: Selected Financial Information for Integrity-Jupiter

Financial Measure ($000s)	Jun - 09	Dec - 08	Dec - 07	Dec - 06	Dec - 05
Total Assets	105,298	129,448	123,970	105,775	73,640
Gross Loans and Leases	70,946	89,587	98,100	82,789	55,741
Securities	23,230	30,329	17,970	14,422	7,392
Deposits	98,511	107,848	105,249	89,956	58,497
Net Income (Loss)	10,968	5,131	1,063	435	496

Source: Uniform Bank Performance Reports (UBPR) and Consolidated Reports of Condition and Income (Call Report) for Integrity-Jupiter.

Causes of Failure and Material Loss

Integrity-Jupiter failed primarily because of ineffective oversight by the institution's Board and management. Turnover and extended vacancies in the positions of President and Chief Executive Officer (CEO) and Senior Lending Officer (SLO) during the short life of the institution contributed to the weak oversight. In addition, the Board and management did not effectively manage the risks associated with the institution's heavy concentration in ADC loans. Weak ADC loan underwriting and administration, particularly with respect to out-of-territory loan participations acquired from Integrity-Alpharetta, were contributing factors in Integrity-Jupiter's failure.

The lack of effective Board and management oversight, together with a significant concentration in risky ADC loans, made the institution vulnerable when the Florida and Georgia real estate markets began to decline in 2007. Notably, a Board dispute that began in 2007 over control of the institution presented a significant distraction when the Board's undivided attention was needed on the institution's deteriorating financial condition. By 2008, the quality of Integrity-Jupiter's loan portfolio had become critically deficient, with additional deterioration continuing into 2009. The associated losses and provisions depleted Integrity-Jupiter's capital, rendering the institution insolvent. OFR closed Integrity-Jupiter on July 31, 2009 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

Board Oversight and Management Turnover

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

The knowledge, experience, and involvement of Board directors and executive officers are especially critical for newly-chartered institutions (also referred to as de novo institutions), such as Integrity-Jupiter. This point was underscored in a 2004 study conducted by the FDIC, which found that problems occurring during the first 6 years of an institution's operation were predominantly attributable to weak oversight by the Board and management inexperience and turnover.[4] As described below, a lack of effective oversight by Integrity-Jupiter's Board and excessive turnover of executive officers were key factors in the institution's failure.

Board Oversight

Integrity-Jupiter's Board did not provide effective oversight of the institution's operations. As discussed more fully in subsequent sections of this report, the Board did not effectively manage the risks associated with the institution's heavy ADC loan concentration or ensure appropriate due diligence, loan underwriting, and credit administration practices related to its ADC loans.

Further, a dispute among Integrity-Jupiter's Board directors over control of the institution presented a significant distraction when management's attention should have been more focused on the institution's deteriorating financial condition. In mid to late 2007, tension developed among certain Board directors regarding the overall direction of the institution, including its focus on ADC lending and its plans to build a new branch location. At that time, Integrity-Jupiter's real estate lending markets were deteriorating and the quality of the institution's ADC loans was beginning to decline. Dissent among the Board directors culminated in a special shareholder action on December 12, 2007 during which 6 of the Board's 10 directors, including its Chairman, were removed and 4 new directors were elected.

In the months that followed the special shareholder action, several of Integrity-Jupiter's former Board directors disputed their removal from the Board. Among other things, the former directors requested that OFR deny the new Board's application to acquire control of the institution[5] or grant a hearing during which the merits of the application could be disputed. The former directors also sent a letter to the institution's shareholders stating that the change in Board control was not in the best interests of the institution's shareholders or its customers, and requesting shareholder support for their reinstatement to the Board. Integrity-Jupiter's new Board spent valuable time in 2008 addressing regulatory concerns related to the manner in which the change in control was handled and defending the new Board's structure and business plans with shareholders, presenting a distraction from the institution's financial problems. Adding to the management instability at Integrity-Jupiter during that time was the resignation of two Board directors in April 2008 and the resignation of the President and CEO in May 2008.

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[4] The study included 58 de novo institutions established between 1993 and 2003 that were troubled (i.e., had composite supervisory ratings of "3" or worse) prior to the end of the second calendar year of operation and 75 young institutions established between 1993 and 2003 that were troubled for the first time between the fourth and sixth year of operation.

[5] Florida statute requires that any person or group of persons seeking to acquire a controlling interest in a Florida-chartered institution first provide OFR with an *Application for Certificate of Approval to Purchase or Acquire a Controlling Interest in a State Bank or Trust Company*. The FDIC Rules and Regulations require a similar advance filing for state nonmember institutions. See *Change in Control* in the glossary of terms for more information.

OFR never approved the new Board's application to acquire control of the institution. In February 2009, the new Board withdrew the application because it was no longer considered relevant in light of the material events and changes that had occurred at the institution since December 2007.

Management Turnover

The position of President and CEO changed numerous times during Integrity-Jupiter's 5 years of operation and remained vacant for extended periods of time. Of note, the institution operated without a full-time President and CEO between May 2005 and May 2006. During this period, executive officers from Integrity-Alpharetta, including its President and CEO, traveled to Integrity-Jupiter on a rotational basis to assist in managing the day-to-day affairs of the institution. Further, during periods when Integrity-Jupiter did have a full-time President and CEO, the individual holding the position was often required to assume additional SLO responsibilities due to frequent turnover in the SLO position. Notably, Integrity-Jupiter was without a full-time SLO during the first 9 months of the institution's operation and during the periods May 2006 through July 2007 and July 2008 through July 2009. Appendix 1 contains a timeline illustrating key management events pertaining to Integrity-Jupiter, including those involving changes in its executive officer positions.

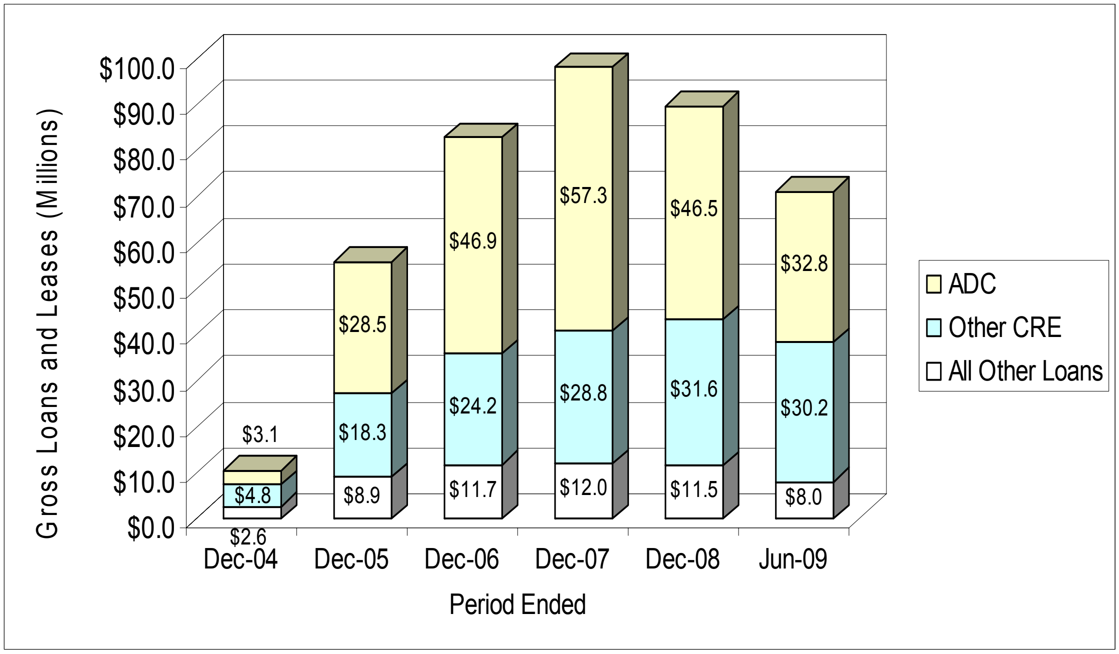
Tension between Integrity-Jupiter's Board directors and executive officers was a contributing factor in the management turnover that occurred at the institution. At least two individuals who served as President and CEO resigned due to tension with the Board. In addition, a third-party management evaluation performed on behalf of Integrity-Jupiter in March 2009 found that many of the problems facing the institution may have stemmed from the failure of the Board and executive officers to accept input from subordinates that differed from their own beliefs and paradigms. The management evaluation noted that staff had left the organization because of those differences.

ADC Loan Concentration

From the time it was chartered until its failure in July 2009, almost all of Integrity-Jupiter's loans pertained to real estate. At year-end 2008, nearly 100 percent of the loan portfolio was invested in real estate, placing the institution in the 99th percentile of its peer group[6] average for concentrations in real estate loans based on average gross loans and leases. A significant portion of the real estate loans involved ADC and included both locally-originated loans as well as loan participations purchased from other institutions, including Integrity-Alpharetta. As of March 31, 2007, approximately $22.1 million (or 25 percent) of Integrity-Jupiter's $89.4 million loan portfolio consisted of out-of-territory loan participations purchased from Integrity-Alpharetta. Figure 1 illustrates the general composition and growth of Integrity-Jupiter's loan portfolio.

[6] 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. Integrity-Jupiter's peer group included institutions with assets between $100 million and $300 million in a metropolitan area with two or fewer full service offices.

Figure 1: Composition and Growth of Integrity-Jupiter's Loan Portfolio



Source: Call Reports for Integrity-Jupiter.

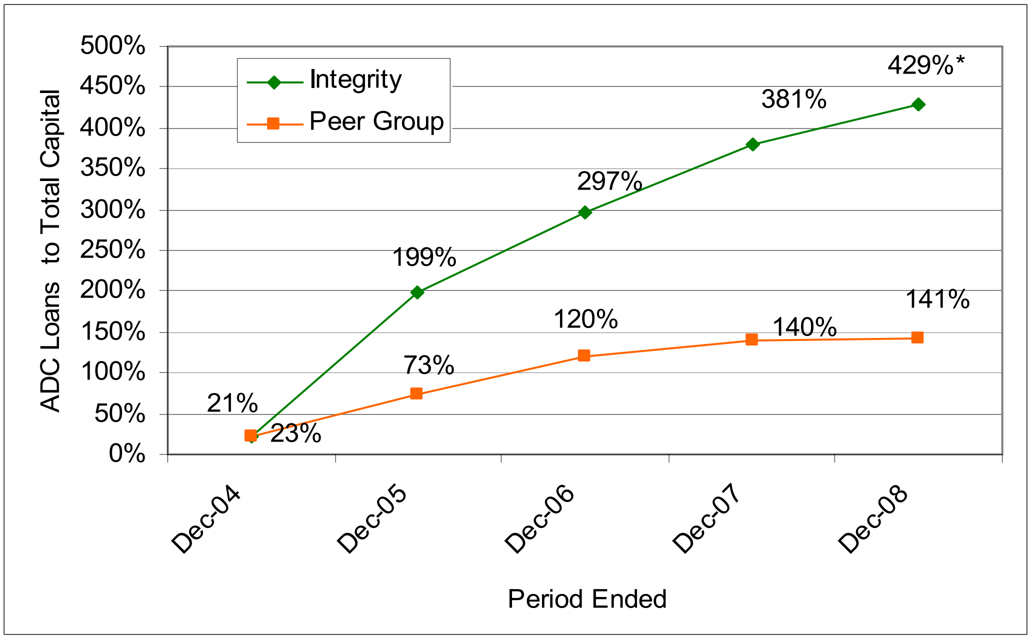
In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. Although the guidance does not establish specific CRE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

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

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

As of December 31, 2007, Integrity-Jupiter's non-owner occupied CRE loans represented 552 percent of the institution's total capital. Further, approximately 58 percent of Integrity-Jupiter's loan portfolio at year-end 2007 consisted of ADC loans, representing 381 percent of the institution's total capital. Both of these levels were significantly higher than the levels defined in the 2006 guidance as possibly warranting further supervisory analysis. Integrity-Jupiter's CRE and ADC concentrations were allowed to reach high levels, in part, because the institution had not established reasonable concentration limits. Specifically, the institution's loan policy, revised and approved by the Board in April 2008, allowed up to 750 percent of the institution's Tier 1 Capital to be invested in ADC loans. Integrity-Jupiter's concentration in ADC loans, together with weak risk management practices related to these loans discussed later in this report, made the institution vulnerable when its lending markets began to decline in 2007. Figure 2 illustrates Integrity-Jupiter's ADC concentration relative to its peer group average.

Figure 2: Integrity-Jupiter's ADC Concentration Compared to Peer Group



Source: UBPRs for Integrity-Jupiter.
* The increase in the ADC loan concentration in December 2008 resulted from a decline in Integrity-Jupiter's capital rather than growth in ADC lending.

Integrity-Jupiter did not have any classified assets until the June 2007 examination, at which time examiners classified a total of $4.1 million in assets (or 25 percent of Tier 1 Capital and the Allowance for Loan and Lease Losses (ALLL)). This moderate increase in classified assets reflected a decline in the institution's local and out-of-territory lending markets. Based on negative trends in its lending markets, Integrity-Jupiter decided to discontinue purchasing loan participations from Integrity-Alpharetta and significantly reduced its ADC lending activities. Integrity-Jupiter also increased its ALLL in the fourth quarter of 2007 and the second quarter of 2008 by $1.7 million and $1 million, respectively, bringing the institution's ALLL to approximately 3.1 percent of total loans as of June 30, 2008.

By July 2008, Integrity-Jupiter's asset quality had become critically deficient, with adverse classifications totaling $26.2 million, or 169 percent of Tier 1 Capital and the ALLL. Approximately $25.7 million of the $26.2 million in adverse classifications pertained to loans, with the majority attributed to ADC. Based on the results of a joint FDIC and OFR visitation in April 2009, and updated appraisal information received in June 2009, examiners determined that Integrity-Jupiter's financial condition had further deteriorated and that the institution was no longer viable absent a large capital infusion. According to Integrity-Jupiter's Call Report for the quarter ended June 30, 2009, the institution had negative Tier 1 Capital of approximately $1.5 million after recognizing a loss of almost $11 million during the first 6 months of 2009, again largely attributable to ADC loans.

Risk Management Practices Associated with ADC Loans

Weaknesses in Integrity-Jupiter's due diligence, loan underwriting, and credit administration practices were contributing factors in the ADC loan quality problems that developed when the institution's real estate lending markets deteriorated in 2007 and 2008. A brief description of these weaknesses follows.

Due Diligence for Out-of-Territory Loan Participations

Shortly after it opened in July 2004, Integrity-Jupiter began purchasing out-of-territory loan participations from Integrity-Alpharetta as a means of growing its loan portfolio. As of March 31, 2007, Integrity-Jupiter held 12 such participations valued at $22.1 million (or 144 percent of Tier 1 Capital). All of these loan participations were secured by properties in Georgia, with the exception of one loan valued at $3 million that was secured by land in North Carolina. According to the Examination Manual, institutions purchasing loan participations must make a thorough, independent evaluation of the transactions and the risks involved before committing any funds. Institutions should also apply the same standards of prudence, credit assessment, and approval criteria that would be employed if the purchasing organization were originating the loan.

Integrity-Jupiter did not perform proper due diligence before it purchased the loan participations from Integrity-Alpharetta. For example, Integrity-Jupiter did not perform global cash flow analyses on borrowers and guarantors to assess their overall debt and the status of their other real estate projects. Our review of examination reports for Integrity-Alpharetta found that it, too, did not perform global cash flow analyses when originating some of the same loan participations held by Integrity-Jupiter. Integrity-Jupiter also relied on Integrity-Alpharetta to review property appraisals on the loan participations instead of performing its own independent appraisal reviews. Poor communication between Integrity-Jupiter and Integrity-Alpharetta further exacerbated the risks associated with the loan participations. For example, Integrity-Alpharetta executed forbearance agreements with several borrowers without first consulting with Integrity-Jupiter or providing Integrity-Jupiter with the details of the agreements.

Integrity-Jupiter's decision to purchase out-of-territory loan participations also represented a material deviation from the institution's business plan. Specifically, Integrity-Jupiter's business plan limited the institution's lending area to a 5-mile radius around Jupiter, and the plan did not address loan participations. Further, the FDIC's order approving Integrity-Jupiter's application for federal deposit insurance included a number of conditions. One such condition was that the institution operate within the parameters of its business plan and, during the first 3 years of operation, notify the FDIC of any proposed major deviation or material change from the plan 60 days before consummation of the change. However, Integrity-Jupiter did not formally notify the FDIC of its departure from the business plan as prescribed in the order. Loan participations purchased from Integrity-Alpharetta accounted for approximately

$11.4 million (or 44 percent) of the $25.7 million in adverse loan classifications identified during the July 2008 examination.

Loan Underwriting

The June 2007 examination report noted a number of weak loan underwriting practices that impaired the quality of the institution's ADC loans, particularly the loan participations from Integrity-Alpharetta. For example, Integrity-Jupiter did not establish or implement:

- Appropriate controls over the disbursement of funds for construction projects (e.g., procedures for obtaining current project budgets and timelines, and appropriate requirements for pre-lease, pre-sale, and lot release).

- Formal policies or procedures for controlling the use of interest reserves on ADC loans.

- Procedures for conducting global cash flow analyses on borrowers and guarantors of large or complex loans.

- Procedures for "rate shocking" individual loans to determine how an increase in interest rates could affect a borrower's cash flow.

Credit Administration

The June 2007 examination report also noted weak credit administration practices that further impaired the quality of Integrity-Jupiter's ADC loans. In some cases, these weaknesses were caused by poor communication with Integrity-Alpharetta. The credit administration weaknesses included, but were not limited to:

- A lack of current property appraisals and financial information (e.g., financial statements and tax returns) for borrowers and guarantors. These weaknesses were particularly prevalent for the loan participations purchased from Integrity-Alpharetta.

- Allowing the continued use of interest reserves on both locally-originated loans and participations from Integrity-Alpharetta when the underlying construction project was halted or experiencing other significant problems. Such practices resulted in a delayed recognition of performance problems on some loans.

- A lack of adequate economic and real estate market analysis for the institution's out-of-territory lending markets.

The above ADC loan underwriting and administration weaknesses, and in particular the lack of due diligence related to the out-of-territory loan participations acquired from Integrity-Alpharetta, were contributing factors in Integrity-Jupiter's failure.

The FDIC's Supervision of Integrity-Jupiter

The FDIC, in coordination with OFR, provided ongoing supervisory oversight of Integrity-Jupiter through regular on-site risk management examinations, visitations, and offsite monitoring activities. In addition, because Integrity-Jupiter was a newly-chartered institution, it was subject to higher capital requirements and more frequent examinations during its first 3 years of operation. Through its supervisory efforts, the FDIC identified key risks in Integrity-Jupiter's operations and brought these risks to the attention of the institution's Board and management.

Although examiners raised concerns about Integrity-Jupiter's management in the years preceding the failure, the FDIC determined that the institution's management was generally satisfactory prior to the July 2008 examination, as reflected in the supervisory component ratings of "2" for management.[7] In retrospect, a stronger supervisory response to the risks associated with Integrity-Jupiter's management at earlier examinations may have been prudent. Such a response could have included lowering the institution's supervisory component rating for management and requiring the institution to develop a management succession plan. The FDIC's supervisory approach for addressing Integrity-Jupiter's ADC concentration was generally reasonable. However, a lesson learned with respect to ADC concentrations is that early supervisory intervention is prudent, even when an institution has significant capital and few or no classified assets. Finally, while examiners noted that Integrity-Jupiter had materially deviated from its business plan during the June 2007 examination, the deviation should have been noted and been the subject of corrective action at earlier examinations.

The FDIC recently issued guidance to institutions and examiners to better address the types of risks that existed at Integrity-Jupiter. Specifically, in recognition of the elevated risk that newly chartered institutions pose to the DIF, the FDIC extended their de novo periods from 3 to 7 years for purposes of on-site examinations, capital maintenance, and other requirements, including that the institutions obtain prior approval from the FDIC before making material changes in their business plans. The FDIC also established procedures to better communicate and follow up on risks and deficiencies identified during examinations.

Supervisory History

The FDIC and OFR conducted five on-site risk management examinations and three visitations of Integrity-Jupiter during the 5 years that the institution was in operation. Table 2 on the following page summarizes key supervisory information for these examinations and visitations.

[7] Pursuant to the Uniform Financial Institutions Rating System (UFIRS), federal and state regulators assign supervisory ratings to financial institutions based on the results of safety and soundness examinations and other supervisory activities. Ratings consist of a "composite" rating reflecting the institution's overall financial condition and operations and six "component" ratings 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. Ratings are assigned on a scale of 1 to 5, with 1 representing the least supervisory concern and 5 representing the greatest supervisory concern.

Table 2: On-site Examinations and Visitations of Integrity-Jupiter

Examination Start Date	Type of Examination	Regulator	Supervisory Ratings	Informal or Formal Actions Taken*
2/7/2005	Risk Management	OFR	122322/2	None
8/8/2005	Risk Management	FDIC	122322/2	None
6/19/2006	Risk Management	OFR	122322/2	None
6/11/2007	Risk Management	FDIC	122322/2	None
2/21/2008	Visitation	FDIC	n/a	None
7/14/2008	Risk Management	OFR	354524/4	C&D
4/6/2009	Visitation	FDIC	555544/5	(see C&D above)
6/4/2009	Visitation	OFR	n/a	(see C&D above)

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for Integrity-Jupiter.
* Informal enforcement actions often take the form of Bank Board Resolutions or Memoranda of Understanding. Formal enforcement actions often take the form of Cease and Desist (C&D) orders, but under severe circumstances can also take the form of insurance termination proceedings.

The February 2008 visitation was conducted in response to the special shareholder action in December 2007 that restructured Integrity-Jupiter's Board. As part of the February 2008 visitation, the FDIC also assessed the overall financial status of the institution. The April 2009 and June 2009 visitations were conducted to review the status of certain problem loans and to assess the impact that these loans were having on the institution's financial condition. The FDIC's offsite monitoring procedures generally consisted of contacting the institution's management from time to time to discuss current and emerging business issues and using automated tools[8] to help identify potential supervisory concerns. The FDIC's offsite monitoring procedures indicated that an increase in Integrity-Jupiter's non-accrual loans and provision expense in December 2007 was negatively affecting the quality of the institution's assets.

Based on the results of the July 2008 examination, the FDIC and OFR determined that Integrity-Jupiter's asset quality was critically deficient and that the Board and management were not providing effective oversight and guidance to the institution. Integrity-Jupiter entered into a stipulation and consent to the issuance of a C&D by OFR on November 14, 2008. The FDIC separately executed an addendum to the C&D acknowledging the order. The addendum stated that its execution represented a commitment to the FDIC by the institution's Board to comply with the terms of the stipulation and the order. Among other things, the C&D required Integrity-Jupiter to:

- Identify and recruit new Board directors with sufficient expertise to return the institution to a safe and sound condition.

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

- Engage an outside firm to review the institution's management and determine whether the institution is adequately staffed by qualified personnel.

- Submit a management succession plan covering all key officer positions.

- Submit a capital plan for maintaining a Tier 1 Leverage Capital ratio, Tier 1 Risk-Based Capital ratio, and a Total Risk-Based Capital ratio of at least 8 percent, 10 percent, and 12 percent, respectively.

- Submit a plan for reducing the institution's concentration risk.

The capital ratios required by the C&D were higher than the minimum levels for *Well Capitalized* institutions as defined in Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations. The higher capital levels reflected the institution's elevated risk profile. In addition, the C&D defined specific timeframes for meeting its requirements and directed the institution to submit periodic progress reports to the FDIC and OFR describing compliance with the order. Based on the results of the April 2009 visitation, and updated appraisal information received in June 2009, the FDIC and OFR determined that Integrity-Jupiter's financial condition had further deteriorated. Examiners determined that after the institution charged off all of the assets (or portions thereof) that had been classified as loss during the visitation, the institution's capital would fall to approximately negative $3 million, rendering the institution imminently insolvent. OFR closed Integrity-Jupiter on July 31, 2009 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

Supervisory Response to Management Issues

The FDIC, in coordination with OFR, closely monitored the activities of Integrity-Jupiter's Board and the changes in the institution's executive officers in the years preceding the failure. Prior to the July 2008 examination, the FDIC and OFR raised numerous concerns regarding the institution's management practices. Such concerns included, but were not limited to, the following:

- In August 2005, OFR notified Integrity-Jupiter's Board Chairman of several management concerns, including the heavy influence that Integrity-Alpharetta was having on Integrity-Jupiter's operations. At that time, Integrity-Alpharetta was providing significant managerial and operational assistance to Integrity-Jupiter without a written agreement.

- In February 2006, OFR notified Integrity-Jupiter's Board of an ongoing concern that the institution continued to operate without the leadership of a President and CEO. The notification explained that the ultimate success of a newly-chartered institution depends heavily upon the knowledge and expertise of its President and CEO and other executive officers.

- The June 2006 examination report noted that while Integrity-Jupiter had recently filled a year-long vacancy in the President and CEO position, the resume of the individual promoted into the position had “a lack of operational expertise, which is crucial to the management of a new community bank.”

- The June 2007 examination report stated that Integrity-Jupiter’s President and CEO was required to assume the duties of SLO and that such additional duties were taking time away from managing the day-to-day operations of the institution. The report also noted that the institution had materially deviated from its business plan when it purchased out-of-territory loan participations from Integrity-Alpharetta.

- In January 2008, OFR hand-delivered a letter demanding that Integrity-Jupiter submit a completed change in control application. Under a Florida statute, the application was required to be submitted before the change in control took place.

- In April 2008, an OFR examiner advised Integrity-Jupiter’s Board Chairman that the Board’s decision to place the President and CEO on leave was not handled properly. During this same month, the FDIC notified Integrity-Jupiter’s Board Chairman that the new Board had failed to provide advance notification of the change in control of the institution, as required by the FDIC Rules and Regulations.

Notwithstanding the concerns noted above, prior to the July 2008 examination, examiners determined that Integrity-Jupiter’s management was generally satisfactory and assigned supervisory component ratings of “2” for management. Examiners considered downgrading the management component rating to a “3” during the August 2005, June 2006, and June 2007 examinations. However, examiners concluded that the financial condition of the institution during those examinations did not warrant a lower rating for management. Based on the results of the July 2008 examination, OFR downgraded the management component rating from a “2” to a “4,” and OFR, acting in coordination with the FDIC, issued a C&D that included several management provisions.

Given the risks associated with the continued turnover of Integrity-Jupiter’s executive officers, the tension among Board directors and management, and the institution’s newly-chartered status, a stronger supervisory response at earlier examinations may have been prudent. For example, the FDIC could have downgraded the institution’s supervisory component rating for management as early as the August 2005 examination and required that the institution develop a management succession plan at that time. Such action would have helped to set an appropriate supervisory tenor of expectations with the Board at an early point in the institution’s operation.

Supervisory Oversight of ADC Loan Concentration

Examiners first raised concerns about Integrity-Jupiter’s concentration risk management practices in the August 2005 examination report. The report included a number of recommendations to develop and implement systems for identifying, monitoring, and reporting asset concentrations, including setting appropriate concentration limits. The June 2006 examination report noted that, although asset quality continued to remain satisfactory, risks within the loan portfolio were increasing, primarily due to the institution's growing ADC concentration. At that time, Integrity-Jupiter's ADC concentration represented 279 percent of Tier 1 Capital. However, the examination report also noted that Integrity-Jupiter's management was committed to reducing its ADC concentration.

The June 2007 examination report noted that the ADC concentration had increased to 346 percent of Tier 1 Capital, exposing the loan portfolio to heightened credit risk due to the ongoing deterioration in the institution's real estate lending markets. The report contained a number of recommendations to strengthen the institution's concentration risk management practices. Among other things, the report recommended that Integrity-Jupiter establish more detailed policy limits for its loan concentrations, significantly improve its concentration monitoring practices, and establish contingency plans for mitigating its concentration risks. Examiners determined that the institution's asset quality was generally satisfactory during the June 2007 examination, due in part to the moderate level of classified assets. However, the FDIC requested that the institution provide a written response to the examination report describing the actions taken or planned to correct the noted deficiencies. Integrity-Jupiter provided a response on January 25, 2008 stating that, among other actions, the institution had begun to take measures to diversify its loan portfolio.

Integrity-Jupiter did, indeed, curtail its ADC lending activities following the June 2007 examination. However, by the time of the July 2008 examination, the institution's ADC loan concentration, coupled with a weakening real estate market, had translated into a significant deterioration in the loan portfolio. Examiners downgraded Integrity-Jupiter's supervisory component rating for asset quality from a "2" to a "5" during the July 2008 examination and advised the Board that allowing the loan portfolio to be concentrated in speculative loans was an unsafe and unsound practice.

A lesson learned with respect to Integrity-Jupiter's ADC loan concentration is that early and aggressive supervisory intervention is prudent. At the time of the June 2006 examination, Integrity-Jupiter's capital position was well above the minimum threshold for *Well Capitalized* institutions, the institution had no adversely classified assets, and management indicated a commitment to addressing examiner recommendations. Under such circumstances, the supervisory approach of making recommendations to address Integrity-Jupiter's growing concentration risk was reasonable. With the benefit of hindsight, however, additional supervisory steps may have been prudent. Such steps could have included requiring the institution to provide a written plan to address its concentration risks and/or conducting a visitation prior to the June 2007 examination to assess the institution's progress in reducing its concentration risk.

In that regard, the FDIC issued guidance to its examiners on January 26, 2010 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.

Business Plan Deviation

The June 2007 examination report noted that Integrity-Jupiter held loan participations from Integrity-Alpharetta totaling $22.1 million (or 144 percent of Tier 1 Capital). According to the examination report, Integrity-Jupiter's decision to purchase these loan participations represented a material deviation from the institution's business plan because the plan limited Integrity-Jupiter's lending activities to a 5-mile radius around Jupiter. In addition, the business plan did not address loan participations. Further, examiners noted that Integrity-Jupiter failed to notify the FDIC of the change in its business plan as required by the FDIC's order approving the institution's deposit insurance.

In retrospect, examiners should have raised concerns about Integrity-Jupiter's deviation from its business plan as early as the August 2005 examination. At that time, Integrity-Jupiter held over $10 million in out-of-territory loan participations from Integrity-Alpharetta and planned to continue purchasing loan participations as a means of growing the loan portfolio. The deviation should have been the subject of corrective action on the part of Integrity-Jupiter's Board and management. For example, examiners could have recommended that Integrity-Jupiter update its business plan to address out-of-territory loan participations provided that appropriate internal controls (including due diligence procedures, management expertise, and out-of-territory market analysis) were implemented to manage the risk associated with this type of lending.

In recognition of the elevated risk that newly chartered institutions pose to the DIF, the FDIC issued Financial Institution Letter (FIL)-50-2009, entitled *Enhanced Supervisory Procedures For Newly Insured FDIC-Supervised Depository Institutions*, dated August 28, 2009. The FIL states that recent supervisory experience has identified common issues with troubled or failed de novo institutions, such as weak risk management practices, asset concentrations without compensatory management controls, and significant deviations from business plans. To better address such risks, the FIL extends the de novo period for newly-chartered institutions from 3 to 7 years for purposes of on-site examinations, capital maintenance, and other requirements, including that institutions obtain prior approval from the FDIC before making material changes in their business plans.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered based on an institution's capital levels. Based on the supervisory actions taken with respect to Integrity-Jupiter, the FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act. However, PCA's role in the failure of Integrity-Jupiter was limited because capital was a lagging indicator of the institution's financial health. Table 3 illustrates Integrity-Jupiter's capital levels relative to the PCA thresholds for *Well Capitalized* institutions for the quarters ended March 31, 2009 and June 30, 2009, and for the 4 preceding calendar years.

Table 3: Integrity-Jupiter's Capital Levels

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well Capitalized Thresholds	5% or more	6% or more	10% or more	
Integrity's Capital Levels				
Dec – 05	21.22	21.25	22.05	*Well Capitalized*
Dec – 06	14.47	15.54	16.45	*Well Capitalized*
Dec – 07	11.10	12.07	13.34	*Well Capitalized*
Dec – 08	7.07	9.04	10.30	*Well Capitalized*
Mar – 09	4.03	5.36	6.62	*Undercapitalized*
Jun – 09	-1.26	-1.79	-1.79	*Critically Undercapitalized*

Source: UBPRs for Integrity-Jupiter.

As previously discussed, OFR issued a C&D on November 14, 2008 that included a capital provision. Specifically, the C&D directed Integrity-Jupiter to maintain minimum capital ratios that were higher than those required for *Well Capitalized* institutions and to submit a capital plan for maintaining those higher ratios within 30 days of the order. Integrity-Jupiter provided OFR with a capital plan on December 16, 2008. The plan called for raising as much as $7 million in new capital. However, the institution's efforts in this regard were not successful. Based on updated financial information obtained by OFR on March 16, 2009, OFR determined that the institution would likely become *Critically Undercapitalized* by the end of March 2009. As a result, OFR issued a capital call letter on March 17, 2009 directing the institution to raise its Tier 1 Capital ratio to not less than 6 percent by April 15, 2009.

Based on Integrity-Jupiter's Call Report for the quarter ended March 31, 2009, the institution fell from *Well Capitalized* to *Undercapitalized*. On April 6, 2009, the FDIC and OFR performed a joint visitation of Integrity-Jupiter and determined that the institution's reported capital position was overstated. After adjusting for losses identified during the visitation, examiners determined that the institution's capital position was actually *Critically Undercapitalized*. Integrity-Jupiter's management disagreed with the severity of the examiners' classifications and ordered new appraisals for certain properties. However, when the new appraisals were received and reviewed by OFR in June 2009, examiners confirmed that the institution was *Critically Undercapitalized*.

The FDIC formally notified Integrity-Jupiter on May 4, 2009 that, based on its Call Report for the quarter ended March 31, 2009, the institution was considered

Undercapitalized. The notification included a reminder that the institution was subject to certain restrictions and requirements defined under section 38, including the submission of a capital restoration plan. Integrity-Jupiter submitted a capital restoration plan to the FDIC on June 19, 2009. However, the FDIC determined that the plan significantly underestimated the amount of capital that the institution needed and was deficient in many other respects. An FDIC official verbally notified Integrity-Jupiter on July 6, 2009 that its capital plan was unacceptable. OFR closed Integrity-Jupiter on July 31, 2009 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

Corporation Comments

We issued a draft of this report on February 11, 2010. DSC management subsequently provided us with additional information for our consideration. We made certain changes to the report that we deemed appropriate based on the information that DSC management provided. On February 24, 2010, the Director, DSC, provided a written response to the draft report. The response is presented in its entirety as Appendix 5 of this report.

In its response, DSC reiterated the OIG's conclusions regarding the causes of Integrity-Jupiter's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. DSC also noted that it had recently issued guidance to institutions and examiners extending the de novo period for newly-chartered institutions from 3 to 7 years and had established procedures to more formally communicate and follow up on risks and deficiencies identified during examinations.

Timeline of Key Management Events

Date	Management Event
July 12, 2004	Integrity-Jupiter opens for business.
September 1, 2004	A director on Integrity-Jupiter's Board resigns.
October 21, 2004	A second director on Integrity-Jupiter's Board resigns.
February 7, 2005	The February 2005 examination report notes that Integrity-Jupiter has been operating without an SLO.
April 25, 2005	A third director on Integrity-Jupiter's Board resigns. In addition, Integrity-Jupiter hires an SLO.
May 23, 2005	Integrity-Jupiter's President and CEO resigns. Executive officers of Integrity-Alpharetta begin traveling to Integrity-Jupiter to help manage the institution.
August 18, 2005	Integrity-Jupiter's Board re-appoints two former directors.
August 22, 2005	OFR raises concern with Integrity-Jupiter's Board Chairman that, based on information obtained during the FDIC's ongoing examination, the directors and officers of Integrity-Alpharetta appear to be managing Integrity-Jupiter.
August 26, 2005	Integrity-Jupiter's Board Chairman advises OFR that the Board is in full control of the institution and agrees to establish a written agreement describing the services acquired from Integrity-Alpharetta.
February 2, 2006	OFR advises Integrity-Jupiter's Board of its continuing concern that the institution is operating without the leadership of a President and CEO.
May 18, 2006	Integrity-Jupiter's SLO is promoted to President and CEO, but retains the duties of SLO until an SLO replacement is found.
June 19, 2006	The June 2006 examination report notes concern about the undue influence that Integrity-Alpharetta had over Integrity-Jupiter's activities.
July 16, 2007	Integrity-Jupiter hires an SLO.
December 7, 2007	One of Integrity-Jupiter's Board directors resigns for a second time.
December 12, 2007	A special shareholder action results in the removal of six existing Board directors and the appointment of four new directors at Integrity-Jupiter.
January 24, 2008	OFR visits Integrity-Jupiter to assess the change in Board control and to hand deliver a letter demanding the submission of a completed *Application for Certificate of Approval to Purchase or Acquire a Controlling Interest in a State Bank or Trust Company*.

Timeline of Key Management Events

Date	Management Event
February 15, 2008	Former directors of Integrity-Jupiter's Board request that OFR deny the new Board's application for a change in control or schedule a hearing wherein the merits of the application can be disputed.
February 21-22, 2008	The FDIC conducts an on-site visitation of Integrity-Jupiter to assess the management situation at the institution.
April 4, 2008	Integrity-Jupiter's Board Chairman sends a letter to shareholders responding to concerns raised by former Board directors regarding the change in control of the institution.
April 10, 2008	Two directors of Integrity-Jupiter's Board resign.
May 22, 2008	Integrity-Jupiter's President and CEO resigns.
July 17, 2008	Integrity-Jupiter's SLO is promoted to President and CEO.
September 15, 2008	The July 2008 examination report lowers Integrity-Jupiter's supervisory component rating for management from a "2" to a "4."
November 14, 2008	OFR issues a C&D requiring, among other things, that Integrity-Jupiter's Board (1) identify and recruit new Board directors with sufficient expertise to return the institution to a safe and sound condition, (2) engage an outside firm to review the institution's management, and (3) prepare a management succession plan for all key officers.
January 21, 2009	Integrity-Jupiter's President and CEO provides the Board with a 30-day notice of resignation.
April 6, 2009	Based on the results of the April 2009 visitation, examiners lower Integrity-Jupiter's supervisory component rating for management from a "4" to a "5."
April 15, 2009	A director on Integrity-Jupiter's Board resigns.
June 19, 2009	OFR advises Integrity-Jupiter's Board Chairman that the institution is "imminently insolvent," as that term is defined in the Florida statutes.
June 25, 2009	Integrity-Jupiter's Board passes a resolution consenting to the appointment of the FDIC as receiver for the institution.
July 30, 2009	A director on Integrity-Jupiter's Board resigns.
July 31, 2009	OFR closes Integrity-Jupiter.

Objectives, Scope, and Methodology

Objectives

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

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

We conducted this performance audit from October 2009 to February 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 focused on Integrity-Jupiter's business operations from 2004 until its failure on July 31, 2009. Our work also included an evaluation of the regulatory supervision of the institution during this same time period.

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

- Analyzed examination reports issued by the FDIC and OFR between 2004 and 2009.

- Reviewed the following:

    - Institution data and correspondence maintained in DSC's Atlanta Regional Office and South Florida Field Office.

    - Relevant reports prepared by the Division of Resolutions and Receiverships and DSC's Washington, D.C. Office staff relating to the institution's failure.

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

Objectives, Scope, and Methodology

- Interviewed DSC examination staff in the Washington, D.C. Office, the Atlanta Regional Office, and South Florida Field Office.

- Met with OFR examiners and managers to obtain their perspectives and discuss their role in the supervision of the institution.

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, examination reports, and interviews of examiners to understand Integrity-Jupiter'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 examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that was used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC 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.

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) through the following three categories: Substandard, Doubtful, and Loss.
Affiliate	Under section 23A of the Federal Reserve Act (12 U.S.C. 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. Under the Bank Holding Company Act (12 U.S.C. 1841), an affiliate is generally any company (to include banks) that controls, is controlled by, or is under common control with another company. "Control" is defined, in general, in a similar manner under both statutes to mean the power to vote 25 percent of any class of voting securities, or to control the election of a majority of directors of, the bank or company. Both statutes contain various restrictions or limitations on certain transactions or applications of affiliated entities.
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.
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 formal enforcement action issued by financial regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. 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

Term	Definition
Change in Control	Section 658.28, *Acquisition of Control of a Bank or Trust Company*, of the Florida statutes states that any person or group of persons, acting directly or indirectly, or by or through one or more persons, proposing to purchase or acquire a controlling interest in any state bank or state trust company, and thereby to change the control of that bank or trust company, shall first make application to OFR for a certificate of approval of such proposed change in control. OFR issues a certificate of approval only after it has made an investigation and determined that the proposed new owner(s) are qualified by reputation, character, experience, and financial responsibility to control and operate the bank or trust company in a legal and proper manner and that the interests of the other stockholders, if any, and the depositors and creditors of the bank or trust company and the interests of the public generally will not be jeopardized by the proposed change in control. Subpart E of Part 303 of the FDIC Rules and Regulations, implementing section 7(j) of the FDI Act, also defines procedures for submitting advance notice to the FDIC for acquiring control of an insured state nonmember institution. Such transactions typically require 60 days prior written notice to the FDIC.
Concentration	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 if not properly managed.
De Novo Institution	Prior to the issuance of FIL-50-2009 on August 28, 2009, and for the purposes of FDIC-supervised institutions, this term referred to an institution within its first 3 years of operation. FIL-50-2009 changed the de novo period for newly-chartered FDIC-supervised institutions from 3 years to 7 years. Under the new de novo period, institutions must undergo a limited-scope examination within the first 6 months of operation, and a full-scope examination within the first 12 months of operation. Subsequent to the first examination, and through the 7^{th} year of operation, institutions remain on a 12-month examination cycle. Extended examination intervals (i.e., 18-month intervals) do not apply during the de novo period.
Imminently Insolvent	The term is defined under Florida statute as a condition in which a financial institution has total capital accounts, or equity in the case of a credit union, of less than 2 percent of its total assets, after adjustment for apparent losses.

Glossary of Terms

Term	Definition
Insolvent	The term is defined under Florida statute as a condition in which (1) the capital accounts, or equity in the case of a credit union, and all assets of a financial institution are insufficient to meet liabilities; (2) the financial institution is unable to meet current obligations as they mature, even though assets may exceed liabilities; or (3) the capital accounts, or equity in the case of a credit union, of a financial institution are exhausted by losses and no immediate prospect of replacement exists.
Interest Reserve Account	An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of a loan. The interest is capitalized and added to the loan balance. ADC loans often include an interest reserve to carry the project from origination to completion and may cover the project's anticipated sell-out or lease-up period.
President and CEO	An executive officer responsible for the day-to-day executive management and strategic and capital planning for the institution. The President and CEO is also responsible for reviewing and responding to audit reports, management letters, and examination reports.
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 C.F.R., 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*.
Senior Lending Officer (SLO)	An executive officer typically responsible for overseeing all aspects of an institution's lending activities, including planning, organizing, and directing loan production and administration, credit review, and collection activities and ensuring that all such activities are conducted profitably and in compliance with applicable law.
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of an institution's financial data and ratios that includes extensive comparisons to peer groups. The report is produced by the Federal Financial Institutions Examination Council for use by regulators, bankers, and the general public. UBPRs are produced quarterly from data contained in Call Reports.
Young Institution	A term that formerly referred to institutions in their 4th through 9th year of operation.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CEO	Chief Executive Officer
CFR	Code of Federal Regulations
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FIL	Financial Institution Letter
GMS	Growth Monitoring System
OFR	Office of Financial Regulation
OIG	Office of Inspector General
PCA	Prompt Corrective Action
SCOR	Statistical CAMELS Offsite Rating
SLO	Senior Lending Officer
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.C.	United States Code

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

February 24, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Integrity Bank, Jupiter, Florida (Assignment 2009-070)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Integrity Bank, Jupiter, Florida (Integrity-Jupiter) which failed on July 31, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on February 11, 2010.

The Report concludes that Integrity-Jupiter's failure was primarily due to ineffective oversight by its Board and management. The Board and management did not effectively manage the risk associated with Integrity-Jupiter's heavy concentration in acquisition, development and construction (ADC) loans, coupled with underwriting and administration weaknesses, particularly with respect to out-of-territory loan participations acquired from Integrity Bank, Alpharetta, Georgia.

The FDIC and the Florida Office of Financial Regulation (OFR) provided ongoing supervisory oversight of Integrity-Jupiter with five on-site risk management examinations, three visitations, and offsite monitoring during the five years that the institution was in operation. Examiners first raised concern about Integrity-Jupiter's concentration risk management practices at the August 2005 examination. The examination report included a number of recommendations, including setting appropriate concentration limits. The June 2007 examination noted an increased ADC concentration, exposing the loan portfolio to heightened credit risk due to the ongoing deterioration in the institution's real estate lending markets. The examination report made a number of recommendations to strengthen the institution's concentration risk management practices. The Report states that the FDIC's supervisory approach for addressing Integrity-Jupiter's ADC concentration was reasonable.

DSC recently issued guidance to institutions and examiners to address the types of risks that existed at Integrity-Jupiter. In recognition of the elevated risk that newly-chartered institutions pose, the de novo period has been extended from 3 to 7 years and de novo institutions are required to obtain advance approval of material changes in business plans. DSC has also established procedures to more formally communicate and follow up on risks and deficiencies identified during examinations.

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