Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-006

Material Loss Review of American Southern Bank, Kennesaw, Georgia

December 2009

Office of Inspector General

Executive Summary

Material Loss Review of American Southern Bank, Kennesaw, Georgia

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Why We Did The Audit

On April 24, 2009, the Georgia Department of Banking and Finance (GDBF) closed American Southern Bank (American Southern), Kennesaw, Georgia, and named the FDIC as receiver. On June 5, 2009, the FDIC notified the OIG that American Southern's total assets at closing were $113.4 million and the material loss to the Deposit Insurance Fund (DIF) was $41.7 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of American Southern.

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

Background

American Southern was a state-chartered, nonmember bank that was insured by the FDIC on August 30, 2005. During most of the bank's existence, American Southern was designated as a "de novo" institution, indicating a newly established bank that is in its first 3 years of operation. American Southern was headquartered in Kennesaw, Georgia, and had no branch offices. American Southern provided traditional banking services within its marketplace and was a full-service community bank specializing in residential and commercial real estate loans, including residential acquisition, development and construction (ADC) loans. The bank was wholly-owned by a one-bank holding company, American Southern Bancorp, Incorporated, with no other subsidiaries or affiliates.

Audit Results

Causes of Failure and Material Loss

American Southern failed because its Board of Directors and management materially deviated from its business plan by pursuing a strategy of growth centered in ADC lending, while excessively relying on wholesale funding sources to fund that growth. Further, American Southern management did not exercise proper oversight of the bank's significant concentrations in ADC loans. The weaknesses in American Southern's loan portfolio were accentuated by a downturn in the bank's market area. Declining earnings resulting from the deteriorating quality of loans in American Southern's ADC loan portfolio severely eroded the bank's capital. In turn, the bank's liquidity became deficient as wholesale funding sources that American Southern used to fund its asset growth were restricted.

The FDIC's Supervision of American Southern

The FDIC and GDBF provided continuous supervisory oversight of American Southern from the bank's inception in August 2005 until the bank was closed in April 2009. The FDIC's examinations and visitations of American Southern identified key concerns for attention by bank management, including the high ADC loan concentrations and dependency on volatile funding that ultimately led to the bank's failure. Also, the FDIC and GDBF pursued enforcement action in 2008 as the bank's financial condition deteriorated prior to its failure in 2009. However, more supervisory attention may have been warranted, in light of the bank's de novo status and material deviations from its business plan. Also, more aggressive supervisory follow-up to ensure the bank implemented corrective actions for examiner concerns related to ADC loan concentrations and use of brokered deposits may have mitigated, to some extent, American Southern's losses.

With respect to PCA, the FDIC properly implemented applicable PCA provisions of section 38; however, PCA's role in mitigating the losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure. The FDIC notified American Southern that it was *Adequately Capitalized* on February 6, 2009. On March 11, 2009, the FDIC informed the bank that its PCA capital category had fallen to *Critically Undercapitalized*, where it remained until the bank was closed.

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On November 30, 2009, the Director, DSC, provided a written response to the draft report.

DSC reiterated the OIG's conclusions regarding the causes of American Southern's failure. With regard to our assessment of the FDIC's supervision of American Southern, DSC's response acknowledged that stringent supervisory attention is necessary for de novo institutions and stated that the examinations, visitations, and offsite monitoring conducted on American Southern identified key concerns for management attention, including the deviation from the business plan, high concentration levels, and weak risk management practices. DSC's response also stated that DSC had recently extended its supervisory program so that de novo institutions receive a full-scope examination every year for 7 years, as opposed to 3 years, and de novo business plans are being closely monitored against approved financial projections throughout the 7-year period. Specifically, FIL-50-2009, issued in August 2009, describes the program changes for de novo institutions and warns that changes undertaken without required prior notice may subject an institution or its insiders to civil money penalties. Further, DSC has issued updated guidance reminding examiners to take appropriate supervisory action when capital levels are inadequate for CRE concentrations or funding risks are imprudently managed.

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

DATE:	December 2, 2009
MEMORANDUM TO:	Sandra L. Thompson, Director Division of Supervision and Consumer Protection
FROM:	/**Signed**/ Stephen M. Beard Assistant Inspector General for Material Loss Reviews
SUBJECT:	*Material Loss Review of American Southern Bank, Kennesaw, Georgia* (Report No. MLR-10-006)

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 American Southern Bank (American Southern), Kennesaw, Georgia. On April 24, 2009, the Georgia Department of Banking and Finance (GDBF) closed the institution and named the FDIC as receiver. On June 5, 2009, the FDIC notified the OIG that American Southern's total assets at closing were $113.4 million and the material loss to the Deposit Insurance Fund (DIF) was $41.7 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 which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); ascertains why the institution's problems resulted in a material loss to the DIF; and makes recommendations to prevent future losses.

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38 of the FDI Act. Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of terms; and Appendix 3 contains a list of acronyms used in the report. Appendix 4 contains the Corporation's comments on this report.

[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.

This report presents the FDIC OIG's analysis of American Southern's failure and the FDIC's efforts to ensure American Southern's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations, as warranted.

Background

American Southern was a state-chartered, nonmember bank established by the GDBF and insured by the FDIC effective August 30, 2005. At the time American Southern was established and received deposit insurance, the bank was designated as a "de novo" institution, indicating a newly established bank that is in its first 3 years of operation. The bank initially opened in a temporary location in Roswell, Georgia, and subsequently relocated to a permanent location in Kennesaw, Georgia, in October 2008. American Southern provided traditional banking services within its marketplace and was a full-service community bank specializing in residential and commercial real estate (CRE) loans, including residential acquisition, development, and construction (ADC) loans. The bank was wholly-owned by a one-bank holding company, American Southern Bancorp, Incorporated, with no other subsidiaries or affiliates.

Table 1 provides details on American Southern's financial condition as of December 2008, and for the 3 preceding calendar years.

Table 1: Selected Financial Information for American Southern

Financial Data	Dec 2008	Dec 2007	Dec 2006	Dec 2005
Total Assets ($000s)	$110,070	$67,575	$46,337	$24,554
Total Loans ($000s)	$64,703	$52,372	$30,192	$7,164
Total Deposits ($000s)	$102,124	$57,088	$34,490	$14,244
Total Brokered Deposits ($000s)	$52,750	$8,438	$6,988	$0
Brokered Deposits as a % of Total Deposits	51.65%	14.78%	20.26%	0%
Net Income (Loss) ($000s)	**($3,511)**	**($1,681)**	**($97)**	**($728)**

Source: Uniform Bank Performance Reports (UBPR) and Reports of Examination (ROE) for American Southern.

Causes of Failure and Material Loss

American Southern failed because its Board of Directors (BOD) and management materially deviated from its business plan by pursuing a strategy of growth centered in ADC lending, while excessively relying on wholesale funding sources to fund that growth. Further, American Southern management did not exercise proper oversight of the bank's significant concentrations in ADC loans. The weaknesses in American Southern's loan portfolio were accentuated by a downturn in the bank's market area. Declining earnings resulting from the deteriorating quality of loans in American

Southern's ADC loan portfolio severely eroded the bank's capital. In turn, the bank's liquidity became deficient as wholesale funding sources that American Southern used to fund its asset growth were restricted.

Evidence of the cause of American Southern's failure can also be seen in its adversely classified assets, which increased significantly from $1.8 million at the July 2007 examination to $14.1 million identified at the August 2008 examination. In addition, loans on which borrowers were not current with their payments reached a substantial 12.5 percent of gross loans as of the August 2008 examination and the percentage of such loans in American Southern's portfolio was significantly higher than its peer group averages in 2007, 2008, and 2009. The resulting provisions for loan and lease losses reduced net income levels and contributed to material operating losses. In addition, property taken over by the bank through loan foreclosures – referred to as other real estate owned (OREO) – had increased substantially and totaled $4.7 million at the August 2008 examination. The majority of the OREO consisted of residential lots, both undeveloped and developed.

Deviation from the Business Plan

American Southern's original business plan essentially was to maintain a low-risk profile characterized by the bank's plans to operate a traditional bank, catering to small- and medium-size businesses in its market area. Traditional banking services would be offered to the local community and no high-risk lending was planned. The bank planned to fund asset growth through traditional sources and would avoid all undue concentrations of loans to a single industry or a single type of collateral. In addition, American Southern's planned business strategy included establishing core deposits, including checking accounts, Money Market accounts, a variety of certificates of deposit (CD), and individual retirement accounts. The bank planned to avoid jumbo deposits, with its primary sources of deposits consisting of the small- to medium-sized commercial customer and the customer working or residing within the vicinity of the bank.

However, upon opening the bank, management quickly deviated from its original business plan and moved quickly to a high-risk profile involving ADC concentrations and brokered deposits. These two business strategies and their consequences are discussed in detail in the following two sections of this report.

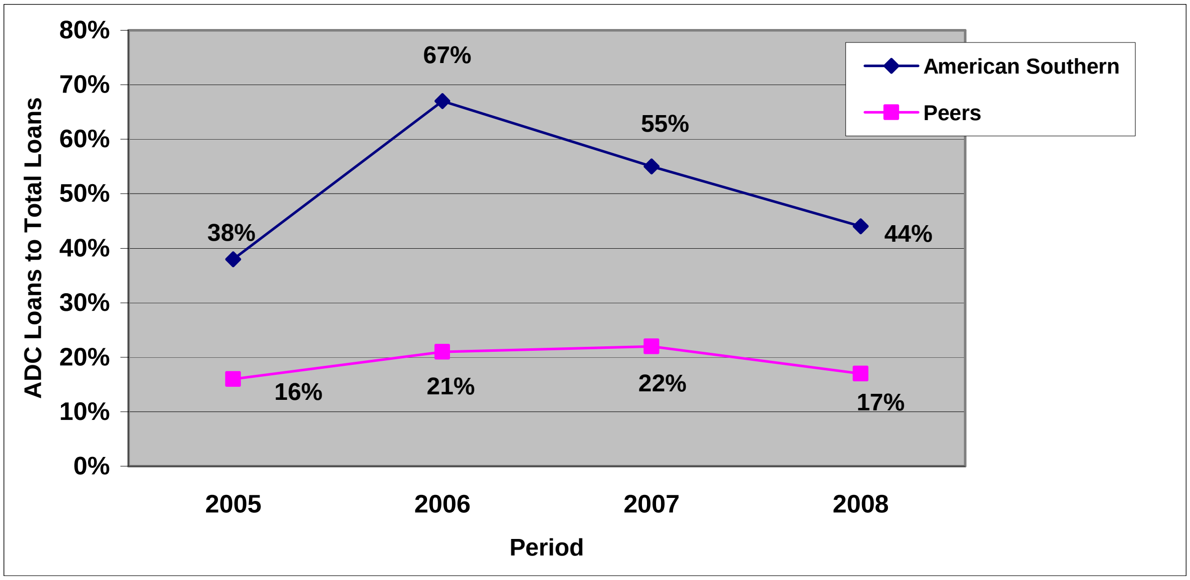
Rapid Growth in ADC Lending

American Southern's decision to concentrate in ADC loans was the principal factor leading to the bank's poor financial condition and subsequent failure. Deficient oversight of its high ADC loan concentrations negatively impacted the bank's ability to effectively manage operations in a declining economic environment.

Immediately following its establishment, American Southern pursued a strategy of rapid loan growth. From December 2005 through December 2006, the bank's loan portfolio increased 321 percent. American Southern's loan growth resulted in concentrations in

ADC loans that significantly exceeded the bank's peer group averages. As shown in Figure 1, in 2005 and 2006, the bank's ADC loans as a percentage of total loans was 2 to 3 times higher than that of its peer group.

Figure 1: American Southern's ADC Loan Concentration Compared to Peers



Source: December 2005 to 2008 UBPR data for American Southern.

According to Financial Institution Letter (FIL) 104-2006, entitled *Concentrations in Commercial Real Estate, Sound Risk Management Practices*, dated December 12, 2006, such concentrations can pose substantial potential risks and can inflict large losses on institutions. Although the guidance does not specifically limit a bank's ADC lending, the guidance provides supervisory criteria for identifying financial institutions that may have potentially significant ADC loan concentrations warranting greater supervisory scrutiny. Specifically, it states that ADC concentrations that represent 100 percent or more of the institution's total capital can pose substantial potential risk to an institution.

As shown in Table 2, in the years 2006-2008, American Southern's concentrations in ADC loans exceeded the regulatory guidance thresholds, which identified institutions that may have warranted greater supervisory scrutiny. In addition, ADC loans as a percentage of the bank's total capital were significantly above the bank's peer group averages during the same period.

Table 2: American Southern's ADC Loans as a Percentage of Total Capital

Period Ended	American Southern	Peers	American Southern Percentile
Dec 2005	26%	27%	61
Dec 2006	168%	86%	80
Dec 2007	267%	131%	85
Dec 2008	356%	130%	95

Source: UBPR data for American Southern.

FIL-104-2006 also describes a risk management framework that institutions should implement to effectively identify, measure, monitor, and control concentration risk. That framework includes effective oversight by bank management, including the BOD and senior executives; portfolio stress testing and sensitivity analysis; sound loan underwriting and administration; and portfolio management practices.

The dollar volume of American Southern’s ADC loans far exceeded the bank’s original business plan projections. Specifically, the bank originally projected that by year 3 it would have $5.3 million in such loans. However, by the August 2008 examination, 3 years after the bank was established, the actual ADC loan portfolio totaled $13.4 million (154 percent above the bank’s initial projection). Additionally, by August 2008, American Southern’s ADC loans totaled 332 percent of Tier 1 Capital, a level that was in excess of the bank’s then-internal policy limit of 250 percent for that concentration.

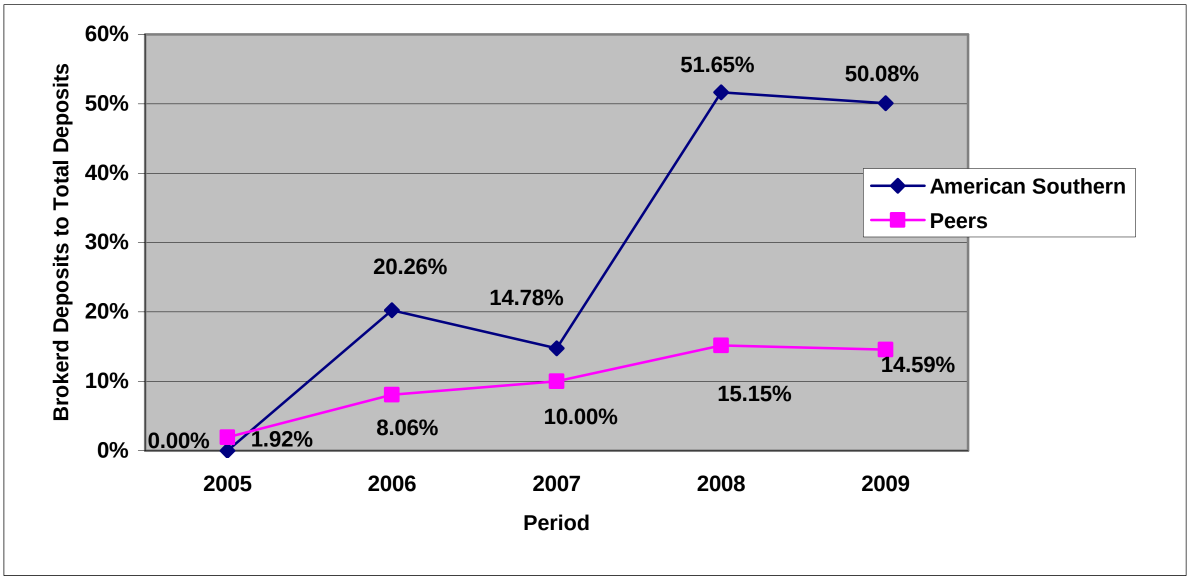
At the first full-scope examination performed by GDBF in February 2006, examiners noted that the bank had one individual concentration and that management should begin tracking and reporting concentrations to the BOD at least quarterly. At that time, American Southern had an ADC concentration of 26 percent of Tier 1 Capital. By the time the FDIC conducted its examination in August 2006, the ADC concentration had increased to 156 percent of Tier 1 Capital. The FDIC cited American Southern for violating the Order for Federal Deposit Insurance provision for materially operating outside of its business plan, which only projected an 8-percent concentration in ADC lending.

Reliance on Wholesale Funding Sources

American Southern heavily relied on wholesale sources to fund its asset growth. Starting in 2006, American Southern’s loan growth had outpaced core deposit growth, and the bank began to show an increasing reliance on non-core funds. As a result of the bank's slower-than-projected core deposit growth, a substantial volume of brokered deposits was obtained to fund ADC lending.

From December 2006 through December 2008, bank management increased brokered deposits from $6.9 million to $52.7 million. In addition, the bank held Internet and out-of-territory CDs totaling $11 million. With the exception of 2007, the bank maintained brokered deposit levels well above peer group averages, as shown in Figure 2.

Figure 2: American Southern's Brokered Deposits Compared to Peers



Source: December 2005 to March 2009 UBPR data for American Southern.

During the August 2008 examination, examiners found the bank's poor financial performance had directly affected management's access to borrowing facilities and its efforts to address the institution's strained liquidity position. The increased volume of non-performing loans and OREO decreased cash inflows at a time when American Southern still needed to fund maturing brokered deposits and existing unfunded loan commitments. According to the examiners, deposit growth lagged the bank's business plan projections, primarily due to the bank's poor location, poor visibility, and a competitive rate environment.

Two banks declined to extend credit to American Southern on an unsecured basis; rather, they required the bank to collateralize any advances with investment securities. Moreover, the Federal Home Loan Bank of Atlanta denied management's application to establish a borrowing line due, in part, to the bank's distressed financial position. Further, due to the institution's deteriorated state, management could no longer obtain brokered deposits through the Certificate of Deposit Account Registry Service (CDARS)[3] program, and maturing CDARS deposits could not be renewed. After exhausting the options outlined above, on November 14, 2008, management filed an application under the U.S. Department of the Treasury's Troubled Asset Relief Program; however, they later withdrew the application. Ultimately, absent funding, the bank failed on April 24, 2009.

[3] CDARS is a program in which depositors may attain full FDIC insurance on deposits of up to $50 million.

The FDIC's Supervision of American Southern

The FDIC's examinations and visitations of American Southern identified key concerns for attention by bank management, including the high ADC loan concentrations and dependency on volatile funding that ultimately led to the bank's failure. Also, the FDIC and GDBF pursued enforcement action in 2008 as the bank's financial condition deteriorated prior to its failure in 2009. However, more supervisory attention may have been warranted, in light of the bank's de novo status and material deviations from its business plan. Also, more aggressive supervisory follow-up to ensure the bank implemented corrective actions for examiner concerns related to ADC loan concentrations and use of brokered deposits may have mitigated, to some extent, American Southern's losses.

Supervisory History

As a de novo bank, American Southern was required to adhere to conditions[4] established by the GDBF, which granted American Southern's charter, and by the FDIC, which approved the bank's application for deposit insurance. Those conditions included, but were not limited to, operating within the parameters of the bank's business plan, obtaining annual financial statement audits, and obtaining qualified and experienced management. In addition, as a de novo institution, American Southern was subject to an increased examination frequency, with examinations during the first 3 years conducted on a 12-month schedule.

The GDBF and FDIC alternated safety and soundness examinations of American Southern, conducting four full-scope examinations from February 2006 through June 2008. In addition, the GDBF conducted a pre-opening visitation in August 2005, and three subsequent visitations between October 2005 and April 2006.[5] Also, a limited scope joint visitation was conducted prior to the closing of the bank to determine the condition of the asset quality and the level of capital.

Table 3 lists American Southern's examination and visitation dates, the entity conducting the examination, the CAMELS component and composite ratings,[6] and any supervisory action taken.

[4] Along with the submission of initial applications for deposit insurance, proposed financial institutions are expected to submit business plans that include information on a bank's business strategy and financial data for a 3-year period.

[5] Three visitations were conducted by the GDBF in October 2005, January 2006, and April 2006 to identify and assess issues related to the BOD. These visitations did not result in ratings being assigned or changed.

[6] 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.

Table 3: American Southern's Supervisory History from 2005 to 2009

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
August 24, 2005	Pre-Opening Visitation	GDBF	Not Rated	None
October 5, 2005	Visitation	GDBF	Not Rated	None
January 10, 2006	Visitation	GDBF	Not Rated	Administrative Actions
February 24, 2006	December 31, 2005	GDBF	112312/2	None
April 10, 2006	Visitation	GDBF	Not Rated	None
August 14, 2006	June 30, 2006	FDIC	112322/2	None
July 16, 2007	June 30, 2007	GDBF	112322/2	None
August 4, 2008	June 30, 2008	FDIC	444543/4	Cease and Desist Order
April 1, 2009*****	Visitation	Joint*****	555555/5	Rating Downgrade

Source: ROEs and visitations for American Southern.

***** Joint visitation conducted by the FDIC and GDBF.

January 10, 2006. The GDBF conducted an onsite visitation and made recommendations related to concerns identified at prior visitations. Specifically, the GDBF recommended that American Southern implement two administrative actions involving (1) hiring a full-time Chief Financial Officer and (2) limiting the involvement of the bank's Chairman of the Board and his son from daily involvement in the bank's operations.

February 24, 2006. The GDBF conducted the first full-scope examination and concluded that the overall condition of the bank was satisfactory. Examiners noted that management had addressed or was in the process of addressing issues identified during the two prior visitations. Earnings were found less than satisfactory; however, according to regulators, this was to be expected in a de novo bank. Asset quality was considered strong with no adversely classified assets recognized at this examination. The examination resulted in the bank being rated a composite "2."

August 14, 2006. The FDIC conducted the second full-scope examination of the bank. Again, earnings were seen as typical of a de novo bank and were less than satisfactory, and liquidity was deemed adequate. Overall, management had satisfactorily instituted formal policies and control measures. Asset quality and capital were rated strong. Examiners also noted that due to the bank's slower-than-projected core deposit growth, a substantial volume of brokered deposits had been obtained and constituted 27 percent of total deposits. These deposits, along with other deposits, had been used to fund ADC lending, which amounted to 74 percent of gross loans. According to examiners, the actual concentration of ADC lending constituted a material change from the pre-opening business plan that projected only 8 percent of total loans as ADC; however, no prior notification from management was given to the regulators regarding the change in the plan. The bank's overall condition was found to be satisfactory and the bank was rated a composite "2."

July 16, 2007. The GDBF conducted the third full-scope examination. The overall condition of the bank was considered satisfactory. Asset quality and capital levels were considered strong. Examiners found that the bank's earnings continued to improve and the bank had a moderate reliance on non-core funding sources to fund strong asset growth, while the bank's sensitivity to market risk remained adequately monitored. Management, loan underwriting, and credit administration were considered satisfactory. In addition, the bank was operating under a new business plan that the GDBF had approved through the issuance of a *Non-Objection Letter* dated January 17, 2007. As a result of the examination findings, the bank was assigned an examination rating of a composite "2."

August 4, 2008. The FDIC conducted the final full-scope examination of the bank. The overall condition of the bank had deteriorated significantly since the previous GDBF examination due to losses in the ADC loan portfolio, combined with the downturn in the Atlanta real estate market. Earnings performance was critically deficient because of high non-performing asset levels, substantial loan loss reserve provisions, and elevated funding costs. Examiners noted that bank management's decision to increase ADC lending, coupled with its inability to properly oversee the expansion of the ADC loan portfolio, was primarily responsible for the decline in asset quality. Poor financial performance had directly affected management's access to borrowing facilities, which impacted efforts to address the institution's strained liquidity position. As a result of the examination findings, the bank was downgraded to a composite "4."

During a March 11, 2009 meeting, the BOD was presented with a copy of a proposed Cease and Desist Order (C&D) resulting from the FDIC's August 4, 2008 examination. The bank was formally notified of the proposed C&D on December 11, 2008. On March 19, 2009, bank management agreed to the C&D. The C&D contained provisions that addressed management, capital, liquidity, asset quality, earnings, reserves, information technology, and brokered deposits. The C&D remained outstanding until the institution closed.

April 1, 2009. The FDIC and the GDBF conducted a targeted visitation to assess capital and the bank's allowance for loan and lease losses. Examiners confirmed that the bank was *Critically Undercapitalized*. Based on the findings of the interim visitation, the bank's CAMELS rating was downgraded to a composite "5." Due to the bank's failure to raise additional capital, American Southern was closed on April 24, 2009.

Supervisory Attention Given to American Southern's Adherence to Its Business Plan

As referenced earlier, American Southern continually and materially deviated from its original and revised business plans by quickly and consistently exceeding ADC loan growth projections and obtaining substantial amounts of brokered deposits to fund the ADC loan growth. In January 2007, American Southern submitted, and the regulators approved, a revised business plan that contained updated financial projections for the bank. However, the revised plan also included potentially risky practices related to the types and acceptable levels of ADC loans and the use of brokered deposits.

Proposed financial institutions are expected to submit business plans with their initial applications for federal deposit insurance. According to the *FDIC Statement of Policy on Applications for Deposit Insurance*, and consistent with sections 5 and 6 of the FDI Act, the FDIC must be assured that the proposed institution does not present an undue risk to the DIF. The FDIC expects that proposed institutions will submit a business plan commensurate with the capabilities of its management and the financial commitment of the incorporators. Any significant deviation from the business plan within the first 3 years of operation – the de novo phase – as required by the FDIC's Final Order for Deposit Insurance must be reported by the insured depository institution to the primary federal regulator 60 days before consummation of the change.[7]

DSC's *Risk Management Manual of Examination Policies* (Examination Manual) states that examiners should review and evaluate current business plans and any changes to the plan since the previous examination. The August 2006 through August 2008 examination analyses of American Southern's compliance with its business plans identified that the deposit growth had lagged pre-opening projections. Also, ADC loans dominated the loan function and exceeded the original business plan, which projected ADC loans would be 8 percent of total loans. By year end 2006, ADC loans represented 67 percent of total loans. In addition, although the original business plan did not specify brokered deposit limits, the bank had obtained a substantial volume of brokered deposits. In fact, they represented 27 percent of total deposits. According to examiners, although bank management had provided no prior notification to the regulators, the bank's ADC concentrations and use of brokered deposits constituted a material change from the pre-opening business plan.

American Southern requested approval from the GDBF and FDIC of a revised business plan in January 2007. The proposed revisions included, but were not limited to, the following:

- ADC lending was added to the revised business plan as a desirable loan type, and a CRE concentration range of 400 percent to 500 percent of the bank's capital was added. In addition, the plan was revised to allow construction loans to be made on a contract (pre-sold) or speculative basis.

- The bank's use of brokered deposits was added with limits of 75 percent to 80 percent of the bank's total deposits. Further, the revised plan stated that if management was unable to fund the bank's loan demand using core deposits, management would rely on jumbo and brokered deposits until such time as sufficient core deposits could be raised to support loan demand.

According to the regulators, the proposed revisions were reasonable, given the level of competition in the Roswell area and the experience of the bank management team in the

[7] On August 28, 2009, the FDIC issued FIL-50-2009, entitled *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*. Notably, the FIL extended the de novo period to 7 years for examinations, capital, and other requirements. In addition, material changes in business plans for newly insured institutions would require prior FDIC approval during the first 7 years of operation.

proposed market. However, during the review of the revised business plan, the regulators expressed concern that although the 3-year projections were not unreasonable, they seemed optimistic.

On January 17, 2007, the GDBF informed the bank that it had no objections to the revisions as submitted, after being advised by the FDIC that it had no objection to the revised plan. The only condition the FDIC added was that the bank should ensure it maintained a Tier 1 Leverage Capital ratio of at least 8 percent for its first 3 years of operation.

Prior to the failure of American Southern, the FDIC had not issued guidance to examiners that defined what would constitute a major change or deviation in a business plan. However, in conjunction with the issuance of FIL-50-2009, the FDIC issued internal guidance to its examiners, which noted that examiner judgment is critical in determining a major change or material deviation in the business plan. The internal guidance also specified selected circumstances – such as a bank entering into a new line of business – that would be considered a major change or deviation in a business plan.

Consideration of Risk Presented by ADC Concentrations

American Southern's rapid growth in ADC lending consistently exceeded supervisory guidelines and resulted in a high-risk profile for the institution. This was particularly true given its de novo status. This high-risk profile, however, did not result in elevated supervisory concern or actions early enough to sufficiently mitigate American Southern's vulnerability to substantial losses.

Onsite examinations of American Southern identified concerns related to the bank's ADC lending that could have resulted in elevated supervisory concern by the FDIC. As early as 2006, up through 2008, the bank's ROEs warned that guidelines were necessary for the proper management of the inherent risk associated with concentrations of credit. Throughout this period, ROEs noted the continued increase in concentrations of ADC loans, increasing trends in adversely classified assets, and increasing amounts of nonperforming loans and OREO. In addition, the ROEs noted that the bank's risk management policies and practices for the credit function needed improvements, to include:

- Establishing policy limits and risk tolerance levels for ADC lending,
- Tracking and reporting concentrations to the BOD,
- Preparing detailed loan-aging reports, and
- Identifying exposures by borrower and property location.

Also, according to examiners, the bank's failure to require up-front cash equity, and its neglect in performing global cash flow analyses and verifying the liquid assets of some borrowers, contributed to the deterioration within the loan portfolio.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized. With respect to PCA, the FDIC properly implemented applicable PCA provisions of section 38; however, PCA's role in mitigating the losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure.

On February 6, 2009, the FDIC sent American Southern a Notification of Capital Category informing the bank that based on the bank's December 31, 2008 Consolidated Reports of Condition and Income (Call Report), the capital ratios indicated that the bank had become less than *Well Capitalized*, and was considered *Adequately Capitalized*. As a result of its *Adequately Capitalized* status, American Southern was prohibited from accepting, renewing, or rolling over brokered deposits unless it applied for and was approved for a waiver.

On March 11, 2009, the FDIC sent the bank's BOD a second Notification of Capital Category informing the bank that, based on the results of a bank-initiated external loan review, the bank's loan loss provision of approximately $8 million would exceed the bank's capital account by approximately $1.7 million. According to the FDIC, a significant portion of the $8 million provision was associated with the actions of one bank official that "masked" the condition of the loan portfolio. As a result, the bank was considered *Critically Undercapitalized*. The bank was informed that, effective immediately, it would be subject to restrictions on asset growth, dividends, other capital disbursements, and management fees. The bank was also restricted from entering into any material transaction other than in the usual course of business, including any investment, expansion, acquisition, or sale of assets. In addition, the bank was required to file a written capital restoration plan with the Regional Director within 30 days of the date of receipt of the notification letter. Also, the bank was reminded that it was restricted from accepting, renewing, or rolling over any brokered deposits.

The FDIC and GDBF conducted an interim visitation on April 1, 2009 and confirmed that the bank was *Critically Undercapitalized*. The bank's composite rating was downgraded to "5." According to the bank's March 31, 2009 Call Report data, American Southern's capital ratios were as follows:

Tier 1 Leverage Capital	-0.37 percent
Tier 1 Risk-Based Capital	-0.47 percent
Total Risk-Based Capital	-0.47 percent.

Such negative ratios were far below those of an institution that is considered *Significantly Undercapitalized*, clearly placing American Southern in the *Critically Undercapitalized* capital category. On April 24, 2009, the GDBF closed American Southern and the FDIC was appointed receiver.

Corporation Comments

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On November 30, 2009, 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 American Southern's failure. With regard to our assessment of the FDIC's supervision of American Southern, DSC's response acknowledged that stringent supervisory attention is necessary for de novo institutions and stated that the examinations, visitations, and offsite monitoring conducted on American Southern identified key concerns for management attention, including the deviation from the business plan, high concentration levels, and weak risk management practices. DSC's response also stated that DSC had recently extended its supervisory program so that de novo institutions receive a full-scope examination every year for 7 years, as opposed to 3 years, and de novo business plans are being closely monitored against approved financial projections throughout the 7-year period. Specifically, FIL-50-2009, issued in August 2009, describes the program changes for de novo institutions and warns that changes undertaken without required prior notice may subject an institution or its insiders to civil money penalties. Further, DSC has issued updated guidance reminding examiners to take appropriate supervisory action when capital levels are inadequate for CRE concentrations or funding risks are imprudently managed.

Objectives, Scope, and Methodology

Objectives

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

Our audit objectives were to (1) determine the causes of the 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 June 15, 2009 to October 23, 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of American Southern's operations from August 30, 2005 until its failure on April 24, 2009. 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 ROEs prepared by the FDIC and the GDBF examiners from February 24, 2006 to August 4, 2008.

- Reviewed the following:

  - Bank data and correspondence maintained at the FDIC's Atlanta Regional Office (ARO) and Atlanta Field Office (AFO).

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed available bank records maintained by DRR in Dallas, Texas, for information that would provide insight into the bank's failure.

  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:
    - DSC management in Washington, D.C., and the ARO.
    - DRR officials from the Dallas Regional Office.
    - FDIC examiners from the ARO and AFO who participated in examinations or reviews of examinations of American Southern.
- Met with officials from the GDBF to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

We performed the audit field work at the DSC offices in Atlanta, Georgia.

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 American Southern'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. 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.

Appendix 2

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of loan.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
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 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 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

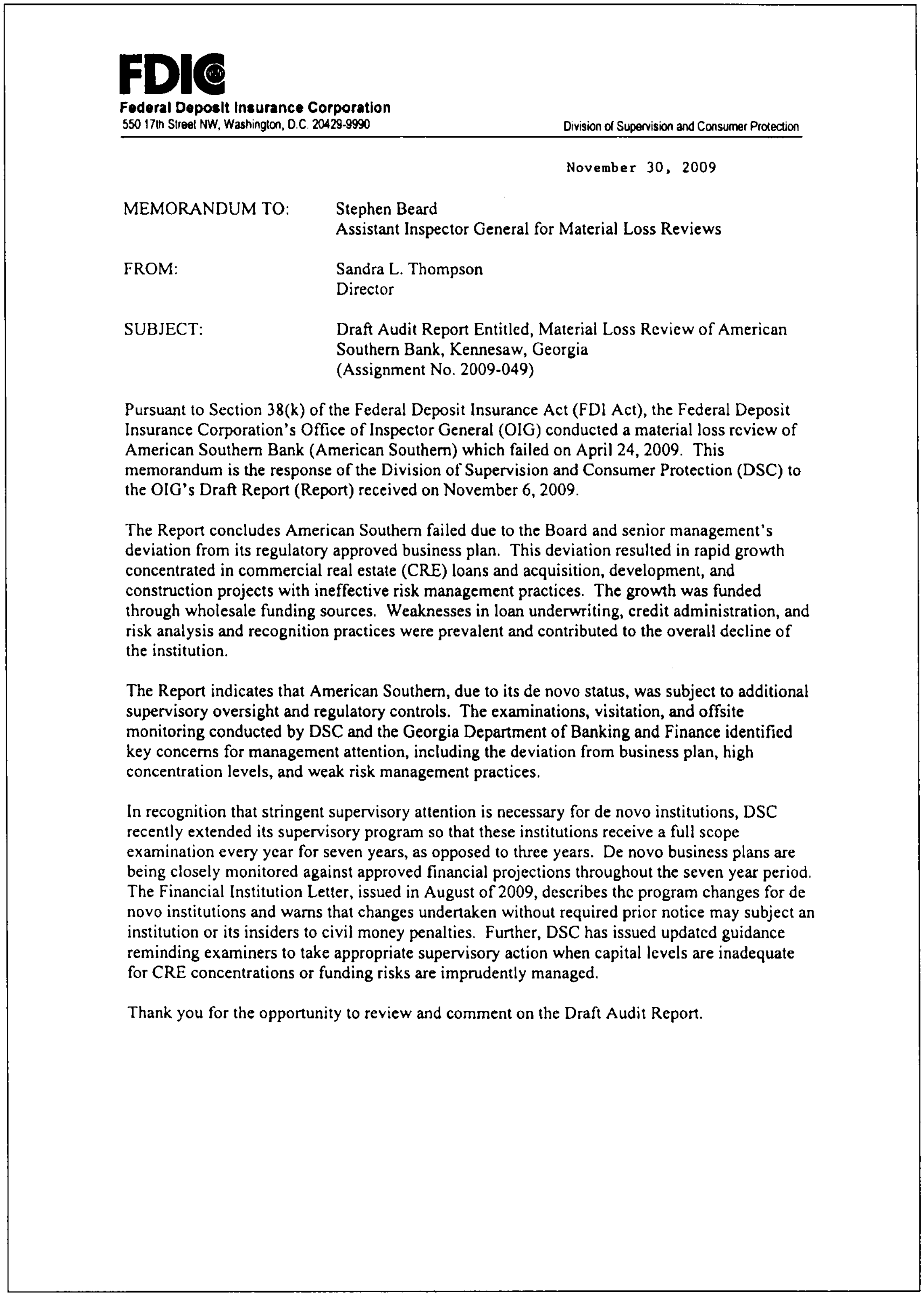
Appendix 3

Acronyms

ADC	Acquisition, Development, and Construction
AFO	Atlanta Field Office
ARO	Atlanta Regional Office
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
CDARS	Certificate of Deposit Account Registry Service
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
GDBF	Georgia Department of Banking and Finance
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Appendix 4

Corporation Comments



FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

November 30, 2009

MEMORANDUM TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of American Southern Bank, Kennesaw, Georgia
(Assignment No. 2009-049)

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 American Southern Bank (American Southern) which failed on April 24, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on November 6, 2009.

The Report concludes American Southern failed due to the Board and senior management's deviation from its regulatory approved business plan. This deviation resulted in rapid growth concentrated in commercial real estate (CRE) loans and acquisition, development, and construction projects with ineffective risk management practices. The growth was funded through wholesale funding sources. Weaknesses in loan underwriting, credit administration, and risk analysis and recognition practices were prevalent and contributed to the overall decline of the institution.

The Report indicates that American Southern, due to its de novo status, was subject to additional supervisory oversight and regulatory controls. The examinations, visitation, and offsite monitoring conducted by DSC and the Georgia Department of Banking and Finance identified key concerns for management attention, including the deviation from business plan, high concentration levels, and weak risk management practices.

In recognition that stringent supervisory attention is necessary for de novo institutions, DSC recently extended its supervisory program so that these institutions receive a full scope examination every year for seven years, as opposed to three years. De novo business plans are being closely monitored against approved financial projections throughout the seven year period. The Financial Institution Letter, issued in August of 2009, describes the program changes for de novo institutions and warns that changes undertaken without required prior notice may subject an institution or its insiders to civil money penalties. Further, DSC has issued updated guidance reminding examiners to take appropriate supervisory action when capital levels are inadequate for CRE concentrations or funding risks are imprudently managed.

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