



Office of Inspector General

September 2009
Report No. AUD-09-028

**Material Loss Review of Freedom Bank
of Georgia, Commerce, Georgia**

AUDIT REPORT





Federal Deposit Insurance Corporation

Material Loss Review of Freedom Bank of Georgia, Commerce, Georgia

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Freedom Bank of Georgia (Freedom), Commerce, Georgia. On March 6, 2009, the Georgia Department of Banking and Finance (GDBF) closed Freedom and named the FDIC as receiver. On March 20, 2009, the FDIC notified the OIG that Freedom's total assets at closing were \$176.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was \$36.2 million. Since that time, the loss has decreased to \$35.8 million.

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

Freedom was a state-chartered nonmember bank insured on February 17, 2004. As a de novo bank for its first 3 years in operation, Freedom was subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency. Freedom engaged principally in traditional banking activities within its local marketplace, which experienced a significant economic downturn starting in 2007. At closing, Freedom had three branch offices and was wholly owned by a one-bank holding company. Freedom had no subsidiaries or affiliates.

Audit Results

CAUSES OF FAILURE AND MATERIAL LOSS

Freedom failed primarily due to the bank's rapid growth and the Board of Directors' failure to ensure that bank management identified, measured, monitored, and controlled the risk associated with the institution's lending activities. Specifically, bank management materially deviated from its business plan and did not properly oversee the bank's significant concentrations in residential real estate construction and development. In addition, loan underwriting, credit administration, and other risk management practices were inadequate.

Declining earnings resulting from the deteriorating quality of loans in Freedom's concentrations, coupled with the economic downturn in the bank's market area, severely eroded the bank's capital. The bank's liquidity became deficient and the availability of wholesale funding sources that Freedom used to fund its asset growth was restricted. The GDBF ultimately closed Freedom due to the bank's capital position and inability to meet liquidity needs. The resulting loss to the DIF is now estimated at \$35.8 million.

OVERVIEW AND ASSESSMENT OF FDIC SUPERVISION

As a de novo bank, Freedom was subject to additional supervisory oversight and regulatory controls, such as adherence to conditions established by the GDBF, which granted Freedom's charter, and by the FDIC, which approved the bank's application for deposit insurance. Those conditions included operating within the parameters of the bank's business plan and obtaining annual financial statement audits. In addition, Freedom was subject to an increased examination frequency with examinations during the first 3 years conducted on a 12-month schedule rather than every 18 months.

The FDIC's examinations and off-site review identified key concerns for attention by bank management, including the high concentration levels and weak risk management practices that ultimately led to the bank's failure. Together with the GDBF, the FDIC pursued enforcement action in 2008 as the bank's financial condition deteriorated prior to failure in 2009. However, more supervisory attention may have been warranted, in light of the bank's de novo status, deviation from its business plan, and significant CRE/ADC concentrations, at earlier examinations and as a result of off-site reviews. In addition, more aggressive supervisory follow-up to ensure the bank implemented recommendations related to ADC loan concentrations, loan underwriting, and credit administration practices may have mitigated, to some extent, Freedom's losses.

Background (cont.)

Freedom's assets consisted principally of commercial real estate (CRE) loans, including a significant concentration in residential acquisition, development, and construction (ADC) loans.

Audit Results (cont.)

With regard to PCA, on November 7, 2008, the FDIC informed Freedom, as required by the Act, that the bank's Total Risk-Based Capital had fallen below 8 percent as of September 30, 2008, which placed the bank in the *Undercapitalized* category. The bank took several measures to preserve capital and worked for several months seeking capital injections but with minimal success. The FDIC's Atlanta Regional Office also received a Troubled Asset Relief Program application from Freedom Bancshares, Inc., the holding company for the bank in November 2008. The application was subsequently withdrawn by the holding company in early December 2008.

On December 17, 2008, the GDBF, in consultation with the FDIC, issued a Cease and Desist Order (C&D) that required Freedom to take several actions aimed at raising the bank's capital to acceptable levels. Freedom was unable to raise the additional capital required by the C&D. On February 25, 2009, the FDIC issued a letter to the bank notifying the BOD that the bank was *Critically Undercapitalized*, and GDBF closed the bank on March 6, 2009.

Management Response

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC reiterated the OIG conclusions regarding the causes of Freedom's failure and the resulting material loss to the DIF and supervisory activities related to Freedom. DSC also acknowledged the need for more stringent supervisory attention for de novo institutions. DSC further noted that the FDIC recently extended the de novo period from the current 3-year period to 7 years for examinations, capital, and other requirements, and that material changes in business plans for newly insured institutions will require prior FDIC approval during the first 7 years of operation.

BACKGROUND	2
CAUSES OF FAILURE AND MATERIAL LOSS	2
Asset Growth	3
CRE/ADC Concentrations	4
Risk Management Practices	5
Key Risk Management Practices Related to Concentrations	5
Loan Underwriting and Credit Administration Practices	6
Adversely Classified Assets and Allowance for Loan and Lease Losses	7
Reliance on Wholesale Funding Sources and Liquidity Management	8
Wholesale Funding Sources	8
Contingency Liquidity Planning	9
OVERVIEW AND ASSESSMENT OF FDIC SUPERVISION	10
Overview of FDIC Supervision	10
OIG Assessment of FDIC Supervision	13
Consideration of Risk Presented by CRE/ADC Concentrations	13
Revision and Adherence to the Business Plan	15
Off-site Monitoring	17
Volatile Liability Dependence	19
Contingency Liquidity Plan	20
IMPLEMENTATION OF PCA	20
CORPORATION COMMENTS	22
APPENDICES	
1. OBJECTIVES, SCOPE, AND METHODOLOGY	23
2. GLOSSARY OF TERMS	25
3. CORPORATION COMMENTS	26
4. ACRONYMS USED IN THE REPORT	27
TABLES	
1. Financial Condition of Freedom	2
2. CRE/ADC Concentrations to Total Capital Compared to Peer	4
3. Freedom's Non-Core Funding Sources and Net Non-Core Funding Dependence Ratios	9
4. Freedom's Examination History	11
5. Results of the FDIC's Off-site Review of Freedom	18
6. Probability of Downgrades in Component and Composite Ratings	19
7. Freedom's Capital Ratios Compared to Peer	21
FIGURES	
1. Freedom's Growth Compared to Its Business Plans	3
2. Freedom's Asset Growth Compared to Peer	4



DATE: September 18, 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 Freedom Bank of Georgia,
Commerce, Georgia (Report No. Aud-09-028)*

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss¹ review of the failure of Freedom Bank of Georgia (Freedom), Commerce, Georgia. On March 6, 2009, the Georgia Department of Banking and Finance (GDBF) closed the institution and named the FDIC as receiver. On March 20, 2009, the FDIC notified the OIG that Freedom's total assets at closing were \$176.4 million and the material loss to the Deposit Insurance Fund (DIF) was \$36.2 million. Since that time, the loss decreased to \$35.8 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency 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 supervision² 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

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.

contains a glossary of terms; Appendix 4 contains a list of acronyms used in the report.

This report presents the FDIC OIG's analysis of Freedom's failure and the FDIC's efforts to ensure Freedom'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

Freedom was a state-chartered non-member bank, established by the GDBF and insured by the FDIC effective February 17, 2004. Freedom, which was headquartered in Commerce, Georgia:

- operated a main office in Commerce, Georgia, and three branches in Jefferson, Homer, and Winder, Georgia;
- was a full-service community bank specializing in residential and commercial real estate loans (CRE), including residential acquisition, development, and construction (ADC) loans;
- provided traditional banking services within its marketplace; and
- was wholly-owned by a one-bank holding company, Freedom Bancshares, Incorporated, in Commerce, Georgia, with no other subsidiaries or affiliates.

A summary of Freedom's total assets, deposits, loans, and net income or loss, as of December 2008, and for the 4 preceding calendar years follow in Table 1.

Table 1: Financial Condition of Freedom

	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets (\$000s)	\$172,454	\$147,114	\$132,536	\$82,513	\$50,305
Total Deposits (\$000)	\$159,048	\$115,783	\$104,520	\$66,847	\$39,935
Total Loans (\$000s)	\$106,212	\$118,288	\$102,792	\$60,778	\$34,849
Net Income (Loss) (\$000s)	(8,950)	305	646	617	(1,045)

Source: Uniform Bank Performance Reports (UBPR) for Freedom.

CAUSES OF FAILURE AND MATERIAL LOSS

Freedom failed primarily due to the bank's rapid growth and the Board of Directors' (BOD) failure to ensure that bank management identified, measured, monitored, and controlled the risk associated with the institution's lending activities. Specifically, bank management materially deviated from its business plan and did not exercise proper oversight over the bank's significant concentrations in residential real estate construction and development. In addition, loan underwriting, credit administration, and other risk

management practices were inadequate. Deficient oversight of high concentrations, coupled with weak risk management practices and controls, negatively impacted the bank's ability to effectively manage operations in a declining economic environment.

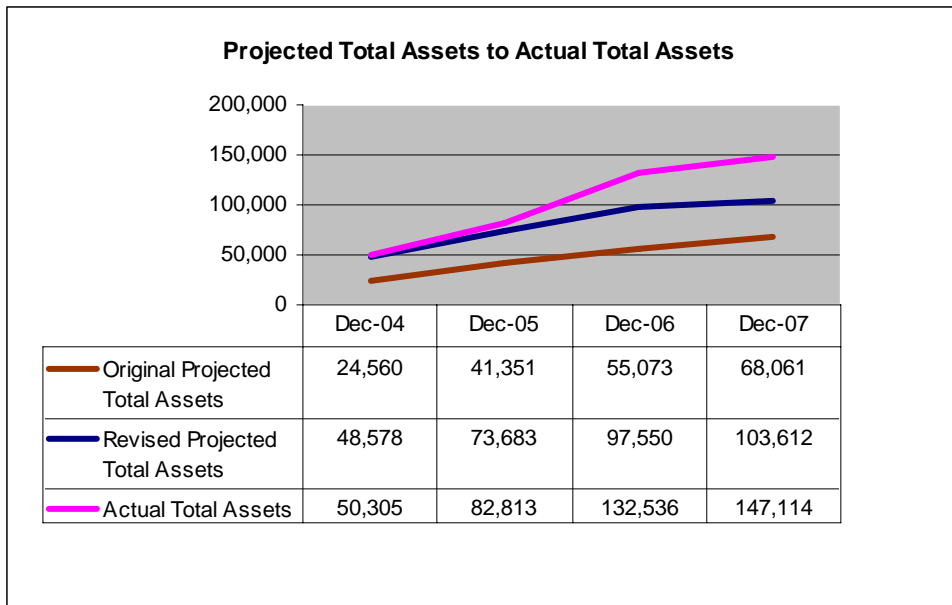
The weaknesses in Freedom's loan portfolio were accentuated by a downturn in the bank's market area. Declining earnings resulting from the deteriorating quality of loans in Freedom's concentrations, in the face of an economic downturn, severely eroded the bank's capital. In turn, the bank's liquidity became deficient considering the level of risk exposure to the bank's capital and earnings; and the wholesale funding sources that Freedom used to fund its asset growth were restricted. The GDBF ultimately closed Freedom due to the bank's capital position and inability to meet liquidity needs. The resulting loss to the DIF at closing was estimated at \$35.8 million.

Asset Growth

The rate of Freedom's asset growth, which included concentrations in CRE/ADC loans, quickly and significantly exceeded the bank's projected growth included in Freedom's original business plan that the FDIC had approved. More specifically, Freedom's original business plan projected that assets at the end of the bank's first year would total \$24.6 million and would be comprised primarily of CRE/ADC loans. In October 2004, Freedom revised its business plan to update the bank's financial projections. The revised plan, approved by the FDIC, projected even greater growth.

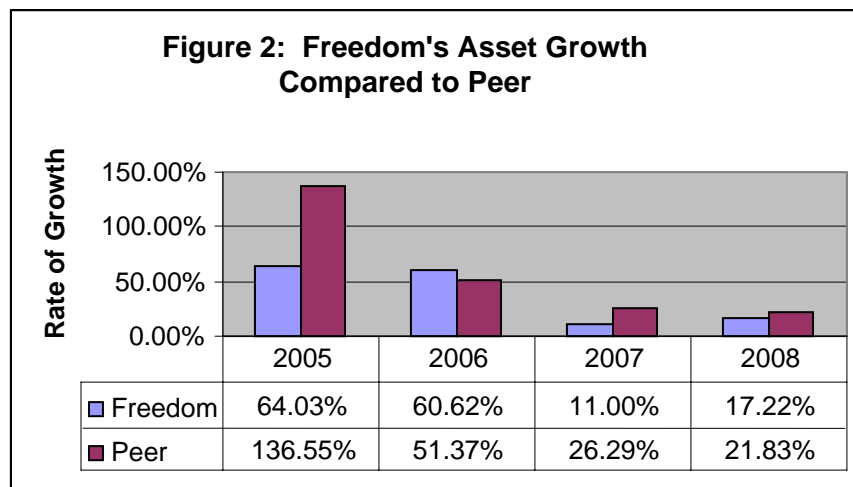
As shown in Figure 1 below, Freedom consistently and significantly exceeded the asset growth projections included in the bank's original business plan. Figure 1 also shows that the bank's actual growth during calendar years 2006 and 2007 significantly exceeded the asset growth projections in Freedom's revised business plan.

Figure 1: Freedom's Growth Compared to Its Business Plans



Source: Freedom's Original and Revised Business Plans and UBPRs.

Although Freedom's growth consistently exceeded the bank's projections, the bank's rate of asset growth was generally less than the bank's peer group,³ as indicated below in Figure 2.



Source: UBPRs for Freedom.

CRE/ADC Concentrations

Freedom developed and maintained a high concentration in CRE/ADC loans. As shown in Table 2, the bank's concentrations in CRE/ADC loans, as a percent of the bank's total capital, were significantly above the bank's peer group averages from 2004 through 2008.

Table 2: CRE/ADC Concentrations to Total Capital Compared to Peer

Period Ended	CRE		ADC	
	Freedom	Peer	Freedom	Peer
	Percent of Total Capital			
Dec-04	370.84	77.05	147.19	22.00
Dec-05	365.49	199.74	162.90	73.29
Dec-06	688.37	301.84	380.99	119.79
Dec-07	707.61	365.00	427.64	139.80
Dec-08	1,368.21	409.58	709.71	139.65

Source: UBPRs for Freedom.

According to 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 CRE lending, the guidance provides the

³ Commercial banks are assigned to one of 15 peer groups based on asset size, number of branches, and whether the bank is located in a metropolitan or non-metropolitan area. In addition, de novo banks are grouped by the year of opening with other de novo banks for a period of 5 years subject to the asset limitation. Each de novo peer group is described by its year, e.g., 2002, 2003, 2004, 2005, or 2006. Freedom's peer group included institutions with assets less than \$750 million established in 2004.

following supervisory criteria for identifying financial institutions that may have potentially significant CRE loan concentrations warranting greater supervisory scrutiny:

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

FIL-104-2006 describes a risk management framework that institutions should implement to effectively identify, measure, monitor, and control CRE 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. As discussed later, Freedom's management did not establish such controls, and that proved detrimental to the bank's viability.

The GDBF's June 2008 examination indicated that Freedom's concentrations in ADC loans totaled 413.39 percent of total capital as of March 31, 2008, more than four times the supervisory criteria identifying banks that may have potentially significant ADC concentrations warranting greater supervisory scrutiny. The ROE also noted that this level of concentrations highly exposed the bank's earnings and capital to adverse market conditions. Further, according to the GDBF, while the bank historically maintained a high level of concentrations in ADC lending, Freedom did not take action to improve identification, measurement, monitoring, and controls of concentration risks.

Risk Management Practices

Freedom management did not: (1) develop and effectively implement key risk management practices consistent with FIL-104-2006 to identify, measure, monitor, and control the risks related to the bank's CRE/ADC concentrations; (2) establish sound loan underwriting and credit administration practices, including those recommended by its external auditor and examiners; and (3) maintain a sufficient allowance for loan and lease losses (ALLL).

Key Risk Management Practices Related to Concentrations

- **BOD and Management Oversight.** Freedom's BOD did not establish sufficient policies, procedures, and risk limits for lending concentrations. For example, Freedom's loan policy required management to perform additional analysis or take appropriate actions, as CRE/ADC concentrations equaled or exceeded 300 percent of capital. However, the loan policy did not discuss what specific measures should be taken or what additional analysis should be performed to mitigate increased concentration risks.

- **Portfolio Management.** Sound portfolio management involves identifying the level of correlation between real estate sectors, such as lot development and 1-4 single family residential construction, and establishing limits to control risk exposure. In addition, contingency plans for reducing or mitigating CRE concentrations in adverse market conditions are also necessary for sound portfolio management. Freedom's management did not establish risk limits for all types of CRE and did not develop a concentration contingency plan or strategies to participate or sell portions of the CRE portfolio in adverse market conditions.
- **Portfolio Stress Testing and Sensitivity Analyses.** Freedom's management did not implement an adequate stress testing model to identify, measure, monitor, and control risk. The stress testing was only performed on some individual loans and not on the portfolio as a whole and was not adequate relative to the size, complexity, and risk characteristics in the CRE portfolio.

Loan Underwriting and Credit Administration Practices

The FDIC, GDBF, and a firm hired by Freedom identified the need for the bank to improve loan underwriting, credit administration, and, in general, controls associated with CRE/ADC concentrations. However, the bank failed to take adequate and timely action to address those concerns.

- The bank hired a firm to conduct an independent loan review in the third quarter of 2006, and the firm noted the bank's significant concentrations in CRE/ADC loans, and made recommendations to improve the bank's management practices for CRE/ADC concentrations.
- During the FDIC's February 2007 examination of Freedom, examiners reviewed 13 loan relationships that totaled \$21 million (21 percent of the total loan portfolio). Based on that review, the FDIC identified several loan underwriting and credit administration deficiencies, including: (1) the lack of global cash flow analysis,⁴ (2) financing for many of the loans at or near 100 percent of cost, (3) the need for Freedom to monitor the adequacy of collateral, and (4) the need for Freedom to prepare detailed credit memoranda to assist the loan committee in making informed decisions regarding loan commitments. In addition, the FDIC identified deficiencies with the bank's loan policy. The FDIC recommended improvements to Freedom's construction loan guidelines as well as various risk management practices associated with the bank's ADC loans.
- The GDBF 2008 examination found that Freedom's loan underwriting and credit administration practices were still in need of improvement, considering the level of risk in the bank's loan portfolio. Examiners noted that some loan files lacked current financial information; cash flow analyses were not being performed or

⁴ Global cash flow analysis generally involves the evaluation of a borrower's complete financial situation and could include reviewing the borrower's loans, other obligations, cash flow, and property information for the purpose of assessing creditworthiness.

were inadequate; appraisals were out-of-date in some files because of the deterioration in the market; and criticized and classified loans did not contain asset improvement plans, as required by the loan policy.

Freedom's failure to implement recommendations made over 3 consecutive years to improve these aspects of its operations limited the bank's ability to identify, measure, monitor, and mitigate heightened risks associated with its loan portfolio.

Adversely Classified Assets and Allowance for Loan and Lease Losses

According to the 2004 through 2007 ROEs, asset quality was rated 1 or 2, and the allowance for loan and lease losses (ALLL) was considered adequate for the risk inherent in the loan portfolio. However, the firm that conducted the independent loan review in 2006 determined that Freedom's level of adversely classified loans was increasing. In addition, the firm noted that watch grade loans had weaknesses that, if not addressed, could lead to further decline in asset quality. Among other things, the firm recommended that Freedom obtain up-to-date financial information to support repayment ability, project future cash flow using payment assumptions, and enforce repayment plans. Consistent with the 2006 independent loan review, adversely classified assets increased from less than 1 percent at the 2006 examination, to about 5 percent in 2007, and then to 18 percent of total assets in 2008. CRE/ADC loans comprised the majority of the \$27.7 million of adversely classified items, with the remaining classifications primarily attributable to other real estate owned and contingent liabilities. The \$27.7 million of adversely classified items represented 187.29 percent of the total of Freedom's Tier 1 Capital and ALLL and resulted in deficient earnings and capital. In addition, the GDBF 2008 examination concluded that Freedom's ALLL was underfunded, meaning that the allowance account did not include a reasonable estimate of the credit losses included in the loan portfolio.

At the GDBF's 2008 examination, examiners concluded that Freedom's methodology for determining its ALLL was not in compliance with FIL-105-2006, *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, dated December 13, 2006. The ALLL interagency policy states that each institution must analyze the collectibility of its loans and maintain an ALLL at a level that is appropriate and determined to be in accordance with Generally Accepted Accounting Principles (GAAP).⁵ An appropriate ALLL covers estimated loan losses on individually evaluated loans that are determined to be impaired as well as estimated loan losses inherent in the remainder of the loan and lease portfolio. The policy further indicates that management should document qualitative factors for determining estimated losses. Qualitative factors that should be considered include:

⁵ FIL-105-2006 reiterates key concepts and requirements pertaining to the ALLL included in GAAP and existing regulatory guidance. In addition, the policy describes the nature and purpose of the ALLL; the responsibilities of BODs, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound loan grading system.

- levels of and trends in delinquencies and impaired loans;
- levels of and trends in charge-offs and recoveries;
- national and local economic trends and conditions; and
- industry conditions and credit concentrations.

Freedom's methodology determined estimated losses in groups of non-impaired loans by multiplying the groups' book balances against historical loss percentages in peer group data. As a result, Freedom's methodology only addressed a few of the relevant factors listed in the policy.

Reliance on Wholesale Funding Sources and Liquidity Management

Freedom pursued a risky business strategy that included heavy reliance on wholesale funding sources to fund its asset growth concentrated in CRE/ADC loans. In addition, the bank did not develop an adequate contingency liquidity plan (CLP).

Wholesale Funding Sources

Freedom's funding structure centered on high-cost volatile funds to fund its growth, including Federal Home Loan Bank (FHLB) borrowings, time deposits of \$100,000 or greater, and Internet certificates of deposit (CD). As of March 31, 2008, Freedom's liquidity levels were low due to an increasing level of nonperforming assets, and because a significant level of deposits being held as collateral was not available as a funding source. Accordingly, the bank's ability to meet funding obligations was threatened. As Freedom's financial condition deteriorated, access to funding sources, namely FHLB advances and brokered deposits, became restricted. Further, the bank was subject to restrictions on the interest rates it could pay on other deposits, making it difficult for Freedom to attract such deposits.⁶

As shown in Table 3, for the years ended December 2004 through December 2008, Freedom was heavily dependent on high-cost, non-core volatile funding sources such as FHLB borrowings and time deposits of \$100,000 or greater. Except for 2008, Freedom consistently exceeded its peer group average for net non-core funding.

⁶As discussed later in the report, according to section 29 of the FDI Act, once an institution is determined to be undercapitalized, as defined in Part 325 of the FDIC Rules and Regulations, the institution is prohibited from receiving brokered deposits. In addition, section 38 of the FDI Act permits the FDIC to restrict the interest rates paid by a significantly undercapitalized institution.

Table 3: Freedom’s Non-Core Funding Sources and Net Non-Core Funding Dependence Ratios

Period Ended	Non-Core Funding Sources (Dollars in Thousands)		Net Non-Core Funding Dependence Ratios (Percent)		
	Time Deposits of \$100M or More	FHLB Borrowings	Freedom	Peer Group	Percentile ^a
Dec-04	\$11,979	\$3,700	27.65	(28.29)	Not applicable
Dec-05	\$23,085	\$4,500	36.19	11.30	Not applicable
Dec-06	\$42,800	\$16,000	46.87	22.73	89
Dec-07	\$45,771	\$18,500	47.01	28.50	86
Dec-08	\$71,460	\$8,000 ^b	36.99	37.18	48

Source: UBPRs for Freedom.

^a Percentile represents Freedom’s ranking within the bank’s designated peer group average, meaning that Freedom’s ratio was higher than 89 percent of the institutions in its peer group in December 2006.

^b The FHLB borrowing lines were reduced in excess of 50 percent due to a large percentage of the pledged commercial loans deemed to be nonconforming.

A bank’s net non-core funding dependence ratio indicates the degree to which the bank is relying on non-core/volatile liabilities to fund long-term earning assets. Generally, a lower ratio reflects less risk exposure, whereas higher ratios indicate greater risk exposure and a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

A heavy reliance on potentially volatile liabilities to fund asset growth is a risky business strategy because the availability and access to these funds may be limited in the event of deteriorating financial or economic conditions, and assets may need to be sold at a loss in order to fund deposit withdrawals and other liquidity needs.

The GDBF’s June 2008 examination concluded that the bank’s net non-core dependence ratio was excessive—at 44.35 percent as of March 31, 2008—indicating great risk exposure and potentially unavailable funding sources. That ratio had increased to 56.07 percent as of June 30, 2008. The GDBF June 2008 ROE stated that bank management should take immediate action to improve liquidity and funds management, including reducing the bank’s dependence on volatile funds.

Contingency Liquidity Planning

Freedom did not have a CLP that addressed, at a minimum, all sources and uses of funding, current and expected availability of any secondary sources of funding, and marketing strategies to attract core deposits. As discussed previously, when the bank’s financial condition deteriorated in 2008, various sources of funding were restricted, and bank management was not successful in obtaining sufficient liquidity for the institution.

Examiners noted that management had not developed a sources and uses of funds statement to (1) assess future liquidity needs or address the borrowers’ failure to pay and (2) indicate the effect of operating losses on liquidity. A more detailed sources and uses statement could have helped to project the liquidity position of Freedom. The GDBF

recommended in the 2008 examination that Freedom develop a written liquidity contingency plan and enhance its sources and uses of funds reporting to improve liquidity management.

According to the Examination Manual, CLPs should be in force and include strategies for handling liquidity crises and procedures for addressing cash-flow shortfalls in emergency situations. The manual also states that financial institutions should have an adequate CLP in place to manage and monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources.

OVERVIEW AND ASSESSMENT OF FDIC SUPERVISION

The FDIC's examinations and off-site review identified key concerns for attention by bank management, including the high concentration levels and weak risk management practices that ultimately led to the bank's failure. Together with the GDBF, the FDIC pursued enforcement action in 2008 as the bank's financial condition deteriorated prior to failure in 2009. However, more supervisory attention may have been warranted, in light of the bank's de novo⁷ status, material deviation from its business plan, and significant CRE/ADC concentrations at the FDIC's 2005 and 2007 examinations and after the 2007 examination during off-site reviews. In addition, more aggressive supervisory follow-up to ensure the bank implemented corrective actions for recommendations related to ADC loan concentrations, loan underwriting, and credit administration practices may have mitigated, to some extent, Freedom's losses.

Overview of FDIC Supervision

As a de novo bank, Freedom was subject to additional supervisory oversight and regulatory controls, such as adherence to conditions⁸ established by the GDBF, which granted Freedom'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 and obtaining annual financial statement audits. In addition, Freedom 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 Freedom, conducting 5 examinations from August 2004 through June 2008. Table 4 lists Freedom's examination dates, who conducted the examination, and the CAMELS component and composite ratings.

⁷ At the time Freedom was established and received deposit insurance, the designation as a "de novo" institution indicated newly established banks that were in their first 3 years of operation. The FDIC issued guidance in August 2009 extending the de novo period to 7 years.

⁸ 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. The FDIC can impose standard conditions and may include nonstandard conditions for bank operations, as deemed appropriate, in the Final Order for Deposit Insurance.

Table 4: Freedom’s Examination History

Examination Date	Examination Conducted By	CAMELS* Component and Composite Ratings
08/12/2004	GDBF	222312/2
01/31/2005	FDIC	212322/2
02/02/2006	GDBF	112312/2
02/05/2007	FDIC	212222/2
06/09/2008	GDBF	555554/5

Source: ROEs for Freedom.

* 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.

The FDIC conducted its first visitation of Freedom concurrently with the GDBF’s August 2004 examination. Although the FDIC did not make any formal recommendations, the visitation identified rapid loan growth, underwriting concerns, and large cumulative losses, which included the bank’s pre-opening expenses. The FDIC’s 2004 visitation also determined that Freedom was developing an ADC concentration that represented 73.6 percent of total capital and 23.1 percent of total loans.

In 2005 and 2006, the FDIC and GDBF, respectively, conducted examinations and determined that the bank’s overall condition was satisfactory. The FDIC’s 2005 examination noted that the bank’s ADC reporting would be enhanced to include the bank’s anticipated concentration in ADC lending. At that time, according to UBPRs and based on the FDIC’s supervisory guidelines, Freedom had already established CRE/ADC concentrations—with CRE representing 371 percent and ADC representing 147 percent of total capital, respectively. The FDIC also concluded that Freedom’s total assets and deposits were consistent with the asset and deposit projections included in the bank’s revised business plan.

The FDIC’s February 2007 examination identified and reported Freedom’s significant CRE/ADC concentrations and included recommendations to improve Freedom’s operations. These recommendations related to Freedom’s identification and monitoring of loan concentrations, loan underwriting and credit administration, and improvements needed in the bank’s risk management controls.

Between the 2007 and 2008 examinations, the FDIC’s supervisory approach was limited to off-site review activities.⁹ These efforts were conducted quarterly from March 2007 through March 2008 (except for September 2007) and noted concerns related, but not

⁹ The Off-site Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Off-site Reviews are performed quarterly for each bank that appears on the Off-site Review List. DSC’s regional office management is responsible for implementing procedures to ensure that Off-site Review findings are factored into examination schedules and other supervisory activities.

limited, to asset growth, reliance on volatile funding, and other risk factors. In response to FDIC inquiries during this time frame, Freedom's management reported that changes in the residential construction market would not have a material impact on the bank. However, bank management's assertions later proved to be incorrect.

On March 31, 2008, the FDIC completed an off-site review of the institution's December 31, 2007 Consolidated Reports of Condition and Income (Call) Report data and noted significant concentrations in ADC and CRE of 431 percent and 204 percent, respectively, and a high probability of downgrade to Freedom's CAMELS and composite ratings. In addition, the off-site review noted that the level of increasing problem assets was expected to continue in light of the market conditions. As a result of the bank's deteriorating financial condition, the GDBF accelerated the 2008 examination from the scheduled date of August 2008 to June 2008. Although ARO officials could not provide documentation indicating that the acceleration decision was based on DSC's off-site monitoring, ARO officials stated that the acceleration of the State's examination was at the very least a mutual decision by the regional office and the GDBF. The GDBF's June 2008 examination revealed that the overall condition of the institution was poor and the viability of the institution was questionable. The FDIC conducted a visitation in November 2008 to obtain an update on Freedom's liquidity status and contingency planning, as well as a summary of the FHLB findings of its onsite collateral review¹⁰ at the bank. In September 2008, the FDIC and the GDBF required Freedom to begin reporting its liquidity position until further notice. The bank's liquidity reports revealed a declining liquidity position for Freedom.

On December 17, 2008, the GDBF, in consultation with the FDIC, issued a Cease and Desist Order (C&D). The C&D required Freedom management to, among other things:

- revise its capital plan to meet the minimum capital requirements;
- revise its funds management plan and detail how the bank would restore its liquidity to an adequate level;
- review concentrations of credit to identify the level of risk and revise its written concentrations of credit plan to systematically reduce the bank's level of concentration risk; and
- review the adequacy of the ALLL and improve its policy for determining the adequacy of the ALLL.

On March 6, 2009, the GDBF closed Freedom because of its severely deteriorated financial condition and inability to raise additional capital and appointed the FDIC as receiver of the bank.

¹⁰ The FHLB conducted an onsite review to check the bank's pledged loan files for conformity with the FHLB's pledging agreement between itself and Freedom.

OIG Assessment of FDIC Supervision

The FDIC and GDBF conducted regular examinations of Freedom and reported issues that led to the bank's ultimate failure. However, more aggressive or timelier supervisory actions could have been taken based on the risk presented by the bank's (1) CRE/ADC concentrations, including those identified through off-site review; (2) material deviations from its business plan; (3) dependence on volatile funding; and (4) inadequate contingency liquidity plan.

Consideration of Risk Presented by CRE/ADC Concentrations. Freedom's rapid growth and CRE/ADC concentrations resulted in a high-risk profile for the institution—particularly given its de novo status—and consistently exceeded supervisory guidelines. This high-risk profile, however, did not result in elevated supervisory concern or actions early enough to sufficiently mitigate Freedom's vulnerability to substantial losses.

Supervisory guidance, risk factors, and supervisory monitoring that should have resulted in elevated supervision by the FDIC include the following.

- In 2003, the DSC Atlanta Regional Office (ARO) conducted a CRE Review Project that included institutions exhibiting significant levels of CRE concentration (more than 300 percent of Tier 1 Capital)—a level that, according to the FDIC, traditionally represented a relatively high concentration of CRE loans and increased risk to the bank. Freedom's level of concentrations consistently and significantly exceeded that level as early as December 2004.

The CRE review (1) confirmed the need for bank management to develop and implement lending programs that incorporate certain key components; (2) concluded that a sound CRE lending program begins with BOD and senior management direction and oversight; and (3) stated that developing and adhering to a comprehensive loan policy that establishes clear and measurable standards for production, underwriting, diversification, risk review, reporting, and monitoring was critical.

- In November 2004, Freedom submitted, and the FDIC approved, a revised business plan with updated financial projections for the bank. Freedom materially deviated from its original and revised business plan by quickly and consistently exceeding asset growth projections. (We discuss Freedom's business plan and the supervisory coverage the plan was provided in more detail in the next section of this report.)
- At the January 2005 FDIC examination, bank management indicated that the ADC reporting would be modified to include Freedom's anticipated concentration in ADC lending. However, according to the Freedom's December 31, 2004 UBPR, the bank had already established a concentration in CRE and ADC loans of 371 percent and 147 percent, respectively. These levels significantly exceeded those of the bank's peer group. However, the FDIC rated asset quality a "1" at

the January 2005 examination, indicating that (1) Freedom had strong asset quality and credit administration practices, (2) identified weaknesses were minor in nature, (3) risk exposure was modest in relation to capital protection and management's abilities, and (4) asset quality was of minimal supervisory concern.

- As a de novo bank, Freedom established and maintained significant levels of higher-risk CRE/ADC loans. Freedom exhibited risk factors reported in DSC's *2004 De novo Bank Study*,¹¹ which concluded that de novo institutions frequently exhibit factors that present significant risks, including, but not limited to (1) weak oversight by the BOD; (2) rapid asset growth, including CRE/ADC loans; (3) dependence on non-core deposits to fund asset growth; and (4) departure from the business plan by exceeding projected asset growth.
- The FDIC's pre-examination planning (PEP) memorandum for the February 2007 examination noted various issues that presented elevated concern. Among other things, the memorandum reported that Freedom's:
 - asset level was more than double the bank's original third-year projected level;
 - concentration in ADC loans was significant, representing 420 percent of Tier 1 Capital as of December 31, 2006—this level was more than four times the supervisory guidelines;
 - continued and rapid loan growth was 69 percent over the past year's growth rate, and was primarily in ADC loans with a continued focus on construction and development loans;
 - past due loans had increased from .04 percent to 2.04 percent and that the ratio remained manageable;
 - Real Estate Stress Test (REST)¹² score was 5—indicating the highest level of exposure to potential market deterioration—due to concentration in ADC loans;
 - watch list reflected significant increases in adversely classified assets but the adversely classified items coverage ratio was minimal at 6.79 percent.

The memorandum also noted that Freedom planned to raise \$4 million in additional capital in the first quarter of 2007 to support asset growth centered in

¹¹ The DSC Atlanta Region led an interregional study of de novo financial institutions in fulfillment of a DSC 2004 business line objective. The purpose of the study was to review the timing of, and susceptibility to, problems of de novo financial institutions and to determine important factors in the application process that would aid in the efficient supervision of new banks. The study also provided information on "young" banks, which are banks in the fourth through ninth years of operation. The FDIC's Division of Insurance and Research and Legal Division also participated in the study.

¹² REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. The primary risk factor is the ratio of construction and development loans to total assets. Other risk factors include the percentage of CRE loans, percentage of multifamily loans, percentage of commercial and industrial loans, and high non-core funding and rapid asset growth. A bank with a high concentration in construction and development loans, coupled with rapid asset growth, would appear to be riskier than a bank with similar concentrations but low asset growth. REST uses statistical techniques and Call Report data to forecast an institution's condition over a 3- to 5-year period and provides a single rating from 1 to 5 in descending order of performance quality.

ADC loans, earnings were moderately ahead of original projected levels, and the bank's net income was higher than the original third year projection.

It was apparent from the 2007 ROE that examiners conducted procedures to address the issues in the PEP memorandum. For instance, the ROE stated that Freedom had a concentration in ADC loans that represented 585 percent of Tier 1 Capital, as of December 31, 2006. This concentration level was more than 5 times above the 100 percent supervisory criteria that FIL-104-2006 indicates may warrant greater supervisory scrutiny. In addition, Freedom's CRE level was more than twice that of its peer group, and the bank's ADC level was more than three times its peer group's concentration. Further, the FDIC's 2007 examination reported that the bank planned a 30-percent increase in assets, with significant increases in ADC loans, which already greatly exceeded the supervisory criteria in FIL-104-2006. Examiners also noted that the bank's asset growth was continuing to outpace Freedom's capital. Finally, the ROE for this examination included several recommendations related to Freedom's risk management processes, controls related to the bank's CRE/ADC concentrations, and Freedom's loan policy.

Although the ROE included annotations indicating that bank management had agreed to consider or implement the recommendations, the FDIC's transmittal letter for the ROE did not require a formal response or status reports on corrective actions. According to the DSC *Case Manager Procedures Manual*, for institutions rated a 1 or 2, the transmittal letter can merely reference the examination report and request the BOD to review the report and note its review in the BOD minutes. For those institutions with moderate concerns, the transmittal letter should include a brief discussion of problem areas and a request for a written response. Based on the above guidance and considering the significance of the recommendations included in the February 2007 ROE, it may have been prudent for the FDIC to specifically request that Freedom's BOD provide a written response to the ROE that would have outlined the planned and/or actual corrective actions to address the FDIC's concerns and identified deficiencies.

Finally, in spite of the risks identified in the PEP memorandum and ROE, the FDIC rated Freedom's asset quality as a "1" in the 2007 ROE. The rating was based, in part, on the fact that (1) the level of adverse classifications totaled approximately \$719,000, were generally confined to one relationship, and the adversely classified asset ratio was 5.64 percent; (2) the past-due ratio was 2.04 percent; and (3) bank management had identified all classified loans. However, the risks identified in the PEP memorandum and subsequent examination seem to be in contrast with the broader definition of a 1-rating, which, in part, indicates that asset quality was of minimal supervisory concern.

Revision and Adherence to the Business Plan. 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 in compliance 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.

Freedom requested approval of its revised business plan in November 2004, stating that the only significant variance from the original business plan was the rapid asset growth the bank had experienced. In fact, Freedom’s actual total assets as of September 30, 2004, had already grown to \$41.3 million—far exceeding the projected total assets of \$24.6 million as of December 30, 2004 in its original business plan. The FDIC advised Freedom in December 2004 that it had no objection to the revised plan. The only condition the FDIC imposed was that the bank should ensure it maintained a Tier 1 Leverage ratio of at least 8 percent until February 2007.

The Examination Manual states that examiners should review and evaluate current business plans and any changes thereto since the previous examination. In that regard, the FDIC addressed the business plan in visitations and examinations conducted in 2004 through 2007 and noted the following:

- **2004 FDIC Visitation Memorandum:** The FDIC indicated that the balance sheet reflected loan growth well beyond pre-opening projections.
- **2005 FDIC ROE:** The FDIC stated that operating losses exceeded projections indicated in the Application for Deposit Insurance primarily due to higher than expected provision expenses associated with the bank’s strong loan growth. The report also noted that the business plan was revised in October 2004 to update the financial projections. The FDIC noted that asset growth exceeded the initial projections due to tremendous loan growth but was in line with the revised projections. The report contained comparisons between the original business plan, revised business plan, budget, and actual results. The comparisons showed that actual total loans were almost three times the initial projections, but slightly lower than revised projections. Actual total assets were double the original estimates and slightly higher than revised estimates.
- **2006 GDBF ROE:** The report noted that management had revised the original business plan to mirror revised performance expectations and that variance reports using the revised plan were being prepared monthly for the BOD.
- **2007 FDIC ROE:** The report stated that “There have been no major deviations or material changes to the business plan that was originally submitted to the FDIC.” The ROE included a section that compared financial projections at the

time the bank received deposit insurance to the actual balance sheet as of February 2007. The section included a statement that the bank had significantly exceeded original growth projections and showed third-year projected real estate loans of \$29.1 million versus actual real estate loans of \$94.1 million.

Of note in the aforementioned reports is the fact that the 2004 visitation memorandum—issued before the revised business plan was submitted for approval—included key findings of rapid loan growth and early-on underwriting concerns. However, the report concluded that loan quality issues appeared to be contained largely due to management’s actions. That trend of findings largely continued in 2005 and 2006; that is, high growth in excess of projections was noted. The FDIC expressed limited or no concern based on the FDIC’s conclusion that Freedom’s asset quality was considered to be strong with nominal adverse classifications and past due loans. With regard to the FDIC’s 2007 ROE, the conclusion that there had been no major deviations or material changes to the business plan seems inconsistent with the difference between projected and actual real estate loans discussed above, and with the fact that, as of December 2006, Freedom’s total actual assets exceeded original projections by about 140 percent and revised projections by 36 percent. It should be noted, however, that at the time this examination was conducted, DSC had not issued guidance to examiners that defined what would constitute a “material deviation” from a business plan. Further, ARO officials advised us that regional practice did not consider growth in excess of projections as a material deviation.

In August 2009, DSC issued a memorandum that provides supplementary guidance to its examiners for processing deposit insurance applications and requests for changes in business plans by de novo institutions and provides guidance regarding supervision and examination procedures for de novo institutions for which the FDIC is the primary federal regulator. While the guidance notes that examiner judgment is critical in determining a major change or deviation in business plan, it specifically states that any variance between projected and actual asset levels exceeding 25 percent will be considered a material deviation from the business plan. Going forward, new deposit insurance orders for state nonmember institutions will require institutions to obtain prior approval from the FDIC on any proposed major change or deviation in their business plan. Finally, in those instances when an institution has implemented a material change in its business plan without providing prior notice or obtaining the FDIC’s prior non-objection, the assessment of civil money penalties or other enforcement action against the institution or other appropriate parties should be considered.

Off-site Monitoring. Because February 2007 was the end of the de novo period for Freedom and the bank’s composite and component ratings were 1 or 2, the bank’s next full-scope examination was scheduled to be conducted by the GDBF 18 months later. The FDIC’s intervening off-site reviews of Freedom identified heightened risk the bank was facing. However, the results of the reviews did not result in substantial adjustments to the FDIC’s supervisory strategy.

As shown in Table 5, for the first two quarterly off-site reviews conducted for quarters ending March and June 2007, the FDIC generally had positive observations regarding Freedom's loan portfolio and management. However, at the time of these reviews, Freedom's level of concentrations in CRE/ADC loans was significantly high and substantially exceeded the levels that the 2006 supervisory guidance identified as warranting increased attention. A subsequent off-site review conducted in March 2008 based on December 2007 Call Report data, did identify several risk areas that should have resulted in greater supervisory attention.

Table 5: Results of the FDIC's Off-site Review^a of Freedom

Date of Financial Data Used for Off-Site Review	3/31/2007	6/30/2007	12/31/2007	3/31/2008
Date FDIC Conducted Off-Site Review	7/2/2007	9/26/2007	3/17/2008	7/2/2008
FDIC's Off-site Review Comments				
Asset/loan growth was consistent with rapid growth of de novo banks	✓	✓		
ADC loan concentration was manageable in the normal course of business	✓	✓		
Management was knowledgeable and monitoring the bank's exposure	✓	✓		
Capital supported the bank's risk profile	✓	✓		
Management planned to raise capital to support asset growth	✓	✓		
The bank was relying on volatile funding	✓	✓		
The bank was flagged for having a REST Score of 5			✓	
Significant CRE/ADC loans representing 431 percent and 204 percent of capital and ALLL			✓	
High probability of downgrades in five of the six CAMELS ratings			✓	
Elevated levels of non-accrual and past due loans			✓	
The level of increasing problem assets was expected to continue			✓	
FDIC would continue to monitor the bank closely			✓	
Multiflags indicated the need for off-site review ^b			✓	✓
ADC loans represented 464 percent of total Capital and CRE loans represented 234 percent of total Capital				✓
Past due loans represented 9.68 percent of total loans				✓
The bank's return on average assets (ROAA) was a negative 2.63 percent				✓
Loan review had classified 200 percent of Tier 1 Capital and ALLL				✓

Source: FDIC off-site review reports for Freedom.

^a According to the FDIC *Case Manager Procedures Manual*, off-site reviews must be completed and approved 3½ months after each Call Report date. This generally provides 45 days to complete the off-site reviews once Call Report data is finalized -- generally 45 days after the Call Report financial date.

^b Multiflag represents the process of combining multiple risk measures such as the REST, Statistical CAMELS Off-site Rating (SCOR), SCOR-Lag, Young Institutions, and Consistent Grower. According to the FDIC, institutions with multiple exceptions are considered to be high-risk institutions.

Further, as shown below in Table 6, Freedom was flagged for review in March 2008 based on its December 31, 2007 financial data. The primary concerns noted were the

bank's rapid loan growth—which was concentrated in CRE/ADC loans—and the probability of downgrades in the bank's CAMELS ratings.

Table 6: Probability of Downgrades in Component and Composite Ratings

CAMELS Category	Rating at the Time of Off-site Review	Probability of Downgrade Based on SCOR (Percent)
Capital	2	53
Asset Quality	1	97
Management	2	85
Earnings	2	92
Liquidity	2	64
Sensitivity to Market Risk	2	Not provided in SCOR
Composite Rating	2	89

Source: FDIC's SCOR model, based on financial data as of December 31, 2007.

According to the Examination Manual, limited scope examinations and visitations may be used to determine changes in an institution's risk profile and to follow up on SCOR results. In this case, based on the December 2007 review, the FDIC did not conduct a visitation to assess the bank's financial condition. Instead, the FDIC decided to closely monitor Freedom, noting that the onsite GDBF examination was scheduled for the third quarter of 2008.

Although the GDBF's examination was accelerated from August to June 2008, 2 months had elapsed since the off-site measures reflected increased risk, and 16 months had elapsed since the previous examination. Furthermore, while the timing of the 2008 examination was consistent with FDIC policies for examination of a 1- or 2-rated bank, this lag in detailed examination coverage may have prevented more thorough coverage of the risks and timelier supervisory action—and perhaps took away opportunities to minimize the loss that the institution ultimately suffered.

Volatile Liability Dependence. As early as the January 2005 examination, the FDIC reported that bank management relied on CDs acquired through the Internet and FHLB advances to fund growth. Although the bank's internally-calculated net non-core dependence ratio continually increased, management considered the majority of the large CDs to be stable deposits of loyal customers. The bank's net non-core funding dependence ratio ranged from a level of 27.65 percent in December 2004 to a high of 47.01 percent in December 2007.

According to the Examination Manual, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. However, the FDIC did not take exception to, or require the bank to reduce, its dependence on potentially volatile funding sources. The FDIC could have expressed a greater level of concern and/or required the bank to develop strategies for reducing the volatility of its funding at the 2007 examination because (1) at that time, Freedom's net non-core funding dependence ratio was reported at 46.87 percent at December 31, 2006—an increase from the 43 percent reported at the prior examination of Freedom,

(2) Freedom's dependence ratios consistently exceeded its peer group, and (3) a bank's access to secondary funding sources can be limited when its financial condition deteriorates.

Contingency Liquidity Plan. The GDBF June 2008 ROE stated that bank management lacked a CLP and had not developed a sources and uses of funds statement to assess future liquidity needs. In contrast, the FDIC concluded at the bank's 2007 examination that liquidity contingency arrangements were adequate and funds management practices were satisfactory.

The FDIC's Examination Manual states that financial institutions should have an adequate CLP in place to manage and monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources.

Based on our review of the above plan, which was in effect at the time the FDIC conducted its 2007 examination, we determined that the plan did not include the following elements:

- assessment of the possible liquidity events that the institution might encounter;
- assessment of the potential for erosion of liquidity by funding source under various scenarios and the potential liquidity risk posed by activities, such as asset sales and securitization programs; and
- a matching of potential sources and uses of funds.

However, the FDIC had not identified deficiencies in the CLP or recommended that the bank enhance the plan before, or as a result of, its 2007 examination.

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.

Table 7, on the next page, shows how Freedom's capital ratios compared to the bank's peer group for each examination and the change in capital ratios between the August 2004 examination and the June 2008 examination. In addition, Table 7 shows that Freedom's capital ratios were significantly lower than the bank's peer group for each examination conducted by the FDIC and the GDBF.

Table 7: Freedom’s Capital Ratios Compared to Peer

Examination Dates	Financial Data as of Date	Tier 1 Leverage Capital		Tier 1 Risk-Based Capital		Total Risk-Based Capital	
		Bank	Peer	Bank	Peer	Bank	Peer
August 2004	March 31, 2004	69.54	N/A*	90.15	N/A*	91.38	N/A*
February 2005	December 31, 2004	15.24	51.34	17.36	85.40	18.61	86.27
February 2006	September 30, 2005	13.61	22.09	17.27	29.81	18.52	30.82
February 2007	December 31, 2006	9.02	14.30	10.62	17.18	11.72	18.23
June 2008	March 31, 2008	8.13	11.41	9.27	13.33	10.53	14.38

Source: ROEs and UBPRs for Freedom.

* Not applicable because the UBPR data for these ratios was determined to be unreliable.

As of September 30, 2008, Freedom’s capital ratios were as follows:

- Tier 1 Leverage Capital 5.63 percent
- Tier 1 Risk-Based Capital 6.60 percent
- Total Risk-Based Capital 7.88 percent

On November 7, 2008, the FDIC informed Freedom that, based on the September 30, 2008, Call Report, the bank reported Total Risk-Based Capital of 6.60 percent – below the 8 percent threshold as required by PCA, which placed the bank in the *Undercapitalized* category. Based on this capital category, Freedom had to comply with various restrictions. Those restrictions were related, but not limited to, asset growth, dividends, other capital distributions, and management fees. Freedom was also required to file a written capital restoration plan with the FDIC within 45 days. Although Freedom was not using brokered deposits, this capital category prohibited the bank from accepting, renewing, or rolling over any brokered deposits. In early November 2008, the bank contracted with an investment banker to assist with raising capital. The agreement with the investment banker included seeking capital investors, selling fixed assets, or finding a merger partner. The bank also took several measures to preserve capital, including significant expense reductions, limiting new loans, and improving earnings with the installation of an interest rate floor on new and renewing loans. The bank also worked for several months seeking capital injections from board members and existing shareholders but with minimal success.

The ARO also received a Troubled Asset Relief Program Application from Freedom Bancshares, Inc., the holding company for the bank in November 2008. The application was subsequently withdrawn by the holding company in early December 2008.

The December 2008 C&D included, among other things, provisions related to capital and required Freedom to:

- Within 30 days, develop and adopt a plan to meet the minimum capital requirements set forth in the C&D.
- Within 60 days, revise its capital plan to meet the minimum risk-based capital requirements for a *Well Capitalized* bank.

- Within 90 days, attain a Tier 1 Capital ratio of no less than 8 percent of total assets. The level of capital was to be maintained in addition to a fully funded ALLL satisfactory to the GDBF and the FDIC, as determined at subsequent examinations or visitations.

Freedom responded to the FDIC on January 7, 2009 that it was working to restore capital to adequate levels. The FDIC issued a letter to Freedom on February 9, 2009, stating that, based on December 31, 2008 Call Report data, the bank was considered to be *Significantly Undercapitalized*. On February 25, 2009, the FDIC issued a letter when Freedom became *Critically Undercapitalized*, and GDBF closed the bank on March 6, 2009.

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 September 16, 2009 the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety as Appendix 3 of this report.

DSC reiterated the OIG's conclusions that Freedom Bank failed primarily due to a rapid growth strategy and the Board of Directors' failure to ensure that Freedom's management identified, measured, monitored, and controlled the risks associated with the institution's lending activities. As it relates to our assessment of the FDIC's supervision of Freedom, DSC acknowledged the need for more stringent supervisory attention for de novo institutions. DSC further noted that the FDIC recently extended the de novo period from the current 3-year period to 7 years for examinations, capital, and other requirements, and that material changes in business plans for newly insured institutions will require prior FDIC approval during the first 7 years of operation.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides 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 April to September 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 Freedom's operations from February 17, 2004 until its failure on March 6, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution from 2004 to 2009.

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

- Analyzed examination and visitation reports prepared by the FDIC and GDBF from 2004 to 2008.
- Reviewed the following:
 - Bank data and correspondence maintained at DSC's Atlanta Regional Office and Field Office.
 - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.
 - Records of the bank's external auditor, Nichols, Cauley & Associates LLC, Atlanta, Georgia, as made available through the external auditor's counsel Carlock, Copeland & Stair, LLP, Atlanta, Georgia.

- Records of the bank's internal auditor, Mauldin & Jenkins, LLP, Atlanta, Georgia, as made available through the internal auditor's counsel Greenfield, Bost, & Kliros, P.C., Atlanta, Georgia.
- Pertinent DSC policies and procedures.
- Interviewed the following FDIC officials:
 - DSC management in Washington, D.C.; and Atlanta, Georgia.
 - FDIC examiners from the Atlanta Field Office who participated in Freedom examinations.
- Met with officials from the GDBF of Atlanta, Georgia, to discuss their historical perspective of the institution, its examinations, state banking laws, and other activities regarding the GDBF'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 Freedom's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various 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 were used to support our audit conclusions.

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

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)	<p>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, <i>Prompt Corrective Action</i>, 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.</p> <p>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.</p>
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.

CORPORATION COMMENTS



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

Division of Supervision and Consumer Protection

September 16, 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 Freedom
Bank of Georgia, Commerce, GA (Assignment No. 2009-029)

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 Freedom Bank of Georgia (FBG), Commerce, Georgia, which failed on March 6, 2009. The Division of Supervision and Consumer Protection (DSC) received the OIG's Draft Audit Report (Report) on September 2, 2009, providing information on the cause of failure and an assessment of the FDIC's supervision of FBG.

The Report notes FBG failed primarily due to a rapid growth strategy and the Board of Directors' failure to ensure FBG management identified, measured, monitored, and controlled the risk associated with the institution's lending activities. Declining earnings, resulting from rapidly deteriorating asset quality in the commercial real estate (CRE)/acquisition, development, and construction (ADC) concentrations, combined with the economic downturn, severely eroded capital. Liquidity became deficient and secondary funding sources became restricted. FBG ultimately closed due to its capital position and inability to meet liquidity needs.

The Report indicates that FBG, 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 high concentration levels and weak risk management practices. The Report concludes more supervisory attention may have been warranted at earlier examinations and as a result of offsite reviews.

In recognition that stringent supervisory attention is necessary for de novo institutions, DSC recently extended our supervisory program so that these institutions receive a full scope examination every year for seven years, as opposed to three years. 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 Report.

ACRONYMS USED IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ARO	Atlanta Regional Office
BBR	Bank Board Resolution
BOD	Board of Directors
C&D	Cease and Desist Order
CALL	Consolidated Reports of Condition and Income
CAMELS	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity, and <u>S</u> ensitivity to Market Risk
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GDBF	Georgia Department of Banking and Finance
OIG	Office of Inspector General
PCA	Prompt Corrective Action
REST	Real Estate Stress Test
ROE	Report of Examination
SCOR	Statistical CAMELS Off-site Rating
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System