Audit Report

OIG-12-036

SAFETY AND SOUNDNESS: In-Depth Review of Unity National Bank

January 11, 2012

Office of Inspector General

DEPARTMENT OF THE TREASURY

Contents

Abbreviations

ADC	acquisition, development, and construction
ALLL	allowance for loan and lease losses
CRE	commercial real estate
CRP	capital restoration plan
DIF	Deposit Insurance Fund
FDIC	Federal Deposit Insurance Corporation
IMCR	individual minimum capital ratio
MLR	material loss review
MRA	matter requiring attention
OCC	Office of the Comptroller of the Currency
PCA	prompt corrective action
ROE	report of examination

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January 11, 2012

John G. Walsh
Acting Comptroller of the Currency

This report presents the results of our in-depth review of the failure of Unity National Bank (Unity), of Cartersville, Georgia, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed Unity and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on March 26, 2010. As of September 30, 2011, FDIC estimated that the loss to the Deposit Insurance Fund (DIF)[1] would be $71 million. FDIC also estimated that Unity's failure resulted in a loss of $174,000 to the Transaction Account Guarantee Program.

Our in-depth review of Unity was made pursuant to section 38(k) of the Federal Deposit Insurance Act. We initiated this review under the material loss review (MLR) provision of section 38(k), which at the time of Unity's failure defined a loss to the DIF as material if the loss exceeded the greater of $25 million or 2 percent of the institution's total assets. However, effective July 21, 2010, section 38(k) was amended by P.L. 111-203. As a result, among other things, the loss threshold to the DIF triggering a required MLR was reset to losses that exceed $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar year 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met). As amended, section 38(k) provides that the cognizant Inspector General is to perform an in-depth review of failures under the material loss threshold if the Inspector General determines that unusual circumstances exist with respect to the failure. Because our audit fieldwork was

[1] Certain terms that are underlined when first used in this report are defined in *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (April 11, 2011). That document is available on the Treasury Office of Inspector General's website at http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx.

substantially finished when section 38(k) was amended, we determined that this was an unusual circumstance and therefore completed our review of Unity as an in-depth review.

Our objectives were to determine the causes of Unity's failure; assess OCC's supervision of Unity, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed OCC and FDIC officials. We conducted our fieldwork from June through July 2010. Appendix 1 contains a more detailed description of our review objectives, scope, and methodology. Appendix 2 contains background information on Unity's history and OCC's assessment fees and examination hours.

In brief, Unity failed because of its aggressive growth strategy concentrated in commercial real estate (CRE) including acquisition, development, and construction (ADC) loans, and ineffective credit risk management. These factors, combined with the dramatic real estate market decline, resulted in Unity's asset quality deterioration, and the bank's eventual failure. OCC provided ongoing supervision of Unity through regular on-site and off-site reviews. Although OCC's supervision did not prevent a loss to the DIF, we concluded that its supervision of Unity was appropriate.

We are not making any new recommendations to OCC as a result of our in-depth review of Unity. We provided a draft of this report to OCC for its review. In a written response, which is included as appendix 3, OCC did not provide any specific comments on the report content.

Causes of Unity's Failure

Aggressive Growth Strategy

Unity's board and management pursued an aggressive growth strategy primarily throughout the Atlanta, Georgia, metropolitan market. From January 1, 2005, to December 31, 2009, total assets increased $102 million, or 51 percent. The bank achieved its asset growth with CRE loans.

OCC guidance to examiners provides that when the total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total risk-based capital, a concentration risk exists, which may need further analysis.[2] From 2005 through 2009, ADC concentration levels ranged from 178 percent to 251 percent of Unity's total risk-based capital, which exceeded this supervisory benchmark.

The board and management's strategy resulted in asset growth that exceeded capital growth, causing the bank's capital ratios to gradually decline over several years. To support the growth, the bank's holding company bolstered Unity's capital levels by downstreaming funds from the proceeds of a $3 million trust preferred offering in 2003. Unity also used noncore, wholesale funding, such as more costly brokered deposits, Internet Certificates of Deposit, and Federal Home Loan Bank advances, to support its growth strategy. As of December 31, 2009, brokered deposits stood at $29 million, nearly triple the amount it held in June 2005, and Internet Certificates of Deposit totaled approximately $57 million. When the bank fell below the PCA well-capitalized level on June 30, 2009, Unity's access to brokered deposits and high interest rate deposits was restricted.

Weak Credit Administration Practices

OCC guidance states that credit administration is an important control mechanism and that backroom processing functions are often the first line of defense. Weaknesses in credit administration can pose significant safety and soundness issues.

Unity lacked sound credit administration practices. OCC noted that Unity historically based credit decisions more on character and collateral than cash flow and capacity, but that approach was no longer appropriate given the then current market environment and loan portfolio. In its 2008 report of examination (ROE), OCC commented that Unity's credit administration and monitoring of its loan portfolio needed to improve. OCC found financial or collateral exceptions in 31 of 91 loans (34 percent of sampled loans). Also during the 2008 examination, OCC downgraded 14 of 40 problem

[2] OCC Bulletin 2006-46, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Dec. 6, 2006).

loans (35 percent of loans reviewed). In the 2008 ROE, examiners stated that if Unity's management had timely identified the riskiness of the bank's loans, it could have dealt effectively with troubled assets. In the 2009 ROE, OCC stated that Unity's management did not obtain updated loan appraisals or evaluate renewal of existing credits. OCC also reported loan administration exceptions such as missing financial statements to document repayment sources. Furthermore, OCC stated that Unity's allowance for loan and lease losses (ALLL) reserve was underestimated by $2 million in 2008 and by $4.6 million in 2009.

Unity's declining asset quality was exacerbated by credit administration weaknesses, particularly the board's and management's failure to respond to changing market conditions by changing lending and problem loan identification practices.

OCC's Supervision of Unity

OCC identified several key risks in Unity's operations through its on-site and off-site reviews. These risks included an asset growth strategy funded in part with wholesale funding, high concentrations of CRE and ADC loans, weak credit administration practices, and failure to change lending practices in an evolving market. OCC timely identified and reported these problems to Unity, and issued enforcement actions and used its authority under PCA. Based on our review of the supervisory record, we concluded that OCC's supervision of Unity was appropriate.

Table 1 summarizes the results of OCC's examinations of Unity from 2004 to 2009.

Table 1. OCC Examinations of Unity National Bank (March 2004–August 2009)

		Examination Results			
Date Started Type of examination	**Assets (millions)[a]**	**CAMELS rating**	**No. of MRAs**	**No. of corrective actions**	**Informal/Formal enforcement actions**
3/1/2004 (Full-scope examination)	$160	2/222222	0	0	None
9/6/2005 (Full-scope examination)	$219	2/222222	0	0	None
2/26/2007 (Full-scope examination)	$266	2/222222	0	0	None
9/22/2008 (Full-scope examination)	$315	3/433432	5	0	Formal agreement issued 2/3/2009, and individual minimum capital ratio issued 4/14/2009
8/3/2009 (Full-scope examination)	$298	5/555543	7	3	PCA notice issued 9/15/09, and capital directive issued 12/16/2009

Source: OCC ROEs, PCA directive, individual minimum capital ratio.
[a] This table reflects assets at examination start dates.

In the 2007 ROE, examiners reported that asset growth exceeded earnings and capital growth, causing Unity's capital ratios to decline. Examiners also noted that funds from the trust preferred offering, described earlier, increased capital, and compensated for Unity's risk. While OCC examiners found some issues during the 2007 examination, they told us these were technical exceptions, which did not rise to the level of matters requiring attention (MRAs). Given the problems as documented by the examiners, we believe the examiners' conclusions were reasonable.

The slowing economy and the sharp decline in the Atlanta real estate market adversely impacted Unity's asset growth by 2008. During the 2008 examination, examiners reported that the bank's policies and lending standards had promoted growth which led to problems in the loan portfolios. OCC's first quarter monitoring of

2008 identified that Unity's capital levels continued to be pressured by loan growth of 9 percent. Additionally, negative asset quality trends adversely impacted earnings, and credit risk began to increase.

In the ROE for the 2008 examination, OCC issued MRAs directing Unity to (1) implement a plan for promptly identifying and resolving criticized assets; (2) revise loan policies, procedures, and underwriting standards to address current market conditions and the condition of the loan portfolio, including strengthening the risk management process for CRE concentrations; (3) ensure liquidity sources are sufficient to meet fund demand; (4) finalize and implement capital plans to protect existing capital and ensure additional support is available if needed; and (5) revise the bank's business plans and strategies for the next 3 years. As a result of its supervisory concerns, OCC also entered into a Formal Agreement with the bank on February 3, 2009. The agreement contained eight actionable articles which instructed the board and management to, among other things: (1) address criticized assets; (2) implement a CRE concentration risk management program consistent with regulatory guidance, which includes portfolio stress testing and sensitivity analysis of CRE concentrations;[3] (3) improve loan portfolio management; and (4) establish a program for maintenance of an adequate ALLL balance.

Also, on February 3, 2009, OCC notified the board of a proposed individual minimum capital ratio (IMCR) citing Unity's less-than-satisfactory condition and significant deterioration in asset quality. OCC explained that although Unity was well-capitalized for PCA purposes, the PCA well-capitalized minimum ratios alone were not sufficient given the bank's current condition. The proposed IMCR required that the bank achieve and maintain a Tier-1 leverage ratio at least equal to 8 percent of adjusted total assets and a total risk-based capital ratio at least equal to 11 percent of risk weighted assets (compared to PCA minimums for well capitalized of Tier 1 leverage ratio at least equal to 5 percent of adjusted total assets and total risk-based capital ratio at least equal to 10 percent of risk

[3] Stress testing is a risk management concept where a bank alters assumptions about one or more financial, structural, or economic variables to determine the potential effect on the performance of a loan, concentration, or portfolio segment.

weighted assets). On April 14, 2009, OCC notified Unity's board by letter of the establishment of the IMCR.

In its 2009 examination, OCC found that Unity's condition had deteriorated substantially and that poor management decisions combined with a weak economy threatened Unity's viability. In the related ROE, OCC added two more MRAs to the five outstanding MRAs. The two new ones required Unity to develop an appropriate ALLL methodology to conform to regulatory guidance, and achieve compliance with the formal agreement and the IMCR.

In summary, Unity's board and management did not control loan growth and react to market conditions that began in 2007. In 2008, OCC concluded that based on past performance Unity's board and management should be capable of addressing the bank's problems. However, by 2009, examiners concluded that poor management decisions threatened the bank's viability and that the severity of problems was beyond the ability of Unity's board and management to correct. This resulted in the closure of the bank in March 2010.

OCC Appropriately Used PCA

The purpose of PCA is to resolve problems of insured depository institutions with the least possible long-term loss to the DIF. PCA requires federal banking agencies to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility to supervise institutions based on criteria other than capital levels to help reduce deposit insurance losses caused by unsafe and unsound practices. As of June 30, 2009, Unity was undercapitalized under the PCA minimum capital standards based on its amended call report, which showed a total risk-based capital ratio of 7.1 percent. OCC implemented PCA as described below:

- In a letter dated September 15, 2009, OCC notified Unity of its undercapitalized status and required the bank to submit an acceptable capital restoration plan (CRP) to OCC no later than October 13, 2009.

- On September 23, 2009, OCC assigned the bank a CAMELS composite of 5 and transferred supervision of Unity to OCC's Special Supervision Division.

- Unity submitted a CRP to OCC on October 13, 2009. In a letter dated November 24, 2009, OCC notified Unity that it did not accept the bank's CRP. In this regard, OCC was unable to determine that the projected capital infusion described in the CRP was a realistic possibility and that it was unlikely to succeed in restoring the bank's capital.

- Unity's call report for the quarter ended December 31, 2009, showed that its PCA capital level was significantly undercapitalized. In a letter dated March 17, 2010, OCC informed Unity of its continuing obligation to submit an acceptable CRP. OCC closed the bank 9 days later.

Conclusion

We are not making any new recommendations to OCC as a result of our in-depth review of the Unity failure. As we have reported in previous MLRs, high concentrations in CRE loans were a significant factor in the failure of other banks. For example, in our May 2010 MLR report on Union Bank, we recommended that OCC work with its regulatory partners to determine whether to propose legislation and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high-risk concentrations.[4] The failure of Unity was another case where a bank failed primarily because of its high concentration in CRE loans.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-6512 or Susan Roy, Audit Manager, at

[4] *Safety and Soundness: Material Loss Review of Union Bank, National Association*, OIG-CA-10-009 (May 11, 2010). The review of Union Bank was performed by Mayer Hoffman McCann P.C., an independent public accounting firm, under the supervision of our office.

(202) 927-5746. Major contributors to this report are listed in appendix 4.

/s/
Michael J. Maloney
Audit Director

We conducted an audit of the failure of Unity National Bank (Unity), of Cartersville, Georgia, in response to section 38(k) of the Federal Deposit Insurance Act.[5] Our objectives were to determine the causes of Unity's failure; assess the Office of the Comptroller of the Currency's (OCC) supervision of Unity, including implementation of the prompt corrective action provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish our objectives, we conducted fieldwork at OCC's southern district office in Dallas, Texas, its field office in Atlanta, Georgia, and Unity's former headquarters in Cartersville, Georgia. We conducted our fieldwork from June 2010 through July 2010.

To assess the adequacy of OCC's supervision of Unity, we determined (1) when OCC first identified Unity's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OCC took to get the bank to correct the problems. We also assessed whether OCC (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following work:

- We determined that the time period relating to OCC's supervision of Unity covered by our audit would be from March 2004 through Unity's failure on March 26, 2010. This period included five safety and soundness examinations before OCC assigned it a composite rating of 5.

- We reviewed OCC's examination reports, supporting documentation, and related correspondence. We performed this review to gain an understanding of any issues identified and the approach and methodology OCC used to assess the bank's condition.

- We analyzed OCC's supporting supervisory documentation and related supervisory correspondence. We also assessed the regulatory action OCC used to compel bank management to address deficient conditions identified during examinations. We

[5] 12 U.S.C. § 1831o(k).

did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.

- We interviewed and discussed various aspects of the supervision of Unity with OCC officials, examiners, and an attorney to obtain their perspective on the bank's condition and the scope of the examinations.

- We interviewed officials from FDIC's Division of Resolutions and Receiverships who were involved in the receivership process for Unity.

- We assessed OCC's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[6]

We conducted this performance audit 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.

[6] 12 U.S.C. § 1811 et seq.

History of Unity National Bank

Unity National Bank (Unity) was established in November 1998 as a chartered institution in Cartersville, Georgia. From the bank's inception, the Office of the Comptroller of the Currency (OCC) was its primary federal regulator. Until March 26, 2010, Unity operated five full-service offices. Unity was 100 percent owned by its holding company, Unity Holdings, Inc. Consistent with its charter, the bank engaged in general commercial and retail banking businesses, primarily in Bartow County, Georgia, and surrounding counties. Starting in 2005, Unity's board and management pursued an asset growth strategy that relied on developing significant commercial real estate concentrations in the local real estate market. This growth was funded in part with wholesale funding. A substantial portion of these concentrations consisted of residential lots and loans secured by land in Unity's primary market.

OCC Assessments Paid by Unity

OCC funds its operations in part through semiannual assessments on national banks. OCC publishes annual fee schedules, which include general assessments to be paid by each institution based on the institution's total assets. If the institution is a problem bank (i.e., it has a CAMELS composite rating of 3, 4, or 5), OCC also applies a surcharge to the institution's assessment to cover additional supervisory costs. These surcharges are calculated by multiplying the sum of the general assessment by 50 percent for 3-rated institutions or by 100 percent for 4- and 5-rated institutions. Table 2 shows the assessments that Unity paid to OCC from 2004 through 2009 and their share of the total assessments paid by OCC-regulated banks.

Table 2: Assessments Paid by Unity to OCC, 2004–2009

Billing Period	Exam Rating	Amount Paid	Percent of Total Collections
January 2004	2	$28,878	0.012
July 2004	2	30,263	0.012
January 2005	2	33,951	0.012
July 2005	2	35,836	0.012
March 2006	2	38,064	0.013
September 2006	2	39,681	0.012
March 2007	2	42,608	0.013
September 2007	2	46,285	0.014
March 2008	2	44,134	0.012
September 2008	3	46,238	0.013
March 2009	3	69,084	0.018
September 2009	5	66,921	0.018

Source: OCC.

Number of OCC Staff Hours Spent Examining Unity

Table 3 shows the number of OCC staff hours spent examining Unity.

Table 3: Number of OCC Hours Spent Examining Unity, 2004-2009

Examination Start Date	Number of Examination Hours[a]
3/1/2004	471
9/6/2005	560
2/26/2007	468
9/22/2008	722
8/3/2009	1,090

Source: OCC.
[a] Hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations and do not include time spent performing off-site monitoring.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Michael J. Maloney, Audit Director

From: John Walsh, Acting Comptroller of the Currency /s/

Date: January 3, 2012

Subject: Response to In-Depth Review of Unity National Bank, Cartersville, Georgia

We have received and reviewed your draft report titled "In-depth Review of Unity National Bank, Cartersville, Georgia (Unity)." This review was initiated under the material loss review provision of section 38(k) of the Federal Deposit Insurance Act, which at the time of Unity's failure defined a loss to the Deposit Insurance Fund as material if the loss exceeded the greater of $25 million or 2 percent of the institution's total assets. Because your audit fieldwork was substantially finished when section 38(k) was amended, you determined that this was an unusual circumstance and therefore completed your review as an in-depth review. Your objectives were to determine the causes of Unity's failure; assess OCC's supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, you reviewed the supervisory files and interviewed OCC and FDIC officials.

You conducted your audit fieldwork during June and July 2010 in accordance with generally accepted government auditing standards. Those standards require that you plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for your findings and conclusions. You believe that the evidence obtained provides a reasonable basis for your findings and conclusions.

You concluded that the primary causes of Unity's failure were aggressive growth strategy and weak credit administration.

You also concluded that OCC's supervision of Unity was appropriate and that OCC appropriately used PCA.

Your report did not contain any new recommendations.

Thank you for the opportunity to review and comment on your draft report. If you need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-874-5020.

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Office of the Deputy Chief Financial Officer, Risk and Control Group

Office of the Comptroller of the Currency

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