Audit Report

OIG-11-069

SAFETY AND SOUNDNESS: Material Loss Review of Greater Atlantic Bank

May 16, 2011

Office of Inspector General

Department of the Treasury

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

May 16, 2011

MEMORANDUM FOR JOHN E. BOWMAN
ACTING DIRECTOR
OFFICE OF THRIFT SUPERVISION

FROM: Jeffrey Dye /s/
Director, Banking Audits

SUBJECT: Material Loss Review of Greater Atlantic Bank

INTRODUCTION

The Office of Thrift Supervision (OTS) closed Greater Atlantic Bank (Greater Atlantic), Reston, Virginia, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on December 4, 2009. As of September 3, 2010, FDIC estimated that Greater Atlantic's loss to the Deposit Insurance Fund was $38 million.

Under section 38(k) of the Federal Deposit Insurance Act, we are responsible for conducting a material loss review of the failure of Greater Atlantic.[1] To help fulfill this responsibility, we contracted with Crowe Horwath LLP, an independent certified public accounting firm. Crowe Horwarth's report dated April 21, 2011, is provided as Section I.

RESULTS OF MATERIAL LOSS REVIEW

We concur with Crowe Horwath's reported conclusions regarding Greater Atlantic's causes of failure and OTS's supervision of Greater Atlantic:

- Greater Atlantic failed primarily because of (1) an inability to generate sufficient and consistent core earnings from banking operations; (2) reliance on wholesale funding sources such as Federal Home Loan Bank advances; (3) commercial lending, including commercial construction, commercial real

[1] At the time of Greater Atlantic's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k defines a loss as material if it exceeds $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar years 2014 and thereafter (with a provision that the threshold be raised temporarily to $75 million under certain conditions).

estate, and land development loans, which caused greater risk exposure and ultimately higher level of loan losses; and (4) significant decline in value of its investment portfolio. Net losses and management's inability to generate sufficient earnings from core banking operations caused capital levels to erode. This, combined with the thrift's inability to consummate the sale of the bank, prompted the OTS to close the thrift.

- OTS identified Greater Atlantic's inability to generate sufficient core earnings from thrift operations but decided not to pursue enforcement action in 2007 because of a proposed sale of Greater Atlantic to another bank. Ultimately, the sale failed because of Greater Atlantic's mounting losses and financial declines in the potential acquiring institution. Only then did OTS take enforcement action against the thrift by issuing an Order to Cease and Desist on April 25, 2008.

Details of Crowe Horwath's conclusions are contained in their report.

We also concur with Crowe Horwath's reported recommendation that:

- OTS ensure that issues which have been previously included in informal enforcement actions and have not been adequately addressed by thrift management be elevated to formal enforcement actions according to OTS policy. This is especially important for thrifts that have had CAMELS[2] components downgraded to a rating of 4, and where previous informal actions were issued and not fully addressed.

Please be advised that in accordance with Treasury Directive 40-03, "Treasury Audit Resolution, Follow-up, and Closure," OTS is responsible for taking corrective action on this recommendation. OTS should also record the recommendation and related actions in the Department of the Treasury's Joint Audit Management Enterprise System (JAMES).

OBJECTIVES, SCOPE, AND METHODOLOGY

Under section 38(k), we are responsible to prepare a report to OTS that (1) ascertains why Greater Atlantic's problems resulted in a material loss to the Deposit Insurance Fund; (2) reviews OTS's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38(k); and (3) makes recommendations for preventing any such loss in the future.

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[2] CAMELS is an acronym for performance rating components for financial institutions: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst.

To assist us in fulfilling this responsibility, we contracted with Crowe Horwath to perform a material loss review in accordance with generally accepted government auditing standards. We evaluated the nature, extent, and timing of the work; monitored progress throughout the audit; reviewed the documentation of Crowe Horwath; met with its principals and staff; evaluated the key judgments; met with OTS officials; performed independent tests of OTS supervisory records; and performed other procedures we deemed appropriate in the circumstances. We conducted our work in accordance with generally accepted government auditing standards.

Should you wish to discuss the report, you may contact me at (202) 927-0384.

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Section I

Crowe Horwath LLP's Report on the Material Loss Review of Greater Atlantic Bank

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Greater Atlantic Bank
Material Loss Review
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Abbreviations

C&D	Cease and desist
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FRB	Federal Reserve Board
MRBA	Matters requiring board attention
OTS	Office of Thrift Supervision
PCA	Prompt corrective action
ROE	Report of examination

Inspector General
Department of the Treasury

RE: Transmittal of Results for the Material Loss Review Report for Greater Atlantic Bank, Reston, Virginia.

This letter is to acknowledge delivery of our performance audit report of the Material Loss Review for Greater Atlantic Bank (Greater Atlantic). The objectives of this performance audit were to: (1) determine the causes of Greater Atlantic's failure and resulting material loss to the Deposit Insurance Fund and (2) evaluate the Office of Thrift Supervision's (OTS) supervision of Greater Atlantic, including implementation of the prompt corrective action (PCA) provisions of section 38.

The results are in the accompanying audit report. The information included in this report was obtained during our fieldwork which occurred during the period from March 2010 through June 2010.

We conducted our 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.

We also included several appendices to this report. Appendix 1 contains a more detailed description of our material loss review objectives, scope and methodology. Appendix 2 contains background information on Greater Atlantic and OTS's thrift supervision processes. Appendix 3 is a glossary of terms used in this report. The terms defined in the glossary are underlined the first time they are used in the report.

Fort Lauderdale, Florida
April 21, 2011

Results in Brief

Greater Atlantic failed primarily because of (1) an inability to generate sufficient and consistent core earnings from banking operations; (2) reliance on wholesale funding sources such as Federal Home Loan Bank advances; (3) commercial lending, including commercial construction, commercial real estate, and land development loans, which caused greater risk exposure and ultimately higher level of loan losses; and (4) significant decline in value of its investment portfolio. As the condition of the thrift deteriorated, Greater Atlantic faced restrictions on its ability to restructure its business model due to limitations on issuing new loans and limitations on its ability to access alternative funding sources. The thrift was also unable to adequately reduce costs associated with its operations. Net losses and management's inability to generate sufficient earnings from core banking operations caused capital levels to erode. This, combined with the thrift's inability to consummate the sale of the bank, prompted the OTS to close the thrift.

Our audit found that OTS identified Greater Atlantic's inability to generate sufficient core earnings from thrift operations but did not escalate enforcement action against the thrift until April 25, 2008, when an Order to Cease and Desist became effective. OTS decided not to pursue enforcement action in 2007 because of a proposed sale of Greater Atlantic to another bank. Ultimately, the sale failed because of Greater Atlantic's mounting losses and financial declines in the potential acquiring institution. Based on documentation within the reviewed reports of examination (ROEs), OTS identified significant problems including the lack of management's ability to implement corrective actions, the poor financial condition of the thrift and the erosion of its capital position. However, OTS did not take a formal enforcement action like issuing a formal agreement until the anticipated sale failed.

We are recommending that the Director of OTS, in accordance with OTS policy, ensure that issues which have been previously included in informal enforcement actions and have not been adequately addressed by thrift management be elevated to formal enforcement action.

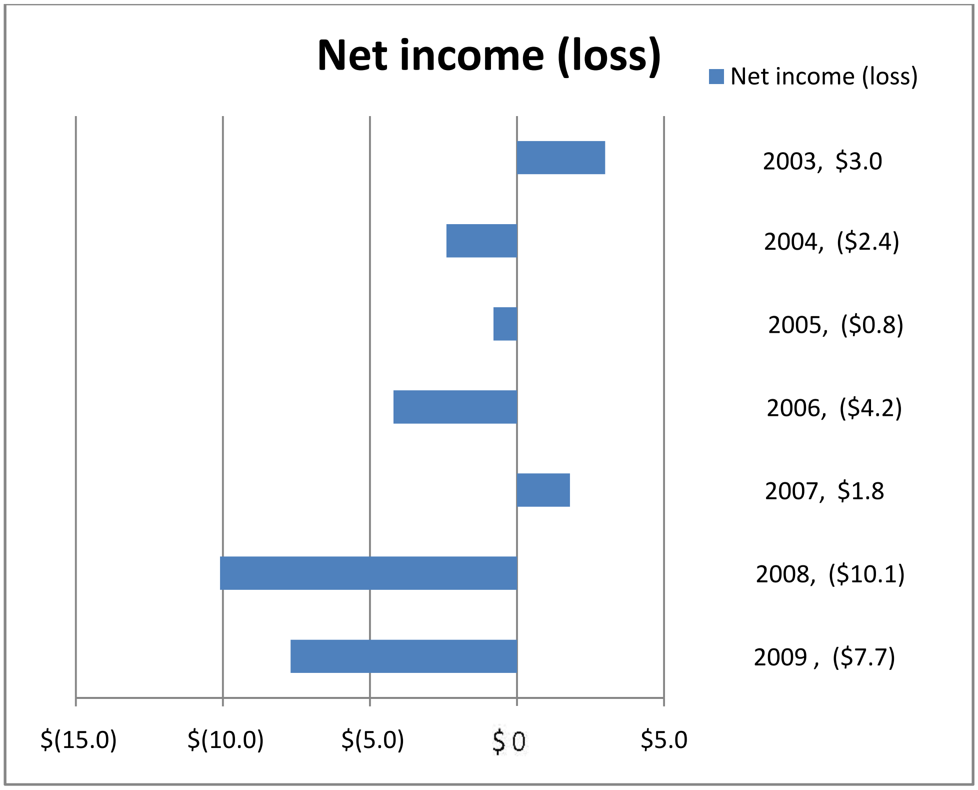
Causes of Greater Atlantic Bank's Failure

Greater Atlantic failed because it was unable to generate stable and consistent core earnings. The thrift relied on earnings from its mortgage subsidiary through 2004 and was never able to diversify its revenue streams to generate sufficient earnings from other sources. Once the thrift's mortgage subsidiary discontinued operations in 2005 due to continued losses, it was unable to develop a sufficient net interest margin to operate profitably. In addition, Greater Atlantic recognized a loss from closing the mortgage subsidiary and additional costs related to the failed attempts to sell the thrift, all of which depleted capital. Management's attempts to increase its interest margin and stem continued losses caused thrift management to increase the risk profile in the lending portfolio. This coincided with management actively shrinking assets to attempt to maintain adequate capital levels. Greater Atlantic's strategy was unsuccessful, and management was advised by the OTS to sell the thrift. When no viable acquirers could be identified and no viable alternative plans to increase capital were available, failure became inevitable.

Insufficient Core Earnings from Bank Operations

In 2003 and 2004, the thrift relied heavily on earnings from its mortgage banking operations to sustain operations. Greater Atlantic was unable to generate sufficient net interest income to cover operating overhead when revenue from the mortgage banking operations was eliminated in 2005. Figure 1 details Greater Atlantic's net income (loss) from fiscal 2003 to fiscal 2009. Greater Atlantic's positive net income in 2007 was primarily due to the sale of a branch at a gain of $4.26 million.

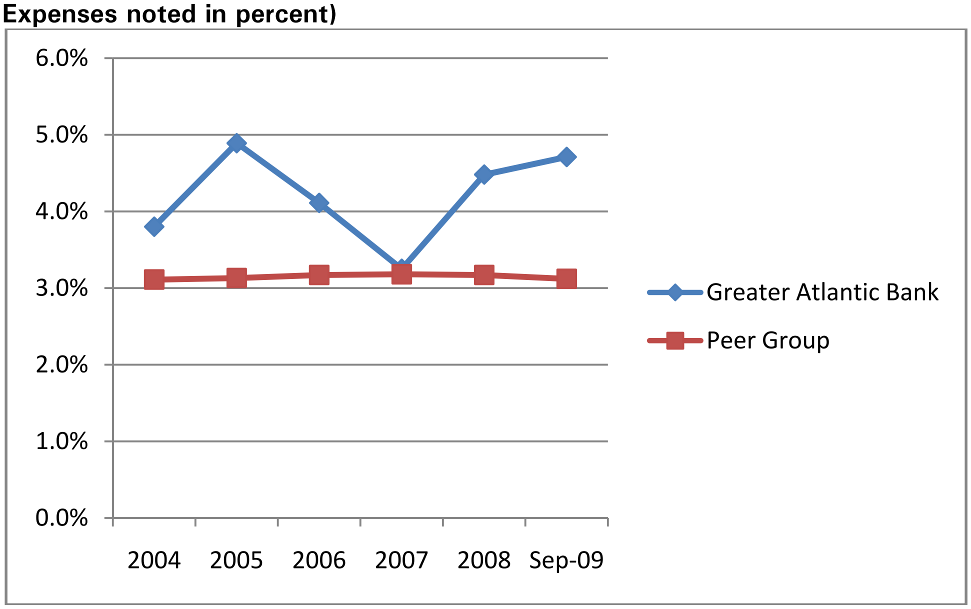
Figure 1 - Greater Atlantic's Net Income (loss) from fiscal 2003 through fiscal 2009 (in millions)



Source: - Greater Atlantic's Thrift Financial Reports (TFR)

As losses continued, Greater Atlantic's management reduced the thrift's assets to bolster capital ratios; however, general and administrative expenses did not decrease proportionally to the decrease in assets. Greater Atlantic consistently operated with higher non-interest expenses, as a percentage of average assets. Figure 2 identifies Greater Atlantic's non-interest expense trends compared to peers from 2004 through 2009.

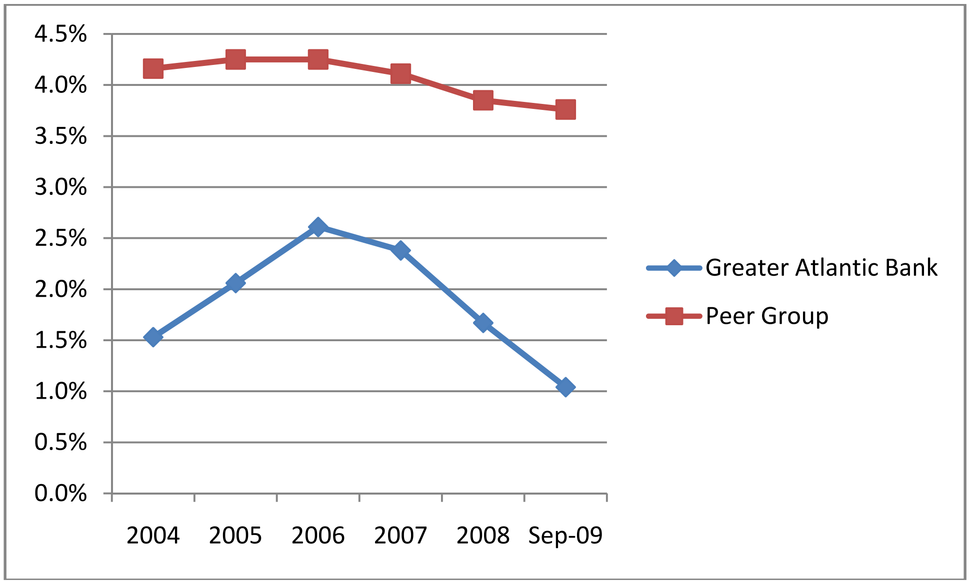
Figure 2 – Comparison of Greater Atlantic's Non-interest Expenses to Average Assets from 2004 through September 2009 to Peer Group Medians. (Non-interest Expenses noted in percent)



Source: - Uniform Thrift Performance Reports (UTPR) for Greater Atlantic

The thrift's net interest income as a percentage of average assets from 2003 through 2008 ranged between a low of 1.53 percent in 2004 and a high of 2.61 percent in 2006. Management and the board were not able to develop and execute a strategy to generate a net interest margin sufficient to cover operating costs and positively contribute to the thrift's capital. Figure 3 notes the year to year net interest margin trend compared to its peer group.

Figure 3 – Comparison of Greater Atlantic's Net Interest Income/Average Assets by Year to Peer Group (Net-interest Income noted in percent)



Source: - UTPRs for Greater Atlantic

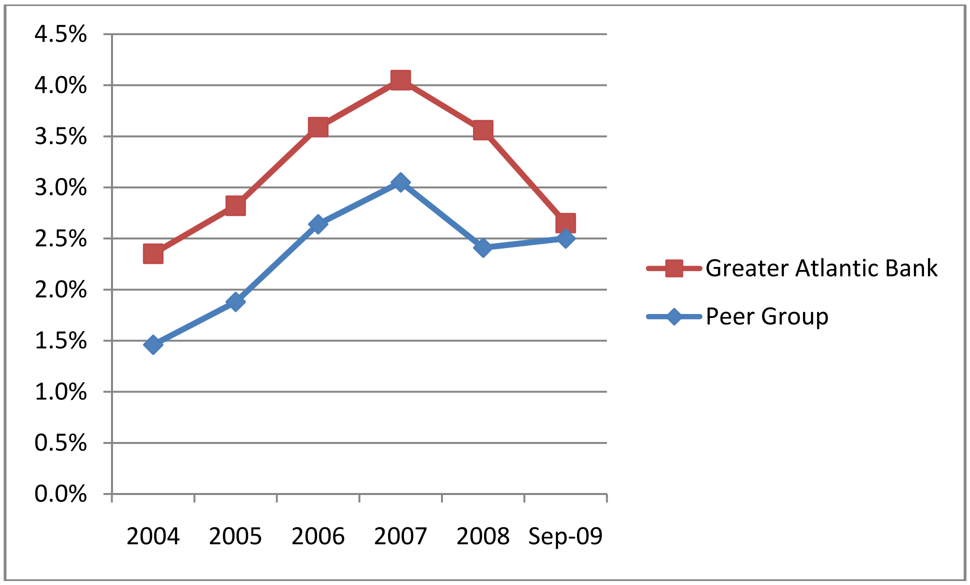
Greater Atlantic's earnings were also negatively impacted during the periods reviewed (2003 through 2009) due to various accounting transactions that included (1) in 2006, $1.3 million in write-offs associated with the closed mortgage banking subsidiary; and (2) in 2008, $2.7 million for the recognition of goodwill impairment ($1.0 million) and recognition of a deferred tax asset valuation allowance ($1.7 million).

Once management decided to pursue a sale of the thrift during 2006, operating expenses were also impacted due to charges related to the pursuit of the sale.

Reliance on Higher Cost Wholesale Funding Sources

Greater Atlantic utilized higher cost Federal Home Loan Bank (FHLB) borrowings and other wholesale funding as a portion of its funding structure. As shown in Figure 4, the reliance on higher cost wholesale funding sources caused Greater Atlantic to have a higher interest expense as a percentage of average assets compared to its peers.

Figure 4 – Comparison of Greater Atlantic's Interest Expense/Average Earning Assets by Year to Peer Group (Interest Expense noted in percent)



Source: UTPRs for Greater Atlantic

In 2000, management obtained long-term, fixed-rate FHLB borrowings. As market interest rates later declined, the fixed rate structure of these advances did not allow the cost of funds to decline in line with the decline in interest income. This borrowing negatively impacted the thrift's net interest margin. While Greater Atlantic actively decreased its use of borrowings from 35.6 percent of total deposits and borrowings at the end of fiscal 2003 to 14.9 percent at the end of fiscal 2008, the related interest costs on the borrowings remained a high percentage of the overall cost of funds. For fiscal 2008, interest expense for FHLB and other borrowings represented 19.4 percent of total interest expense. Greater Atlantic's inability to reprice these wholesale funding sources contributed to Greater Atlantic's lower net interest margin during the periods reviewed (2003 through 2009).

Commercial Lending

After Greater Atlantic discontinued its mortgage banking operations and actively reduced the bank's assets, its level of commercial-related lending (including multi-family, construction, commercial real estate, land and commercial business) became a greater proportion of its overall lending portfolio. Commercial-related loans totaled 36 percent of total loans at September 30, 2003, and increased to as high as 50.3 percent in 2007. Commercial lending generally exposes a lender to a greater risk of non-payment and loss than one-to-four family residential loans because repayment of the loans often depends on the successful operation of the property and the income stream of the borrower. Ultimately the increased level of commercial lending and resulting increase in risk resulted in an increase in charge-offs from $1.0 million in fiscal 2003 to $3.1 million in fiscal 2008, and $1.8 million of charge-offs in fiscal 2009 (through June 30). Of the $3.1 million in charge-offs in fiscal 2008, $3.0 million were related to commercial business and commercial real estate lending. These charge-offs further eroded Greater Atlantic's capital.

Decline in Value of Certain Investment Securities

Greater Atlantic's investment portfolio, which consisted primarily of corporate debt, non-agency collateralized mortgage obligations, and agency mortgage backed securities, also experienced significant decline in fair market value. Beginning in 2007 and continuing into 2009, the investment portfolio declined as the broader economic market value of these securities fell and the economy stagnated. While most securities reflected a decline in value, the decline in value of the corporate debt securities and collateralized mortgage obligations was most significant. At September 30, 2009, the decline in value of the securities was $4.3 million. As of that date, however, Greater Atlantic had not determined whether an other than temporary impairment existed and therefore had not reflected any of the declines in the value of the investment portfolio in its earnings.

OTS's Supervision of Greater Atlantic Bank

Despite having identified poor earnings and capital issues at Greater Atlantic as early as 2004, OTS did not issue a formal enforcement action until the 2008 ROE. Greater Atlantic received CAMELS composite ratings of 3 in 2004 and 2005. The thrift was downgraded to a CAMELS composite rating of 4 during the 2006 examination, along with component ratings of 4 for both capital and earnings, without any formal enforcement action being taken.

Based on the 2004 and 2005 examinations resulting in two consecutive CAMELS composite ratings of 3 and the 2006 examination resulting in a CAMELS composite rating of 4, there was adequate reason for earlier formal enforcement action.

Summary of OTS's Greater Atlantic Supervisory Actions

Table 1 summarizes the results of OTS's safety and soundness and limited examinations from 2003 until its closure. Matters requiring board attention (MRBA) represent the most significant items reported in ROEs requiring corrective action.

Table 1. Summary of OTS's Examinations and Enforcement Actions for Greater Atlantic

		Examination Results			
Date started/ completed	Assets (in	CAMELS rating	Number of MRBAs	Number of corrective actions	Enforcement actions
2/24/2003 4/11/2003	$529	2/222321	-	3	None
5/3/2004 6/10/2004	$396	3/323332	3	11	None
7/25/2005 9/07/2005	$365	3/323332	1	4	Board resolution
10/30/2006 3/9/2007	$305	4/423432	5	11	None
5/19/2008 8/27/2008	$231	4/433532	1	5	Consent Order dated 4/25/08
5/22/2009	N/A	5/533532	-	-	PCA Directive dated 5/22/09
9/21/2009 11/13/2009	N/A	5/544533	3	7	None

A Strong Supervisory Response to Address Greater Atlantic's Earnings and Capital Issues was Warranted in 2005

We concluded that a stronger OTS supervisory response was warranted in 2005 to address the earnings concerns that were recognized by the examiners as early as 2003. Greater Atlantic's earnings received a CAMELS component rating of 3 in 2003, 2004, and 2005. As additional component ratings also fell to a 3, the OTS issued composite ratings of 3 for Greater Atlantic's 2004 and 2005 examinations. The 2006 examination resulted in Greater Atlantic receiving a CAMELS composite rating of 4 including ratings of 4 for the capital and earnings components.

After the second consecutive composite 3 rating, the OTS field manager met with the board in September 2005 and encouraged the thrift to pursue a sale if it could not correct operating deficiencies in the near term. In addition, the OTS regional supervisory action committee met in November 2005 and agreed on the informal enforcement action of a board resolution for the need for an expeditious decision on the sale of the bank, a plan for recapitalization, and/or a new management team.[3] We found no evidence that the OTS considered taking formal enforcement action as a result of the 2005 examination. At its March 2006 board of directors meeting, the board executed a resolution authorizing and directing actions to determine the level of interest in engaging in a potential merger or acquisition of the company. In addition, the board of director's minutes identified that the board was concurrently exploring recapitalization options.

The OTS Examination Handbook Section 80 indicates that there is a presumption that savings associations with a composite rating of 3 for the latest safety and soundness examination warrant formal enforcement action under any of the following circumstances:

- Management is weak.
- There is uncertainty as to whether management and the board have the ability or willingness to take appropriate corrective measures.
- Conditions are rapidly deteriorating.
- A 3-rating continues for two consecutive examinations following the thrift entering into the informal enforcement action, unless the thrift complies with the informal enforcement action and no new grounds exist for taking a formal action.

The above guidance supports that formal enforcement action was warranted in 2005 given the two consecutive CAMELS composite

[3] Committee includes senior management officials of the OTS region who determine if and when formal enforcement action will be taken. OTS order 96-72 delegated the authority to execute supervisory agreements to regional directors.

ratings of 3 and the indication that OTS determined management to be weak, since the regional supervisory action committee suggested the board consider replacing the management team. Prior to the second composite 3 rating in 2005, the OTS had used MRBAs to seek correction of both the capital and earnings issues without success.

The OTS further downgraded the earnings component rating to a 4 in 2006, citing various issues such as:

- Net interest margin was insufficient to cover the thrift's operational expenses.
- continued losses and high expenses despite the sale of thrift branches in 2005.
- net loss resulting from final disposition costs associated with discontinuing the mortgage banking operations in March 2006.
- high general and administrative costs attributed to high legal, office occupancy, and marketing expenses.

In addition, in 2006 examiners noted concerns in regard to capital including concern over continued capital deterioration from operating losses and the overall level of capital based on the increase in higher risk loans. At September 30, 2006, Greater Atlantic's capital fell below well capitalized to adequately capitalized. OTS noted that capital was insufficient given the thrift's risk level. As such, OTS downgraded the capital component rating to a 4 as well, and restricted Greater Atlantic from paying dividends in 2007 based on concerns over regulatory capital levels.

OTS also downgraded the CAMELS composite rating to a 4 as a result of the 2006 examination. Despite downgrading capital, earnings and the overall composite ratings to 4 in 2006, OTS personnel stated that a formal enforcement action was not issued because of the negative impact a formal, public enforcement action could have on the active merger negotiations between Greater Atlantic and another financial institution. The OTS regional supervisory action committee met on April 3, 2007, and decided to give Greater Atlantic until April 23, 2007, to secure a definite agreement from the potential purchaser or face a cease and desist order (C&D). The definitive agreement was obtained; however, the potential purchaser terminated the agreement in April 2008 because of Greater Atlantic's mounting losses and financial declines in the potential acquiring institution. OTS promptly executed a C&D on April 25, 2008.

OTS policy[4] allows for discretion in the taking of enforcement actions with authorization by senior management. In this case, the enforcement approach toward Greater Atlantic was approved by the regional supervisory action committee in accordance with policy. While the formal enforcement action was delayed due to the pending sale, we conclude that OTS senior management used its enforcement discretion in an appropriate manner in 2007.

Prompt Corrective Action Used Appropriately

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund. PCA provides federal banking agencies with the authority to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility based on criteria other than capital to help reduce deposit insurance losses caused by unsafe and unsound practices. For example, OTS's Enforcement Action Policy allows for the imposing of more severe limitations than a thrift's PCA capital category would otherwise permit or require if it is determined that the thrift is operating in an unsafe or unsound condition or engaging in unsafe or unsound practices.

Greater Atlantic's capital levels fell from well capitalized to adequately-capitalized based on the September 30, 2006 TFR. The thrift's reduction in capital was identified in OTS's October 2006 ROE. OTS issued a notice on February 15, 2007, notifying Greater Atlantic that it was considered adequately capitalized. Based on Greater Atlantic's TFR data reported from September 2007 to March 2008, its capital category returned to well capitalized primarily due to shrinking assets. Based on the TFR filed for June 30, 2008, Greater Atlantic's capital ratios reflected the thrift returning to adequately capitalized.

[4] Office of Thrift Supervision Bulletin RB 32-28 "Enforcement Actions"

We concluded that OTS took the following appropriate PCA in a timely manner as the thrift's capital levels subsequently fell below adequately capitalized. Those actions, however, did not prevent Greater Atlantic's failure.

- OTS placed Greater Atlantic under a C&D effective April 25, 2008, indicating, among other things, a requirement to maintain a Tier 1 capital ratio of 6 percent and total risk-based capital ratio of 12 percent.
- Greater Atlantic's quarterly capital ratios for December 2008 reflected the institution being undercapitalized. OTS notified the institution on February 10, 2009, that it was considered undercapitalized and required the bank to submit an acceptable capital restoration plan.
- Greater Atlantic was considered significantly undercapitalized as of March 31, 2009, based on its TFR filed April 30, 2009. OTS notified Greater Atlantic on May 11, 2009, that it was considered significantly undercapitalized.
- Greater Atlantic was considered critically undercapitalized as of September 15, 2009. In May 2009, OTS issued a Stipulation and Consent to a PCA which was executed by the thrift on November 20, 2009, and which required the thrift:

    1. Recapitalize by merging with or be acquired within 10 days.
    2. Achieve and maintain minimum capital ratios.
    3. Make all diligent and good faith efforts to increase the thrift's capital and find another financial institution to recapitalize the bank through merger.
    4. Submit a weekly report from the Board of Directors to OTS and FDIC on these efforts and any potential candidate for merger.
    5. If the thrift becomes critically undercapitalized, fully cooperate with the FDIC to avoid a loss and minimize exposure to the insurance fund.
    6. Authorize FDIC to market the thrift to prospective acquirers.
    7. Prepare a weekly written report related to its compliance with the PCA and submit the report to OTS.

8. Adhere to various other restrictions on the conduct of its day to day business operations, including the following.
    - The thrift will not issue any securities, enter into any agreement to merge, or sell substantially all its assets and liabilities without first notifying the OTS in writing and receiving the OTS's non-objection.
    - The thrift will not pay interest on deposits at rates that exceed the prevailing rate of interest on deposits of similar amounts and maturities in the thrift's local market area.
    - The thrift will not increase average total assets in the quarter to exceed the average total assets of the previous quarter unless approved by OTS.

OTS closed Greater Atlantic on December 4, 2009.

Recommendation

As a result of our material loss review of Greater Atlantic Bank, we recommend that the Director of OTS ensure that issues which have been previously included in informal enforcement actions and have not been adequately addressed by thrift management be elevated to formal enforcement actions according to OTS policy. This is especially important for thrifts that have had CAMELS components downgraded to a rating of 4, and where previous informal actions were issued and not fully addressed.

Management Response

OTS responded that they concurred with the recommendation. In addition, OTS noted that it has issued a revised enforcement action policy which has been incorporated in OTS Examinations Handbook Section 080. OTS also responded that it has adopted enforcement procedures that require all recommendations regarding enforcement actions, including recommendations for no further action, be brought to the OTS Washington Enforcement Review Committee for determination.

Crowe Horwath LLP Comment

The implementation of the recommendation is the responsibility of OTS management.

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We appreciate the courtesies and cooperation provided to our staff during the audit.

Our objectives were to determine the causes of Greater Atlantic Bank's (Greater Atlantic) failure and assess its supervision by the Office of Thrift Supervision (OTS). We conducted this material loss review of Greater Atlantic under contract with the Department of the Treasury Office of Inspector General (OIG) in response to its mandate under section 38(k) of the Federal Deposit Insurance Act.[5] This section provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that:

- ascertains why the institution's problems resulted in a material loss to the insurance fund;
- reviews the agency's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38(k); and
- makes recommendations for preventing any such loss in the future.

At the time of Greater Atlantic's failure, section 38(k) defined a loss as material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.[6] The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

The OIG contracted with our firm to conduct this material loss review of Greater Atlantic based on the loss estimated by the Federal Deposit Insurance Corporation (FDIC). As of September 3, 2010, FDIC estimated that the loss to the Deposit Insurance Fund from Greater Atlantic's failure would be $38 million.

To accomplish our audit, we conducted fieldwork at OTS's Southeast Regional Office in Atlanta, GA; and at FDIC's satellite office located in Jacksonville, FL. We also interviewed officials of FDIC's Division of Supervision and Consumer Protection, contract personnel at FDIC's Division of Resolutions and Receivership, and

[5] 12 U.S.C. § 1831o(k).
[6] . P.L. 111-203, signed into law on July 21, 2010, changed the definition of material loss in section 38(k) to any estimated loss in excess of $200 million for a loss occurring in 2010 and 2011, $150 million for a loss occurring in 2012 and 2013, and $50 million for a loss occurring in 2014 or after (with a provision for a temporary increase to $75 million if certain conditions are met).

interviewed OTS personnel who worked on the Greater Atlantic examinations. We conducted our fieldwork from March 2010 through June 2010.

To assess the adequacy of OTS's supervision of Greater Atlantic, we determined (1) when OTS first identified the thrift's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the thrift to correct the problems. We also assessed whether OTS (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 period covered by our audit would be from February 24, 2003, through the thrift's failure on December 4, 2009. This period included six full-scope safety and soundness examinations prior to the appointment of FDIC as receiver of the thrift on December 4, 2009.
- We reviewed OTS's supervisory files and records for Greater Atlantic from 2003 through 2009. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OTS used to assess the thrift's condition, and the regulatory action used by OTS to compel thrift management to address deficient conditions. We 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 the thrift with OTS officials and examiners to obtain their perspectives on the thrift's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring Greater Atlantic for federal deposit insurance purposes.
- We selectively reviewed Greater Atlantic's documents that had been taken by FDIC and inventoried by FDIC Division of Resolutions and Receivership personnel. We identified from FDIC's inventory list those documents for our review that were most likely to shed light on the reasons for the thrift's failure

and OTS's supervision of the institution based on review of FDIC's description of documents in inventory.
- We assessed OTS's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act, as amended by 12 U.S.C. § 1820(d).

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.

Greater Atlantic Bank History

Greater Atlantic Bank (Greater Atlantic) was established by charter as Greater Baltimore Savings and Loan Association in Baltimore, Maryland, on May 27, 1988. On May 31, 1989, Greater Baltimore Savings and Loan Association converted from a state savings bank to a federal savings bank. The bank operated as such until June 1997 when Greater Atlantic Financial Corporation was formed as a savings and loan holding company and conducted substantially all of their business through its wholly-owned subsidiary, Greater Atlantic, a federally-charted savings bank. Greater Atlantic offered traditional banking services through its branch network located in the greater Washington D.C. metropolitan area. Greater Atlantic grew total assets to $529 million at December 31, 2003, but intentionally shrank its asset size and had assets of $203 million at September 30, 2009.

Types of Examinations Conducted by OTS

OTS conducts various types of examinations, including safety and soundness, compliance, and information technology.

OTS conducts full-scope examinations of insured thrifts once every 12 or 18 months.[7] During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns the thrift a CAMELS composite rating based on its assessment of the overall condition and level of supervisory concern.

OTS uses the 12-month cycle until the thrift's management has demonstrated its ability to operate the institution in a safe and sound manner and has satisfied all conditions imposed at the time of its charter approval. OTS examined Greater Atlantic on the 12-month cycle.

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7 18-month examination interval applies to insured thrifts that have total assets of $500 million or less that (1) received a CAMELS composite rating of 1 or 2 and a Compliance rating of 1 or 2 for their most recent examination;(2) received a CAMELS management component rating of 1 or 2 for their most recent examination;(3) are well-capitalized, (4) are not currently subject to a formal enforcement proceeding or order by OTS or the Federal Deposit Insurance Corporation; and (5) have not undergone a change in control during the 12-month period since completion of the last full-scope examination.

Enforcement Actions Available to OTS

OTS performs various examinations of thrifts that result in the issuance of reports of examinations (ROE) identifying areas of concern. OTS uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

Informal Enforcement Actions

When a thrift's overall condition is sound, but it is necessary to obtain written commitments from a thrift's board of directors or management to ensure that it will correct identified problems and weaknesses, OTS may use informal enforcement actions. OTS commonly uses informal actions for problems in well- or adequately-capitalized thrifts and thrifts with a composite rating of 1, 2, or 3.

Informal actions notify a thrift's board and management that OTS has identified problems that warrant attention. A record of informal action is beneficial in case formal action is necessary later.

If a thrift violates or refuses to comply with an informal action, OTS cannot enforce compliance in federal court or assess civil money penalties for noncompliance. However, OTS may initiate more severe enforcement action against a noncompliant thrift. The effectiveness of informal action depends in part on the willingness and ability of a thrift to correct deficiencies that OTS notes.

Informal enforcement actions include supervisory directives, memoranda of understanding, and board resolutions.

Formal Enforcement Actions

If informal tools do not resolve a problem that has been identified, OTS is to use formal enforcement tools.

Formal enforcement actions are enforceable under the Federal Deposit Insurance Act. They are appropriate when a thrift has significant problems, especially when there is a threat of harm to the thrift, depositors, or the public. OTS is to use formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems. OTS can assess civil money penalties against thrifts and individuals for noncompliance with a formal agreement or final orders. OTS can also request a federal court to require the thrift to comply with an order. Unlike informal actions, formal enforcement actions are public.

Formal enforcement actions include cease and desist orders, civil money penalties, and prompt corrective action directives.

OTS Enforcement Guidelines

Considerations for determining whether to use informal action or formal action include:

- the extent of actual or potential damage, harm, or loss to the thrift because of the action or inaction;
- whether the thrift has repeated the illegal action or unsafe or unsound practice;
- the likelihood that the conduct may occur again;
- the thrift's record for taking corrective action in the past;
- the capability, cooperation, integrity, and commitment of the thrift's management, board of directors, and ownership to correct identified problems;
- the effect of the illegal, unsafe, or unsound conduct on other financial institutions, depositors, or the public;
- the examination rating of the thrift;
- whether the thrift's condition is improving or deteriorating; and
- the presence of unique circumstances.

OTS Assessments Paid by Greater Atlantic

OTS funds its operations in part through semiannual assessments on savings associations. OTS determines each institution's assessment by adding together three components reflecting the size, condition, and complexity of an institution. OTS computes the size component by multiplying an institution's total assets, as reported on its thrift financial report, by the applicable assessment rate. The condition component is a percentage of the size component and is imposed on institutions that have a 3, 4, or 5 CAMELS composite rating. OTS imposes a complexity component if (1) a thrift administers more than $1 billion in trust assets, (2) the outstanding balance of assets fully or partially covered by recourse obligations or direct credit substitutes exceeds $1 billion, or (3) the thrift services over $1 billion of loans for others. OTS calculates the complexity component by multiplying set rates by the amounts by which an association exceeds each threshold. Table 4 shows the assessments that Greater Atlantic paid to OTS from 2003 through 2009.

Table 2: Assessments Paid by Greater Atlantic to OTS, 2003-2009

Billing Period	Exam Rating	Amount Paid	
1/1/2003 - 6/30/2003	2	$	54,347
7/1/2003 - 12/31/2003	2	$	53,278
1/1/2004 - 6/30/2004	2	$	55,181
7/1/2004 - 12/31/2004	3	$	87,911
1/1/2005 - 6/30/2005	3	$	75,659
7/1/2005 - 12/31/2005	3	$	68,645
1/1/2006 - 6/30/2006	3	$	64,541
7/1/2006 - 12/31/2006	3	$	61,242
1/1/2007 - 6/30/2007	3	$	61,481
7/1/2007 - 12/31/2007	4	$	77,614
1/1/2008 - 6/30/2008	4	$	72,188
7/1/2008 - 12/31/2008	4	$	69,116
1/1/2009 - 6/30/2009	4	$	64,212
7/1/2009 - 12/31/2009	5	$	68,128
Total		**$**	**933,543**

Source: OTS

Table 3: Number of OTS Hours Spent on Examining Greater Atlantic, 2003-2009

Examination Start Date	Number of Examination Hours*
2/24/2003	617
5/03/2004	940
7/25/2005	801
10/30/2006	922
5/19/2008	957
9/21/2009	954
Total	**5191**

Source: OTS
*Hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations.

Board resolution	A document designed to address one or more specific concerns identified by the Office of Thrift Supervision (OTS) and adopted by a thrift's board of directors.
Brokered deposit	Any deposit that is obtained, directly or indirectly, from a deposit broker. The bank or thrift solicits deposits by offering rates of interest that are significantly higher than the rates offered by other insured depository institutions in its normal market area. Use of brokered deposits is limited to well-capitalized insured depository institutions and, with a waiver from the Federal Deposit Insurance Corporation (FDIC), to adequately capitalized institutions. Undercapitalized institutions are not permitted to accept brokered deposits. (See 12 U.S.C. § 1831(f) and 12 C.F.R. 337.6.)
CAMELS	An acronym for performance rating components for financial institutions: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst.
Capital restoration plan	A plan submitted to the appropriate federal banking agency by an undercapitalized insured depository institution. A capital restoration plan specifies the steps the insured depository institution is to take to become adequately capitalized, the levels of capital to be attained during each year in which the plan is in effect, how the institution is to comply with the restrictions or requirements then in effect, the types and levels of activities in which the institution is to engage, and any other information that the federal banking agency may require.

Cease and desist order	A type of formal enforcement action. A cease and desist order issued by OTS normally requires the thrift to correct a violation of a law or regulation, or an unsafe or unsound practice. OTS may issue a cease and desist order in response to violations of federal banking, securities, or other laws by thrifts or individuals or if it believes that an unsafe and unsound practice or violation is about to occur.
Commercial real estate loan	A loan for real property where the primary or significant source of repayment is from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property. Commercial real estate loans include construction and real estate development loans, land development loans, and commercial property loans (such as for office buildings and shopping centers).
Compliance	The part of a financial institution examination that includes an assessment of how well the institution manages compliance with consumer protection and public interest laws and regulations, including the Bank Secrecy Act.
Direct credit substitute	An institution's guaranty, purchase, or assumption of a recourse exposure from another organization. For example, a purchased subordinated security is a direct credit substitute.
Deferred tax assets	Deferred tax assets represent temporary differences between the book and tax bases of assets and liabilities at enacted tax rates. A valuation allowance for deferred tax assets is recorded to reflect future tax benefits that are not expected to be realized.
Division of Resolutions and Receiverships	A division within the FDIC that is charged with resolving failing and failed financial institutions, including ensuring that depositors have prompt access to their insured funds.

Formal agreement	A type of formal enforcement action authorized by statute. Formal agreements are generally more severe than informal actions and are disclosed to the public. Formal actions are also enforceable through the assessment of civil money penalties.
Full-scope examination	Examination activities performed during the supervisory cycle that (1) are sufficient in scope to assign or confirm an institution's CAMELS composite and component ratings; (2) satisfy core assessment requirements; (3) result in conclusions about an institution's risk profile; (4) include onsite supervisory activities; and (5) generally conclude with the issuance of a report of examination.
Generally accepted accounting principles	A widely accepted set of rules, standards, and procedures for reporting financial information established by the Financial Accounting Standards Board.
Impairment	Decline in fair value of an asset below the amortized cost basis.
Matter requiring board attention	A practice noted during an OTS examination of a thrift that deviates from sound governance, internal control, and risk management principles. The matter, if not addressed, may adversely affect the thrift's earnings or capital, risk profile, or reputation or may result in substantive noncompliance with laws or regulations, internal policies or processes, supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by the institution. Although matters requiring board attention are not formal enforcement actions, OTS requires that thrifts address them. A thrift's failure to do so may result in a formal enforcement action.
Prompt corrective action	A framework of supervisory actions for insured

institutions that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as an institution falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. (See 12 U.S.C. § 1831o.)

The prompt corrective action minimum requirements are as follows:

Capital Category	Total Risk-Based		Tier 1/ Risk-Based		Tier 1/ Leverage
Well capitalized[a]	10% or greater	and	6% or greater	and	5% or greater
Adequately capitalized	8% or greater	and	4% or greater	and	4% or greater (3% for 1-rated)
Undercapitalized	Less than 8%	or	Less than 4%	or	Less than 4% (except for 1-rated)
Significantly undercapitalized	Less than 6%	or	Less than 3%	or	Less than 3%
Critically undercapitalized	Has a ratio of tangible equity to total assets that is equal to or less than 2 percent. Tangible equity is defined in 12 C.F.R. § 565.2(f).				

To be well-capitalized, a thrift also cannot be subject to a higher capital requirement imposed by OTS.

Recourse — With respect to financial assets such as loans, the legal ability of the purchaser of an asset to make a claim against the seller of the asset if the asset fails to pay. For example, a loan sold with a recourse provision would allow the loan's purchaser to make a claim against the loan's seller in the event of debtor default.

Risk-based capital — The sum of Tier1 plus Tier 2 capital.

Safety and soundness — The part of an examination that includes a review and evaluation of each of the component CAMELS ratings (see explanation of CAMELS, above).

Tangible equity	Total assets minus intangible assets minus total liabilities.
Tier 1 capital	Common shareholder's equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.
Thrift financial report	A financial report that thrifts are required to file quarterly with OTS. The report includes detailed information about the institution's operations and financial condition and must be prepared in accordance with generally accepted accounting principles. The thrift financial report is similar to the call report required of commercial banks.
Wholesale funding	Funding obtained by financial institutions through such sources as federal funds, public funds, FHLB advances, the Federal Reserve's primary credit program, foreign deposits, and brokered deposits.

Office of Thrift Supervision
Department of the Treasury

Thomas A. Barnes
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April 19, 2011

MEMORANDUM FOR: Crowe Horwath, LLP
Contractor to Treasury Office of Inspector General

FROM: Thomas A. Barnes /s/
Deputy Director

SUBJECT: Draft Audit Report on the Material Loss Review (MLR) of Greater Atlantic Bank

Thank you for the opportunity to comment on the draft Material Loss Review Report (Report) for Greater Atlantic Bank prepared by Crowe Horwath, LLP for the Department of the Treasury Office of Inspector General (OIG). The stated objectives of the Report were to determine the causes of Greater Atlantic's failure and to evaluate the Office of Thrift Supervision's (OTS) supervision of the Bank. The Report concluded that Greater Atlantic failed due to the Bank's inability to generate core earnings from its banking operations, its reliance on wholesale funding sources, its risk exposure to, and loan losses from, commercial construction, commercial real estate and land development loans, and the decline in the value of its investment portfolio. Net losses caused capital levels to erode and the Bank was unable to consummate a planned sale.

The Report notes that OTS identified significant problems at Greater Atlantic, including the Bank's insufficient core earnings, eroding capital position and poor financial condition, and management's lack of ability to implement corrective actions. However, OTS did not take a formal enforcement action against Greater Atlantic until April 25, 2008, when an Order to Cease and Desist became effective. OTS did not pursue formal enforcement action in 2007 in consideration of the proposed sale of Greater Atlantic to another bank, which ultimately failed to close. The Report recommends that the Director of OTS, in accordance with OTS policy, ensure that issues which have been previously included in informal enforcement actions and have not been adequately addressed by thrift management be elevated to formal enforcement action.

We acknowledge and concur with the conclusions and the recommendation in the Report. OTS issued a revised enforcement action policy under cover of Regulatory Bulletin (RB) 37-23, dated July 18, 2008. The enforcement action policy was incorporated in OTS Examinations Handbook Section 080 and requires, among other things, that formal action be considered for CAMELS composite 3 rated institutions when there is uncertainty of management's ability or willingness to take appropriate corrective actions, the Management component is rated 3 or below, the thrift is not in compliance with prior commitments, its overall condition is rapidly deteriorating, and/or a composite 3 rating has continued for two examinations after informal action has been taken. In addition, OTS has adopted enforcement procedures that require all recommendations regarding enforcement actions against an institution, including recommendations for no further action, be brought to the OTS Washington Enforcement Review Committee for determination in order to ensure compliance with the OTS policy and consistency among all OTS Regions. We believe the policies and procedures that OTS has put in place fully address the recommendation contained in the Report.

Thank you again for the opportunity to review and respond to the draft Report. OTS appreciates the professionalism and courtesies provided by your staff on behalf of the Office of Inspector General.

Section II

Report Distribution

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