



# Audit Report



OIG-11-087

SAFETY AND SOUNDNESS: Material Loss Review of New South Federal Savings Bank

July 14, 2011

Office of  
Inspector General

Department of the Treasury

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**Memorandum for the Acting Director, Office of Thrift Supervision**

**Section I Moss Adams LLP's Report on the Material Loss Review of  
New South Federal Savings Bank**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

OFFICE OF  
INSPECTOR GENERAL

July 14, 2011

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

**FROM:** Donald P. Benson /s/  
Audit Director

**SUBJECT:** Material Loss Review of New South Federal Savings Bank

**INTRODUCTION**

The Office of Thrift Supervision (OTS) closed New South Federal Savings Bank (New South), Irondale, Alabama, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on December 18, 2009. As of September 3, 2010, FDIC estimated that New South's loss to the Deposit Insurance Fund was \$227 million.

Under section 38(k) of the Federal Deposit Insurance Act, we are responsible for conducting a material loss review of the failure of New South.<sup>1</sup> To help fulfill this responsibility, we contracted with Moss Adams LLP, an independent certified public accounting firm. Moss Adams's report dated July 14, 2011, is provided as Section I.

**RESULTS OF MATERIAL LOSS REVIEW**

We concur with Moss Adams's reported conclusions regarding New South's causes of failure and OTS's supervision of New South:

- New South failed primarily because of significant loan losses incurred as a result of a concentration in higher-risk loan products, including residential construction, land, nonconforming residential mortgage,

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<sup>1</sup> At the time of New South'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).

and indirect auto loans in geographic areas hit hardest by the economic recession. New South management attempted to achieve better earnings through this strategy but failed to manage the risk.

- OTS identified the high risks associated with New South's portfolio of higher-risk loan products, but did not aggressively pursue resolution until it was too late. During examinations from 2004 through 2008, OTS reported that the risk was mitigated by adequate credit administration and lending controls. Prior to 2009, OTS's only action was an informal agreement in 2003 to require New South to maintain higher levels of capital due to its high-risk profile. However, OTS relaxed the requirements of the agreement in 2005, and did not take further action as concentrations rose and capital ratios declined, until 2009.

Details of Moss Adams's conclusions are contained in their report.

We also concur with Moss Adams's reported recommendation that OTS consider tracking and re-assessing capital requirements as risk and concentrations change on a quarterly basis. While we believe this recommendation is appropriate based on the findings and conclusions by Moss Adams, it should be noted that pursuant to P.L. 111-203, the functions of OTS will transfer to other federal banking agencies on July 21, 2011

## **OBJECTIVES, SCOPE, AND METHODOLOGY**

Under section 38(k), we are required to prepare a report to OTS that (1) ascertains why New South'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.

To assist us in fulfilling this responsibility, we contracted with Moss Adams 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 Moss Adams; 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 (617) 223-8638.

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## **Section I**

### **Moss Adams LLP's Report on the Material Loss Review of New South Federal Savings Bank**

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**INSPECTOR GENERAL  
DEPARTMENT OF THE TREASURY  
MATERIAL LOSS REVIEW  
NEW SOUTH FEDERAL SAVINGS BANK**

**July 14, 2011**

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## Abbreviations

ALLL	Allowance for loan and lease Loss
C&D	Cease and desist
CEO	Chief executive officer
New South	New South Federal Savings Bank
FDIC	Federal Deposit Insurance Corporation
LTV	Loan-to-value
MRBA	Matters requiring board attention
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
PCA	Prompt corrective action
ROE	Report of examination
TFR	Thrift financial report

Inspector General  
Department of the Treasury

RE: Transmittal Results for the Material Loss Review for  
New South Federal Savings Bank, Irondale, Alabama

This letter is to acknowledge delivery of our performance audit report on the Material Loss Review for New South Federal Savings Bank (New South).

The objectives of this performance audit were to: (1) determine the causes of New South's failure and resulting loss to the Deposit Insurance Fund and (2) assess the Office of Thrift Supervision's (OTS) supervision of New South, including implementation of the prompt corrective action (PCA) provisions of section 38 of the Federal Deposit Insurance Act.

The information included in this report was obtained during our fieldwork, which occurred during the period from March 15, 2010, through July 31, 2010. The estimated loss to the Deposit Insurance Fund for New South at the time of its failure on December 18, 2009, was \$227 million.

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.

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 New South's history and OTS's supervision process.

Spokane, Washington  
July 14, 2011

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## Results in Brief

The primary cause of New South Federal Savings Bank's failure was the significant loan losses incurred as a result of aggressive lending strategies. This led to a concentration<sup>2</sup> in higher-risk loan products, including residential construction, land,<sup>3</sup> nonconforming residential mortgage, and indirect auto loans in geographic areas hit hardest by the economic recession.

OTS's supervision of New South did not aggressively pursue resolution to risks and problems identified in the examinations until it was too late.

The only OTS action prior to 2009 was an informal agreement in 2003 to require New South to maintain higher levels of capital due to its high-risk profile. The requirements of the agreement, however, were relaxed in 2005 by OTS. We found no tracking or revisions to that agreement as concentrations rose and capital ratios declined, nor any other directive to retain more capital prior to 2009.

It was not until after the September 2008 examination that OTS took a formal enforcement action by issuing a cease and desist order (C&D) in April 2009.

As a result of the work we performed, we recommend OTS consider tracking and re-assessing capital requirements as risk and concentrations change on a quarterly basis.

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<sup>2</sup> 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 (OIG) website at [http://www.treasury.gov/about/organizational-structure/ig/Documents/oig11065%20\(508\).pdf](http://www.treasury.gov/about/organizational-structure/ig/Documents/oig11065%20(508).pdf)

<sup>3</sup> Land loans include lot loans and land development loans.

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## Causes of New South's Failure

The primary cause of New South's failure was the significant loan losses incurred as a result of a concentration in higher-risk loan products, including residential construction, land, nonconforming residential mortgage, and indirect auto loans in geographic areas hit hardest by the economic recession. New South management attempted to achieve better earnings through this strategy but failed to manage the risk.

### **New South Incurred Significant Loan Losses Beginning in 2008**

New South experienced significant net operating losses between January 2008 and September 2009. Net loan charge offs of over \$120 million were taken in New South's residential construction, land, nonconforming residential mortgage, and indirect auto loan portfolios during the same timeframe. New South's equity capital declined from over \$140 million at January 1, 2008, to less than \$3 million at September 30, 2009, leaving it classified as "critically undercapitalized." When New South began to experience significant loan losses in 2008, the majority of those losses were from residential construction, land, and nonconforming residential mortgage loans.

The nonconforming residential mortgage and indirect auto loans included high levels of loans with subprime characteristics. Between December 31, 2005, and September 30, 2008, total loans with subprime characteristics grew from \$270 million to \$455 million.

Management's strategy was to retain nonconforming mortgage loans, which included the subprime loans, in order to increase the yield of New South's loan portfolio. Additionally, New South generated these loans in rising real estate markets around the country. When real estate values in these markets experienced severe declines beginning in 2006, New South was exposed because of its higher-risk portfolio and was limited in its ability to respond in a declining market.

New South did not experience net operating losses until the second quarter of 2008. Net losses accelerated in subsequent quarters. During the period of January 2008 through September 2009, New

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South had a total of over \$135 million in net losses, with nearly 70 percent, or \$100 million, of the net losses occurring in the second and third quarters of 2009.

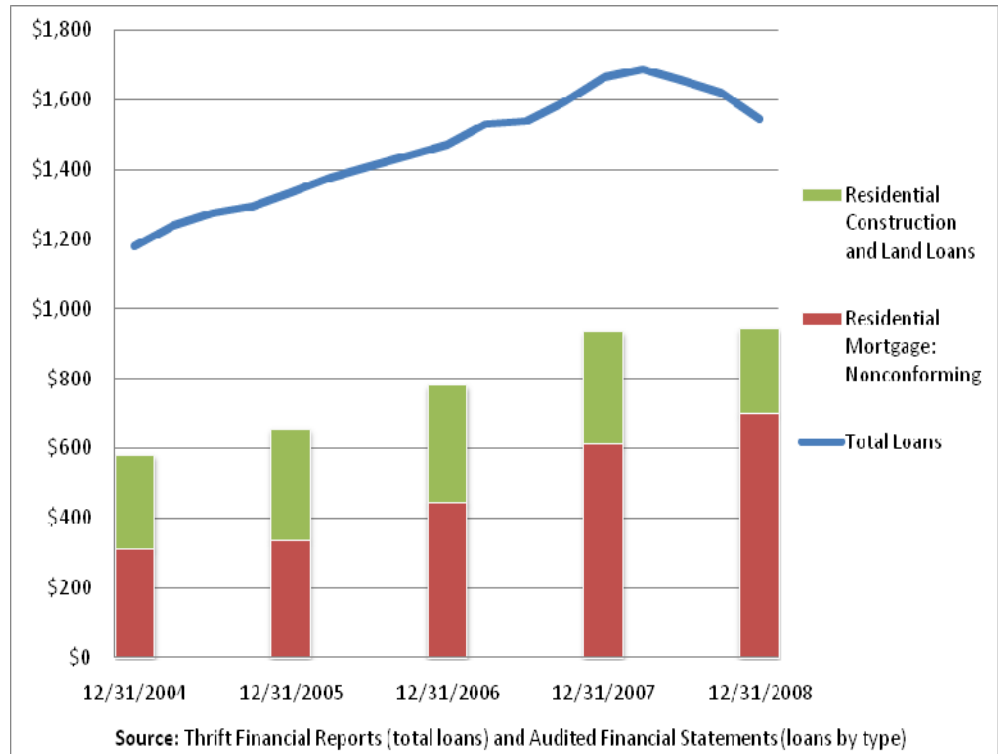
Net losses were driven by the increase in the provision expense, which was needed to increase the allowance for loan and lease loss (ALLL). In its 2004, 2006, and 2007 examinations, OTS examiners concluded that the ALLL balance was sufficient. However, in the 2008 examination, examiners determined the ALLL was insufficient and instructed management to enhance its methodology to take into account delinquency rates and trends, and to improve the appraisal review function within the impairment calculation to include better documentation of independent reviews. Also in the September 2008 examination, examiners classified \$41 million of loans, which resulted in management's calculation of an additional \$1 million needed in the ALLL as of September 30, 2008.

This increase in the provision expense was significantly affected by both subprime lending and the declining housing market. Although residential construction and land loans made up \$349 million of total loans at December 31, 2007, representing 21 percent of total loans, net charge offs experienced in this segment of the portfolio were approximately \$84 million, representing more than 65 percent of net charge offs from January 1, 2008, to September 30, 2009.

### **New South Pursued an Aggressive Growth Strategy and Carried High Loan Concentrations**

New South generated loans through a growth strategy from 2004 through 2008. This growth strategy resulted in high concentrations of loans, both by loan type and geography. These loan concentrations included residential construction, land, and nonconforming residential mortgage loans. Additionally, this strategy was coupled with growth in some of the fastest growing real estate markets in the country, including Nevada, Georgia, Arizona, and Texas. New South increased total loans by approximately 43 percent or \$507 million from December 31, 2004, through the peak at March 31, 2008. This growth is shown in the following graph, noted as Figure 1.

**Figure 1: Loan Growth by Category**  
(\$ in millions)



In addition to New South's growing concentrations during the years 2005 through 2008 shown in Figure 1, of particular note is the following:

- The largest piece of the loan portfolio during this period was the nonconforming residential mortgage loans, which reached a peak in 2008 of \$701 million, or 547 percent of risk-based capital.
- The second largest piece of the loan portfolio during the period of 2005 through 2008 was the residential construction and land loans, which reached a peak in 2006 of \$337 million, or 218 percent of risk-based capital.
- Although the nonconforming residential mortgage loans represented the largest concentration of the loan portfolio, as



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noted above, the residential construction and land loans increased from \$269 million at December 31, 2004, to \$337 million at December 31, 2007, an increase of \$68 million, or 25 percent.

With loan production offices in 12 states, New South was able to grow and diversify its loan portfolio geographically. Virtually all of the loans were secured by real estate and concentrated in six<sup>4</sup> major markets. Many of these markets experienced unprecedented declines in real estate values from January 2006 to December 2008, which furthered the deterioration of New South's asset quality.

New South's residential construction and land loans increased significantly in Nevada, and also increased moderately in Georgia, Tennessee, Arizona, and Texas. Each of these markets experienced a decline from 2006 to 2008, and the largest decline took place in Nevada, the state where New South's concentration grew the most over the period.

With the drop in housing and real estate prices, many residential construction and development projects were worth less than the outstanding loan balances. New South was forced to write down the balances of many loans due to rapidly declining collateral values following significant delinquencies. Additionally, as a result of falling home values, borrowers were unable to sell properties at prices adequate to pay off existing loans. Many borrowers did not repay loan obligations and defaulted on mortgage loans as did homebuilders and developers.

On December 31, 2005, of the more than \$270 million of subprime loans in New South's loan portfolio, management noted that over \$100 million of these loans had at least one delinquent payment in the previous 12-month period. Management, however, continued to increase the Bank's exposure to subprime credits to over \$455 million as of September 30, 2008.

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<sup>4</sup> Based on review of OTS examination files, the major markets that New South was lending in were Nevada, Georgia, Tennessee, Arizona, Texas, and Alabama.

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## **New South Board and Management Failed to Adequately Manage Risk**

New South's operating strategy and business model was built on higher-risk activities that included growth, subprime lending, and a practice of retaining high-yielding, high-risk loans in its portfolio. This operating strategy was an attempt to achieve better earnings but resulted in substantial losses once the economic environment became less favorable.

In our review of the examination reports and OTS summary of Board minutes and actions, as well as the Board-approved annual business plans, we noted that as early as 2006, when mortgage loan originations began to decline, management and the Board refocused its attention to nonconforming residential mortgage loans to keep production levels higher. During 2007, management increased the nonconforming residential mortgage loan portfolio by approximately \$170 million, or 38 percent. The Board discussed this strategy throughout 2007 and concluded this was the appropriate direction, given the higher yields and the overall strategic plan of New South.

Management was slow to respond when property values began to decline and did not adequately monitor geographic concentrations. As early as 2006, management identified that home sales nationally were down 13 percent from a year earlier. The Board noted that this was due to consumers expecting home prices to begin declining. Management's response was to specifically include expansion of the mortgage lending programs in its 2007 strategic plan.

During the fourth quarter of 2007, the Board and management were informed of at least five homebuilders in various markets that were having difficulties meeting their loan obligations. These builders were located in Arizona and Georgia and their developments should have raised concerns with the Board and management about economic developments in these areas. By the first quarter of 2008, classified assets had increased by 25 percent to \$104 million. This increase was primarily due to problem loans in the residential construction lending portfolio. Despite this increase in problem loans, management did not increase the ALLL.

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New South's management team was based primarily in Alabama, geographically distant from states where the thrift had significant amounts of residential construction and land loans. While the 2007 OTS examination specifically mentioned management's "excellent job of analyzing the local areas and economies prior to entering a particular marketplace," there was no evidence in the examination reports and supporting documentation of ongoing monitoring of these marketplaces after the Bank had established a presence in a particular market.

In the quarterly Board meetings from 2006 through 2008, there was no mention of geographically-specific economic issues, nor any evidence that the economic conditions of the lending areas were considered. Management acknowledged late in 2008 that New South had not been as conservative as it should have been during the years 2005 through 2007 in its management of the residential construction lending portfolio.

Management designed and promoted lending programs for higher-risk borrowers, particularly in the indirect auto lending and the residential mortgage lending programs. These programs successfully attracted subprime borrowers, defined by New South as borrowers with credit scores of 660 or lower. As of September 30, 2008, according to OTS's examination report of the same date, New South carried approximately \$455 million of these subprime loans, which was 23 percent of loans outstanding. This represented an increase of \$185 million in these high-risk loans, as compared to December 31, 2005. The increase in this segment of the portfolio was a direct result of management's strategy of retaining these types of loans because of the higher-yields they typically carry.

Net charge offs in the residential mortgage and indirect auto loan portfolios from January 1, 2008, to September 30, 2009, totaled over \$36 million. The significant increase in subprime loans New South retained in 2006 and 2007, noted previously, created a significant credit risk exposure.

As a result of this high-risk business strategy and management's

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inadequate monitoring of the conditions it created, coupled with the economic downturn and decline in property values, New South experienced losses from which it did not recover.

## OTS's Supervision of New South

OTS's supervision of New South did not aggressively pursue resolution to risks and problems as identified in the examinations, related to curtailing New South's high-risk business model and retaining additional capital commensurate with its risk profile, until it was too late.

In the October 2004 safety and soundness examination, OTS identified New South's loan portfolio as "high-risk given its significant nonhomogenous auto and nonconforming subprime mortgage portfolios." The theme was repeated in each examination leading up to the September 2008 examination. However, it was also noted that this risk was mitigated by adequate credit administration and lending controls. It was not until the September 2008 examination and subsequent January 2009 visitation that OTS took formal supervisory action at New South.

The only OTS action prior to 2009 was an informal agreement in 2003 to require New South to maintain higher levels of capital due to its high-risk profile. The requirements of the agreement, however, were relaxed in 2005 by OTS. We found no tracking or revisions to that agreement as concentrations rose and capital ratios declined, nor any other directive to retain more capital prior to 2009.

### **OTS Identified the Risk at New South but Failed to Take Appropriate Action**

OTS correctly identified New South's portfolio as high risk, but failed to use its supervisory capacity to reduce the credit risk the institution's lending strategies were creating. During the September 2008 full scope safety and soundness examination, OTS became fully aware of the financial stress New South was under. The report of examination (ROE) identified for the first time that New South was in an "unsafe and unsound condition" requiring immediate action by management and the Board of Directors to address the concerns noted in the report.

Until 2008, New South had received CAMELS composite ratings of “2” in the previous five ROEs, dating back to February 2002. In virtually every examination, very few matters requiring board attention (MRBA) were noted in the examinations and only a few items were noted for corrective action. OTS examiners, however, repeatedly expressed concern about the high risk posed by New South’s concentration of land, construction, indirect auto, and nonconforming residential mortgage loans. OTS also noted the concentrations continued to grow in 2006 and 2007. Table 1 provides the historical details of New South’s previous examinations.

**Table 1. Summary of OTS’s New South Examinations and Enforcement Actions**

<i>Date Started</i>	<i>Date Mailed</i>	<i>Assets (in millions)</i>	<b>Examination Results</b>			<i>Informal and Formal Enforcement Actions</i>
			<i><u>CAMELS</u> Rating</i>	<i>Number of MRBAs</i>	<i>Number of Corrective Actions</i>	
10/25/2004	2/18/2005	1,403	2/222211	0	2	None
1/30/2006	5/19/2006	1,653	2/222211	1	1	None
5/31/2007	9/27/2007	1,812	2/222211	1	1	None
9/2/2008	2/13/2009	1,962	4/444442	9	14	None
NA	NA	NA	4/444442	NA	NA	On 5/15/2009, OTS issued a <u>C&amp;D</u> to New South
1/23/2009	1/26/2009	1,944	4/444442	NA	NA	None
NA	NA	NA	4/444442	NA	NA	On 8/3/2009, New South deemed “Significantly Undercapitalized”; Prompt Corrective Action initiated 8/3/2009; requires New South to file a <u>Capital Restoration Plan</u> with OTS by August 28, 2009.
9/4/2009	9/4/2009	1,712	5/554542	NA	NA	Rating downgrade

Source: OTS Reports of Examination.

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New South received exactly the same component and composite CAMELS ratings in the 2004, 2006, and 2007 examinations, followed by a downgrade to a composite 4 in 2008. We noted capital and concentration concerns prevailed throughout the period. The increasing loan losses contributed to the deterioration of capital. More aggressive enforcement actions may have been appropriate to increase capital requirements, to curtail lending activity, and to sell nonconforming loans until concentrations came within acceptable guidelines.

### **OTS Should Have Required New South to Curtail Its High-Risk Business Model**

OTS defines a concentration as a group of similar types of assets or liabilities that, when aggregated, exceeds 25 percent of a thrift's risk-based capital. Concentrations pose additional risk because the same economic, political, or environmental event can negatively affect the entire group of assets or liabilities. New South had high concentrations, as defined by OTS, in residential construction, land, nonconforming residential mortgages, and indirect auto loans, without adequate additional levels of capital to compensate for the additional risk.

Section 212 of the OTS Examination Handbook specifically addresses nontraditional mortgage products and the appropriate supervisory response. Appendix F of Section 212, dated March 2007, states that institutions should have risk management practices and monitoring systems to track and manage concentrations. Ineffective management of concentrations is subject to elevated supervisory attention to assure timely remediation.

Section 201 of the OTS Examination Handbook, dated June 2005, does not provide specific tolerable concentration levels; however, it does provide some examples of concentrations that represent supervisory concern. Examiner emphasis should be on assessing management's effectiveness in identifying and controlling concentration risk.

As noted earlier, New South increased total loans by approximately 43 percent or \$507 million from 2004 through the peak in 2008, and as shown on Figure 1, New South invested in high-risk loans during this

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time period, resulting in mounting concentration and credit risk. OTS examiners did not require New South to limit concentrations in higher-risk loan products until 2008, when these loans began deteriorating in asset quality.

Also as previously noted, OTS and New South entered into an informal agreement in January 2003 because of concerns related to capital levels. Based on discussions with management, OTS was persuaded to relax some of those requirements in 2005, at a time when loan concentrations were growing and capital concerns had not been adequately addressed. Rather than relax the capital requirements, we believe OTS should have taken formal enforcement action, such as a formal written agreement, to curb and monitor New South's higher risk and concentrated loan growth as soon as it became a repeat finding in the examination. The OTS did not take formal or informal enforcement action until 2009 when a Letter Notification of Troubled Condition was sent and a C&D Order was issued to New South.

We also believe OTS should have deployed more aggressive enforcement actions and monitoring from 2005 forward to curtail the aggressive business model that laid the path to New South's failure.

### **OTS Should Have Required New South to Retain Additional Capital**

OTS has the authority to establish a higher than normal capital requirement for a thrift. In January 2003, New South entered into an informal agreement that required New South to provide additional risk-based capital to support the loan portfolio because loan-to-value (LTV) and credit quality portrayed characteristics of subprime lending. The intent of the agreement was to require New South to keep additional capital to compensate for the additional risk in its loan portfolio. The terms of the agreement required that New South utilize higher percentages in calculating the required capital for certain higher-risk loan types. Not all segments of loans required additional risk weightings; however, the agreement specified additional capital consideration for nonconforming residential mortgage loans, conforming residential mortgage loans, manufactured housing loans, and auto loans.

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In October 2005, New South requested OTS consider reducing some of the requirements in the agreement. After review, OTS took no exception to New South's request primarily due to management's argument that the historical losses associated with the nonprime portfolio were not significant to warrant appreciable additional capital support. Additionally, management contended that the expense of tracking those loans with delinquencies greater than 1 year was considerable. The original agreement distinguished between loans with late payments within the prior 24 months, the prior 18 months, and within the prior 12 months. The revised agreement allowed the Bank to subdivide the delinquencies into two categories – those with no late payments over the previous 12 months and all others.

The result of this change was a reduction in the required capital under the revised agreement. Based on September 30, 2005, data, New South would be required to hold approximately \$124 million in capital, compared to \$130 million required under the original agreement, a decrease of \$6 million, in order to maintain a risk-based capital level of 10.94 percent. The revised plan became effective December 31, 2005.

From December 2005 until June 2008, the core capital of New South increased from \$130 million to \$140 million, but the core capital ratio declined from 10.72 percent to 9.83 percent. This decline resulted from assets growing at a quicker pace than the Bank's retained capital generated from earnings.

The use of the informal agreement was an appropriate initial response to the risk in New South's loan portfolio but did not go far enough to assure that capital levels matched the increasing risk in the loan portfolio. OTS examiners repeatedly expressed concern about the high risk posed by New South's concentration of land, residential construction, and nonconforming residential mortgages. The intent of the informal agreement was to require New South to retain additional capital in order to offset the credit risk in the Bank's portfolio. OTS noted that concentrations continued to grow in 2006 and 2007, but the 2005 agreement for higher-capital ratios was not revised to reflect the increasing risk. During our interviews with examiners, they indicated that because the Bank continued to be rated an overall composite 2,



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they saw no reason to revise the agreement to require higher capital ratios.

Quarterly monitoring reviews based on Thrift Financial Reports (TFR) are performed at a high level, focusing on lending trends and asset quality. The Detailed Hits Report, included in the reviews, cite significant changes and highlight key variances; however, there was no indication that the relationship of capital requirements to rising concentrations and delinquencies were included in the review analytics.

New South was continuing to increase its risk profile, as noted in the OTS Quarterly Monitoring Reviews, we believe OTS should have recognized that New South's voluntary capital level was not achieving its intended outcome and, as a result, taken a stronger regulatory approach.

#### **OTS Used PCA After Capital Fell to Significantly Undercapitalized Level**

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost 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.

On May 15, 2009, OTS issued a C&D. OTS required New South to meet and maintain specific capital levels, and OTS deemed the thrift to be adequately capitalized, even though New South's capital level met the definition of well capitalized. While its capital level met the definition of well capitalized, OTS examiners stated in the 2008 ROE that New South's capital was considered insufficient to fully support the risk profile of New South. Because of its adequately capitalized designation, New South was prohibited from accepting or renewing brokered deposits unless it obtained a waiver from the Federal Deposit Insurance Corporation (FDIC). New South remained designated as adequately capitalized until June 2009.

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OTS implemented PCA as described below, based on specific criteria:

- On August 3, 2009, OTS notified New South that it was significantly undercapitalized based on the Bank's June 30, 2009, TFR. OTS directed New South to submit an acceptable capital restoration plan by August 28, 2009. OTS also informed New South that it must comply with PCA-required restrictions on the payment of dividends and management fees. New South submitted a plan on August 28, 2009, and a revised plan on August 31, 2009.
- On September 24, 2009, New South informed OTS that based on financial results, as of August 31, 2009, it had fallen into the "critically undercapitalized" category under PCA standards.
- On October 30, 2009, OTS denied New South's capital restoration plan submitted on August 28, 2009, and revised on August 31, 2009. Also, OTS issued a Notice of Intent to Issue a Prompt Corrective Action Directive.
- On November 10, 2009, OTS issued New South a Prompt Corrective Action Directive, and New South stipulated and consented to the terms of the agreement. The terms required recapitalization in order to achieve and maintain minimum capital requirements within 30 days or the delivery of a binding merger agreement with another financial institution within 15 days.

We concluded that the actions taken were in accordance with PCA requirements. However, capital concerns existed throughout the examinations and OTS should have taken action sooner and more forcefully through its other enforcement authorities.

### **OTS' Internal Failed Bank Review**

OTS conducted an internal failed bank review of New South dated October 28, 2010, in accordance with OTS policy. The internal review found that New South's failure was caused primarily by losses on loans that resulted from the decline in real estate values as well as the

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economic recession, and was aggravated further by concentrations in various loan types, which raised its risk exposure.

OTS's review concluded that from the September 2008 examination through the date New South was closed, OTS took timely and appropriate action. However, the review further noted that OTS oversight in prior years could have been stronger to limit New South's risk exposure. We concur with this conclusion.

OTS findings and resulting recommendations related to (1) concentration limits, (2) supplementing OTS guidance and training on appropriate stress testing, and (3) on-site examiner presence in high volume locations. OTS has taken action on concentration limits<sup>5</sup> and on-site examiner presence in high volume locations,<sup>6</sup> and we recommend that action also be taken to implement the other recommendation noted in the report.

## Recommendation

As a result of the work we performed, we recommend OTS consider tracking and re-assessing capital requirements as risk and concentrations change on a quarterly basis.

### Management Response

OTS generally concurred with the findings and recommendation, as noted in a July 12, 2011, written response to our draft report. OTS management considers being in compliance with this recommendation through the quarterly monitoring process, which includes a review of the capital risk as well as concentration risk analysis. For the full text of OTS response to the draft report, see Appendix 4.

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<sup>5</sup> Concentrations were addressed in OTS CEO Letter 311 Risk Management Asset and Liability Concentrations issued on July 9, 2009.

<sup>6</sup> Examination Scheduling, Scoping and Management was addressed in OTS Regulatory Bulletin 37-68 issued February 10, 2011.

## Appendix 1 Objectives, Scope, and Methodology

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We performed a Material Loss Review of the failure of New South Federal Savings Bank (New South) under a contract with the Department of the Treasury Office of Inspector General. Our objectives were to determine the causes of New South's failure and assess its supervision by the Office of Thrift Supervision (OTS).

We conducted this review of New South in response to Section 38(k) of the Federal Deposit Insurance Act. 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 Deposit Insurance Fund;
- reviews the agency's supervision of the institution, including its implementation of the prompt corrective action provisions of section 38; and
- makes recommendations for preventing any such loss in the future.<sup>7</sup>

To accomplish our review, we conducted fieldwork at OTS regional office in Atlanta, Georgia. We also interviewed officials of the Federal Deposit Insurance Corporation's (FDIC) Division of Supervision and Consumer Protection and interviewed FDIC's Division of Resolutions and Receiverships personnel. Additionally, we visited the Jacksonville, Florida, FDIC offices to conduct on-site reviews of certain documents seized from New South and retained by the FDIC. We conducted our fieldwork during April 2010 through July 2010.

To assess the adequacy of OTS's supervision of New South, we determined (1) when OTS first identified New South's safety and soundness problems; (2) the gravity of the problems; and (3) the supervisory response OTS took to get the Bank to correct the

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<sup>7</sup> At the time of New South'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. Amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, effective July 21, 2010, Section 38(k) defines a material loss as any loss in excess of \$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 can be raised temporarily to \$75 million if certain conditions are met).

## Appendix 1 Objectives, Scope, and Methodology

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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 procedures:

- Based on reviews of the reports of examination, we established the scope of our audit would be from 2004 through 2009. We reviewed OTS's supervisory files and records for New South from 2004 through 2009. We analyzed ROEs, 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 Bank's condition, and the regulatory action used by OTS to compel Bank management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated financial statements other than those available through the supervisory files. The documents available through review of the supervisory files consisted primarily of audited financial statements and internal control recommendations made by the external auditors.
- We interviewed and discussed various aspects of the supervision of New South with OTS officials and examiners to obtain their perspective on the Bank's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring New South for federal deposit insurance purposes.
- We performed work and interviewed personnel at FDIC's Division of Resolutions and Receiverships who were involved in the receivership process, which was conducted before and after New South's closure and appointment of receiver.
- We assessed OTS's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act, at 12 U.S.C. § 1820 et seq.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that

## Appendix 1 Objectives, Scope, and Methodology

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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 the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Appendix 2 Background

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### New South History

New South Federal Savings Bank (New South) was formed in 1985 as a subsidiary of Collateral Investment Company. Collateral Investment Company was reorganized in 1986 to form Collateral Mortgage, Ltd. New South remained a subsidiary of Collateral Mortgage, Ltd., until 1994 when it was transferred to New South Bancshares, Inc. (Bancshares). Bancshares was a unitary, nondiversified holding company existing for the sole purpose of holding New South stock. Bancshares was controlled by its majority shareholders. As of September 30, 2009, New South had only one branch in Irondale, Alabama, for retail banking and loan production offices located in Alabama, Arizona, Arkansas, Georgia, Nevada, North Carolina, Tennessee, and Texas.

New South had two main business lines: mortgage banking and traditional commercial and retail banking. New South's mortgage banking operations historically supplied a considerable amount of recurring interest and fee income. New South's commercial banking line focused on out-of-market lending to residential developers and other commercial facilities. Many of these commercial facilities were auto dealers and New South provided automobile floor plan lending. The retail line primarily focused on residential loans and indirect auto lending.

### Types of Examinations Conducted by OTS

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

OTS must conduct full-scope, onsite examinations of insured thrifts once during a 12-month cycle or an 18-month cycle, based on the asset size of the institution and other factors. Examinations of New South were required to be conducted every 12 months.

During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns each thrift a composite rating based on its assessment of the overall condition and level of supervisory concern.

## Appendix 2 Background

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### Enforcement Actions Available to OTS

OTS performs various examinations of thrifts that result in the issuance of reports of examinations 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 it will correct identified problems and weaknesses, OTS may use informal enforcement actions. OTS commonly uses informal actions for problems in a well or adequately capitalized thrift 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 actions 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, as amended. 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,



## Appendix 2 Background

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or otherwise unlikely to secure correction of safety and soundness or compliance problems.

Because formal actions are enforceable, 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 following:

- 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.

## Appendix 2 Background

### OTS Assessments Paid by New South Federal Savings Bank

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 TFR, 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 more than \$1 billion in loans for others. OTS calculates the complexity component by multiplying set rates by the amounts by which an association exceeds each threshold. The following table shows the assessments that New South paid to OTS from 2004 through 2009.

### Assessments Paid by New South Federal Savings Bank to OTS, 2004–2009.

Billing Period	Examination Rating	Amount Paid
1/1/2004 - 6/30/2004	2	\$134,811
7/1/2004 - 12/31/2004	2	129,049
1/1/2005 - 6/30/2005	2	136,024
7/1/2005 - 12/31/2005	2	151,327
1/1/2006 - 6/30/2006	2	153,297
7/1/2006 - 12/31/2006	2	158,715
1/1/2007 - 6/30/2007	2	168,889
7/1/2007 - 12/31/2007	2	170,484
1/1/2008 - 6/30/2008	2	178,927
7/1/2008 - 12/31/2008	2	188,885
1/1/2009 - 6/30/2009	4	378,575
7/1/2009 - 12/31/2009	4	<u>371,710</u>
<b>Total</b>		<b>\$ 2,320,693</b>

Source: OTS

## Appendix 2 Background

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### **Number of OTS Staff Hours Spent Examining New South Federal Savings Bank**

The following table shows the number of OTS staff hours spent examining New South Federal Savings Bank from 2004 to 2009. Hours are totaled for safety and soundness examinations, limited examinations, and compliance examinations.

<b>Examination Start Date</b>	<b>Number of Examination Hours</b>
2004	2,156
2006	2,369
2007	2,905
2008	3,020
1/1/2009 – 7/9/2009	<u>812</u>
<b>Total</b>	<b>11,262</b>

Source: OTS

## Appendix 3 Management Response



### Office of Thrift Supervision

Department of the Treasury

Thomas A. Barnes  
*Deputy Director, Examinations, Supervision, and Consumer Protection*

1700 G Street, N.W., Washington, DC 20552 • (202) 906-5650

July 12, 2011

**MEMORANDUM FOR:** Moss Adams LLP  
Contractor to  
Office of Inspector General  
U.S. Department of the Treasury

**FROM:** Thomas A. Barnes  
Deputy Director

**SUBJECT:** Draft Material Loss Review of  
New South Federal Savings Bank  
Irondale, AL

Thank you for the opportunity to comment on the draft memorandum prepared by Moss Adams LLP entitled "Material Loss Review of New South Federal Savings Bank, Irondale, Alabama" (the Bank).

The memorandum summarizes the primary causes of the Bank's failure, which are consistent with the information contained in the OTS Reports of Examination and documents in support of the grounds for receivership. Specifically, the memorandum cites the primary cause of the failure was significant loan losses incurred as a result of aggressive lending strategies. This led to a concentration in higher-risk loan products, including residential construction, land, nonconforming residential mortgage and indirect auto loans in geographic areas hit hardest by the economic recession.

The memorandum discusses the internal failed bank review completed by OTS and reaffirms the recommendations from that review addressing risks from uncontrolled growth and concentrations. The memorandum also recommends that OTS consider tracking and re-assessing capital requirements as risk and concentrations change on a quarterly basis. OTS management considers being in compliance with this recommendation through the quarterly monitoring process, which includes a review of capital risk as well as concentration risk analysis.

Thank you again for the opportunity to review and respond to the draft memorandum on New South Federal Savings Bank. OTS appreciates the professionalism and courtesies provided by the staff from Moss Adams LLP and the Office of Inspector General.

**Section II**  
**Report Distribution**

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