Board of Governors of the Federal Reserve System

Material Loss Review of the Park Avenue Bank

Office of Inspector General

November 2011

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

November 22, 2011

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Mr. Parkinson:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of the Park Avenue Bank (Park Avenue). Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. The FDI Act requires that we

- review the agency's supervision of the failed institution, including the agency's implementation of prompt corrective action (PCA);
- ascertain why the institution's problems resulted in a material loss to the DIF; and
- make recommendations for preventing any such loss in the future.

Park Avenue was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the State of Georgia Department of Banking and Finance (State). The State closed Park Avenue on April 29, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. On May 27, 2011, the FDIC Office of Inspector General notified our office that Park Avenue's failure would result in a $326.1 million loss to the DIF, or 39 percent of the bank's $841.03 million in total assets at closing.

Park Avenue failed because its Board of Directors and management did not adequately control the risks associated with the bank's growth strategy that led to concentrations in commercial real estate (CRE) and construction, land, and land development (CLD) loans. The bank's strategy involved higher risk CRE lending and expansion into new markets, which resulted in a CLD loan concentration that made the bank particularly vulnerable to real estate market declines. The Board of Directors' and management's failure to establish credit risk management practices commensurate with the risks of CRE lending, coupled with high concentrations and weakening real estate markets, led to rapid asset quality deterioration. Mounting losses depleted earnings and eroded capital, which prompted the State to close Park Avenue and appoint the FDIC as receiver on April 29, 2011.

With respect to supervision, FRB Atlanta complied with the examination frequency guidelines for the timeframe we reviewed, 2001 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Atlanta and the State conducted 10 full scope examinations, 3 target examinations, and a horizontal CRE review; executed 6 enforcement actions—a Memorandum of Understanding, 3 Board Resolutions, a Written Agreement, and a PCA Directive; and implemented the applicable provisions of PCA.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. Our analysis of FRB Atlanta's supervision of Park Avenue revealed that FRB Atlanta identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

The bank's failure to establish basic credit administration practices in earlier years should have served as a red flag for examiners that the bank lacked credit administration practices commensurate with the high risk in its loan portfolio, especially as its CRE and CLD concentrations increased. Supervisory criticisms of credit risk management diminished as asset quality ratios and earnings performance improved in 2003, despite continued weaknesses and few signs that credit risk management had improved in proportion with the heightened risk in the loan portfolio. Although Park Avenue did not appropriately identify, monitor, and limit the risk in its loan portfolio, examiners rated the bank satisfactory from 2003 through 2007 based, in part, on the bank's strong earnings and low level of classified assets. In our opinion, FRB Atlanta should have been more aggressive in its supervisory activities when signs of credit risk management weaknesses persisted, regardless of the bank's financial performance. Specifically, it should not have upgraded the bank's CAMELS composite rating in 2003 or terminated the 2003 Board Resolution before Park Avenue had clearly demonstrated that it had resolved its credit risk management deficiencies.

Further, we believe that FRB Atlanta should have held bank management accountable for not timely developing a CRE risk management program consistent with the guidance outlined in Supervision and Regulation (SR) Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, especially given prior fundamental credit risk management weaknesses. Management's and the Board of Directors' pursuit of fast-growing markets resulted in a focus on CRE lending in the metro Atlanta area. In addition, the bank failed to establish appropriate limits for (1) overall CRE exposure; (2) specific sub-types of CRE lending, such as CLD; or (3) geographic concentrations. As a result, Park Avenue was particularly vulnerable to market declines given its CRE and CLD concentrations.

While we believe that FRB Atlanta had opportunities for earlier and more forceful supervisory action, it is not possible for us to predict the effectiveness or impact of any corrective measures that might have been taken by the bank. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected Park Avenue's financial deterioration or the ultimate cost to the DIF.

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Park Avenue's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Park Avenue's failure illustrates (1) the risks associated with a strategic focus on high-risk loan products and expansion into new markets; (2) the importance of establishing appropriate credit risk management practices, including concentration limits and strong underwriting consistent with SR Letter 07-01 and the *Commercial Bank Examination Manual*, prior to pursuing higher risk lending; and (3) the importance of scrutinizing any weaknesses in a function with previously noted deficiencies and implementing aggressive supervisory action to address those weaknesses.

We provided you with our draft report for review and comment. In your response, which is included as Appendix 3, you concurred with our conclusions and lessons learned and our observation that the Reserve Bank staff had opportunities to be more aggressive in their supervisory activities when signs of credit risk management weaknesses persisted.

We appreciate the cooperation that we received from FRB Atlanta and Federal Reserve Board staff during our review. The Office of Inspector General principal contributors to this report are listed in Appendix 4. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

Anthony J. Castaldo
Associate Inspector General
for Inspections and Evaluations

cc: Chairman Ben S. Bernanke
Vice Chair Janet L. Yellen
Governor Daniel K. Tarullo
Governor Elizabeth A. Duke
Governor Sarah Bloom Raskin
Mr. Michael Johnson

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Background

The Park Avenue Bank (Park Avenue) was founded in 1956 in Valdosta, Georgia. In 1982, the bank established a parent holding company, PAB Bankshares, Inc. (PAB). PAB became a public company in 1996, listed on the American Stock Exchange.[1] Park Avenue's business activities primarily focused on commercial real estate lending, initially in local markets near Valdosta, Georgia, but eventually expanded to the metro Atlanta and Florida markets beginning in 2000. Park Avenue became a state member bank in 2001 and was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the State of Georgia Department of Banking and Finance (State). FRB Atlanta conducted its first safety and soundness examination of Park Avenue in November 2001. PAB acquired six banks in southern Georgia and northern Florida between 1985 and 2000.[2] These banks were merged into Park Avenue between 2001 and 2002.[3]

The State closed Park Avenue on April 29, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that Park Avenue's failure would result in a $326.1 million loss to the Deposit Insurance Fund (DIF), or 39 percent of the bank's $841.03 million in total assets at closing.[4] On May 27, 2011, the FDIC Office of Inspector General notified our office that Park Avenue's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act, as amended (FDI Act), a material loss to the DIF is defined as any estimated loss in excess of $200 million.[5]

Objectives, Scope, and Methodology

When a loss to the DIF is considered material, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency

- review the agency's supervision of the failed institution, including the agency's implementation of prompt corrective action (PCA);

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[1] In 2005, PAB listed its securities on the National Association of Securities Dealers Automatic Quotation System.

[2] The acquired banks included Friendship Community Bank of Ocala, Florida; Baxley Federal Bank of Baxley, Georgia; Eagle Bank and Trust of Statesboro, Georgia; First Community Bank of Southwest Georgia of Bainbridge, Georgia; Farmers and Merchants Bank of Adel, Georgia; and Bainbridge National Bank of Bainbridge, Georgia. In 1998, Bainbridge National Bank merged into First Community Bank.

[3] FRB Atlanta's assessment of the proposed consolidation of four banks into Park Avenue by a series of mergers resulted in a formal approval on November 5, 2001. The merger of Friendship Community Bank of Ocala, Florida was previously approved before Park Avenue became a state member bank.

[4] Subsequent to receiving initial notice of the failure, the FDIC revised its estimated loss to the DIF to exclude $20 million in debt issued by the holding company under the FDIC's Temporary Liquidity Guarantee Program.

[5] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, enacted on July 21, 2010, the $200 million materiality threshold applies if the loss occurred during the period January 1, 2010, through December 31, 2011. Section 38(k) of the FDI Act had previously defined a material loss to the DIF as the greater of $25 million or 2 percent of the institution's total assets.

• ascertain why the institution's problems resulted in a material loss to the DIF; and

• make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Atlanta, the State, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by Park Avenue, examination reports issued from 2001 through 2011, examination work papers prepared by FRB Atlanta, and relevant FDIC documents. Appendixes at the end of this report contain a glossary of key banking and regulatory terms and a description of the CAMELS rating system.[6] We conducted our fieldwork from July 2011 through October 2011 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

Park Avenue failed because its Board of Directors and management did not adequately control the risks associated with the bank's growth strategy that led to concentrations in commercial real estate (CRE) loans and construction, land, and land development (CLD) loans.[7] The bank's strategy involved higher risk CRE lending and expansion into new markets, which resulted in a CLD loan concentration that made the bank particularly vulnerable to real estate market declines. The Board of Directors' and management's failure to establish credit risk management practices commensurate with the risks of CRE lending, coupled with high concentrations and weakening real estate markets, led to rapid asset quality deterioration. Mounting losses depleted earnings and eroded capital, which prompted the State to close Park Avenue and appoint the FDIC as receiver on April 29, 2011.

Bank Strategy: CRE Lending and Out-of-Market Expansion

In 2000, Park Avenue's Board of Directors and management implemented a strategic plan to expand the bank's focus outside its local markets near Valdosta, to pursue higher growth markets. In order to improve profitability, Park Avenue expanded into north Georgia and Florida markets, where management perceived significant growth opportunities.[8] As a result, Park Avenue's loans in the north Georgia market increased to 47 percent of total loans by 2005.[9] The bank funded these loans with deposits from its traditional south Georgia market and noncore funding sources, primarily brokered deposits, rather than by obtaining a corresponding increase

[6] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

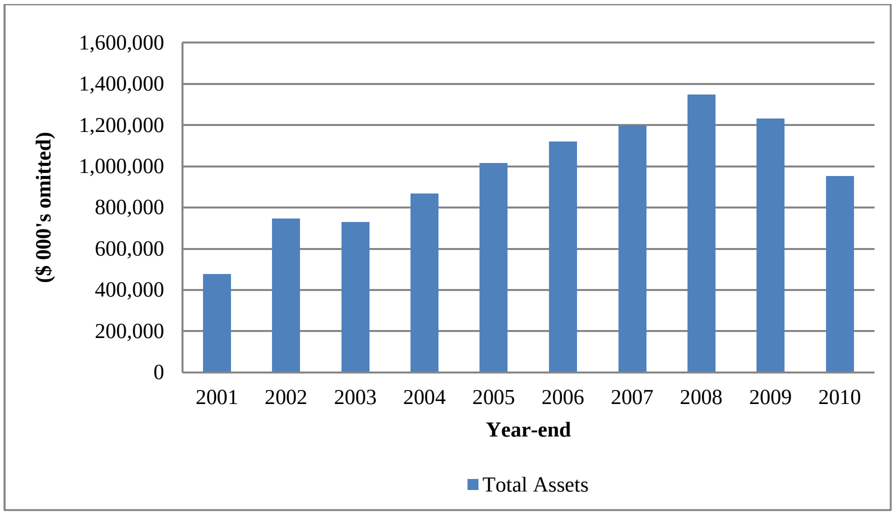
[7] CLD loans are a subset of CRE loans that provide funding for acquiring and developing land for future development and/or construction and provide interim financing for residential or commercial structures.

[8] Park Avenue defined the "north Georgia market" as Henry County, Hall County, Gwinnet County, Forsyth County, and Athens, GA. These markets comprise some of Atlanta's exurbs.

[9] Loans in the bank's Florida markets represented only 8 percent of total loans by 2005. Hence, Park Avenue's growth was primarily focused in Georgia.

in deposits from north Georgia borrowers. As illustrated in Chart 1, Park Avenue's expansion into north Georgia resulted in 183 percent growth between 2001 and 2008, with total assets increasing from $477.4 million in 2001 to $1.35 billion in 2008.

Chart 1: Total Assets



Rapid growth in the bank's north Georgia market provided an opportunity for residential construction lending. Park Avenue pursued an approach to CLD lending that examiners characterized as "fairly aggressive." Between 2001 and 2008, CLD loans increased from 12 to 33 percent of total loans, while total CRE loans (which include CLD loans) increased from 49 to 62 percent of total loans. Examiners concluded that this strategy "contributed favorably" to the bank's earnings.

Composition of Management Influences Strategic Direction and Risk Identification

Examiners eventually concluded that Board members' backgrounds may have contributed to the bank's CRE lending strategic focus as the majority of the bank's outside directors either had real estate development experience or connections to the commercial real estate industry. Examiners also noted that the directors' connections to the real estate development community may have also contributed to Park Avenue's failure to take more aggressive actions in response to signs of deteriorating market conditions and declining collateral values for many of the bank's CRE projects. In addition, a key senior management official had prior banking experience in the metro Atlanta area, which may have contributed to the bank's geographic focus.

Park Avenue frequently promoted internal candidates to key senior management positions between 2001 and 2009. In each of the three instances when Park Avenue's Chief Executive

Officer (CEO) position became available, the bank filled the position with internal candidates rather than electing an external candidate.[10] In addition, Park Avenue also relied on internal candidates to fill other senior management positions. In our opinion, given the bank's aggressive lending strategy and out-of-market expansion, Park Avenue may have benefitted from a fresh perspective on its strategic direction and key risks by hiring external candidates. Further, during examinations in 2002 and 2005, examiners noted that Park Avenue lacked a strong middle management team with the appropriate depth to support bank operations.

Park Avenue faced an additional challenge in identifying and mitigating credit risk due to turnover, senior management serving in dual capacities, and extended vacancies in the Chief Credit Officer (CCO) position between 2001 and 2007. During this period of significant loan growth, at least four individuals served as the CCO while also being employed by the bank in another capacity. Examiners recommended that Park Avenue create a "separate and distinct" CCO position in 2003. In 2003, Park Avenue hired an external candidate to serve as CCO, but he resigned after six months due to philosophical differences with management. Following the resignation, the bank operated without a separate and distinct CCO until appointing a full-time CCO in 2007. A CCO is instrumental in assuring strong management of a bank's credit risks. We believe that the frequent turnover and absence of a CCO for multiple years may have contributed to the bank's failure to implement a credit administration program capable of mitigating the risk in Park Avenue's loan portfolio.

Loan Portfolio Concentrations

Due to Park Avenue's strategic focus on CRE lending, the bank developed a potentially significant CRE concentration risk. In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. Park Avenue's CRE loans accounted for 499 percent of total risk-based capital during the bank's first examination as a state member bank in 2001, as illustrated in Chart 2. Examiners noted that the bank (1) did not have a loan concentration report and (2) could not identify any business lines that would constitute a concentration of credit. The CRE concentration declined from 2001 to 2003 as the bank charged off problem assets. However, from 2003 through 2008, the total CRE concentration increased from 359 percent to 569 percent.[11]

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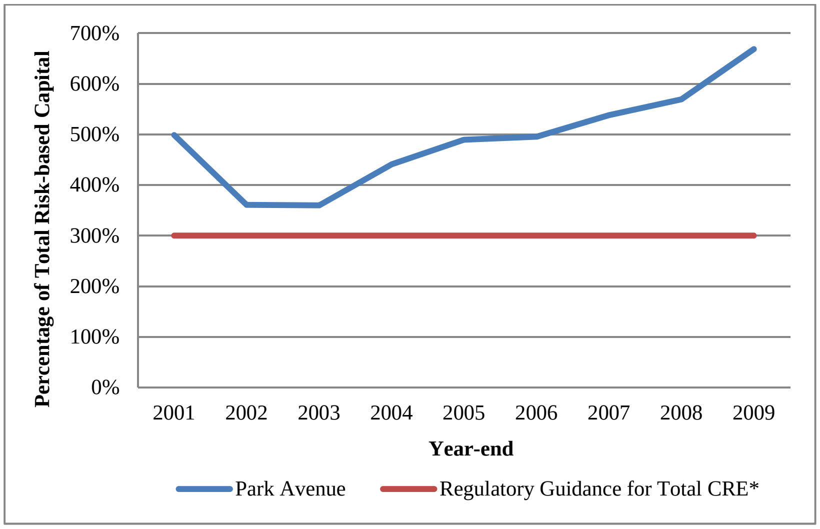
[10] In 2001, Park Avenue's CEO and President became a regional president, and PAB's CEO and President became Park Avenue's CEO and President. In 2003, Park Avenue's CEO and President relinquished the President position, and he ultimately retired from the bank in 2004. Following that retirement, the recently appointed President assumed the CEO role. In 2009, Park Avenue's President and CEO retired, and the bank's Chief Financial Officer assumed both positions.

[11] According to the Federal Reserve Board's Supervision and Regulation (SR) Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, an institution presents potential significant CRE concentration risk if it meets the following criteria: (1) total reported loans for CLD represent 100 percent or more of an institution's total capital; or (2) total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Chart 2: Total CRE Concentration

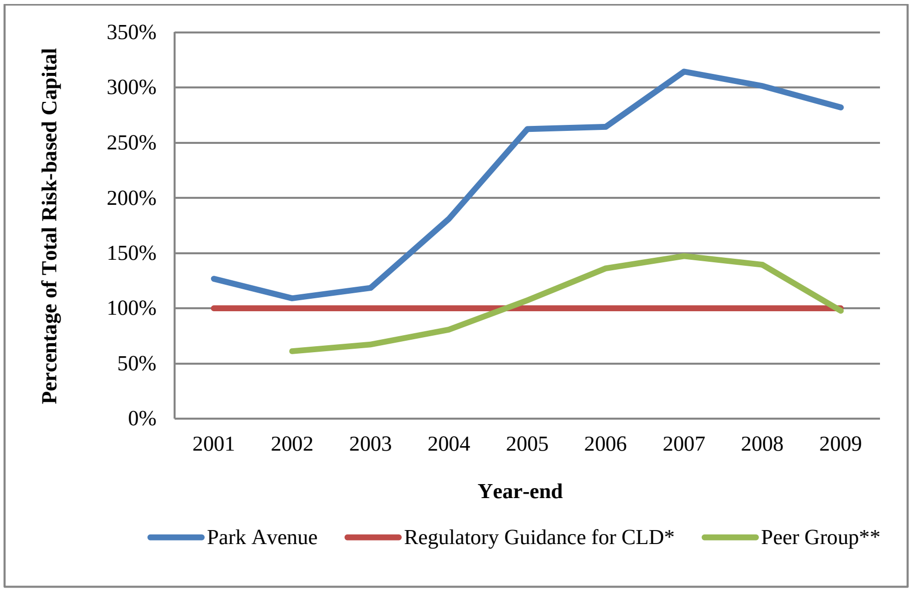


*SR Letter 07-01 became effective in 2007, so the depiction of the CRE and CLD concentration guidelines is for illustrative purposes only prior to 2007.

Within Park Avenue's CRE portfolio, the bank had a concentration in CLD loans, as illustrated in Chart 3. From 2003 to 2008, Park Avenue's CLD concentration increased from 119 percent to 301 percent, which reflected the bank's expansion into residential development lending in north Georgia.[12] The CLD concentration in 2008 exceeded by 200 percent the threshold in SR Letter 07-01 for an institution presenting a potentially significant CLD concentration risk. CLD concentrations generally present heightened risk because a developer's capacity to repay a loan is contingent on whether a developer can either obtain long-term financing or find a buyer for the completed project.

[12] Within this timeframe, the bank's annual CLD concentration peaked in 2007 at 314 percent.

Chart 3: Total CLD Loan Concentration



*SR Letter 07-01 became effective in 2007, so the depiction of the CRE and CLD concentration guidelines is for illustrative purposes only prior to 2007.
**Peer group data became available in 2002.

In addition, 61 percent of Park Avenue's CRE loans were made in the north Georgia market, as of first quarter 2006. Furthermore, total CRE and CLD loans made in the north Georgia market accounted for 300 percent and 188 percent of total risk-based capital, respectively. This geographic concentration of CRE and CLD loans increased the bank's vulnerability to real estate market declines in north Georgia.

Failure to Develop Credit Risk Management Consistent with Risks in Loan Portfolio

Overall, Park Avenue had significant risk in its loan portfolio with minimal mitigating credit risk management practices, such as reasonable and effective concentration limits. SR Letter 07-01 states that the sophistication of an institution's CRE risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution. Despite the institution's CRE and CLD concentrations, Park Avenue failed to implement appropriate credit risk management practices. The credit administration deficiencies noted during the bank's first examination as a state member bank in 2001 indicated that the bank had failed to establish fundamental practices, such as (1) documenting basic information in the loan files concerning loan purpose, sources of repayment, collateral values, individual loan stress test analysis, or applicable covenants; (2) analyzing borrower debt-to-income ratios on consumer loans; (3) assigning proper internal loan grades; and (4) complying with Regulation Y's appraisal requirements.[13]

[13] The Federal Reserve Board's Regulation Y, Subpart G (1) identifies which real estate-related financial transactions require the services of an appraiser, (2) prescribes which categories of federally related transactions shall be appraised by a State certified appraiser and which by a State licensed appraiser, and (3) prescribes minimum standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of the Federal Reserve Board.

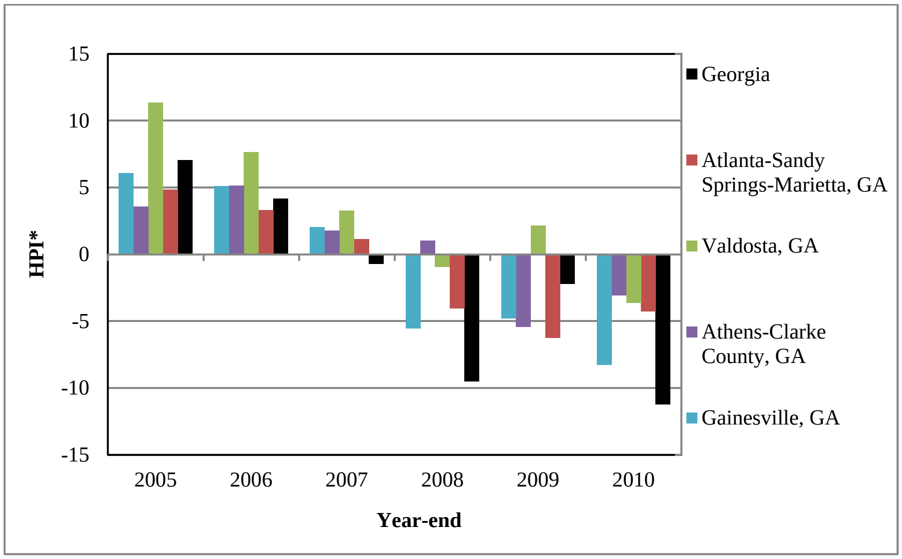
Despite subsequent incremental improvement in basic credit administration practices, fundamental weaknesses persisted and the bank exhibited few signs that credit administration practices evolved in a manner consistent with the heightened risk in the loan portfolio. Between 2003 and 2008, examiners repeatedly identified opportunities for Park Avenue to enhance its credit risk management. During multiple examinations in this time frame, examiners highlighted the need to conduct a full analysis of the contingent liabilities of borrowers and guarantors, perform portfolio-wide stress testing, and incorporate considerations of the bank's concentration levels into its allowance for loan and lease losses (ALLL) methodology. As previously noted, during this time frame Park Avenue lacked an individual dedicated solely to the CCO position, which is responsible for identifying, monitoring, and controlling credit risk at the institution.

In addition, the bank failed to establish reasonable internal CRE or CLD lending limits to control the institution's overall risk exposure, which is a key component of risk management for an institution considerably involved in CRE lending. Although SR Letter 07-01 states that loan concentration levels of 100 percent for CLD and 300 percent for total CRE indicate that an institution is potentially exposed to significant CRE concentration risk and that heightened risk management practices are warranted, the bank's 2008 Loan Policy set a limit of 300 percent for CLD and no limit for total CRE concentrations. In our opinion, the bank set an unreasonably high CLD concentration limit, which it exceeded. Further, Park Avenue failed to establish any limits for total CRE or for CRE lending by geographic area, which could have mitigated the bank's concentration risk. As a result of the bank's exposure to CRE and CLD loans and its failure to implement a strong credit administration program to control those risks, Park Avenue was extremely vulnerable to real estate market deterioration.

Decline in Real Estate Market Leads to Deterioration in Asset Quality

As illustrated in Chart 4, housing prices declined significantly in Park Avenue's markets, particularly in north Georgia. As sales in the residential real estate sector weakened, the bank's CLD portfolio deteriorated as its borrowers struggled to complete and sell their residential construction projects.

Chart 4: Housing Price Index (HPI) by Metropolitan Statistical Area (MSA)[14]



* The HPI is a broad measure of the movement of single-family house prices. The HPI is a weighted repeat-sales index that measures average price changes in repeat sales or refinancings on the same properties.

By June 2008, asset quality began to deteriorate, with classified assets increasing from 10 percent of tier 1 capital plus the ALLL during the prior examination to 81 percent. Classifications primarily consisted of CLD loans, resulting from deterioration in the Georgia and Florida real estate markets. According to Park Avenue's management reports, one county within its north Georgia market, Henry County, accounted for 69 percent of delinquent and nonaccrual loans as of April 30, 2008.[15]

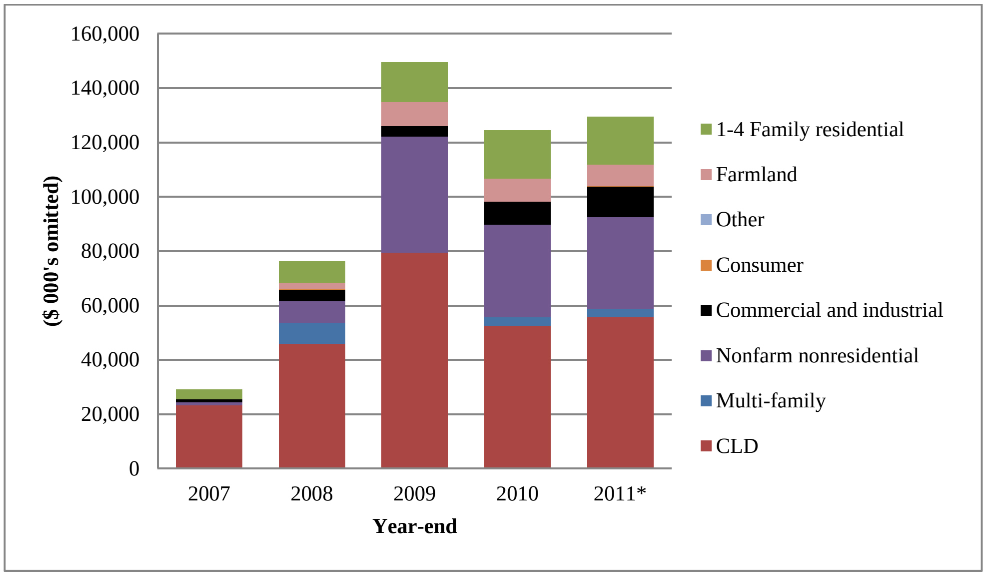
Given Park Avenue's vulnerability to a downturn in the real estate markets, particularly in the north Georgia market, asset quality continued to deteriorate significantly throughout 2009 and 2010. Examiners determined that classified assets increased to 147 percent of tier 1 capital and the ALLL (or $173.2 million) during a January 2009 examination, 203 percent (or $227.7 million) during a September 2009 examination, and 424 percent (or $314.8 million) during a May 2010 examination. A December 2010 examination noted that the excessive risk associated with Park Avenue's high loan concentrations and problem assets resulted from weak risk management. A significant majority of delinquent and nonaccrual loans at Park Avenue were comprised of CRE loans, particularly CLD loans, as illustrated in Chart 5.[16] In addition, loan losses at Park Avenue increased substantially in 2009 as delinquent loans were charged off. The majority of loan losses were also due to CLD loans.

[14] MSAs are geographic areas defined by the Office of Management and Budget to be used by federal statistical agencies in collecting, tabulating, and publishing federal statistics. Athens/Clarke MSA includes Clarke County and Oconee County. Atlanta/Sandy Springs/Marietta MSA includes Henry, Forsyth, and Gwinnett Counties. Gainesville MSA includes Hall County. These MSAs generally overlap the bank's "north Georgia market."

[15] For the purposes of this report, delinquent loans include loans 30-89 days past due and loans 90 days and more past due.

[16] Total CRE includes CLD, nonfarm nonresidential, and multi-family loans.

Chart 5: Delinquent and Nonaccrual Loans by Type



*As of March 31, 2011

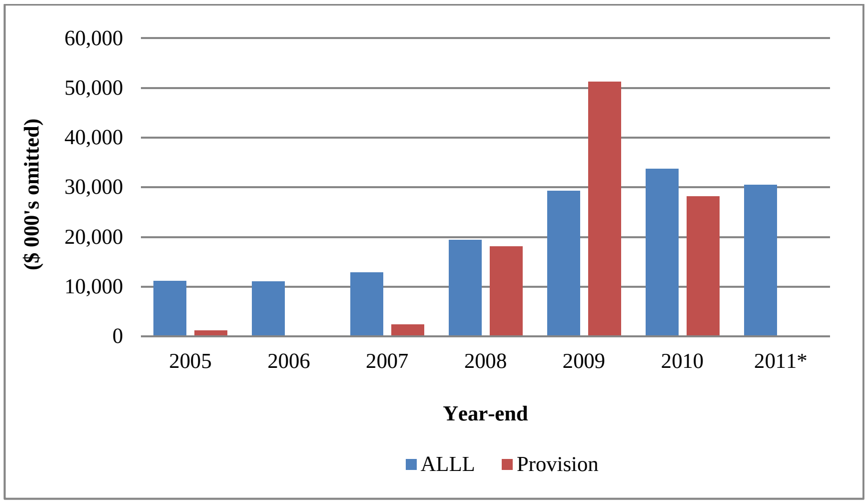
Significant Provision Expenses Result in Losses

Given the asset quality deterioration identified during a June 2008 examination, examiners determined that the ALLL might not support the risk in the loan portfolio and recommended improvements to the ALLL methodology to place more emphasis on the bank's recent loss experience. ALLL coverage of nonaccruals was low, and examiners suggested increasing the reserve from 0.35 percent to 0.5 percent coverage of nonaccruals. As shown in Chart 6, provision expenses for 2008 totaled $18.1 million.

By September 2009, examiners determined that the ALLL had not increased in proportion with Park Avenue's credit risk profile. Examiners identified serious deficiencies in the reserve methodology, primarily due to untimely problem loan recognition and stale collateral valuations. As a result, examiners required the bank to increase the ALLL by $31.4 million in order to bring the ALLL to a minimally adequate level. Provision expenses for the year totaled $51.2 million; however, loan losses depleted much of the increase to the reserve by year-end.

By May 2010, examiners determined that the level of the ALLL was inappropriate and deficient, as the bank did not incorporate loss data from 2010 into the methodology, apply appropriate discounts to collateral values to compensate for property value declines, or sufficiently document the process for incorporating environmental factors. The December 2010 examination required an additional $7 million provision to the reserve, primarily due to inaccuracies in the fair value estimates of collateral. Provision expenses for the year totaled $28.2 million.

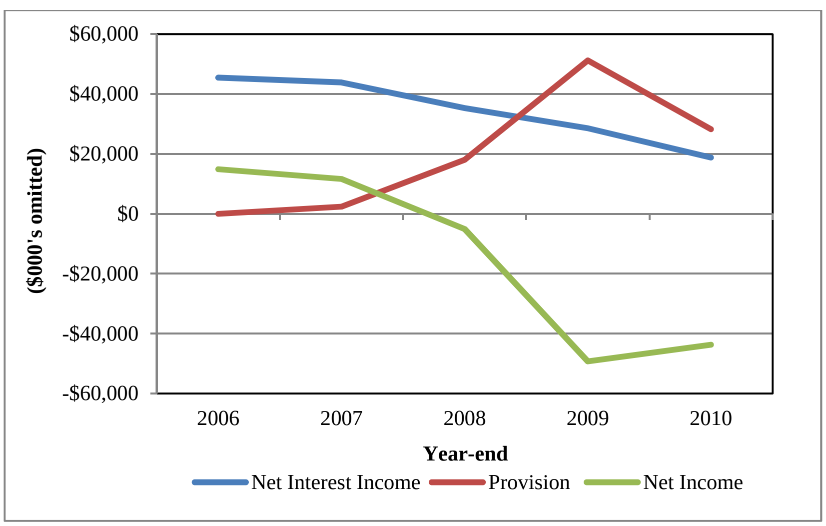
Chart 6: ALLL Balance and Provision Expenses



*As of March 31, 2011

The substantial provision expenses resulted in significant losses at Park Avenue, as illustrated in Chart 7. The bank incurred losses of $5.1 million in 2008 and $49.3 million in 2009. Although provision expenses decreased in 2010, earnings were unable to rebound due to a continued decline in net interest income and increased costs for administering problem loans and foreclosures.

Chart 7: Impact of Provision Expenses and Net Interest Income on Net Income



Losses Erode Capital

FRB Atlanta implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies in troubled depository institutions. Although the holding company raised $13.4 million in preferred stock in mid-2009, losses of $49.3 million for year-end 2009 caused the bank to fall to *adequately capitalized* status.[17] On February 8, 2010, FRB Atlanta notified the bank that it had fallen to *adequately capitalized* status as of the fourth quarter 2009. As a result, Park Avenue was prohibited from accepting, renewing, or rolling over any brokered deposits.[18]

On August 9, 2010, FRB Atlanta deemed the bank *significantly undercapitalized* and required the bank to submit an acceptable capital plan by August 30, 2010. The bank submitted a capital restoration plan that outlined the bank's intent to raise capital through a public offering of common stock and the sale of problem assets. FRB Atlanta rejected the plan because (1) it was not sufficiently specific or certain with respect to the amount of capital that could likely be raised, (2) it did not contain a realistic timeline, and (3) it did not contain financial forecasts and projections based on realistic assumptions. The bank resubmitted its capital restoration plan on October 29, 2010, which was subsequently accepted by FRB Atlanta. The plan included steps and a timeline to sell distressed assets and make a public offering and private placement. In addition, the plan concluded that the bank would need $200 million in additional capital in order to absorb losses and restore the bank to a *well capitalized* level. The plan also included an alternate strategy to be merged with or acquired by another depository institution. However, although Park Avenue identified potential buyers for some of its assets, the sales were never completed and the bank was unsuccessful in raising capital through a private placement or a public offering.

The Federal Reserve Board issued a PCA Directive on December 13, 2010, that, among other things, required Park Avenue to accomplish the following within 90 days of the Directive's date: (1) raise additional capital or take other measures to achieve the *adequately capitalized* PCA designation; or (2) be acquired by, or merge with, another depository institution. Capital levels continued to decline due to continuing asset quality deterioration and provision expenses, and by year-end 2010, with total losses of $43.7 million, the bank's capital ratios declined to a *critically undercapitalized* level. Mounting losses in the CRE portfolio and required provision expenses had eroded the bank's capital as it dropped from *well capitalized* to *critically undercapitalized* in 15 months. The State closed the bank on April 29, 2011, and appointed the FDIC as receiver.

Supervision of Park Avenue Bank

FRB Atlanta complied with the examination frequency guidelines for the timeframe we reviewed, 2001 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Atlanta and the State conducted 10 full scope examinations, 3 target examinations, and a horizontal CRE review; executed 6 enforcement actions—a Memorandum

[17] $12.7 million of the $13.4 million in capital raised by the holding company was injected into the bank in September 2009.

[18] As of December 31, 2009, 15.6 percent of the bank's total deposits were comprised of brokered deposits.

of Understanding (MOU), 3 Board Resolutions, a Written Agreement, and a PCA Directive; and implemented the applicable provisions of PCA.

As shown in Table 1 on page 21, Park Avenue's initial examination as a state member bank began in November 2001 and resulted in a composite 3 (fair) rating. Partially due to the credit administration weaknesses noted in the examination, FRB Atlanta issued an MOU in May 2002. A subsequent October 2002 examination maintained Park Avenue's CAMELS composite 3 rating. Despite continued deficiencies in credit administration, a June 2003 target examination focused on asset quality determined that the bank was in satisfactory condition and assigned the bank a CAMELS composite 2 (satisfactory) rating. In August 2003, FRB Atlanta terminated the MOU and required the bank to adopt a Board Resolution to address the remaining weaknesses from the MOU. Park Avenue also received CAMELS composite 2 ratings during December 2003 and January 2005 examinations, although examiners made several recommendations to improve the bank's credit administration practices.

Due to the bank's high concentration in CRE lending, FRB Atlanta included Park Avenue in a horizontal review of CRE lending at several banks in its district in January 2005. While this review was not an examination and did not result in any CAMELS ratings, FRB Atlanta provided multiple suggestions to improve risk management in Park Avenue's CRE lending program. Following the review, FRB Atlanta conducted a targeted examination of CRE lending in September 2005. Although the examination report noted that the bank had incorporated several suggestions from the horizontal review and determined that the bank's CRE risk management practices were generally satisfactory, examiners recommended additional enhancements to the CRE risk management program.

Park Avenue received CAMELS composite 2 ratings during full scope examinations in 2006 and 2007. Examiners downgraded the bank to a CAMELS composite 3 rating during a June 2008 examination due to the combination of asset quality and earnings deterioration and credit risk management deficiencies. In addition, FRB Atlanta double-downgraded the bank's asset quality and management CAMELS component ratings from 1 (strong) to 3. As a result of the bank's deteriorating condition, FRB Atlanta required Park Avenue to adopt a Board Resolution in October 2008 to improve the deficiencies noted during the examination. Nevertheless, Park Avenue's condition continued to weaken, and a January 2009 full scope examination downgraded the CAMELS composite rating to a 4 (marginal). FRB Atlanta implemented a formal enforcement action, in the form of a Written Agreement, in June 2009. A full scope examination conducted in September 2009 resulted in a downgrade in the CAMELS composite rating to 5 (critically deficient), reflecting continued deterioration in the bank's overall condition. The bank's capital, asset quality, and earnings ratings were also downgraded to 5. Park Avenue's CAMELS composite 5 rating was maintained during a May 2010 full scope examination. In November 2010, FRB Atlanta conducted a target review that downgraded Park Avenue's management CAMELS component rating to 5.

Our analysis of FRB Atlanta's supervision of Park Avenue revealed that FRB Atlanta identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

Table 1: Park Avenue Supervisory Overview

Examination			Agency Conducting Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
11/27/01	5/3/02	Full	FRB, with the assistance of the State	3	3	3	3	4	2	2	MOU
10/28/02	2/7/03	Full	Joint	3[19]	2	3	3	2	2	2	
6/23/03	8/19/03	Target	FRB, with the assistance of the State	2	2	2	2	2	2	2	Board Resolution
12/8/03	3/16/04	Full	FRB	2	2	2	2	2	2	2	
1/17/05	4/22/05	Full	Joint	2	2	2	2	2	2	2	Board Resolution
1/31/05	4/8/05	Horizontal CRE Review	FRB	NA	NA	NA	NA	NA	NA	NA	
9/2/05	10/11/05	CRE Target	FRB	NA[20]	NA	NA	NA	NA	NA	NA	
3/16/06	7/19/06	Full	FRB, with the assistance of the State	2	2	2	2	1	2	2	
5/7/07	8/3/07	Full	Joint	2	2	1	1	2	2	2	
6/5/08	9/19/08	Full	Joint	3	3	3	3	3	3	2	Board Resolution
1/19/09	6/5/09	Full	Joint	4	4	4	3	4	3	3	Written Agreement
9/14/09	2/1/10	Full	Joint	5	5	5	4	5	4	3	
5/10/10	12/8/10	Full	Joint	5	5	5	4	5	4	4	
11/29/10	3/28/11	Target	FRB	5	5	5	5	5	4	4	PCA Directive

November 2001 Full Scope Examination Resulted in a CAMELS Composite 3 Rating and a Memorandum of Understanding

The November 2001 full scope examination resulted in a CAMELS composite 3 rating. Park Avenue had recently elected a new CEO prior to the examination. Examiners considered Park Avenue's credit risk high and increasing due to weak credit administration practices, deficiencies in the balance and methodology for calculating the ALLL, increasing trends in problem loans in certain market sectors, and weaknesses in the loan review function. Classified assets increased to 53.1 percent of tier 1 capital and the ALLL. Examiners also noted poor management oversight, weak credit underwriting, failure to follow policies and procedures, a flawed loan approval process, an inadequate loan review process, and insufficient staffing.

[19] As discussed further below, the State assigned the bank a CAMELS composite 2 rating.
[20] This examination did not explicitly assign any CAMELS ratings.

FRB Atlanta concluded that management pursued excessive loan growth without adequate operations support and that Park Avenue's credit risk management was weak, which exposed the bank to an unacceptable level of risk. Examiners identified six categories of weaknesses in credit risk management: credit underwriting, loan approval process, loan policy, loan review process, problem loan resolution, and loan operations. FRB Atlanta cited numerous fundamental deficiencies in each of these categories, indicating that the bank had failed to establish even basic credit risk management practices. Examiners concluded that the loan files failed to document loan purpose, sources of repayment, collateral values, stress testing of income streams, covenants, independent pre-construction cost analyses, lien searches on accounts receivable and inventory, and debt-to-income calculations on consumer loans. Furthermore, FRB Atlanta indicated that the loan files did not contain management's rationale for lending to borrowers with unsatisfactory credit histories. Examiners noted that financial analysis should be evident in credit files.

In addition, the bank did not produce loan concentration reports to identify areas of risk, despite the bank's high CRE concentration ratios. Examiners also concluded that the bank's loan policy lacked officer lending limits; overdraft limits; specific timeframes for charging off loans; parameters for specialized lending; requirements for stress testing; and guidelines for obtaining contractor credit reports, inspection reports, and pre-construction loan agreements. The bank also failed to demonstrate that the Board of Directors or a credit committee approved large, complex transactions. Examiners downgraded a large percentage of loans during the examination, which demonstrated the inadequacy of the loan review function and management's inability to assign accurate loan grades. Further, the bank had several loans with real estate appraisal violations.[21] Our analysis revealed that Park Avenue did not have many of the basic controls necessary to monitor and manage credit risk in its loan portfolio. In our opinion, based on the guidance contained throughout the CBEM, these pervasive weaknesses indicated that Park Avenue had failed to implement the fundamental practices of a sound credit risk management program.

In response to the examination findings, FRB Atlanta and the State issued an MOU on May 20, 2002, that required the bank to correct the deficiencies identified during the examination. The MOU primarily focused on credit administration enhancements, but also required a written plan to improve and sustain earnings and capital.

October 2002 Joint Full Scope Examination Resulted in a Disagreement Concerning the Appropriate Composite Rating

During the October 2002 joint full scope examination, the State upgraded the bank's CAMELS composite rating to a 2 given satisfactory capital, earnings, liquidity, and sensitivity ratings and the improved overall condition of the bank. Component ratings for capital and earnings also received upgrades. FRB Atlanta issued a separate letter that assigned a 3 composite rating due to

[21] Examiners identified five instances of loans that did not comply with Regulation Y, Subpart G.

continuing weaknesses with management, asset quality, and overall risk management practices.[22] FRB Atlanta concurred with the component rating upgrades for capital and earnings. In our opinion, FRB Atlanta acted appropriately by noting that it was premature to upgrade the bank's CAMELS composite rating given the numerous unresolved issues and concerns. Specifically, examiners identified continued credit administration issues relating to loan file documentation and organization, including lack of current financial statements. In addition, the bank's loan policy did not address the "specialized types of lending" that the bank offered. The bank also lacked a strategic plan despite the recent mergers, growth, and expansion into new markets.

June 2003 Target Examination Resulted in a CAMELS Composite Rating Upgrade to a 2 and a Board Resolution to Replace the MOU

A June 2003 target examination focused on asset quality and credit risk management and resulted in an upgrade of the CAMELS composite rating to a 2. Examiners noted that Park Avenue had recently hired a new CCO, which FRB Atlanta anticipated would have a positive influence on the bank's credit risk management. Examiners determined that Park Avenue made satisfactory progress in the overall credit risk management process, which resulted in an upgrade in the asset quality and management CAMELS component ratings to 2.

In our opinion, examiners' criticisms of the bank's credit risk management practices diminished as Park Avenue's asset quality ratios and earnings performance improved, although specific weaknesses persisted. Examiners noted that opportunities remained to strengthen the overall lending process and credit culture of the bank and reminded management to ensure that all new and renewed loans complied with the bank's loan policy. The examination report also emphasized the need for the consistent use of sound underwriting practices and preparation of credit memorandums. Examiners identified the following areas in which specific weaknesses remained: (1) limited financial analysis on several loans, (2) lack of consistent cash flow analyses on speculative construction loans, and (3) loan files lacking credit memorandums.

In our opinion, although examiners noted persistent weaknesses in fundamental credit risk management practices, FRB Atlanta did not assure that those weaknesses were resolved and that the risk management program was commensurate with the risk in the bank's loan portfolio before upgrading the CAMELS composite rating. Despite FRB Atlanta's conclusion that bank management was committed to implementing positive changes in credit risk management, notable deficiencies remained, which we believe indicated that the upgrade in the bank's CAMELS composite rating did not appear to be justified.

While the 2003 target examination rated the bank satisfactory, examiners noted several areas from the 2002 MOU, including credit administration, that required continued attention by management. Examiners determined that, given the improvements, a Board Resolution was sufficient to address the remaining concerns. FRB Atlanta terminated the MOU and replaced it

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[22] While we believe that FRB Atlanta generally followed the requirements of the Federal Reserve Board's SR Letter 99-17, *Supervisory Ratings for State Member Banks, Bank Holding Companies, and Foreign Banking Organizations, and Related Requirements for the National Examination Database*, by assigning its different CAMELS composite rating in a separate report, we noted that FRB Atlanta did not appropriately identify the examination as a "concurrent" examination.

with a Board Resolution on August 26, 2003. The ongoing concerns noted in the Board Resolution further support our view that an upgrade to the composite rating of the bank during the 2003 target examination did not appear to be justified.

December 2003 Full Scope Examination Maintained a CAMELS Composite 2 Rating

The December 2003 examination maintained Park Avenue's CAMELS composite 2 rating and 2 ratings for all CAMELS components. The examination included a review of the bank's growing residential construction lending portfolio, policies, and procedures. Examiners concluded that the loan files reviewed were well organized and that credit memoranda reflected improved analyses.[23] While examiners determined that asset quality was satisfactory overall, they noted areas of credit administration that could be strengthened. Although the bank used builder trade reports to support its lending decisions, examiners recommended that management use these reports more consistently to evidence borrowers' payment history with vendors. In addition, while the use of lien waivers was required in the construction lending policy, the bank did not appear to be requiring the waivers in practice. Furthermore, examiners expressed concern regarding the bank's growing construction lending activities; vacant CCO position; failure to implement a satisfactory internal loan review capability; and lack of a system for monitoring, tracking, and reporting real estate loans with loan-to-value (LTV) amounts exceeding supervisory guidelines in order to ensure compliance with Regulation H.[24] In addition, the bank continued to operate without a strategic plan.

Examiners noted that the bank's residential construction activities were focused in the north Georgia/Atlanta region—primarily, Henry, Gwinnett, and Hall counties and the Athens area—where management and the Board of Directors perceived the greatest potential for loan growth. Examiners mentioned that management needed to deliver on its commitment to adopt the construction lending recommendations cited in this examination report. FRB Atlanta urged management to continue to proceed cautiously because these markets were very competitive and other banks perceived similar opportunities. Examiners also recommended that Park Avenue hire a CCO with the full-time responsibility of enforcing quality credit underwriting and adherence to policies and procedures. Despite continued credit risk management weaknesses and notable areas of heightened risk, the Board Resolution was terminated due to Park Avenue's improved financial condition. In our opinion, this enforcement action should not have been terminated until the deficiencies were resolved and Park Avenue demonstrated that its credit risk management program was commensurate with the risk associated with its lending activities.

[23] Specifically, the credit memoranda generally contained real estate market and industry analysis, borrower's background analysis, management analysis, financial analysis, and guarantor analysis.

[24] The Federal Reserve Board's Regulation H, Subpart J, Appendix C states that the aggregate amount of all loans in excess of the supervisory LTV limits should not exceed 100 percent of total capital. Moreover, within the aggregate limit, total loans for all commercial, agricultural, multifamily, or other non-one- to four-family residential properties should not exceed 30 percent of total capital. An institution will receive increased supervisory scrutiny as the total of such loans approaches these levels.

January 2005 Joint Full Scope Examination Maintained a CAMELS Composite 2 Rating but Resulted in a Board Resolution for Bank Secrecy Act Program Deficiencies

In January 2005, a joint full scope examination maintained Park Avenue's CAMELS composite and component 2 ratings. In August 2004, the bank hired a new CEO. Park Avenue returned to "growth mode" despite examiners' prior warnings concerning the competitive market and the fact that Park Avenue continued to operate without a CCO. Examiners deemed the bank's overall condition satisfactory, but noted that management's focus on growth in the north Georgia and Florida markets expanded the bank's traditional markets substantially as well as its CLD lending.

Despite the satisfactory ratings, the examination noted continued credit administration weaknesses. Examiners recommended that management (1) ensure adequate staffing and appropriate procedures given Park Avenue's loan growth, (2) identify and monitor potential geographic concentrations, and (3) develop loan approval procedures to allow for timely and thorough review of loan requests. Examiners reminded management that loan files should contain documentation supporting loan underwriting decisions and that stronger internal underwriting procedures would provide the Board of Directors with the additional information necessary to facilitate sound credit decisions. The examination report indicated that the bank's loan policy needed to be updated to cover the bank's CLD lending activities. Examiners recommended that the bank (1) establish limits for speculative residential and commercial real estate loans and (2) ensure sufficient CRE reporting to management and the Board of Directors. Examiners noted one violation of Regulation Y, as one of the bank's loans made in excess of $250,000 did not have a written appraisal. The new CEO acknowledged the need to further strengthen credit administration, according to examiners.

As a result of the review of the Bank Secrecy Act program, FRB Atlanta issued a Board Resolution for corrective action to strengthen the Bank Secrecy Act/Anti-Money Laundering program.

January 2005 FRB Atlanta Conducted a Horizontal CRE Review

FRB Atlanta conducted reviews of CRE lending and associated practices of a number of state member banks in the sixth district to assess the risk associated with increasing CRE exposure. CAMELS ratings were not assigned during these reviews, but FRB Atlanta produced a white paper to summarize its findings. While the white paper did not disclose individual banks, FRB Atlanta offered individual institutions feedback and suggestions for enhancing CRE programs.

For Park Avenue, FRB Atlanta suggested that the bank improve its CRE lending program by (1) providing greater stratification of the CRE loan portfolio (by property type, geographic concentration, etc.) and establishing appropriate sub-limits for monitoring CRE concentrations; (2) producing inventory aging, market inventory, and other real estate related reports; (3) including all pertinent information in credit files; (4) uniformly applying stress testing for applicable CRE loans; (5) addressing the current and proposed level of CRE concentrations in strategic and capital planning; (6) incorporating CRE concentration risk into loan review; and (7) including CRE concentration considerations when determining the adequacy of the ALLL. In our opinion, the comprehensive nature of these recommendations further demonstrated that Park Avenue's credit risk management program was not commensurate with the risks associated with its CRE lending. The horizontal review demonstrated that management had failed to enhance its credit risk management program in proportion with the heightened risks of its CRE lending.

September 2005 FRB Atlanta Conducted a Target CRE Examination and Concluded CRE Risk Management Practices Were Generally Satisfactory

In September 2005, FRB Atlanta conducted a target CRE examination due to the bank's concentration levels to assess management's progress in addressing the recommendations from the horizontal review. The examination determined that the bank's CRE risk management practices were generally satisfactory. FRB Atlanta noted that management implemented most of the suggestions from the horizontal review related to operating policies and procedures; however, examiners identified several opportunities for additional enhancements to the bank's CRE risk management practices, including (1) reviewing inventory aging reports on a monthly basis and creating a report highlighting the level of speculative construction projects by builder, subdivision, and market; (2) establishing sub-limits for categories within the CRE loan portfolio; (3) implementing a formal appraisal review process as described by interagency guidelines; (4) incorporating an evaluation of credit risk management practices into the bank's loan review due to its CRE concentration; and (5) including concentration risk in the bank's ALLL calculation.

Our review of examiner work papers indicated that the bank was in violation of Regulation H, which was also an area of weakness noted in the December 2003 examination report. In the December 2003 examination, examiners noted that the bank was not tracking LTV guidelines in order to ensure compliance with Regulation H. In 2005, examiners determined that the amount of CRE loans made with LTVs in excess of guidelines represented 43 percent of the bank's capital—a violation of Regulation H, although no comment was made in the examination report. In our opinion, this finding should have been reflected in the report, especially given the prior findings in this area and Park Avenue's significant CRE and CLD concentration levels. We believe this examination presented a missed opportunity for FRB Atlanta to hold Park Avenue accountable for failing to implement appropriate risk management practices for an institution concentrated in CRE.

March 2006 Full Scope Examination Maintained the CAMELS Composite 2 Rating

FRB Atlanta began a full scope examination, with the assistance of the State, in March 2006 that maintained the bank's CAMELS composite 2 rating because examiners concluded that the bank remained in satisfactory overall condition. Examiners upgraded the bank's CAMELS component rating for earnings to a 1. FRB Atlanta noted that Park Avenue's earnings performance was strong because of the favorable interest rate environment and its nominal credit-related losses. During this time, management actively pursued growth opportunities in the Atlanta, Georgia, and Jacksonville, Florida, markets. Examiners noted that Park Avenue's credit risk trend was increasing due to the growth in the bank's loan portfolio. However, examiners characterized the bank's overall credit risk as moderate due to Park Avenue's acceptable risk management practices, including sound credit administration and underwriting; effective board and management oversight; and adequate loan review, internal audit, and ALLL methodology.

Although FRB Atlanta recommended that the bank establish sub-limits for CRE concentrations during the September 2005 target examination, those sub-limits had not been established. Examiners noted that the bank's strategic plan was in the process of being revised and would include specific limitations. In addition, the report noted that management was only stress testing income producing property loans and contained suggestions for additional stress tests, such as for interest rate fluctuations or occupancy rates. Although examiners noted that the bank's ALLL methodology did not specifically mention CRE loans, examiners concluded that the CRE concentration was included in the reserve calculation. In our opinion, examiners did not provide adequate support for this conclusion, especially since incorporating the CRE concentration into the ALLL calculation was recommended during both the 2005 horizontal CRE review and the September 2005 target examination. In our opinion, FRB Atlanta did not ensure that the recommendations to enhance CRE credit risk management practices made during previous examinations were fully implemented.

The examination report identified violations of Regulations H and Y. Due to incorrect loan categorization identified during the examination, the volume of the bank's LTV exceptions exceeded the real estate lending guidance as outlined in Regulation H. Examiners recommended that management monitor LTV exception reporting to ensure compliance. In addition, examiners observed that four loans did not have adequate appraisals in accordance with Regulation Y. We believe that Park Avenue's recurring problems complying with these requirements indicated that that bank's basic internal controls and risk management practices remained weak and had not progressed to a level commensurate with the risk in the bank's loan portfolio.

May 2007 Joint Full Scope Examination Maintained a CAMELS Composite 2 Rating

During a May 2007 joint examination, examiners concluded that the bank's overall condition remained satisfactory and retained Park Avenue's CAMELS composite 2 rating. The bank's earnings component rating was downgraded to a 2, but the management and asset quality component ratings were upgraded to 1. Although the bank experienced record earnings in 2005 and 2006, management did not expect 2007 to continue that trend due to a slowdown in the bank's growth coupled with increased operating expenses. The strategic plan anticipated continued growth in the metro Atlanta area and into north and central Florida markets, which we believe indicated escalating risk in the loan portfolio due to increasing vulnerability to a real estate downturn in these markets.

Park Avenue's asset quality component rating received an upgrade due to the bank's declining classified assets as a percentage of tier 1 capital and the ALLL. Examiners considered credit risk management practices generally satisfactory, even though they recommended further credit administration enhancements. Specifically, these recommendations related to obtaining and analyzing contingent liabilities of borrowers and guarantors, routinely obtaining construction status reports on all projects, and preparing updated status memorandums for construction projects. Examiners also recommended that the bank adjust its loan grading practices to reflect deterioration in borrower financial status in a timely manner.

Despite the January 2007 release of SR Letter 07-01 and the bank's significant CRE concentrations, the bank's application of the guidance was not a primary focus of the examination. Given the bank's previously noted deficiencies in credit risk management, particularly related to CRE, this examination represented another missed opportunity to assure that Park Avenue was operating with appropriate risk management practices to address its CRE concentration risk.

June 2008 Joint Full Scope Examination Resulted in a CAMELS Composite 3 Rating and a Board Resolution

A June 2008 joint examination downgraded Park Avenue's CAMELS composite rating to 3. Examiners considered the bank's condition less than satisfactory due to a significant increase in loan classifications, which directly affected earnings. All CAMELS component ratings received downgrades to 3 except for sensitivity, which remained a 2.

Examiners concluded that credit risk management practices were weak, reflecting Park Avenue's elevated level of credit risk. Unfavorable economic conditions and increased problem loans, particularly in loans secured by real estate, further contributed to the bank's high credit risk. FRB Atlanta required the bank to establish sub-limits for CRE exposure, which it had repeatedly recommended since 2005. Examiners also noted that CLD loan underwriting would be improved by expanding project feasibility and market analysis beyond the analysis included in an appraisal. Also, examiners observed that the bank had not performed any portfolio-wide stress testing to assess the potential impact of an economic downturn on the bank's capital. While capital ratios remained above the *well capitalized* PCA threshold, examiners identified the need for formal capital planning in order to fully support the bank's elevated level of credit risk.

Although examiners noted the risk associated with Park Avenue's CRE concentration, which amounted to 541 percent as of first quarter-end 2008, and determined that credit risk management was weak relative to the size and composition of the bank's CRE portfolio, they concluded that the bank generally met the supervisory expectations outlined in SR Letter 07-01. In our opinion, the combination of weak credit risk management practices and CRE concentration levels and limits well above the significant concentration levels outlined in the guidance indicated that the bank had not met the expectations outlined in SR Letter 07-01. In our opinion, FRB Atlanta should have taken earlier supervisory action to assure that the bank had appropriate risk management procedures in place to address CRE concentration risk and out-of-market lending, especially given the bank's history of fundamental weaknesses in credit administration. Although examiners repeatedly noted weaknesses in the bank's credit administration program, FRB Atlanta did not assure that those weaknesses were fully resolved and that the program's sophistication and the bank's risk management capabilities were consistent with the significant risks in the bank's loan portfolio.

FRB Atlanta and the State jointly requested that Park Avenue adopt a Board Resolution due to its deteriorating overall condition and the findings of the June 2008 examination. The Board Resolution required the bank to adopt a plan of action to strengthen its financial and operational condition. Specific requirements included (1) a capital plan, (2) a strategic plan, (3) a plan to improve problem loan resolution, (4) an enhanced ALLL methodology, (5) improved management reporting for CRE loans with interest reserves, (6) monthly liquidity reports to FRB Atlanta and the State, (7) CRE concentration limits and sub-limits, and (8) a restriction on dividends. In our opinion, however, stronger supervisory action was warranted—at a minimum an MOU—to clearly convey the need for urgent action in resolving these recurring and fundamental weaknesses.

January 2009 Joint Full Scope Examination Resulted in a Downgrade of the CAMELS Composite Rating to a 4 and a Recommendation for a Written Agreement

A January 2009 joint examination downgraded Park Avenue's CAMELS composite rating to a 4. The CAMELS component ratings for capital, asset quality, earnings, and sensitivity were downgraded to 4, 4, 4, and 3, respectively. After the on-site portion of the examination, an interim CEO was elected following the retirement of the previous CEO. The report noted that the bank's exposure to CRE had a significant negative impact on the loan portfolio and earnings performance. Examiners attributed the bank's losses and ratings downgrades to general credit quality deterioration and the bank's declining net interest margin. While the bank remained above the *well capitalized* PCA threshold, examiners determined that capital levels did not support the bank's risk profile.

Examiners noted that the bank had failed to comply with certain requirements of the October 2008 Board Resolution, including updating the strategic plan and establishing sub-limits for CRE exposure. Nevertheless, examiners credited management for being "largely proactive and timely" in identifying risks and recognizing losses in problem assets. In addition, examiners noted that management actively monitored the bank's capital position, which continued to decline. Examiners considered the ALLL and its supporting methodology adequate for the risk identified at the examination.

FRB Atlanta escalated the Board Resolution to a Written Agreement due to the bank's continued financial deterioration and noncompliance with the Board Resolution. The Written Agreement expanded on the provisions of the Board Resolution and required (1) a written plan to strengthen credit risk management, including CRE limits and stress testing consistent with SR Letter 07-01; (2) a written lending and credit administration program to address underwriting standards that require analysis of global cash flow, debt service, and repayment sources; (3) a written plan for asset quality improvement, including restrictions on credit extensions to borrowers with previously unpaid loans or with previously "doubtful" or "substandard" loans, without the approval of the Board of Directors; (4) a charge-off of all assets classified as "loss"; (5) a formalized written program for the maintenance of an adequate ALLL and enhanced ALLL methodology; (6) a written Capital Plan that takes into account the volume of classified loans, concentration of credit, ALLL, current and projected asset growth, and projected retained earnings; (7) the bank to notify the Reserve Bank if capital ratios fall below the approved plan's minimum ratios; (8) a written Earnings Plan and Budget; (9) a written Liquidity/Funds Management Plan designed to improve management of the liquidity position; (10) additional dividend restrictions; and (11) debt and stock redemption restrictions.

September 2009 Joint Full Scope Examination Resulted in a CAMELS Composite Rating Downgrade to 5

A September 2009 joint full scope examination downgraded Park Avenue's CAMELS composite rating to 5 because of further asset quality deterioration. Capital, asset quality, and earnings component ratings were downgraded from 4 to 5, while management and liquidity were downgraded from 3 to 4 ratings. Sensitivity to market risk remained 3-rated. In June 2009, the interim CEO was elected as the permanent replacement for the previous CEO. Asset quality deterioration continued to have a significant impact on earnings, capital adequacy, and liquidity. The bank's third quarter loss resulted, in part, from a $31.4 million provision expense. Examiners recommended that the bank hire a qualified individual to oversee the problem loan work-out process. The $13.4 million in common equity raised by the holding company in the third quarter of 2009, of which $12.7 million was injected into the bank, was offset by credit losses and declining interest income. The bank remained *well capitalized*; however, losses had eroded capital to the point where examiners questioned the bank's continued viability. Examiners assessed the bank's progress addressing the requirements of the Written Agreement and determined that the bank was making a "good faith effort to comply with the Written Agreement," but that significant work remained in order to achieve full compliance. Examiners also determined that untimely problem loan recognition and stale collateral valuations represented the primary weaknesses of the ALLL methodology.

May 2010 Joint Full Scope Examination Retained the CAMELS Composite 5 Rating

In May 2010, the State began a joint full scope examination that determined that the bank was in critical condition because its overall viability remained a significant concern. The CAMELS composite rating and the majority of component ratings remained unchanged from the prior examination, although examiners downgraded the sensitivity component rating to 4. Continued operating losses, excessive provisions to the ALLL, and collateral value write-downs further eroded capital and threatened Park Avenue's viability. Year-end 2009 provision expenses of $51.2 million, net interest margin compression, and increased costs for administering problem loans and foreclosures contributed to the bank's continued losses. The bank's capital ratios declined to an *adequately capitalized* PCA position as of December 2009; however, as of June 30, 2010, the bank's tier 1 leverage capital ratio declined to 2.98 percent, bringing the bank to a *significantly undercapitalized* position under PCA standards.[25] In addition, Park Avenue's ALLL methodology continued to be inappropriate and unacceptable. Examiners noted that the troubled condition of the bank was largely the result of poor strategic planning coupled with the economic decline. The bank remained in only partial compliance with the Written Agreement.

November 2010 Target Examination Focused on Financial Condition and Compliance with Supervisory Agreement

In November 2010, FRB Atlanta began a target examination of Park Avenue. The examination assessed specific components of the bank's financial condition and compliance with the Written Agreement and maintained the previously issued CAMELS composite 5 rating. Examiners determined that the bank's condition had deteriorated to a seriously deficient level. FRB Atlanta

[25] Park Avenue received a letter notifying the bank of the change in its capital position on August 9, 2010.

downgraded the management rating to a 5. Examiners attributed the bank's condition to the Board of Directors' and management's prior acceptance of heightened risk and substantial concentrations in CRE loans without sound risk management practices in place to identify, monitor, and manage such significant risks. The bank remained in partial compliance with the Written Agreement. Park Avenue still had not completed the recommended stress testing of its loan portfolio, despite the high CRE concentration level. During the examination, examiners required an additional $7 million provision expense and noted the bank's continued reliance on stale appraisals. Due to continued deterioration in asset quality and requisite provision expenses, the bank became *critically undercapitalized* as of December 2010. Management was unable to raise capital, and the State closed the bank on April 29, 2011, and appointed FDIC as receiver.

Conclusions and Lessons Learned

Park Avenue failed because its Board of Directors and management did not adequately control the risks associated with the bank's growth strategy that led to concentrations in CRE and CLD loans. The bank's strategy involved higher risk CRE lending and expansion into new markets, which resulted in a CLD loan concentration that made the bank particularly vulnerable to real estate market declines. The Board of Directors' and management's failure to establish credit risk management practices commensurate with the risks of CRE lending, coupled with high concentrations and weakening real estate markets, led to rapid asset quality deterioration. Mounting losses depleted earnings and eroded capital, which prompted the State to close Park Avenue and appoint the FDIC as receiver on April 29, 2011.

With respect to supervision, FRB Atlanta complied with the examination frequency guidelines for the timeframe we reviewed, 2001 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Atlanta and the State conducted 10 full scope examinations, 3 target examinations, and a horizontal CRE review; executed 6 enforcement actions—an MOU, 3 Board Resolutions, a Written Agreement, and a PCA Directive; and implemented the applicable provisions of PCA.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. Our analysis of FRB Atlanta's supervision of Park Avenue revealed that FRB Atlanta identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

The bank's failure to establish basic credit administration practices in earlier years should have served as a red flag for examiners that the bank lacked credit administration practices commensurate with the high risk in its loan portfolio, especially as its CRE and CLD concentrations increased. Supervisory criticisms of credit risk management diminished as asset quality ratios and earnings performance improved in 2003, despite continued weaknesses and few signs that credit risk management had improved in proportion with the heightened risk in the loan portfolio. Although Park Avenue did not appropriately identify, monitor, and limit the risk in its loan portfolio, examiners rated the bank satisfactory from 2003 through 2007 based, in part, on the bank's strong earnings and low level of classified assets. In our opinion, FRB Atlanta should have been more aggressive in its supervisory activities when signs of credit risk management weaknesses persisted, regardless of the bank's financial performance. Specifically, it should not have upgraded the bank's CAMELS composite rating in 2003 or terminated the 2003 Board Resolution before Park Avenue had clearly demonstrated that it had resolved its credit risk management deficiencies.

Further, we believe that FRB Atlanta should have held bank management accountable for not timely developing a CRE risk management program consistent with the guidance outlined in SR Letter 07-01, especially given prior fundamental credit risk management weaknesses. Management's and the Board of Directors' pursuit of fast-growing markets resulted in a focus on CRE lending in the metro Atlanta area. In addition, the bank failed to establish appropriate limits for (1) overall CRE exposure; (2) specific sub-types of CRE lending, such as CLD; or (3) geographic concentrations. As a result, Park Avenue was particularly vulnerable to market declines given its CRE and CLD concentrations.

While we believe that FRB Atlanta had opportunities for earlier and more forceful supervisory action, it is not possible for us to predict the effectiveness or impact of any corrective measures that might have been taken by the bank. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected Park Avenue's financial deterioration or the ultimate cost to the DIF.

Lessons Learned

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Park Avenue's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Park Avenue's failure illustrates (1) the risks associated with a strategic focus on high-risk loan products and expansion into new markets; (2) the importance of establishing appropriate credit risk management practices, including concentration limits and strong underwriting consistent with SR Letter 07-01 and the CBEM, prior to pursuing higher risk lending; and (3) the importance of scrutinizing any weaknesses in a function with previously noted deficiencies and implementing aggressive supervisory action to address those weaknesses.

Analysis of Comments

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director concurred with our conclusions and lessons learned and our observation that the Reserve Bank staff had opportunities to be more aggressive in their supervisory activities when signs of credit risk management weaknesses persisted. His response is included as Appendix 3.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)

A valuation reserve established and maintained by charges against the bank’s operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. The reserve must be sufficient to absorb probable losses inherent in the institution’s loan and lease portfolio.

Board Resolution

An informal supervisory enforcement action that represents a number of commitments made by a bank’s Board of Directors. The commitments are incorporated into the bank’s corporate minutes.

Call Reports

The Reports of Condition and Income are commonly known as Call Reports. Every state member bank is required to file a consolidated Call Report normally as of the close of business on the last calendar day of each calendar quarter, i.e., the report date.

Classified Assets

Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Classified assets are divided into more specific subcategories ranging from least to most severe: “substandard,” “doubtful,” and “loss.” An asset classified as “substandard” is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. An asset classified as “doubtful” has all the weaknesses inherent in one classified as “substandard,” with the added characteristic that the weaknesses make full collection or liquidation highly questionable and improbable. An asset classified as “loss” is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE) Loans

Land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm, nonresidential property where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Appendix 1 (continued)

Concentration

A significant amount of direct or indirect extensions of credit and contingent obligations that possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations.

Construction and Land Development (CLD) Loans; also known as Construction, Land, and Land Development (CLD) Loans

A subset of commercial real estate loans, secured by real estate (including non-agricultural vacant land), for (1) on-sight construction of industrial, commercial, residential, or farm buildings, and (2) land development, including pre-construction preparatory work such as laying sewer and water pipes.

Enforcement Actions

The Federal Reserve Board has a broad range of enforcement powers that include formal or informal enforcement actions that may be taken, typically after the completion of an on-site bank examination. Formal enforcement actions consist of Written Agreements, Temporary Cease-and-Desist Orders, Cease-and-Desist Orders, Prohibition and Removal Orders, and Prompt Corrective Action directives; while informal enforcement actions include Commitments, Board Resolutions, and Memoranda of Understanding.

Memorandum of Understanding (MOU)

A highly structured, written, but informal supervisory enforcement action that is signed by both the Reserve Bank and the member bank's Board of Directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management.

Non-Core Funding

Funding that can be very sensitive to changes in interest rates, such as brokered deposits, certificates of deposit greater than $100,000, federal funds purchased, and borrowed money.

Prompt Corrective Action (PCA)

A framework of supervisory actions, set forth in 12 U.S.C. 1831o, for insured depository institutions whose capital positions have declined below certain threshold levels. It was intended to ensure that action is taken when an institution becomes financially troubled, in order to resolve the problems of the institution at the least possible long-term loss to the DIF. The capital

Appendix 1 (continued)

categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

Underwriting

Detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history; and the lender's evaluation of the borrower's credit needs and ability to pay.

Written Agreement

A formal supervisory enforcement action that is generally issued when a financial or an institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Federal Reserve Board or a Federal Reserve Bank that may require the financial institution or the institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. This enforcement action is the least severe of the formal enforcement actions.

Appendix 2 – CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of the institution's financial condition and operations. These component factors address the adequacy of *capital*, the quality of *assets*, the capability of *management*, the quality and level of *earnings*, the adequacy of *liquidity*, and the *sensitivity* to market risk (CAMELS). Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definition

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the Board of Directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences, such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institutions' size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For financial institutions to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the Board of Directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institutions' size, complexity, and risk profile. There are no material supervisory concerns; and, as a result, the supervisory response is informal and limited.

Appendix 2 (continued)

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institutions' size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the Board of Directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institutions' size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the DIF. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institutions' size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institutions to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the DIF, and failure is highly probable.

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of Banking Supervision and Regulation

Date: November 17, 2011

To: Anthony Castaldo, Associate Inspector General for Inspections and Evaluation

From: Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***

Subject: Material Loss Review of Park Avenue Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of the Park Avenue Bank (Park Avenue) of Valdosta, Georgia, prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act, as amended. The report finds that Park Avenue failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which resulted in a concentration in commercial real estate (CRE), particularly in construction, land, and development (CLD) loans. Park Avenue was supervised by the Federal Reserve Bank of Atlanta (FRB Atlanta) under delegated authority from the Board.

FRB Atlanta complied with examination frequency guidelines for the time period that was reviewed, 2001 through 2011. During this time FRB Atlanta and the State of Georgia Department of Banking and Finance (State) conducted ten full scope examinations and three target examinations, a horizontal CRE review and regular off-site monitoring. Further, over this timeframe supervisors executed six enforcement actions (four informal and two formal actions) with Park Avenue and implemented all applicable PCA provisions. The report recognizes that examiners identified the fundamental weaknesses that contributed to the bank's failure, but concludes that they did not take early, forceful supervisory action to address those weaknesses. The report states that it is not possible to determine whether alternative supervisory actions would have affected Park Avenue's eventual failure.

Banking Supervision and Regulation staff concurs with the conclusions and lessons learned in the report. Specifically staff concurs with the report's observations that Reserve Bank staff had opportunities to be more aggressive in their supervisory activities when signs of credit risk management weaknesses persisted. Park Avenue's failure illustrates the risks associated with a strategic focus on high-risk loan products and expansion into new markets and the importance of establishing appropriate credit risk management practices prior to pursuing such higher risk lending. Moreover, it reinforces the importance of taking aggressive supervisory actions to address uncorrected safety and soundness concerns.

Appendix 4 – Office of Inspector General Principal Contributors to This Report

Karen M. Goldfarb, Project Leader and Auditor

Valerie L. Hoglund, Auditor

Michael P. VanHuysen, Office of Inspector General Manager