Board of Governors of the Federal Reserve System

Material Loss Review of BankFirst

Office of Inspector General

February 2010

growth. In our opinion, the 2006 full scope examination represented a missed opportunity at a critical juncture to (1) uncover the full extent of BankFirst's credit risk management weaknesses, including a compensation program that rewarded making loans but lacked incentives to ensure that the loans were safe and sound, and (2) compel management to address identified deficiencies. We believe that an earlier supervisory action to have BankFirst refrain from making additional loans may have reduced the loss to the DIF.

Recurring corporate governance weaknesses throughout the timeframe preceding the 2007 target examination also presented an opportunity for FRB Minneapolis to take more forceful supervisory action. During examinations conducted between May 2005 and October 2006, examiners noted a variety of corporate governance deficiencies, including (1) persistent strategic planning issues; (2) a corporate organizational structure that created divided loyalty between BankFirst and its holding company; (3) the substantial sharing of employees between affiliated entities; and (4) the need for a Chief Risk Officer, or other advocate, with sufficient power to manage financial and legal risk resulting from BankFirst's transactions with affiliated entities. We believe that the corporate governance deficiencies identified by examiners during these multiple examinations represented red flags that, at a minimum, warranted an earlier and more forceful supervisory response, including an appropriate enforcement action.

FRB Minneapolis did not conclude that a formal enforcement action was necessary until the 2007 target examination. Upon reaching that conclusion, issuing the formal enforcement action took five months. We believe that the time taken to issue the enforcement action was unduly prolonged, but likely did not have a material impact. The critical juncture to uncover and forcefully address BankFirst's loan growth and pervasive control deficiencies was in 2005 and 2006.

BankFirst's failure offers important lessons learned for Federal Reserve examiners and managers. First, heightened supervisory attention is vital when a bank implements a new business strategy featuring growth in high-risk lending outside of the institution's traditional market area. In addition, BankFirst's failure demonstrates the importance of confirming that new business activities operate within an effective internal control infrastructure. The failure also highlights the need for immediate, aggressive, and forceful supervisory action when (1) management deviates from business plan projections or (2) examiners detect corporate governance deficiencies that blur the barriers between affiliated entities.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. Overall, the Director concurred with our conclusions and lessons learned, and noted the critical importance of supervisors detecting and addressing serious issues sufficiently early so that risks to the bank's viability can be controlled. His response is included as Appendix 3.

We appreciate the cooperation that we received from FRB Minneapolis and Board staff during our review. The 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,

/signed/

Elizabeth A. Coleman
Inspector General

cc: Chairman Ben S. Bernanke
Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Governor Kevin M. Warsh
Mr. Stephen R. Malphrus
Mr. Patrick M. Parkinson
Mr. Ron J. Feldman

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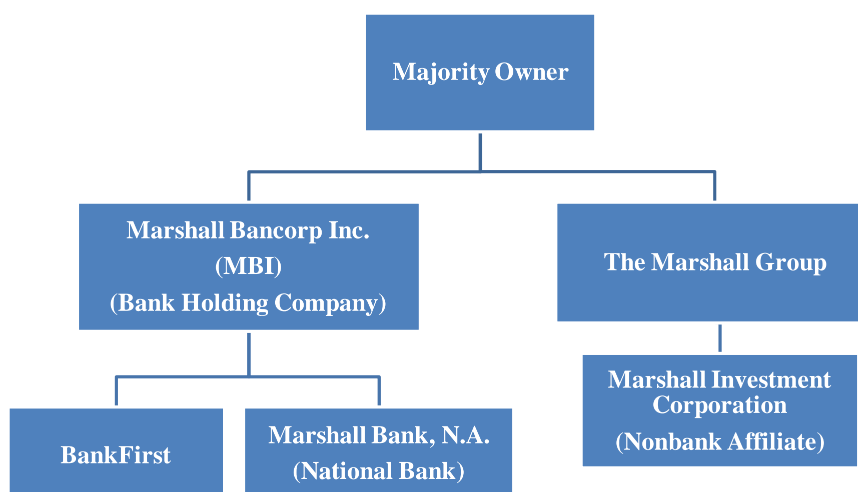
Background

BankFirst, headquartered in Sioux Falls, South Dakota, became a state member bank in March 1997. The bank was supervised by the Federal Reserve Bank of Minneapolis (FRB Minneapolis) under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the South Dakota Division of Banking (State). BankFirst was a limited purpose credit card bank with a business strategy that focused on nationwide subprime credit card lending. The bank ceased opening new subprime credit card accounts or increasing existing credit lines because of a formal enforcement action (a Written Agreement) in April 2003 and began focusing on other businesses, such as offering stored value cards to business customers.

In September 2004, Marshall Bancorp Inc. (MBI), a bank holding company that had various subsidiaries, including a national bank—Marshall Bank, N.A.—submitted an application to the Board to acquire BankFirst by purchasing BankFirst's parent company.[3] When the acquisition closed on January 5, 2005, the bank sold its subprime credit card receivables to a third-party vendor. BankFirst retained responsibility for monitoring the third-party vendor's compliance with the 2003 Written Agreement's terms related to subprime credit card account servicing. As shown in Chart 1 below, BankFirst became an affiliate of a nonbank entity held under common control by MBI's majority owner.[4] The affiliate—Marshall Investment Corporation—engaged in originating, syndicating, and servicing commercial real estate (CRE) loans on a nationwide basis.[5]

Chart 1 – BankFirst's Banking and Nonbanking Affiliates Following Acquisition[6]



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[3] BankFirst's parent company was a bank holding company named BankFirst Corporation.

[4] The majority owner of MBI also separately owned The Marshall Group, a nonbank holding company.

[5] Syndicating loans refers to collaboration among lenders to share in a loan or a package of loans.

[6] Marshall Bancorp Inc. changed its name to Marshall BankFirst Corporation following the acquisition of BankFirst. However, to avoid any confusion resulting from the name change, we use the original name, "MBI," or "bank holding company" throughout this report.

FRB Minneapolis reviewed MBI's business plan for BankFirst and approved the bank's strategy to engage in commercial and CRE lending activities on March 9, 2005. BankFirst's transition from a limited purpose credit card bank to a commercial bank marked a substantial strategic and operational shift. After the acquisition, BankFirst began originating loans directly and assumed syndication activities from Marshall Investment Corporation in various markets throughout the country, including Arizona, California, Colorado, Georgia, and Florida.

The State closed BankFirst on July 17, 2009, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that the bank's failure would result in a $90 million loss to the Deposit Insurance Fund (DIF), or 36.6 percent of the bank's $246.1 million in total assets. In a letter dated August 19, 2009, the FDIC Inspector General advised us that the FDIC had determined that BankFirst's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

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 and

- ascertain why the institution's problems resulted in a loss to the DIF;
- review the agency's implementation of Prompt Corrective Action (PCA); and
- make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed staff and collected data from the Board in Washington, D.C., and FRB Minneapolis. We also reviewed correspondence, surveillance reports, Reports of Examination (examination reports) issued between 2005 and 2009, and examination work papers prepared by FRB Minneapolis. Appendixes at the end of this report contain a glossary that defines key banking and regulatory terms and a description of the CAMELS rating system.[7] We conducted our fieldwork from September 2009 through December 2009, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

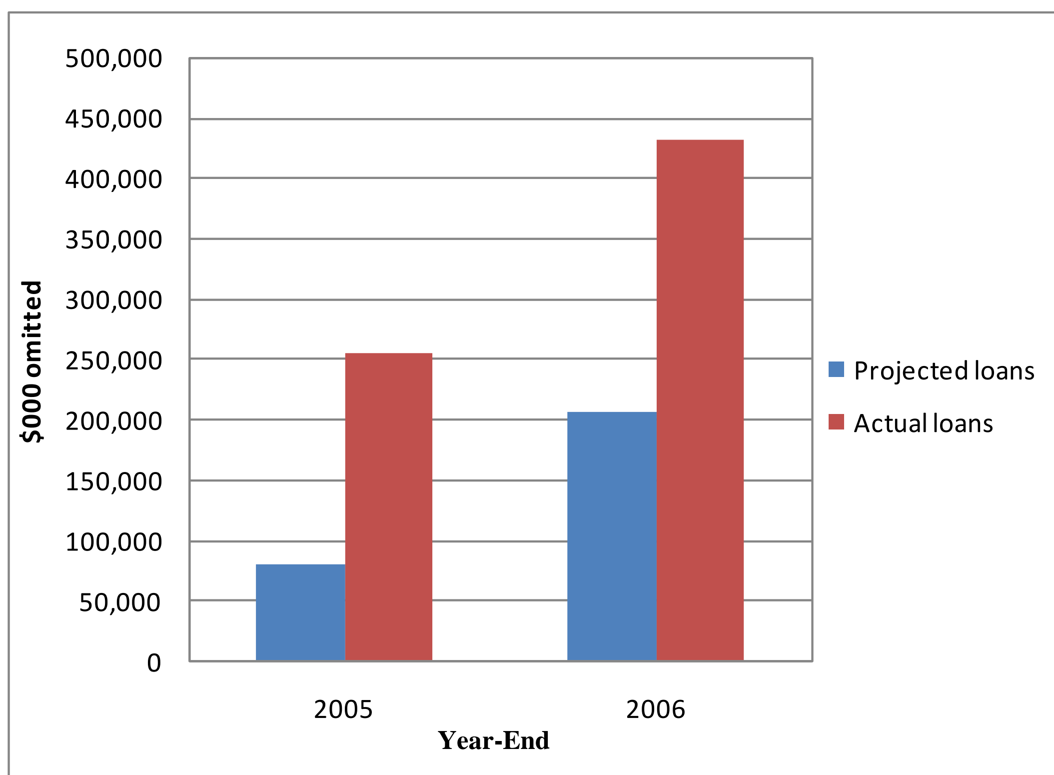
BankFirst failed because its Board of Directors and management did not establish a corporate governance and oversight framework to control the risks associated with its aggressive loan growth and high concentration in CRE loans. The lack of effective credit risk management

[7] 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.

controls resulted in a large volume of poorly underwritten CRE loans that were originated within an eighteen-month period. BankFirst had pervasive internal control deficiencies, and the inability of bank management to identify and address loan portfolio weaknesses led to asset quality deterioration and significant losses. Mounting losses eliminated earnings and depleted capital, which ultimately caused the State to close BankFirst and appoint the FDIC as receiver on July 17, 2009.

BankFirst experienced rapid loan growth during 2005 and 2006 as it transitioned from a limited purpose credit card bank to a commercial bank. The bank's loan portfolio increased 1,179 percent from $36.6 million as of March 31, 2005, to $431.8 million by year-end 2006. Examiners noted that BankFirst's rapid loan growth significantly exceeded management's projections. The bank's business plan projected its annual loan portfolio to be $80 million in 2005, $205 million in 2006, and $373 million in 2007. As shown in Chart 2, BankFirst's year-end loan portfolio significantly exceeded annual projections in 2005 and 2006. For example, in 2006, less than two years after it began making loans as a commercial bank, BankFirst surpassed its $205 million projection by approximately $220 million, or 110 percent.

Chart 2 – Actual Loans Compared to Business Plan Projections for 2005 and 2006



BankFirst's significant loan portfolio growth included numerous borrowers who eventually proved to be less than creditworthy. The bank's compensation practices emphasized loan growth and encouraged excessive risk taking—factors that contributed to the high-risk portfolio. According to examiners, BankFirst's compensation program rewarded loan officers for

generating fee income on loans they originated, but did not contain incentives to ensure that the bank made safe and sound loans.

The bank's rapid growth strategy also led to a CRE concentration that reached 350 percent of risk-based capital by year-end 2006.[8] In general, concentrations of credit increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. Therefore, concentrations may represent a substantial risk to the safety and soundness of an institution.

BankFirst's asset quality deteriorated and exposed pervasive corporate governance deficiencies at the bank. Examiners noted that BankFirst's organizational structure created divided loyalty between bank management and holding company management. For example, BankFirst's President did not oversee and control the bank's lending activities because its Chief Credit Officer reported to the bank holding company's Chief Operating Officer. In addition, examiners noted extensive sharing of employees that blurred institutional barriers between BankFirst and Marshall Investment Corporation and made it difficult to determine which functions were performed by each entity.

BankFirst's credit administration program contained significant and pervasive control deficiencies, and management's inability to identify and address loan portfolio weaknesses led to further asset quality deterioration. For example, BankFirst's credit administration program did not include an independent loan review function to provide an impartial assessment of loan quality. In general, an independent loan review function can be essential to a bank's safety and soundness, especially for those banks engaged in risky lending activities. In addition, BankFirst's loan risk rating process consistently produced unreliable results and examiners routinely downgraded management's loan ratings. Further, the full extent of loan portfolio weaknesses was masked by the bank's use of (1) automatic maturity extensions without fully assessing the underlying loan's creditworthiness and (2) interest reserves on speculative land loans.[9] Asset quality continued to deteriorate as loans not previously classified began to perform poorly due to declines in markets served by the bank. As a result of BankFirst's inability to correct credit administration deficiencies and manage its deteriorating loan portfolio, classified assets increased from $4.2 million in April 2005, to $180.4 million in February 2008.

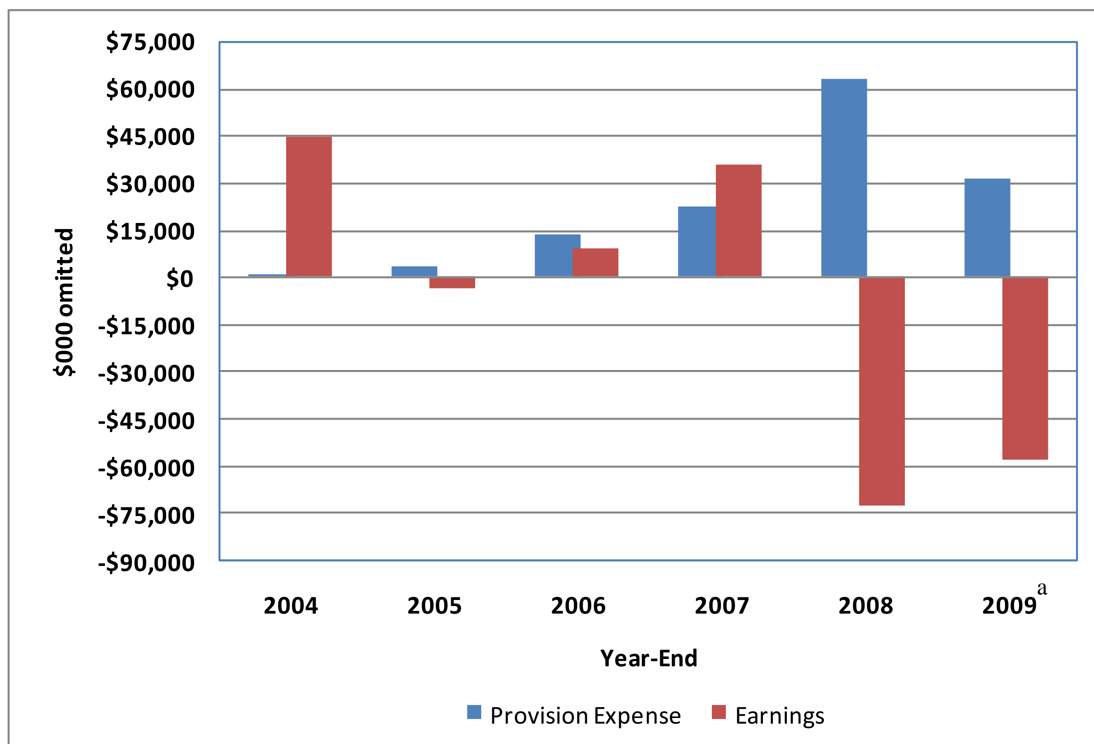
The growth in classified assets prompted corresponding increases in BankFirst's allowance for loan and lease losses (ALLL) and loss provision expense (provision). As shown in Chart 3 on page 13, the provision totaled $3.4 million for the year ending December 31, 2005. By the end of 2008, the provision increased eighteenfold to $63.1 million, contributing to the bank's net loss

[8] According to Supervision and Regulation Letter 07-01, institutions that meet the following criteria present potential CRE concentration risk: (1) total CRE loans represent 300 percent or more of the institution's total capital and (2) the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior thirty-six months.

[9] Lenders may establish an interest reserve account to periodically advance loan funds to pay interest charges on the outstanding balance of an acquisition, development, and construction loan. The interest is capitalized and added to the loan balance. This practice can mask loans that would otherwise be reported as delinquent and erode collateral protection, increasing a lender's exposure to credit losses.

of $72.7 million. The 2008 loss eliminated retained earnings and significantly reduced BankFirst's capital; however, the bank remained *adequately capitalized* through 2008.[10]

Chart 3 – Impact of Provision Expense on Net Income



a Data as of 6/30/2009

The bank's 2009 first quarter loss of $14.5 million reduced capital by nearly 50 percent; and in April 2009, FRB Minneapolis implemented PCA by notifying the bank that its capital position had fallen to *significantly undercapitalized*. The Board issued a PCA Directive on June 15, 2009, that, among other things, required BankFirst to (1) raise additional capital to achieve the *adequately capitalized* designation, or (2) be acquired by or merge with another depository institution. BankFirst's efforts to obtain new capital from insiders or its parent company or to identify a viable acquisition or merger candidate were not successful. The State closed BankFirst and appointed the FDIC as receiver on July 17, 2009.

Supervision of BankFirst

FRB Minneapolis complied with examination frequency guidelines for the 2005 through 2009 time frame that we reviewed. As shown in Table 1 on page 15, FRB Minneapolis and the State conducted four full scope examinations and seven target examinations from 2005 until BankFirst's failure in July 2009. The bank received CAMELS composite 3 (fair) ratings from

[10] Written Agreements executed in 2003 and 2007 required the bank to meet and maintain a specific minimum capital level. Under PCA, the bank's capital designation would be kept at *adequately capitalized* if it maintained that level of capital.

May 2005 through October 2006. In December 2006, FRB Minneapolis began an ALLL target examination that resulted in BankFirst being downgraded to a CAMELS composite 4 (marginal) rating. During this examination, CAMELS component ratings for capital and asset quality received double downgrades to 4 and earnings received a triple downgrade to 5. Examiners returned to conduct an asset quality target examination in April 2007, one month after issuing the ALLL target examination report. Subsequently, a Written Agreement (WA 2007) was issued in August 2007 to address the bank's weaknesses, including Board of Directors' oversight, loan policy, credit administration, and compliance with affiliate transaction requirements. A full scope examination report issued in February 2008 further downgraded the bank's CAMELS composite rating to a 5 (unsatisfactory) and questioned the bank's viability in light of its "precarious" financial condition.

Three subsequent examinations revealed that BankFirst's Board of Directors and its management did not fully implement the actions required under WA 2007 and prior examination reports. The bank did not develop (1) a business plan that met FRB Minneapolis' expectations for returning the institution to a safe and sound operating condition and (2) a credit administration program tailored to the needs of its deteriorating loan portfolio. During an August 2008 full scope examination, FRB Minneapolis found the bank to be materially noncompliant with the terms of WA 2007. The ensuing February 2009 ALLL target examination declared the bank *significantly undercapitalized* and resulted in a PCA letter. The Board subsequently issued a PCA Directive requiring BankFirst to (1) increase its capital to an *adequately capitalized* position or (2) be acquired by, or merge with, another depository institution. The State closed BankFirst on July 17, 2009, subsequent to its failure to meet the deadlines imposed in the PCA Directive.

Table 1 – BankFirst Supervisory Overview[11]

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions/PCA Notifications
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
5/9/2005	8/19/2005	Full	FRB Minneapolis	3	2	2	3	3	1	2	
12/12/2005	1/30/2006	Credit Administration Target	FRB Minneapolis	n/a							
1/23/2006	3/15/2006	Corporate Governance Target	FRB Minneapolis	n/a							
4/3/2006	5/26/2006	Mortgage Banking Target	FRB Minneapolis	n/a							
7/3/2006	10/13/2006	Full	FRB Minneapolis	3	2	2	3	2	2	2	
12/11/2006	3/7/2007	ALLL Target	FRB Minneapolis	4	4	4	4	5	3	2	Written Agreement
4/23/2007	7/6/2007	Asset Quality Target	FRB Minneapolis	n/a							
7/9/2007	2/7/2008	Full	FRB Minneapolis	5	4	5	5	5	4	3	
3/3/2008	7/23/2008	Asset Quality Target	FRB Minneapolis	n/a							
8/11/2008	12/18/2008	Full	Joint FRB Minneapolis - State	5	5	5	5	5	5	4	
2/17/2009	5/1/2009	ALLL Target	Joint FRB Minneapolis - State	5	5	5	5	5	5	4	PCA Letter PCA Directive

A synopsis of key Federal Reserve supervisory activities follows, including full scope examinations, target examinations, and enforcement actions.

[11] This table only includes safety and soundness examinations and, therefore, does not include Bank Secrecy Act target examinations that began in March 2007 and March 2008.

the bank in an extremely weak financial condition. At the time, the bank operated at a loss, and examiners speculated that such losses would likely continue for the foreseeable future.[15]

Corporate governance remained a key concern throughout the examination. The request to refrain from expanding the loan portfolio made during the 2006 full scope examination prompted management to contemplate repositioning BankFirst as a "plain vanilla community bank." According to examiners, management encountered difficulties developing "a vision of what a 'plain vanilla community bank' will look like or how the Bank intends to achieve the objective of becoming such an organization." Because of these difficulties, examiners required management to develop a comprehensive written business plan to return the bank to profitability and a safe and sound operating condition. Examiners noted that "effective oversight and resolution of the Bank's serious risk management deficiencies have been hampered by the very high turnover in Bank directors and senior management since the last examination." By the conclusion of the examination, only one of the directors elected in January 2007 remained, and BankFirst had only three directors in total. In addition, the bank President and the Chief Credit Officer also left the institution in the summer of 2007.

March 2008 Asset Quality Target Examination Revealed Continued Asset Quality Deterioration

FRB Minneapolis began an asset quality target examination in March 2008. The July 2008 examination report confirmed that the ratings issued during the 2007 full scope examination remained appropriate, although the target examination report did not assign formal ratings. Examiners' prior prediction of "losses for the foreseeable future" proved accurate as the bank's asset quality continued to deteriorate. This examination report identified significant deficiencies in every area of credit administration. Examiners observed that loan review and risk rating processes produced unreliable grades. FRB Minneapolis agreed with only half of the loan grades assigned by management. With respect to corporate governance, examiners noted that the business plan submitted to fulfill a prior examination requirement did not meet any of the specifications outlined by examiners. The examination report emphasized that management had not fully addressed FRB Minneapolis' prior directive to consider options to sell or liquidate the bank.

August 2008 Joint FRB Minneapolis-State Full Scope Examination Revealed Continued Noncompliance with the 2007 Written Agreement

A joint FRB Minneapolis and State full scope examination that began in August 2008 downgraded BankFirst's capital and liquidity to CAMELS component 5 ratings. In a report issued in December 2008, examiners noted that asset quality deterioration further strained the bank's operating results and caused capital levels to decline. According to examiners, BankFirst's management indicated that a capital injection from the holding company was not an option because the holding company had a negative net worth and the majority shareholder would not provide additional capital. At this juncture, management's business plan consisted of

[15] These operating results did not include a $51.8 million gain associated with the sale of BankFirst's stored value card business unit. Examiners noted that the sale provided a short-term boost to capital as of November 30, 2007, but removed one of the bank's few profitable business lines.

ceasing operations as an insured depository institution by selling its assets. Examiners noted that the success of this plan relied on a number of factors, including identifying a willing buyer. Examiners also found that the bank and its holding company were "materially noncompliant" with the terms of WA 2007 because many of the required actions remained unaddressed.

February 2009 Joint FRB Minneapolis-State ALLL Target Examination Resulted in a PCA Letter

FRB Minneapolis conducted a joint examination with the State that began in February 2009. It confirmed that the ratings issued in the December 2008 examination report remained the same. Examiners observed that the continuing decline in equity capital, poor asset quality, and sizable operating losses increased the likelihood of failure in the near term. Examiners observed that issues related to the adequacy of the ALLL, which had become evident during the 2007 ALLL target examination, were never resolved. The bank's capital position dropped to *significantly undercapitalized*, and FRB Minneapolis issued a PCA letter on April 20, 2009.

On May 5, 2009, the State issued a formal order requiring BankFirst's Board of Directors and management to increase the bank's capital position and develop a capital plan by June 15, 2009. Management's response, dated May 29, 2009, indicated that additional capital was not available. On June 15, 2009, the Board issued a PCA Directive requiring BankFirst to (1) increase its capital to an *adequately capitalized* position or (2) merge with, or be acquired by, another depository institution. The State closed BankFirst on July 17, 2009, subsequent to its failure to meet the deadlines imposed in the PCA Directive.

Conclusions and Lessons Learned

BankFirst failed because its Board of Directors and management did not establish a corporate governance and oversight framework to control the risks associated with its aggressive loan growth and high concentration in CRE loans. The lack of effective credit risk management controls resulted in a large volume of poorly underwritten CRE loans that were originated within an eighteen-month period. BankFirst had pervasive internal control deficiencies, and bank management's inability to identify and address loan portfolio weaknesses led to asset quality deterioration and significant losses. Mounting losses eliminated earnings and depleted capital, which ultimately caused the State to close BankFirst and appoint the FDIC as receiver on July 17, 2009.

Our analysis of BankFirst's supervision revealed that FRB Minneapolis did not devote sufficient supervisory attention to verifying that BankFirst's Board of Directors and management implemented a credit risk management framework to sufficiently control the bank's rapid growth in a new activity—CRE lending. Supervisory guidance related to assessing Board of Directors and management oversight of new business activities states that examiners should confirm that bank management has implemented the infrastructure and internal controls necessary to manage the risks associated with new business activities. A target examination report issued in March 2007 marked the point when FRB Minneapolis began to identify the full extent of the credit risk management weaknesses that contributed to BankFirst's eventual failure. Many of the findings and conclusions cited during the 2007 target examination contradicted the results from five prior

examinations. We believe that FRB Minneapolis should have focused greater attention on credit risk controls during examinations that immediately followed the bank's transition to commercial lending.

Specifically, we believe that the full scope examinations conducted in 2005 and 2006 presented opportunities for FRB Minneapolis to take more forceful supervisory action. During the May 2005 examination, FRB Minneapolis noted that BankFirst's updated annual projection for loan portfolio growth would almost triple the forecasted amount cited in management's business plan. In our opinion, the magnitude of this projected increase provided FRB Minneapolis with an opportunity to take immediate supervisory action to restrain further loan portfolio growth. During the July 2006 full scope examination, examiners did request that BankFirst curtail further loan growth to allow the loan portfolio to season, so examiners could assess the risks associated with the bank's strategy. However, examiners did not conduct sufficient testing to confirm that the bank's CRE lending controls were adequate to support the bank's rapid loan growth. In our opinion, the 2006 full scope examination represented a missed opportunity at a critical juncture to (1) uncover the full extent of BankFirst's credit risk management weaknesses, including a compensation program that rewarded making loans but lacked incentives to ensure that the loans were safe and sound, and (2) compel management to address identified deficiencies. We believe that an earlier supervisory action to have BankFirst refrain from making additional loans may have reduced the loss to the DIF.

Recurring corporate governance weakness throughout the timeframe preceding the 2007 target examination also presented an opportunity for FRB Minneapolis to take more forceful supervisory action. During examinations conducted between May 2005 and October 2006, examiners noted a variety of corporate governance deficiencies, including (1) persistent strategic planning issues; (2) a corporate organizational structure that created divided loyalty between BankFirst and its holding company; (3) the substantial sharing of employees between affiliated entities; and (4) the need for a Chief Risk Officer, or other advocate, with sufficient power to manage financial and legal risk resulting from BankFirst's transactions with affiliated entities. We believe that the corporate governance deficiencies identified by examiners during these multiple examinations represented red flags that, at a minimum, warranted an earlier and more forceful supervisory response, including an appropriate enforcement action.

FRB Minneapolis did not conclude that a formal enforcement action was necessary until the 2007 target examination. Upon reaching that conclusion, it took five months to issue the formal enforcement action. We believe that the time taken to issue the enforcement action was unduly prolonged, but likely did not have a material impact. The critical juncture to uncover and forcefully address BankFirst's loan growth and pervasive control deficiencies was in 2005 and 2006.

Lessons Learned

BankFirst's failure offers important lessons learned for Federal Reserve examiners and managers. First, heightened supervisory attention is vital when banks implement a new business strategy featuring growth in high-risk lending outside of the institution's traditional market area. In addition, BankFirst's failure demonstrates the importance of confirming that new business activities operate within an effective internal control infrastructure. The failure also highlights

the need for immediate, aggressive, and forceful supervisory action when (1) management deviates from business plan projections or (2) examiners detect corporate governance deficiencies that blur the barriers between affiliated entities.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. In his response, included as Appendix 3, the Director agreed with the report's conclusions and lessons learned. He noted that FRB Minneapolis did not conduct sufficient testing to confirm that BankFirst's underwriting and CRE lending controls were adequate to support that bank's rapid loan growth. The Director stated that, in hindsight, an earlier supervisory action compelling management to address identified deficiencies may have reduced the loss to the DIF, and noted that FRB Minneapolis made a number of changes to its supervision program during 2008 and 2009 in response to what was learned from BankFirst's failure.

APPENDIXES

APPENDIX 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
The ALLL is a valuation reserve established and maintained by charges against the financial institution'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. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.

Classified Assets
Classified assets are loans that exhibit well-defined weaknesses and a distinct possibility of loss. The term "classified" is 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. Assets classified as "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

Commercial Real Estate (CRE)
CRE loans are 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 primarily derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Concentration
A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.

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 Cease-and-Desist Orders and Written Agreements, while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Interest Reserves
Interest reserves are accounts set up by lenders to periodically advance loan funds to pay interest charges on the outstanding balance of an acquisition, development, and construction loan. The interest is capitalized and added to the loan balance. This practice can mask loans that would otherwise be reported as delinquent and erode collateral protection, increasing a lender's exposure to credit losses.

APPENDIX 1 (continued)

Limited Purpose Bank
Under the Community Reinvestment Act, a bank may apply to its primary federal regulator to be designated a limited purpose bank. A limited purpose bank is a financial institution that offers only a narrow product line (such as credit card or motor vehicle loans) to a regional or broader market.

Liquidity
Liquidity is the ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

Nonperforming Loans
Nonperforming loans are the sum of total loans and lease financing receivables past due 90 or more days and still accruing interest and total nonaccrual loans and lease financing receivables.

Prompt Corrective Action (PCA)
PCA is a framework of supervisory actions, set forth in 12 U.S.C. 1831o, for insured depository institutions whose capital position has 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 categories are *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*.

Stored Value Cards
The term "stored value" is associated with products for which prefunded value is recorded on the payment instrument. The term "prepaid" is associated with products for which the prefunded value is recorded on a remote database, which must be accessed for payment authorization. There are a variety of applications for prepaid cards, including gift cards, payroll cards, flexible spending account cards, government benefit cards (such as food stamps), insurance claim cards, employee reward cards, travel cards, remittance payment cards, and transportation cards. Most prepaid cards serve a single purpose, but there are a few cases in which multiple prepaid functions are combined on one card.

Syndicating Loans
Syndicating loans refers to collaboration among lenders to share in a loan or a package of loans.

Uniform Bank Performance Report (UBPR)
The UBPR is an individual analysis of a financial institution's financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council based on quarterly data provided by banks and is for the use of banking supervisors, bankers, and the general public.

APPENDIX 1 (continued)

Underwriting
Underwriting is part of a bank's lending policies and procedures that enable the bank's lending staff to evaluate all relevant credit factors. These factors include the capacity of the borrower or income from the underlying property to adequately service the debt; the market value of the underlying real estate collateral; the overall creditworthiness of the borrower; the level of the borrower's equity invested in the property; any secondary sources of repayment; and any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

Written Agreement
A Written Agreement is a formal, legally enforceable, and publicly available action to correct practices that are believed to be unlawful, unsafe, or unsound. All Written Agreements must be approved by the Board's Director of the Division of Banking Supervision and Regulation and General Counsel.

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: February 18, 2010

To: Elizabeth A. Coleman, Inspector General

From: Patrick M. Parkinson, Director ***/signed/***

Subject: Draft "Material Loss Review of BankFirst"

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of BankFirst, Sioux Falls, South Dakota, that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that BankFirst failed because its Board of Directors and management did not establish a corporate governance and oversight framework to control the risks associated with the bank's aggressive loan growth and high concentration in CRE loans. The lack of effective credit risk management controls resulted in a large volume of poorly underwritten CRE loans that were originated nationwide within an eighteen-month period. The bank was supervised by the Federal Reserve Bank of Minneapolis (FRB Minneapolis) under delegated authority from the Board.

We concur with the conclusions and lessons learned contained in the report. FRB Minneapolis did not conduct sufficient testing to confirm that the bank's underwriting and CRE lending controls were adequate to support the bank's rapid loan growth in 2005 and 2006. It was not until early 2007 that examiners uncovered the full extent of BankFirst' s credit risk management weaknesses, including a compensation program that rewarded making loans but lacked incentives to ensure that the loans were safe and sound. However, by early 2007, future losses were already embedded in the portfolio. Moreover, in hindsight, this Division concurs that an earlier supervisory action compelling management to address identified deficiencies may have reduced the loss to the Deposit Insurance Fund. The report highlights important lessons learned, including (l) the critical need for heightened supervisory attention and testing of underwriting and lending controls when a bank implements a business strategy featuring growth in high risk lending outside of the institution's traditional market area; and (2) the need for immediate, aggressive, and forceful supervisory action when corporate governance deficiencies are identified. In response to the lessons learned from BankFirst, FRB Minneapolis made a number of changes to its supervision program during 2008 and 2009.

Board staff very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for the failure of Bank First. The events described in the report highlight the critical importance that supervisors' detect and address serious issues sufficiently early that risks to a bank's viability can be controlled.

APPENDIX 4 – Principal Contributors to this Report

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