Board of Governors of the Federal Reserve System

Summary Analysis of Failed Bank Reviews

Office of Inspector General

September 2011

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

OFFICE OF INSPECTOR GENERAL

September 30, 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:

This report analyzes failed state member bank reports that the Office of the Inspector General issued between June 29, 2009, and June 30, 2011, to determine the common characteristics, circumstances, and emerging themes related to (1) the cause of the bank failures and (2) Federal Reserve supervision of the failed institutions. Our analysis yielded a series of common observations. We also conducted supplemental research and analysis to understand why certain institutions withstood the financial crisis better than others.

With respect to the cause of the state member bank failures, the majority of the reports cited common themes. In addition to the economic decline that triggered asset quality deterioration and significant losses at each of the failed banks, the common themes included (1) management pursuing robust growth objectives and making strategic choices that proved to be poor decisions; (2) rapid loan portfolio growth exceeding the bank's risk management capabilities and/or internal controls; (3) asset concentrations tied to commercial real estate or construction, land, and land development (CLD) loans, which increased the bank's vulnerability to changes in the marketplace and compounded the risks inherent in individual loans; and (4) management failing to have sufficient capital to cushion mounting losses. Additionally, the reports revealed certain practices that contributed to specific failures, such as risky funding strategies and incentive compensation programs that inappropriately encouraged risk taking.

With respect to the supervision of the failed state member banks, many of the reports noted that examiners identified key safety and soundness risks, but did not take sufficient supervisory action in a timely manner to compel the Boards of Directors and management to mitigate those risks. In many instances, examiners eventually concluded that a supervisory action was necessary, but that conclusion came too late to reverse the bank's deteriorating condition.

In our supplemental research and analysis comparing failed banks to those that withstood the financial crisis, we found that lower commercial real estate and CLD concentration levels, strong capital positions, and minimal dependence on non-core funding were key differentiating characteristics. Our research also revealed a correlation between high CLD concentration levels and the likelihood of failure during the recent financial crisis.

Based on our mandate to assess the bank failures to determine how losses to the Deposit Insurance Fund might be avoided in the future and our assessment of the emerging themes from the failures we reviewed, this report contains three recommendations and three matters for consideration.

We provided our draft report to you for review and comment. In a response included as Appendix 6, your Deputy Director concurred with the general findings of the report and generally agreed with the report's recommendations and matters for consideration.

We appreciate the cooperation that we received from the Board of Governors of the Federal Reserve System staff during our review. The Office of Inspector General principal contributors to this report are listed in Appendix 7. 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

Enclosure

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

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Summary Analysis of Failed Bank Reviews

I. Background on Failed Bank Reporting Requirements

Section 38(k) of the Federal Deposit Insurance Act (FDI Act) requires that the Inspector General of the appropriate federal banking agency complete a review of the agency's supervision of a failed institution when the projected loss to the Deposit Insurance Fund (DIF) is material. The FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), defines a material loss to the DIF as an estimated loss in excess of $200 million.[1] This materiality threshold applies to losses to the DIF that occur between January 1, 2010, and December 31, 2011.

The Dodd-Frank Act also created new reporting requirements for failures that result in losses below the $200 million materiality threshold. In these situations, the Inspector General must review the failure to determine, among other things, whether the loss exhibits "unusual circumstances" that warrant an in-depth review. If unusual circumstances exist, the Inspector General must prepare a report consistent with the requirements of a material loss review (MLR). The Office of Inspector General (OIG) of the Board of Governors of the Federal Reserve System considers a loss to the DIF to present unusual circumstances when the conditions associated with the bank's deterioration, ultimate closure, or supervision have not been previously addressed in an MLR or an in-depth review, or the failure involved potentially fraudulent activity.

For each MLR and in-depth review (collectively referred to as failed bank reviews), section 38(k) of the FDI Act requires the Inspector General of the appropriate federal banking agency to

- review the supervision of the institution, including the agency's implementation of prompt corrective action (PCA);
- ascertain why the institution's problems resulted in (1) a material loss to the DIF or (2) a failure beneath the material loss threshold that presents unusual circumstances; and
- make recommendations for preventing any such losses in the future.

Pursuant to the Dodd-Frank Act, the OIG is not required to prepare a report when a loss to the DIF falls beneath the materiality threshold and no unusual circumstances surround the failure. However, the OIG must explain its determination concerning the absence of unusual circumstances in a semiannual report.

II. Purpose, Scope, and Methodology

We conducted a cross-cutting analysis of our failed bank reviews to determine the common characteristics, circumstances, and emerging themes related to (1) the cause of the bank failures and (2) Federal Reserve supervision of the failed institutions.[2] Our assessment yielded a series of common observations. We also conducted supplemental research and analysis to understand why certain institutions withstood the financial crisis better than others. Consistent with the OIG's legislative mandate to provide recommendations concerning the prevention of bank

[1] Prior to the enactment of the Dodd-Frank Act on July 21, 2010, section 38(k) of the FDI Act defined a material loss to the DIF as the greater of $25 million or 2 percent of the institution's total assets.

[2] The respective Federal Reserve Banks conduct banking supervision activities pursuant to delegated authority from the Board of Governors of the Federal Reserve System.

failures that result in material losses to the DIF, this report contains three recommendations and presents three matters for consideration. We performed our review between October 2010 and July 2011 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

It is important to note that our assessment was limited to the 35 state member bank (SMB) failures we reviewed. These failures represent 4.2 percent of the approximately 824 SMBs supervised by the Board of Governors of the Federal Reserve System (Federal Reserve Board) during this period. The total estimated loss to the DIF associated with these failures was approximately $4.8 billion.

Appendix 1 contains selected excerpts from MLRs and in-depth reviews relevant to the contributing causes and supervision observations related to the failed institutions. This appendix also describes the results of our supplemental analysis.

III. Summary of Failed Bank Reports Issued by the OIG

Between June 29, 2009, and June 30, 2011, the OIG completed reviews of 35 SMB failures.[3] As shown in Appendix 2, the SMB failures were concentrated in the Southeast, Midwest, and West; and specific states within those regions—Florida, Georgia, Illinois, Michigan, and California—experienced multiple failures. Of these 35 failures, (1) 18 resulted in MLRs, (2) 2 required in-depth reviews, and (3) 15 did not present unusual circumstances that required an in-depth review as identified in our October 28, 2010, and April 29, 2011, *Semiannual Reports to Congress*.[4]

With respect to the total asset size of the failed SMBs, 31 of the 35 failures clustered within three peer groups: (1) 11 banks with $100 to $300 million in assets, (2) 16 banks with $300 million to $1 billion in assets, and (3) 4 banks with $1 to $3 billion in assets. The average loss to the DIF associated with these failures was 21 percent of total assets.

IV. Common Elements that Contributed to SMB Failures

For the 20 reviews that resulted in OIG reports, in general, the majority exhibited a common fact pattern that contributed to the respective bank's failure. In addition to the economic decline that triggered asset quality deterioration and significant losses at each of the failed banks, common elements included (1) management pursuing aggressive growth objectives and making strategic choices that eventually proved to be poor decisions; (2) rapid loan portfolio growth exceeding the bank's risk management capabilities and/or internal controls; (3) asset concentrations tied to commercial real estate (CRE) or construction, land, and land development (CLD) loans, which increased the bank's vulnerability to changes in the marketplace and compounded the risks inherent in individual loans; and (4) management failing to raise sufficient capital to cushion mounting losses.

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[3] During this time period, there were 300 bank failures according to information available on the Federal Deposit Insurance Corporation's web site, so the SMB failures represent approximately 12 percent of the total failures during the time period for our review.

[4] Our October 28, 2010, *Semiannual Report to Congress* (SAR) describes 10 failures and our April 29, 2011, SAR describes 5 failures that did not present usual circumstances.

Of these common elements, this report focuses on aggressive growth strategies, asset concentrations, and ineffective internal controls and poor risk management. We also discuss certain practices that contributed to specific bank failures, such as risky funding strategies and incentive compensation programs that inappropriately encouraged risk taking.

1. **Aggressive Growth and Poor Strategic Decision-making –** Many bank failures involved the Board of Directors and management making strategic decisions to pursue aggressive growth that increased the bank's risk profile and ultimately contributed to the failure. In Appendix 1, we highlight seven examples of strategic decisions that proved to be poor decisions with the benefit of hindsight. These decisions included departing from the institutions' traditional business strategy by expanding into new activities or market areas; introducing new product offerings; continuing loan growth following initial signs of a market downturn; and pursuing growth opportunities through mergers, acquisitions, or loan pool purchases without conducting sufficient due diligence.

2. **Asset Concentrations in CLD Loans Correlated to Likelihood of Failure –** Asset concentrations contributed to each of the 20 failures. We observed that the vast majority of the failed institutions had high CRE concentrations.[5] Because of the apparent significance of this finding, we conducted additional analysis of the top 25 SMBs that had high CRE concentration levels prior to the financial crisis (using data as of June 30, 2007) to better understand the role of concentrations in the failures. We found that the existence or magnitude of a CRE concentration prior to the onset of the crisis was not necessarily predictive of a bank failure; rather, our analysis suggested a correlation between a concentration in the CLD loan component of CRE and a bank's likelihood to fail.

   We also reviewed institutions that maintained a CAMELS composite rating of 1 or 2 through the financial crisis to analyze their concentration levels to identify key differentiators between those banks and the failed SMBs.[6] Our research revealed that strong capital positions, loan portfolio diversification, and low reliance on non-core funding were common characteristics among the highest rated institutions.

   Appendix 1 describes the results of our research in greater detail.

3. **Reliance on Certain Specific Funding Sources –** Ten of the 20 banks failed, in part, because of an over-reliance on non-core funding; and two of the 10 banks failed, in part, because of an over-reliance on mortgage loan asset sales to the secondary market. Reliance on non-core funding sources is a risky strategy because these funds may not be available in times of financial stress and can lead to liquidity shortfalls. In addition, the costs associated

[5] Supervision and Regulation (SR) Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate*, indicates that a significant CRE concentration exists at 300 percent of total risk-based capital and a significant CLD concentration exists at 100 percent of total risk-based capital.

[6] 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. 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 as the highest rank in the scale.

with obtaining non-core funding typically strained banks' profitability because non-core funding is a higher cost funding source. Similarly, over-reliance on mortgage loan sales to the secondary market is a risky strategy because demand can diminish or disappear based on changing economic conditions. The evaporation of secondary market demand for mortgage asset sales during the financial crisis forced some banks to hold loans that management intended to sell. Certain banks experienced significant losses on loans that could not be sold as a result of declines in the residential real estate market. We describe three of these situations in Appendix 1.

4. **Ineffective Internal Controls and Poor Risk Management –** As outlined in Appendix 3, Table 1, 16 of the 20 failed banks included in our analysis had significant risk management and internal control weaknesses. Appendix 1 describes three examples where internal control weaknesses contributed to the failure. In each of the three examples, the applicable Board of Directors and management did not assure that their bank's risk management capabilities and internal controls kept pace with the bank's rapid growth and increasingly complex operations. These weaknesses provided an early indication of Board of Directors and management weaknesses and foreshadowed an increasing probability for failure at these institutions.

5. **Compensation Incentives May Encourage Inappropriate Risk Taking –** Three failures appeared to establish a connection between compensation program incentives and risk-taking.[7] In one failure, it appeared that a dominant Chief Executive Officer (CEO) pursued an aggressive and risky growth strategy that resulted in a high concentration in CLD loans because, in part, the bank's growth rate contributed to the size of the CEO's annual incentive compensation. The bank's rapid growth rates during the CEO's tenure appeared to establish a possible connection between compensation incentives and the bank's growth strategy. In the other two failures, compensation programs appeared to influence loan officer behavior. In those failures, loan officer compensation programs contained incentives for loan production, but did not include similar incentives related to loan quality. These institutions experienced substantial growth, in part, because of loosened underwriting standards, which resulted in the banks originating low quality loans.

[7] On March 30, 2011, the Federal Reserve Board announced the interagency promulgation of a proposed rule concerning incentive compensation arrangements at covered financial institutions. The proposed rule would apply to certain institutions, including SMBs, with more than $1 billion in total assets. In general, the proposal encourages covered institutions to design incentive compensation programs in a manner that appropriately accounts for risk. In addition, the proposal generally prohibits incentive compensation that encourages inappropriate risk-taking.

V. Observations Regarding Federal Reserve Supervision of Failed SMBs

1. **Stronger Supervisory Action Sooner –** We noted in our 20 reports that examiners often identified many of the SMBs' key safety and soundness risks, but did not take sufficient supervisory action in a timely manner to compel the Board of Directors and management to mitigate those risks. In many instances, supervisors eventually concluded that a supervisory action was necessary, but that conclusion came too late to reverse the bank's deteriorating condition. In most failures, it was not possible to determine the degree to which earlier or more forceful supervisory responses might have affected a bank's deterioration or the ultimate cost to the DIF.

2. **Different Approaches to Aggressive Growth Strategies –** We observed different supervisory approaches for SMBs that pursued aggressive growth strategies. In specific situations, examiners did not intervene or question the advisability of management's continued portfolio growth despite significant risks associated with the already concentrated loan portfolios. In other instances, the examination teams questioned the advisability of additional loan portfolio growth and requested that management consider refraining from additional lending activities. Appendix 1 notes five failures that exemplify these two different approaches.

3. **Board of Directors and Management Accountability for Managing the Risks Associated with New Activities and Implementing Required Corrective Actions –** Many of the supervisory histories associated with the failures that we reviewed illustrated the need to reinforce supervisory fundamentals and demonstrated the importance of examination teams (1) assuring that the Board of Directors and management appropriately mitigate the risks associated with strategic transitions or new business activities, (2) using escalating supervisory actions when appropriate, and (3) assuring that the Board of Directors and management timely implement required corrective actions. Our examples also highlight the need for supervisors to ensure that CAMELS composite and component ratings are consistent with narrative examination comments to clearly convey the need for urgent action when appropriate. Appendix 1 contains five examples of these situations.

4. **Limitations of PCA Assessments –** Specific failures revealed the limitations of PCA's quantitative assessments of a bank's capital position.[8] As discussed in Appendix 1, in three instances, specific SMBs remained *well capitalized* under PCA guidelines, even though the applicable examination team noted that the institution's capital position did not support the bank's risk profile prior to declines in the bank's PCA status.[9] The contrast highlights how significantly PCA quantitative assessments can lag examiners' more subjective assessment of capital in relation to a bank's risk profile.

[8] In June 2011, the Government Accountability Office released a study on PCA that contained recommended actions for the federal banking agencies.

[9] The Federal Deposit Insurance Corporation Improvement Act of 1991 established the PCA standards for undercapitalized banks. Based on their level of capitalization, banks are designated as *well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, or *critically undercapitalized*. A bank's capitalization designation is based on its total risk-based capital ratio, tier 1 risk-based capital ratio, and leverage ratio.

5. **Declines in Financial Performance as a Prerequisite to Aggressive Supervisory Action –** As mentioned above, prior to and early in the financial crisis, examiners acknowledged and identified many of the risks that ultimately caused specific SMBs to fail, but we found certain circumstances where examiners did not take aggressive supervisory action until the institution's financial performance declined. The deteriorating economic conditions during the financial crisis demonstrated how quickly specific risks can impact a bank's condition, making it critical that such issues are addressed timely. This supervisory risk indicates the need for "forward-looking" examinations with clear and forceful communication in more stable economic periods. We highlight three examples of this observation in Appendix 1.

6. **Limitations of SR Letter 07-01, *Interagency Guidance on Concentrations in Commercial Real Estate* –** Given the prominent role that CRE (including CLD) concentrations played in these SMB failures, we solicited Reserve Bank staff opinions concerning the effectiveness of SR Letter 07-01. In general, examiners perceived the guidance to be "too little, too late." Many examiners suggested that the guidance might have been more effective if issued sooner and that more detailed guidance on the topic would be beneficial. Examiners mentioned that many institutions did not quickly adopt the risk management practices outlined in the guidance prior to the onset of the financial crisis. Appendix 1 contains further discussion of this topic.

VI. Recommendations

Based on our mandate to assess the bank failures to determine how losses to the DIF might be avoided in the future and our assessment of the emerging themes from the failures reviewed, we recommend the following actions:

1. **We recommend that the Director of the Division of Banking Supervision and Regulation (BS&R) supplement current examiner training programs with case studies from the recent failures**.

   Based on our cause of failure and supervisory observations, we believe that case studies involving the recent SMB failures would provide examiners the opportunity to assess different supervisory approaches and the associated implications and outcomes. We also noted the need for examiner training sessions designed to reinforce the importance of (a) issuing CAMELS composite and component ratings consistent with examination comments, (b) escalating supervisory actions based on management's failure to resolve examination comments, (c) assuring that Boards of Directors and management implement appropriate controls and risk management practices for new business activities, (d) addressing significant deviations from previously submitted and approved business plans, and (e) following regulatory and examination guidance and seeking clarifications as needed.

2. **We recommend that the Director of the Division of BS&R develop standard examination procedures to evaluate compensation arrangements.**

   In our opinion, BS&R should develop standard examination procedures to review incentive compensation arrangements for key personnel, including loan origination staff, of all SMBs

(regardless of total asset size) consistent with the risk-focused examination approach. According to the *Commercial Bank Examination Manual* (CBEM), the risk-focused examination approach seeks to ensure that institutions have in place the processes necessary to identify, measure, monitor, and control risk exposures. We believe that examination procedures can be tailored to this approach to evaluate incentive compensation programs for executive management and key risk-taking personnel, such as loan origination staff, and assure the alignment of incentives to the safe and sound operation of the institution. Executing the procedures should provide examiners with an understanding of the potential influence of incentive compensation on strategic and risk-taking activities.

3. **We recommend that the Director of BS&R provide supplementary guidance on CRE concentrations**.

   Based on examiner feedback and our analysis, we recommend that the Director of BS&R provide supplementary guidance to SR Letter 07-01. In our opinion, updated guidance should, at a minimum, (1) address the unique risks associated with CLD lending and appropriate and effective risk management practices, and (2) identify specific practices that proved effective in managing concentrations during the financial crisis.

VII. Matters for Consideration

1. **We suggest that the Director of BS&R continue to work with the other federal banking agencies to identify opportunities to enhance PCA.**

   It is our understanding that an interagency effort is currently assessing enhancements to PCA. As part of this effort, BS&R should consider, in conjunction with the other federal banking agencies, whether PCA assessments of bank capital can be improved to (1) eliminate the disconnect that may arise between a specific bank's PCA status and examiners' subjective assessment of capital or (2) create a standard supervisory approach when such a disconnect arises. We also suggest that BS&R consider whether PCA requirements should be amended to provide examiners with the ability to restrict a bank's business activities upon concluding that the bank's capital does not support its risk profile.

2. **We suggest that the Director of BS&R define the appropriate supervisory response for highly concentrated SMBs that continue to pursue aggressive growth strategies.**

   As we mentioned above, we observed that examiners followed different approaches to addressing highly concentrated institutions that sought further growth. We encourage BS&R to resolve the following policy questions related to the supervision of highly concentrated SMBs that continue to pursue an aggressive growth strategy: (1) What is the appropriate role of the examination staff in questioning the advisability of management's aggressive growth strategy? and (2) Under what circumstances, if any, may supervisors intervene to request or require that a bank refrain from pursuing a strategy that will increase a bank's already heightened risk profile?

3. **We suggest that the Director of BS&R encourage and take appropriate steps to implement a supervisory approach that requires strong and consistent supervisory action during stable economic periods.**

   We believe that the Director of BS&R should encourage and take appropriate steps to implement a supervisory approach that addresses significant management, credit risk management, and internal control weaknesses whenever those issues arise notwithstanding a bank's financial condition and results. For example, in our First Georgia report, we referenced statements by Federal Reserve Board officials concerning the timing and forcefulness of supervisory efforts. These officials acknowledged that supervisors must have an even firmer resolve and provide clear and very forceful communication in "good times," when risks appear low, losses or write downs have not yet been recognized, and "optimism abounds" because a bank's financial results should not mitigate examiners' willingness to take strong and consistent supervisory action.

VIII. Analysis of Comments

We provided our draft report to BS&R for review and comment. In a response included as Appendix 6, BS&R's Deputy Director concurred with the general findings of the report and generally agreed with the report's recommendations and matters for consideration.

Appendixes

Appendix 1 – Detailed Analysis Results

Causes of the Failures

1. Aggressive Growth and Poor Strategic Decision-making

Below we provide excerpts from seven MLRs that illustrate poor strategic decisions in pursuit of aggressive growth: (1) Michigan Heritage Bank (Michigan Heritage), (2) BankFirst, (3) CapitalSouth, (4) Irwin Union Bank & Trust (IUBT), (5) Marco Community Bank (Marco), (6) Barnes Banking Company (Barnes), and (7) Community Bank of Nevada (CBON).

Michigan Heritage

Michigan Heritage, headquartered in Farmington Hills, Michigan, focused on equipment lease financing until 2002, when management transitioned to CRE lending, a new business activity for the bank. Michigan Heritage faced challenges transitioning from equipment lease financing to CRE lending because of significant turnover in senior lending officers and other staff. While the bank attempted to stabilize the situation by replacing key lending staff during 2003, examiners were only "guardedly optimistic" about the new lending team's ability to obtain quality loans in Michigan Heritage's competitive market environment. Within three years, the bank experienced rapid growth in its CRE lending activities and developed a CLD concentration of nearly 200 percent. Because of the subsequent deterioration of economic conditions in Southeast Michigan, the bank experienced substantial losses on these loans. In 2007, the bank attempted to improve its credit administration and credit risk management capabilities by overhauling its management team. By 2008, CLD loans accounted for 63 percent of the bank's loan charge-offs. Despite the bank's efforts to overhaul management and improve its risk management practices and internal controls, the losses associated with these loans depleted capital and ultimately caused the bank to fail in April 2009. This situation illustrates the importance of the Board of Directors and management implementing a strong internal control and risk management framework prior to engaging in a new business activity.

BankFirst

BankFirst became an SMB in 1997. At the time, the bank operated as a limited purpose credit card bank engaged in nationwide subprime lending. In 2005, a bank holding company purchased BankFirst, and new management transitioned the bank's business activities to CRE lending after selling the bank's subprime credit card receivables to a third party vendor. Within two years, management surpassed its projections for its commercial lending activities by approximately $220 million, or 110 percent. These projections were previously discussed with regulators as part of the application process associated with the strategic transition. The bank grew so quickly, in part, because of its incentive compensation program that rewarded loan officers for originations but did not contain similar incentives for loan quality. Further, BankFirst had not made an effective transition to its new commercial lending activities due to pervasive internal control weaknesses. In this failure, the pace of growth resulted in a CRE concentration that ultimately caused the failure as economic conditions deteriorated. Among other things, this closure demonstrates poor strategic decision-making since management pursued a new business

Appendix 1 – (continued)

activity without aligning the incentives in key compensation programs to the safe and sound operation of the institution or implementing the internal controls necessary to manage a new business activity.

CapitalSouth

CapitalSouth became an SMB in 1978. The bank's primary business strategy involved lending to small- and medium-sized businesses. In 2003, CapitalSouth embarked upon an expansion strategy to grow its traditional business lending activities, including CRE lending, and acquire other institutions. Between 2005 and 2007, the bank's loan portfolio more than doubled from $240 million to $644 million, in part, because CapitalSouth acquired a federal savings association (thrift) and its mortgage subsidiary in 2007. The bank's CRE and CLD concentrations and the losses associated with those loans contributed to the failure, and the thrift acquisition also contributed to the failure. As part of the application related to the acquisition, CapitalSouth's management indicated that the thrift did not engage in subprime lending activities. However, subsequent examinations contradicted management's assertion concerning the scope of the thrift's activities. The thrift, through a mortgage subsidiary, did engage in subprime lending activities, which were heavily concentrated in the state of Florida. Losses associated with the thrift's loans hastened the pace of CapitalSouth's failure. This failure demonstrates poor strategic decision-making by the Board of Directors and management, since the bank acquired another institution without fully understanding the scope of the institution's activities and the risks associated with those activities.

IUBT

IUBT was founded in 1871 and became an SMB in 1997. It conducted commercial lending activities in three states. The 2001 to 2002 time frame marked a significant period of change for IUBT as it transitioned from a community bank, to a large banking organization engaged in consumer and commercial lending activities nationwide. In 2001, Irwin Home Equity (IHE), which conducted consumer lending activities on a nationwide basis, became a nonbank subsidiary of IUBT. In 2002, IUBT added Irwin Mortgage Corporation (IMC) as a nonbank subsidiary involved in mortgage banking activities nationwide. These transitions and the resulting growth within these businesses helped IUBT to nearly triple its total assets to more than $6 billion by year-end 2005.

IHE and IMC pursued a risky "originate-to-distribute" business model that relied on the bank's ability to originate loans and sell them in the secondary mortgage market to generate the funds necessary for further lending. This strategy presumed that secondary market demand for asset sales would not disappear. In addition to this risk, IHE engaged in risky product offerings, including refinance and debt consolidation loans with a maximum combined loan-to-value ratio (CLTV) ratio of 125 percent. The subsidiary also offered this product to subprime customers. Significant concentrations developed in these high-risk product offerings, and by 2005, 56 percent of the IHE portfolio consisted of 125 percent CLTV ratio loans. When secondary market demand for the subsidiary's loans diminished, the bank held these assets in its portfolio, and the

losses associated with these products contributed to the bank's failure. This situation highlights the risks associated with relying on a risky business strategy and high risk product offerings to achieve growth.

Marco

Marco, chartered as a state nonmember bank in August 2003, became an SMB in December 2003. The bank's strategy consisted of meeting the mortgage needs of retirees and small to mid-size business lending. Between 2003 and 2005, the bank's loan portfolio grew 633 percent to $132.8 million—more than double management's planned growth of 287 percent. The bank developed CLD and home equity loan concentrations well in excess of peer institutions because of this growth. When the bank's loan portfolio growth peaked in 2005, management turned to third party loan pool purchases in pursuit of further growth. Despite the fact that the bank's purchases ultimately represented $14 million or 98 percent of the bank's capital, the Board of Directors and management did not thoroughly conduct due diligence of the loan pools and failed to comprehensively review (1) the delinquency status of the underlying loans, (2) the experience and qualifications of the borrowers, and (3) the quality of the third party's underwriting. Marco ultimately recognized more than $7 million in loan losses from the loan pools. Examiners attributed these losses to Marco's failure to identify and consider that the third party lender allowed borrowers to provide minimal cash equity and did not thoroughly assess borrowers' repayment capacity. The losses on these loan pools depleted the bank's capital and ultimately contributed to its failure. This failure demonstrates poor strategic decision-making by the Board of Directors and management, since the bank attempted to maintain its growth without fully understanding the risks associated with its loan pool purchases.

Barnes

Barnes, a community bank headquartered in Kaysville, Utah, was founded in 1891, and for the next 100 years was a single branch office bank with assets that gradually increased but stayed under $100 million. During the 1990s, Barnes began expanding its branch office network, and, by 1999, it had assets totaling over $340 million. By 2005, the bank had expanded to 10 branch offices in Utah, primarily within the Salt Lake City and Ogden metropolitan areas. In the 2000s, Barnes pursued a growth strategy focused on CRE lending—specifically residential CLD lending—and the bank's total assets increased to nearly $1.0 billion by 2008. Barnes failed because its Board of Directors and management did not effectively control the risks associated with the bank's aggressive growth strategy that led to a CRE loan concentration, particularly in CLD loans.

In 2007, examiners stated that "the greatest regulatory concern [at Barnes] is the rapid growth in the CRE portfolio during a time of pronounced economic weaknesses in this market segment." Examiners noted that Barnes' CRE concentration had reached 473 percent of capital, largely as a result of a 68 percent increase in the CLD portfolio. Examiners expressed explicit concern over the "disconnect" between Barnes' Board of Directors' vote to expand CRE lending limits, while simultaneously acknowledging that the CRE market was deteriorating. Significant growth in

classified assets in 2008 and 2009 caused the bank to experience sizeable losses, which ultimately depleted capital and caused the bank's failure. This failure highlights poor strategic decision-making as the bank's Board of Directors expanded previously established limits to allow for further lending despite signs of market downturn.

CBON

CBON, headquartered in Las Vegas, Nevada, also failed because of poor strategic decision-making based on management's optimism. From 2001 through 2008, CBON's average annual asset growth rate was approximately 27 percent, compared to its peers' average of 11 percent. Following this extended growth period, CBON's management maintained what examiners described as a "lethal sense of optimism" regarding the resilience of the local Las Vegas market. According to examiners, the bank's Board of Directors and management were confident that the bank's underwriting practices, risk management efforts, and historically low loss history would sustain its sound financial position. Accordingly, management did not increase the level of the allowance for loan and leases losses (ALLL) commensurate with increases in the bank's classified assets. This poor strategic decision-making contributed to the bank's failure. As a result of a target examination that began in October 2008, examiners determined that CBON's ALLL was insufficient due to the exponential growth of the bank's classified assets. The Federal Reserve Bank of San Francisco (FRB San Francisco) required CBON to increase its provision expense by more than 4,000 percent from $2.6 million as of year-end 2007, to $118.5 million for year-end 2008. The magnitude of this provision expense eliminated earnings, depleted the bank's capital, and contributed to the bank's failure. This failure illustrates how a previous period of sustained growth can cloud the Board of Directors' and management's perceptions.

2. Asset Concentrations in CLD Loans Correlated to Likelihood to Fail

Asset concentrations contributed to the cause for each failure we reviewed. We conducted supplemental research to better understand this common characteristic. We learned more about concentrations by comparing concentration levels and other key performance measures for the highest CAMELS rated institutions during the financial crisis to the failed banks. We also analyzed the highest CRE and CLD concentrated SMBs prior to the financial crisis. Finally, we sought to understand SMB improvement stories where specific banks with CAMELS 4 and 5 composite ratings became 3 rated institutions.

CRE or CLD Concentration Magnitude as an Indicator of Likelihood to Fail

SR Letter 07-01 indicates that CRE concentrations in excess of 300 percent of risk-based capital and CLD concentrations that exceed 100 percent of risk-based capital may warrant heightened scrutiny. Among the 426 SMBs that maintained a CAMELS 1 (strong) or 2 (satisfactory) composite rating during the financial crisis, 19.4 percent of the institutions had CRE concentrations above 300 percent while less than 10 percent of those institutions had CLD concentrations above 100 percent. For the period between 2007 and 2010, the highest CAMELS rated institutions that exceeded SR Letter 07-01's CRE and CLD concentrations guidelines did

so by 30 and 36 percent, respectively.[10] By contrast, every failed bank exceeded SR Letter 07-01's tolerances for significant CRE or CLD concentrations prior to its eventual failure, and certain institutions exceeded the thresholds by as much as 131 to 321 percent.[11] Other banks failed with much lower variance levels—specific failed institutions exceeded the guidance for CRE and CLD concentrations by only 16 percent and 54 percent, respectively. Among the failed institutions we reviewed, CRE and CLD concentration levels varied significantly. CRE concentrations ranged from 347 percent (Marco Community Bank) to 695 percent (Midwest Bank and Trust). CLD concentrations also significantly exceeded peer group averages and ranged from 154 percent (Midwest Bank and Trust) to 421 percent (Community Bank of West Georgia). In our opinion, the variance from SR Letter 07-01's threshold concentration levels for CRE and CLD and the significant CRE and CLD concentration ranges among the failed banks did not yield conclusive results concerning concentration magnitude as a reliable indicator of likelihood to fail.

Supplemental Research on CRE and CLD Concentrations

These inconclusive results prompted our office to consider whether other factors might prove to be more reliable indicators of a bank's likelihood to fail. To analyze this matter, we examined three distinct categories of SMBs, including (1) the top 25 SMBs based on CRE loans as a percentage of risk-based capital as of June 30, 2007; (2) those SMBs that maintained a CAMELS 1 or 2 composite rating between December 31, 2007, and December 31, 2010; and (3) SMBs that were considered to be in "troubled condition" because of a CAMELS composite 4 or 5 rating between June 30, 2007, and June 30, 2010, that received an upgrade to a CAMELS composite 3 rating or better.[12] To conduct this supplemental research, we compiled UBPRs, surveillance reports, and examination results data on the SMBs that met these criteria.

CLD Concentration Correlated to Likelihood to Fail

We identified the top 25 CRE loan concentrated SMBs prior to the on-set of the financial crisis as of June 30, 2007, and determined that 4 of the top 5 concentrated CRE banks had not failed, and only 7 of those 25 SMBs had failed. We interviewed BS&R officials to better understand how and why the 18 SMBs withstood the financial crisis, which confirmed our initial impression that the magnitude of a CRE concentration did not necessarily predetermine a failure. BS&R attributed multiple SMBs' resilience to low CLD loan levels.

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[10] The percentages represent a blended average of year-end data taken from the Uniform Bank Performance Reports (UBPRs) from 2007 through 2010 for each of the highest rated institutions that exceeded SR letter 07-01's guidelines for CRE and CLD concentrations.

[11] To assess these variances, we obtained CRE and CLD concentration information six quarters prior to the applicable bank's failure to minimize the impact of declining capital levels on the ratios. Our results are outlined in Appendix 3, Table 2.

[12] Section 225.71(d) of Regulation Y defines "troubled condition" for an SMB or bank holding company as an institution that (i) has a composite rating of 4 or 5; (ii) is subject to a cease-and-desist order or a formal written agreement that requires action to improve the institution's financial condition, unless otherwise informed in writing by the Federal Reserve; or (iii) is informed in writing by the Federal Reserve that it is in a troubled condition.

Appendix 1 – (continued)

We conducted further research on SMBs highly concentrated in CLD loans by identifying the top 25 CLD loan-concentrated banks prior to the financial crisis. Those institutions experienced a higher failure rate than the top 25 CRE concentrated SMBs—58 percent versus 32 percent.[13] Further, every top 25 CRE concentrated SMB that eventually failed also appeared on the list of top 25 CLD concentrated institutions. In our estimation, these results demonstrated a correlation between high CLD concentrations and SMB failures.[14]

We also attempted to identify other differentiating characteristics between SMBs that maintained a CAMELS composite 1 or 2 rating from December 31, 2007, to December 31, 2010, and those that failed. To conduct this supplemental research, we analyzed the following key indicators: (1) average CRE and CLD loan concentrations, (2) capital strength via the tier 1 leverage ratio, and (3) net non-core funding dependence ratio. We observed that 1 and 2 rated banks had an average CRE loan concentration ranging from 175 to 189 percent and a CLD loan concentration averaging between 31 to 44 percent. As mentioned above, these averages are well beneath the CRE and CLD thresholds established in SR Letter 07-01 and the concentration averages of the failed SMBs. Low concentration levels for these 1 and 2 rated SMBs likely reduced their vulnerability to market downturns during the recent financial crisis.

We assessed the CAMELS 1 and 2 rated banks' capital strength by focusing on their tier 1 leverage ratios.[15] The 1 and 2 rated banks' tier 1 leverage ratios averaged between 10.6 to 11.1 percent during the financial crisis, which is more than double the *well capitalized* minimum of 5.0 percent. We also compared the highest rated banks' net non-core funding dependence ratio to the failed banks. The average net non-core funding dependence ratios for the sample of 1 or 2 rated SMBs ranged from -4.3 to 8.5 percent, which is significantly lower than the 32.6 to 39.5 percent dependence levels for the failed SMBs.[16] Over-reliance on non-core funding sources can be a risky strategy since that funding may not be available in times of financial stress or adverse changes in market conditions.

Finally, we identified 18 improvement stories involving CAMELS composite 4 or 5 rated institutions that received upgrades to a 3 or better during the financial crisis. We sought to understand how these institutions improved their overall condition during turbulent economic conditions by discussing each institution with BS&R. Our discussions revealed that (1) specific institutions received capital infusions, which improved the respective bank's overall condition,

[13] Six of the 14 SMBs that were highly concentrated in CLD loans that did not fail were either merged or acquired. Three of the 18 highly concentrated CRE state member banks that did not fail were either merged or acquired. We deducted merged or acquired banks from the respective list before calculating the failure rate based on the remaining institutions. Accordingly, 11 out of 19 is the failure rate for CLD and 7 out of 22 is the failure rate for CRE.

[14] We sought to further support this point by analyzing the top 50 CRE and the top 50 CLD loan concentrated institutions prior to the on-set of the financial crisis. There were five CRE and seven CLD additional failures identified among this broader population. These additional failures support our conclusion concerning the importance of CLD concentrations because the five CRE failures also appeared on the top 50 CLD list.

[15] The tier 1 leverage ratio measures tier 1 capital in comparison to average total assets.

[16] In this case, the negative net non-core funding ratio is a result of short-term investments exceeding non-core funding sources.

and (2) the Board of Directors' and management's receptiveness to change, including facilitating third party investments, was important.

In summary, we found a 58 percent failure rate among the top 25 CLD concentrated banks as of June 30, 2007, and determined that some of the highest CRE concentrated institutions remained resilient during the crisis, in part, because of their low CLD levels. In addition, we determined that every top 25 CRE concentrated SMB that eventually failed also appeared on the top 25 CLD concentrated SMBs. These facts led us to conclude that a high CLD concentration level proved to be a more reliable indicator of a potential failure during the recent financial crisis than a high CRE concentration. Further, our analysis of the CAMELS 1 and 2 rated banks also revealed some key differentiating characteristics between those institutions and the failed banks—lower CRE and CLD concentration levels, strong capital positions, and minimal dependence on non-core funding.

3. Reliance on Certain Specific Funding Sources

As outlined in the summary Table 1 in Appendix 3, 10 failures involved banks relying on non-core funding or another primary funding source as a contributing cause. Eight of the 10 banks relied on non-core funding sources to foster growth. Two banks relied on access to the secondary mortgage market to sell loans to transfer risk and generate the funds necessary to support additional lending activities. The three failures described below demonstrate the risks associated with reliance on specific funding sources.

Midwest Bank & Trust

In 1959, Midwest Bank and Trust Company was established as a state chartered bank in Elmwood Park, Illinois, to provide community and commercial banking services to individuals and businesses in the western suburbs of Chicago. In July 1995, Midwest became an SMB supervised by the Federal Reserve Bank of Chicago. Midwest grew to become a large community bank that focused on CRE lending in the Chicago metropolitan area. In 2004 and 2005, the bank overhauled its management, and the new management team pursued an aggressive growth strategy while attempting to resolve some of the bank's traditional weaknesses. One of these traditional weaknesses involved a lack of diversity among the bank's funding sources. New management sought to address this weakness by raising core deposits, but struggled to do so because of the competitive Chicago market for deposit customers. As a result of this challenge, new management increasingly relied on non-core funding to pursue its growth objectives. Midwest's non-core funding dependence ratio increased significantly between 2005 and 2007 and remained well in excess of its peers from 2005 through 2008. This dependence on non-core funding contributed to a consistent decline in the bank's net interest margin, which forced bank management to ultimately rely on holding company capital support to sustain operations. When the holding company could no longer provide capital support, the bank failed because of the mounting losses in its CRE and CLD loan portfolios.

IUBT

As discussed on page 18, IUBT relied on an "originate-to-distribute" strategy for the consumer lending activities conducted in its nonbank subsidiaries. This strategy involved originating home mortgages and home equity loans to be sold in the secondary market. Lenders pursue this originate-to-distribute strategy to (1) package and sell their loans to avoid the interest rate risk associated with holding loans to maturity, and (2) generate the funding necessary to support additional mortgage origination activities. In terms of liquidity, the business model and strategy provides an opportunity for self-sufficiency, presuming uninterrupted secondary market demand for mortgage loans. If the secondary market demand for the loans evaporates, the funding necessary to generate additional loans is eliminated and the bank must hold the loans in its portfolio. During the financial crisis, secondary market demand evaporated, and IUBT experienced substantial asset quality deterioration on the loans in its portfolio, which ultimately contributed to IUBT's failure.

SolutionsBank (Solutions)

Solutions, headquartered in Overland Park, Kansas, began operations in 1881 as a national bank focused on agricultural lending in south-central Kansas. In February 2002, the bank became a state chartered member bank. In 2004, Solutions expanded the scope of its business activities to include commercial lending to businesses in the Kansas City metropolitan area and regional real estate developers. Solutions failed because its Board of Directors and management did not control the risks associated with an aggressive growth strategy funded by non-core deposit sources. The bank's net non-core funding dependence ratio consistently exceeded its peer group average. Solutions funded its loan growth primarily with high-rate certificates of deposit (CDs) over $100,000, supplemented by Federal Home Loan Bank borrowings and brokered deposits. Reliance on non-core funding from the CDs and brokered deposits is considered a risky strategy that can have a significant negative effect on liquidity, since the associated customers may have no other relationship with the institution and merely seek the highest yielding investment.

The bank's growth strategy resulted in a significant loan concentration in CRE, including CLD, that made the bank particularly vulnerable to real estate market deterioration. When economic conditions declined, the bank experienced significant losses, which depleted capital. Solutions' declining PCA designation resulted in brokered deposit restrictions and limitations on the interest rates it could pay to depositors. These restrictions tightened the bank's liquidity. Following a PCA directive requiring the bank to raise capital, Solutions experienced significant net deposit withdrawals, which further tightened the bank's already strained liquidity and ultimately contributed to the failure.

4. Ineffective Internal Controls and Poor Risk Management

Risk management and internal control deficiencies proved to be a common characteristic among many of the failed SMBs. Common weaknesses observed involved loan underwriting, credit

administration, or loan review. At certain failed banks, pervasive control deficiencies foreshadowed the institutions' problems. We provide three illustrative examples below.

Elmwood

The Bank of Elmwood, a community bank headquartered in Racine, Wisconsin, commenced operations as a Wisconsin state chartered nonmember bank in December 1960, with a focus on serving the needs of middle-income to low-income households. In August 1986, Elmwood became an SMB. Elmwood failed because its Board of Directors and management pursued a risky loan growth strategy that featured new loan products and out-of-market lending without developing adequate credit risk management controls. In 2004, Elmwood's Board of Directors and management implemented a new loan growth strategy to improve marginal earnings. The new loan strategy focused on originating and holding one- to four-family residential loans and purchasing out-of-market CRE loan participations. During the 2004 to 2007 period, Elmwood opened three loan production offices—two in Wisconsin cities outside of the bank's market area, and one in Scottsdale, Arizona. In addition, Elmwood developed several loan programs to attract investors within its local market area interested in purchasing or building non-owner occupied properties with little or no down payment.

Examiners noted "a lax credit culture at the bank" that ultimately contributed to the bank's failure. Supervisors observed weaknesses related to exceptions to the bank's underwriting standards during the loan origination process. In addition, an ineffective loan monitoring system compounded the bank's credit risk management deficiencies. The bank was unable to evaluate the continued creditworthiness of commercial borrowers because current financial information often was lacking. Further, Elmwood did not maintain documentation supporting the sufficiency of the bank's collateral and failed to adequately monitor its CRE participation loans. These deficiencies ultimately resulted in low quality loans and substantial loan losses, which contributed to the bank's failure.

BankFirst

As discussed above, BankFirst transitioned from limited purpose credit card lending to commercial lending activities after being acquired in 2005. 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 18-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.

In terms of corporate governance, 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, rather than the bank President. In addition, examiners noted extensive sharing

of employees between BankFirst and a nonbank affiliate, which made it difficult to determine which entity performed which functions.

In addition to organizational design weaknesses, BankFirst's credit administration program contained significant and pervasive control deficiencies. 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 the bank's 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. These weaknesses and deficiencies fostered an uncontrolled operating environment that helped to facilitate the unfettered loan portfolio growth that ultimately caused the bank to fail.

IUBT

At IUBT, examiners determined in 2002 that risk management weaknesses and other internal control deficiencies warranted transition to a continuous supervision process. The continuous supervision program revealed various key weaknesses in the bank's internal control and corporate control functions, including (1) the Board of Directors' and management's inability to resolve previously noted control weaknesses; (2) key strategic changes that had occurred without proper evidence of analysis by management or communication to the Board of Directors; (3) the internal audit program not having kept pace with the size and complexity of the consolidated organization and internal audit's tendency to rely on management's assertions without conducting testing; and (4) systemic and recurring violations of consumer lending laws at key consumer lending subsidiaries.[17] The pervasive nature of these weaknesses, in part, revealed the Board of Directors' and management's difficulties identifying, monitoring, and managing the risks associated with operating a large, geographically dispersed banking organization engaged in multiple businesses. These weaknesses served as early warning signs concerning the bank's ability to effectively manage its risk.

5. Compensation Incentives May Encourage Inappropriate Risk Taking

Three failures appeared to demonstrate that compensation incentives may influence management's decision-making and employee risk-taking activities. The other 17 failures did not address compensation in the examination reports; therefore, this potential correlation could not be assessed.

[17] IUBT's complex banking organization included two consumer finance subsidiaries and a commercial finance subsidiary that housed three additional subsidiaries. Each of these subsidiaries had its own Board of Directors and management.

Appendix 1 – (continued)

Orion Bank

Orion was a community bank with $2.7 billion in total assets. The bank had a dominant CEO, who may have pursued an aggressive growth strategy, in part, because the bank's earnings growth rate affected the size of the CEO's annual bonus. This provided an "incentive to delay recognition of problem credits [loans] and associated provisions." During the CEO's tenure, Orion experienced significant growth. Total CRE loans more than doubled from $722.3 million in 2004, to $1.49 billion in 2006, with CLD loans increasing from $481 million to $1 billion during the same period. In our opinion, this significant growth appeared to establish a possible correlation between the bank's strategy and the CEO's incentive compensation. Prior to the failure, FRB Atlanta issued a PCA Order to remove the CEO. He was also indicted on a series of criminal charges related to a conspiracy to engage in a series of fraudulent transactions to augment the bank's declining capital.

Elmwood and BankFirst

In two other failures, Elmwood and BankFirst, compensation programs appeared to influence behavior at the loan officer level. In both failures, loan officer compensation programs contained incentives for generating new loans, but lacked any incentives to ensure the quality of the loans. In Elmwood, the bank experienced significant growth in its commercial lending and one- to four-family residential loan businesses, in part, because of these incentives. 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 loan portfolio increased 1,179 percent from $36.6 million as of March 31, 2005, to $431.8 million by year-end 2006. The loan portfolio growth included numerous borrowers who eventually proved to be less than creditworthy. Both of these institutions experienced substantial loan portfolio growth, in part, because of inappropriate incentives that emphasized loan origination activity more than prudent underwriting.

Supervisory Observations

1. Stronger Supervisory Action Sooner

In a January 2011 report issued by the Financial Crisis Inquiry Commission, Richard Spillenkothen, former Director of BS&R from 1991-2006, discussed the division's approach to supervisory action during his tenure. The report quoted former Director Spillenkothen as stating that "supervisors understood that forceful and proactive supervision, especially early intervention before management weaknesses were reflected in poor financial performance might be viewed as i) overly-intrusive, burdensome, and heavy handed, ii) an undesirable constraint on credit availability, or iii) inconsistent with the Fed's public posture."[18] Each of our reports identified

[18] According to the report, the quote originated from a memorandum submitted to the Financial Crisis Inquiry Commission.

the need for stronger supervisory action to occur sooner. We provide four illustrative examples of situations where earlier and stronger supervisory action was necessary.

Barnes

Supervisors had multiple opportunities to take forceful supervisory action prior to Barnes' failure in January 2010. The bank continued to originate CLD loans in 2007 and 2008, despite apparent weaknesses in Utah's real estate market and economy. The Board of Directors' and management's failure to effectively manage the resulting credit risk, in conjunction with declining market conditions, led to rapid asset quality deterioration.

Circumstances noted during a 2007 full scope examination, including repeated regulatory criticisms, declining market trends, and continuing growth of Barnes' CLD loan portfolio, provided FRB San Francisco with an opportunity to pursue earlier, more forceful supervisory action. This examination resulted in a CAMELS component rating downgrade for sensitivity only, even though the examination report criticized Barnes' credit risk management, CRE concentrations monitoring, ALLL methodology, and other critically important control processes. Additionally, examiners expressed concern over Barnes' aggressive growth in CRE lending despite evidence of "pronounced economic weaknesses" within that market segment. Examiners cautioned that "continued inaction" by the bank to resolve prior recommendations reflected poorly on the quality of the Board of Directors' oversight and might result in additional supervisory oversight or action. Our report concluded that these findings warranted stronger supervisory action such as downgrading CAMELS ratings or executing an informal enforcement action.

A June 2008 credit risk target examination also provided an opportunity for FRB San Francisco to pursue earlier, more forceful supervisory action. The target examination provided strong evidence that Barnes' risk profile and financial condition had significantly changed. Additionally, examiners noted repeat criticisms regarding Barnes' credit risk management. While FRB San Francisco subsequently performed a separate ratings assessment and downgraded several CAMELS ratings, the target examination did not result in an enforcement action. Following a subsequent full scope examination, examiners executed a Written Agreement with the bank in May 2009 because of an "excessive number of repeat criticisms" as well as unsafe and unsound banking practices. The bank failed in January 2010.

IUBT

Prior to IUBT's failure, FRB Chicago took two informal supervisory actions—in the form of Board of Directors' resolutions—against the bank based on the results of an examination conducted in 2001. The first resolution (Resolution 1) required the bank to maintain a total risk-based capital ratio of 12 percent, which exceeds the minimum requirement for *well capitalized* banks. The second resolution (Resolution 2) required a series of control enhancements concerning liquidity risk management, market risk management, model validation, compliance with affiliate transaction restrictions, and corporate governance. Because of the weaknesses

Appendix 1 – (continued)

observed during this examination, FRB Chicago transitioned the bank to an informal continuous supervision program in 2002, which was formalized in 2003.

Examinations in 2002 revealed extensive weaknesses in two of the bank's key corporate control functions—internal audit and compliance. The bank's internal audit program had not kept pace with the size and complexity of the consolidated organization. Examiners raised specific concerns about internal audit's reliance on management's assertions without conducting testing. IUBT's Compliance Function also contained serious deficiencies. An August 2002 compliance and Community Reinvestment Act examination of IUBT and a subsidiary revealed "systemic" violations of various consumer banking laws applicable to mortgage lending. Because of these weaknesses, examiners encouraged the Board of Directors to adopt a third resolution (Resolution 3) consisting of the risk management requirements outlined in Resolution 2 and required enhancements to the bank's internal audit and compliance programs.

Between 2004 and 2005, IUBT had not fully resolved Resolutions 1 and 3. In a 2005 full scope examination, FRB Chicago noted that 7 required actions and 53 expected actions remained open on IUBT's issues tracking log. Examiners encouraged management to assure that resolving these issues became its highest priority. In June 2005, IUBT's Board of Directors adopted an amended resolution (Resolution 4) that included a model risk validation requirement and several items related to consumer compliance program enhancements.

A 2006 full scope examination downgraded the CAMELS component rating for management from a 2 to a 3. During this examination, FRB Chicago once again identified the need for IUBT to strengthen risk management practices. Examiners noted that "the board and management must establish a proactive risk management process that self identifies weaknesses, rather than one that responds to regulatory scrutiny." FRB Chicago emphasized that a supervisory action would be implemented if the governance and risk management issues noted during the examination were not "on the path to resolution by year-end."

In terms of management's progress towards resolving previously identified weaknesses, examiners acknowledged management's efforts but noted that 8 required actions and 51 expected actions remained open. FRB Chicago indicated that this volume of internal control weaknesses was "high relative to other financial institutions" supervised by FRB Chicago.

In 2007, a full scope examination revealed the Board of Directors' failure to create an acceptable compliance program that met the required actions in Resolution 4. As a result, FRB Chicago placed IUBT under a Memorandum of Understanding (MOU) exclusively related to the consumer compliance program.

Examiners noted that the Board of Directors and management had made some progress in resolving the number of previously noted required and expected actions. In terms of the issues that had been open since May 2006, 4 required actions and 29 expected actions had been resolved. However, FRB Chicago noted 23 new issues during the examination, including 1 required action and 22 expected actions. In sum, there were 5 unresolved required actions and

Appendix 1 – (continued)

44 unresolved expected actions. Resolution 4 remained in place because of management's failure to fully resolve a supervisory issue related to market risk management.

In February 2008, FRB Chicago downgraded IUBT's CAMELS composite rating from a 3 to a 4, and every component rating received a downgrade or double downgrade. FRB Chicago noted that the declining economic environment had clearly affected the organization's condition, but that the "strategic choices and the lack of risk mitigation actions to manage the institution through this difficult environment have led to serious safety and soundness concerns." Examiners informed management that a supervisory action would be forthcoming.

The February 2008 examination attributed the bank's condition to the Board of Directors' and management's ineffectiveness. Examiners noted that the Board of Directors and management had established and promoted inherently risky business models and strategies that laid the foundations for the bank's current problems. FRB Chicago also noted management's failure to proactively implement sound risk management practices that could prevent issues from becoming regulatory concerns. Examiners observed many examples of management reacting to, rather than anticipating and resolving, risk. This reactive management approach led FRB Chicago to conclude that "poor Board [of Directors] and senior management oversight has led to the institution's current overall weak condition."

On July 26, 2008, FRB Chicago and the Indiana Department of Financial Institutions entered into an MOU with IUBT. The MOU obligated IUBT to (1) submit a plan to strengthen the Board of Directors' oversight; (2) conduct a management assessment for all senior bank management, including all executive officers, to assess qualifications and prior performance; (3) submit a liquidity/funds management plan; (4) submit a capital plan; (5) enhance the ALLL methodology; and (6) submit a three-year strategic plan. Each of these required actions had a defined time period for completion.

As a result of a 2008 asset quality target examination, FRB Chicago entered into a Written Agreement with IUBT containing provisions similar to the MOU, but with adjusted timelines. Following an asset quality visitation in August 2009, FRB Chicago placed the bank under a Cease-and-Desist Order (C&D Order) for, among other things, failure to comply with Resolution 1's capital maintenance requirements on September 15, 2009. The bank failed three days later.

IUBT's failure demonstrates the importance of taking strong supervisory action to address corporate governance, risk management, and internal control weaknesses, even in the absence of declines in financial performance. When the Board of Director resolutions did not prompt management to completely resolve the noted weakness as observed over a period of years, FRB Chicago should have escalated the enforcement action to include defined time periods to implement required actions. FRB Chicago eventually implemented an MOU with defined time periods for action items in 2008 and escalated that informal enforcement action to formal enforcement actions in 2008 and 2009 in the forms of a Written Agreement and C&D Order. The timing of these aggressive supervisory actions proved to be too late as the bank did not succeed in implementing the comprehensive changes contemplated by the Written Agreement.

Appendix 1 – (continued)

This failure highlights the need for timely and escalating supervisory actions when informal enforcement actions do not prompt the Board of Directors and management to resolve the identified weaknesses over an extended time period.

Michigan Heritage

The Michigan Heritage failure represents another example in which examiners expressed reservations about the bank's strategy but did not take decisive supervisory action to address an escalating risk profile. The bank failed because its Board of Directors and management did not adequately control the risk associated with a high concentration in the CLD loan component of the bank's CRE portfolio. Michigan Heritage developed a CLD concentration after changing its lending strategy from equipment lease financing to CRE and commercial and industrial loans. The decline in southeast Michigan's economy affected the bank's local real estate market, and the CLD loan portfolio experienced significant losses.

Michigan Heritage faced challenges transitioning from equipment lease financing to CRE lending because of significant turnover in senior lending officers and other staff. While the bank attempted to stabilize the situation by replacing key lending staff during 2003, examiners were only "guardedly optimistic" about the new lending team's ability to obtain quality loans in Michigan Heritage's competitive market environment. This "guarded optimism" regarding the bank's strategic transition should have resulted in quick and decisive supervisory action following any initial signs of potential issues.

FRB Chicago's October 2007 examination noted a significant decline in the bank's asset quality because of increasing lay-offs in the auto industry and a declining local housing market. The examination downgraded Michigan Heritage's CAMELS composite rating to 3. According to examiners, the bank's loan portfolio experienced significant deterioration as classified assets increased from $2.7 million to $12.5 million in a 12-month period. Examiners noted that future prospects for improving Michigan Heritage's financial condition and performance were "mixed" because of the Michigan economy and the bank's location in the northern suburbs of Detroit. Employment losses and the fear of further losses were cited as factors in economic stagnation, particularly in the local real estate market. In addition, examiners commented that protracted weaknesses in the real estate markets could have a significant impact on potential portfolio losses.

Nevertheless, FRB Chicago noted that the new management team hired in 2007 was comprised of experienced risk managers who were (1) responsive to regulatory concerns, (2) working aggressively to improve credit problems, and (3) implementing day-to-day changes in risk analysis and control that would immediately benefit the bank. Accordingly, examiners decided to give the new management team an opportunity to implement its program for improving the bank's condition. FRB Chicago planned an asset quality target examination to begin six months after the October 2007 examination report was issued, and examiners noted that they would revisit the possibility of issuing an enforcement action based on the target examination results.

Appendix 1 – (continued)

The asset quality target examination that began in June 2008 resulted in a double downgrade of the bank's CAMELS composite rating from 3, assigned five months earlier, to 5. The examination report issued in October 2008 highlighted further declines in asset quality and attributed the bank's problems to the stagnant local economy and distressed real estate market. FRB Chicago acknowledged that Michigan Heritage's condition continued to worsen even though the new management team had implemented numerous corrective actions. Based on the results of this examination, a formal enforcement action in the form of a Written Agreement was executed on December 16, 2008. The bank failed five months later.

We believe that the circumstances FRB Chicago observed during the late 2007 to early 2008 time period provided an opportunity for a more forceful supervisory response.

CapitalSouth

CapitalSouth failed because its Board of Directors and management did not implement a credit risk management infrastructure commensurate with its aggressive expansion strategy and high concentration of CRE loans, including CLD loans. The bank pursued an aggressive expansion strategy even though its modest earnings and capital position did not provide the buffer necessary to withstand significant asset quality deterioration. The bank had a history of modest earnings due to high funding costs. High overhead costs associated with CapitalSouth expanding its branch network further strained the bank's modest earnings. A 2005 examination report highlighted the bank's key risk—little margin for error and inability to withstand any significant level of problem loans because of its modest earnings and growth strategy. After examiners released the bank from an informal improvement plan in 2007 that was designed to address the bank's earnings weaknesses, capital planning, and credit risk management, supervisors reiterated the bank's limited margin for error in absorbing problem loans and loan losses. CapitalSouth experienced significant asset quality deterioration in 2008, and a 2008 full scope examination resulted in a C&D Order requiring enhanced Board of Directors and management oversight, credit risk management practices, lending and credit administration policies, and loan review policies. Following the order, the bank experienced further significant asset quality deterioration, and the bank failed.

In this situation, examiners noted the bank's key risk on multiple occasions but did not take decisive supervisory action until it was too late. We believe that FRB Atlanta should have stressed to CapitalSouth the need for solid earnings performance before the bank pursued its risky growth strategy. In our opinion, examiners should have suggested that CapitalSouth postpone its growth objectives until it enhanced its modest earnings and credit risk management practices.

2. Different Approaches to Supervising Banks Pursuing Aggressive Growth

We noted five failures that exemplify different supervisory approaches for banks that pursued aggressive growth strategies—three situations where examiners questioned the advisability of management's strategy and two failures without similar intervention. While neither supervisory

approach proved particularly effective for any of the banks involved, the differing approaches raise the issue of the appropriate role for supervisors when presented with similar circumstances in the future. Specifically, we believe that BS&R should consider the following: (1) What is the appropriate role of the examination staff in questioning the advisability of management's business strategy? (2) Under what circumstances, if any, is it appropriate for supervisors to intervene to request or direct a bank to refrain from pursuing a particular strategy?

BankFirst

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. BankFirst's year-end loan portfolio significantly exceeded annual projections in 2005 and 2006. 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. During a 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. Despite this, the bank still failed because of its CRE concentration, credit risk management weaknesses, and pervasive internal control deficiencies.

Elmwood

Elmwood failed because its Board of Directors and management pursued a risky loan growth strategy that featured new loan products and out-of-market lending without developing adequate credit risk management controls. The bank pursued this strategy even though its modest earnings and capital position did not provide adequate support to withstand possible asset quality deterioration.

When Elmwood initiated a loan growth strategy in 2004 to counter the bank's historically marginal earnings performance, examiners noted that the bank should control further loan growth until it demonstrated that it could produce "sufficient retention of earnings to provide the bank with adequate internal capital generation." Despite the request and the bank's failure to resolve its earnings weaknesses, FRB Chicago observed in 2005 that the bank increased its loan portfolio by about 30 percent over the previous two years by expanding into new geographical markets and purchasing CRE loan participations to enhance income.

Barnes

The Barnes failure provides another example where examiners questioned the advisability of additional loan portfolio growth. The bank continued to originate CLD loans in 2007 and 2008, despite apparent weaknesses in Utah's real estate market and economy. Examiners stated that

"the greatest regulatory concern [at Barnes] is the rapid growth in the CRE portfolio during a time of pronounced economic weaknesses in this market segment." Examiners noted that Barnes' CRE concentration had reached 473 percent of capital, largely as a result of a 68 percent increase in the CLD portfolio. Examiners expressed explicit concern over the "disconnect" between Barnes' Board of Directors' vote to expand CRE lending limits, while simultaneously acknowledging that the CRE market was deteriorating. Examiners also urged management to re-evaluate, fully document, obtain Board of Directors approval, and improve segmenting of CRE concentration limits and sub-limits, which we believe was an attempt to have the bank reconsider its growth strategy.

CBON

CBON provides an example where supervisors did not intervene to question the bank's strategy to continue lending despite initial signs of a local real estate market decline. A precipitous and unprecedented deterioration of economic conditions within Las Vegas affected the local real estate market, and the bank's CLD portfolio experienced significant losses. Bank management was optimistic that conditions would improve and, therefore, failed to identify and quantify the magnitude of risk within its heavily concentrated portfolio.

In this failure, the bank pursued a strategy that involved concentrating the bank's loan portfolio in CRE and CLD. CBON's CRE loan concentration grew to 699 percent of total capital by 2001, and it subsequently remained close to 600 percent through June 2008. In 2002, the Board of Directors authorized a CRE loan limit of 900 percent of capital, pursuant to the bank's aggressive growth strategy, and by September of that year, CBON's concentration ranked third highest among SMBs under FRB San Francisco's supervision. Despite a subsequent decrease of the CRE loan limit to 700 percent, management committed to its strategy of developing a highly concentrated CRE loan portfolio. Within its CRE loan portfolio, CBON's concentration of CLD loans rose from 270 percent of total capital in 2001, to approximately 400 percent by year-end 2006, where it remained through June 30, 2008. Despite the magnitude of these concentrations, examiners did not question the advisability of the bank's strategy in the years preceding the failure.

Neighborhood Community Bank (Neighborhood)

Neighborhood Community Bank (Neighborhood)—a community bank in Newnan, Georgia—opened on April 20, 2000, as a state nonmember bank serving metropolitan Atlanta. Neighborhood became an SMB on April 13, 2001. Neighborhood failed because its Board of Directors and management did not properly manage the risks associated with the bank's concentration in CLD loans tied to the residential real estate market. Neighborhood expanded its CLD loan portfolio when the areas served by the bank experienced rapid growth. A declining residential real estate market—coupled with management's failure to recognize and act upon weakening market conditions—led to deteriorating asset quality and significant losses, particularly in the CLD loan portfolio.

Appendix 1 – (continued)

The bank's CLD loans almost doubled from $41.6 million in 2004 to $82.3 million by 2007. Neighborhood's CLD loan concentration reached 389 percent of total capital by 2006 and subsequently remained well above 300 percent. This concentration was triple the bank's peer group averages for CLD concentrations between 2004 and 2008. Examiners did not question the advisability of this growth strategy even though concentrations of credit increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans.

3. Board of Directors and Management Accountability for Managing the Risks Associated with New Activities and Implementing Required Corrective Actions

Many of the supervisory histories associated with the failures that we reviewed illustrate the need to reinforce key supervisory fundamentals. The examples outlined below demonstrate the importance of examination teams (1) assuring that the Board of Directors and management appropriately mitigate the risks associated with strategic transitions or new business activities, (2) using escalating supervisory actions when appropriate, and (3) assuring that Boards of Directors and management timely implement required corrective actions. In addition, supervisors should ensure CAMELS composite and component ratings are consistent with narrative examination comments to clearly convey the need for urgent action when appropriate.

BankFirst – Supervision of Strategic Changes and New Business Activities Consistent with the CBEM

In this failure, 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 contained in the CBEM 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.

Elmwood – Supervision of New Products and Business Activities Consistent with the CBEM

Elmwood failed because its Board of Directors and management pursued a risky growth strategy that featured new loan products and out-of-market lending without developing adequate credit risk management controls. The bank's credit risk management weaknesses noted by examiners in 2006 and 2007 provided early warning signs regarding (1) the potential for asset quality deterioration in Elmwood's growing loan portfolio, and (2) management's ability to control the bank's increasing credit risk profile. The examination reports issued during this period highlighted credit administration deficiencies, such as inadequate monitoring of out-of-market CRE participation loans, incomplete financial data on borrowers and projects, and weak loan underwriting standards. Examiners warned that credit administration deficiencies could make it difficult for management to detect and promptly correct credit problems. Additionally, the 2007

examination report noted a significant increase in classified assets and a corresponding rise in past due and non-accrual loans, yet the bank received an asset quality component 2 rating. In our opinion, the weaknesses cited by examiners warranted an appropriate supervisory response in 2007 compelling bank management to immediately correct the identified deficiencies. In this failure, the Board of Directors and management had not established the control infrastructure necessary to support new products and activities in new markets, yet examiners did not hold management accountable for these deficiencies.

IUBT – Escalating Supervisory Actions

Over the course of a five-year period, supervisors implemented four informal enforcement actions in the form of Board of Directors' resolutions related to the bank's key corporate control weaknesses, pervasive internal control deficiencies, and risk management weaknesses. Despite mounting evidence of the bank's inability to resolve these issues, supervisors did not take escalating supervisory action against the bank related to its key weaknesses until two years after the issuance of the last Board of Directors Resolution. In our opinion, the continued ineffectiveness of the Board of Directors Resolutions and the findings from subsequent full scope examinations warranted CAMELS rating downgrades and escalating enforcement actions specifying time frames for required actions. In 2006, examiners' observation that the bank's internal control weaknesses exceeded weaknesses at other institutions supervised by FRB Chicago warranted a more forceful supervisory response, especially given the bank's escalating risk profile.

Barnes – Assuring that the Board of Directors and Management Timely Implement Corrective Actions

Circumstances noted during a 2007 full scope examination—including repeated regulatory criticisms, declining market trends, and continuing growth of Barnes' CLD loan portfolio—provided FRB San Francisco an opportunity to pursue earlier, more forceful supervisory action. The examination cited several deficiencies regarding credit risk management, CRE concentrations monitoring, the ALLL methodology, and other critically important control processes. Specifically, examiners reiterated criticisms regarding the bank's loan grading, stress testing, strategic planning, and ALLL methodology processes. The examination report also cited concerns regarding repeat external audit findings, including a deficiency in segregating duties within the credit function that allowed loan officers to review, approve, and fund loans. Additionally, examiners expressed concern over (1) Barnes' aggressive growth in CRE lending despite evidence of pronounced economic weaknesses within that market segment, and (2) "continued inaction" by the bank to resolve prior recommendations. We believe that other supervisory actions were warranted at the conclusion of the 2007 examination, such as downgrading CAMELS ratings or executing an informal enforcement action.

A June 2008 credit risk target examination provided another opportunity to pursue earlier, more forceful supervisory action. The target examination provided strong evidence that Barnes' risk profile and financial condition had significantly changed, and examiners once again repeated

prior criticisms. While FRB San Francisco subsequently performed a separate ratings assessment and downgraded several CAMELS ratings, an enforcement action was not executed until May 2009, nearly one year after the target examination was initiated. This failure highlights the need for escalating responses to the Board of Directors and management's failure to resolve previously noted examination issues in a timely manner.

Midwest – CAMELS Ratings Consistent with Examination Comments

The Midwest failure demonstrates the importance of CAMELS composite and component ratings being consistent with the narrative examination comments. In our opinion, the risks associated with specific examination findings appeared to warrant rating downgrades.

Our report on the Midwest failure noted that FRB Chicago did not hold management accountable for failing to diversify the bank's loan portfolio and funding sources between 2005 and 2007. During this time, management succeeded in achieving double-digit growth, but failed to address the weaknesses that ultimately contributed to the bank's failure, including CRE and CLD concentrations and reliance on non-core funding and holding company capital support. We believe that a 2007 full scope examination presented the opportunity to downgrade the bank's asset quality and liquidity ratings. We believe the bank's asset quality rating did not reflect the risks associated with the bank's increase in classified assets and other problem loans. Further the bank's liquidity rating did not reflect an increasing dependence on non-core funding and a sharp decline in the bank's primary liquidity ratio.

Further, in our opinion, a 2008 full scope examination presented another opportunity for stronger supervisory action. Specifically, the severity of the findings noted during this examination warranted additional CAMELS component rating downgrades and a CAMELS composite downgrade. This examination acknowledged management's failure to diversify the bank's loan portfolio and funding sources—two key strategic objectives of the new management team—but did not downgrade the bank's management component rating. Also, we believe that Midwest's 2 liquidity component rating did not reflect the gravity of the persistent challenges facing the institution. If these additional component rating downgrades had occurred, four of the six CAMELS components would have received 3 ratings, which would have led to a CAMELS composite rating downgrade to a 3 (fair).

4. Limitations of PCA Assessments

The following failures reveal the limitations of PCA quantitative assessments of a bank's capital position. A quantitative assessment alone does not permit the subjectivity necessary to assess whether the bank's capital suffices to support the bank's risk profile. In this respect, the PCA designations may directly contradict an examination team's actual assessment of the bank's capital position and thereby send mixed messages to the Board of Directors and management. We observed three failures where this scenario occurred.

Appendix 1 – (continued)

CBON

From 2001 through 2008, CBON's CRE loan concentration remained approximately double the 300 percent threshold established in SR letter 07-01.[19] In addition, the bank's CLD concentration nearly tripled the 100 percent threshold established in the SR letter, and between 2006 and 2008 it quadrupled the recommended amount. The 4,000 percent increase in the bank's provision expense between 2007 and 2008 eliminated the bank's earnings and depleted the bank's capital position. During the October 2008 examination, FRB San Francisco noted that the bank's current capital level was insufficient for its risks. CBON was *well capitalized* during that examination. Following the provision expense and additional asset quality deterioration, the bank eventually dropped beneath PCA's *well capitalized* designation in May 2009, and the bank failed three months later after becoming *critically undercapitalized* in August 2009. This failure reveals a limitation in PCA's quantitative assessments of a bank's capital position.

Marco

Marco grew more quickly than management anticipated in its business plan and relied on capital injections from the holding company to sustain operations. The growth resulted in Marco developing high concentrations in (1) the CLD component of the bank's CRE loan portfolio, and (2) home equity lines of credit. Also, in 2006 and 2007, the bank executed management's strategic decision to supplement its declining loan production by purchasing a pool of short-term acquisition and renovation loans on properties primarily located in two Florida counties. These loan pools created an additional concentration risk for Marco. As the local real estate market weakened, the bank's asset quality deteriorated significantly and resulted in large provision expenses that eliminated earnings and depleted capital.

In a 2007 examination, FRB Atlanta concluded that the bank's capital did not support its elevated risk profile, even though Marco remained *well capitalized*. Despite this conclusion, the bank maintained its *well capitalized* designation until 2009 because capital support from the bank's holding company helped to offset the capital depletion associated with Marco's significant asset quality deterioration. The holding company eventually exhausted its available resources to support the bank, and Marco declined from a *well capitalized* institution to a failed institution in just over six months. This failure highlights the disconnect that can exist between PCA's quantitative assessment of capital and a subjective assessment of the bank's capital position in relation to its risks.

Midwest

Similar to the Marco failure, Midwest also relied on capital support to maintain its *well capitalized* designation. As the bank experienced asset quality deterioration related to its CRE

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[19] SR letter 07-01 became effective in 2007, so it is provided for illustrative purposes only for data prior to 2007.

and CLD loan portfolios and following a significant write-down in the value of its Fannie Mae and Freddie Mac securities, Midwest became increasingly reliant on capital support to sustain its operations. In December 2008, the bank received $84.8 million from the U.S. Department of the Treasury's Troubled Asset Relief Program. In 2008 and 2009, Midwest experienced significant losses, and Midwest's holding company injected $87 million in additional capital to preserve the bank's *well capitalized* status. Despite receiving more than $170 million in capital support in a two-year period, asset quality deterioration associated with the bank's CRE and CLD loan portfolios ultimately caused the bank to fail. In this failure, Midwest remained *well capitalized* until January 2010, despite a clear disconnect between the bank's PCA designation and its risk profile. By 2010, the previous capital injections depleted the holding company's financial reserves and prevented it from further supplementing the bank's capital. The bank failed within five months. This precipitous decline to failure highlights how rapidly PCA quantitative assessments can become outdated, because they fail to consider the bank's actual risk profile in relation to its capital position.

5. Declines in Financial Performance as a Prerequisite to Supervisory Action

Many failed banks received at least one double or triple downgrade of a CAMELS composite or component rating prior to failing. The severity of these downgrades highlights a weakness among many of the examinations that we reviewed. Despite acknowledging and identifying many of the risks that ultimately caused the bank to fail, examiners appeared reluctant to take aggressive supervisory action until the bank's financial performance declined. The deteriorating economic conditions during the financial crisis demonstrated how quickly specific risks can affect a bank's condition, making it critical that such issues are addressed timely. This supervisory risk highlights the need for forward-looking examinations.

Barnes

Barnes exemplifies a situation where examiners detected key risks but failed to take decisive supervisory action. As early as 2006, examiners noted increased credit risk due to rapid growth in CRE loans, specifically CLD loans, which had more than doubled since the prior examination to 247 percent of the bank's risk-based capital. SR letter 07-01 indicates that significant CLD loan concentrations exist at 100 percent; the bank's CLD loan concentration was more than double that amount. However, examiners continued to rate the bank's overall condition satisfactory, but noted that management planned to reduce its exposure to speculative CLD lending. Nevertheless, the bank continued to originate CLD loans in 2007 and 2008, despite apparent weaknesses in Utah's real estate market and economy. In addition, a 2007 full scope examination cited repeated regulatory criticisms, declining market trends, and continuing growth of Barnes' CLD loan portfolio. Yet Barnes received the same satisfactory CAMELS ratings as the 2006 exam. A subsequent June 2008 credit risk target examination provided strong evidence that Barnes' risk profile and financial condition had significantly changed, and the bank's composite rating was downgraded to a 3. Within a year of that downgrade, examiners double downgraded the bank to a CAMELS composite 5. In an October 2009 exam, Barnes received another CAMELS composite 5 rating, and all CAMELS components were also assigned 5

ratings. Shortly thereafter in January 2010, the bank was placed in receivership. This failure highlights the need to take supervisory action when a risk is detected.

Solutions

Solutions provides another example where examiners detected key risks early that did not result in CAMELS composite and component ratings downgrades until almost a year before the bank failed. The bank received CAMELS composite 2 ratings for the full scope examinations conducted between November 2004 and January 2008. In the December 2004 examination report, examiners noted that earnings "while improving, were weak and less than adequate to support operations and augment capital during periods of rapid asset growth." Similarly, a June 2006 examination concluded that earnings would not augment capital given its significant growth. In addition, the examination also acknowledged that the bank's net non-core funding dependence ratio was "well above" its peer group average and violated the bank's internal policy. Concerns regarding the bank's increased reliance on net non-core funding, capital ratios below its peer group, and the loan portfolio's large concentration in CRE and CLD were reiterated in the November 2007 examination, yet the bank maintained its satisfactory rating. In November 2008, examiners began an asset quality target examination that resulted in Solutions being double downgraded to a CAMELS composite 4 rating. Capital, asset quality, management, earnings, and sensitivity were also double downgraded from 2 to 4, while liquidity was downgraded from 3 to 4. Examiners expressed concern that management's decision to execute an aggressive growth strategy without the support of an adequate capital position resulted in the bank's unsatisfactory financial condition. Shortly thereafter in an April 2009 examination, the bank was downgraded further to a CAMELS composite 5, and was closed in December 2009. This failure highlights a situation where the examination team highlighted the risks that ultimately caused the bank to fail, but did not compel the bank to mitigate those risks.

CapitalSouth

CapitalSouth exemplifies a third situation involving the need for a forward-looking supervisory approach. In 2003, CapitalSouth's business strategy focused on CRE lending and growth by acquisitions. A 2005 examination report highlighted that the bank had little margin for error and could not afford to have any significant level of problem loans because of its modest earnings and growth strategy. After examiners released the bank from an informal improvement plan in 2007 designed to address the bank's earnings weaknesses, capital planning, and credit risk management, supervisors reiterated the bank's limited margin for error in absorbing problem loans and loan losses. The first full scope examination following the bank's acquisition of a Florida federal savings association resulted in a CAMELS composite rating double downgrade and double downgrades to all CAMELS component ratings except for sensitivity to market risk. The examination resulted in a C&D Order requiring enhanced Board of Directors and management oversight, credit risk management practices, lending and credit administration policies, and loan review policies. The bank experienced substantial asset quality deterioration, management could not resolve the requirements of the order, and the bank failed.

Appendix 1 – (continued)

6. Limitations of SR Letter 07-01

For each MLR and in-depth review, we sent a team to the applicable Reserve Bank to discuss the circumstances surrounding the failure. We conducted those discussions with senior management at the Reserve Bank and senior examination staff. During those interviews, we typically sought feedback concerning SR Letter 07-01 given the nexus between credit concentrations and SMB failures. During those discussions, we heard the following criticisms of SR Letter 07-01:

- The guidance would have been more useful two to three years earlier. The proposed guidance was distributed for comment in January 2006, but the final guidance was not issued until January 2007.

- SR Letter 07-01 was not very forceful, and aspects of the guidance could be implemented by banks gradually.

- The guidance was very high-level. As an example, a Reserve Bank examiner mentioned that expectations for stress testing were not well defined, even though stress testing at many community banks was in its infancy.

Our failed bank reports did not evaluate the validity of these criticisms. In our estimation, these observations suggest that there may be a need to revisit the guidance based on lessons learned from the financial crisis.

Appendix 2 – List of SMB Failures[a]

	SMB	Location	FR District	Asset Size (millions)	Closure Date	Projected Loss to DIF (millions)	Loss as % of Assets
1	First Georgia Community Bank	GA	AT	229	12/5/2008	72.2	32%
2	County Bank	CA	SF	1,692	2/6/2009	135.8	8%
3	Riverside Bank of the Gulf Coast	FL	AT	536.7	2/13/2009	201.5	38%
4	Michigan Heritage Bank	MI	CH	160.9	4/24/2009	68.3	42%
5	Neighborhood Community Bank	GA	AT	210.4	6/26/2009	66.6	32%
6	Community Bank of West Georgia	GA	AT	200	6/26/2009	85.1	43%
7	BankFirst	SD	MN	246.1	7/17/2009	90	37%
8	Community First (Prineville)	OR	SF	199.8	8/7/2009	44.4	22%
9	Community Bank of Nevada	NV	SF	1,500	8/14/2009	766.5	51%
10	CapitalSouth Bank	AL	AT	588.5	8/21/2009	146	25%
11	Irwin Union Bank &Trust	IN	CH	2,700	9/18/2009	552.4	20%
12	Warren Bank	MI	CH	530.9	10/2/2009	276.3	52%
13	San Joaquin Bank	CA	SF	771.8	10/16/2009	90.4	12%
14	Bank of Elmwood	WI	CH	339.1	10/23/2009	90.6	27%
15	Orion Bank	FL	AT	2,700	11/13/2009	593.8	22%
16	SolutionsBank	KS	KC	510.1	12/11/2009	119	23%
17	Independent Bankers Bank	IL	IL	773.7	12/18/2009	20.8	3%
18	Barnes Banking Company	UT	SF	745.5	1/15/2010	266.3	36%
19	Marco Community Bank	FL	AT	126.9	2/19/2010	36.9	29%
20	Sun American Bank	FL	AT	543.6	3/5/2010	103	19%
21	Bank of Illinois	IL	CH	205.3	3/5/2010	53.7	26%
22	Old Southern Bank	FL	AT	351	3/12/2010	90.5	26%
23	1st Pacific Bank	CA	SF	327.3	5/7/2010	75.1	23%

Appendix 2 – (continued)

	SMB	Location	FR District	Asset Size (millions)	Closure Date	Projected Loss to DIF (millions)	Loss as % of Assets
24	Midwest Bank and Trust	IL	CH	3,100	5/14/2010	200.7	6%
25	Metro Bank of Dade County	FL	AT	442.3	7/16/2010	67.6	15%
26	Thunder Bank	KS	KC	32.6	7/23/2010	4.5	14%
27	Sterling Bank	FL	AT	407.9	7/23/2010	45.5	11%
28	Home Valley Bank	OR	SF	251.8	7/23/2010	37.1	15%
29	Pacific State Bank	CA	SF	312.1	8/20/2010	32.6	10%
30	Horizon Bank	FL	AT	187.8	9/10/2010	58.9	31%
31	Progress Bank of Florida	FL	AT	93.4	10/22/2010	25	27%
32	First Banking Center	WI	IL	785.8	11/19/2010	142.6	18%
33	Paramount Bank	MI	IL	239.3	12/10/2010	89.4	37%
34	First Commercial Bank of Florida	FL	AT	614.5	1/5/2011	78	13%
35	Community First Bank of Chicago	IL	IL	51.5	2/4/2011	11.7	23%

[a]The data reported in the table reflects the amount reported by the FDIC in formal notice to our office.

Appendix 2 – (continued)

Tables 1 and 2 below summarize the geographic distribution and total asset size distribution according to peer group of the 35 failed banks reviewed by the OIG. As Table 1 illustrates, the failures were concentrated in three geographic regions—the Southeast, Midwest, and West. Within each of the regions, the failures were concentrated in specific states. Ten of the 14 failures from the Southeast involved Florida banks, and 3 others involved Georgia banks. Seven of the 13 failures in the Midwest related to Michigan and Illinois banks—with 3 and 4 SMB failures occurring in each state, respectively. Four out of the eight failures in the Western region involved California banks. Table 2 outlines the peer group distribution of the failed banks according to the institutions' total asset size preceding the failure. Thirty-one of the 35 failed banks reviewed clustered in 3 peer groups—11 banks in $100 to $300 million, 16 banks in $300 million to $1 billion, and 4 banks in $1 to $3 billion. The average total asset size for the banks reviewed was approximately $649 million, and the average loss to the DIF associated with the failures reviewed was 21 percent of total assets.

Table 1 – Failed SMBs by Region

Region	Banks
Southeast	14
Midwest	13
West	8
Total	35

Table 2 – Failed SMBs by Peer Group

Peer Group According to Total Asset Size	Failed Banks Reviewed
Less than $50 million	1
$50-$100 million	2
$100-$300 million	11
$300 million-$1 billion	16
$1 billion-$3 billion	4
Greater than $3 billion	1
Total	35

Appendix 3 – Summary Results Tables

We compiled the following tables to help summarize the results of our analysis of the 20 banks that required an MLR or in-depth review by the OIG. These tables identify specific common characteristics related to the causes of the failures in the MLRs that have been completed. The tables also identify common characteristics related to the supervision of each of the failed banks. The tables provide a nonexhaustive summary of our results.

Table 1- Contributing Causes of the Failures

	Contributing Causes of the Failure					
	Strategic Planning, Decision-making, or Execution	Reliance on Certain Specific Funding Sources	Concentration Risk	Risk Management or Internal Control Deficiencies	Liberal Maturity Extensions and Interest Reserves	De Novo Bank
Bank of Elmwood	X	X	X	X		
BankFirst	X		X	X	X	
Barnes Banking Company	X		X	X	X	
Capital South	X		X	X		
Community Bank of Nevada	X		X	X		
Community Bank of West Georgia	X		X	X		X
Community First	X		X	X		
County Bank	X		X	X		
First Georgia Community Bank	X	X	X			
Irwin Union Bank and Trust	X	X	X	X		
Marco Community Bank	X	X	X	X		X
Michigan Heritage	X		X	X		
Midwest Bank and Trust	X	X	X	X		
Neighborhood Community Bank	X		X	X		
Orion Bank	X	X	X	X	X	
Riverside Bank of the Gulf Coast	X	X	X			
San Joaquin	X	X	X		X	
Solutions Bank	X	X	X			
Warren Bank	X		X	X	X	
Independent Bankers' Bank	X	X	X	X		

Appendix 3 – (continued)

Table 2 – Summary of Supervisory Observations and Loan Concentrations

	Supervisory Observations			Loan Concentrations			
	Need for Stronger Supervisory Action Sooner	CAMELS Ratings Inconsistent with Narrative Comments	Specific Recommendations	Failure Date	As of Date for CRE and CLD Data	CRE as % of Risk-Based Capital	CLD as % of Risk-Based Capital
Bank of Elmwood	X			10/23/2009	3/31/2008	249.24	51.2
BankFirst	X			7/17/2009	12/31/2007	220.73	166.22
Barnes Banking Company	X	X		1/15/2010	6/30/2008	449.4	337.9
Capital South	X			8/21/2009	12/31/2007	564.12	299.06
Community Bank of Nevada	X		Clarification concerning pre-merger examination requirements in SR Letter 98-28	8/14/2009	12/31/2007	590.74	399.6
Community Bank of West Georgia	X	X		6/26/2009	9/30/2007	667.04	421.1
Community First	X			8/7/2009	12/31/2007	542.02	238.05
County Bank	X		CBEM updates to address examination frequency for de novo banks and cross reference SR Letter 91-17	2/6/2009	6/30/2007	419.05	156.01
First Georgia Community Bank	X			12/5/2008	3/31/2007	680.4	418.13
Irwin Union Bank and Trust	X	X		9/18/2009	12/31/2007	279.62	78.87
Marco Community Bank	X		Timely notice of brokered deposit restrictions	2/19/2010	6/30/2008	347.05	191.54
Michigan Heritage	X			4/24/2009	9/30/2007	292.35	167.72
Midwest Bank and Trust	X	X	Disagreements with state supervisory agencies	5/14/2010	9/30/2008	694.71	154.35
Neighborhood Community Bank	X			6/26/2009	9/30/2007	558.94	383.22
Orion Bank	X			11/13/2009	3/31/2008	643.62	414.87
Riverside Bank of the Gulf Coast	X			2/13/2009	6/30/2007	442.99	337.16
San Joaquin	X			10/16/2009	3/31/2008	675.64	289.84
Solutions Bank	X			12/11/2009	3/31/2008	679.97	365.38
Warren Bank	X			10/2/2009	3/31/2008	560.56	274.16
Independent Bankers' Bank	X			12/18/2009	3/31/2008	194.48	59.8

Appendix 4 – 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. There are three types of informal supervisory actions, and their order, by increasing severity, is commitment, board resolution, and memorandum of understanding.

Brokered Deposits

A deposit purchased from a broker acting as an agent for depositors. The broker pools certificates of deposit from many small investors and markets them to financial institutions, usually in blocks nearing $100,000, and negotiates a higher rate for certificates of deposit placed with the purchaser. Federal law prohibits undercapitalized banks and thrifts from accepting brokered deposits.

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.

Cease-and-Desist Order (C&D Order)

A formal supervisory enforcement action against a financial institution or an institution-affiliated party that violates a law, rule, regulation, written commitment, or written agreement, or that is engaged in unsafe or unsound business practice. The order may require a financial institution or institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The provisions of a C&D and the problems found at the institution are more severe than those of a written agreement, which is the least severe type of formal supervisory enforcement action.

Appendix 4 – (continued)

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.

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.

Core Deposits

Deposits that are largely derived from a bank's regular customer base and, therefore, are typically the most stable, least costly, and least interest-rate sensitive source of funding.

De Novo

A State Member Bank that has been in operation for five years or less.

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 C&D Orders, C&D Orders, Prohibition and Removal Orders, and Prompt Corrective Action Directives; while informal enforcement actions include Commitments, Board Resolutions, and MOUs.

Appendix 4 – (continued)

Federal Home Loan Bank

One of 12 banks chartered by Congress in 1932 to provide low-cost credit to residential housing lenders. Federal Home Loan Banks help meet the borrowing needs of communities by providing credit products and services to member financial institutions. Each bank is privately owned by its members, which include commercial banks, savings institutions, credit unions, thrift and loan companies, and insurance companies.

Interest Reserves

Accounts set up and funded to periodically advance loan funds to pay interest charges on the outstanding balance of an acquisition, development, and construction loan or a construction, land, and land development loan. The interest is capitalized and added to the loan balance.

Liquidity

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.

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. There are three types of informal supervisory actions, and their order, by increasing severity, is commitment, board resolution, and MOU.

Net Interest Margin

A ratio that evaluates the relationship between net interest income and assets generating interest income. The net interest margin is calculated by dividing the difference between a bank's interest income on a tax equivalent basis and interest expense by the average of the respective asset accounts involved in generating interest income.

Net Non-core Funding Dependence Ratio

A ratio that measures the extent to which a bank is funding longer-term assets with non-core funding. The net non-core funding dependence ratio is calculated by dividing the difference between an institution's non-core liabilities and short-term investments by long-term assets. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Appendix 4 – (continued)

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

State Member Bank (SMB)

Commercial banks that are state chartered and members of the Federal Reserve System.

Secondary Mortgage Market

A market where institutions buy and sell mortgages in the form of whole loans (that is, mortgages that have not been securitized) and mortgage-related securities.

Sub-prime loans

Loans made to borrowers with the following characteristics: (1) a relatively high default probability; (2) a bankruptcy in the last 5 years; (3) 2 or more 30-day delinquencies in the last 12 months or 1 or more 60-day delinquencies in the last 24 months; (4) a judgment, foreclosure, repossession, or charge-off in the last 24 months; and/or (5) a debt-service-to-income ratio of 50 percent or greater.

Tier 1 Capital

The sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

Appendix 4 – (continued)

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.

Uniform Bank Performance Report (UBPR)

An analytical tool created for bank supervisory, examination, and bank management purposes. The report facilitates evaluation of a bank's current condition, trends in its financial performance, and comparisons with the performance of its peer group.

Written Agreement (WA)

A formal supervisory enforcement action that is generally issued when a financial institution 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 5 – 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, the strongest performance and risk management practices, and the least degree of supervisory concern, while a 5 indicates the lowest rating, the 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 5 – (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 6 – Deputy Division Director's Comments

BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

September 28, 2011

Mr. Anthony Castaldo
Associate Inspector General
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Mr. Castaldo,

Thank you for the opportunity to review and comment on the Office of Inspector General (OIG) draft September 2011 report entitled "Summary Results of Failed Bank Reviews". The Federal Reserve Board (FRB) concurs with the general findings of the report.

In the draft report, the OIG recommends that the Director of Banking Supervision and Regulation (BS&R) consider taking various actions to address common elements that contributed to State Member Bank (SMB) failures. Specifically, the OIG recommends that BS&R consider the following recommendations: (1) supplement current examiner training programs with case studies from recent SMB failures, (2) develop standard examination procedures to evaluate compensation agreements, and (3) provide supplementary guidance on commercial real estate (CRE) concentrations. Also suggested for BS&R's consideration are to: (1) continue to work with other federal banking agencies to identify opportunities to enhance Prompt Corrective Action (PCA), (2) define the appropriate supervisory response for highly concentrated SMBs that continue to pursue aggressive growth strategies, and (3) implement a supervisory approach that encourages strong and consistent supervisory action during stable economic periods.

BS&R generally agrees with the specific recommendations and matters for consideration. The recommendation to enhance examiner training with case studies from recent failures will be considered as examiner education programs are reviewed and revised. Some case studies have already been presented by Federal Reserve staff via the Banking Supervision Learning Center. With regard to compensation agreements, interagency work is underway to prescribe regulations and guidelines to address incentive compensation based on the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This work, along with the recommendation to develop standard examination procedures for all SMBs will be considered in any future revisions to examination processes. Further, work is underway to update interagency guidance related to CRE concentrations.

Appendix 6 – (continued)

The need to enhance PCA, address growth strategies, and implement a stronger supervisory approach during stable periods will be considered as supervisory processes are revised and to some extent may require interagency coordination for effective implementation. Thus far, an examination issues tracking process has been developed for Federal Reserve systemwide use to enhance the monitoring of supervisory issues for Federal Reserve-supervised institutions. This is intended to be used to minimize uncorrected safety and soundness weaknesses and lead to more timely supervisory attention. With regard to PCA, while early in the process, interagency work is underway to review and improve capital standards based on the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the U.S. implementation of the Basel III capital accord.

As noted above, some recommendations require interagency agreement and coordination and may require a long-term approach to implementation. Where specific action has not been taken, BS&R will consider the recommendations as we continue to refine our processes and programs after an assessment of lessons learned during the financial crisis. Practical limitations will need to be considered, as well as the possibility of unintended consequences.

Sincerely,

/signed/

Maryann Hunter
Deputy Director

Appendix 7 – Office of Inspector General Principal Contributors to This Report

Michael P. VanHuysen, Project Leader and OIG Manager

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