

# **Board of Governors of the Federal Reserve System**

## **Review of the Failure of Independent Bankers' Bank**



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**Office of Inspector General**

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**March 2011**

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



OFFICE OF INSPECTOR GENERAL

March 31, 2011

The Honorable Daniel K. Tarullo  
Chairman  
Committee on Supervisory and Regulatory Affairs  
Board of Governors of the Federal Reserve System  
Washington, DC 20551

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted an in-depth review of the failure of Independent Bankers' Bank (IBB). IBB opened in 1986 as a state-chartered member bank of the Federal Reserve System. As a bankers' bank, IBB provided correspondent services, such as check clearing, wire transfers, automated clearing house transactions, and cash management services, to its client banks. IBB was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the Illinois Department of Financial and Professional Regulation (State). The State closed IBB on December 18, 2009, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. IBB's failure will result in a loss to the Deposit Insurance Fund (DIF).

Under section 38(k) of the FDI Act, as amended, a material loss to the DIF is defined as an estimated loss in excess of \$200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. The material loss review provision of section 38(k) requires that the Inspector General of the appropriate federal bank agency

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

In addition, the Dodd-Frank Act requires the Inspector General of the appropriate federal banking agency to review each loss to the DIF below the materiality threshold that occurred after October 1, 2009, to determine whether an "unusual circumstance" existed in connection with the loss. When the Inspector General determines that the loss exhibited an unusual circumstance, the Dodd-Frank Act requires an in-depth review of the loss.

According to the FDIC Inspector General, IBB's failure will result in an estimated \$20.8 million loss to the DIF, or 2.7 percent of the bank's \$773.7 million in total assets. While the loss is not material, we conducted an in-depth review after determining that IBB's failure presented an unusual circumstance because it was a bankers' bank that was unable to continue processing payments on behalf of its respondent banks. When an unusual circumstance is identified, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review.

IBB failed because its Board of Directors and management did not effectively control the risks associated with the bank's business strategy. IBB kept service fees low to attract respondent banks and relied on interest income from its investment portfolio to supplement income. The bank acquired collateralized debt obligations (CDOs), primarily backed by trust preferred securities and private label mortgage-backed securities, to obtain higher yields, and developed a concentrated, high-risk investment portfolio. In addition, the bank depended on non-core funding sources to support asset growth and provide liquidity. A sharp decline in economic conditions, coupled with increasing turmoil in the CDO market, led to rapid devaluation in IBB's investment portfolio and forced the bank to recognize significant losses. These losses eliminated earnings, depleted capital, and severely strained liquidity. On December 18, 2009, the State closed IBB, under its emergency authority, due to concerns about IBB's ability to continue processing payments on behalf of respondent banks and appointed the FDIC as receiver.

With respect to supervision, FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted five full scope examinations and a joint target examination, executed three enforcement actions, and implemented the applicable PCA provisions.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. Our analysis of FRB Chicago's supervision of IBB revealed that FRB Chicago had opportunities for earlier and more forceful supervisory action.

We believe that IBB's risky business strategy should have prompted earlier and more in-depth examiner scrutiny. IBB focused on keeping service fees low to attract and retain respondent banks, leading the bank to acquire risky high-yield investments to supplement its below-peer service fee income. This strategy contributed to management assuming excessive risks by developing a concentration in higher risk CDOs. However, FRB Chicago did not assess the adequacy of the investment policies and controls over investment decisions until a January 2009 examination when the investment portfolio had already exhibited significant deterioration.

During the January 2009 examination, examiners noted that the Board of Directors had (1) not been “fully aware of how the credit risk profile of the portfolio increased significantly with the purchase of lower investment grade and otherwise risky securities,” (2) failed to adequately diversify IBB’s investment portfolio, and (3) developed a concentration, which ultimately contributed to the bank’s failure. According to Supervision and Regulation (SR) Letter 98-12, *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, bank staff should understand the risks and cash flow characteristics of the institution’s investments and be capable of managing the risks before acquiring a material position in investments such as CDOs. In hindsight, we believe that earlier examiner scrutiny would have revealed that management and the Board of Directors did not fully understand the investment products the bank purchased and were not managing the risks, which might have prompted examiners to apply provisions in SR Letter 98-12 to restrict IBB from developing a concentration in high-risk investments.

We also believe that early indications of economic decline should have prompted a more forceful supervisory response. By 2008, signs of market deterioration were evident. A March 2008 examination report indicated that investment portfolio classifications more than doubled since the 2006 examination and totaled \$7.7 million. These classified investments included five mortgage-related and two automobile-related investments. In August 2008, IBB notified FRB Chicago that the bank’s investment portfolio had significant impairments. FRB Chicago suggested that the bank establish a special group to handle the impaired investments and, to minimize potential losses, proposed selling these investments to IBB’s holding company; however, management took no immediate action. FRB Chicago did not perform an on-site comprehensive evaluation of the bank’s investment portfolio until the January 2009 examination. We believe that rapidly deteriorating economic conditions should have prompted examiners to (1) evaluate IBB’s investments earlier and (2) compel the bank’s Board of Directors and management to mitigate potential losses.

Finally, in our opinion, IBB’s excessive reliance on non-core funding sources presented FRB Chicago with opportunities to take earlier and more forceful supervisory action. In general, non-core funding sources increase an institution’s liquidity risk profile because deteriorating financial conditions can restrict access to such funding. Even though IBB’s use of non-core funding sources significantly exceeded its peers, examiners consistently rated the bank’s liquidity component a 1 and did not emphasize the need to limit funding concentrations or establish a contingency funding plan until the January 2009 examination. IBB’s rapidly deteriorating financial condition during 2009 restricted the bank’s access to non-core funds and resulted in the bank’s inability to meet the collateral requirement to continue processing payments on behalf of its respondent banks. We believe that the bank’s historically high reliance on non-core funding sources warranted an earlier supervisory action requiring IBB to limit funding concentrations and to establish contingency funding plans appropriate for a bankers’ bank.

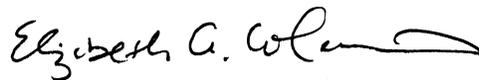
Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that IBB’s failure highlights several lessons learned that can be applied when supervising banks with similar characteristics. In our opinion, examiners should obtain a comprehensive understanding of the risks embedded in

investment portfolios and any external factors that may heighten these risks. Specifically, examiners should gain thorough knowledge of investment product characteristics and risk attributes and be cognizant of market conditions or significant events that may adversely affect the value of an institution's investments. We also believe that IBB's failure underscores the unique nature of a bankers' bank and the critical functions that a bankers' bank provides to its respondent banks. Therefore, examiners should (1) closely monitor the condition of a bankers' bank to facilitate immediate response to adverse changes; and (2) evaluate risk exposure stemming from concentrations in loans, investments, and funding sources.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director acknowledged our conclusions and concurred with the lessons learned. His response is included as Appendix 3.

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

Sincerely,



Elizabeth A. Coleman  
Inspector General

cc: Chairman Ben S. Bernanke  
Vice Chair Janet L. Yellen  
Governor Elizabeth A. Duke  
Governor Sarah Bloom Raskin  
Governor Kevin M. Warsh  
Mr. Patrick M. Parkinson  
Ms. Cathy Lemieux

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March 2011



# Table of Contents

	<b>Page</b>
<b>Background</b> .....	9
<b>Objectives, Scope, and Methodology</b> .....	10
<b>Cause of the Failure</b> .....	10
IBB Adopted a Risky Business Strategy .....	11
CDO Acquisitions Significantly Increased the Bank’s Credit Risk .....	11
Inadequate Board of Directors Oversight Promoted a Weak Control Environment .....	12
Investment Impairments Increased as the Economic Conditions Worsened .....	13
Over-Reliance on Non-core Funding Sources Strained Liquidity .....	13
Concerns about IBB’s Ability to Continue Servicing Respondent Banks .....	14
<b>Supervision of Independent Bankers’ Bank</b> .....	14
Supervision History from 2004 through 2007 .....	16
Investment Portfolio Deterioration Reported in 2008 .....	17
January 2009 Full Scope Examination Resulted in a Double Downgrade to a CAMELS Composite 4 Rating and a Written Agreement .....	17
A Cease-and-Desist Order Was Issued in September 2009 .....	18
October 2009 Target Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating and a Memorandum of Understanding .....	19
<b>Conclusions and Lessons Learned</b> .....	20
Lessons Learned .....	21
<b>Analysis of Comments</b> .....	22
<b>Appendixes</b> .....	23
Appendix 1 – Glossary of Banking and Regulatory Terms .....	25

Appendix 2 – CAMELS Rating System .....	29
Appendix 3 – Division Director’s Comments .....	31
Appendix 4 – Office of Inspector General Principal Contributors to this Report .....	33

## Background

Independent Bankers' Bank (IBB), the sole subsidiary of Bankers' Bancorp, opened in 1986 as a state-chartered member bank of the Federal Reserve System. As a bankers' bank, IBB was established exclusively to conduct business with other financial institutions and did not make loans to or accept deposits from the general public.<sup>1</sup> The bank provided correspondent services, such as check clearing, wire transfers, automated clearing house transactions, and cash management services, to its client banks, also referred to as respondent banks. IBB had over 450 respondent banks in Illinois, Indiana, Iowa, and Michigan.

IBB was based in Springfield, Illinois, and was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the Illinois Department of Financial and Professional Regulation (State). On December 18, 2009, the State closed IBB and named the Federal Deposit Insurance Corporation (FDIC) as receiver. On January 27, 2010, the FDIC Inspector General advised our office that the estimated loss to the Deposit Insurance Fund (DIF) from the bank's failure would be \$20.8 million, or 2.7 percent of the bank's \$773.7 million in total assets. At the time, this did not meet the material loss threshold as defined under section 38(k) of the Federal Deposit Insurance Act (FDI Act) that would require a material loss review by the Office of Inspector General.<sup>2</sup>

Under section 38(k) of the FDI Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in July 2010, a material loss to the DIF is defined as an estimated loss in excess of \$200 million if the loss occurred between January 1, 2010, and December 31, 2011. However, under the Dodd-Frank Act, the Inspector General of the appropriate federal banking agency is required to review each loss to the DIF below the materiality threshold that occurred after October 1, 2009, to determine whether an "unusual circumstance" existed in connection with the loss. When the Inspector General determines that the loss exhibits an unusual circumstance, the Dodd-Frank Act requires an in-depth review of the loss. We believe that IBB's failure exhibited an unusual circumstance because it was a bankers' bank and was unable to continue processing payments on behalf of its respondent banks.

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<sup>1</sup> A bankers' bank is generally owned by the financial institutions it services, and its Board of Directors is comprised of client bank executive officers, as was the case with IBB.

<sup>2</sup> A December 18, 2009, FDIC press release indicated that IBB's total assets as of September 30, 2009, were \$585.5 million, and the estimated loss to the DIF was \$68.4 million. However, on January 27, 2010, the FDIC Inspector General provided updated information that revised the total assets at closure to \$773.7 million, and the estimated DIF loss to \$20.8 million. According to FRB Chicago, the difference in asset size was attributable to IBB's success in offering respondent banks attractive deposit pricing, which resulted in an increase in IBB's total assets. The reduction in the initial DIF loss estimate by \$47.6 million occurred because this amount of the total loss was allocated to the FDIC Temporary Liquidity Guarantee Program. Under this program, the FDIC temporarily guaranteed certain demand deposit accounts. These loss estimates could change significantly as ongoing liquidation efforts establish the value of the bank's securities portfolio.

## Objectives, Scope, and Methodology

When a loss to the DIF presents unusual circumstances, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal banking agency

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

To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Chicago, the State, the FDIC, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by IBB, examination reports issued between 2004 and 2009, and examination work papers prepared by FRB Chicago. Appendixes at the end of this report contain a glossary that defines key banking and regulatory terms and a description of the CAMELS rating system.<sup>3</sup> We conducted our fieldwork from September 2010 through December 2010 in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

## Cause of the Failure

IBB failed because its Board of Directors and management did not effectively control the risks associated with the bank's business strategy. IBB kept service fees low to attract respondent banks and relied on interest income from its investment portfolio to supplement income. The bank acquired collateralized debt obligations (CDOs), primarily backed by trust preferred securities (TPS) and private label mortgage-backed securities, to obtain higher yields, and developed a concentrated, high-risk investment portfolio.<sup>4</sup> In addition, the bank depended on non-core funding sources to support asset growth and provide liquidity. A sharp decline in economic conditions, coupled with increasing turmoil in the CDO market, led to rapid devaluation in IBB's investment portfolio and forced the bank to recognize significant losses. These losses eliminated earnings, depleted capital, and severely strained liquidity. On December 18, 2009, the State closed IBB, under its emergency authority, due to concerns about IBB's

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<sup>3</sup> The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the least regulatory concern.

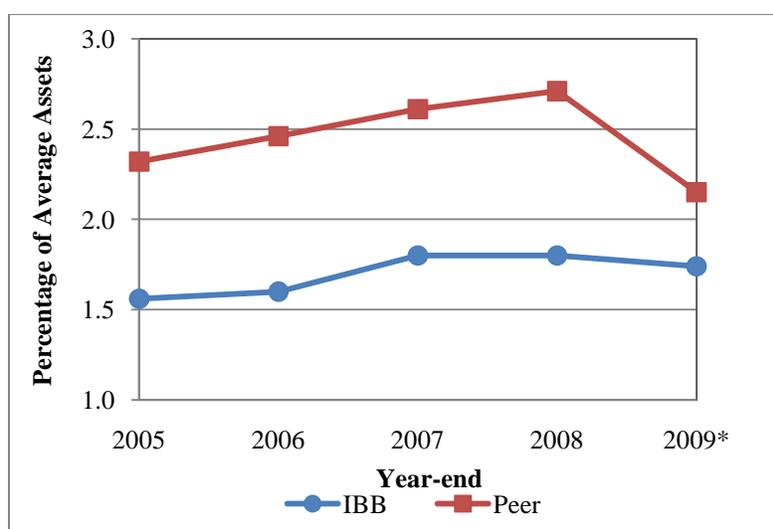
<sup>4</sup> Trust preferred securities are preferred securities issued by a trust subsidiary of a bank holding company. Private label mortgage-backed securities are securitized mortgages that do not meet the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation underwriting and documentation guidelines.

ability to continue processing payments on behalf of respondent banks and appointed the FDIC as receiver.<sup>5</sup>

### **IBB Adopted a Risky Business Strategy**

IBB adopted a business strategy that primarily focused on keeping service fees low to attract and retain respondent banks. As a result, the bank's income from selling services to respondent banks was insufficient to sustain operations. As shown in Chart 1 below, the bank's non-interest income was significantly below peer averages between 2005 and 2009.<sup>6</sup> IBB's low service fee income led the bank's management team and Board of Directors to supplement these shortfalls by investing in risky, high-yield investment products.

**Chart 1: Non-Interest Income**<sup>7</sup>



\*Non-interest income as of 09/30/2009.

### **CDO Acquisitions Significantly Increased the Bank's Credit Risk**

To supplement low service fee income, the bank began investing in risky CDOs backed by trust preferred securities (TPS) and private label mortgage-backed securities. CDOs are complex financial investment products that generate value and cash flow from a pool of underlying assets such as bonds, loans, mortgage-backed securities, and other CDOs. These assets are segregated into risk classes, or tranches, and interests in each tranche are sold to investors. While higher risk tranches often result in greater investment returns, such returns only occur after obligations to investors in lower risk tranches are satisfied. The structure of CDOs is complex, which can make it difficult to understand and measure the inherent risks within these investment products.

<sup>5</sup> Pursuant to section 52 of the Illinois Banking Act, 205 ILL. COMP. STAT. ANN. 5/52, the State closed IBB, citing an emergency situation that may have resulted in serious losses to IBB's respondent banks.

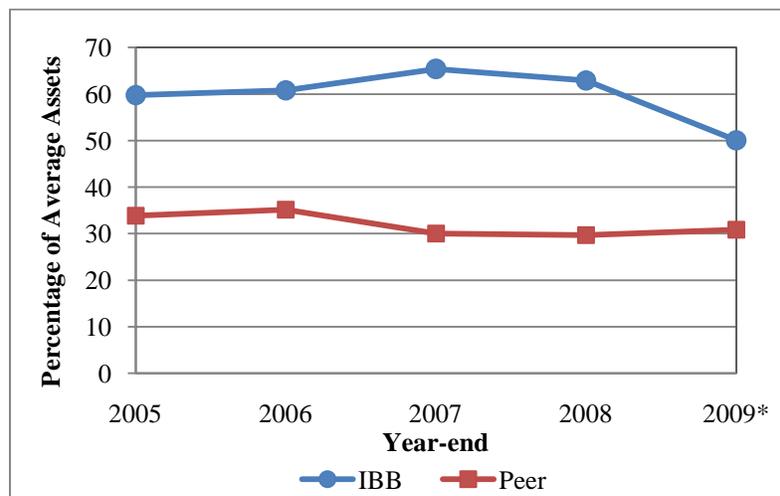
<sup>6</sup> Peer group data incorporates the financial performance metrics of all other bankers' banks across the nation.

<sup>7</sup> The non-interest income line item of the income statement includes all sources of income not attributable to earning assets such as loans and securities. This includes fee income generated from a bankers' bank's products and services.

IBB's overall credit risk profile increased as the bank sought higher returns, and its investment portfolio became concentrated in higher risk CDO tranches.

The risk presented by these investment products was heightened by the substantial size of the bank's investment portfolio, particularly if economic conditions deteriorated. As shown in Chart 2 below, between 2005 and 2009, IBB's investment portfolio consistently exceeded 50 percent of the bank's average assets and peaked in 2007 at 66 percent; during the same timeframe, peer group investment portfolios remained below 36 percent.

**Chart 2: Investment Portfolio**



\*Investment portfolio as of 09/30/2009.

### **Inadequate Board of Directors Oversight Promoted a Weak Control Environment**

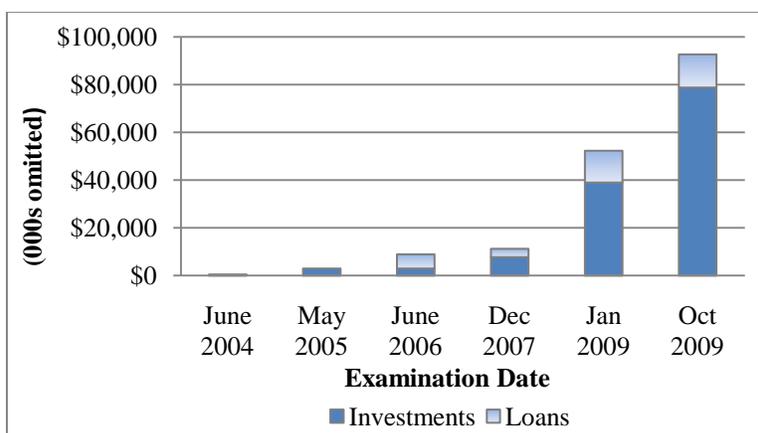
In 2009, examiners noted weaknesses in the Board of Directors' oversight, as well as deficiencies in investment policy and procedures, which contributed to IBB's development of a risky and concentrated investment portfolio. Examiners noted that IBB's investment policy—which was reviewed annually by the Board of Directors—was inadequate because it allowed for the acquisition of lower quality investment grade securities without establishing adequate limits, and it did not address potentially risky products such as CDOs. Management and the Board of Directors placed considerable reliance on ratings produced by credit rating agencies and presumed that securities with any rating considered "investment grade" presented minimal credit risk.

Examiners indicated that the chief executive officer (CEO) exercised significant influence over IBB's investment activities and was primarily responsible for executing investment transactions. Contrary to IBB's internal policies, the bank's Investment Committee often did not review and approve the CEO's securities purchases and sales until the transactions had already been executed. Examiners commented that the CEO regularly assembled voluminous packages of operational and financial information for the Board of Directors' review—which sometimes exceeded 600 pages—but did not summarize key data regarding the bank's investment portfolio.

## Investment Impairments Increased as the Economic Conditions Worsened

Beginning in 2007, an increase in mortgage delinquencies, coupled with substantial declines in property values, led to an overall contraction in the economy. As the economic situation continued to deteriorate, the market for corporate obligations such as bonds, commercial paper, and TPS declined as many corporate entities had difficulty meeting financial commitments. Consequently, CDO investments backed by non-performing corporate obligations became critically impaired, and by 2008, major investment banks began reporting substantial losses from deteriorating CDO investments. Increasing turmoil in the financial markets led to the rapid devaluation of IBB's investment portfolio. Chart 3 below shows the increase in IBB's adversely classified assets from the June 2004 examination to the bank's final examination in October 2009.

**Chart 3: Adversely Classified Assets**



IBB recognized significant impairment losses on its CDOs in 2008 and 2009. Investment portfolio impairment losses totaled \$22.3 million for the four quarters ending December 31, 2008, and \$22.6 million for the three quarters ending September 30, 2009. Impairment losses eliminated earnings and depleted capital, and in May 2009, FRB Chicago notified IBB that the bank's PCA position fell from *well capitalized* to *adequately capitalized*.

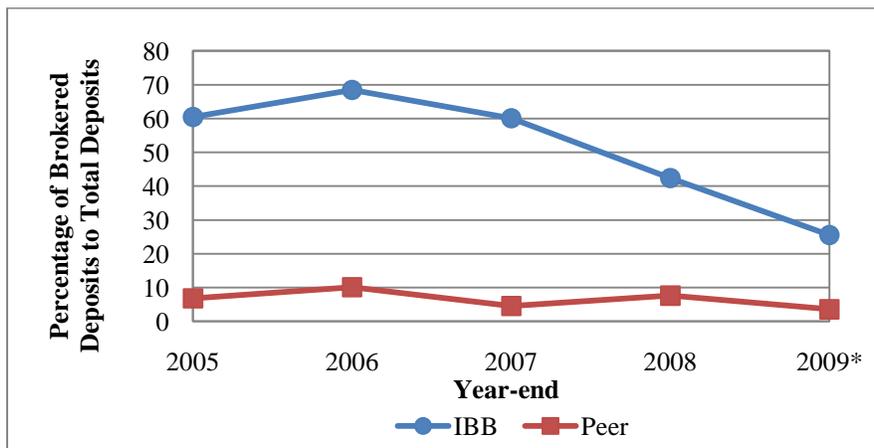
## Over-Reliance on Non-core Funding Sources Strained Liquidity

IBB primarily used non-core funding sources such as brokered deposits and federal funds purchases to fund its assets and provide its liquidity.<sup>8</sup> IBB's deteriorating financial condition and heavy reliance on non-core funding sources strained the bank's liquidity position. As shown in Chart 4, the bank's brokered deposits represented as much as 68 percent of total deposits while the peer group remained at or below 10 percent. Generally, concentrations in non-core funds can pose significant liquidity risk to an institution because the ability to accept brokered deposits and purchase federal funds is restricted to institutions of sound financial condition.

<sup>8</sup> Commercial banks are required to maintain a portion of their deposits as reserves at regional Federal Reserve Banks. Federal funds are funds in excess of reserve requirements that can be lent to other banks, most often repayable the following business day.

Once IBB was deemed no longer *well capitalized* in May 2009, the bank was prohibited from accepting, renewing, or rolling over any brokered deposits. Furthermore, IBB’s contingency lines of credit, which served as alternate funding sources, were cancelled or became unavailable in the fourth quarter of 2009.

**Chart 4: Brokered Deposits to Total Deposits**



\*Brokered deposits to total deposits as of 09/30/2009.

### Concerns about IBB’s Ability to Continue Servicing Respondent Banks

As a bankers’ bank, IBB processed transactions on behalf of its respondent banks. In doing so, the bank was required to maintain sufficient funds in an account with FRB Chicago to cover, among other things, wire transfers and automated clearing house transactions. The bank’s deteriorating financial condition adversely affected IBB’s ability to maintain sufficient liquidity to cover transactions at FRB Chicago and raised regulatory concerns about the bank’s ability to continue processing transactions on behalf of respondent banks.

On November 30, 2009, FRB Chicago required IBB to pledge \$180 million in eligible collateral by December 14, 2009. IBB’s strained liquidity and high level of impaired assets prevented the bank from satisfying the collateral requirement within the specified timeframe. On December 18, 2009, the State closed IBB under its emergency closure authority and appointed the FDIC as receiver, citing concerns about IBB’s ability to continue servicing respondent banks.

### Supervision of Independent Bankers’ Bank

FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During the period covered by our review, FRB Chicago and the State conducted five full scope examinations and one joint target examination; executed three enforcement actions—a Written Agreement, a Cease-and-Desist Order (C&D), and a Memorandum of Understanding (MOU)—and implemented the applicable provisions of PCA.

As shown in Table 1, the bank received CAMELS composite 1 (strong) ratings in 2004 and 2005, and 2 (satisfactory) ratings in 2006 and 2008. A January 2009 full scope examination resulted in a double downgrade to a CAMELS composite 4 (deficient) rating, triple downgrades of the capital and liquidity components to 4, and the execution of a Written Agreement in June 2009 to address a variety of serious deficiencies.

In September 2009, concerns over weaknesses in IBB's accounting practices resulted in a C&D that required the bank to enhance its controls over its accounting practices. During a subsequent target examination that began in October 2009, examiners found that IBB's condition had declined significantly and downgraded the bank to a CAMELS composite 5 (critically deficient) rating, expressing growing concerns for an imminent liquidity failure. As a result, in November 2009, IBB entered into an MOU that prohibited further borrowings from the federal funds agent pool.<sup>9</sup>

IBB's critically deficient financial condition prompted FRB Chicago to require that the bank pledge \$180 million of collateral by December 14, 2009, to continue processing payments on behalf of IBB's respondent banks. IBB was unable to meet the collateral requirement, and on December 18, 2009, the State closed IBB under its emergency authority and appointed the FDIC as receiver.

Our analysis of FRB Chicago's supervision of IBB revealed that examiners identified key weaknesses, such as the bank's CDO concentration in its investment portfolio, an over-reliance on non-core funding sources, and a business strategy focused on low service fees supplemented by interest income from high-risk complex investment products, but did not act on multiple opportunities to take earlier and more forceful supervisory action.

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<sup>9</sup> As a bankers' bank, IBB functioned as a federal funds agent. (See Appendix 1 for definitions of federal funds and federal funds agent pool.) IBB designated itself, in accordance with IBB's agent pool agreement, as an approved institution for borrowing these funds. Despite its deteriorating condition, IBB continued its self-designated status to borrow funds.

**Table 1: IBB Supervisory Overview**

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
6/21/2004	8/13/2004	Full	FRB	1	1	1	1	2	1	1	
5/16/2005	8/15/2005	Full	State	1	1	1	1	2	1	1	
6/5/2006	9/1/2006	Full	FRB	2	1	1	2	2	1	2	
12/16/2007	3/19/2008	Full	State	2	1	2	2	2	1	2	
1/20/2009	4/30/2009	Full	FRB	4	4	4	4	4	4	3	Written Agreement, C&D
10/13/2009	12/11/2009	Target	Joint <sup>a</sup>	5	5	5	5	5	5	4	MOU

<sup>a</sup> FDIC also participated in the examination.

### Supervision History from 2004 through 2007

In June 2004, FRB Chicago began a full scope examination that resulted in a CAMELS composite 1 rating. Examiners assigned a 1 rating to all the CAMELS components except for earnings, which received a 2. The August 2004 examination report noted that management was considered strong and risk management was satisfactory. Examiners expressed concerns, however, related to security and policies over IBB's information technology and required management to improve the bank's information security. Examiners also noted that the bank's earnings were below peer because of IBB's desire to provide low cost services to its respondent banks and the high cost of funds from a significant amount of non-core deposits.

In May 2005, the State conducted a full scope examination and again assigned the bank a CAMELS composite 1 rating, with the earnings component remaining a 2. Examiners commented that underfunded deferred compensation plan liability and expenses associated with a planned satellite office adversely affected earnings and net income. While the August 2005 examination report again noted the bank's high reliance on non-core funding, examiners stated that management adequately monitored the use of these funds.

In June 2006, FRB Chicago conducted a full scope examination that downgraded IBB's CAMELS composite rating to a 2. In addition to earnings, the management and sensitivity to market risk CAMELS components received 2 ratings. Asset quality, however, remained a 1, and

credit risk management practices were considered “strong” despite a sharp increase in classified assets from \$3 million to \$8.9 million in a 12-month period.

The September 2006 examination report indicated that IBB’s operational risk was increasing because of weaknesses in information technology. Examiners required the bank to enhance its information technology standards and practices. In addition, examiners acknowledged that the bank’s investment portfolio represented approximately 55 percent of IBB’s total assets and noted potential interest rate risk in the investment portfolio.<sup>10</sup>

Liquidity was rated strong even though IBB exhibited a high dependence on non-core funding sources. The bank’s net non-core funding dependence ratio was 79 percent compared to the peer group average of 40 percent. Examiners noted liquidity risk due to (1) IBB’s use of volatile non-core funding sources and (2) its liquidity needs for providing the funding services to its respondent banks; nonetheless, examiners stated that the bank had strong liquidity risk management practices as well as a sizeable investment portfolio that could be used as collateral for additional liquidity.

The State began a full scope examination in December 2007 that maintained IBB’s CAMELS composite 2 rating. Capital and liquidity remained at a 1 rating, and asset quality was downgraded to a 2. The March 2008 examination report indicated that classified assets increased from \$8.9 million to \$11.3 million. Furthermore, investment portfolio classifications more than doubled since the 2006 examination and represented 68 percent of total classified assets, or \$7.7 million. These classified investments included five securities related to the real estate mortgage industry and two related to the automobile industry. Despite this, liquidity was deemed “more than sufficient.” Examiners acknowledged that the bank relied heavily on non-core funding sources, but stated that management had established adequate lines of credit to mitigate any liquidity risk.

### **Investment Portfolio Deterioration Reported in 2008**

In August 2008, IBB notified FRB Chicago of significant impairments in the bank’s investment portfolio. In response, examiners suggested that the bank establish a special assets group to manage the impaired investments and mitigate potential losses. Furthermore, an FRB Chicago official proposed that IBB minimize potential losses by selling impaired investments to Bankers’ Bancorp, its bank holding company. According to examiners, the CEO was confident that the investment impairments were temporary and did not take immediate actions.

### **January 2009 Full Scope Examination Resulted in a Double Downgrade to a CAMELS Composite 4 Rating and a Written Agreement**

In January 2009, FRB Chicago conducted a full scope examination that resulted in a double downgrade to a CAMELS composite 4 rating and a formal enforcement action in the form of a June 2009 Written Agreement. FRB Chicago presented examination findings to IBB’s Board of Directors in March 2009, and an April 2009 examination report downgraded all CAMELS

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<sup>10</sup> Interest rate risk is the exposure of an institution’s financial condition to adverse movements in interest rates.

components to 4 ratings except sensitivity to market risk, which received a 3. Examiners noted significant deterioration in IBB's investment portfolio and an increased risk to capital and liquidity. The Written Agreement, among other things, required the Board of Directors to enhance investment portfolio risk management practices, develop capital and earnings plans, and strengthen liquidity management.

Examiners expressed a high degree of concern regarding a substantial increase in classified assets and a large volume of high-risk investments. Examiners concluded that asset quality was deficient and noted that classified assets increased 373 percent, from \$11 million at the December 2007 State examination to \$52 million at the January 2009 examination. Investment classifications represented 75 percent of the classified assets, totaling \$39 million. In addition, the bank recognized a \$22 million impairment loss from its investment portfolio. Examiners stated that (1) risk management practices over the investment portfolio were weak, (2) investment policies and procedures were inadequate, (3) reporting to the Board of Directors did not adequately reflect changes in the quality and composition of the investment portfolio, and (4) the bank's revenue sources and investments were not adequately diversified. Examiners concluded that the bank took on excessive risk without implementing appropriate compensating controls.

Deterioration of the investment portfolio led to liquidity deficiencies. As the quality of the investment portfolio decreased, the value of securities available as collateral for additional liquidity declined by \$39 million in 2008. In addition, impairments in the investment portfolio contributed to an \$8 million net loss, which lowered the bank's capital ratios. Although the bank remained *well capitalized* at the time of the examination, examiners warned that continued deterioration in asset quality threatened IBB's ability to maintain its PCA position and, therefore, jeopardized access to brokered deposits. Examiners required the bank to enhance liquidity risk management practices by establishing accurate liquidity measurements, developing a contingency funding plan, and implementing risk limits on non-core funding.

The management CAMELS component was also deemed deficient because inadequate oversight and controls of the investment portfolio had led to excessive risk-taking. IBB acquired CDOs to obtain higher yield and developed a concentrated, high-risk investment portfolio. Examiners noted that the Board of Directors was not fully aware of the bank's reliance on income from these investments and that management lacked sufficient understanding of the risks presented by these complex investment products. Although risk management deficiencies were evident and the management component was downgraded, examiners stated that the bank's management team was "competent and capable of overseeing the organization's internal operations and external business processes" and determined that management and the Board of Directors demonstrated "the willingness and ability to mitigate deficiencies and control weaknesses once identified."

### **A Cease-and-Desist Order Was Issued in September 2009**

In May 2009, IBB was deemed *adequately capitalized* and prohibited from accepting, renewing, or rolling over any brokered deposits. In July 2009, examiners learned that IBB sold approximately \$60 million in loans in June 2009, and then re-purchased approximately \$53

million of these loans in July 2009 in an attempt to maintain the bank's *adequately capitalized* PCA position. Examiners questioned the validity of the loan sales and required the bank to re-file its regulatory reports as of June 30, 2009. In addition, material accounting errors and improper accounting treatments identified in August 2009 necessitated re-filing of regulatory reports for multiple quarters. Shortly after the re-filings, IBB's chief financial officer was terminated. As a result of these questionable transactions, FRB Chicago's accounting specialists and fraud examiner reviewed IBB's records, and did not find any additional concerns.

In September 2009, due to examiners' concerns over IBB's inadequate financial reporting, the Federal Reserve Board, the State, and the bank entered into a C&D. According to the C&D, IBB allegedly engaged in questionable transactions and accounting practices and incomplete recordkeeping in mid-2009. The C&D required IBB to (1) have an independent accounting firm review the control over the bank's regulatory report filing process; (2) employ a qualified, full-time chief financial officer; and (3) submit a plan to enhance and ensure internal controls and the completeness and accuracy of the bank's accounting records.

### **October 2009 Target Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating and a Memorandum of Understanding**

FRB Chicago and the State conducted a joint target examination in October 2009 that resulted in IBB's CAMELS composite rating being downgraded to 5. All CAMELS component ratings were downgraded to 5 except sensitivity to market risk, which received a 4. Examiners noted a significant decline in IBB's overall condition since the January 2009 examination and stated that "failure appears imminent."

Liquidity was rated critically deficient and, according to examiners, threatened the viability of the bank. Due to the significant deterioration in the investment portfolio, IBB was unable to pledge investments as a source of liquidity. IBB historically placed high reliance on non-core funding sources; however, as stated previously, the bank was prohibited from accepting, renewing, or rolling over any brokered deposits due to its *adequately capitalized* PCA position. In addition, subsequent to the September 2009 C&D, contingency lines of credit were no longer available.

Asset quality continued to erode, mainly from further investment portfolio deterioration. Classified assets increased from \$52 million at the January 2009 examination to \$93 million, with 85 percent of the classified assets centered in the investment portfolio. IBB also recognized approximately \$23 million in an investment impairment loss for the first three quarters in 2009, and examiners predicted that the bank would incur additional impairment losses for at least the following two quarters.

IBB's unsafe and unsound condition prompted FRB Chicago to take additional supervisory actions in November 2009. FRB Chicago and the State required that the Board of Directors adopt an MOU that suspended IBB's ability to borrow any funds from the federal funds agent pool. FRB Chicago also required that IBB pledge \$180 million in collateral by December 14, 2009, to continue processing payments on behalf of IBB's respondent banks. The bank was

unable to meet this collateral requirement. As a result, on December 18, 2009, the State closed IBB under emergency provisions and appointed the FDIC as receiver.

## **Conclusions and Lessons Learned**

IBB failed because its Board of Directors and management did not effectively control the risks associated with the bank's business strategy. IBB kept service fees low to attract respondent banks and relied on interest income from its investment portfolio to supplement income. The bank acquired CDOs, primarily backed by TPS and private label mortgage-backed securities, to obtain higher yields, and developed a concentrated, high-risk investment portfolio. In addition, the bank depended on non-core funding sources to support asset growth and provide liquidity. A sharp decline in economic conditions, coupled with increasing turmoil in the CDO market, led to rapid devaluation in IBB's investment portfolio and forced the bank to recognize significant losses. These losses eliminated earnings, depleted capital, and severely strained liquidity. On December 18, 2009, the State closed IBB, under its emergency authority, due to concerns about IBB's ability to continue processing payments on behalf of respondent banks and appointed the FDIC as receiver.

With respect to supervision, FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted five full scope examinations and a joint target examination, executed three enforcement actions, and implemented the applicable PCA provisions.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. Our analysis of FRB Chicago's supervision of IBB revealed that FRB Chicago had opportunities for earlier and more forceful supervisory action.

We believe that IBB's risky business strategy should have prompted earlier and more in-depth examiner scrutiny. IBB focused on keeping service fees low to attract and retain respondent banks, leading the bank to acquire risky high-yield investments to supplement its below-peer service fee income. This strategy contributed to management assuming excessive risks by developing a concentration in higher risk CDOs. However, FRB Chicago did not assess the adequacy of the investment policies and controls over investment decisions until the January 2009 examination when the investment portfolio had already exhibited significant deterioration.

During the January 2009 examination, examiners noted that the Board of Directors had (1) not been "fully aware of how the credit risk profile of the portfolio increased significantly with the purchase of lower investment grade and otherwise risky securities," (2) failed to adequately diversify IBB's investment portfolio, and (3) developed a concentration, which ultimately contributed to the bank's failure. According to Supervision and Regulation (SR) Letter 98-12, *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, bank staff should understand the risks and cash flow characteristics of the institution's investments and be capable of managing the risks before acquiring a material position in investments such as

CDOs. In hindsight, we believe that earlier examiner scrutiny would have revealed that management and the Board of Directors did not fully understand the investment products the bank purchased and were not managing the risks, which might have prompted examiners to apply provisions in SR Letter 98-12 to restrict IBB from developing a concentration in high-risk investments.

We also believe that early indications of economic decline should have prompted a more forceful supervisory response. By 2008, signs of market deterioration were evident. The March 2008 examination report indicated that investment portfolio classifications more than doubled since the 2006 examination and totaled \$7.7 million. These classified investments included five mortgage-related and two automobile-related investments. In August 2008, IBB notified FRB Chicago that the bank's investment portfolio had significant impairments. FRB Chicago suggested that the bank establish a special group to handle the impaired investments and, to minimize potential losses, proposed selling these investments to IBB's holding company; however, management took no immediate action. FRB Chicago did not perform an on-site comprehensive evaluation of the bank's investment portfolio until the January 2009 examination. We believe that rapidly deteriorating economic conditions should have prompted examiners to (1) evaluate IBB's investments earlier and (2) compel the bank's Board of Directors and management to mitigate potential losses.

Finally, in our opinion, IBB's excessive reliance on non-core funding sources presented FRB Chicago with opportunities to take earlier and more forceful supervisory action. In general, non-core funding sources increase an institution's liquidity risk profile because deteriorating financial conditions can restrict access to such funding. Even though IBB's use of non-core funding sources significantly exceeded its peers, examiners consistently rated the bank's liquidity component a 1 and did not emphasize the need to limit funding concentrations or establish a contingency funding plan until the January 2009 examination. IBB's rapidly deteriorating financial condition during 2009 restricted the bank's access to non-core funds and resulted in the bank's inability to meet the collateral requirement to continue processing payments on behalf of its respondent banks. We believe that the bank's historically high reliance on non-core funding sources warranted an earlier supervisory action requiring IBB to limit funding concentrations and to establish contingency funding plans appropriate for a bankers' bank.

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

## **Lessons Learned**

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that IBB's failure highlights several lessons learned that can be applied when supervising banks with similar characteristics. In our opinion, examiners should obtain a comprehensive understanding of the risks embedded in investment portfolios and any external factors that may heighten these risks. Specifically,

examiners should gain thorough knowledge of investment product characteristics and risk attributes and be cognizant of market conditions or significant events that may adversely affect the value of an institution's investments. We also believe that IBB's failure underscores the unique nature of a bankers' bank and the critical functions that a bankers' bank provides to its respondent banks. Therefore, examiners should (1) closely monitor the condition of a bankers' bank to facilitate immediate response to adverse changes; and (2) evaluate risk exposure stemming from concentrations in loans, investments, and funding sources.

## **Analysis of Comments**

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response is included as Appendix 3. The Director acknowledged our conclusions and concurred with the lessons learned.

# **Appendixes**



## **APPENDIX 1 – Glossary of Banking and Regulatory Terms**

### **Automated Clearing House (ACH)**

A computer-based clearing and settlement facility for interchange of electronic debits and credits among financial institutions. ACH entries can be substituted for checks in recurring payments such as mortgages or in direct deposit distribution of federal and corporate benefit payments.

### **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**

Assets 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.

### **Concentration**

A significant amount of credit, assets, or other obligations with similar risk characteristics that a financial institution has committed to a particular industry, person, or group. These assets are similarly affected by adverse economic, financial, or business conditions, and in the aggregate, may present a risk to the institution.

### **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.

### **Correspondent Bank**

A bank that has authorized a Reserve Bank to make debit and credit entries to its master account on behalf of one or more other institutions (i.e., respondents). This term also refers to an institution that maintains a reserve balance in its master account on behalf of one or more respondents.

### **Credit Rating Agency**

A company that rates the quality of bonds and other financial securities. The rating gives a lender or investor an indication of the probability that the issuer of the bond or other security will be able to pay back the borrowed funds—that is, the rating assesses the probability of default. A poor credit rating indicates a high risk of default, thus leading the lender or investor to charge a higher interest rate or refuse to make the transaction. Well known rating agencies include

## Appendix 1 (continued)

Moody's, Standard & Poor's, and Fitch Ratings. Credit rating agencies must meet standards established by the Securities and Exchange Commission.

### Enforcement Actions

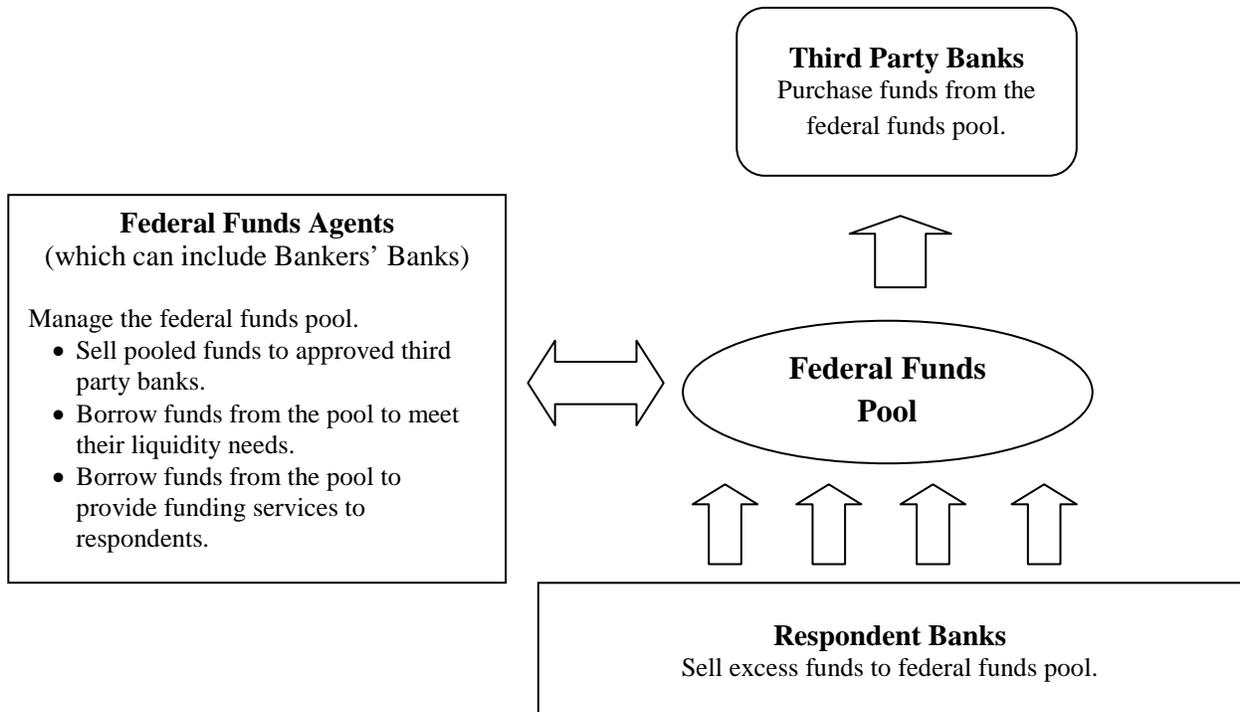
The Federal Reserve Board has a broad range of enforcement powers that include formal or informal enforcement actions that may be taken, typically after the completion of an on-site bank examination. Formal enforcement actions consist of Written Agreements, temporary Cease-and-Desist Orders, Cease-and-Desist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

### Federal Funds

Funds that commercial banks deposit in Federal Reserve Banks, including funds in excess of bank reserve requirements. Banks may lend these funds to other banks on an overnight basis at the federal funds rate.

### Federal Funds Agent Pool

The aggregate amount of federal funds sold by respondent banks to a designated agent or correspondent bank. The pool of federal funds is managed by the agent bank and either purchased in whole or in part by the agent bank, acting as principal, or sold to approved third party banks by the agent bank, acting as agent.



## **Appendix 1 (continued)**

### **Interest Rate Risk**

The exposure of an institution's financial condition to adverse movements in interest rates.

### **Investment Grade**

Corporate or municipal bonds/securities rated as high-quality by two or more credit rating agencies and, thus, considered suitable investments for banks, trust departments, and fiduciaries. (One rating may suffice if a bond/security has only been rated by one organization.) Those bonds/securities rated by Standard & Poor's and Fitch's Investors Service must be rated BBB or higher; those rated by Moody's Investors Service must be rated Baa or higher. U.S. Treasury securities and federal agency securities are also considered investment quality securities.

### **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 memorandum of understanding.

### **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.

### **Non-core Deposits**

Deposits that are generally unstable and costly. Such deposits include certificates of deposit greater than \$100,000, brokered deposits, and deposits obtained from outside a bank's general market area.

### **Private Label Mortgage-Backed Securities**

Securitized mortgages that do not meet the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation underwriting and documentation guidelines.

### **Prompt Corrective Action (PCA)**

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

## **Appendix 1 (continued)**

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

### **Respondent Bank**

A bank that settles some or all of its non-Fedwire Services transactions in another institution's master account. The term includes nonmember institutions that maintain required reserve balances through a correspondent; this is commonly referred to as a pass-through relationship.

### **Trust Preferred Securities**

Preferred securities issued by a trust subsidiary of a bank holding company.

### **Written Agreement**

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 2 – CAMELS Rating System**

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

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, 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 2 (continued)**

### **Composite 3**

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

### **Composite 4**

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

### **Composite 5**

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

## Appendix 3 – Division Director’s Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
Division of Banking Supervision and Regulation

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**Date:** March 28, 2011  
**To:** Elizabeth A. Coleman, Inspector General  
**From:** Patrick M. Parkinson, Director, Banking Supervision and Regulation (*signed*)  
**Subject:** Material Loss Review of Independent Bankers' Bank

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The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Independent Bankers’ Bank (IBB) of Springfield, Illinois, prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act, as amended. The report finds that IBB failed due to management and the Board of Directors’ failure to effectively control the risks associated with the bank’s business strategy to attract respondent banks by offering low service fees while relying on interest income from a high-risk, concentrated investment portfolio to supplement income. The investment portfolio primarily consisted of collateralized debt obligations backed by trust preferred securities and private label mortgage-backed securities. IBB was supervised by the Federal Reserve Bank of Chicago (FRB Chicago) under delegated authority from the Board.

FRB Chicago complied with examination frequency guidelines for the time period that was reviewed, 2004 through 2009. During this time FRB Chicago and the state of Illinois conducted five full scope examinations and one target examination, and conducted regular off-site monitoring. Further, supervisors executed one informal and two formal enforcement actions with IBB and implemented all applicable PCA provisions. The report recognizes that examiners identified key weaknesses that contributed to the bank’s failure, but concludes that they did not act on opportunities to take earlier and more forceful supervisory action that might have prompted management to resolve identified weaknesses. The report states that it is not possible to determine whether alternative supervisory actions would have affected IBB’s eventual decline.

Banking Supervision and Regulation staff concurs with the lessons learned in the report. Specifically, staff concurs with the report’s observations that examiners should have a comprehensive knowledge of the characteristics and risk attributes of investment portfolios while also understanding the impact external factors pose to such a portfolio. Bankers’ banks provide critical functions to respondent banks and have unique characteristics. Staff concurs that it is important to understand these characteristics, closely monitor risk exposure, and be able to immediately respond to any adverse changes in the condition of a bankers’ bank.



## **Appendix 4 – Office of Inspector General Principal Contributors to this Report**

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Sam Nop, Auditor

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