Board of Governors of the Federal Reserve System

Material Loss Review of Michigan Heritage Bank

Office of Inspector General

December 2009

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

OFFICE OF INSPECTOR GENERAL

December 18, 2009

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), as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of Michigan Heritage Bank (Michigan Heritage). The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

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

Michigan Heritage was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Michigan Office of Financial and Insurance Regulation (State). The State closed Michigan Heritage in April 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On June 22, 2009, the FDIC Inspector General notified us that Michigan Heritage's failure would result in an estimated loss to the DIF of $68.3 million, or 42.5 percent of the bank's $160.9 million in total assets.

Michigan Heritage failed because its Board of Directors and management did not adequately control the risk associated with a high concentration in the construction and land development (CLD) loan component of the bank's commercial real estate (CRE) portfolio. The bank 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. In early 2007, the Board of Directors hired new management to strengthen risk management and credit administration, but efforts to improve the deteriorating CLD loan portfolio were unsuccessful. As losses mounted, Michigan Heritage's earnings were eliminated, and capital was severely depleted. The bank was closed on April 24, 2009, after it failed to meet a regulatory deadline to either increase its capital, be acquired by another institution, or take other necessary measures to make the bank *adequately capitalized*.

With respect to supervision, FRB Chicago complied with the frequency of safety and soundness examinations prescribed in regulatory guidance and conducted off-site monitoring commensurate with concerns and risks identified during examinations. Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted additional or alternative supervisory actions. Accordingly, we believe that the circumstances examiners observed in the late 2007 to early 2008 timeframe, including (1) deteriorating economic conditions, (2) a more than four-fold increase in classified assets, and (3) concerns regarding the bank's future prospects, provided an opportunity for a stronger supervisory response, such as an appropriate enforcement action requiring management to maintain capital commensurate with an increasing risk profile.

The financial impact of the deteriorating local economy and real estate market was evident during the examination that FRB Chicago began in October 2007. Auto industry lay-offs were increasing, causing what examiners referred to as economic stagnation, particularly in the real estate market. Michigan Heritage's concentration in CLD loans made the bank vulnerable to a downturn in the real estate market. Significant asset quality deterioration was also evident, and classified assets more than quadrupled from $2.7 million to $12.5 million in a twelve-month period. Examiners warned that protracted weaknesses in the real estate market could have a significant impact on potential portfolio losses, and they noted that the 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. While 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, it is not possible to determine whether any such action would have affected Michigan Heritage's subsequent decline or the cost to the DIF.

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Michigan Heritage's failure offers a lesson learned that can be applied in supervising community banks with similar characteristics and circumstances. Michigan Heritage changed its business strategy from equipment lease financing to CRE and commercial and industrial loans; in doing so, it developed a concentration in CLD loans. Many of the problem loans that eventually led to Michigan Heritage's failure were underwritten during its lending strategy transition to CLD loans when the bank did not have the appropriate leadership, personnel, and infrastructure to support the change. Accordingly, we believe that a lesson learned from Michigan Heritage's failure is that a bank making a significant change to its business strategy warrants heightened supervisory attention, including an in-depth assessment of management's experience and capability to manage the risks associated with any new lines of business.

We provided our draft report for review and comment to the Director of the Division of Banking Supervision and Regulation. Overall, the Director agreed with our conclusion and concurred with the lesson learned, noting "the importance of heightened supervisory attention for any bank making a significant change to its business strategy." His response is included as Appendix 4.

We appreciate the cooperation that we received from FRB Chicago and Board staff during our review. The principal contributors to this report are listed in Appendix 5. 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

Elizabeth A. Coleman
Inspector General

cc: Vice Chairman Donald L. Kohn
Governor Elizabeth A. Duke
Mr. Patrick Parkinson
Ms. Cathy Lemieux

Board of Governors of the Federal Reserve System

Material Loss Review of Michigan Heritage Bank

Office of Inspector General

December 2009

Table of Contents

Background

Michigan Heritage Bank (Michigan Heritage), headquartered in Farmington Hills, Michigan, was a state-chartered member bank (SMB) of the Federal Reserve System. Michigan Heritage opened in March 1997 and had as many as five branches, which primarily served a competitive banking market in Oakland County, Michigan, where the automotive industry has a strong presence. The bank's initial business strategy focused on equipment lease financing. In 2002, its strategy changed to traditional banking, to include commercial real estate lending. Michigan Heritage was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Board), and by the Michigan Office of Financial and Insurance Regulation (State).

The State closed Michigan Heritage on April 24, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $68.3 million loss to the Deposit Insurance Fund (DIF), or 42.5 percent of the bank's $160.9 million in total assets. In a letter dated June 22, 2009, the FDIC Inspector General advised us that the FDIC had determined that Michigan Heritage's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

When a loss to the DIF is considered material, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of the failed institution, including the agency's implementation of Prompt Corrective Action, and

- ascertain why the institution's problems resulted in a loss to the DIF; and
- make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected data from the Board in Washington, D.C.; FRB Chicago; and the Michigan Office of Financial and Insurance Regulation. We also reviewed correspondence, surveillance reports, Reports of Examination (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, a key events timeline, and a description of the CAMELS rating system.[1] We conducted our fieldwork from July 2009 through September 2009, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

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

Cause of the Failure

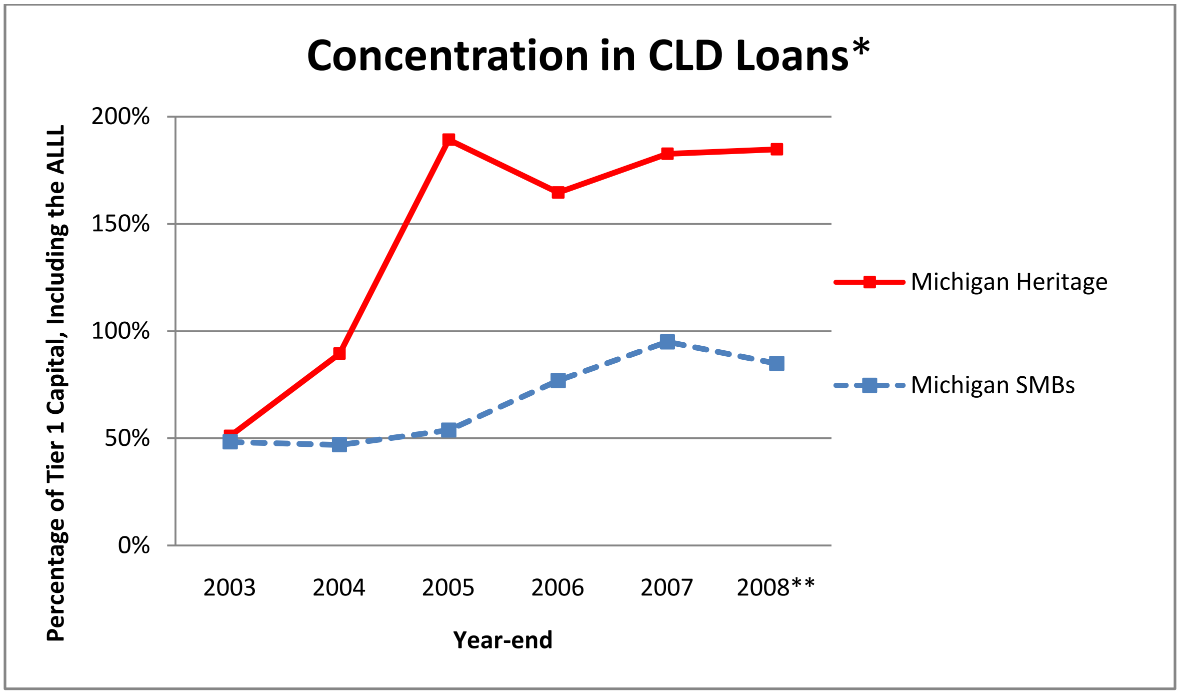
Michigan Heritage failed because its Board of Directors and management did not adequately control the risk associated with a high concentration in the construction and land development (CLD) loan component of the bank's commercial real estate (CRE) portfolio. The bank developed a CLD concentration after 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. In early 2007, the Board of Directors hired new management to strengthen risk management and credit administration, but efforts to improve the deteriorating CLD loan portfolio were unsuccessful. As losses mounted, Michigan Heritage's earnings were eliminated, and capital was severely depleted. The bank was closed on April 24, 2009, after it failed to meet a regulatory deadline to either increase its capital, be acquired by another institution, or take other necessary measures to make the bank *adequately capitalized*.

Change in Business Strategy Led to a High Concentration in CLD Loans

Michigan Heritage's business strategy focused on equipment lease financing until 2002, when the bank began transitioning its lending activities to focus on CRE and commercial and industrial loans. Michigan Heritage faced challenges when making this transition 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.

The bank's new business strategy featured significant growth in the CLD component of its commercial real estate portfolio. Michigan Heritage's CLD loans increased from zero in 2002 to $33 million in 2005. As shown in the chart below, by 2005, the bank's CLD loan concentration was almost 200 percent of Tier 1 capital, including the allowance for loan and lease losses (ALLL). In addition, Michigan Heritage's CLD concentration was significantly higher than other SMBs in the state. The bank maintained a high CLD loan concentration until it was closed.

Chart 1



*Michigan Heritage's figures are based on regulatory reports submitted by the bank. Michigan SMBs' figures represent aggregate rates for all SMBs in Michigan.

**Figure represents data available at end of the third quarter.

Deteriorating Economy Led to Significant Losses in CLD Loans

The deteriorating local economy and real estate market, along with weak risk management practices under prior management, contributed to the decline in Michigan Heritage's CLD portfolio. As shown in Table 1 (see page 12), the number of housing permits issued in Oakland County decreased 26 percent from 6,358 in 2004 to 4,686 in 2005, and dropped another 82 percent to 840 by 2008. In addition, housing prices in the bank's market area began decreasing in 2006 and fell as much as 16 percent in a one-year period. The bank's asset quality deteriorated as worsening market conditions substantially reduced the appraised value of collateral supporting CLD loans. Accordingly, Michigan Heritage's classified assets grew from $4 million in 2005 to $24 million in 2008, and examiners noted that the majority of problem loans were in the CLD portfolio. Our analysis also revealed that CLD loans accounted for 63 percent of loan loss charge-offs in 2008. [2]

---

[2] A loan is charged off when a financial institution determines it is no longer collectable.

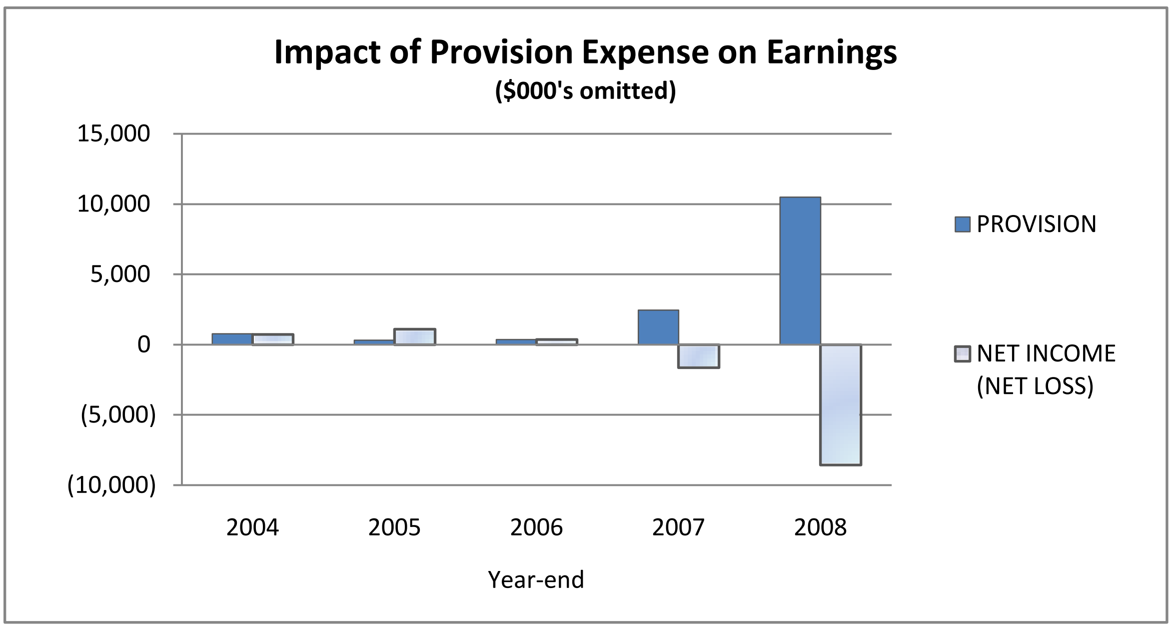
Table 1 – Selected Real Estate Data

	2003	2004	2005	2006	2007	2008
Total Housing Permits in Oakland County	5,597	6,358	4,686	2,390	1,259	840
Annual Percentage Change in Housing Price in Detroit MSA*	3.62%	3.17%	2.03%	-1.50%	-6.13%	-16.42%

*MSA – Metropolitan Statistical Areas are geographic entities defined by the U.S. Office of Management and Budget for use by federal statistical agencies in collecting, tabulating, and publishing federal statistics. Detroit MSA comprises six counties: Lapeer, Livingston, Macomb, Oakland, St. Clair, and Wayne.

The growth in classified assets prompted corresponding increases in Michigan Heritage's ALLL and loan loss provision expense (provision). As shown in Chart 2, the provision for the year ending December 31, 2006, totaled $370,000. By the end of the following year, the provision increased 576 percent to $2.5 million, contributing to the bank's 2007 net loss of $1.6 million. In 2008, the bank recognized a provision of $10.5 million, leading to a net loss of $8.6 million. The loss eliminated retained earnings and significantly reduced Michigan Heritage's capital.

Chart 2



In early 2007, Michigan Heritage's Board of Directors and management attempted to deal with the bank's deteriorating condition by hiring a group of experienced commercial bankers. The new management team immediately focused on upgrading the bank's risk management and loan underwriting practices by implementing a new loan policy, employing a more detailed loan grading system, re-grading the bank's loans, and reevaluating borrowers' financial condition. Despite these efforts, Michigan Heritage's CLD portfolio continued to decline and weaken the bank's financial condition.

Loan Portfolio Losses Eroded Capital

Michigan Heritage's deteriorating capital position invoked the Prompt Corrective Action (PCA) provisions of the FDI Act. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled depository institutions. FRB Chicago implemented PCA and made timely notifications when the bank reached various PCA capital categories. In June 2008, Michigan Heritage fell from the *well capitalized* PCA threshold to *adequately capitalized* and was restricted from accepting, renewing, or rolling over brokered deposits. Michigan Heritage's financial condition continued to decline, and its capital position dropped to *undercapitalized* in September 2008. A full scope examination that began in November 2008 revealed that the bank's loan portfolio had experienced further deterioration, and FRB Chicago required Michigan Heritage to increase its ALLL. As a result of incorporating the increase into the bank's third quarter financial data, Michigan Heritage's PCA position dropped to *significantly undercapitalized.* Ongoing examination work revealed that the bank's fourth quarter 2008 regulatory report once again understated the ALLL. Examiners instructed Michigan Heritage to increase its ALLL, and the bank's capital position fell to *critically undercapitalized* in December 2008.

On April 1, 2009, the Board issued a PCA Directive instructing Michigan Heritage to either (1) raise capital and restore the bank to *adequately capitalized*, (2) be acquired by another depository institution, or (3) take other necessary measures to make the bank *adequately capitalized* by April 15, 2009. Efforts to attract new capital or find an acquirer were unsuccessful. Michigan Heritage was closed by the State on April 24, 2009, and the FDIC was named receiver.

Supervision of Michigan Heritage Bank

FRB Chicago and the State conducted five safety and soundness examinations and a visitation in the five-year period preceding Michigan Heritage's failure in April 2009. As shown in Table 2, the bank's performance through 2006 was rated a CAMELS composite 2, which is considered satisfactory. In an FRB Chicago examination report issued in January 2008, examiners downgraded Michigan Heritage to a CAMELS composite 3 rating, which is a less than satisfactory rating, with both asset quality and earnings rated 3. Ongoing concerns regarding the deteriorating local real estate market prompted FRB Chicago to begin an asset quality target examination in June 2008. The target examination resulted in an October 2008 double downgrade to a CAMELS composite 5 rating based on deteriorating asset quality and its adverse effect on earnings, capital, and liquidity. The target examination led to a formal enforcement action. A subsequent joint examination also assigned a CAMELS composite 5 rating in a March 2009 report, and examiners questioned the bank's viability in light of its critically depleted capital position.

Table 2 – Supervisory Overview of Michigan Heritage

Examination		Agency Conducting the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
05/10/2004	5/28/2004[a]	FRB Chicago	n/a	n/a	n/a	n/a	n/a	n/a	n/a	
03/28/2005	04/27/2005	State	2	2	2	2	3	2	2	
10/16/2006	12/22/2006	FRB Chicago	2	2	2	2	3	2	2	
10/01/2007	01/14/2008	FRB Chicago	3	2	3	2	3	2	2	
06/16/2008	10/24/2008[b]	FRB Chicago	5	5	4	3	5	4	3	Written Agreement
11/03/2008	03/31/2009	Joint FRB Chicago – State	5	5	5	4	5	4	4	PCA Directive

[a] Visitation
[b] Asset quality target examination

Below is a summary of Michigan Heritage's supervision beginning with the 2007 FRB examination when the first sign of asset quality deterioration appeared.

FRB Chicago Examination Initiated in October 2007 Resulted in a CAMELS Composite 3 Rating

The report for the examination that began in October 2007 cited a significant decline in asset quality because of increasing lay-offs in the auto industry and a declining local housing market. Michigan Heritage was downgraded to a CAMELS composite 3 rating, with asset quality and earnings rated less than satisfactory. 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 twelve-month period. The majority of classified assets were in CLD and non-owner occupied real estate. 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. Examiners further noted that the real estate decline was "taking its toll" on seasoned, well-capitalized developers, and that future losses were "unpredictable." 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 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 examination report was issued, and examiners noted that they would revisit the possibility of issuing an enforcement action based on the target examination results.

2008 FRB Chicago Asset Quality Target Examination Resulted in a CAMELS Composite 5 Rating and an Enforcement Action

The asset quality target examination that began in June 2008 resulted in Michigan Heritage receiving a CAMELS composite 5 rating, a double downgrade from the CAMELS composite 3 assigned five months earlier. Banks with a CAMELS composite 5 rating exhibit extremely unsafe and unsound practices or conditions and pose a significant risk to the DIF because failure is highly probable. 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. Examiners noted that the largest classified loans were primarily in the residential construction and vacant land development loans portfolio. Examiners also commented that Michigan Heritage's capital was not sufficient to support the bank's deteriorating asset quality. The examination report acknowledged that Michigan Heritage's condition continued to worsen even though the new management team had implemented numerous corrective actions.

According to examiners, the Board of Directors realized the seriousness of the bank's condition and was exploring options for raising capital that included a "rights offering" to current shareholders, selling stock to a private investor, and merging with another financial institution. Following the target examination, in November 2008, FRB Chicago requested a formal enforcement action in the form of a Written Agreement. Executed on December 16, 2008, the Written Agreement required Michigan Heritage to submit a plan to improve the bank's capital position, resolve problem loans, strengthen the ALLL methodology, and prepare a contingency funding and business plan. In addition, the bank was required to amend and correct previously filed regulatory reports.

Joint FRB Chicago–State Examination Resulted in Another CAMELS 5 Rating and a PCA Directive

The joint full-scope examination completed in 2009 also assigned Michigan Heritage a CAMELS composite 5 rating. Examiners noted that the current real estate downturn hit the bank's CLD portfolio "particularly hard." According to examiners, asset quality was critically deficient due to a significant increase in classified assets, nonperforming loans, and loan losses. Capital was also labeled as critically deficient, and examiners predicted that capital would continue to decline due to deteriorating asset quality and negative earnings performance.

On April 1, 2009, the Board issued a PCA Directive, a type of formal enforcement action designed to resolve a bank's capital deficiencies, requiring the bank to either (1) increase its capital to an *adequately capitalized* position, (2) be acquired by another depository institution, or (3) take other necessary measures to make the bank *adequately capitalized* no later than April 15, 2009. A private investor communicated a strong interest in providing additional capital by purchasing newly issued stock of the bank's parent company. An application for the transaction was submitted to FRB Chicago on April 16, 2009, but it was quickly withdrawn. Michigan Heritage was unable to find another investor or obtain additional capital, and it was closed by the State on April 24, 2009.

Conclusions and Lesson Learned

Michigan Heritage 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. The bank 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. In early 2007, the Board of Directors hired new management to strengthen risk management and credit administration, but efforts to improve the deteriorating CLD loan portfolio were unsuccessful. As losses mounted, Michigan Heritage's earnings were eliminated, and capital was severely depleted. The bank was closed on April 24, 2009, after it failed to meet a regulatory deadline to either increase its capital, be acquired by another institution, or take other necessary measures to make the bank *adequately capitalized*.

With respect to supervision, FRB Chicago complied with the frequency of safety and soundness examinations prescribed in regulatory guidance and conducted off-site monitoring, commensurate with concerns and risks identified during examinations. Five examinations were conducted during the period spanning 2005 to 2009: three by FRB Chicago, one by the State, and one jointly. In addition, the Federal Reserve issued a Written Agreement in December 2008 and a PCA Directive in April 2009.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine whether, in hindsight, the circumstances surrounding the bank's failure warranted additional or alternative supervisory actions. Accordingly, we believe that the circumstances examiners observed in the late 2007 to early 2008 timeframe, including (1) deteriorating economic conditions, (2) a more than four-fold increase in classified assets, and (3) concerns regarding the bank's future prospects, provided an opportunity for a stronger supervisory response, such as an appropriate enforcement action requiring management to maintain capital commensurate with an increasing risk profile.

The financial impact of the deteriorating local economy and real estate market was evident during the examination that FRB Chicago began in October 2007. Auto industry lay-offs were increasing, causing what examiners referred to as economic stagnation, particularly in the real estate market. Michigan Heritage's concentration in CLD loans made the bank vulnerable to a downturn in the real estate market. Significant asset quality deterioration was also evident, and classified assets more than quadrupled from $2.7 million to $12.5 million in a twelve-month period. Examiners warned that protracted weaknesses in the real estate market could have a significant impact on potential portfolio losses and noted that the 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. While 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, it is not possible to determine whether any such action would have affected Michigan Heritage's subsequent decline or the cost to the DIF.

Lesson Learned

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Michigan Heritage's failure offers a lesson learned that can be applied in supervising community banks with similar characteristics and circumstances. Michigan Heritage changed its business strategy from equipment lease financing to CRE and commercial and industrial loans; in doing so, it developed a concentration in CLD loans. Many of the problem loans that eventually led to Michigan Heritage's failure were underwritten during its lending strategy transition to CLD loans when the bank did not have the appropriate leadership, personnel, and infrastructure to support the change. Accordingly, we believe that a lesson learned from Michigan Heritage's failure is that a bank making a significant change to its business strategy warrants heightened supervisory attention, including an in-depth assessment of management's experience and capability to manage the risks associated with any new lines of business.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. In his response, included as Appendix 4, the Director agreed with the report's conclusions and concurred that a more forceful supervisory response appeared warranted in late 2007 when significant deterioration at Michigan Heritage was evident. He also agreed with the lesson learned and noted "the importance of heightened supervisory attention for any bank making a significant change to its business strategy."

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
The ALLL is a valuation reserve established and maintained by charges against the financial institution's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.

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

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

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

Construction and Land Development (CLD) Loans
CLD loans are the subset of commercial real estate loans that provide funding for acquiring and developing land for future development and/or construction and provide interim financing for residential or commercial structures.

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

Appendix 1 (continued)

Prompt Corrective Action (PCA)
PCA is a framework of supervisory actions, set forth in 12 U.S.C. 1831o, for insured depository institutions whose capital 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*.

Rights Offering
A rights offering is the issuance of rights to current shareholders allowing them to purchase additional shares, usually at a discount to market price. Shareholders who do not exercise these rights are usually diluted by the offering.

Tier 1 Capital
Tier 1 capital is a regulatory capital measure that may include common shareholder's equity (common stock, surplus, and retained earnings), non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

Underwriting
Underwriting is a part of a bank's lending policies and procedures that enable the bank's lending staff to evaluate all relevant credit factors. These factors include the capacity of the borrower or income from the underlying property to adequately service the debt; the market value of the underlying real estate collateral; the overall creditworthiness of the borrower; and the level of the borrower's equity invested in the property.

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

Appendix 2 – Key Events Timeline

Date	Key Event
03/10/1997	Michigan Heritage opened as a state member bank in Oakland County, Michigan.
2002	Michigan Heritage began making a transition from lease financing to commercial banking business.
08/05/2002	The State began a full-scope examination. The examination report issued in December 2002 assigned a CAMELS composite 2 rating and cited weakness in loan administration.
09/29/2003	FRB Chicago began a full-scope examination. The examination report issued in December 2003 assigned a CAMELS composite 2 rating and cited an increasing level of problem loans.
05/10/2004	FRB Chicago conducted a visitation and noted progress in reducing and eliminating problem loans, yet credit administration weakness remained.
03/28/2005	The State began a full-scope examination. The examination report issued in April 2005 assigned a CAMELS composite 2 rating.
10/16/2006	FRB Chicago began a full-scope examination. The examination report issued in December 2006 assigned a CAMELS composite 2 rating.
10/01/2007	FRB Chicago began a full-scope examination. The examination report issued in January 2008 assigned a CAMELS composite 3 rating and cited a significant deterioration in asset quality because of increasing lay-offs and a declining local housing market.
06/16/2008	FRB Chicago began an asset quality target examination. The examination report issued in October 2008 resulted in a double downgrade to a CAMELS composite 5 rating, cited further decline in asset quality, and attributed the bank's problems to the stagnant local economy and distressed real estate market.
06/30/2008	Michigan Heritage fell to the *adequately capitalized* PCA designation.
09/30/2008	Michigan Heritage's PCA designation fell to *significantly undercapitalized*, effective this date, based on revised third quarter financial results.
11/03/2008	FRB Chicago and the State began a joint, full-scope examination. The examination report, issued in March 2009, assigned a CAMELS composite 5 rating reflecting Michigan Heritage's troubled condition.

Appendix 2 (continued)

Date	Key Event
12/16/2008	FRB Chicago and the State placed Michigan Heritage under a Written Agreement.
12/31/2008	Michigan Heritage fell to the *critically undercapitalized* PCA designation.
04/01/2009	The Board issued a PCA Directive requiring Michigan Heritage to either (1) increase its capital to an *adequately capitalized* position, (2) be acquired by another depository institution, or (3) take other necessary measures to make the bank *adequately capitalized* no later than April 15, 2009.
04/24/2009	The State closed Michigan Heritage and appointed FDIC as receiver.

Appendix 3 – 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 an institution's financial condition and operations. These components 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). Evaluation of the components takes 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 is the highest rating and indicates the strongest performance and risk management practices and the least degree of supervisory concern, while a 5 is the lowest rating and indicates 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 a financial institution 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 institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Appendix 3 (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 institution's 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 institution's 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 institution 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 4 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of Banking Supervision and Regulation

Date: December 10, 2009

To: Elizabeth A. Coleman, Inspector General

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

Subject: Material Loss Review of Michigan Heritage Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Michigan Heritage Bank ("Michigan Heritage"), Farmington Hills, Michigan, that was prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that Michigan Heritage failed because its Board of Directors and management did not adequately control the risk associated with the bank's highly concentrated construction and land development (CLD) loan portfolio. The decline in southeast Michigan's economy adversely affected the bank's local real estate market, and resulted in substantial reductions in the appraised value of collateral supporting the bank's CLD loans. Michigan Heritage's high concentration in CLD loans resulted in significant losses that quickly depleted the bank's capital.

We concur with the conclusion and lesson learned contained in the report. The Federal Reserve Bank of Chicago (FRB Chicago) complied with the frequency of safety and soundness examinations prescribed in regulatory guidance and accurately assessed the risks facing the bank. Nonetheless, we concur with the report's conclusion that a more forceful supervisory response appeared warranted in late 2007 when significant deterioration at Michigan Heritage was evident. We also agree, however, that it is not possible to determine the degree to which such action would have affected the bank's subsequent decline or the cost of resolution to the DIF. Last, we concur with the lesson learned highlighted in the report regarding the importance of heightened supervisory attention for any bank making a significant change to its business strategy.

This Division very much appreciates the opportunity to comment on the IG report and welcomes the report's observations and contribution to understanding the reasons for the failure of Michigan Heritage. The events described in the report are another example of the dangers of concentrations in risky assets that are subject to dramatic and swift market swings, and a reminder that the risks arising from such may be beyond a bank's ability to control.

Appendix 5 – Principal Contributors to this Report

Chie N. Hogenmiller, Project Leader and Auditor

David K. Horn, Auditor

Timothy P. Rogers, Team Leader for Material Loss Review Projects and Senior Auditor

Anthony J. Castaldo, Assistant Inspector General for Inspections and Evaluations