Board of Governors of the Federal Reserve System

Material Loss Review of Warren Bank

Office of Inspector General

April 2010

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

OFFICE OF INSPECTOR GENERAL

April 29, 2010

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 Warren Bank. 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) is material—that is, it exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

- review the institution's supervision, including the agency's implementation of Prompt Corrective Action;
- 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.

Warren Bank 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 Michigan Office of Financial and Insurance Regulation (State). The bank opened in 1998 and had as many as six branch offices and a mortgage company. It primarily served Macomb County, Michigan, where the automotive industry has a strong presence. The State closed Warren Bank on October 2, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On October 29, 2009, the FDIC Inspector General notified us that Warren Bank's failure would result in an estimated loss to the DIF of $276.3 million, or 52 percent of the bank's total assets of $530.9 million.

Warren Bank failed because its Board of Directors and management did not adequately manage loan portfolio risks as regional economic conditions began a protracted decline. Management placed a high reliance on (1) the bank's familiarity with borrowers and (2) the collateral pledged to secure loans. Warren Bank's Board of Directors and management were overly optimistic about the bank's ability to withstand the economic downturn and did not adequately manage the risks associated with its loan portfolio, which was highly concentrated in commercial real estate. In some instances, management renewed and extended loans and advanced additional funds to existing customers, apparently in the hope that market conditions would improve. However, management did not properly analyze the value of the underlying collateral and the borrowers' creditworthiness. The bank's asset quality deteriorated as underlying collateral values declined and loan defaults increased. The resulting losses eliminated earnings and depleted capital, which ultimately led to Warren Bank's failure.

With respect to supervision, for the period November 2003 through 2009, FRB Chicago complied with the frequency of safety and soundness examinations prescribed in regulatory guidance. During the six-year period preceding Warren Bank's failure in 2009, FRB Chicago and the State conducted eight examinations and three visitations, executed a Written Agreement, and issued a non-consent Prompt Corrective Action (PCA) Directive. Examiners also performed additional off-site assessments and surveillance.

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 an earlier or alternate supervisory action. Our analysis of FRB Chicago's supervision of Warren Bank revealed that examiners repeatedly criticized the bank's loan grading practices and allowance for loan and lease losses (ALLL) methodology. Despite recurring supervisory comments and findings, improvements made by bank management were insufficient to ensure that the bank's credit risk management practices were commensurate with its risk profile. Examiners also cited recurring concerns regarding Warren Bank's capital position. In 2003, examiners suggested that management maintain capital well above the PCA minimums due to the bank's high risk profile. Management was encouraged to set capital levels above its industry peer group. Similar concerns were expressed in subsequent examination reports; however, Warren Bank's year-end risk weighted capital levels never exceeded its peers.

Examiners did not issue an enforcement action compelling the bank to rectify recurring regulatory concerns regarding loan grading, the ALLL, and capital levels until September 2008. In our opinion, these recurrent examination comments and findings warranted an enforcement action as early as 2006. In addition, we believe that an earlier supervisory action requiring the bank to maintain a higher capital threshold commensurate with its high risk profile could have reduced the cost of the failure to the DIF.

We believe that Warren Bank's failure offers a lesson learned that can be applied when supervising banks with similar characteristics and circumstances. Specifically, Warren Bank's failure illustrates the importance of an early and forceful response to recurring supervisory concerns, particularly when examiners determine that capital levels are not commensurate with an institution's overall risk profile.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. Overall, the Director concurred with our conclusions and lesson 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 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

Elizabeth A. Coleman
Inspector General

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

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Background

Warren Bank, headquartered in Warren, Michigan, was a state member bank of the Federal Reserve System. The bank opened in 1998 and had as many as six branch offices and a mortgage company. It primarily served Macomb County, Michigan, where the automotive industry has a strong presence. Warren Bank 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 Michigan Office of Financial and Insurance Regulation (State).

The State closed Warren Bank on October 2, 2009, and named the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that the bank's failure would result in a $276.3 million loss to the Deposit Insurance Fund (DIF), or 52 percent of the bank's $530.9 million in total assets. In a letter dated October 29, 2009, the FDIC Inspector General advised us that the FDIC had determined that Warren Bank'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 (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 *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected data from the Federal Reserve Board in Washington, D.C., and from FRB Chicago. We also reviewed bank reports, correspondence, surveillance reports, enforcement actions, Reports of Examination (examination reports) issued between 2003 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.[1] We conducted our fieldwork from November 2009 through February 2010, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

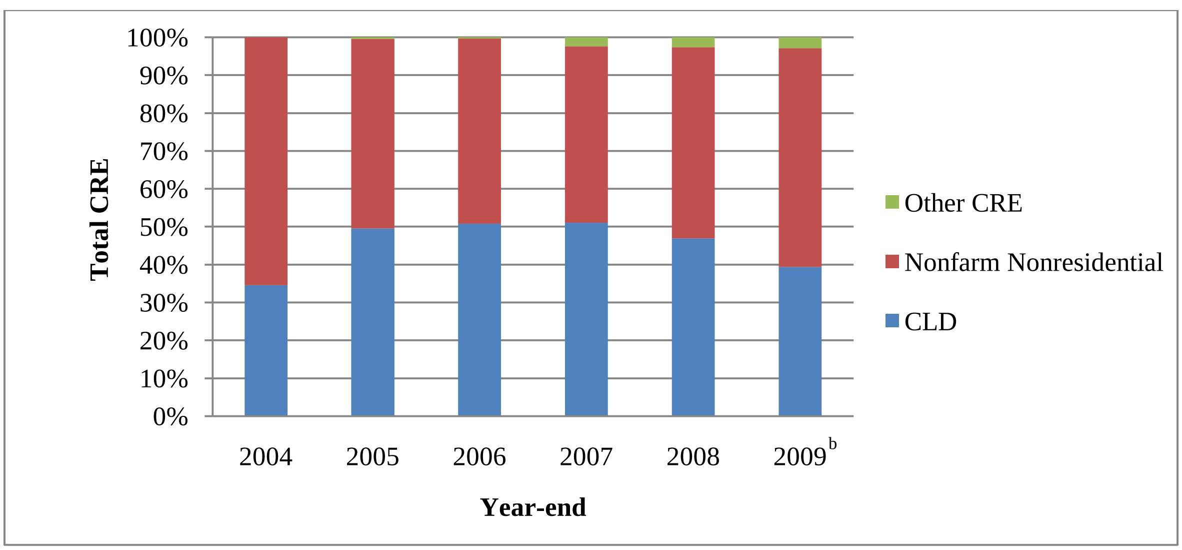
[1] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the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

Cause of the Failure

Warren Bank failed because its Board of Directors and management did not adequately manage loan portfolio risks as regional economic conditions began a protracted decline. Management placed a high reliance on (1) the bank's familiarity with borrowers and (2) the collateral pledged to secure loans. Warren Bank's Board of Directors and management were overly optimistic about the bank's ability to withstand the economic downturn and did not adequately manage the risks associated with its loan portfolio, which was highly concentrated in commercial real estate (CRE). In some instances, management renewed and extended loans and advanced additional funds to existing customers, apparently in the hope that market conditions would improve. However, management did not properly analyze the value of the underlying collateral and the borrowers' creditworthiness. The bank's asset quality deteriorated as underlying collateral values declined and loan defaults increased. The resulting losses eliminated earnings and depleted capital, which ultimately led to Warren Bank's failure.

From its opening in 1998 through 2004, Warren Bank originated CRE loans in Macomb County and the surrounding communities, achieving an annual growth rate of approximately 20 percent. By the end of 2004, CRE constituted approximately 790 percent of total capital ($45.9 million), and 70 percent of total assets ($515.8 million). The CRE concentration contributed to the high level of credit risk in the bank's loan portfolio. The bank established its market presence by relying on the Board of Directors' and management's banking experience and familiarity with local commercial real estate developers. As shown in Chart 1, the bank's CRE portfolio included construction and land development (CLD) loans.

Chart 1: Warren Bank CRE Loan Portfolio Composition[a]



[a] CRE includes owner-occupied properties.
[b] Represents 2009 data as of June 30, 2009.

Management's loan underwriting philosophy included (1) conservative loan-to-value ratios, (2) sufficient collateral, and (3) personal guarantees; however, Warren Bank's actual practices did not fully adhere to this philosophy, thereby exposing the bank to heightened credit risk. For example, a review of the bank's lending function conducted by an external party in 2005 disclosed instances of conditional loan approvals before receiving appraisals, acceptance of stale financial information from guarantors, and closure of loans before receipt of all required information. In 2006, FRB Chicago examiners criticized the bank for not following regulatory guidelines regarding the independence of the appraisal process because loan officers who were involved in the production of the loans were ordering appraisals for prospective borrowers.

Warren Bank's real estate loan portfolio was affected by a protracted decline in southeastern Michigan's auto industry that, according to examiners, began by 2004. As illustrated in Table 1, the number of residential building permits in Macomb County began to decrease in 2005, reflecting a reduced demand for housing. House prices began to decrease in 2006. At the same time, borrowers were affected by an increasing unemployment trend, as shown in Table 2. The Macomb County unemployment rates rose every year since 2004 and were at least slightly above the state average since 2005. Furthermore, the unemployment rates were markedly above the national average in all periods since 2004. By 2009, the unemployment rate for Macomb County was 15.7 percent, well over the U.S. average of 9.3 percent.

Table 1: Selected Real Estate Data[a]

	2004	2005	2006	2007	2008	2009
Number of Residential Building Permits in Macomb County	5,170	3,902	2,451	1,114	307	243
Annual Percent Change in House Prices of the Metropolitan Statistical Area including Macomb County	4.06	3.35	-1.50	-6.73	-10.97	-9.96

[a] Figures reflect numbers as of December 31, with one exception: the percent change in house prices for 2009 represents data as of September 30, 2009.

Table 2: Unemployment Rates[a]

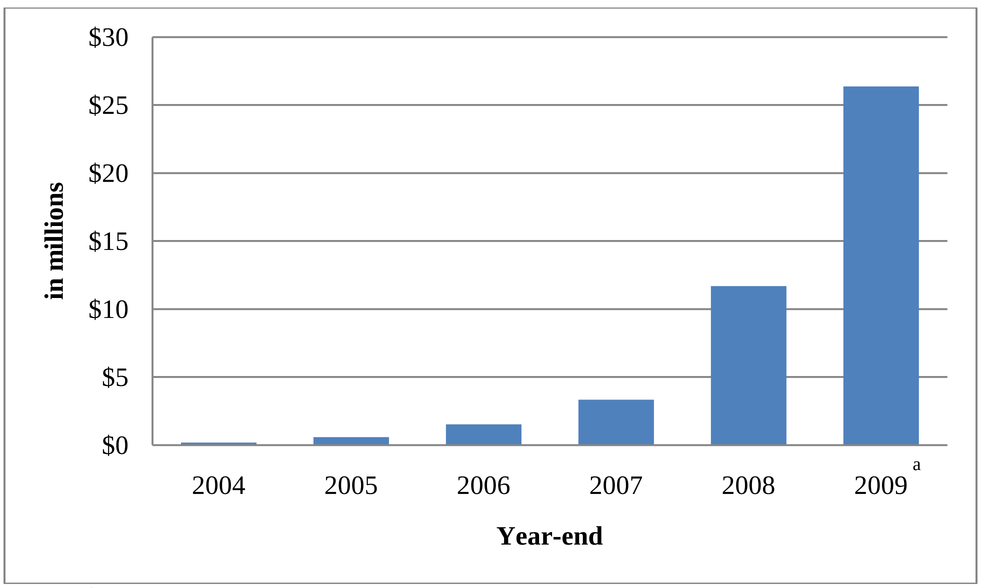
	2004	2005	2006	2007	2008	2009
Macomb County	6.8	6.9	7.2	7.4	8.8	15.7
Michigan	7.1	6.8	6.9	7.1	8.4	13.6
U.S. Average	5.5	5.1	4.6	4.6	5.8	9.3

[a] Figures reflect statistics at December 31.

Bank management relied on its collective experience and interactions with local developers to gauge the softening residential real estate market and, in 2005, curtailed lending to new borrowers in response to the market decline. Nevertheless, overall loan volume did not decrease substantially until 2009 because management extended, renewed, and originated new loans to existing customers. These practices fostered an environment that deferred problem loan identification. For example, in some instances the bank granted additional interest reserves to less creditworthy customers without adequate support, such as a collateral analysis or a documented rationale. In other cases, management allowed real estate projects to remain dormant, while waiting for market conditions to improve, and modified loan terms to interest-only. Some loans were renewed multiple times, even though the projects were stalled and the loans were non-performing. In 2007, examiners identified loans that were approved and concurrently placed on the bank's watch list because of insufficient cash flow.[2]

Warren Bank renewed and extended certain loans because management reasoned that the bank would be protected by the strength of its relationships with the borrowers and the value of the collateral supporting the loans. For example, examiners noted a case where bank management believed that a borrower would bring a loan current, despite the fact that it had been renewed three times and was considered a bad debt under Michigan law (hereafter referred to as the Michigan bad debt law), which required that the loan be written off.[3] The repayment for this loan, like many CLD loans in Warren Bank's loan portfolio, was dependent on cash flow and/or sale of the land. With demand for residential housing declining, however, land development projects stalled and properties remained unsold. As such, loan delinquencies increased, contributing to the growth in classified assets from approximately 2 percent of total loans in 2004, to 37 percent of total loans in 2009. Furthermore, in some cases, the bank assumed the underlying collateral as other real estate owned (OREO).[4] As shown in Chart 2, OREO grew from $182,000 in 2004, to $26 million by the third quarter of 2009.

Chart 2: Other Real Estate Owned



[a] Reflects volume at September 30, 2009.

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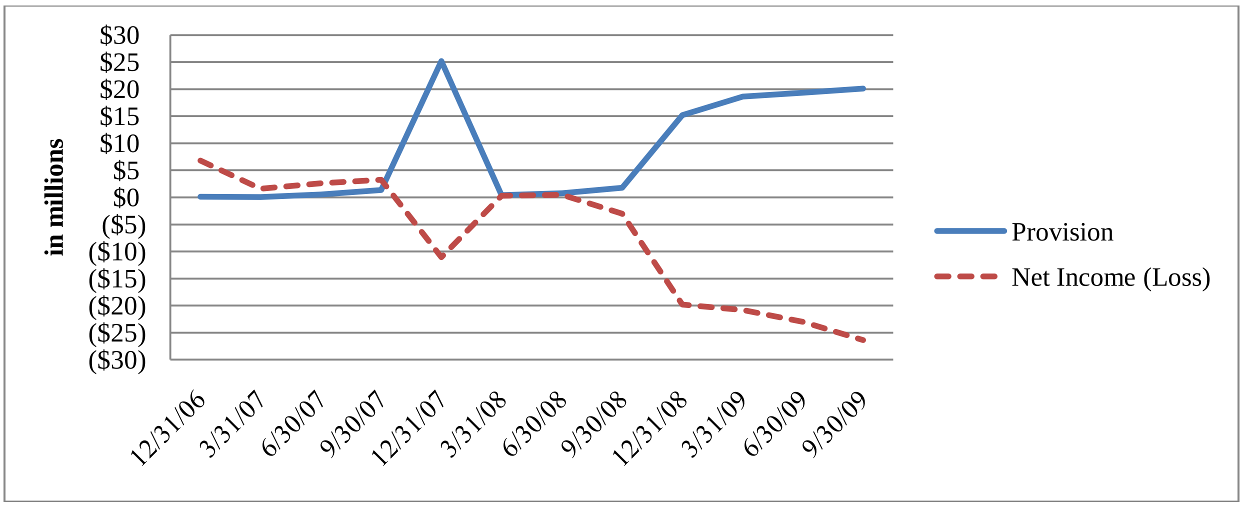
[2] Warren Bank's watch list included loans with potential weaknesses that management believed required close attention.

[3] At the time of this examination, section 4205 of the Michigan Banking Code of 1999 stated that, unless a debt is well secured and in process of collection or the debt constitutes a claim against a solvent estate in probate, a bad debt due to a bank on which interest is past due and unpaid for a period of six months shall be charged off to the allowance for loan and leases losses of the bank.

[4] OREO is real property owned by a banking institution that is not directly related to its business. OREO is often a result of foreclosure on real property because of a default by the borrower, who used the property as collateral for the loan.

The growth in classified assets prompted corresponding increases in the allowance for loan and lease losses (ALLL) and the loan loss provision expense. As shown in Chart 3, additional provision expenses had a negative effect on earnings. For the year ended December 31, 2007, examiners noted that the loan loss provision expense was underfunded by approximately $14 million, and the bank recognized a total provision expense of approximately $25 million. In the first quarter of 2008, examiners cited management for recording less provision expense than was budgeted, which enabled the bank to appear profitable. By year-end 2008, examiners once again cited the bank's provision expense as being underfunded. They required Warren Bank to record a provision expense of approximately $15 million, leading to a net loss of almost $20 million. The loss eliminated retained earnings and significantly reduced Warren Bank's capital.

Chart 3: Provision Expense and Earnings, per Quarter



FRB Chicago implemented PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled depository institutions. During a 2008 full scope examination, examiners noted that, as was mentioned above, an additional $14 million of provision expense was required for year-end 2007, which caused the bank to fall to *adequately capitalized*. However, Warren Bank obtained a capital infusion of $14 million on June 24, 2008, that restored its *well capitalized* status. The bank remained *well capitalized* until the period ending December 31, 2008, when capital levels dropped to *adequately capitalized*. The bank reported that it was *undercapitalized* effective February 28, 2009, and FRB Chicago required it to submit an acceptable capital restoration plan.

After rejecting Warren Bank's capital restoration plan, FRB Chicago sent the bank a draft PCA Directive in June 2009. After receiving Warren Bank's response indicating that the "issues and directives of the PCA are premature and, as such, are impossible to comply with in such a short time frame," the Federal Reserve Board issued a non-consent PCA Directive in July 2009. The non-consent PCA Directive cited Warren Bank's inadequate capital restoration plan and its capital status, which had slipped to *significantly undercapitalized*.[5] Warren Bank's capital continued to decline, and the bank was notified on August 4, 2009, that it had fallen to *critically undercapitalized*. Warren Bank was unable to find a merger partner or obtain additional capital and was closed by the State on October 2, 2009, which named the FDIC as receiver.

Supervision of Warren Bank

During the six-year period preceding Warren Bank's failure in 2009, FRB Chicago and the State conducted eight examinations and three visitations, executed a Written Agreement, and issued a non-consent PCA Directive. Examiners also performed additional off-site assessments and surveillance. As shown in Table 3, the bank was rated a CAMELS composite 2 (satisfactory) through an examination that was completed in April 2007. The bank was downgraded to a CAMELS composite 3 (fair) rating in late 2007 as a result of a target examination. Warren Bank was downgraded to a CAMELS composite 4 (marginal) rating seven months later, based on a joint full scope examination by FRB Chicago and the State, and a Written Agreement was recommended. In July 2008, a joint target examination that focused on asset quality resulted in a CAMELS composite 5 (unsatisfactory) rating, and the Written Agreement was executed in September 2008. A subsequent full scope examination that began in early 2009 resulted in another CAMELS composite 5 rating and a non-consent PCA Directive.

Our analysis of FRB Chicago's supervision of Warren Bank revealed that examiners had repeated criticisms of the bank's loan grading practices, ALLL methodology, and capital levels. We believe these recurrent examination comments and findings warranted earlier and stronger supervisory actions.

[5] A non-consent PCA Directive is a formal enforcement action requiring bank management to take certain actions due to the bank's weakened capital position. The Directive is issued without the Board of Directors' concurrence and allows the bank to appeal within 14 calendar days of receipt.

Table 3: Supervisory Overview of Warren Bank

Examination			Agency Conducting the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Enforcement Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
11/3/2003	2/6/2004	Full	FRB Chicago	2	2	2	2	2	2	2	
6/9/2004	7/16/2004	Visitation	FRB Chicago	N/A							
9/13/2004	10/20/2004	Visitation	FRB Chicago	N/A							
12/6/2004	2/9/2005	Full	State	2	2	2	2	2	2	2	
1/23/2006	4/13/2006	Full	FRB Chicago with State participation	2	2	2	2	2	2	2	
1/8/2007	4/13/2007	Full	Joint State and FRB Chicago	2	2	2	2	2	2	2	
7/2/2007	11/9/2007	Target	FRB Chicago with State participation	3	2	3	2	3	2	2	
1/28/2008	6/24/2008	Full	Joint FRB Chicago and State	4	4	5	4	5	4	3	Written Agreement, subsequently issued in September 2008
7/14/2008	1/23/2009	Target	FRB Chicago with State and FDIC participation	5	5	5	4	5	4	3	
12/1/2008	1/8/2009 [a]	Visitation	FRB Chicago	N/A							
2/17/2009	8/14/2009	Full	Joint State and FRB Chicago with FDIC participation	5	5	5	5	5	4	4	Non-Consent PCA Directive

[a] The results of the visitation were communicated verbally to the bank at an exit meeting.

November 2003 Full Scope Examination Resulted in a CAMELS Composite 2 Rating

In November 2003, FRB Chicago began a full scope examination. The report issued in February 2004 maintained the CAMELS composite 2 rating from the previous examination, with each component rated a 2. The examination report indicated that the bank's infrastructure had not kept pace with growth, credit risk was high, and risk management practices were weak. Examiners commented that, given the bank's inherently high risk profile, capital should be maintained well above the PCA minimums. Management was encouraged to benchmark capital ratios to its industry peer group and target capital levels above peer.[6]

Examiners noted that Warren Bank's classified assets were increasing, but management was not downgrading loans promptly or following its loan grading policy. According to examiners, the slowdown in the local economy represented "potentially troublesome situations" because Warren Bank's loans were highly dependent on the economy and, therefore, susceptible to general market downturns. Examiners also expressed concerns with the bank's ALLL methodology, which was noncompliant with regulatory guidance.

FRB Chicago Conducted Two Visitations in 2004

In June 2004, FRB Chicago conducted a visitation at Warren Bank to evaluate management's progress in addressing credit risk administration deficiencies and operational issues identified in the prior full scope examination. In the July 2004 report, examiners credited bank management for making enhancements to policies and procedures and taking steps to address FRB Chicago's issues and concerns.

FRB Chicago returned to Warren Bank in September 2004 to assess the bank's financial condition and follow up on previous recommendations. In the October 2004 visitation report, examiners again credited bank management for continuing to improve the bank's financial condition. Additionally, examiners characterized the bank's growth as "fast and deliberate."

December 2004 Full Scope Examination Resulted in a CAMELS Composite 2 Rating

In December 2004, the State began a full scope examination of Warren Bank. The report issued in February 2005 maintained the bank's CAMELS composite 2 rating, with each component rated a 2. The examination report noted that inherent credit risk was high and increasing, in part due to the growing concentration in CRE. Examiners noted that risk management policies and practices were inadequate for the lending function. Examiners stated that the bank's capital policy set minimum capital levels to achieve a *well capitalized* designation in accordance with PCA. However, examiners suggested that the Board of Directors review the appropriateness of the bank's minimum capital levels in light of its high risk profile and continued growth prospects.

Examiners expressed concerns about loan grading, independence of the loan review function, and violations of appraisal regulations. Further, examiners stated that the ALLL methodology

[6] The peer group was defined as all insured commercial banks having assets between $300 and $500 million with three or more banking offices.

needed enhancement and was not in compliance with certain generally accepted accounting principles (GAAP) and supervisory guidance. Examiners noted that two loans met the definition for troubled debt restructuring but were not identified in financial or call reports as required by GAAP. Examiners also stated that the internal loan review process for debt repayment was insufficient. Bank management was reminded that any loan for which repayment was dependent on cash flows, personal or otherwise, should include a repayment analysis.

January 2006 Full Scope Examination Resulted in a CAMELS Composite 2 Rating

In January 2006, FRB Chicago, with State participation, began a full scope examination. It resulted in a CAMELS composite 2 rating, with each component rated a 2. Examiner analysis revealed that although the bank was *well capitalized*, capital levels fell somewhat below its peer average on a risk weighted basis. Examiners stated that they expected capital targets and limits to be more closely aligned with the Board of Directors' and management's actual risk tolerance, and noted that "capital should be maintained at a level that comfortably exceeds the minimums required for *well capitalized* institutions."

In the April 2006 examination report, bank management was again asked to improve the ALLL methodology and to develop a revised loan grading system. According to examiners, the bank's grading system provided no meaningful information because 96 percent of its loans were rated pass. Examiners noted that the bank managed credit risk by relying on anecdotal information and its experience, rather than focusing on timely identification of emerging risks. Examiners cited the local economic downturn and stated that, should trends continue, borrowers' cash flows would be affected and result in a higher volume of problem assets. Examiners also stated, "Although arguably a remote possibility, a steep and protracted market downturn exposes the bank to substantial loss of earnings."

January 2007 Full Scope Examination Resulted in a CAMELS Composite 2 Rating

In January 2007, FRB Chicago and the State began a joint full scope examination of Warren Bank. The April 2007 report maintained a CAMELS composite 2 rating, with each component rated a 2. Examiners once again noted that although capital ratios were above regulatory thresholds, levels fell significantly below peer average on a risk weighted basis.

Examiners noted that the bank was operating under high credit risk conditions. A stagnant real estate market coupled with negative employment trends increased credit risk. In addition, despite incremental improvements since the last examination, examiners noted that the bank had credit management issues that again included untimely and inconsistent loan grading. Several loans reviewed by examiners were non-performing and also exhibited borrower cash flow problems, but management had graded them higher than the standard set in the bank's loan policy. Other borrowers were extended additional interest reserves without formal documentation to demonstrate transparency and policy compliance. Examiners cautioned management that using practices to mask problems and defer collection was unacceptable. Classified assets increased, most notably in the CLD component of the CRE loan portfolio. Examiners noted that the ALLL was adequate, but, despite improvements, the methodology was still not in full compliance with supervisory guidance and GAAP.

July 2007 Target Examination Resulted in Downgrading the CAMELS Composite Rating to a 3

In July 2007, FRB Chicago, with State participation, began a target examination because of the bank's high and increasing credit risk profile, elevated levels of non-performing loans, and other indicators that credit risk was increasing. The November 2007 examination report downgraded the CAMELS composite rating to a 3, as well as the asset quality and earnings component ratings. According to examiners, the downgrades reflected overall supervisory concern regarding an unfavorable economic environment, the bank's declining earnings performance, increasing levels of classified assets, and the overall risk exposure in the bank's loan portfolio.

Examiners noted that asset quality was negatively affected by several large CLD loans that defaulted due to local economic conditions. The corresponding provision expenses reduced the bank's net earnings. Examiners concluded, however, that credit risk management was acceptable and adequately managed, and that capital was satisfactory in relation to the bank's risk profile. Examiners noted that, despite anticipating further deterioration, the prospect of a composite downgrade at the next examination was unlikely.

January 2008 Full Scope Examination Resulted in Downgrading the CAMELS Composite Rating to a 4

In January 2008, FRB Chicago and the State began a joint full scope examination of Warren Bank. The June 2008 report downgraded the CAMELS composite rating to a 4. Examiners downgraded Warren Bank's component ratings for capital (from 2 to 4), asset quality (from 3 to 5), management (from 2 to 4), earnings (from 3 to 5), liquidity (from 2 to 4), and sensitivity (from 2 to 3).

Examiners noted that the overall financial condition of the bank was deficient. Economic conditions had not improved, and the extremely high volume of adversely classified assets and non-performing loans posed significant risks to the condition of the bank. According to examiners, the decline in collateral values placed Warren Bank in a precarious position, and a $14 million additional provision expense necessary to ensure an adequate ALLL produced a sizeable net loss for year-end 2007. This loss reduced capital, and resulted in the bank dropping to *adequately capitalized*. However, the Board of Directors executed an internal directive in February 2008 to increase capital levels prior to issuance of the examination report, and subsequently was able to raise additional capital to regain the bank's *well capitalized* status.

Examiners reviewed delinquent loans to ensure compliance with the Michigan bad debt law. Based on a risk-based loan review, examiners generated a list of loans that were past due over 180 days and that reflected whether the loans were well-secured and in the process of collection. In one instance, examiners recommended that the entire balance of a $5 million loan, 219 days overdue at December 31, 2007, be written off. Examiners asked the bank to perform additional analysis of the list and "write down" loans to reflect a reasonable collateral value. Furthermore, bank management was informed that it must take steps to avoid future violations of the Michigan bad debt law.

The target examination that began in July 2007 noted that credit risk was high but adequately managed; however, during the January 2008 examination, examiners found that Warren Bank's governance was insufficient, and credit risk was deemed a supervisory concern. Examiners noted that management's oversight of credit risk was not commensurate with the stressed regional market and the bank's elevated risk profile. In addition, loan grading remained an issue, and the ALLL was not in full compliance with regulatory guidance and GAAP. Examiners stated that the bank's Board of Directors and management were slow to recognize asset quality problems and that the bank was not adequately staffed to handle troubled loans. The June 2008 examination report recommended a formal enforcement action in the form of a Written Agreement.

July 2008 Target Examination Resulted in Downgrading the CAMELS Composite Rating to a 5

In July 2008, FRB Chicago, with State and FDIC participation, began a target examination that resulted in the CAMELS composite rating being downgraded to a 5. Examiners also downgraded the capital component from 4 to 5. Examiners stated that the bank was in a "critically deficient condition" primarily due to decreasing capital, a continued high volume of classified assets and non-performing loans, an inadequate ALLL, and decreased earnings.

Examiners noted that the bank was again not in compliance with the Michigan bad debt law. Based on a risk-based loan review, examiners identified approximately $9.4 million of loans that they believed should be charged off to the ALLL in accordance with the Michigan bad debt law.[7] Since the review did not cover 100 percent of the loans, examiners required the bank to (1) generate a report that included, among other things, an analysis of all loans more than 180 days overdue; and (2) determine if these loans also complied with the Michigan bad debt law. Examiners stated that management must take appropriate steps to charge off all the bad debt losses identified.

Before the examination report was issued in January 2009, a Written Agreement was executed in September 2008, pursuant to the recommendation in the previous examination. The agreement required the Board of Directors to address a variety of issues, including oversight of management and bank operations; credit risk management; loan renewals; asset improvement; the ALLL; capital; liquidity and funds management; earnings and budget; dividends; debt and stock redemptions; and executive management.

December 2008 Visitation Noted Progress Towards Written Agreement Compliance

In December 2008, FRB Chicago conducted a visitation to (1) assess the bank's liquidity, market sensitivity position, and risk management processes; and (2) follow up on issues from the previous examination and the Written Agreement. In January 2009, examiners made recommendations in the areas of liquidity and sensitivity to market risk. Examiners also noted that progress was being made towards meeting Written Agreement provisions.

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[7] The actual charge-off may have been lower than the amount shown above if the unsecured portion of the loan was less than book balance.

February 2009 Full Scope Examination Resulted in Changes to CAMELS Component Ratings, and the Bank was Issued a Non-consent PCA Directive

In February 2009, FRB Chicago and the State, with FDIC participation, began a joint full scope examination. The August 2009 examination report maintained the CAMELS composite 5 rating and changed two component ratings. Management was downgraded from 4 to 5, and sensitivity fell from 3 to 4.

Based on a preliminary analysis by examiners, the bank was still in violation of the Michigan bad debt law by an estimated $27.3 million, with 1 loan 634 days past due. However, a July 2009 change to the Michigan bad debt law modified the collection criteria and extended the past-due period from six months to one year. The amended law reduced the estimated violation amount by $7.2 million.

Based on call report data for the period ended December 31, 2008, the bank was notified that its capital level dropped to the *adequately capitalized* PCA classification. During the examination, Warren Bank's financial condition continued to deteriorate, and its PCA designation ultimately dropped to *critically undercapitalized.* The Federal Reserve Board issued a non-consent PCA Directive on July 28, 2009, which, among other things, required the bank to (1) increase 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 August 28, 2009. Warren Bank was unable to find an acquirer or obtain additional capital, and the State closed Warren Bank on October 2, 2009, appointing the FDIC as receiver.

Conclusions and Lesson Learned

Warren Bank failed because its Board of Directors and management did not adequately manage loan portfolio risks as regional economic conditions began a protracted decline. Management placed a high reliance on (1) the bank's familiarity with borrowers and (2) the collateral pledged to secure loans. Warren Bank's Board of Directors and management were overly optimistic about the bank's ability to withstand the economic downturn and did not adequately manage the risks associated with its loan portfolio, which was highly concentrated in CRE. In some instances, management renewed and extended loans and advanced additional funds to existing customers, apparently in the hope that market conditions would improve. However, management did not properly analyze the value of the underlying collateral and the borrowers' creditworthiness. The bank's asset quality deteriorated as underlying collateral values declined and loan defaults increased. The resulting losses eliminated earnings and depleted capital, which ultimately led to Warren Bank's failure.

With respect to supervision, for the period November 2003 through 2009, FRB Chicago complied with the frequency of safety and soundness examinations prescribed in regulatory guidance. During the six-year period preceding Warren Bank's failure in 2009, FRB Chicago and the State conducted eight examinations and three visitations, executed a Written Agreement, and issued a non-consent PCA Directive. Examiners also performed additional off-site assessments and surveillance.

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 an earlier or alternate supervisory action. Our analysis of FRB Chicago's supervision of Warren Bank revealed that examiners repeatedly criticized the bank's loan grading practices and ALLL methodology. Despite recurring supervisory comments and findings, improvements made by bank management were insufficient to ensure that the bank's credit risk management practices were commensurate with its risk profile. Examiners also cited recurring concerns regarding Warren Bank's capital position. In 2003, examiners suggested that management maintain capital well above the PCA minimums due to the bank's high risk profile. Management was encouraged to set capital levels above its industry peer group. Similar concerns were expressed in subsequent examination reports; however, Warren Bank's year-end risk weighted capital levels never exceeded its peers.

Examiners did not issue an enforcement action compelling the bank to rectify recurring regulatory concerns regarding loan grading, the ALLL, and capital levels until September 2008. In our opinion, these recurrent examination comments and findings warranted an enforcement action as early as 2006. In addition, we believe that an earlier supervisory action requiring the bank to maintain a higher capital threshold commensurate with its high risk profile could have reduced the cost of the failure to the DIF.

Lesson Learned

We believe that Warren Bank's failure offers a lesson learned that can be applied when supervising banks with similar characteristics and circumstances. Specifically, Warren Bank's failure illustrates the importance of an early and forceful response to recurring supervisory concerns, particularly situations when examiners determine that capital levels are not commensurate with an institution's overall risk profile.

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 concurred with our conclusion that, in hindsight, an earlier enforcement action compelling Warren Bank to rectify recurring regulatory concerns could have reduced the cost of failure to the DIF, but noted that the degree to which such cost might have been reduced cannot be determined. The Director also concurred with our lesson learned regarding the importance of an early and forceful response to recurring supervisory concerns. The Director welcomed our report's observations and contribution to understanding the reasons for Warren Bank's failure.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

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

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

Collateral
Collateral is the property or properties securing or being improved by the extension of credit.

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 primarily derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

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

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.

Delinquency
A loan is delinquent when it is unpaid within a given number of days from the payment due date as expressed in the loan agreement.

Appendix 1—*continued*

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 Prompt Corrective Action Directives, while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Generally Accepted Accounting Principles (GAAP)
Generally accepted accounting principles are standards for financial accounting established by the Financial Accounting Standards Board.

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

Michigan Bad Debt Law
Until July 2009, the Michigan bad debt law required a bank to charge off a debt to its allowance for loan and lease losses if the interest on the debt due to the bank was past due and unpaid for a period of six months, unless the debt was well secured and in the process of collection or it constituted a claim against a solvent estate in probate.

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

Non-Consent Prompt Corrective Action (PCA) Directive
A non-consent PCA Directive is an immediate formal enforcement action requiring bank management to take certain actions due to the bank's weakened capital position. The directive is issued without the Board of Directors' concurrence and allows the bank to appeal within 14 calendar days of receipt.

Other Real Estate Owned (OREO)
OREO is real estate acquired by a lender through foreclosure in satisfaction of a debt. A loan secured by foreclosed real estate is counted as a nonperforming loan in reporting loan quality in call reports.

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

Appendix 1—*continued*

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

Troubled Debt Restructuring (TDR)
TDRs are compromises (concessions) that lenders make to improve collectability or reduce losses on problem loans. These concessions emanate from a borrower's deteriorating financial condition, which in turn prompts the lender to focus on achieving the maximum recovery. Qualifying restructuring activities include one or more of the following: asset transfers, granting of equity interests, and modification of loans terms. Not all debt restructuring is considered "troubled." Loan renewals or extensions at interest rates that are equal to the current interest rate or a market rate of interest are not considered renegotiated debt.

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

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

Appendix 2 – CAMELS Rating System

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

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

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2—*continued*

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: April 28, 2010

To: Elizabeth A. Coleman, Inspector General

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

Subject: Material Loss Review of Warren Bank

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Warren Bank, Warren, Michigan, prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report finds that Warren Bank failed because its Board of Directors and management did not adequately manage loan portfolio risks as regional conditions began a protracted decline. Further, the report notes that management did not properly analyze the value of the underlying collateral and the borrowers' creditworthiness. Warren Bank was supervised by the Federal Reserve Bank of Chicago (FRB Chicago) under delegated authority from the Board.

We concur with the conclusions and lesson learned contained in the report. FRB Chicago complied with the frequency of safety and soundness examinations prescribed in regulatory guidance. Examiners repeatedly criticized the bank's loan grading practices and an ALLL methodology. Examiners also cited recurring problems regarding warren Bank's capital position. As noted in the report, during the six-year period preceding the bank's failure FRB Chicago and the State conducted eight examinations and three visitations, executed a Written Agreement and the bank was issued a non-consent PCA Directive. Examiners also performed off-site assessments and surveillance. Nonetheless, we concur with the report's conclusion that in hindsight an earlier enforcement action compelling the bank to rectify recurring regulatory concerns could have reduced the cost of failure to the FDIC deposit insurance fund, although we note the degree to which such cost might have been reduced cannot be determined.

The report highlights a lesson learned applicable to banks with similar characteristics and circumstances. In particular, the report notes the importance of an early and forceful response to recurring supervisory concerns and we concur with this conclusion

Board staff appreciates the opportunity to comment on the IG report and welcomes the reports observations and contribution to understanding the reasons for Warren Bank's failure.

Appendix 4 – Principal Contributors to this Report

Anna Saez, Project Leader and Senior Auditor

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

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