Review of the Failure of Fayette County Bank
Executive Summary, 2018-SR-B-016, September 26, 2018

Review of the Failure of Fayette County Bank

Finding

Fayette County Bank (FCB) failed primarily because of an aggressive growth strategy coupled with ineffective oversight by its board of directors, leading to declining asset quality and rapid capital depletion. In addition, the bank’s board of directors was unable to hire and retain effective management following a long-tenured Chief Executive Officer’s retirement in December 2012.

In early 2013, FCB’s board of directors encouraged the bank’s management to lead a significant and rapid expansion of the bank’s loan portfolio. The bank fueled this growth with loans that had little to no underwriting, leading to losses that eroded the bank’s capital. Board members had limited banking experience and relied heavily on external consultants to improve the bank’s condition. In late 2014, shareholders, including board members, injected sufficient capital to stabilize the bank temporarily, but management continued the bank’s poor underwriting practices. As losses from asset quality deterioration continued to mount, the bank’s capital once again fell to critical levels. FCB was unable to obtain sufficient funding to recapitalize the bank a second time, resulting in the bank’s failure.

With respect to supervision, the Federal Reserve Bank of St. Louis (FRB St. Louis) generally took decisive supervisory action to address FCB’s weaknesses and deficiencies during the time frame we reviewed, 2011 through 2017, by appropriately downgrading the bank’s CAMELS composite rating consistent with its risk profile and promptly issuing an emergency supervisory directive. FRB St. Louis’s supervisory activity included formal enforcement actions and a recommendation to implement an enforcement action against an FCB bank official.

Our review resulted in a finding related to enhanced communication between the Board of Governors of the Federal Reserve System’s Legal Division and FRB St. Louis. Because our office has recently issued a recommendation to address that communication issue, our report contains no new recommendations. In its response to our report, the Board acknowledges the conclusions in the report and outlines ongoing efforts to address the previously issued recommendation.

Purpose

In accordance with the requirements of section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, we conducted an in-depth review of the failure of FCB because the failure presented unusual circumstances that warranted an in-depth review.

Background

FCB began operations as a state chartered bank on February 26, 1915, in St. Elmo, Illinois, and became an insured depository institution on January 1, 1934. On February 28, 1941, FCB became a state member bank and was supervised by FRB St. Louis and the Illinois Department of Financial and Professional Regulation (IDFPR). On May 26, 2017, the IDFPR closed the bank and appointed the Federal Deposit Insurance Corporation as receiver.
Review of the Failure of Fayette County Bank

Finding: Communication Between the Board’s Legal Division and FRB St. Louis Examiners Can Be Improved

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MEMORANDUM

DATE: September 26, 2018

TO: Michael S. Gibson
   Director, Division of Supervision and Regulation
   Board of Governors of the Federal Reserve System

   Mark E. Van Der Weide
   General Counsel, Legal Division
   Board of Governors of the Federal Reserve System

FROM: Melissa Heist
       Associate Inspector General for Audits and Evaluations


We have completed our report on the subject evaluation. We conducted this evaluation to satisfy our statutory mandate to assess failures that do not result in a material loss to the Deposit Insurance Fund when our office determines that unusual circumstances surrounding the failure warrant such a review.

Our review resulted in a finding related to communication between the Board of Governors of the Federal Reserve System’s Legal Division and the Federal Reserve Bank of St. Louis. Because our office has recently issued a recommendation to address a similar finding, this report contains no new recommendations. We provided you with a draft of our report for review and comment. In your response, you acknowledge the conclusions in the report and outline ongoing efforts to address the previously issued recommendation. We have included your response as appendix C to our report.

We appreciate the cooperation that we received from the Division of Supervision and Regulation, the Legal Division, and the Federal Reserve Bank of St. Louis. Please contact Michael VanHuysen, Senior OIG Manager for Supervision and Regulation, or Daniel Novillo, OIG Manager, if you would like to discuss this report or any related issues.

cc: Mary Aiken, Senior Associate Director, Division of Supervision and Regulation
    Kevin Bertsch, Associate Director, Division of Supervision and Regulation
    Richard M. Ashton, Deputy General Counsel, Legal Division
    Julie Stackhouse, Executive Vice President, Supervision, Credit, Community Development, and the Center for Learning Innovation Division, Federal Reserve Bank of St. Louis
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Introduction

Background

Fayette County Bank (FCB) began operations as a state chartered bank on February 26, 1915, with one location in St. Elmo, Illinois, and became an insured depository institution on January 1, 1934. On February 28, 1941, FCB became a state member bank and was supervised by the Federal Reserve Bank of St. Louis (FRB St. Louis) under delegated authority from the Board of Governors of the Federal Reserve System (Board) and the Illinois Department of Financial and Professional Regulation (IDFPR).

FCB historically focused on originating agricultural loans in its local market and maintained a loan portfolio of approximately $12 million for several years preceding the retirement of a long-tenured Chief Executive Officer (CEO) in December 2012. Under the leadership of a new CEO, the bank pursued an aggressive growth strategy that resulted in the bank’s assets tripling in 18 months. Management implemented this strategy by making loans with little to no underwriting, including many loans to borrowers outside the bank’s local market. This approach eventually led to significant losses and a rapid decline in FCB’s financial condition.

On May 26, 2017, the IDFPR took possession of FCB for the purpose of examination, reorganization, or liquidation through receivership and subsequently appointed the Federal Deposit Insurance Corporation (FDIC) as receiver of the institution. On the same day, the FDIC entered into a purchase and assumption agreement with United Fidelity Bank from Evansville, Indiana, to assume all the deposits of FCB. In addition, United Fidelity Bank agreed to purchase approximately $28.9 million of the failed bank’s assets. The FDIC retained the remaining assets for later disposition and estimated that FCB’s failure would result in a $10.0 million loss to the Deposit Insurance Fund (DIF). Section 987 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, an act that amends section 38(k) of the Federal Deposit Insurance Act, defines a material loss to the DIF as an estimated loss in excess of $50 million.

Although the estimated loss to the DIF from the failure of FCB did not meet the material loss threshold, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires our office to assess the circumstances surrounding the bank’s failure. Upon identifying unusual circumstances, we conduct an in-depth review similar to a material loss review. Our initial unusual circumstances review uncovered several questionable business practices under bank management’s leadership, and we determined that FCB’s failure warranted an in-depth review.

1 According to the March 31, 2017, Call Report, FCB had approximately $34.4 million in total assets and $34.0 million in total deposits.

2 The $50 million materiality threshold applies to losses that occurred on or after January 1, 2014.

3 This review fulfills a statutory mandate and does not serve any investigative purposes.
Objectives, Scope, and Methodology

When a loss to the DIF presents unusual circumstances, section 38(k) of the Federal Deposit Insurance Act requires the Inspector General of the appropriate federal banking agency to prepare a report in a manner that is consistent with the requirements of a material loss review. Specifically, the Inspector General of the appropriate federal banking agency is required to undertake the following:

- 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
- make recommendations for preventing any such loss in the future

To accomplish our objectives, we reviewed FRB St. Louis’ supervision of FCB from February 2011 until its failure in May 2017. We reviewed the Federal Reserve System’s Commercial Bank Examination Manual and relevant supervisory guidance. We interviewed staff and collected relevant documentation from FRB St. Louis, the IDFPR, and the Board’s Division of Supervision and Regulation (S&R) and Legal Division. We reviewed supervisory documentation related to FCB, including enforcement actions, examination reports, examination workpapers prepared by FRB St. Louis, surveillance and watch list reports, correspondence, and relevant FDIC documents. In addition, we obtained and reviewed publicly available local market data for FCB, including economic, demographic, and real estate data.

We conducted this evaluation from September 2017 through July 2018 in accordance with the Quality Standards for Inspection and Evaluation issued by the Council of the Inspectors General on Integrity and Efficiency. Appendixes at the end of the report include a glossary of key banking and regulatory terms and a description of the CAMELS rating system.

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4 The Board’s Division of Supervision and Regulation leads the execution of supervisory responsibilities by coordinating and participating in supervisory programs and activities. Under delegated authority from the Board, the respective Federal Reserve Banks conduct banking supervision activities, such as onsite examinations and offsite monitoring.

5 The CAMELS acronym represents six components: capital adequacy, asset quality, management capability, earning performance, liquidity position, and sensitivity to market risk. For full-scope examinations, examiners assign a rating of 1 through 5 for each component and an overall composite score, with 1 indicating the least regulatory concern and 5 indicating the greatest concern.
Causes of the Failure

FCB failed primarily because of an aggressive growth strategy coupled with ineffective oversight by its board of directors, leading to declining asset quality and rapid capital depletion. In addition, the bank’s board of directors was unable to hire and retain competent management following the bank CEO’s retirement in December 2012. In early 2013, FCB’s board of directors encouraged the bank’s management to lead a significant and rapid expansion of the bank’s loan portfolio. The bank fueled this growth with loans that had little to no underwriting, leading to losses that eroded the bank’s capital. Board members had limited banking experience and relied heavily on external consultants to improve the bank’s condition. In late 2014, shareholders, including board members, injected sufficient capital to stabilize the bank temporarily, but management continued the bank’s poor underwriting practices. As losses from asset quality deterioration continued to mount, the bank’s capital once again fell to critical levels in December 2016. FCB was unable to obtain sufficient funding to recapitalize the bank a second time, and on May 26, 2017, the IDFPR closed the bank and appointed the FDIC as receiver.

Board of Directors Oversight During a Leadership Change and Strategy Shift Was Ineffective

FCB’s long-time President, CEO, and Director (CEO 1) retired from the bank at the end of 2012. Examiners stated that CEO 1 managed FCB’s loan portfolio conservatively for years, with a focus on serving the local community by making loans within the bank’s local agricultural market. Under CEO 1’s leadership, the bank maintained a total loan portfolio of approximately $12.0 million for several years prior to his retirement.

In January 2013, FCB’s board of directors appointed a new President, CEO, and Director (CEO 2) to replace CEO 1. According to examiners, the board of directors sought a fundamental change in FCB’s strategic direction as CEO 2 took over management of the bank. At the board of directors’ encouragement, CEO 2 began executing an aggressive growth strategy, facilitated in part by marketing loan products outside the bank’s local market. As a result, the bank’s loan portfolio more than tripled during the subsequent 18 months, from $12.0 million in December 2012 to $40.0 million in June 2014. To fund the bank’s loan growth, management began using brokered deposits from out-of-market customers, adding $18.1 million in brokered deposits and thereby substantially increasing the bank’s liquidity risk. FCB also entered into a business arrangement with an out-of-state mortgage company that examiners noted was “highly unusual” for a small community bank in a rural market.

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6 Liquidity risk is the potential that an institution (1) will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding or (2) cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions. Brokered deposits are funds a depository institution obtains, directly or indirectly, from or through the mediation or assistance of a deposit broker, for deposit into one or more deposit accounts. The use of brokered deposits can contribute to the weakening of a bank by allowing it to grow at an unmanageable or imprudent pace and can exacerbate the condition of a troubled bank. Once a bank’s PCA capital level falls to adequately capitalized, the bank may not accept, renew, or roll over any brokered deposit unless the FDIC grants it a waiver.
The board of directors failed to provide effective oversight of the implementation of FCB’s new growth strategy, allowing CEO 2 to grow the loan portfolio recklessly. A board member with prior banking experience retired at the end of 2012, and at the start of 2013, none of the members of FCB’s board of directors, with the exception of CEO 2, possessed any banking experience; their backgrounds were in oil production and farming. According to FRB St. Louis examiners, the board of directors had limited ability to oversee the bank’s implementation of its new strategy and failed to implement appropriate controls, such as placing limits on the pace of the bank’s growth or requiring board approval of loans, to ensure that FCB engaged in safe and sound lending practices.

By March 2014, when FRB St. Louis examiners began the first full-scope examination of FCB under CEO 2’s tenure, the bank’s financial condition had deteriorated substantially. According to an FRB St. Louis official, under the leadership of CEO 2, the bank originated some loans with no underwriting. Examiners were initially unable to assess the quality of several loans because of the absence of expected loan documentation, and they classified a total of $11.5 million in loans as special mention pending the availability of additional information. In April 2014, FRB St. Louis reacted quickly and decisively by issuing an emergency supervisory directive to FCB to address its unsafe and unsound lending practices and by revoking CEO 2’s individual lending authority. In August 2014, examiners downgraded most of the loans previously classified as special mention to substandard because of their poor quality. CEO 2 remained at the bank until his employment was terminated in September 2015. Figure 1 depicts the rapid growth of FCB’s loan portfolio beginning in June 2013 and reaching a peak in June 2014 after FRB St. Louis issued an emergency supervisory directive that required the bank to charge off several loans.

Figure 1. FCB’s Total Loans Outstanding, December 2011–December 2016

Figure 1 depicts the rapid growth of FCB’s loan portfolio beginning in June 2013 and reaching a peak in June 2014 after FRB St. Louis issued an emergency supervisory directive that required the bank to charge off several loans.

7 The emergency supervisory directive issued by FRB St. Louis on April 17, 2014, was an informal supervisory action instructing FCB to immediately cease adding new borrowers, take actions to determine the quality of its loan portfolio, take steps to enhance its liquidity, and raise additional capital. Informal supervisory actions are not enforceable, and failure to comply with those actions cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action.
Because of its lack of banking experience, the board of directors relied on external consultants to attempt to correct the deficient practices implemented by CEO 2. According to an FRB St. Louis official, the consultants also assisted the bank in hiring CEO 3 to serve on an interim basis. Examiners noted that CEO 3 had substantial experience in banking; however, examiners told us that CEO 3 became uninterested and resigned less than a year later in May 2015.

CEO 3’s replacement, CEO 4, began working at FCB in April 2015 and became CEO in June 2015. CEO 4 engaged in many of the same unsafe and unsound lending practices that led to CEO 2’s removal, such as originating new loans without adequate underwriting or collateral. As a result of these practices, examiners eventually adversely classified $2.0 million of the $3.2 million (more than 60 percent) of loans originated during CEO 4’s tenure, including $648,000 of charge-offs on two highly speculative loans that precipitated the bank’s failure. FRB St. Louis examiners questioned whether the board of directors fully understood the challenges facing the bank. The Board and FRB St. Louis issued several supervisory and enforcement actions that sought to address FCB’s poor asset quality and dire capital position, but the board of directors was unable to take sufficient action to implement effective loan underwriting controls.

**Declining Asset Quality Led to Persistent Losses and Depleted Capital**

A rapid deterioration in FCB’s asset quality resulted in losses that depleted the bank’s capital. During the second quarter of 2014, FCB shareholders injected $1.0 million in new capital in response to FRB St. Louis’s emergency supervisory directive. However, during the August 2014 examination, examiners adversely classified $13.3 million in loans—an amount equal to 33 percent of the bank’s total loans. Of those newly classified loans, examiners classified $12.6 million as substandard, $116,000 as doubtful, and $506,000 as a loss.

Examiners also noted that credit weaknesses were prevalent throughout the loan portfolio; FCB’s management failed (1) to identify borrowers’ primary source of repayment, (2) to perfect the bank’s security interest in loan collateral, or (3) to obtain an appraisal on the underlying property. Examiners noted that over 95 percent of the dollar volume of loans reviewed lacked appropriate documentation. Figure 2 depicts FCB’s total adversely classified loans and loans classified as a loss over time.

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8 Perfecting a security interest is the legal process necessary to secure an interest in property. Perfection provides the bank assurance that it has an interest in the collateral. The category of collateral will dictate the method of perfection to be used. The most common methods of perfection are (1) automatic perfection, when the security interest attaches; (2) perfection by possession; (3) the filing of a financing statement in one or more public filing offices; and (4) compliance with a state certificate of title law or central filing under a state statute other than the Uniform Commercial Code.
Figure 2. FCB’s Total Adversely Classified Loans and Loans Classified as a Loss, December 2010–December 2016

Source. OIG analysis of examination report data.

After an August 2014 examination, FRB St. Louis required the bank to take a loan loss provision expense of at least $5.3 million. This provision exceeded FCB’s total tier 1 capital of $3.9 million, leaving the bank insolvent. In October 2014, the Board issued a PCA directive requiring FCB to restore its capital to adequately capitalized, among other requirements. In December 2014, in response to the PCA directive, FCB’s shareholders injected $450,000 into the bank and created a limited liability company that purchased $5.4 million in problem loans from the bank. These actions raised FCB’s PCA status to well capitalized and decreased the amount of adversely classified loans to $7.1 million. The Board terminated this PCA directive in June 2015, the same day that FCB entered into a written agreement with FRB St. Louis.

Although this injection temporarily stabilized the bank’s capital levels, the poor underwriting practices under CEO 2 continued to affect FCB’s financial condition. Despite a significant decrease in adversely classified assets and the appointment of CEO 3, credit risk remained high because of weaknesses in the loans originated during CEO 2’s tenure. Although examiners noted some improvements in underwriting and credit administration in early 2015, asset quality remained critically deficient and examiners urged management to reduce the level of risk identified within the loan portfolio to limit future losses. CEO 3 left in May 2015, and poor underwriting practices under CEO 4 led to further asset quality deterioration.

Tier 1 capital is the sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Board determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital—namely, permanent equity.
and declines in the bank’s capital. Total adversely classified loans increased to $7.3 million in September 2015, and FCB’s capital levels again fell to undercapitalized in the fourth quarter of 2015.

The board of directors’ efforts to raise new capital were insufficient: FCB raised just $512,000 of the $2.1 million in new capital needed. In February 2016, loans classified as a loss increased to $1.0 million from $400,000 in 2015. Despite $1.1 million in net loan loss charge-offs through the third quarter of 2016, adversely classified loans totaled $7.1 million, as examiners identified additional loan impairments.

In October 2016, the bank’s capital declined to significantly undercapitalized, and the Board issued a second PCA directive to FCB. That month, examiners learned that CEO 4 made a large, highly speculative loan of $505,000 without formal board approval. In February 2017, examiners learned that CEO 4 originated another loan of $143,000 without obtaining the borrower’s financial statements. At the end of 2016 and in early 2017, examiners classified both of these loans as losses, along with the remainder of the bank’s poor quality loans. These losses eroded the bank’s capital levels to critically undercapitalized, and the board of directors was unable to secure additional capital. As a result of its inability to recapitalize, FCB failed on May 26, 2017. Figure 3 illustrates the bank’s capital levels over time.

**Figure 3. FCB’s Capital Levels, December 2011–December 2016**

Market Limitations Contributed to FCB’s Inability to Hire and Retain Competent Management

According to FRB St. Louis officials and examiners, market limitations and the bank’s limited resources contributed to the board of directors’ inability to hire and retain competent management. Examiners repeatedly emphasized the need for FCB’s board of directors to hire a qualified CEO with experience in addressing problem loans. However, FCB’s board of directors was unable to identify and retain a CEO capable of turning around the bank’s financial condition.

FCB was located in an agricultural town that is approximately 20 miles from Effingham, Illinois, the closest micropolitan statistical area. The U.S. Census Bureau estimated that as of the end of 2017, the population of St. Elmo was 1,384, and the median household income in 2016 was $33,125. Examiners believed that the lack of growth opportunities in St. Elmo rendered FCB unable to generate sufficient revenue or income to offer an attractive compensation package to a potential CEO.

According to an FRB St. Louis senior official, a “declining population, stagnant lending and business, and aging management teams” have challenged small community banks in similar rural areas across the Reserve Bank’s District. According to this official, although the management of family-owned banks has traditionally been passed down from generation to generation, recent trends have shown a steady migration of young professionals from rural areas, potentially affecting many community banks’ succession plans. This official also stated that national competitors increasingly have better technological capabilities to attract customers. A 2016 report issued jointly by the Federal Reserve System and the Conference of State Bank Supervisors outlines several similar concerns raised by community bankers, including an inability to recruit and retain expertise and a difficulty in attracting sufficient talent for future bank leadership.10

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Supervision of Fayette County Bank

From February 2011 through May 2017, FRB St. Louis complied with the examination frequency requirements outlined in section 1000.1 of the Federal Reserve System’s *Commercial Bank Examination Manual*. FRB St. Louis and the IDFPR conducted 10 examinations during that time period, including 5 full-scope examinations, 2 target examinations jointly performed by FRB St. Louis and the IDFPR, 2 limited-scope examinations, and 1 visitation. The FDIC jointly conducted a visitation with FRB St. Louis and the IDFPR and participated in 4 other examinations. Our conclusion that FRB St. Louis complied with examination frequency requirements includes our determination that FCB met the criteria for an 18-month examination cycle with the issuance of an October 2012 examination report because it received a CAMELS composite rating of 2 during the 2011 and 2012 full-scope examinations.

According to a 2012 examination report, the bank’s overall condition was *satisfactory*, with *strong* capital adequacy, *satisfactory* asset quality, and *adequate* management. However, a subsequent examination that began in March 2014 revealed FCB’s troubled condition, and FRB St. Louis downgraded the bank’s composite rating to 4. This double downgrade reflected a significant deterioration in the bank’s financial condition under the leadership of CEO 2. Five months later, during the August 2014 joint limited-scope examination, examiners downgraded the bank’s composite rating again to 5, with all components also rated 5. The bank retained the *troubled condition* designation until its failure in May 2017 (table 1).
Table 1. Supervisory Overview of Fayette County Bank, 2011–2017

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Source. FRB St. Louis and IDFPR examination reports, 2011 to 2017.

Note. This table does not include IDFPR enforcement actions against FCB.

n.r. no rating.

**FRB St. Louis Acted Aggressively After Learning of FCB’s Declining Condition**

During a full-scope examination in 2011 led by FRB St. Louis and a full-scope examination in 2012 led by the IDFPR, examiners assigned the bank a CAMELS composite rating of 2 (satisfactory) and noted that CEO 1 had considerable experience and the knowledge to appropriately supervise bank operations. Therefore, FCB was eligible for an 18-month examination cycle, with the next examination scheduled for the first quarter of 2014. Between examinations, FRB St. Louis examiners conducted offsite monitoring of the bank and reviewed the bank’s financial condition on a quarterly basis. FRB St. Louis generally expects offsite monitoring examiners to complete an institutional overview, which should include a call to the
management of each bank in their portfolio to inquire about any changes to operations.\textsuperscript{11} This expectation is specific to FRB St. Louis and is not a broader Federal Reserve System requirement.

According to FRB St. Louis examiners, in the first quarter of 2013 and again in the second quarter of 2013, FRB St. Louis experienced turnover in the role of the offsite monitoring examiner assigned to FCB. The first transition occurred as part of a planned portfolio rotation, and the second occurred because the offsite examiner accepted a new position. A third examiner assigned by FRB St. Louis to monitor FCB during the year did not make the expected call to the bank in the third quarter of 2013 as part of the quarterly institutional overview.

The missed phone call may have contributed to a short delay in FRB St. Louis's recognizing the bank's aggressive loan growth. However, we believe that it had minimal, if any, effect on the supervision of FCB because the bank had already originated the bulk of the poorly underwritten loans by that time and FRB St. Louis had already scheduled a full-scope examination for the following quarter. Further, had the offsite monitoring examiner made the expected phone call and discovered the rapid loan growth through that phone call, FRB St. Louis likely would not have been able to assess the quality of the new loans until the onsite examination began because loan documentation would not have been available until that time.

Examiners told us that they discovered the bank’s rapid loan growth when FCB’s third quarter 2013 Consolidated Reports of Condition and Income (Call Report) data became available in November 2013. In this Call Report, FCB did not accurately report its use of brokered deposits to fund its loan growth. According to an FRB St. Louis official, examiners detected this Call Report error because the bank could not have attracted enough core deposits in such a short period to fund the growth. On January 7, 2014, FRB St. Louis examiners conducted an initial scoping visit for the upcoming March 2014 full-scope examination.

When examiners began the full-scope examination on March 24, 2014, they identified unsafe and unsound practices that eventually led to a double downgrade of the bank’s CAMELS composite rating from 2 to 4. Examiners noted that CEO 2 aggressively marketed loan products outside the bank’s local market area and that the board of directors failed to ensure prudent controls were in place to promote safe and sound lending. As FCB’s loan portfolio rapidly grew, from $11.8 million in December 2012 to $28.2 million in December 2013, the bank originated many loans without obtaining the documentation necessary to support credit decisions. Without this documentation, examiners could not fully assess the quality of the loan portfolio. In addition, examiners noted that the bank had deficient liquidity, lacked contingency funding sources, and had a high risk of losing a large deposit from the out-of-state mortgage company.

In response to discovering FCB’s dire financial condition, FRB St. Louis issued an emergency supervisory directive on April 17, 2014, just weeks after beginning a March 2014 full-scope examination. Through the emergency supervisory directive, examiners sought to prompt the board of directors and bank management to take action to improve the bank’s condition before the Board and FRB St. Louis could implement a more formal enforcement action. The emergency supervisory directive required FCB to cease adding new borrowers, determine the quality of its existing loan portfolio, enhance its liquidity, and

\textsuperscript{11} Institutional overviews include background information about an institution; financial, supervisory, and risk assessments; and the Reserve Bank’s supervisory plan.
raise additional capital. This informal supervisory action led to a $1.0 million capital injection from shareholders in May 2014. However, in June 2014, FRB St. Louis submitted a memorandum to the Board recommending that FCB be placed under a written agreement to formally address the unsafe and unsound practices identified during the March examination.

The Board Issued a PCA Directive

In August 2014, as the Board prepared the written agreement, examiners began a limited-scope examination of FCB. During this examination, examiners found that the bank was “at immediate risk of failure” and downgraded FCB’s CAMELS composite rating to 5. According to examiners, unsafe and unsound banking practices by the board of directors and management continued to occur after the March 2014 examination. Examiners stated that CEO 2 lacked the ability to resolve credit administration weaknesses and that his continued involvement with the bank would result in further asset quality deterioration. Examiners identified additional loan impairments and required FCB to make an immediate loan loss provision of $5.3 million. The required provision completely depleted FCB’s capital, causing the bank to have negative equity and dropping its PCA capital category from well capitalized to critically undercapitalized.

When FRB St. Louis and the Board learned of FCB’s PCA status decline, the Board tabled preparing the written agreement and prioritized issuing a PCA directive that would address the bank’s urgent need for additional capital. On October 2, 2014, the Board issued a PCA directive that required the bank to increase equity so the bank would be designated adequately capitalized and to submit a progress report. The PCA directive also placed certain restrictions on operations, including capital distributions, new deposits, and executive compensation.

FCB’s directors responded to the PCA directive and took actions to stabilize the bank by injecting their own private capital into the bank, but losses from problem loans continued to threaten the bank’s longer-term viability. Two board members contributed $3.0 million from their personal resources to form a limited liability company and used that company to purchase $2.9 million in adversely classified loans from the bank. Board members also injected an additional $450,000 in capital on December 3, 2014. These actions infused the bank with sufficient equity to avoid closure temporarily. The limited liability company also borrowed $3.0 million from an unaffiliated bank and used the loan proceeds to purchase an additional $2.6 million in problem loans. These efforts returned FCB’s capital ratios to well capitalized levels. However, because the PCA directive remained outstanding until its termination in June 2015, FCB was subject to operating restrictions that apply to undercapitalized banks.

FRB St. Louis Issued a Written Agreement

FRB St. Louis and the IDFPR began a full-scope examination in April 2015 and found that the bank’s condition remained critically deficient despite the efforts of the board of directors to recapitalize it. FCB still held high levels of adversely classified loans and had critically deficient capital and earnings. In addition, management failed to address recommendations that FRB St. Louis cited in the previous examination and lacked sufficient banking knowledge, forcing FCB to rely on consultants to manage the bank’s operations. In June 2015, FRB St. Louis and FCB entered into a written agreement to address the financial soundness of the bank, among other things. The agreement required the board of directors to strengthen oversight and credit risk management. It also required the bank to submit several items to
FRB St. Louis, including lending and credit administration policies and procedures, a program for effectively grading the loan portfolio, a capital plan, and an earnings plan.

In October 2015, a visitation from FRB St. Louis, the IDFPR, and the FDIC determined that the bank’s overall condition had further deteriorated. Examiners expressed concerns about the viability of the bank and reiterated the need for immediate additional financial assistance. The bank’s adversely classified assets were elevated and increasing. During the visitation, FRB St. Louis examiners noted that FCB’s capital levels would likely fall to undercapitalized unless immediate actions were taken. Four months later, in February 2016, FRB St. Louis notified FCB that its PCA status had declined to undercapitalized and required FCB to submit a capital restoration plan. In March 2016, FRB St. Louis recommended that the Board issue an order of prohibition against CEO 2.

The full-scope examination that began in April 2016 revealed FCB’s critically deficient financial condition despite shareholders contributing an additional $512,000 of capital during the previous month. Examiners stated that total adversely classified loans were excessive and continued to increase, posing a direct threat to the viability of the bank. The bank’s capital position was critically deficient and continued to erode through ongoing losses. In addition, FCB failed to correct numerous weaknesses identified in previous examinations. Examiners also noted that CEO 4 did not have sufficient time, resources, or competent staff to address the problems that the bank faced. FCB failed to produce an acceptable capital restoration plan as required in the February 2016 PCA notification letter. As a result, on October 12, 2016, FRB St. Louis notified FCB that the bank’s PCA status was deemed to be significantly undercapitalized.

The Board Issued a Final PCA Directive

When a limited-scope examination began on October 24, 2016, the bank’s overall financial condition remained critically deficient. Although FRB St. Louis examiners acknowledged efforts to improve the bank’s condition and to raise additional capital, they also noted that these efforts were unsuccessful and that capital and asset quality had further deteriorated. Credit underwriting and board oversight of lending activities remained poor. Examiners learned that CEO 4 originated a highly speculative loan for $505,000 without documented board approval. Further, examiners noted that the underwriting completed prior to originating the loan did not show a tangible repayment source or collectible collateral. This loan was eventually charged off as a loss. On October 31, 2016, the Board issued a final PCA directive to FCB, requiring the bank to increase its equity and placing certain restrictions on the bank’s operations.

The results of a February 2017 target examination showed that FCB’s failure was imminent. Examiners identified the need for $314,000 in loan loss provision expenses and $149,000 in additional charges to earnings, and FCB’s PCA status declined to critically undercapitalized. Examiners also identified that the bank originated additional loans totaling $143,000 without obtaining financial statements prior to origination or documentation of any collectible collateral. Examiners required FCB to classify these loans as losses and charge them off immediately. The board of directors’ efforts to raise additional capital did not materialize, and on May 26, 2017, the IDFPR closed the bank and appointed the FDIC as receiver. Figure 4 shows a timeline of events pertaining to requests from FRB St. Louis and the issuing of enforcement actions.
Conclusion

From early 2014 through the bank’s failure in May 2017, FRB St. Louis generally took decisive supervisory action to address FCB’s weaknesses and deficiencies. In response to the findings of the first full-scope examination conducted after the bank’s change in management and strategy, FRB St. Louis issued an emergency supervisory directive that led to a capital injection of $1.0 million. In addition, FRB St. Louis appropriately downgraded the bank—first from 2 to 4, and then from 4 to 5—in a manner consistent with the bank’s risk profile.

FRB St. Louis did not conduct an expected quarterly phone call to the bank in the third quarter of 2013. However, based on the timing of the bank’s loan growth and the availability of Call Report data, we do not believe the missed phone call had a material effect on FRB St. Louis’s supervision or the bank’s financial condition.

In addition to the emergency supervisory directive, FRB St. Louis, in conjunction with the Board, issued a written agreement that sought to correct the bank’s deficient lending practices, as well as two PCA directives requiring the bank to increase its equity.
Finding: Communication Between the Board’s Legal Division and FRB St. Louis Examiners Can Be Improved

Communication between the Board’s Legal Division and FRB St. Louis following the Reserve Bank’s submission of recommendations for enforcement actions could have been more robust. FRB St. Louis submitted to the appropriate parties, including the Legal Division and S&R, recommendations for (1) a written agreement in June 2014 and (2) a prohibition order for CEO 2 in March 2016. The Board issued a written agreement to FCB in June 2015, a year after the initial recommendation, and the investigation into a possible prohibition order for CEO 2 is ongoing. The Board’s attorneys provided us with reasonable explanations for the length of time it took to issue the written agreement and to pursue the potential prohibition order; however, according to FRB St. Louis officials, the Legal Division did not keep the Reserve Bank apprised of the status of the investigation into a possible prohibition order. We attribute lapses in communication to a lack of guidance or expectations on how the Legal Division and the Reserve Banks should communicate after a Reserve Bank submits a request for action. A senior Legal Division official indicated that the division is planning to implement quarterly updates on ongoing cases to the referring Reserve Bank. Because we made a recommendation to address this issue in a prior report, we are not making a similar recommendation in this report.12

Communication Between the Legal Division and FRB St. Louis Was Limited

During interviews, multiple FRB St. Louis officials indicated that they were generally not kept apprised of the status of the Legal Division’s efforts to respond to the recommendation they made for an order of prohibition.

Under the Board’s delegations of authority, the General Counsel, with the concurrence of the Director of S&R, has responsibility for certain formal enforcement actions. The General Counsel has authority for all legal aspects of enforcement activity, while the Director of S&R is responsible for all supervisory elements. Board internal guidance outlines a procedure for Reserve Banks to simultaneously submit recommendations concerning formal enforcement actions to both the Legal Division and S&R. This simultaneous submission process allows the Legal Division to begin its review of enforcement matters early in the process. Board internal guidance also states that the Legal Division and S&R should coordinate closely with regard to any enforcement actions against banks.

In June 2014, FRB St. Louis submitted a recommendation memorandum to the Legal Division and S&R to place FCB under a written agreement. Although the Legal Division has final approval for enforcement actions, S&R is responsible for drafting them. In August 2014, the Board provided FRB St. Louis with a draft written agreement for review. An FRB St. Louis official immediately responded with additional

feedback and communicated that FCB’s capital would likely be downgraded to either significantly undercapitalized or critically undercapitalized. According to Board attorneys, upon learning of FCB’s capital deterioration, the Board began preparing a PCA directive and placed the written agreement on hold. After the bank’s capital improved to adequately capitalized in December 2014, the Board resumed drafting the written agreement. In June 2015, the Board and FRB St. Louis executed the written agreement with FCB.

In March 2016, FRB St. Louis submitted a recommendation for a prohibition order against CEO 2 to the Legal Division and S&R. An FRB St. Louis official learned that the Legal Division contacted FRB St. Louis regarding the recommendation to obtain more information, but the official did not know whether the Legal Division initiated an investigation. Subsequently, Legal Division attorneys told us that they did not consider this a high-priority case because CEO 2 no longer worked in the banking industry. As we reported in the Review of the Failure of Allied Bank, around this time, the Legal Division had limited resources available and had to balance competing priorities.

We believe that the explanations we received regarding the Legal Division’s and S&R’s actions in response to FRB St. Louis’s recommendation justify the length of time it took to issue the written agreement. However, we also believe that FRB St. Louis examiners should have been afforded status updates on the potential prohibition order. Similar to what we reported in the Review of the Failure of Allied Bank, we attribute this apparent communication breakdown to a lack of clear expectations for how the Reserve Banks and the Legal Division should communicate after a Reserve Bank submits a request for an enforcement action.

According to a senior Legal Division official, the division is assessing opportunities to increase coordination and further clarify expectations for communications to and from the Reserve Banks on recommendations for enforcement action. Specifically, the official noted that the division is planning to implement quarterly updates on ongoing cases to the referring Reserve Bank.

Management’s Response

In its response to our draft report, the Board acknowledges the conclusions in the report and outlines ongoing efforts to enhance communication between the Legal Division and Reserve Bank examiners.
Appendix A: Glossary of Banking and Regulatory Terms

adversely classified assets—Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Adversely classified assets are divided into subcategories: 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.

brokered deposits—Brokered deposits are funds a depository institution obtains, directly or indirectly, from or through the mediation or assistance of a deposit broker, for deposit into one or more deposit accounts.

Consolidated Reports of Condition and Income (Call Reports)—All state member banks are required to file Call Reports as of the last day of each calendar quarter. The bank should submit completed Call Reports no later than 30 calendar days after the report date. Call Reports provide consolidated, detailed financial information on assets, liabilities, capital, and off-balance-sheet activity, which permits a uniform analysis and comparison of the reporting bank’s data to that of other insured banks. The report also aggregates certain figures on loans to executive officers, directors, principal shareholders, and their related interest as well as information such as consolidated earnings, changes in capital accounts, and the allowance for loan and lease losses and charge-offs and recoveries.

emergency supervisory directive—A type of informal supervisory action. Informal supervisory actions are used when circumstances warrant a less severe form of action than the formal supervisory actions. Informal actions are not enforceable, and their violation cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action. Informal actions are not published or publicly available.

enforcement actions—The Board has a broad range of enforcement powers that includes formal and informal enforcement actions that may be taken, typically after the completion of an onsite bank examination. Formal enforcement actions consist of written agreements, temporary cease-and-desist orders, cease-and-desist orders, prohibition and removal orders, and PCA directives; informal enforcement actions include commitment letters, board of director resolutions, and memorandums of understanding.

institutional overview—A comprehensive document that provides background information about an institution, financial and supervisory assessments, risk assessments and risk management practices, and the supervisory plan going forward. It is generated from all the key facts, financial information analysis, and general risk discussion documented during the ongoing supervision process. The institutional overview should be updated and approved once during the supervisory cycle.
liquidity—The ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain the funds it needs, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

loan loss provision—An expense a bank incurs to set an allowance against uncollectible or impaired loans based on the likelihood of losses occurring.

micropolitan statistical area—A geographic entity defined by the federal Office of Management and Budget for use by federal statistical agencies, based on the concept of a core area with a population nucleus plus adjacent communities that have a high degree of economic and social integration with that core. To qualify as a micropolitan statistical area, the urban cluster must have a total population of at least 10,000 but less than 50,000.

prohibition order—The Board is authorized to remove any institution-affiliated party as a result of certain violations or misconduct and to prohibit the party from participating in the affairs of any financial institution or its subsidiaries in the future.

prompt corrective action—A framework of supervisory actions, set forth in title 12, section 1831o, of the United States Code, for insured depository institutions whose capital positions have declined below certain threshold levels. The framework was intended to ensure that when an institution becomes financially troubled, action is taken to resolve the problems of the institution and to incur the least possible long-term loss to the DIF. The capital categories are well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

special mention—A special mention loan is defined as having potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may, at some future date, result in the deterioration of the repayment prospects for such loans or the institution’s credit positions. Special mention loans are not considered as part of the classified assets and do not expose an institution to sufficient risk to warrant classification.

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

troubled condition—A state member bank or holding company is in troubled condition if it (1) has a composite rating, determined at its most recent examination, of 4 or 5; (2) is subject to a cease-and-desist order or a formal written agreement that requires action to improve the bank’s financial condition; or (3) is expressly informed by the Board or the Reserve Bank that it is in troubled condition.

underwriting—Detailed credit analysis preceding the granting of a loan that is based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower’s credit history; and the lender’s evaluation of the borrower’s credit needs and ability to pay.
written agreement—A formal supervisory enforcement action that is generally issued when a financial or an institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Board or a Reserve Bank that may require the financial institution or the institution-affiliated party (1) to stop engaging in specific practices or violations or (2) to take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. This enforcement action is the least severe of the formal enforcement actions.
Appendix B: 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:

- adequacy of capital
- quality of assets
- capability of management
- quality and level of earnings
- adequacy of liquidity
- sensitivity to market risk

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 Rating Definitions

Composite and component ratings are assigned based on a 1-to-5 numerical scale. The highest rating, 1, indicates the strongest performance and risk management practices and the least degree of supervisory concern, while 5 indicates the weakest performance, inadequate risk management practices, and the highest degree of supervisory concern. 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 their 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. Because there are no material supervisory concerns, the supervisory response is informal and limited.
**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 board of directors and management are not satisfactorily addressing or resolving weaknesses and problems. Financial institutions in this group generally are not capable of withstanding business fluctuations and may be significantly noncompliant with laws and regulations. Risk management practices are generally unacceptable relative to the institutions’ size, complexity, and risk profile. Close supervisory attention is required; 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 for these 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 C: Management's Response

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
DIVISIONS OF SUPERVISION AND REGULATION & LEGAL

Date: September 19, 2018
To: Melissa Heist, Associate Inspector General for Audits and Evaluations
From: Arthur W. Lindo, Acting Director, Division of Supervision and Regulation
       Mark E. Van Der Weide, General Counsel, Legal Division
Subject: Review of the Failure of Fayette County Bank

The Division of Supervision and Regulation and the Legal Division have reviewed the draft Review of the Failure of Fayette County Bank, St. Elmo, IL, prepared by the Office of Inspector General (“OIG”). The report finds that Fayette County Bank (“Bank”) failed due to significant asset quality deterioration arising from an aggressive and poorly managed growth strategy. Specifically, ineffective oversight by the bank’s board of directors allowed senior management to effectuate an aggressive growth strategy with poor underwriting practices that persisted even after an initial stabilizing capital raise in 2014. The poor lending decisions by management resulted in significant loan losses that eventually depleted the Bank’s capital. Further indication of the board of director’s ineffective oversight included their lack of banking experience, failure to hire and retain effective management, and reliance on external consultants to improve the bank’s condition.

The Federal Reserve Bank of St. Louis (“FRB St. Louis”) supervised the Bank under delegated authority from the Board of Governors of the Federal Reserve System (“Board”). The report states that FRB St. Louis generally took decisive supervisory action to address the Bank’s weaknesses and deficiencies, including appropriately downgrading the Bank’s CAMELS composite ratings, issuing an emergency supervisory directive, placing the Bank under formal enforcement actions, and making a recommendation to implement an enforcement action against an institution affiliated party of the Bank.

The Division of Supervision and Regulation and the Legal Division acknowledge the conclusions in the report. The OIG’s review of the failure of the Bank did not result in any new recommendations. The report, however, makes a finding that communication between the Legal Division and examiners at the St. Louis Reserve Bank could be improved with respect to Reserve Bank enforcement action recommendations. Because the OIG made a recommendation to address this issue in a prior report concerning the failure of Allied Bank, Mulberry, Arkansas, the OIG has not made a similar recommendation in the report on the Bank.¹ The OIG’s Allied Bank report recommended that the Legal Division should clarify expectations for communication following requests for enforcement action from the Reserve Banks.

As noted in the Divisions’ comments on the Allied Bank report, the Legal Division agrees with this recommendation and will work to further clarify expectations concerning communications to and from the Reserve Banks with respect to formal enforcement action recommendations received from the Reserve Banks. The Legal Division appreciates that the Fayette County Bank

report recognizes the Legal Division’s ongoing efforts to clarify expectations for communications to and from Reserve Banks in connection with enforcement action recommendations and the Division’s plans to implement quarterly updates on ongoing cases to the referring Reserve Bank.
## Abbreviations

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td><strong>Board</strong></td>
<td>Board of Governors of the Federal Reserve System</td>
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<td><strong>CEO</strong></td>
<td>Chief Executive Officer</td>
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<tr>
<td><strong>DIF</strong></td>
<td>Deposit Insurance Fund</td>
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<td><strong>FCB</strong></td>
<td>Fayette County Bank</td>
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<tr>
<td><strong>FDIC</strong></td>
<td>Federal Deposit Insurance Corporation</td>
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<td><strong>FRB St. Louis</strong></td>
<td>Federal Reserve Bank of St. Louis</td>
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<tr>
<td><strong>IDFPR</strong></td>
<td>Illinois Department of Financial and Professional Regulation</td>
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<td><strong>OIG</strong></td>
<td>Office of Inspector General</td>
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<tr>
<td><strong>PCA</strong></td>
<td>prompt corrective action</td>
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<td><strong>S&amp;R</strong></td>
<td>Division of Supervision and Regulation</td>
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