



Office of Inspector General



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Report No. EVAL-09-005

**Material Loss Review of Main Street Bank,
Northville, Michigan**

Office of Evaluations



oig



Background and Purpose of Evaluation

As required by section 38(k) of the Federal Deposit Insurance Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Main Street Bank (MSB), Northville, Michigan. On October 10, 2008, the Michigan Office of Financial and Insurance Regulation (OFIR) closed MSB and named the FDIC as receiver. The FDIC notified the OIG on October 17, 2008, that the total assets at closing were \$102 million, and the initial estimated loss to the Deposit Insurance Fund (DIF) was \$36 million.

MSB, a state-chartered nonmember bank, was established and insured on March 1, 2004. As a de novo bank, for its first 3 years in operation, MSB was subject to additional regulatory controls and supervision, including additional requirements imposed upon the financial institution as a result of significant changes to its original business plan. MSB had no subsidiaries or affiliates.

MSB's loan portfolio was concentrated in Commercial Real Estate (CRE), Construction, Residential Rehabilitation, and Home Equity loans. The federal financial regulators issued guidance in December 2006 on a risk management framework that identifies, measures, and controls CRE concentration risk.

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Results of Evaluation

MSB's rapid deterioration and ultimate failure can be attributed to bank management's aggressive pursuit of loan growth just 9 months after opening, fueled by a significant increase in brokered deposit funding, and resulting in concentration of higher-risk loan types, including (1) construction and development, (2) home equity, and (3) non-owner occupied residential improvement loans (rehab loans). The bank's deterioration was exacerbated by the types of loans in the concentrations being particularly vulnerable to markets with depressed and declining real estate values and high unemployment rates prevalent in the Detroit, Michigan, area where MSB operated.

The FDIC and Michigan State OFIR conducted timely and regular visitations and examinations in accordance with schedules established for de novo banks. The FDIC also provided oversight of MSB through its offsite monitoring activities. In approving MSB's revised business plan, the FDIC and OFIR imposed additional reporting requirements on MSB. However, we concluded that more aggressive or timelier supervisory actions could have been taken in several areas.

MSB Management: DSC and OFIR examiners rated MSB Management a "2" in all examinations until the April 2008 examination where examiners proposed that Management be downgraded to a "4." Examiners commented in prior Reports of Examination (ROE) that MSB's BOD was engaged in the bank's operations, and that the ratings were based, in part, on the effectiveness of bank management and the strength of MSB's monitoring of bank operations. Examiners based their proposed 2008 downgrade of Management, in part, on bank management and the BOD allowing very rapid loan growth (from 2005 to mid-2007), resulting in high potential credit risk in certain areas of MSB's lending portfolios, which ultimately caused the bank's deteriorated financial position. Examiners had noted concerns in these areas in prior examinations but neither downgraded MSB's Management rating nor initiated enforcement actions because examiners concluded that MSB management was appropriately addressing the additional risks in the loan portfolios and had committed to addressing examiners' concerns.

Loan Concentrations: MSB concentrations for construction loans exceeded supervisory criteria established in interagency guidance. Given the de novo status of MSB, examiners could have been more aggressive in 2007 by formally recommending that MSB take steps to mitigate the risks associated with the types of loan concentrations identified or initiating informal enforcement actions to address examiners' concerns about concentrations reported in the 2007 ROE.

Brokered Deposits: MSB relied heavily on brokered deposits, with levels reaching nearly 68 percent of total deposits in 2006. The 2006 and 2007 ROEs included a recommendation for MSB's BOD to monitor brokered deposits and enhance the liquidity policy to describe acceptable funding sources, respectively. However, while MSB agreed to the 2006 recommendation, bank management only agreed to consider the 2007 recommendation. Further, the FDIC waived the requirement that MSB's BOD respond to the 2007 recommendations, citing management's commitments to address the reported weaknesses as a reason for the waiver. MSB continued to rely heavily on brokered deposits through January 2008.

Business Plan Modifications: DSC allowed MSB to substantially revise its business plan 9 months after opening to include pursuing high loan growth and increased reliance on brokered deposits. In accordance with requirements associated with MSB's changes to its original business plan, the bank submitted monthly reports to the FDIC and OFIR beginning in March 2005. MSB's reports included information on concentrations and brokered deposits and served as a means by which the FDIC could have monitored key activities of the bank. While we saw some evidence of the FDIC's review of MSB's monthly reports, we did not find any FDIC communication to MSB providing feedback on the extent of concentrations or the level of brokered deposits. Further, the FDIC and OFIR waived the reporting requirement in May 2006 while MSB was still a de novo bank.

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Background and Purpose of Evaluation (continued)

According to the CRE guidance, the framework should include effective oversight by bank management, including the board of directors (BOD) and senior executives, and sound loan underwriting, credit administration, and portfolio management practices.

The evaluation objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) provisions of Section 38, in order to make recommendations for preventing such loss in the future.

Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component, and an overall composite score, is assigned a rating of "1" through "5", with "1" having the least regulatory concern and "5" having the greatest concern.

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Results of Evaluation (continued)

Examination Schedule in 2008: DSC exercised proactive supervision during 2008 by accelerating its examination schedule and joining OFIR on a joint examination of MSB in April 2008. Notwithstanding, a visitation in January or February 2008 may have been beneficial, given the asset quality, liquidity, and capital issues discussed with MSB management in December 2007.

Prompt Corrective Action: From March to September 2008, the FDIC issued four notifications to MSB alerting the bank of applicable restrictions under PCA when MSB fell below the *Well Capitalized* category. The FDIC issued the enforcement actions in accordance with PCA capital provisions. However, these PCA actions were not effective in preventing MSB's failure and the resulting material loss to the insurance fund. In addition, MSB purchased \$16 million in brokered deposits in January 2008 despite incurring a material event in December 2007 which left the bank less than well capitalized. Consistent with PCA provisions, it would have been prudent for the bank to have informed the FDIC of its capital status prior to purchasing the brokered deposits. Fortunately, the purchases did not increase the cost of MSB's failure to the fund. We also concluded that examiners could have considered using non-capital provisions of PCA in supervising MSB to curtail the bank's activities that ultimately caused a material loss to the DIF.

FHLB Advances: MSB acquired \$6 million in Federal Home Loan Bank (FHLB) advances in April and July 2008 to supplement the bank's liquidity even though the bank was less than well capitalized. FHLB advances are an important source of liquidity intended primarily to promote residential and small business lending. DSC indicated that MSB used FHLB advances appropriately and that the advances were important to preventing a disruptive liquidity failure. However, FHLB advances can increase the cost of bank failures to the FDIC because such secured borrowings subordinate the FDIC's position at resolution and must be paid first. FDIC guidance references regulatory restrictions on FHLB advances for banks operating without adequate tangible capital. However, the guidance does not fully address how DSC should monitor or restrict institutions' use of FHLB advances. The implication of FHLB advances on the supervisory approach to a troubled institution is an issue requiring further corporate study.

The FDIC OIG plans to issue a series of summary reports on material loss reviews and will make appropriate recommendations related to the failure of MSB and other FDIC-supervised banks at that time.

Management Response

DSC provided a written response to the draft of this report. DSC generally agreed with our conclusions regarding the causes of MSB's failure. However, DSC stated that its supervisory actions were both timely and appropriate for MSB's situation. Our view remains that more aggressive or timelier supervisory actions could have been taken to address risks associated with MSB's plans, operations, and financial condition. Regarding our observation related to MSB's use of FHLB advances during the period that the bank was receiving PCA capital notifications, DSC stated that MSB acquired FHLB advances to improve its liquidity position and not to fund growth or further lending. We acknowledge that MSB was using the advances for liquidity, which poses less risk than aggressive growth. Nevertheless, the FHLB advances can reduce an institution's franchise value and increase FDIC resolution costs, as discussed in the Corporation's recent guidance to institutions on volatile or special funding sources. Given the risk to the insurance fund, additional and more specific examination procedures in this area may be warranted. DSC's response did not address the consideration of non-capital PCA provisions or the timing of brokered deposit purchases MSB made when the bank apparently knew it was no longer well capitalized. We continue to suggest these issues warrant further study. Finally, DSC's response describes a number of initiatives that it has taken related to the supervision of MSB and similarly situated institutions. These initiatives include providing examiners with additional information for risk analysis purposes, issuing guidance, revising supervisory approaches, and training.

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ACRONYMS

ALCO	Asset and Liability Committee
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
CAMELS	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity, and <u>S</u> ensitivity to Market Risk
C&D	Cease and Desist
CFO	Chief Financial Officer
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
CRO	Chicago Regional Office
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
DFO	Detroit Field Office
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI Act	Federal Deposit Insurance Act
FHLB	Federal Home Loan Bank
FIAP Manual	<i>Formal and Informal Action Procedures Manual</i>
FIL	Financial Institution Letter
HELOC	Home Equity Line of Credit
MOU	Memorandum of Understanding
MSB	Main Street Bank, Northville, Michigan
OFIR	Office of Financial and Insurance Regulation (Michigan)
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System



DATE: April 15, 2009

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

FROM: /S/
Stephen M. Beard
Assistant Inspector General for
Evaluations and Management

SUBJECT: *Material Loss Review of Main Street Bank,
Northville, Michigan* (Report No. EVAL-09-005)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss¹ review of the failure of Main Street Bank (MSB), Northville, Michigan. On October 10, 2008, the Michigan Office of Financial and Insurance Regulation (OFIR) closed MSB and named the FDIC as receiver. On October 17, 2008, the FDIC notified the OIG that MSB's total assets at closing were \$102 million and the material loss to the Deposit Insurance Fund (DIF) was \$36 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA), and ascertains why the institution's problems resulted in a material loss to the DIF.

The evaluation objectives were to: (1) determine the causes of MSB's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38 of the FDI Act, in order to make recommendations for preventing such loss in the future. Appendix I contains details on our objectives, scope, and methodology. Appendix II contains a glossary of terms used in this report.

The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs safety and soundness examinations of FDIC-supervised institutions to assess their overall financial condition, management practices and policies, and compliance with applicable laws and regulations; and

¹ As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of \$25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.

(2) issues related guidance to institutions and examiners. Through the examination process, DSC also assesses the adequacy of management and internal control systems to identify and control risks.

Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six areas represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each area is given a rating of "1" through "5," with "1" having the least regulatory concern and "5" having the greatest concern. The Glossary in Appendix II contains further details.

This report presents the FDIC OIG's analysis of MSB's failure and the FDIC's efforts to require MSB's management to operate the bank in a safe and sound manner. The FDIC OIG plans to issue a series of summary reports on the material loss reviews it is conducting and will make appropriate recommendations related to the failure of MSB and other FDIC-supervised banks at that time. The summary reports will include major causes, trends, and common characteristics of financial institution failures resulting in a material loss to the DIF. Recommendations in the summary reports will address the FDIC's supervision of the institutions, including implementation of PCA provisions of section 38.

BACKGROUND

MSB was a state-chartered nonmember bank, established by the OFIR and insured by the FDIC, effective March 1, 2004. MSB, headquartered in Northville, Michigan, was owned by Main Street Bancorp, Inc., a one bank holding company, and had two branches -- one in Northville, Michigan (closed in early 2008) and one in Plymouth, Michigan. MSB had no subsidiaries or affiliates, other than its parent. MSB's initial business plan involved offering traditional deposit and credit products to its local community -- residential mortgage products, consumer loans, and loans to area businesses, including commercial real estate (CRE) and small business loans. MSB projected that its total assets would reach \$71 million at the end of the third year of business.

DSC's Detroit Field Office (DFO) and OFIR conducted safety and soundness examinations of MSB. With the exception of the April 2008 joint FDIC and OFIR examination, MSB was rated a CAMELS composite "2" since receiving deposit insurance in 2004. Examinations were conducted in February 2005 (DSC), January 2006 (OFIR), February 2007 (DSC), and April 2008 (Joint).² In addition, DSC conducted a 6-month visitation beginning in August 2004, and DSC and OFIR completed a 6-month offsite review in August 2007. Although MSB received a composite "2" rating at the February 2007 examination, examiners reported some asset quality weaknesses and concerns with higher-risk loan types such as construction loans, home equity lines of

² The Report of Examination (ROE) for the April 21, 2008 examination was a draft report and was not officially issued to MSB.

credit (HELOC), and residential rehabilitation loans.³ At the 2008 examination, MSB’s composite rating was downgraded to a “5” due to severe asset quality problems, negative earnings, and capital erosion. On July 22, 2008, the FDIC and OFIR issued a Cease and Desist (C&D) Order.⁴ On September 12, 2008, MSB was officially notified that it was “Critically Undercapitalized” for PCA purposes. On October 10, 2008, OFIR closed MSB and named the FDIC as receiver. Appendix III is a chronology of significant events leading up to the failure of MSB. Appendix IV illustrates the results of DSC’s and OFIR’s examinations of MSB.

Table 1 provides a snapshot of MSB’s financial condition as of March 2008 – the Call Report date used for the last examination of the Bank in April 2008 – and for the 4 preceding years.

Table 1: Financial Condition of Main Street Bank

	Mar.-08	Dec.-07	Dec.-06	Dec.-05	Dec.-04
Total Assets (Dollars in Thousands)	\$131,877	\$136,947	\$140,788	\$95,001	\$31,945
Total Deposits (Dollars in Thousands)	\$119,904	\$121,785	\$122,770	\$84,329	\$25,615
Total Loans (Dollars in Thousands)	\$ 95,811	\$104,709	\$117,867	\$79,516	\$25,311
<i>Net Loan Growth Rate</i>	-23.08%	-11.16%	48.23%	214.16%	n/a
Net Income (Loss) (Dollars in Thousands)	(\$3,185)	(\$4,978)	\$458	(\$804)	(\$1,207)
Loan Mix (% of Avg. Gross Loans):					
All Loans Secured by Real Estate					
Construction and Development	19.62%	21.96%	26.88%	17.96%	5.42%
CRE – Non-farm/non-residential	25.46%	22.13%	16.81%	17.76%	21.24%
Multifamily Residential RE	.76%	.99%	1.04%	1.25%	n/a
1-4 Family Residential (includes HELOCs)	42.57%	42.60%	43.75%	49.07%	56.88%
HELOCs	13.59%	12.39%	16.94%	24.61%	29.84%
Adversely Classified Items Coverage Ratio*	227.10%	35.59%	3.64%	0	0
Examination As of Dates	3-31-2008	12-31-2006	9-30-2005	12-31-2004	6-30-2004

Source: Uniform Banking Performance Report (*UBPR*) and Reports of Examination.

*Note: This ratio is a measure of the level of asset risk and the ability of capital to protect against that risk, and it is the most commonly referenced asset quality ratio.

³ Rehabilitation loans (referred to as “Rehab Loans”) are loans made to investors for the purpose of acquiring distressed properties in disrepair, making necessary improvements, and reselling the properties for a profit.

⁴ Congress has given the FDIC and other federal bank supervisory agencies additional and intermediary powers with respect to banks engaging in or about to engage in unsafe or unsound practices or violations of laws or regulations. This authority permits the use of “Cease and Desist” orders in situations where available facts and evidence reasonably support the conclusion that a bank is engaging in or about to engage in an unsafe or unsound practice or violation of law.

RESULTS IN BRIEF

MSB's rapid deterioration and ultimate failure can be primarily attributed to bank management's aggressive pursuit of loan growth just 9 months after opening, fueled by a significant increase in brokered deposit funding, and resulting in concentration of higher-risk loan types, including (1) construction and development, (2) home equity, and (3) non-owner occupied residential improvement (rehab) loans. The bank's deterioration was exacerbated by the types of loans in the concentrations being particularly vulnerable to markets with depressed and declining real estate values and high unemployment rates prevalent in the Detroit, Michigan area where MSB operated. MSB management and the board of directors (BOD) allowed for rapid growth throughout the bank's de novo⁵ period, which resulted in the concentration of high-risk loan products. This strategy left the bank highly vulnerable to weaknesses in the loan administration process, the economic downturn, and declining real estate values.

The FDIC and OFIR conducted timely and regular examinations in accordance with regulatory schedules⁶ established for de novo banks. In addition, DSC conducted its initial limited-scope examination of MSB (6-month visitation), within the timeframe prescribed by DSC regional guidance. The FDIC also provided oversight of MSB through its offsite monitoring activities. Further, in approving MSB's revised business plan, the FDIC and OFIR imposed additional reporting requirements on MSB. In regard to PCA, enforcement actions addressing MSB's capital deficiencies in 2008 were taken in accordance with PCA capital provisions.

However, the FDIC could have exercised more aggressive or timelier supervision in several areas related to MSB management, loan concentrations, brokered deposits, business plan revisions, and the 2008 examination schedule. We also made several observations regarding non-capital PCA provisions; the timing of brokered deposit purchases and PCA notifications; and the implications of MSB's use of Federal Home Loan Bank (FHLB) advances as a source of liquidity.

CAUSES OF MSB's FAILURE

MSB Management's Attention to the Bank's Safety and Soundness: MSB management and the BOD allowed for rapid growth throughout the bank's de novo period, which resulted in the concentration of high-risk loan products. This strategy left the bank highly vulnerable to weaknesses in the loan administration process, the economic downturn, and declining real estate values.

⁵ For purposes of this report, de novo refers to the first 3 years of the financial institution's operations.

⁶ Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires an annual full-scope, onsite examination of every state nonmember bank at least once during each 12-month period and allows for 18-month intervals under certain circumstances. In the case of de novo banks, subsequent to the first examination and through the third year of operation, at least one examination should be performed each year.

MSB's Aggressive Pursuit of Loan Growth: In December 2004, 9 months after being established, MSB requested a modification to its original business plan because the bank was experiencing a higher demand for CRE and consumer loans than originally projected, and that demand outpaced its core deposit growth. MSB's revised business plan included increasing its brokered deposits and initiating two capital-raising campaigns to allow for a projected growth in assets to \$129 million at the end of year three. In November 2005, MSB requested a second modification to its business plan--revising the plan slightly to request an additional increase in total loans and total brokered deposits at December 31, 2005, which would result in total assets of \$133 million at the end of year three. MSB experienced a rapid growth in assets from the time of the business plan modification in late 2004 through 2006 – a 197 percent growth in assets during 2005 and an additional 48 percent growth in assets during 2006.

Concentration of Higher-Risk Loan Types: DFO examination staff and DSC Chicago Regional Office (CRO) management identified poor quality loans as a contributing factor to MSB's ultimate failure. DSC specifically mentioned MSB's concentrations in construction and development loans, home equity loans, and rehab loans. DSC identified a concentration in these loans in its February 2007 examination, noting that these loan types are particularly vulnerable to markets with depressed and declining real estate values and high unemployment rates.

MSB's Use of Brokered Deposits to Fund Asset Growth: MSB's rapid loan growth was funded in part through brokered deposits, making the use of brokered deposits a contributing factor to the failure. MSB projected a significant increase in brokered deposit funding -- from 7 percent in its original business plan to 66 percent of total deposits in its December 2004 business plan. MSB's brokered deposit levels reached a high of nearly 68 percent of total deposits in October 2006, and the Bank's reliance on brokered deposits consistently exceeded its peer group in 2006 and 2007. In the 2006 and 2007 ROEs, examiners noted a high level of brokered deposits and reported that the exceptionally high brokered deposits-to-deposits ratio was attributed to MSB's very high rate of loan production and not to a failure to generate core deposits.

FDIC's SUPERVISION OF MSB

The FDIC and OFIR conducted visitations and examinations in accordance with regulatory schedules established for de novo banks, and the FDIC provided oversight of MSB through its offsite monitoring activities. However, we identified areas where more aggressive or timelier supervisory actions could have been taken, as discussed in the following sections.

MSB Management

DSC and OFIR examiners rated MSB management a "2" in all examinations of the bank until the April 2008 examination where examiners proposed that Management be downgraded to a "4." Examiners commented in their ROEs that MSB's BOD was

engaged in the bank's operations and that the Management ratings were based, in part, on the effectiveness of bank management and the strength of MSB's monitoring of bank operations. We reviewed MSB BOD minutes for 2006, 2007, and early 2008 and saw that the BOD and management discussed key areas such as loan growth and concentrations; brokered deposits; and examination/audit findings, recommendations, and corrective actions. According to the 2008 ROE, the "4" rating for Management reflected examiners' assessment of the BOD's and management's performance, as well as the unacceptable performance in the remaining CAMELS components – Capital, Asset Quality, Earnings, Liquidity, and Sensitivity to Market Risk.

DSC examination policies state that the quality of bank management is probably the single most important element in the successful operation of a bank and emphasize that in the complex, competitive, and rapidly changing environment of financial institutions, it is important for bank management to be aware of their responsibilities and to discharge those responsibilities in a manner that will ensure stability and soundness of the institution. A bank's BOD is responsible for formulating sound policies and objectives for the bank, effective supervision of its affairs, and promotion of its welfare, and the primary responsibility of senior management is to implement the BOD's policies and objectives of the bank's day-to-day operations.

Prior to the April 2008 examination, examiners consistently gave MSB a rating of "2" for Management, which, by definition, indicates satisfactory management and BOD performance and risk management practices relative to the bank's size, complexity, and risk profile. In general, this rating also implies that significant risks and problems are effectively identified, measured, monitored, and controlled by the bank's management and its BOD.

In the 2006 ROE, examiners reported that (1) MSB management and BOD oversight, direction, and regulatory compliance were considered satisfactory; (2) executive management was considered effective in directing bank activities and identifying and limiting MSB's potential risk exposure; and (3) MSB management was maintaining a rapidly growing de novo bank. In the February 2007 examination, examiners stated that the quality of management was reflected in the overall satisfactory condition of the bank and reported the following observations in regard to management:

- Senior management and the BOD have established sound policies and procedures, coupled with a comprehensive monitoring and reporting structure.
- Management is appropriately addressing the additional risks in the loan portfolio (loan concentrations which are discussed in the next section of this report).
- Management has an action plan to reduce the level of problem loans – loans identified in the 2007 examination as adversely classified assets totaling approximately 35.6 percent of capital and 3.8 percent of total assets.
- The BOD is active in the management of the bank and, with one exception, has regular attendance and active participation during BOD and committee meetings.
- Management is receptive to recommendations and findings of third-party reviews and regulatory examinations.

In regard to the BOD's active participation in managing the bank, we reviewed the minutes for the monthly BOD meetings held in 2006, 2007, and early 2008, and noted that key areas were discussed at the meetings including, brokered deposits; loan growth, concentrations, exceptions, and delinquencies; and examination and audit findings, recommendations, and corrective actions. For example, the minutes for the March 22, 2006 BOD meeting referenced a discussion of the OFIR 2006 ROE results, highlighting items requiring BOD oversight, including establishing policy guidelines for a maximum percentage of brokered deposits and monitoring brokered deposits.

In the April 2008 examination, the examiners' proposed rating of "4" for Management was based in part on MSB management and the BOD allowing the bank's very rapid loan growth (from 2005 to mid-2007), resulting in high potential credit risk within certain areas of the bank's lending portfolios (rehab, residential development, HELOC, and vacant land loans), which ultimately caused the bank's deteriorated financial position. Examiners acknowledged that MSB management started strengthening loan policies and practices in late 2006 and early 2007 in response to examination findings, but examiners were critical of MSB management for expanding into higher-risk loan products in 2006 and 2007 and allowing the resulting high concentrations that played a material role in the Bank's deteriorating condition. As discussed in the next section of this report, examiners had noted concerns in these areas in prior examinations but neither downgraded MSB's management rating nor initiated enforcement actions because they concluded that management was appropriately addressing the additional risks in the loan portfolio and had committed to addressing examiners' concerns.

Loan Concentrations

Given the de novo status of MSB, examiners could have been more aggressive in the February 2007 examination of the bank by initiating informal enforcement actions or formally recommending that MSB take steps to mitigate the risks associated with the types of loan concentrations identified in MSB's operations. In the 2007 ROE, examiners reported MSB's concentration in inherently high-risk loans and that MSB was not formally monitoring the concentration limits or reporting the results to its BOD on a regular basis. Examiners also stated that MSB's policies regarding concentrations were not clear. Although examiners did not formally recommend corrective action to address this finding, the ROE stated that MSB management would revisit the concentration limits within the bank's loan policy and begin to report and monitor the limits.

On December 12, 2006, the FDIC issued Financial Institution Letter FIL-104-2006, *Commercial Real Estate (CRE) Lending Joint (Interagency) Guidance*, which provides supervisory criteria, including numerical indicators, for identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny. FIL-104-2006 included two specific supervisory criteria for the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC to use as a preliminary step to identify institutions that may have CRE concentration risk: (1) Total reported loans for construction, land development, and other

land representing 100 percent or more of an institution's total capital; or (2) Total commercial real estate loans representing 300 percent or more of the institution's total capital when the outstanding balance of the institution's CRE loan portfolio has increased 50 percent or more during the prior 36 months.

DSC's Risk Management (RM) Manual includes information regarding the preparation of a Concentrations Schedule for inclusion in the ROE. The purpose of this schedule is to identify possible absence of risk diversification within the bank's asset structure. In addition, the RM Manual defines concentrations and discusses the need for bank management policies in this area.

We noted that MSB's policy on concentrations conformed to the FIL-104-2006 interagency guidance for CRE loans but exceeded the supervisory criteria for construction loans. Specifically, MSB's Portfolio Diversification Policy, effective February 1, 2006, stipulated that loan concentrations are not to exceed the following percentages of Tier 1 Capital:

- CRE 300 percent.
- Non-CRE 200 percent.
- Consumer 100 percent.
- Residential 300 percent.
- Construction 150 percent.

As discussed further below, DSC became aware of MSB loan concentrations through: (1) OFIR's January 2006 ROE, (2) MSB's information on loan concentrations in the monthly reports submitted to DSC beginning in March 2005, and (3) the 2007 and 2008 examinations. We also noted that eight quarterly Offsite Review Reports (March, June, September, and December in 2006 and the same months in 2007) identified concentrations in MSB's portfolio.

2006 OFIR Examination: OFIR reported construction and real estate industry concentrations in the confidential pages of its 2006 ROE. Specifically, examiners reported MSB's three largest industry concentrations – residential buildings and dwellings, residential remodelers, and nonresidential buildings – totaling slightly over \$14.5 million.

OFIR's 2006 ROE also included a discussion on monitoring real estate loans that exceed recommended supervisory loan-to-value (LTV) limits.⁷ OFIR reported that the examiners' review of loan files disclosed several of these types of loans and recommended that MSB establish a means for monitoring and reporting Part 365 loan exceptions. We noted that MSB's March 22, 2006 BOD meeting minutes included an action item that indicated MSB had established a mechanism for monitoring and

⁷ According to the 2006 OFIR ROE, pursuant to Part 365 of the FDIC Rules and Regulations – Interagency Guidelines for Real Estate Lending Policies, real estate loans that exceed recommended supervisory LTV limits established by regulatory authorities are limited in the aggregate to 100 percent of Tier 2 Capital and must be identified and reported to the BOD.

reporting LTV exceptions for real estate lending. Nevertheless, the 2008 ROE included a repeat finding that LTV limits were not being tracked or reported to the BOD.

MSB Monthly Reporting: As discussed in other sections of this report, FDIC and OFIR required MSB to submit monthly reports as a condition of MSB's request for business plan revisions. Starting in March 2005, MSB submitted monthly reports to DSC's CRO, which included Summary of Loan Portfolio Reports showing industry concentrations, number of loans, total portfolio, percentage of concentrations to total portfolio, and percentage of loans to capital (for certain months). Examiners usually report industry concentrations as a percentage of Tier 1 Capital in the ROE's Summary Analysis of Examination Report (SAER) schedule. MSB's February 2006 monthly loan report identified the five largest industry concentrations as of January 31, 2006, including 38 loans to residential builders valued at nearly \$10.1 million, representing approximately 102 percent of Tier 1 Capital.

2007 and 2008 Examinations: The 2007 and 2008 ROEs for MSB identified concentrations in (1) construction, land development, and other land loans, and (2) non-owner occupied commercial real estate (CRE) loans. The 2007 ROE included a section on Concentrations of Credit – 60 percent of total loans reported for: (1) construction and development loans (204 percent of Tier 1 Capital), (2) home equity loans (142 percent of Tier 1 Capital), and (3) rehab loans (100 percent of Tier 1 Capital). The 2008 ROE included a schedule identifying high CRE concentrations (345 percent of Capital), construction concentrations (119 percent of Capital), and industry concentrations (305 percent of Capital).

The 2007 ROE stated that bank policy guidelines and definitions regarding loan diversifications and concentration limits were not clear, and that MSB was not formally monitoring or reporting the concentrations to the BOD on a regular basis. While DSC rated Asset Quality a "3," DSC examiners did not make a formal recommendation in the 2007 ROE in regard to concentrations. The Risk Management Assessment pages of the 2007 ROE mentioned segmenting the rehab loans and establishing an ALLL allocation for concentrations of credit, but MSB's response to the ROE did not address these issues.

At the bank's request, in August 2007, MSB management met with DSC and OFIR examiners and described the following actions it had taken to address asset quality issues identified in the February 2007 examination:

- reviewed every loan in the bank's portfolio;
- established a policy to limit speculative construction financing to one home per builder in response to a concentration in construction and development loans identified in the 2007 ROE and tightened credit standards in an attempt to reduce the bank's exposure to risks with regard to home equity loans identified as a concentration in the 2007 ROE; and
- narrowed the market area in which rehabilitation loans were offered and started requiring that inspections be performed in response to concentrations included in the 2007 ROE.

DSC told us that because MSB management committed to address the concentrations and improve tracking the concentration limits, there was no need to recommend further actions. In regard to initiating an informal enforcement action, DSC said that MSB was operating within an approved Deposit Insurance Order, with amendments, and was a “2” rated bank; therefore, it is unlikely that the FDIC would have considered initiating an informal action against MSB as part of the 2007 examination.

DSC’s RM Manual and the FDIC’s *Formal and Informal Action Procedures Manual* (FIAP Manual) include provisions for examiners to make formal recommendations or initiate formal or informal enforcement actions designed to address and correct identified weaknesses in a bank’s financial condition, performance, risk management practices, or regulatory compliance. Examiners are expected to document examination findings, conclusions, recommendations, and management responses in the ROEs. Examination recommendations are intended to improve the bank’s safety and soundness practices, and examiners should obtain affirmative commitments from the bank’s management and its BOD to correct problems and weaknesses. The RM Manual also includes a provision that examiners should consider management’s responses to previous regulatory and auditor recommendations.

If corrective actions are not deemed sufficient or examiners determine that stronger actions are necessary, DSC may also take formal or informal enforcement actions against a bank. Appendix V details the FDIC’s policies and procedures regarding recommendations and enforcement actions. The FIAP Manual states that the FDIC **generally** initiates informal (or formal) corrective action against financial institutions with a composite rating of “3,” “4,” or “5,” unless specific circumstances warrant otherwise. We noted that the FIAP Manual provides that:

- Informal actions are particularly appropriate when the FDIC has communicated with bank management regarding deficiencies and has determined that the institution’s managers and its BOD are committed to and capable of effecting correction with some direction but without the initiation of a formal corrective action.
- The FDIC may consider a Bank Board Resolution (BBR), one type of informal action, for institutions that receive a composite rating of “2” or a component rating of “3” where there may be risk in a particular area that needs to be addressed.

In the case of MSB, the bank was rated a composite “2” with a “3” for Asset Quality in the 2007 examination. A BBR would have provided the FDIC with a means to obtain MSB management’s and the BOD’s commitment to: (1) revise the Bank’s portfolio diversification policy, (2) formally monitor concentrations, and (3) routinely report volume concentrations to the BOD, especially in light of the deteriorating economic conditions in Michigan.

Examiners could also have recommended the reinstatement of the requirement for MSB to submit monthly loan and funding reports to DSC and OFIR, the original condition imposed upon the bank for approving changes to its business plan. As previously

mentioned, DSC and OFIR discontinued this reporting requirement in May 2006. Table 2 shows the loan concentration information included in MSB's monthly reports that DSC could have used to monitor MSB's loan concentrations.

Table 2: MSB's Loan Concentrations with Capital Guidelines

Description	CRE Loans	Consumer Loans	Residential Loans	Construction Loans	Rehab Loans
02-28-2007					
Total Portfolio (in thousands)	\$48,673	\$16,135	\$27,332	\$18,396	Not Indicated
Percent of Capital	354.51%	117.52%	199.07%	133.99%	
Maximum Percent Per Report	500%	150%	300%	200%	
Maximum Percent Per MSB Policy	300%	100%	300%	150%	
03-31-2007					
Total Portfolio (in thousands)	\$50,616	\$16,225	\$30,580	\$18,986	\$15,486
Percent of Capital	367.08%	117.67%	221.77%	137.69%	112.31%
Maximum Percent	500%	150%	300%	200%	TBD
Maximum Percent Per MSB Policy	300%	100%	300%	150%	Not Indicated
05-31-2007					
Total Portfolio (in thousands)	\$49,413	\$15,374	\$33,307	\$16,264	\$16,312
Percent of Capital	361.23%	112.39%	243.49%	118.89%	119.24%
Maximum Percent	500%	150%	300%	200%	TBD
Maximum Percent Per MSB Policy	300%	100%	300%	150%	Not Indicated
06-30-2007					
Total Portfolio (in thousands)	\$49,143	\$15,184	\$31,102	\$16,439	\$15,460
Percent of Capital	373.03%	115.26%	236.09%	124.79%	117.36%
Maximum Percent	500%	150%	300%	200%	TBD
Maximum Percent Per MSB Policy	300%	100%	300%	150%	Not Indicated
07-31-2007					
Total Portfolio (in thousands)	\$50,400	\$15,020	\$30,065	\$15,523	\$15,659
Percent of Capital	382.83%	114.09%	228.37%	117.91%	118.94%
Maximum Percent	500%	150%	300%	200%	TBD
Maximum Percent Per MSB Policy	300%	100%	300%	150%	Not Indicated
08-31-2007					
Total Portfolio (in thousands)	\$51,683	\$14,914	\$29,145	\$16,452	\$15,429
Percent of Capital	391.67%	113.02%	220.87%	124.68%	116.93%
Maximum Percent	500%	150%	300%	200%	TBD
Maximum Percent Per MSB Policy	300%	100%	300%	150%	Not Indicated
09-30-2007					
Total Portfolio (in thousands)	\$50,360	\$14,919	\$28,572	\$14,792	\$15,238
Percent of Capital	399.12%	118.24%	226.44%	117.23%	120.76%
Maximum Percent	500%	150%	300%	200%	TBD
Maximum Percent Per MSB Policy	300%	100%	300%	150%	Not Indicated
12-31-2007					
Total Portfolio (in thousands)	\$49,686	\$17,279	\$20,620	\$15,669	\$12,043
Percent of Capital	550.04%	191.29%	228.27%	173.46%	133.32%
Maximum Percent	500%	150%	300%	200%	TBD
Maximum Percent Per MSB Policy	300%	100%	300%	150%	Not Indicated

Source: MSB's Summary of Loan Portfolio by Type and MSB Portfolio Diversification Policy.

Had DSC formally made a recommendation or invoked an informal action in the 2007 examination in the form of a BBR to reinstate the monthly loan reporting requirement, DSC would have learned that:

- Concentrations of CRE and Consumer loans continued throughout 2007.
- MSB used numerical indicators in reporting concentrations that differed from the limits identified in its Loan Diversification Policy, as shown for CRE, Consumer, and Construction loans in Table 2.
- MSB did not establish limits for rehab loans.

Further, either a recommendation or an informal enforcement action in the 2007 examination would have (1) required management responses to address the loan concentrations and policy issues, (2) assured BOD commitments to correct the problems, and (3) prompted follow-up by examiners.

DSC has taken steps to improve its supervisory review of loan concentrations. To illustrate:

- An October 2007 email from the DFO Supervisor to DFO staff (copied to CRO management) relates to CRE concentrations and the need to determine whether the bank has done any stress testing or modeling to determine what would happen to the CRE concentration in a downturn and what effect the downturn would have on the portfolio and ultimately the bank.
- The CRO Joint Examination Activities Checklist used for the April 2008 examination includes a pre-examination step to determine if the bank being examined meets or is approaching the threshold criteria for CRE defined in FIL-104-2006. This step also includes a worksheet entitled “Commercial Real Estate Portfolio Analysis” to assist the examiner in determining CRE concentrations.
- On July 31, 2008, DSC issued Regional Director Memorandum (RDM) Transmittal Number 2008-021, *Supervising Institutions with Commercial Real Estate Concentrations*, to update and re-emphasize CRE loan examination procedures in view of more challenging market conditions, particularly in construction and development lending.

In responding to a discussion draft of this report, DSC agreed that there were loan concentration issues at MSB, but stated that it was actually the manner in which loans were underwritten and administered that resulted in losses rather than simply the concentration level of such loans (e.g., MSB’s practice of extending HELOCs where MSB was not in a first lien position or disbursing the full amount of rehab loans without documenting that the underlying property was improved). Further, DSC officials in Headquarters stated that reporting increases in concentrations could be misleading due to corresponding declines in capital levels. For example, DSC noted that the increase in concentrations for year-end 2007 shown in Table 2 was related to a 34 percent decline in capital during 2007 as opposed to an increase in loan activity.

However, in our review of ROEs, examination working papers, correspondence, and other documents, we saw limited reference to underwriting problems with corresponding recommended corrective actions in the ROEs. Further, DSC’s Chronology of Events leading up to MSB’s failure stated that a combination of loan growth, a lending strategy that resulted in a concentration of higher risk loans, and the deteriorating Michigan economy contributed to the swift deterioration in the condition of MSB, and that the general economic downturn further hindered the bank’s ability to raise capital or find an acquirer. The chronology did not mention underwriting problems as a contributing factor to MSB’s failure.

Brokered Deposits

Given MSB's significant use of brokered deposits to supplement the bank's core deposits and fund the high demand for loan growth and considering the de novo status of the bank, DSC could have more actively monitored MSB's brokered deposit activities. DSC officials became aware of MSB's intention to increase usage of brokered deposits when the bank revised its business plan in 2005. DSC monitored MSB's brokered deposit levels through its examinations, offsite review activities, and reviews of the monthly funding reports and ALCO minutes submitted by MSB from March 2005 to May 2006. However, discontinuing the reporting requirement in May 2006 eliminated a means through which DSC could have monitored the level of brokered deposits used by MSB during the remainder of its de novo stage of operations.

FDIC Rules and Regulations, Section 2000, Part 337.6, *Brokered Deposits*, states that any *Well Capitalized* (PCA category) insured depository institution may solicit and accept, renew, or roll over any brokered deposit without restriction by this section. The RM Manual states that examiners should not wait for the PCA-based brokered deposits restrictions to be triggered, or the viability of an institution to be in question, before raising relevant safety and soundness issues with regard to the use of volatile funding sources. The RM Manual also describes red flags related to the use of such funding sources and adds that, if examiners determine that the bank's use of these funding sources is not safe and sound, that risks are excessive, or that risks adversely affect the bank's condition, then appropriate supervisory action should be taken immediately. The RM Manual states that in situations with a newly chartered institution using brokered deposits and having an aggressive growth strategy, examiners may need to take action to ensure that the risks associated with brokered deposits are managed appropriately.

Business Plan Revision: MSB's December 2004 revised business plan included a projection that brokered deposits were expected to represent two-thirds (approximately 67 percent) of total deposits in the early years and would begin declining as MSB matured. MSB also projected that its need for brokered deposits would be reduced in April 2006. In approving MSB's revised business plan, DSC did not place any limits on the level of brokered deposits or any stipulations restricting the length of time for MSB to use this funding source. We noted that MSB continued its use of brokered deposits in 2006 and 2007. Specifically, MSB either purchased or replaced brokered deposits in all but 4 months of the 24-month period in 2006 and 2007.

A key metric of the risks related to a bank's liquidity management is the net non-core deposit dependency ratio. A bank's net non-core dependency ratio indicates the degree to which the bank relies on non-core/volatile liabilities such as time deposits of more than \$100,000; brokered deposits; and FHLB advances to fund long-term earning assets. Generally, the lower the ratio, the less risk exposure there is for the bank. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. MSB's reliance on brokered deposits continuously exceeded its peer group in 2006 and 2007. For example, as of year-end

2006 and 2007, MSB's use of brokered deposits was in the 98th and 96th percentile, respectively, of FDIC-insured banks in the peer group.⁸ A high percentile ranking does not necessarily reflect an unsatisfactory condition. However, when MSB's use of brokered deposits ranking is analyzed in the context of the bank being in de novo status and growing rapidly, the ranking does serve as a red flag for increased management and examiner attention.

2006 OFIR Examination: The January 2006 OFIR ROE included recommendations that, in light of the relatively high level of brokered deposits, the MSB BOD (1) monitor the Brokered Deposits-to-Deposits and Net Non-Core Funding Dependence ratios and (2) approve an absolute policy guidance limit to the level of brokered deposits that will be used in relationship to total bank deposits. Although MSB management agreed with these policy recommendations, DSC noted in its review of MSB's February 2006 monthly report submission that the report did not include a discussion of these ratios. In our review of the BOD meeting minutes, we found that, in June 2006, MSB's BOD approved the bank's Liquidity Management Policy in which the ALCO recommended a 73-percent limit for the dependency ratio and a 72-percent maximum limit for the Brokered Deposits-to-Deposits Ratio. As previously mentioned, both limits are high in relation to peer group banks. However, DSC examiners did not take issue with the high limits in the 2007 examination.

2007 DSC Examination: DSC's 2007 ROE included recommendations to enhance MSB's Liquidity Policy. MSB's Chief Financial Officer (CFO) agreed to consider the recommendations but did not provide a formal response and planned corrective actions because DSC waived the requirement for a formal response. However, we saw evidence in MSB's Liquidity Management Policy (approved by MSB's BOD on June 20, 2007, and included in DSC's and OFIR's 2008 examination workpapers) that MSB implemented the recommendations. Examiners also reported that although brokered deposits had been used to fund the aggressive loan growth experienced by the bank, MSB's brokered deposit program was "considered well managed."

Contingency Liquidity Plan: According to the RM Manual, a financial institution's liquidity policy should have a contingency liquidity plan (CLP) that addresses alternative funding if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises. The RM Manual states that the need for a CLP is even more critical for banks that have an increasing reliance on alternative funding sources and that the CLP should be updated on a regular basis. MSB's Contingency Funding Policy included a provision regarding the bank's need to ensure sufficient liquidity should the availability of non-core funding sources decline. This plan also provided for MSB BOD involvement and included contingency funding procedures. However, we noted that MSB's policy, dated February 17, 2005, was not updated to reflect the bank's significant reliance on brokered deposit funding requested in the business plan revision. Further, examiners did not identify the need to update the policy in the 2006 or 2007 examinations.

⁸ The UBPR presents three types of data for use in the financial analysis of a bank: (1) the bank's data, (2) data for a peer group of banks similar in size and economic environment, and (3) percentile rankings.

The monthly reports submitted by MSB to DSC and OFIR from March 2005 through May 2006 contained ALCO meeting minutes and funding reports. The ALCO minutes identified general information regarding MSB's reliance on brokered deposit funding and monthly brokered deposit purchases. We also reviewed ALCO minutes for the last half of 2006 and noted that MSB's brokered deposits increased during the last half of 2006 and that the bank raised its brokered deposit limitation to 72 percent in July 2006. Had DSC continued the reporting requirement beyond May 2006, DSC could have learned about (1) MSB's continued growth in brokered deposit funding and (2) the bank's revised brokered deposit limitation to 72 percent of core deposits (as compared to the 66-percent limit initially proposed) – sooner than the February 2007 examination.

Business Plan Modifications

In accordance with requirements associated with MSB's changes to its business plan, the Bank submitted monthly loan and funding reports and ALCO and Loan Committee meeting minutes to DSC and OFIR beginning in March 2005. These reports included information on: loan values, growth, classifications, delinquencies and concentrations; monthly activity of funds purchased and sold, including brokered deposits; ratios, including loans to assets, loans to deposits, non-core deposits to assets, liquidity, and dependency; and bank policy. As previously mentioned, these reports served as a means by which DSC could monitor key activities of MSB. While we saw some evidence of DSC's review of the reports as well as acknowledgments to MSB that the reports were received, we did not locate any DSC communication to MSB providing feedback on the concentration ratios or level of brokered deposits activity. In addition, DSC and OFIR waived the reporting requirement in May 2006 rather than continue the requirement for the remainder of the bank's de novo tenure – until March 2007. This is particularly noteworthy because during that period (June 2006 – March 2007), the availability of brokered deposits (nearly \$93 million as of March 31, 2007) helped MSB in its funding of high-risk construction loans (nearly \$19 million as of March 31, 2007), HELOCs (nearly \$16 million as of March 31, 2007), and rehab loans (over \$15 million as of March 31, 2007).

Proposed financial institutions are required to submit business plans with their initial applications for federal deposit insurance. According to the *FDIC Statement of Policy on Applications for Deposit Insurance*, and in compliance with Sections 5 and 6 of the FDI Act, the FDIC must be assured that the proposed institution does not present an undue risk to the DIF. The FDIC expects that proposed institutions will submit a business plan commensurate with the capabilities of its management and the financial commitment of the incorporators. Any significant deviation from the business plan within the first 3 years of operation – the de novo phase – must be reported by the insured depository institution to the primary regulator before consummation of the change. Business plans that rely on high-risk lending, a special-purpose market, or significant funding from sources other than core deposits, or that otherwise diverge from conventional bank-related financial services, require specific documentation as to the suitability of the proposed activities for an insured institution. Similarly, additional documentation of a

business plan is required where markets to be entered are intensely competitive or economic conditions are marginal.

MSB requested approval from DSC and OFIR to deviate from the business plan, particularly as it related to loan growth and brokered deposit projections submitted as part of MSB's charter and deposit insurance applications. MSB's proposed revisions to its business plan included, among other things, the following projections:

- By mid-year 2005, asset growth will be significantly higher than the original budget.
- By year-end 2005, loan growth will be 228 percent compared to year-end 2004.
- Loan growth from 2005 to 2006 will be slightly over 50 percent, or \$36 million.
- Brokered deposits are expected to represent two-thirds (approximately 67 percent) of total deposits in the early years and will begin to decline as MSB matures.
- Additional capital will be secured and in place by October 2005.

In February 2005, MSB obtained DSC's and OFIR's approval, in the form of a "non-objection," to deviate from its original business plan, with a requirement that MSB submit monthly loan and funding reports to DSC and OFIR. The reporting requirement was intended to be in effect until DSC and OFIR directed otherwise. As previously mentioned, MSB provided the monthly reports starting in March 2005 and ending in May 2006, at which time DSC and OFIR waived the requirement.

DSC and CRO directives provide that a financial institution can deviate from its original business plan if it notifies the Regional Director and its primary federal regulator of any proposed major deviations or material changes from the submitted plan 60 days before the consummation of the change. Further, a CRO directive dated October 5, 2006, entitled *Guidance for First Onsite Presence for Newly Chartered Institutions*, states that examiners should ensure that bank management is complying with the conditions stipulated in the Orders for deposit insurance. This directive provides the following guidelines for examiners to follow in regard to business plans:

- One of the major focuses of all examinations and visitations conducted during the first 3 years of operation should be on compliance with the business plan.
- A comparison of deposit and loan projections set out in the application to actual performance is important.
- Any excessive growth should be analyzed, including a review of core versus volatile funding, and a determination made of the possible adverse impact on liquidity, capital, and/or earnings.
- The nature of the bank's business should be reviewed and compared to the business plan included in the application. For example, it is possible for the institution to report growth totals and earnings performance that are comparable to application projections, but the manner in which such results are achieved can be materially different and create a higher risk profile than what was conveyed in the application. Examples include engaging in subprime lending, accepting brokered deposits, and starting up Internet banking operations.

Accordingly, examiners monitored MSB's business plan changes through their examinations conducted in 2005, 2006, and 2007 and noted the following in the respective ROEs:

- **2005 ROE:** Examiners indicated that MSB was operating within the parameters of its 3-year business plan. Management had submitted a revised business plan to indicate the increased use of brokered deposits to support asset growth. Examiners reported that the Bank's projections were in line with actual performance.
- **2006 OFIR ROE:** Industry concentrations were identified in the confidential pages of the ROE, and examiners noted that the level of brokered deposits invited continuing regulatory scrutiny. Examiners recommended that MSB's BOD monitor brokered deposits.
- **2007 DSC ROE:** Examiners identified concentrations in higher-risk loans, but did not formally recommend any actions in this regard. Examiners also noted that brokered deposits represented 63 percent of total deposits with a Net Non-Core Funding Dependence ratio of 66.7 percent, well above the bank's national peer group ratio of 23.1 percent. As previously mentioned, examiners recommended that MSB consider enhancing its funding policies to identify acceptable funding sources and an acceptable mix of uses by type and maturities. The ROE included a statement that MSB's brokered deposit program was considered well managed.

While these ROEs addressed certain aspects of the revised business plan, examiners did not specify within their reports to what degree they compared loan concentrations and projections or broker deposit projections outlined in the revised business plan to the bank's actual performance in these areas. Further, DSC discontinued the requirement for MSB to submit monthly loan and funding reports earlier than the end of the 3-year de novo period, thereby eliminating one of the means through which DSC could have monitored actual performance against business plan projections on a continuing basis rather than waiting for the next annual examination. DSC officials in Headquarters also noted that there are other means of obtaining information about loan concentrations and brokered deposit levels, namely the UBPR and Call Reports. However, we note that the monthly MSB reports contained more timely and more detailed information about loans, loan concentrations, brokered deposit activity, and policy data related to loans and funding.

Examination Schedule in 2008

DSC exercised proactive supervision during 2008 by accelerating its examination schedule and joining the OFIR on a joint examination of MSB in April 2008. MSB management requested a meeting with DSC and OFIR examiners in July 2007 and December 2007 to discuss actions taken to address asset quality issues identified in the 2007 examination and to discuss staffing changes at MSB, additional problems, and expected year-end operating results. DSC's Examiner-in-Charge (EIC) prepared a memorandum to the file documenting the July 2007 meeting and a December 14, 2007 memorandum for the CRO Regional Director regarding both meetings. The EIC recommended that a visitation be scheduled for MSB in late first quarter 2008 or early

second quarter 2008. DSC scheduled a full examination for April 2008, which DSC indicated was an “acceleration of the normally-scheduled August 2008” date for an OFIR examination. While this proactive supervision is commendable, a visitation in January or February 2008 may have been beneficial given the asset quality, liquidity, and capital issues discussed at the December 2007 meeting.

July 2007 Meeting: In July 2007, MSB requested a mid-year meeting with DSC and OFIR to discuss a staffing change at the Bank, actions taken to address asset quality issues identified at the February 2007 examination, and additional problems that had surfaced since the 2007 examination. The following are excerpts from the memorandum to the file documenting the results of the July 2007 meeting:

- After the February 2007 examination, management established a 12-member team of employees and managers to review every loan in the bank’s portfolio (approximately 1,100 loans). The review included a documentation review, collateral evaluation, and credit quality review. Recognizing the decline in real estate values in Michigan, collateral was discounted 25-50 percent.
- Based on the collateral evaluation, potential losses through 2008 were projected and additional provisions to the Allowance for Loan and Lease Losses (ALLL) were made to address the potential losses.
- ALLL provisions eliminated net income for the first two quarters of 2007. MSB reported net losses of \$691,000 at June 2007.
- MSB management hired a consulting firm to review the methodology used by the bank for its loan review and to validate the bank’s conclusions. Overall, the consulting firm came to similar conclusions as bank management in terms of risk and ALLL needs.
- MSB terminated the employment of its senior lending officer and was negotiating with an experienced lender to become MSB’s new senior credit officer.
- MSB told examiners that the bank would exercise caution in booking new loans during the weak credit cycle and anticipated no growth in the portfolio in the near term. Positive earnings were not expected for 2007.

The memorandum included a note that examiners would continue to monitor MSB’s delinquency and reported losses throughout 2007 and would contact the bank in January 2008 (if not earlier) to review asset quality and earnings results with MSB management.

December 2007 Meeting: In December 2007, MSB requested a second meeting with DSC and OFIR examiners to discuss further asset deterioration and operating losses. The following are excerpts from the memorandum prepared by the DSC EIC to document the meeting and submitted to the DSC CRO Regional Director, through DFO management:

- Since the 2007 examination, MSB’s loan portfolio continued to deteriorate as the Michigan economy and construction/development industry remained extremely weak.
- MSB forecasted a year-end operating loss of \$4.7 million and stated that the capital ratio would be negatively impacted by excess liquidity purposely maintained

throughout the quarter in the event that brokered deposits reacted negatively to the published September 30, 2007 financial reports. MSB was able to renew the deposits that matured during the quarter, but management said that the Bank might take similar precautions in January 2008 before the year-end (2007) financial reports became public, adding that this posture was consistent with MSB's contingency funding plan.

- The 2008 strategies included no loan growth, reducing non-performing assets and delinquent loans, and continuing mortgage banking activities, which MSB viewed as a way to generate revenues (gains on sale) without additional capital.
- Management was still relying on brokered deposits but would continue to shrink this reliance. Brokered deposits at year-end were expected to be \$61 million from a high of \$93 million. Customer deposits had grown to \$62 million compared to \$45 million at year-end 2006.
- MSB tightened loan policies and enhanced underwriting and controls for portfolio lending as a result of the bank's review of all loans in its portfolio. Management had also eliminated rehab, HELOCs, and all out-of-market lending.
- Financial projections were bleak, asset quality was poor, and MSB would probably need additional capital in 2008.

The EIC suggested that DSC schedule an on-site visitation late in the first quarter or early second quarter of 2008 to validate management's internal ratings and ALLL allocations and review management's capital plan. Although MSB had a composite "2" rating, the EIC believed that it was appropriate to maintain the bank on the watch list. In response, the FDIC accelerated an August 2008 scheduled examination to begin in April 2008. DSC management told us that examination resources were not available before the April 2008 examination.

In discussing the results of our evaluation, DSC explained that at the time of the December 2007 meeting with MSB management, the first quarter 2008 examination schedule had been set and initiating an examination within weeks of meeting with bank management, prior to year-end financial statements becoming available, would have been inefficient and ineffective. DSC officials also said that it is unlikely that conducting a visitation in January 2008 would have prevented MSB's failure or mitigated the FDIC's loss exposure. DSC pointed out that its next examination of the bank was scheduled for March 2010, but that DSC DFO convinced OFIR to move its scheduled August 2008 independent examination of MSB to April 2008 and to make the examination a joint DSC OFIR review.

We recognize that DSC acted proactively in accelerating the regularly-scheduled examination of MSB and combining examiner resources with OFIR to conduct the examination in April 2008. Further, DSC's position that an examination in January 2008 may not have been efficient due to the unavailability of year-end financial information is understandable. Notwithstanding, a visitation in January or even February 2008 may have been beneficial, given DSC's knowledge of the condition of the bank from the December 2007 meeting with MSB and because Call Report financial information should

have been available in February for examiners to review and monitor for purposes of assessing capital levels and liquidity management.

Prompt Corrective Actions

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on a bank's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking timely action against insured nonmember banks that are not adequately capitalized. Federal banking regulators established minimum capital levels for five PCA categories as shown in Table 3.

Table 3: PCA Capital Categories and Ratios

Code	Category	Total Risk-Based Capital	Tier 1 Risk-Based Capital	Leverage Ratio
W	<i>Well Capitalized</i>	10 percent or more	6 percent or more	5 percent or greater
A	<i>Adequately Capitalized</i>	8 percent or more	4 percent or more	4 percent or greater or 3 percent or greater if bank has a composite CAMELS rating of "1"
U	<i>Undercapitalized</i>	Less than 8 percent	Less than 4 percent	Less than 4 percent or less than 3 percent if bank has a composite CAMELS rating of "1"
S	<i>Significantly Undercapitalized</i>	Less than 6 percent	Less than 3 percent	Less than 3 percent
C	<i>Critically Undercapitalized</i>	The institution's tangible equity is 2 percent or less regardless of its other capital ratios.		

Source: Section 38 of the FDI Act and 57 Federal Register 44866-01.

PCA mandates the imposition of certain restrictions once a financial institution falls below the *Well Capitalized* category. For example, an *Adequately Capitalized* financial institution cannot accept brokered deposits without a waiver from the FDIC. The FDIC Rules and Regulations⁹ states the following in regard to brokered deposits:

- An *Adequately Capitalized* insured depository institution may not accept, renew, or roll over any brokered deposits unless it has obtained a waiver of this prohibition from the FDIC.

⁹ 12 C.F.R. § 337.6(b).

- Brokered deposits that were previously accepted while the institution was *Well Capitalized* do not require a waiver, but these brokered deposits may not be renewed or rolled over until a waiver is obtained.

Enforcement actions addressing MSB’s capital deficiencies in 2008 were taken in accordance with PCA capital provisions. As shown in Table 4, DSC issued four PCA notifications to the MSB BOD regarding PCA capital-related provisions.

Table 4: PCA Notifications to MSB

Date of FDIC Notification	PCA Category	Basis for Notification and Action Taken	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Tier 1 Leverage Ratio
03-18-2008	<i>Adequately Capitalized</i>	12-31-2007 Reports of Condition and Income.	9.46%	8.20%	6.21%
05-02-2008	<i>Undercapitalized</i>	03-31-2008 Reports of Condition and Income.	6.81%	5.55%	4.03%
05-08-2008	<i>Significantly Undercapitalized</i>	Financial statements for the period ended 04-30-2008. This notification required the Bank to submit a capital restoration plan by 05-31-2008, restrict asset growth, acquisitions, new activities, new branches, payment of dividends, or making any other capital distribution, management fees, and senior management compensation.	4.35%	3.08%	2.20%
09-12-2008	<i>Critically Undercapitalized</i>	Final August 2008 financial statements. The 2008 ROE stated that if the leverage ratio drops below 2 percent, the FDIC is required under section 38 of the Federal Deposit Insurance Act to appoint a receiver for the institution within 90 days after the bank becomes <i>Critically Undercapitalized</i> .	2.60%	1.34%	1.04%*

Source: OIG analysis of PCA notifications.

*Note: The FDIC also reported the Tangible Equity Capital Ratio at 1.04 percent, which was the same level as the Tier 1 Leverage Ratio. This ratio is only presented for the *Critically Undercapitalized* PCA Category.

Based on our review, we have several observations in regard to MSB’s and DSC’s actions related to the timing of brokered deposit purchases and PCA notifications.

Observations in Regard to MSB: Documentation we reviewed indicates that MSB’s BOD apparently knew the bank was no longer well capitalized in late 2007. Specifically, the bank’s Capital Restoration Plan (CRP), effective January 1, 2008, stated that the bank had maintained a “well capitalized position” since inception on March 1, 2004 through November 2007. In addition, the minutes for a December 19, 2007 MSB BOD meeting indicate that DSC cautioned the bank during a December 14, 2007 meeting that MSB’s

ability to raise brokered deposits “may no longer be granted under certain capital situations” and added that a decrease in certain capital ratios would cause the FDIC to restrict MSB from buying or replacing brokered deposits. At the same BOD meeting, MSB’s Chief Lending Officer (CLO) presented a recommendation for the bank to charge off loans totaling slightly over \$1.5 million in December. The CLO indicated that the charge-offs had been reviewed and approved by the Loan Committee earlier that week (week of December 15-19). The charge-offs and resulting net loss reduced MSB’s capital and contributed to the bank’s capital depletion.

PCA provisions state that a financial institution is responsible for providing notice to the FDIC, within 15 calendar days, when an adjustment to its capital category may have occurred. Specifically, 12 C.F.R. § 325.102 (c), Adjustments to reported capital levels and capital category, states the following:

- **Notice of adjustment by bank:** A bank shall provide the appropriate FDIC regional director with written notice that an adjustment to the bank’s capital category may have occurred no later than 15 calendar days following the date that any material event has occurred that would cause the bank to be placed in a lower capital category from the category assigned to the bank for purposes of section 38 and this subpart on the basis of the bank’s most recent Call Report or report of examination.
- **Determination by the FDIC to change capital category:** After receiving notice of adjustment by the bank, the FDIC shall determine whether to change the capital category of the bank and shall notify the bank of the FDIC’s determination.

It appears that MSB should have notified the FDIC of the possible change to its PCA category within 15 calendar days of the December 19, 2007 BOD meeting wherein the charge-offs were discussed. This is important because MSB purchased \$16 million in brokered deposits on January 11 and 16, 2008 – equivalent to over 26 percent of total brokered deposits held by MSB as of December 31, 2007. While the bank’s purchases do not, by definition, constitute a violation of the FDI Act, it would have been prudent and consistent with the spirit of the Act for MSB to inform DSC of its probable capital reclassification before the January 2008 purchases of brokered deposits.

Observations in Regard to DSC: In its March 18, 2008 PCA notification, DSC stated that MSB was “deemed to have been notified of its *Adequately Capitalized* category” on January 31, 2008 (the deadline for filing the December 31, 2007 Call Report).¹⁰ However, we noted that DSC became aware of MSB’s “less than well capitalized” status on February 20, 2008 through an offsite review of Call Report data and informed DSC CRO management (ARDs, Case Managers, and Supervisory Examiners) in an e-mail dated February 21, 2008, of MSB’s capital category. The e-mail suggested that MSB be alerted of a potential change in capital category and reminded of deposit insurance coverage restrictions that involve brokered deposit accounts. On March 18, 2008, DSC formally notified MSB’s BOD of the bank’s capital category and the brokered deposit restrictions.

¹⁰ FDIC Rules and Regulations provide that a bank is considered notified of its capital category as of the most recent (1) filing of its Call Report, (2) delivery of the final ROE, or (3) written notice from the FDIC.

On May 30, 2008, MSB submitted its CRP to DSC and OFIR, and both regulators reviewed and requested that the bank revise the CRP to include a description of possible sources of capital and the targeted levels of capital to be obtained. On July 15, 2008, DSC and OFIR received MSB's revised CRP. On July 22, 2008, DSC and OFIR issued a C&D Order to MSB, effective 10 calendar days after issuance, with provisions that included:

- maintaining qualified management;
- developing a program to monitor the C&D Order;
- ceasing all lending;
- maintaining Tier 1 Capital at 6 percent by August 31, 2008, and 9 percent by December 31, 2008;
- developing a written contingency funding plan; and
- providing progress reports to DSC and OFIR.

PCA Non-Capital Provisions: We have stated in a prior report¹¹ that PCA's focus is on capital, and because capital can be a lagging indicator of an institution's financial health, a bank's capital can remain in the "well to adequate" range long after its operations have begun to deteriorate from problems with management, asset quality, or internal controls. In addition, the use of PCA directives depends on the accuracy and frequency of capital ratios in a financial institution's Call Reports, which are prepared on a quarterly basis. In the case of MSB, the bank's capital adequacy fell from the top category of being *Well Capitalized* in late 2007 to the bottom *Critically Undercapitalized* in September 2008, with a 2-level drop in 6 days – May 2 and May 8, 2008. Further, by the time MSB's capital level fell below the required threshold necessary to implement PCA, the bank's condition had deteriorated to the point at which the institution could not raise additional needed capital through its BOD or find other investors.

Although the primary focus of section 38 of the FDI Act is capital, sections 38 and 39 provide for certain actions based on non-capital factors to facilitate issuance of PCA directives or to address a non-capital problem. Specifically, section 38(g) provides for reclassification of an institution's PCA capital category based on non-capital factors. Section 38(f)(2)(F) provides for regulatory agencies to require an institution to improve management when regulators consider management to be deficient. Finally, section 39 provides for regulators to require a compliance plan from institutions when they identify problems with (1) operations and management; (2) asset quality, earnings, and stock valuation; and (3) compensation. The RM Manual and FIAP Manual have procedures that address section 39 provisions. For example, the FIAP manual states that a Section 39 action can be initiated for non-problem institutions in which inadequate practices and policies could result in a material loss to the institution or management has not responded effectively to prior criticisms. We found no documented indication that DSC considered using non-capital provisions in its supervision of MSB.

¹¹ OIG Audit Report No. 03-038, *The Role of Prompt Corrective Action as Part of the Enforcement Process*, dated September 12, 2003.

Likewise, with regard to brokered deposits and as previously mentioned, DSC's RM Manual provides that examiners should not wait for the PCA provisions to be triggered, or the viability of an institution to be in question, before raising relevant safety and soundness issues with regard to the use of brokered deposit funding sources. If a determination is made that a bank's use of these funding sources is not safe and sound, that risks are excessive, or that they adversely affect the bank's condition, then appropriate supervisory action should be immediately taken. The RM Manual discusses potential red flags that may indicate the need to take action to ensure that the risks associated with brokered or other rate sensitive funding sources are managed appropriately, including:

- Ineffective management or the absence of appropriate expertise,
- The absence of adequate policy limitations on these kinds of funding sources,
- High delinquency rate or deterioration in other asset quality indicators, and
- Deterioration in the general financial condition of the institution.

As previously mentioned, while DSC cautioned the bank in December 2007 that its ability to raise brokered deposits would be diminished with a decrease in capital ratios, DSC examiners did not raise any concerns or take any supervisory action addressing the bank's January 2008 purchase of brokered deposits until March 2008. Fortunately, those brokered deposit purchases did not increase the loss to the DIF because the acquiring financial institution purchased all of the brokered deposits held by MSB at the time of its failure.

Federal Home Loan Bank Advances

During the period that MSB was receiving PCA capital notifications, the bank acquired FHLB advances as a source of borrowing to improve the bank's liquidity position. Specifically, MSB acquired a 6-month \$5 million FHLB advance on April 30, 2008, to help ensure liquidity for the remainder of 2008 and a \$1 million advance on July 21, 2008, to supplement the bank's liquidity. At the time of these purchases, MSB's PCA capital categories were *Adequately Capitalized* and *Significantly Undercapitalized*, respectively.

Financial institutions often use FHLB advances for funding and liability management. Advances are secured borrowings with terms ranging from overnight to 30 years. Rates vary based on the term of repayment and other factors. To obtain advances, a financial institution must be a member of an FHLB and, for most advances, must pledge collateral. The FDIC recognizes that the FHLB advance program provides many financial institutions with access to funding that is not otherwise available, and the Corporation does not discourage the use of FHLB advances as part of a well-managed funding program. However, FDIC guidance cautions that financial institutions that use advances must be familiar with the terms of the particular borrowings that they use and must consider the impact of advances when managing liquidity, interest rate risk, earnings, and capital. A financial institution's use of advances should be consistent with its funds management policies, strategic plans, and management expertise.

Appropriate Use of FHLB Advances: Section 1430 of the Federal Home Loan Bank Act, (12 U.S.C. § 1430), *Advances to Members*, states that a long-term advance may only be made for the purposes of providing funds to (1) any member for residential housing finance, and (2) any community financial institution for small businesses, small farms, and small agri-businesses.

MSB used FHLB borrowings during 2008 primarily to supplement the bank's liquidity once the bank could no longer rely on brokered deposit funding. DSC officials told us that MSB used FHLB advances appropriately and that the advances were important to preventing a liquidity failure. Specifically, MSB needed "replacement funding" to essentially pay maturing brokered deposits and core deposit withdrawals and to fund bank operations. DSC officials told us that had MSB used FHLB advances to fund asset growth in 2008, the FDIC would have limited MSB from receiving FHLB borrowings.

FHLB's regulatory provisions in Title 12, Banks and Banking, Part 950, Subpart A, *Advances to Members*, § 950.4, *Limitations on Access to Advances*, state that the FHLB shall not make a new advance to a member without positive tangible capital¹² unless the member's appropriate federal banking agency or insurer requests in writing that the FHLB make such advance, and that the FHLB shall use the most recently available Call Report to determine whether a member has positive tangible capital. Section 950.4 also provides that the FHLB may limit or deny a member's application for an advance if, in the FHLB's judgment, the member:

- is engaging or has engaged in any unsafe or unsound banking practices;
- has inadequate capital;
- is sustaining operating losses;
- has financial or managerial deficiencies, as determined by the FHLB, that bear upon the member's creditworthiness; or
- has any other deficiencies, as determined by the FHLB.

As discussed earlier, MSB was *Adequately Capitalized* and *Significantly Undercapitalized* when the bank received the 2008 FHLB advances. MSB was also subject to a C&D Order in July 2008 that, among other things, required the bank to cease all lending until capital levels improved. We saw no correspondence between the FDIC and the FHLB regarding the April 2008 \$5 million advance. We did see evidence in CRO's files that, prior to making the \$1 million advance to the bank on July 21, 2008, the FHLB contacted the CRO for updated information on MSB. CRO provided the FHLB publicly available information about the bank. It does not appear that DSC informed the FHLB of the C&D Order that the FDIC imposed on MSB on July 22, 2008.

¹² According to the FHLB policy on borrowing capacity, tangible capital includes capital defined in accordance with generally accepted accounting principles less goodwill and other intangible assets. In addition, if an FHLB member is operating under the control of its primary federal regulator, the member may be deemed by the FHLB to be insolvent on a tangible capital basis.

Impact of FHLB Advances on the Cost of MSB's Failure: The FDIC has reported that reliance on FHLB advances and other wholesale funds increases the risk to the DIF and can increase the cost of bank failures. A July 2008, DRR *e-Focus* article on wholesale borrowing banking industry trends noted that the DIF faces potential exposure from FHLB advances through two channels, namely, FHLB advances could increase (1) default probability by subsidizing risk-taking, or (2) losses-given-default by subordinating the FDIC's position at resolution. At the time of MSB's failure, the bank had a total of \$11 million in FHLB advances – consisting of (1) \$5 million purchased on August 9, 2007, (2) \$5 million purchased on April 30, 2008, and (3) \$1 million purchased on July 21, 2008. MSB's FHLB advances represented nearly 31 percent of the initial estimated material loss to the DIF caused by MSB's failure.

DSC officials noted that while MSB's early growth strategy was funded to a significant degree by brokered deposits, the bank did not use FHLB advances to fund asset growth. Instead, according to DSC, the FHLB advances helped the FDIC arrange an orderly resolution of the bank. While DSC acknowledged difficulty in quantifying the savings to the DIF from an orderly closure of a bank as compared to a liquidity failure, DSC officials stated that experience has shown that there are cost savings as well as reputation values associated with an orderly closure. Further, the officials explained that, in the case of MSB, losses were embedded in the assets that were already funded prior to the bank ceasing its lending activities, shrinking its assets, and deploying contingency funding strategies that moved away from brokered deposits.

FDIC Guidance on the Appropriateness of FHLB Advances: The need for FDIC guidelines on limiting or restricting FHLB advances for a DSC-supervised financial institution is important as the financial markets continue to experience turmoil and financial institution failures increase. The FDIC has identified wholesale borrowings, which include FHLB advances and brokered deposits, as a potential indicator of "failure risk" and reported that wholesale borrowings pose several considerations to the Corporation, including the hierarchy for payment of secured creditors. That is, in a resolution of a failed bank scenario, secured borrowings such as FHLB advances subordinate the FDIC's position at resolution and are paid first.¹³

DSC guidance on FHLB advances is included in the RM Manual provisions for examining liquidity management, an RD Memorandum, *Federal Home Loan Bank Advances*, dated August 22, 2000 (RDM Transmittal Number 2000-046), and RD Memorandum, *Wholesale Funding*, dated August 28, 2002 (RDM Transmittal Number 2002-039). RDM 2000-046 includes a statement that there are regulatory restrictions on new advances or renewals to FHLB members who are operating without adequate tangible capital.

¹³ According to 12 U.S.C. § 1430 (e), "Notwithstanding any other provision of law, any security interest granted to a Federal Home Loan Bank by any member of any Federal Home Loan Bank or any affiliate of any such member shall be entitled to priority over the claims and rights of any party (including any receiver, conservator, trustee, or similar party having rights of a lien creditor) other than claims and rights that – (1) would be entitled under otherwise applicable law; and (2) are held by actual bona fide purchasers for value or by actual secured parties that are secured by actual perfected security interests.

However, we did not find any FDIC regulations or guidance specifically related to (1) the manner in which DSC could limit or restrict a financial institution's FHLB borrowings, should DSC deem such restrictions or limitations necessary, based on financial, managerial, or operational deficiencies identified by DSC, or (2) the specifics of how DSC would notify the FHLB of such restrictions or limitations.

The implications of wholesale borrowings, including FHLB advances, on the supervisory approach to a troubled institution, are issues for the FDIC requiring further study. A framework or decision tree defining when FHLB advances are appropriate and at what point advances should be restricted would appear to be beneficial and warrant consideration.

CORPORATION COMMENTS AND OIG EVALUATION

On April 8, 2009, the Director, DSC, provided a written response to the draft of this report. DSC's response is presented in its entirety in Appendix VI.

In its response, DSC acknowledged our assessment that MSB failed primarily due to bank management and the BOD allowing for rapid growth and concentration of higher-risk loan products—a strategy that left MSB highly vulnerable to the depressed and declining real estate values and high unemployment rates prevalent in the Detroit, Michigan area where MSB operated. DSC also recognized our conclusions that the FDIC and Michigan OFIR conducted timely and regular examinations of MSB in accordance with regulatory schedules established for de novo banks, and that enforcement actions addressing MSB's capital deficiencies in 2008 were taken in accordance with PCA capital provisions.

Regarding our conclusion that more aggressive or timelier supervisory actions could have been taken against MSB, DSC stated that its supervisory actions were both timely and appropriate for MSB's situation. In its response, DSC said that it utilized a range of bank supervisory tools, including on-site visitations and examinations, management reporting, off-site monitoring, interim meetings, PCA notices, and formal enforcement action in supervising MSB's activities. Our view remains that more aggressive or timelier supervisory actions could have been taken to address risks associated with MSB's plans, operations, and financial condition.

With respect to our observation related to MSB's use of FHLB advances during the period that the bank was receiving PCA capital notifications, DSC noted in its response that MSB acquired FHLB advances to improve its liquidity position and not to fund growth or further lending. We acknowledge that MSB was using the advances for liquidity, which poses less risk than aggressive growth. Nevertheless, the FHLB advances can reduce an institution's franchise value and increase FDIC resolution costs as discussed in the Corporation's recent guidance to institutions on volatile or special

funding sources. Given the risk to the insurance fund, additional and more specific examination procedures in this area may be warranted.

Finally, DSC's response did not address the consideration of non-capital PCA provisions or the timing of brokered deposit purchases MSB made when the bank apparently knew that it was no longer well capitalized. We continue to suggest these issues warrant further study.

DSC's response also stated that, in light of the economic deterioration and its impact on MSB and other similarly situated institutions, DSC has undertaken a number of initiatives, listed in its response, related to the supervision of such financial institutions. These initiatives include obtaining additional information from institutions and providing it to examiners for risk analysis purposes, issuing guidance to institutions and examiners, writing articles, revising supervisory approaches to CRE lending practices, and holding a training session on analyzing business plans.

OBJECTIVES, SCOPE, AND METHODOLOGY**Objectives**

We performed this evaluation in accordance with section 38(k) of the FDI Act, which provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our evaluation objectives were to (1) determine the causes of MSB's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38, in order to make recommendations for preventing such loss in the future.

We conducted the evaluation from October 2008 to January 2009 in accordance with the *Quality Standards for Inspections*.

Scope and Methodology

The scope of this evaluation included an analysis of MSB's operations, which opened on March 1, 2004, until its failure on October 10, 2008. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the FDIC and OFIR examiners from 2004 to 2008.
- Reviewed the following:
 - bank data and correspondence maintained at the Division of Supervision and Consumer Protection's Chicago, Illinois Regional Office and Detroit, Michigan field office;
 - reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure;
 - Crowe Chizek and Plante Moran external audit reports;
 - MSB bank records maintained by DRR in Dallas, Texas for information that would provide insight into the bank's failure; various MSB funding and loan reports; MSB BOD meeting minutes; MSB ALCO meeting minutes; accompanying financial statements; and pertinent DSC policies and procedures.

OBJECTIVES, SCOPE, AND METHODOLOGY

- Interviewed the following FDIC officials:
 - DSC management in Washington, D.C., Chicago Regional Office, and Detroit Field Office; and
 - FDIC examiners from the Detroit and Grand Rapids, Michigan, Field Offices who participated in examinations or reviews of examinations of MSB.
- Researched various banking laws and regulations, including the FDI Act and the FDIC Rules and Regulations.

We performed the evaluation field work at DSC offices in Detroit, Michigan, and Chicago, Illinois, and the DRR office in Dallas, Texas.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance With Laws and Regulations

Due to the limited nature of the evaluation objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of MSB's management controls pertaining to its operations as discussed in the finding section of this report.

For purposes of the evaluation, we did not rely on computer-processed data to support our significant findings and conclusions. Our review centered on interviews, ROEs and correspondence, and other evidence to support our evaluation.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the evaluation objectives. DSC's compliance with the Results Act is reviewed in program audits and evaluations of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of reviewing evaluation evidence.

GLOSSARY

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) to three categories: <ul style="list-style-type: none"> • Substandard, • Doubtful, and • Loss.
CAMELS Ratings	CAMELS (an acronym for Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk) represents the overall rating given to a bank based on the six components above. A rating of 1 through 5 is given, with 1 having the least regulatory concern and 5 having the greatest concern. Based on the six component ratings, an overall composite rating of 1 through 5 is given to a bank as follows: <ol style="list-style-type: none"> 1. <i>Indicates strong performance.</i> 2. <i>Reflects satisfactory performance.</i> 3. <i>Represents below average.</i> 4. <i>Refers to marginal performance that could threaten the viability of the institution.</i> 5. <i>Exhibits a critically deficient performance that threatens the viability of the institution.</i>
Cease and Desist (C&D) Order	A C&D Order is a formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D Order may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the Report of Examination. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital.
Loan Loss Reserve - also called Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain a Loan Loss Reserve level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the loan loss reserve should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.
Memorandum of Understanding (MOU)	An informal agreement between a financial institution and the FDIC, which is signed by both parties. MOUs are designed to address and correct identified weaknesses in a financial institution's condition that are considered to be of supervisory concern but have not deteriorated to the point of warranting a formal administrative action. As a general rule, an MOU is to be considered for all financial institutions rated a composite 3.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve problems of insured institutions in order to prevent a failure or minimize resulting losses. Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.101, et. seq, implements section 38, <i>Prompt Corrective Action</i> , of the FDI Act, 12 U.S.C. section 1831(o), establishing a framework of supervisory actions against insured nonmember banks that are not adequately capitalized. The capital categories are: <ul style="list-style-type: none"> <i>Well Capitalized</i> <i>Adequately Capitalized</i> <i>Undercapitalized</i> <i>Significantly Undercapitalized</i> <i>Critically Undercapitalized</i>

GLOSSARY

Term	Definition
Tier 1 (Core) Capital	<p>Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2 (A), as</p> <p>The sum of:</p> <ul style="list-style-type: none"> • Common stockholder’s equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; <p>Minus:</p> <ul style="list-style-type: none"> • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 1 Leverage Capital Ratio	Tier 1 Capital divided by total assets.

CHRONOLOGY OF SIGNIFICANT EVENTS

Date	Event
03-01-2004	First day of Bank operations.
08-23-2004	Six-month FDIC Visitation; UFIRS rating 2/1-1-2-3-1-2; asset quality was noted as strong.
12-16-2004	Bank requested a modification of its original business plan to increase brokered deposits from 7 percent to 66 percent of total deposits.
02-10-2005	FDIC CRO and Michigan OFIR approve modified business plan, which included large increase in brokered deposits.
02-22-2005	First full-scope FDIC examination; UFIRS rating 2/1-1-2-3-2-2; \$32 million in assets; noted significant brokered deposits (39 percent).
11-02-2005	The Bank requested a second modification to the business plan to increase brokered deposits.
01-03-2006	Second full-scope examination (State only); UFIRS rating 2/1-1-2-3-2-2; \$78 million in assets; strong loan growth and \$4.5 million in capital injection noted. Recommendation made for management to better monitor brokered deposits. Earnings considered fair.
02-05-2007	Third full-scope examination; UFIRS rating 2/2-3-2-2-2-2; \$141 million in assets. First indication of asset quality issues (deterioration); asset component rating went from "1" to "3." Classified assets increased almost ten-fold from 3.64 percent to 35.6 percent of capital. Concentrations noted.
08-21-2007	FDIC and OFIR conducted a 6-month offsite review and held a meeting to discuss actions taken to address asset quality issues identified in the February 2007 examination.
12-14-2007	FDIC and OFIR met with bank management who stated that there would be no loan growth in 2008 and the bank would focus on reducing non-performing assets and delinquent loans. At this meeting, DSC cautioned the Bank that MSB's ability to raise brokered deposits may no longer be granted under certain capital situations and added that a decrease in certain capital ratios would cause the FDIC to restrict MSB from buying or replacing brokered deposits.
01-11-2008 01-16-2008	MSB purchased a total of \$16 million in brokered deposits.
03-18-2008	Bank was notified that it was <i>Adequately Capitalized</i> under PCA based on 12-31-2007 financials.
04-21-2008	FDIC/Joint OFIR examination commenced; \$132 million in assets.
04-30-2008	MSB acquired a six-month \$5 million FHLB advance to help ensure projected liquidity for the remainder of 2008.
05-02-2008	Bank notified of <i>Undercapitalized</i> PCA category based on March 31, 2008 Reports of Condition and Income.
05-08-2008	Bank's 04-30-2008 financials place Bank in the <i>Significantly Undercapitalized</i> PCA category. Case Manager discussed order with Legal Division.
05-09-2008	Interim Rating Change Memorandum prepared to downgrade Bank to 5/5-5-4-5-4-4
05-14-2008	FDIC and OFIR met with Bank management to discuss sale and downgrade. OFIR delivered Capital Impairment letter to Bank.
05-19-2008	Bank Holding Company injected capital to keep leverage ratio above <i>Critically Undercapitalized</i> amount.
05-20-2008	CRO continued to draft Cease and Desist (C&D) Order and provided daily updates.
06-12-2008	Bank management met in Washington, D.C., with representatives from DSC (Senior Deputy Director, Associate Director, Regional Director, Regional Counsel, and Case Manager) and DRR Deputy Director. MSB unsuccessfully attempted to obtain regulatory forbearance or open bank assistance.

CHRONOLOGY OF SIGNIFICANT EVENTS

Date	Event
06-25-2008	C&D language finalized. Focus of order was capital. BOD signed the stipulation on 07-09-2008.
07-17-2008	Signed stipulation received in the RO and prepared for final issuance. C&D effective date: 08-01-2008.
07-21-2008	MSB acquired a \$1 million FHLB advance to supplement the Bank's liquidity.
09-12-2008	BOD and regulators met, and Bank was notified that it was <i>Critically Under Capitalized</i> .
10-10-2008	Main Street Bank closed by OFIR at 5:45 p.m., and the FDIC was named receiver.

FDIC AND OFIR REPORTS OF EXAMINATION

Date Examination Started/Agency	CAMELS Ratings	Assets (Millions)	Examination Conclusions and Comments and Risk Management Assessment Items Cited in 2004 Visitation and Reports of Examination 2005-2008
08-23-2004 FDIC Visitation	2/112312	\$17	<p>Examination Conclusions and Comments. Seven recommendations related to the Gramm-Leach-Bliley Act, including developing written program and obtaining BOD approval.</p> <p>Other recommendations included:</p> <ul style="list-style-type: none"> • develop guidelines for placing loans on the watch list, • develop Mortgage Banking Policy, • address outstanding regulations regarding Allowance for Loan and Lease Losses (ALLL), analysis and documentation, and • review and revise policies to appropriately address guidelines regarding ratios. <p>Management to monitor the bank’s progress. Management should specifically revisit the Capital Policy and the Asset Liability Policy.</p> <p>The Risk Management Assessment also included minor recommendations regarding the bank’s ALLL methodology and credit administration. Management was also asked to address seven items regarding asset/liability management in the investment function.</p>
02-22-2005 FDIC	2/112322	\$32	<p>MSB was asked to adopt mortgage banking policies that addressed six areas, including: segregation of duties, origination, closing, funding, quality control, and lending limits. A similar recommendation was made during the initial 6-month visitation.</p> <p>Management should thoroughly document the review of interest rate risk assumptions and they should be reviewed by Asset and Liability Committee (ALCO).</p> <p>The Risk Management Assessment noted that policies should be expanded to include acceptable collateral margins for lending on existing machinery and equipment.</p> <p>Also, the bank should implement an independent review of the bank’s asset/liability area and develop interest risk parameters and improve the Bank Secrecy Act (BSA) policy in four areas, including training and internal audit.</p>

**APPENDIX IV
FDIC AND OFIR REPORTS OF EXAMINATION**

Date Examination Started/Agency	CAMELS Ratings	Assets (Millions)	Examination Conclusions and Comments and Risk Management Assessment Items Cited in 2004 Visitation and Reports of Examination 2005-2008
01-03-2006 OFIR	2/112322	\$78	<p>Three recommendations regarding liquidity and non-interest sensitivity, including monitoring the high level of brokered deposits through the brokered deposits to deposits and net non-core funding dependence ratios, as defined in the Uniform Bank Performance Report (UBPR) User Guide.</p> <p>Also, the BOD should adopt an absolute policy guidance limit to the level of brokered deposits.</p> <p>Seven examination recommendations in the lending functions included :</p> <ul style="list-style-type: none"> • monitoring loan-to-value reporting exceptions, • more comprehensive policy guidance on unsecured lending, and • timeframes for loan modification. <p>The Management/Administration/Risk Management Section (OFIR Reporting language differs from the FDIC) made:</p> <ul style="list-style-type: none"> • recommendations to strengthen the underwriting and credit administration practices, including establishing a mechanism for monitoring and reporting loan exceptions; • three recommendations related to Loan Policy; • one recommendation relating to Mortgage Banking Policy; • one recommendation relating to Credit Quality; and • two recommendations relating to Documentation. <p>There were also three recommendations relating to risk management practices for asset/liability management and general investment guidelines.</p>

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Date Examination Started/Agency	CAMELS Ratings	Assets (Millions)	Examination Conclusions and Comments and Risk Management Assessment Items Cited in 2004 Visitation and Reports of Examination 2005-2008
02-05-2007 FDIC	2/232222	\$141	<p>Recommendations stated that loan quality had deteriorated and the volume of problem assets was considered high.</p> <p>Further, brokered deposits had been used to fund aggressive loan growth, but the brokered deposit program was considered well managed.</p> <p>Concentrations of Credit were noted.</p> <p>The bank's loan portfolio was heavily concentrated in inherently high-risk type loans, such as construction, home equity, and non-owner occupied residential improvement loans. These types of loans were particularly vulnerable in markets with depressed real estate values and high unemployment rates.</p> <p>There was an apparent violation of Regulation O due to a director overdraft, which remained outstanding longer than 5 days, but management had taken steps to prevent future violations.</p> <p>The Risk Management Assessment stated that examiners recommended 11 items to enhance mortgage banking activity, including:</p> <ul style="list-style-type: none"> • reviewing contracts with secondary market investors, • ensuring that quality control reviews were performed and documented, • establishing segregation of duties in the mortgage department, and • expanding internal audit procedures to include mortgage banking activity. <p>Examiners made three recommendations related to the ALLL; two recommendations related to enhancing the liquidity policy; and several recommendations related to internal controls, audit procedures, and compliance with laws and regulations.</p>

APPENDIX IV

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<p>04-21-2008 FDIC and OFIR (Report of Examination not issued)</p>	<p>5/554544</p>	<p>\$132</p>	<p>Examiners noted critical financial position with earnings and capital insufficient to support present banking activities without significant capital inflows.</p> <p>The poor quality of the loan portfolio was internally evidenced by high levels of observed loan delinquencies, non-accruals, defaults, and loan charge offs. Significantly Undercapitalized status under PCA provisions of Section 38 of the FDI Act.</p> <p>A joint regulatory Cease and Desist Order (“Order”) was issued on July 22, 2008, with provisions to address the most immediate Items of regulatory concern. An amendment to that Order was being considered for items mentioned in the Report of Examination.</p> <p>Five examination findings related to Capital; and seven examination findings included a high level of adversely classified assets, non-performing assets, and loan losses. A large number of loans were on management’s “watchlist.” Three findings related to the ALLL.</p> <p>Three findings related to earnings, including unprofitability, inability of earnings to support operations, and net interest margin constricted due to a high level of nonaccrual loans. Three findings related to liquidity, including levels were inadequate. Two findings related to sensitivity to market risk; six related to management, including one apparent violation of law which was a failure to file Suspicious Activity Reports in a timely manner and timeliness of internal audit.</p> <p>Seven recommendations related to mortgage banking, including the following repeat findings. Ensure that quality control reviews are performed and documented regularly and timely. Incorporate testing of the secondary marketing policies, and procedures. Ensure report accuracy within the internal audit schedule. The review should, at a minimum, include processes, segregation of duties, report accuracy, policy compliance, and review of quality control findings. Ensure the Mortgage Lending Policy corresponds with actual practice and corresponds with other portions of the Loan Policy. Finally, review and document, at least annually, the financial condition of the secondary market investors used by the mortgage department.</p> <p>Three recommendations related to the Bank Secrecy Act; three recommendations related to Information Technology; and 22 Loan Policy Recommendations/Observations.</p>
<p>10-10-2008</p>			<p>MSB closed by Michigan Office of Insurance and Financial Regulation (OFIR) and the FDIC appointed Receiver.</p>

EXAMINATION RECOMMENDATIONS AND ENFORCEMENT ACTIONS

A cornerstone of a healthy deposit insurance system is the process used by regulators to identify and, to the extent possible, remedy unsafe and unsound banking practices and noncompliance with laws and regulations. The FDIC's supervisory process attempts to identify problems and seek solutions early enough to enable remedial action that will prevent serious deterioration in a bank's condition and reduce risk to the FDIC insurance fund. When problems are detected, examiners must determine the severity along with the timing and form of needed corrective actions. The FDIC uses a number of tools to address supervisory concerns related to the safety and soundness of financial institutions and their compliance with laws and regulations. These tools include examination recommendations, informal enforcement actions, and formal enforcement actions.

Examination Recommendations

The purposes of bank examinations are to:

- Maintain public confidence in the integrity of the banking system and in individual banks.
- Provide the best means of determining a bank's adherence to laws and regulations.
- Help prevent problem situations from remaining uncorrected and determine the point where costly financial assistance by the FDIC becomes unavoidable.
- Supply supervisory regulators with an understanding of the nature, relative seriousness, and ultimate cause of a bank's problems, thus providing a factual foundation to soundly base corrective measures, recommendations, and instructions.

Nearly all corrective actions are initiated as a result of facts and circumstances uncovered by DSC examiners during examinations of financial institutions. DSC's RM Manual requires examiners to describe any problems detected during examinations and to recommend corrective action. The Examination Conclusions and Comments (ECC) pages of the ROE should convey all significant examination conclusions, recommendations, and management responses to the primary readers of the ROE, namely, bank management and the bank's BOD. Generally, DSC's transmittal of the ROE to the examined bank will request the BOD to review the report, sign the Directors/Trustees page included at the end of the report, and note its review in BOD meeting minutes. For those banks with moderate concerns, the transmittal letter should include a brief discussion of problem areas and a request for a written response.

For relatively inconsequential deficiencies that do not affect the safety and soundness of a bank, it is generally sufficient for examiners to inform the institution's management of the deficiencies and work with the bank to correct the problems. If such action would not be sufficient or if serious deficiencies exist, examiners can discuss appropriate corrective measures, such as formal or informal enforcement actions, with FDIC management and proceed with the action deemed appropriate for the particular circumstances.

EXAMINATION RECOMMENDATIONS AND ENFORCEMENT ACTIONS

Enforcement Actions

Enforcement actions are discussed in the FDIC’s *Formal and Informal Action Procedures Manual* (FIAP Manual), dated December 20, 2005. According to the FIAP Manual, the FDIC generally initiates formal or informal corrective action against institutions with a composite safety and soundness or compliance rating of a “3,” “4” or “5,” unless specific actions warrant otherwise. Informal actions are voluntary commitments made by an insured financial institution’s BOD. Such actions are designed to correct noted safety and soundness deficiencies or ensure compliance with Federal and State laws. Informal actions are not legally enforceable and are not available to the public.

Informal actions are designed to address and correct identified weaknesses in an institution’s financial condition, performance, risk management practices, and regulatory compliance. Further, the FIAP Manual states that informal actions are particularly appropriate when the FDIC has communicated with bank management regarding deficiencies and has determined that the institution’s managers and BOD are committed to and capable of effecting correction with some direction, but without the initiation of a formal action. There are two types of informal actions, as defined below.

Type of Informal Action	Definition	When Used
Bank Board Resolutions (BBR)	Informal commitments adopted by a financial institution’s BOD directing the institution’s personnel to take corrective action regarding specific noted deficiencies.	Generally considered for financial institutions receiving a CAMELS composite rating of “3.” May also be appropriate if an institution’s performance was of supervisory concern at a previous examination, but past corrective action has been successful and remaining concerns are minor.
Memorandum of Understanding (MOU)	An informal agreement between a financial institution and the FDIC, which is signed by both parties. The State authority may also be a party to the agreement.	Generally used when there is reason to believe the deficiencies noted during an examination need a more structured program or specific terms to effect corrective action.

Source: FDIC FIAP Manual.

The FIAP Manual also states that “Informal actions can also include any other informal action deemed necessary for the situation and condition of a financial institution (this category includes any informal action not considered a BBR or MOU, such as a Supervisory Letter).”

Formal actions are notices or orders issued by the FDIC against insured financial institutions and/or individual respondents. The purpose of formal actions is to correct noted safety and soundness deficiencies, ensure compliance with Federal and State

EXAMINATION RECOMMENDATIONS AND ENFORCEMENT ACTIONS

banking laws, assess civil money penalties, and/or pursue removal or prohibition proceedings. Formal actions are legally enforceable. Final orders are available to the public after issuance.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation
550 17th Street NW Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

April 8, 2009

MEMORANDUM TO: Stephen M. Beard
Assistant Inspector General for
Evaluations and Management

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Evaluation Report Titled, *Material Loss Review of Main Street Bank* (Assignment No. 2009-002)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Main Street Bank (MSB), Northville, Michigan, which failed on October 10, 2008. This memorandum represents the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received March 19, 2009.

The OIG found that the FDIC and the Michigan Office of Financial and Insurance Regulation (OFIR) conducted timely and regular examinations of MSB in accordance with regulatory schedules established for de novo banks, and the FDIC provided additional oversight through its off-site monitoring process and site visitations. The Draft Report states the FDIC and OFIR imposed additional reporting requirements on MSB to monitor its revised business plan, and DSC exercised proactive supervision during 2008 by accelerating its examination schedule and joining the OFIR on a joint examination of MSB in April 2008. Additionally, the Draft Report notes that enforcement actions addressing MSB's capital deficiencies in 2008 were taken in accordance with the Prompt Corrective Action (PCA) capital provisions of the Federal Deposit Insurance Act.

The OIG's assessment concluded that MSB's management and Board of Directors allowed for concentration of the loan portfolio in higher-risk Acquisition, Development, and Construction (ADC), home equity, and non-owner occupied residential improvement loans. This strategy left MSB particularly vulnerable to the depressed and declining real estate values and high unemployment rates prevalent in the Detroit, Michigan area where MSB operated. Weakening economic conditions negatively affected collateral protection and borrowers' ability to make payments in a timely manner. The resulting loan losses severely eroded MSB's earnings and capital, leading to MSB's failure and a material loss to the Deposit Insurance Fund.

The Draft Report suggests that more aggressive or timelier supervisory actions could have been taken. DSC believes its actions were both timely and appropriate for MSB's situation. DSC utilized a range of bank supervisory tools including on-site visitations and examinations, management reporting, off-site monitoring, interim meetings, PCA notices and formal

enforcement action in supervising MSB's activities. DSC implemented monthly reporting from MSB management as early as March 2005 to augment off-site monitoring in response to MSB's revised business plan. DSC continued to monitor loan concentrations and brokered deposit volumes through quarterly call reports during off-site reviews.

During the February 2007 examination, which first identified asset quality concerns, MSB management modified lending policies to limit speculative construction financing, tighten credit standards, and reduce exposure to certain loan types. Management also committed to revisit the concentration limits within the loan policy and begin to monitor and report the limits to the Board of Directors in accordance with examiner recommendations.

Following the February 2007 examination, DSC conducted and documented a supervisory follow up meeting with MSB management during July 2007. At that time, MSB had hired a consulting firm to validate MSB's loan review processes and analyze the Allowance for Loan and Lease Losses (ALLL), made appropriate ALLL provisions, and halted growth in the loan portfolio. Further, during a December 2007 meeting with MSB management, DSC confirmed that MSB was no longer lending, brokered deposits had declined significantly, and core deposits had increased substantially. Due to management's actions, DSC did not take additional supervisory action at that time; however, DSC joined OFIR in its April 2008 examination, which had been accelerated from OFIR's August 2008 due date and was 20 months ahead of the FDIC's statutory examination date.

The Draft Report also notes MSB obtained Federal Home Loan Bank (FHLB) funding during the period MSB was receiving PCA capital notifications. DSC has provided examiners with guidance for assessing the appropriate use of wholesale funding sources by institutions with deteriorating financial positions with the issuance of FIL-13-2009, titled *The Use of Volatile or Special Funding Sources by Financial Institutions That are in a Weakened Condition*. MSB acquired FHLB advances to improve its liquidity position; FHLB funding was not used to fund growth or further lending. MSB did not start drawing on its FHLB line until third quarter 2007, which was after MSB management had begun to shrink the size of the institution. In addition, the FHLB line was never fully drawn and was collateralized by securities.

DSC will continue to evaluate existing and emerging risks to the Deposit Insurance Fund. The OIG notes the FDIC has taken special steps to review de novo bank business plans and supervise financial institutions with concentrations in ADC loans. Further, in light of the economic deterioration and its impact on MSB and other similarly situated institutions, DSC has undertaken the following initiatives:

- In May 2007, DSC launched a call program for institutions with significant residential construction, subprime mortgage, or other higher-risk lending activities. A goal of the program was to identify problems early and initiate appropriate supervisory responses.
- DSC examiners authored an article titled *Managing Commercial Real Estate (CRE) Concentrations* in the Winter 2007 edition of *Supervisory Insights*. This article was

prompted by rapid CRE loan growth in the banking industry and elaborates on the authors' field examination experience with the principles set forth in the 2006 CRE Guidance, issued by the FDIC, the Federal Reserve Board, and the Office of the Comptroller of the Currency on December 6, 2006, titled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (2006 CRE Guidance).

- In January 2008, DSC conducted a horizontal review of CRE lending practices. Outcomes of the review include changes to the current supervisory approaches, such as an acceleration of the next scheduled examination or downgrades to composite ratings, where warranted.
- The FDIC issued a Financial Institution Letter on March 17, 2008, titled *Managing Commercial Real Estate Concentrations in a Challenging Environment* (2008 CRE FIL). The 2008 CRE FIL re-emphasizes the importance of strong capital and loan loss allowance levels and robust credit risk management practices and recommends several risk management processes to help institutions manage CRE and ADC concentrations. This FIL also articulates the FDIC's concern about interest reserves for ADC loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.
- In May 2008, the Chicago Regional Office held a training session with case managers on processing applications for Federal Deposit Insurance which included a requirement to perform a more in-depth analysis of business plans that include a concentration in volatile funding sources and commercial real estate.
- In July 2008, DSC developed a comprehensive CRE guidance repository in a Regional Director memorandum which updates and re-emphasizes CRE loan examination procedures in view of more challenging market conditions, particularly in ADC lending.
- DSC examiners authored an article titled *A Primer on the Use of Interest Reserves* in the Summer 2008 edition of *Supervisory Insights*. This article focuses on the use of interest reserves in ADC lending, examines the risks this underwriting practice presents, and reviews regulatory guidance on the use of interest reserves. The article identifies red flags that should alert lenders to potential problems at each stage of the ADC cycle and reinforces the importance of evaluating the appropriateness of interest reserves when ADC projects become troubled.
- In August 2008, DSC issued revised examination instructions to collect information on market conditions and practices at banks potentially exposed to significant CRE concentration risk. These data will provide real-time information relating to CRE markets across the country and FDIC-supervised institutions operating in those markets, and will be available for supervisory purposes.

- The FDIC issued a Financial Institution Letter on August 26, 2008, titled *Liquidity Risk Management* (2008 Liquidity FIL). The 2008 Liquidity FIL highlights the importance of liquidity risk management at financial institutions. The FIL discusses liquidity measurement and management systems and recommends institutions that use wholesale funding, securitizations, brokered deposits, and other high-rate funding strategies should ensure contingency funding plans address stress events. The FIL also addresses the requirements governing the acceptance, renewal, or rolling over of brokered deposits which are applicable to all depository institutions.
- In September 2008, DSC made available to examiners a resource that provides for more detailed information on commercial and residential real estate markets and transactions. These data, which includes estimated property values, comparable sales, leasing rates, capitalization rates, vacancy rates, title/deed documents, and other related information, may aid examiner analysis of market conditions during examinations of banks with significant CRE concentrations.
- The FDIC issued a Financial Institution Letter on November 12, 2008, titled *Interagency Statement on Responsible Lending* (FIL-128-2008). The FIL encourages FDIC-supervised institutions to lend prudently and responsibly to creditworthy borrowers, adjust dividend policies to preserve capital and lending capacity, and implement compensation structures that encourage prudent lending. The FIL further emphasizes that state nonmember institutions' adherence to these expectations will be reflected in examination ratings the FDIC assigns for purposes of assessing safety and soundness, compliance with laws and regulations, and performance in meeting requirements of the Community Reinvestment Act.
- DSC examiners authored an article titled *The Changing Liquidity Landscape* in the Winter 2008 edition of *Supervisory Insights*. This article provides guidance on the importance of contingency funding plans, pro-forma cashflow analysis, and low probability/high impact event risk. The article directs examiners to assess institutions' adherence to the guidance when analyzing liquidity.

Thank you for the opportunity to review and comment on the Draft Report.