Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-037

Material Loss Review of Prosperan Bank, Oakdale, Minnesota

June 2010

Office of
Inspector General

Executive Summary

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Why We Did The Audit

On November 6, 2009, the Minnesota Department of Commerce (MDC), closed Prosperan Bank (Prosperan) and named the FDIC as receiver. On December 2, 2009, the FDIC notified the Office of Inspector General (OIG) that Prosperan's total assets at closing were $206.6 million and the estimated material loss to the Deposit Insurance Fund (DIF) was $59 million. As of April 30, 2010, the estimated loss had decreased to $53.2 million. As required by section 38(k) of the Federal Deposit Insurance Act, the OIG conducted a material loss review of the failure of Prosperan.

The audit 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.

Background

Prosperan, formerly known as Washington County Bank, was established as a national bank on April 6, 1999. The bank converted from a national charter to a state nonmember bank on December 15, 2006, and subsequently changed its name to Prosperan Bank on November 15, 2007. Prior to its conversion, Prosperan was regulated by the Office of the Comptroller of the Currency (OCC). The FDIC performed its first examination of Prosperan on January 16, 2007. Prosperan was wholly-owned by Prosperan Bancshares, Inc., formerly known as WCB Bancshares, Inc. The bank had its main office in Oakdale, Minnesota and operated two branches, one in Maplewood, Minnesota and one in Minnetonka, Minnesota.

Audit Results

Causes of Failure and Material Loss

Prosperan's failure can be primarily attributed to the institution's poor risk management practices associated with concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans, and with its commercial and industrial loan portfolio. In addition, management's decision to change its investment strategy to focus on structured credit products—mostly backed by real estate—was poorly timed and created additional risk for the bank. Further, management failed to sufficiently correct deficiencies that were identified by examiners. When the deterioration of the real estate market occurred, the risk management deficiencies and investment decisions translated quickly into a significant decline in the quality of the institution's loan and investment portfolios. Provisions for losses and actual losses depleted earnings, eroded capital, and strained liquidity. Ultimately, the MDC closed Prosperan on November 6, 2009 and named the FDIC as receiver.

The FDIC's Supervision of Prosperan

Our review focused on supervisory oversight of Prosperan between 2006 and 2009. During that period, the OCC, the FDIC, and the MDC conducted four onsite risk management examinations and the FDIC monitored current and emerging issues at the bank through its offsite monitoring program. Through those supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the

attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's concentrations in ADC and CRE lending and weak underwriting and credit administration policies and practices. Examiners also made recommendations to Prosperan's Board and management in the 2007 examination report for improving the bank's underwriting standards, exception thresholds, and loan diversification.

Prosperan's overall financial condition was considered satisfactory until the 2008 MDC examination. By then, asset quality had rapidly deteriorated due to the decline in the real estate market. The MDC downgraded the bank at the 2008 examination and pursued a Memorandum of Understanding to address numerous high-risk practices and deficiencies identified by examiners. Despite the bank's efforts to address the identified problems and deficiencies, its financial condition continued to deteriorate. By the 2009 examination, the FDIC determined that asset quality, capital, and earnings were critically deficient and appeared to be beyond management's ability to control, and further downgraded the bank. The FDIC also issued a Cease and Desist Order—effective on September 10, 2009—which, among other things, required Prosperan to maintain capital ratios of 10 percent and develop a plan to improve liquidity.

The FDIC's supervisory approach was consistent with practices in place at the time for an institution with Prosperan's risk profile. However, more effective follow-up to the FDIC's 2007 examination recommendations would have been beneficial in mitigating apparent risks at Prosperan. Specifically, had the FDIC ensured that Prosperan's management addressed the recommendations in the 2007 examination earlier and made improvements to the bank's underwriting standards, loan policy exception thresholds, and loan diversification, losses incurred by the DIF may have been mitigated to some extent. Ultimately, although the FDIC and the MDC pursued supervisory actions, and Prosperan took steps to address them, the actions and response were not timely or sufficient to prevent the bank's failure.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. However, on November 6, 2009, the MDC closed Prosperan and named the FDIC as receiver.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On June 1, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Prosepran's failure. With regard to our assessment of the FDIC's supervision of Prosperan, DSC summarized the bank's supervisory history described in our report. In addition, DSC stated "Stronger supervisory follow-up to assess the progress of recommended corrective actions should have been taken, particularly in light of the risks associated with concentrations in CRE/ADC loans and investments in CDOs." DSC also noted that it has updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations. DSC further indicated, as mentioned in our report, that it issued a Financial Institution Letter in 2009 to insured institutions on *Risk Management of Investments in Structured Credit Products*, providing clarification to existing guidance and strongly recommending vigilant due diligence and appropriate internal controls related to these securities.

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3501 Fairfax Drive, Arlington, Virginia 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: June 2, 2010

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

/Signed/

FROM: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of Prosperan Bank, Oakdale, Minnesota* (Report No. MLR-10-037)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Prosperan Bank (Prosperan), Oakdale, Minnesota. On November 6, 2009, the Minnesota Department of Commerce (MDC), closed Prosperan and named the FDIC as receiver. On December 2, 2009, the FDIC notified the OIG that Prosperan's total assets at closing were $206.6 million and the estimated material loss to the Deposit Insurance Fund (DIF) was $59 million. As of April 30, 2010, the estimated loss had decreased to $53.2 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. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review 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[2] of the institution, including implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Prosperan's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal

[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] 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 examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.

recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our material loss reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations, as warranted.[3] Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of terms; and Appendix 3 contains a list of acronyms used in this report. Appendix 4 contains the Corporation's comments on this report.

Background

Prosperan, formerly known as Washington County Bank, was established as a national bank on April 6, 1999. The bank converted from a national charter[4] to a state nonmember bank on December 15, 2006, and subsequently changed its name to Prosperan Bank on November 15, 2007. The FDIC performed its first examination of Prosperan on January 16, 2007. Prosperan was wholly-owned by Prosperan Bancshares, Inc., formerly known as WCB Bancshares, Inc. The bank had its main office in Oakdale, Minnesota and operated two branches, one in Maplewood, Minnesota and one in Minnetonka, Minnesota. Table 1 provides details on Prosperan's financial condition as of June 30, 2009 and for the 4 preceding calendar years.

Table 1: Selected Financial Information for Prosperan, 2005 to 2009

Financial Measure	June-2009	Dec-2008	Dec-2007	Dec-2006	Dec-2005
Total Assets ($000s)	$190,550	$214,483	$228,830	$185,688	$174,816
Total Loans ($000s)	$149,342	$171,014	$162,014	$152,983	$146,631
Total Deposits ($000s)	$183,369	$178,151	$200,768	$164,057	$151,366
Net Income (Loss) ($000s)	($9,634)	($4,914)	($163)	$1,732	$1,638

Source: Uniform Bank Performance Reports (UBPR) for Prosperan.

Causes of Failure and Material Loss

Prosperan's failure can be primarily attributed to the institution's poor risk management practices associated with concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans, and with its commercial and industrial (C&I)[5] loan portfolio. In addition, management's decision to change its investment strategy to focus on structured credit products—mostly backed by real estate—was poorly timed and created additional risk for the bank. Further, management failed to

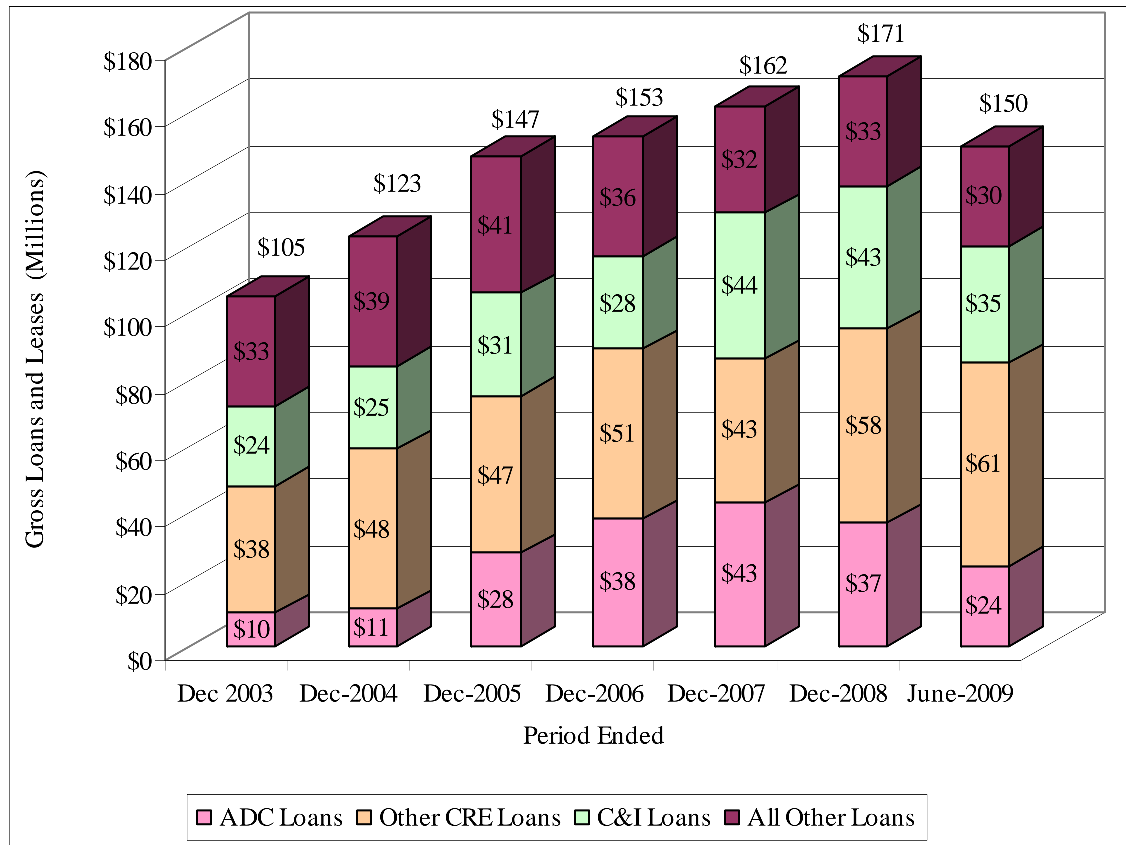
[3] For example, in May 2010, the FDIC OIG's Office of Evaluations initiated a review of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, PCA and section 39, Safety and Soundness Standards) in the banking crisis.
[4] Prior to its conversion, Prosperan was regulated by the Office of the Comptroller of the Currency (OCC).
[5] C&I loans are those that are made to a business or corporation and not to an individual. These loans can be made in order to provide either working capital or to finance major capital expenditures. This type of loan is usually short-term in nature and is almost always backed with some sort of collateral.

sufficiently correct deficiencies that were identified by examiners. When the deterioration of the real estate market occurred, the risk management deficiencies and investment decisions translated quickly into a significant decline in the quality of the institution's loan and investment portfolios. Provisions for losses and actual losses depleted earnings, eroded capital, and strained liquidity. Ultimately, the MDC closed Prosperan on November 6, 2009 and named the FDIC as receiver.

Losses Within Prosperan's ADC, CRE, and C&I Loan Portfolios

Losses within Prosperan's ADC, CRE, and C&I loan portfolios were principal factors leading to the bank's deteriorating financial condition and subsequent failure. The losses were beyond the bank's ability to effectively manage in a declining economic environment and were the result of inadequate risk management practices that are discussed in the next section of this report. The figure below illustrates the general composition and growth of Prosperan's loan portfolio in the years preceding the institution's failure. In total, Prosperan's portfolio of ADC, other CRE, and C&I loans was significant – ranging from 68 percent to 81 percent of gross loans and leases over the period 2003 to 2009.

Composition of Prosperan's Loan Portfolio



Source: OIG analysis of UBPRs and Consolidated Reports of Condition and Income (Call Reports) for Prosperan.

ADC and CRE Concentrations

Federal banking regulatory agencies issued guidance in December 2006, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), recognizing that there are substantial risks posed by CRE and ADC concentrations.[6] The Joint Guidance specifically notes that concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets have contributed to significant credit losses in the past and that such concentrations may make institutions more vulnerable to cyclical CRE markets.

The Joint Guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. According to the guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the previous criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk.

As shown in Table 2, Prosperan's concentrations in ADC loans from 2006 to 2009 exceeded the criteria for concentrations used to identify institutions that may warrant further supervisory analysis. In addition, ADC loans as a percent of the bank's total capital and total loans were significantly above its peer group[7] averages during the same period.

Table 2: Prosperan's ADC Concentrations Compared to Peer Group

Period Ended	ADC Loans as a Percent of Total Capital			ADC Loans as a Percent of Total Loans		
	Prosperan	Peer Group	Prosperan Percentile	Prosperan	Peer Group	Prosperan Percentile
Dec 2006	213.44	106.35	80	24.97	15.65	76
Dec 2007	242.41	107.15	89	26.55	15.03	83
Dec 2008	270.62	96.71	93	21.54	13.05	79
June 2009	681.44*	85.02	99	15.76	11.67	70

Source: UBPR data for Prosperan.
* The increase in risk exposure from ADC loans in 2009 was due primarily to the decline in the bank's capital level.

As shown in Table 3, Prosperan's CRE concentrations from 2007 to 2009 also exceeded the CRE concentration criteria in the Joint Guidance. In addition, CRE loans as a percent of total capital and total loans were significantly above the bank's peer group averages from 2007 to 2009.

[6] The guidance was issued jointly by the OCC, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).
[7] Prosperan's peer group included institutions located in a metropolitan statistical area with assets between $100 million and $300 million and three or more full-service banking offices.

Table 3: Prosperan's CRE Concentrations Compared to Peer Group*

Period Ended	CRE Loans as a Percent of Total Capital			CRE Loans as a Percent of Total Loans		
	Prosperan	Peer Group	Prosperan Percentile	Prosperan	Peer Group	Prosperan Percentile
Dec 2007	424.36	255.69	88	46.48	35.38	76
Dec 2008	495.78	216.05	95	39.46	29.55	74
June 2009	1,638.22**	206.63	99	37.89	28.63	74

Source: UBPR data for the Prosperan.
* Percentages for Prosperan and its peer group excluded owner-occupied CRE. We did not include CRE information for 2006 because the Joint Guidance did not require banks to maintain information on non-owner occupied CRE prior to 2007.
** The increase in risk exposure from CRE loans in 2009 was due primarily to the decline in the bank's capital level.

Although the January 2007 FDIC examination noted that asset quality remained satisfactory, examiners recommended that the Board and management strengthen underwriting and oversight of CRE lending considering the significant concentration and syndication[8] of these loans. The examination report also stated that CRE concentrations represented 549 percent of Tier 1 Capital and 58 percent of Prosperan's total loan portfolio. During the July 2008 MDC examination, examiners noted that, since the January 2007 examination, classified assets had increased from 25 percent of Total Capital and Reserves to 84 percent. MDC examiners also stated that "problems in the loan portfolio related, in large degree, to the bank's high concentration in CRE loans, especially in the area of residential construction and development loans." According to examiners, by the July 2009 examination, the financial condition of the institution had deteriorated due to a significant decline in asset quality that immediately threatened the viability of the bank.

C&I Loan Losses

As previously noted in the figure, C&I lending represented a significant segment of Prosperan's overall loan portfolio. Losses in this portfolio were considerable—Call Report data shows that from 2006 through June 2009, Prosperan charged off a total of $8.9 million in C&I loans, with $8.1 million being charged off in 2009 alone. The FDIC's 2009 examination report attributed three large C&I loan losses, totaling $5.1 million, to loans originated by the bank in late 2007 and in 2008, after the 2007 examination. Therefore, the FDIC did not have the opportunity to review those loans until its 2009 examination at which time it criticized the loans as high risk and exhibiting underwriting and administration weaknesses. According to the FDIC, losses in the C&I portfolio were the result of inadequate risk selection, credit underwriting, and loan administration practices that were magnified by a general decline in the local economy.

[8] A syndicated loan involves two or more banks contracting with a borrower to provide funds at specified terms under the same credit facility.

Oversight and Risk Management Practices

In addition to implementing business strategies that resulted in significant concentrations in ADC and CRE loans, and inherently risky investments, Prosperan's Board and senior management did not implement sound underwriting and credit administration practices. Further, examiners expressed concerns regarding the high level of staff turnover and the impact such turnover could have on the institution. The FDIC's 2009 and final examination report stated that the institution exhibited critically deficient performance, including inadequate risk management practices relative to its risk profile, and was of the greatest supervisory concern. The report also stated that the volume and severity of problems were beyond management's ability to control or correct.

Risk Selection, Loan Underwriting, and Credit Administration

Poor risk selection and weak loan underwriting and credit administration practices contributed to the asset quality problems that developed in Prosperan's CRE, ADC, and C&I loan portfolios when the real estate market began to deteriorate in 2008. According to the FDIC, risk management weaknesses were evident in the 2007 examination and included (1) speculative loans that should have received far more scrutiny from the bank's Board and management; (2) deals that did not make sense based on the market; and (3) bank management's reliance on appraisals regardless of market demand for the project. Further, Prosperan financed residential or commercial construction projects without satisfactory hard equity, with limited pre-sale or pre-lease requirements, and with unreasonable payment terms. In addition, the bank failed to monitor ongoing projects in terms of their leasing timeframes, project completion dates, sales prospects, and global cash flow analyses. Other weaknesses included the lack of (1) concentration limits to promote portfolio diversification; (2) complete and current loan documentation, resulting in high levels of technical exceptions; and (3) current or adequate appraisals.

The OCC first raised concerns about the bank's underwriting practices during its 2006 examination, when examiners noted that "management and the Board will need to strengthen CRE underwriting and enhance their oversight of CRE lending activities." In its 2006 examination report, the OCC recommended that Prosperan's Board and management:

- Strengthen CRE policy requirements and guidance for underwriting, analysis, and monitoring.
- Improve the guarantor analyses, in particular for projects with less than 10 percent hard equity or other underwriting exceptions.
- Implement a tracking system to cumulatively monitor the number and dollar volume of critical policy underwriting exceptions and, once policy exceptions levels reach a specified threshold, revisit underwriting practices or policy limits.
- Clarify and strengthen Board and management leadership and strategic direction governing CRE lending activities.

The FDIC's 2007 examination report also indicated that the Board needed to strengthen underwriting and oversight of its CRE lending, considering the significant concentration and syndication of these loans. The MDC's 2008 examination further found the bank's risk management practices to be less than satisfactory relative to the institution's size, complexity, and risk profile.

Poor oversight by Prosperan's Board and senior management also resulted in apparent violations of rules, contraventions of an interagency policy statement, and the need to amend the June 30, 2009 Call Report to address inaccuracies. For example, during the FDIC's 2009 examination, Prosperan was cited for three apparent violations of Minnesota statutes related to the pledging of assets, other real estate owned, and legal lending limits. In 2009, the bank was also cited for three contraventions related to the allowance for loan and lease losses (ALLL), investment securities, and end-user derivative activities.

Investment Portfolio Risks

Prosperan also significantly increased the credit exposure in its investment portfolio after the January 2007 examination, when approximately 46 percent of the portfolio consisted of U.S. Government agency securities. Specifically, bank management began investing in non-U.S. Government agency structured credit products—primarily private label mortgage-backed securities (MBS) and asset-backed securities (ABS). As of the June 30, 2009 Call Report, the amortized cost of the bank's investment in MBS and ABS totaled $29 million, which represented almost 100 percent of the bank's total securities portfolio. The underlining collateral for MBS was generally Alt-A,[9] first-lien residential mortgages, while ABS issues were collateralized by home equity loans.

Examiners recognized problems with the bank's increased emphasis on non-U.S. Government agency securities in the 2009 examination. The examination report noted that nine securities, totaling $13.3 million, were assigned non-investment grade ratings and two securities, totaling $319,000, were other than temporarily impaired (referred to as OTTI) and adversely classified as Loss. Prosperan's liquidity was also negatively impacted as a result of its investment strategy. Specifically, because the securities were 70-percent pledged and a large volume were considered subinvestment quality, examiners did not consider the bank's investment portfolio a realistic source of liquidity.

The FDIC's 2009 examination report stated that, according to Prosperan's President, the bank's investment strategy implemented in early 2008 sought to improve investment portfolio yields in an effort to offset the earnings impact from increasing levels of nonperforming loans. The President added that bank management viewed the significant price discounts for the MBS purchased in early 2008 as an additional form of credit enhancement against principal loss. Examiners noted that the bank's pre-purchase analysis and prospectus information indicated that each security investment was AAA-rated at the time of purchase. However, according to the 2009 examination report, the Board-approved investment policy did not establish adequate risk limits and controls

[9] Alt-A refers to a mortgage risk categorization that falls between prime and subprime.

regarding structured credit products. Further, the policy did not establish any limits or guidelines regarding concentration limits by investment category, indicate the desired portfolio mix, or specify any dollar limits on individual officer investment authority.

Financial Institution Letter (FIL) 20-2009, *Risk Management of Investments in Structured Credit Products*, issued by the FDIC on April 30, 2009 to clarify existing supervisory guidance on complex structured credit products, provides some insight into Prosperan's failed strategy. FIL-20-2009 states that amid the credit turmoil, some institutions that were attracted to higher yields purchased illiquid and, in some instances, distressed structured securities at a discount. This strategy assumed the discount would provide a margin of safety against principal losses even given continued market stress, including ongoing deteriorating collateral performance and credit rating downgrades. However, in many cases, the discounts signaled the market's well-founded concerns and risk perception. Further, the FDIC has found that, generally, the discounts were not sufficient to cover the losses that followed.

The FDIC's Supervision of Prosperan

Our review focused on supervisory oversight of Prosperan between 2006 and 2009. During that period, the OCC, the FDIC, and the MDC conducted four onsite risk management examinations and the FDIC monitored current and emerging issues at the bank through its offsite monitoring program. Through those supervisory efforts, examiners identified key risks in the bank's operations and brought these risks to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's concentrations in ADC and CRE lending and weak underwriting and credit administration policies and practices. Examiners also made recommendations to Prosperan's Board and management in the 2007 examination report for improving the bank's underwriting standards, exception thresholds, and loan diversification.

Prosperan's overall financial condition was considered satisfactory until the 2008 MDC examination. By then, asset quality had rapidly deteriorated due to the decline in the real estate market. The MDC downgraded the bank at the 2008 examination and pursued a Memorandum of Understanding (MOU) to address numerous high-risk practices and deficiencies identified by examiners. Despite the bank's efforts to address the identified problems and deficiencies, its financial condition continued to deteriorate. By the 2009 examination, the FDIC determined that asset quality, capital, and earnings were critically deficient and appeared to be beyond management's ability to control, and further downgraded the bank. The FDIC also issued a Cease and Desist (C&D) Order—effective on September 10, 2009—which, among other things, required Prosperan to maintain capital ratios of 10 percent and develop a plan to improve liquidity.

The FDIC's supervisory approach was consistent with practices in place at the time for an institution with Prosperan's risk profile. However, more effective follow-up to the FDIC's 2007 examination recommendations would have been beneficial in mitigating

apparent risks at Prosperan. Specifically, had the FDIC ensured that Prosperan's management addressed the recommendations in the 2007 examination earlier and made improvements to the bank's underwriting standards, loan policy exception thresholds, and loan diversification, losses incurred by the DIF may have been mitigated to some extent. Ultimately, although the FDIC and the MDC pursued supervisory actions, and Prosperan took steps to address them, the actions and response were not timely or sufficient to prevent the bank's failure.

Supervisory History

Table 4 summarizes key information pertaining to the supervision of Prosperan until its failure, including the institution's supervisory ratings[10] and supervisory actions taken.

Table 4: Prosperan's Examination History, 2006 to 2009

Date*	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
01/24/2006	OCC	222222/2	N/A
01/16/2007	FDIC	222222/2	N/A
12/31/2007 (Offsite Review)	FDIC	None	N/A
03/31/2008 (Offsite Review)	FDIC	None	N/A
06/30/2008 (Offsite Review)	FDIC	N/A	N/A
07/16/2008	State	343332/3	MOU Effective 12/19/2008
07/13/2009	FDIC	555555/5	C&D Effective 09/10/2009

Source: The FDIC's Virtual Supervisory Information on the Net system and Reports of Examination.
* For the examinations with supervisory ratings, the date refers to the examination start date. For the Offsite Reviews, the date refers to the "as of date."

Offsite Reviews

The FDIC's offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. The FDIC electronically generates an Offsite Review List (ORL) each

[10] 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: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity 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.

quarter and performs offsite reviews for each "1-" and "2-" rated bank that appears on the list. The system-generated ORL includes institutions that are identified:

- by the Statistical CAMELS Offsite Rating (SCOR)[11] system as having a 35 percent or greater probability of downgrade to a "3" or worse, or
- in the Growth Monitoring System (GMS)[12] as having a growth percentile of 98 or 99.

The FDIC conducted three offsite reviews of Prosperan between December 2007 and June 2008.

December 2007 Offsite Review. In December 2007, Prosperan was identified for an offsite review, primarily due to the high volume of nonaccrual and past due loans, and concentrations in the CRE and ADC loan portfolio. Consistent with DSC guidance, the FDIC contacted the bank. According to Prosperan's Chief Financial Officer, the significant increase in nonperforming loans was due to rapid deterioration in the local real estate market. The Chief Financial Officer also informed the FDIC that the bank was taking actions to improve credit quality by formulating a Credit Management Improvement Plan, increasing the ALLL, and employing aggressive collection efforts with management and Board monitoring. The FDIC did not recommend changes in supervisory status or action at the time of this review because (1) the MDC was scheduled to begin a full-scope examination in the third quarter of 2008 and (2) bank management appeared knowledgeable of the situation, was taking action to improve credit quality, and was closely monitoring the bank's exposure. However, the FDIC recommended continued offsite monitoring.

March 2008 and June 2008 Offsite Reviews. In these two subsequent offsite reviews, completed in June and September 2008, respectively, the FDIC found that the level and trend of risk were unchanged, and risk continued to be primarily related to the concentrations and composition of the loan portfolio. The FDIC again did not recommend any action at this time because the MDC had begun an onsite examination on July 15, 2008.

Enforcement Actions

The FDIC and the MDC each pursued a formal enforcement action to address weak risk management practices identified by examiners.

December 2008 MOU. The MDC found substantial deterioration in the bank's condition at the July 2008 examination and, as a result, issued an MOU effective December 19, 2008 that, among other things, required the bank's Board and management to (1) develop a comprehensive, written strategic business plan; (2) submit a capital

[11] SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
[12] GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.

maintenance plan; (3) collect, charge off, or expense all assets classified Loss in the report; (4) adopt plans to reduce the bank's risk; (5) not extend extensions of credit to adversely classified borrowers; (6) correct all asset documentation exceptions; (7) adopt a plan to reduce and monitor the risk in the bank's concentrations of credit; (8) enhance the bank's Contingency Funding Plan; and (9) submit progress reports detailing its progress on compliance with the MOU.

September 2009 C&D. This corrective action was taken in response to the FDIC's July 2009 examination, which reflected Prosperan's *Critically Undercapitalized* position, net losses, and failure to implement all of the December 2008 MOU provisions. The C&D required the bank to, among other things, maintain capital ratios of 10 percent and develop a plan to improve liquidity. The Board stipulated to the C&D, which was effective on September 10, 2009 and remained in effect until the bank was closed.

Supervisory Response to Key Risks

Examiners identified key risks at Prosperan and made recommendations to address them during the 2007 examination. However, follow-up on those recommendations could have been more effective, and enforcement actions were not pursued until after the bank's asset quality and overall financial condition had significantly deteriorated. Various factors appeared to influence the FDIC's supervisory response, including the bank's overall satisfactory condition; a historically low loan loss history; a low level of adversely classified assets (25 percent of Tier 1 Capital); satisfactory management, earnings, and capital; and management's perceived willingness and ability to correct the identified weaknesses.

Following the FDIC's 2007 examination, Prosperan was on an 18-month examination schedule, which allowed the bank to continue making CRE and ADC loans with limited supervisory oversight and assurance that adequate risk management practices were in place. As the real estate market declined, the combination of significant CRE and ADC concentrations and persistent weaknesses in underwriting and credit administration practices caused a rapid deterioration in the bank's portfolio.

The 2006 OCC Examination

In its January 2006 examination, the OCC reported that the bank's asset quality, credit administration practices, and financial condition were satisfactory. However, OCC examiners also stated that management and the Board needed to (1) strengthen critical CRE policy requirements for underwriting, analysis, and monitoring and (2) enhance their oversight of CRE lending activities. The OCC warned the bank that its CRE concentration in excess of 400 percent of capital might result in unwarranted credit risk. Further, the OCC indicated that Prosperan's Board and management should ensure that CRE risk management practices and underwriting were commensurate with the Board's strategic objectives. The OCC planned to follow up with quarterly monitoring of the bank's activities and an onsite follow-up examination of CRE lending to evaluate the bank's ongoing condition and assess supervisory risks. However, the OCC was unable to

follow through with its plans once the bank converted from a national charter to a state nonmember charter in December 2006.

The January 2007 FDIC Examination

The FDIC's 2007 examination report stated that the bank's overall condition was satisfactory and that management had generally implemented previous regulatory recommendations. Examiners did, however, repeat prior supervisory concerns regarding Prosperan's high CRE concentrations and persistent deficiencies in the CRE underwriting guidelines, appraisal review process, monitoring, and tracking. As a result of these concerns, examiners recommended and bank management agreed to (1) enhance its Loan Policy to improve its underwriting standards, (2) establish acceptable policy exception thresholds and monitor and report exceptions, and (3) review diversification standards and risk limits. Prosperan's management agreed to implement these recommendations within 3 months. However, based on our review, we could not find documentation clearly indicating that the FDIC specifically followed up on the recommendations during subsequent contacts with the bank or as part of offsite reviews.

The FDIC also cautioned that the CRE concentrations, which totaled $89 million, represented 549 percent of Tier 1 Capital, 58 percent of the total loan portfolio, and over 80 percent of the volume of adverse classifications. Examiners indicated that these concentration levels might expose the bank to unanticipated earnings and capital volatility if there were adverse changes in the general commercial real estate market.

The 2007 examination report also stated that the weaknesses identified at this examination were within management's willingness and ability to correct. Management told the examiners that they had "tightened underwriting standards" and provided assurances that they were committed to maintaining a fully-funded ALLL and a *Well Capitalized* status for PCA purposes. Examiners found the bank's ALLL to be reasonable based on the bank's internal analysis, the level of risk in the loan portfolio, and the bank's historical loss experience. Further, asset growth was projected at 11 percent for 2007, which examiners did not find alarming. Levels of adverse asset classifications were stable, manageable, and low, consistent with the previous regulatory examination.

With respect to follow-up on examination findings, the FDIC issued guidance to its examiners on January 26, 2010 that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed. Specifically, the guidance defines a standard approach for communicating matters requiring Board attention (e.g., examiner concerns and recommendations) in examination reports. The guidance also states that examination staff should request a response from the institution regarding the actions that it will take to mitigate the risks identified during the examination and correct noted deficiencies.

The 2008 MDC Examination

The MDC's July 2008 examination downgraded the bank to a composite "3" rating due to significant deterioration in asset quality, earnings, capital, and management and an increasing dependence on non-core funding to meet liquidity needs. The MDC found that management had made the requested revisions to the loan policy as examiners had suggested. However, the level of adversely classified assets had already increased from 25 percent to 84 percent of Total Capital and Reserves between the January 2007 and July 2008 examinations, primarily in the CRE and ADC loan portfolio. In addition, the MDC stated that serious problems in the loan portfolio had adversely impacted earnings and strained capital. The bank's Tier 1 Leverage Capital ratio was 7.58 percent compared to the peer group average of 9.59 percent, and Risk-Based Capital ratios were also substantially below peer. Examiners warned that liquidity could be threatened if problems were not quickly resolved. As a result, as discussed previously, the MDC entered into an MOU with Prosperan in December 2008 to address numerous high-risk practices and deficiencies identified at the examination. The MDC monitored the bank's progress in implementing the MOU provisions subsequent to the examination. However, despite the bank's efforts and progress in addressing the identified problems, the bank's financial condition continued to deteriorate.

As discussed earlier in this report, Prosperan's management increased the credit risk exposure within the securities portfolio in early 2008 by investing heavily in structured credit products – primarily private label MBS and ABS. However, the 2008 MDC examination report did not discuss the bank's shift in investment strategy or increased credit risk exposure within the securities portfolio. The MDC Commissioner acknowledged that the securities were purchased in early 2008 but stated that, at the time of the examination, there was little deterioration in the securities portfolio. Only one security was adversely classified and noted in the 2008 MDC examination. By the 2009 examination, credit ratings were downgraded to subinvestment quality, and the credit quality of the underlying loans within the investment structures had eroded, reducing the security portfolio's value as a realistic source of liquidity.

The 2009 FDIC Examination

By the 2009 examination, the FDIC found the bank to be critically deficient. The FDIC stated that the Board's oversight of management and lending was deficient and management had been unable to adapt to the changing economic environment. The level of adversely classified items had increased from 84 percent of Total Capital and Reserves at the 2008 examination, to 382 percent of Total Capital and Reserves during the 2009 examination. In addition, capital had severely eroded due to extensive losses that threatened the bank's viability. The FDIC determined that the continuing weaknesses in Prosperan's policies and practices were significant factors in the increase in adverse classifications in the bank's CRE portfolio and that even the bank's new contingency funding plans and monitoring programs could not adequately offset the risks. The FDIC concluded that the bank's deteriorated condition was beyond management's ability to control or reverse. The FDIC subsequently downgraded the bank to a composite "5" rating and pursued a C&D, which remained in effect until the bank was closed on

November 6, 2009. The C&D, which became effective on September 10, 2009, contained provisions that were consistent with the requirements of the MOU.

Implementation of PCA

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 an institution's capital levels. Part 325, *Capital Maintenance*, of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-charted nonmember banks that are not *Adequately Capitalized*. Enforcement actions addressing Prosperan's capital deficiencies were taken in accordance with PCA-related provisions. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner, as follows:

- On February 12, 2009, the FDIC sent a letter to Prosperan's Board notifying the bank that it was considered *Adequately Capitalized*.

- Based on the June 30, 2009 Call Report, the FDIC sent a letter to Prosperan's Board on July 31, 2009, notifying the bank that it was considered *Undercapitalized* and that it was subject to restrictions on asset growth, acquisitions, new activities, new branches, dividends, other capital distributions, and management fees. The letter also required the bank to file a written Capital Restoration Plan within 45 days, or no later than September 14, 2009, in accordance with Section 38(e)(2) of the FDI Act.

  As of June 30, 2009, the bank's capital ratios were:

  - Total Risk-Based Capital Ratio: 6.28 percent
  - Tier I Risk-Based Capital Ratio: 5.01 percent
  - Tier I Leverage Ratio: 4.25 percent

- On August 14, 2009, the FDIC sent a letter to Prosperan's Board notifying the bank that it was in troubled condition and was within the *Critically Undercapitalized* capital category for PCA purposes, with a Tangible Equity Capital Ratio of 0.70 percent.

  In addition to the restrictions previously identified in the July 31, 2009 letter, the August 14, 2009 letter added restrictions on renewing or accepting brokered deposits, as well as eight other provisions that prohibited the bank from engaging in transactions without prior written approval by the FDIC. The letter recommended that the Board develop policies and procedures to ensure compliance.

- On August 14, 2009, the FDIC sent a separate letter to Prosperan's Board notifying the bank that the findings of its then-ongoing examination revealed the overall condition of the bank had significantly deteriorated and was unsatisfactory. Based on these findings, the FDIC revised the bank's composite rating to a "5."

- On September 16, 2009, the FDIC received Prosperan's capital plan and, subsequently, sent a letter to the bank's Board stating the plan was unacceptable.

- On October 14, 2009, in response to item 5(c), *Brokered Deposits*, of the September 10, 2009 C&D, the President and Chief Executive Officer of the bank sent the FDIC a letter describing a plan for reducing its reliance on brokered deposits.

- On October 27, 2009, Prosperan submitted a second capital plan. However, on November 6, 2009, the MDC closed Prosperan and named the FDIC as receiver.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On June 1, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Prosperan's failure. With regard to our assessment of the FDIC's supervision of Prosperan, DSC summarized the bank's supervisory history described in our report. In addition, DSC stated "Stronger supervisory follow-up to assess the progress of recommended corrective actions should have been taken, particularly in light of the risks associated with concentrations in CRE/ADC loans and investments in CDOs." DSC also noted that it had updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations. DSC further indicated, as mentioned in our report, that it issued a FIL in 2009 to insured institutions on *Risk Management of Investments in Structured Credit Products*, providing clarification to existing guidance and strongly recommending vigilant due diligence and appropriate internal controls related to these securities.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, 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 audit 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 PCA provisions of section 38.

We conducted this performance audit from January 2010 to May 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit concentrated on Prosperan's operations from 2006 until its failure on November 6, 2009. 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 OCC, the FDIC, and the MDC from 2006 to 2009.
- Reviewed the following:
    - Bank data and correspondence maintained on various FDIC systems.
    - Reports prepared by the Division of Resolutions and Receiverships and DSC relating to the bank's closure.
    - Pertinent DSC policies and procedures.
- Interviewed the following officials:
    - DSC management in Washington, D.C., and the Kansas City Regional Office.

- o FDIC examiners from the Minnesota Field Office who participated in the examinations and visitations of Prosperan.
- o Officials from the MDC to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

Internal Control, Reliance on Computer-processed Information, Performance Management, and Compliance with Laws and Regulations

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand Prosperan's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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 audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

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

Glossary of Terms

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) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Asset-Backed Securities	Asset-backed securities are bonds or notes backed by financial assets. Typically, these assets consist of receivables other than mortgage loans, such as credit card receivables, auto loans, manufactured-housing contracts, and home-equity loans.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D 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 a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Mortgage-Backed Securities (MBS)	Securities representing an undivided interest in a pool of mortgages with similar characteristics. Payments on the underlying mortgages are used to make payments to the security holders.

Glossary of Terms

Other Than Temporary Impairment (OTTI)	An impairment of a debt instrument occurs when the fair value of the security is less than its amortized cost basis. According to accounting standards, when the impairment is judged to be other than temporary, the cost basis of the individual security must be written down to fair value, thereby establishing a new cost basis for the security, and the amount of the write-down must be included in earnings as a realized loss.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of:** • 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; **Minus:** • 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).
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Acronyms

ABS	Asset-Backed Security
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
C&I	Commercial and Industrial
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
GMS	Growth Monitoring System
MBS	Mortgage-Backed Security
MDC	Minnesota Department of Commerce
MOU	Memorandum of Understanding
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
ORL	Offsite Review List
OTTI	Other Than Temporarily Impaired
PCA	Prompt Corrective Action
SCOR	Statistical CAMELS Offsite Rating
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

May 25, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Prosperan Bank, Oakdale, Minnesota (Assignment No. 2010-017)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Prosperan Bank (Prosperan) Oakdale, Minnesota, which failed on November 6, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on May12, 2010.

Prosperan failed due to poor risk management practices associated with concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans; and with its commercial and industrial loan portfolio. Furthermore, the Board of Directors (Board) and management pursued an investment strategy that focused on structured credit products centered in real estate that exposed Prosperan to additional risk. These weaknesses left Prosperan vulnerable to the downturn in the local economic and real estate market conditions. Prosperan was closed due to overall deterioration in its loan portfolio, poor earnings, and inadequate capital.

Prosperan converted to a state-chartered institution in December 2006. Between 2006 and 2009, the Office of the Comptroller of the Currency (OCC), FDIC, and the Minnesota Department of Commerce (MDC), jointly and separately conducted four examinations, and the FDIC monitored current and emerging issues through its offsite monitoring program. Examiners identified key risks and brought them to the Board's and management's attention through examination reports and other correspondence. These risks included the CRE/ADC concentrations, along with weak underwriting and credit administration polices and practices. However, management failed to sufficiently correct the deficiencies, and subsequently the MDC and FDIC initiated enforcement actions.

Stronger supervisory follow-up to assess the progress of recommended corrective actions should have been taken, particularly in light of the risks associated with concentrations in CRE/ADC loans and investments in CDOs. DSC has updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations. Additionally, DSC issued a Financial Institution Letter in 2009 to insured institutions on *Risk Management of Investments in Structured Credit Products*, providing clarification to existing guidance and strongly recommending vigilant due diligence and appropriate internal controls related to these securities.

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