Board of Governors of the Federal Reserve System

Material Loss Review of Bank of Elmwood

Office of Inspector General

May 2010

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

OFFICE OF INSPECTOR GENERAL

May 12, 2010

The Honorable Daniel K. Tarullo
Chairman
Committee on Supervisory and Regulatory Affairs
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Governor Tarullo:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, 12 U.S.C. 1831o(k), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of the Bank of Elmwood (Elmwood). The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) is material—that is, it exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

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

Elmwood was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the Wisconsin Department of Financial Institutions (State). The State closed Elmwood on October 23, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On November 12, 2009, the FDIC Inspector General notified us that Elmwood's failure would result in an estimated loss to the DIF of $90.6 million, or 26.7 percent of the bank's $339.1 million in total assets.

Elmwood failed because its Board of Directors and management pursued a risky loan growth strategy that featured new loan products and out-of-market lending without developing adequate credit risk management controls. The bank pursued this strategy even though its modest earnings and capital position did not provide adequate support to withstand possible asset quality deterioration. The growth strategy, coupled with insufficient credit risk management controls, resulted in poorly underwritten loans. Bank management's inability to adequately address loan portfolio weaknesses led to asset quality deterioration and significant losses. Mounting losses eliminated earnings, depleted capital, and strained liquidity. The State closed Elmwood and appointed the FDIC as receiver after the bank failed to meet a regulatory deadline

to restore the bank to *adequately capitalized* or be acquired by or merge with another financial institution.

FRB Chicago complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted six full scope examinations and a target examination focused on asset quality. In addition, the bank was placed under two formal enforcement actions, a Written Agreement in January 2009 and a PCA Directive in July 2009.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or loss to the DIF. Our analysis of FRB Chicago's supervision of Elmwood revealed that examiners repeatedly cited the bank's marginal earnings performance, capital levels that were below its peer group, and inadequate credit risk management practices, but, in our opinion, FRB Chicago had opportunities for earlier and more forceful supervisory action.

Elmwood's loan growth strategy was first discussed in a 2004 State examination report that also noted that the bank's earnings performance "continued to be deficient" and capital ratios remained below peer bank averages. State examiners noted that Elmwood should control further loan growth until the bank demonstrated that it could produce "sufficient retention of earnings to provide the bank with adequate internal capital generation." In its 2005 examination report, FRB Chicago observed that the bank increased its loan portfolio by about 30 percent over the previous two years by strategically expanding into new geographical markets and purchasing commercial real estate (CRE) loan participations to enhance income. However, examiners once again cited weak earnings and capital levels that remained below peer averages. In our opinion, the recurring weaknesses in earnings and capital provided FRB Chicago with an opportunity to suggest that Elmwood refrain from further growth until management satisfactorily addressed the repeat deficiencies.

We also believe that credit risk management weaknesses noted by examiners in 2006 and 2007 provided early warning signs regarding (1) the potential for asset quality deterioration in Elmwood's growing loan portfolio, and (2) management's ability to control the bank's increasing credit risk profile. The examination reports issued during this period highlighted credit administration deficiencies, such as inadequate monitoring of out-of-market CRE participation loans, incomplete financial data on borrowers and projects, and weak loan underwriting standards. Examiners warned that credit administration deficiencies could make it difficult for management to detect and promptly correct credit problems. Additionally, the 2007 examination report noted a significant increase in classified assets and a corresponding rise in past due and non-accrual loans, yet the bank received an asset quality component 2 rating. In our opinion, the weaknesses cited by examiners, coupled with continued marginal earnings and capital levels below peer averages, warranted an appropriate supervisory response in 2007 compelling bank management to immediately correct the identified deficiencies.

While we believe that FRB Chicago had opportunities for earlier and more forceful supervisory actions, it is not possible for us to predict the effectiveness or impact of any

corrective measures that might have been taken by the bank. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected Elmwood's financial deterioration or the ultimate cost to the DIF.

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Elmwood's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Specifically, Elmwood's failure illustrates the risks posed when a bank with modest earnings and capital levels below peer averages implements a risky loan growth strategy that features new product lines or out-of-market lending. In these situations, examiners should ensure that management has implemented a robust credit risk management infrastructure and is effectively addressing shortcomings in the bank's earnings and capital. Elmwood's failure also demonstrates that banks exhibiting significant growth require heightened supervisory attention and should be subject to an immediate and forceful supervisory response when signs of credit risk management deficiencies first appear.

We provided our draft report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director agreed with our conclusions and lessons learned. His response is included as Appendix 3.

We appreciate the cooperation that we received from FRB Chicago and Federal Reserve Board staff during our review. The principal Office of Inspector General contributors to this report are listed in Appendix 4. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

Elizabeth A. Coleman
Inspector General

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

Board of Governors of the Federal Reserve System

Material Loss Review of Bank of Elmwood

Office of Inspector General

May 2010

Table of Contents

Page

Background 9

Objectives, Scope, and Methodology 9

Cause of the Failure 10

Supervision of Bank of Elmwood 13

Supervision History from 2004 through 2007 14

August 2008 State Examination Resulted in a Double Downgrade to a CAMELS Composite 4 Rating 15

Written Agreement Executed in January 2009 16

February 2009 Joint Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating and a PCA Directive 16

August 2009 Joint Examination Resulted in Another CAMELS Composite 5 Rating 17

Conclusions and Lessons Learned 17

Lessons Learned 18

Analysis of Comments 19

Appendixes 21

Appendix 1 – Glossary of Banking and Regulatory Terms 23

Appendix 2 – CAMELS Rating System 27

Appendix 3 – Division Director’s Comments 29

Appendix 4 – Principal Office of Inspector General Contributors to this Report 31

Background

The Bank of Elmwood (Elmwood), a community bank headquartered in Racine, Wisconsin, commenced operations as a Wisconsin state chartered non-member bank in December 1960, with a focus on serving the needs of middle-income to low-income households. In August 1986, Elmwood became a state member bank subject to supervision by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the State of Wisconsin Department of Financial Institutions Division of Banking (State).

The State closed Elmwood on October 23, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. The FDIC estimated that the bank's failure would result in a $90.6 million loss to the Deposit Insurance Fund (DIF), or 26.7 percent of the bank's $339.1 million in total assets. In a letter dated November 12, 2009, the FDIC Inspector General advised us that the FDIC had determined that Elmwood's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

When a loss to the DIF is considered material, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency

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

To accomplish our objectives, we reviewed the *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed FRB Chicago, State, and Federal Reserve Board staff and collected relevant data from FRB Chicago records. We also reviewed correspondence, surveillance reports, regulatory reports filed by Elmwood, Reports of Examination (examination reports) issued between 2004 and 2009, and examination work papers prepared by FRB Chicago. Appendixes at the end of this report contain a glossary that defines key banking and regulatory terms and a description of the CAMELS rating system.[1] We conducted our fieldwork from January 2010 through April 2010, in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

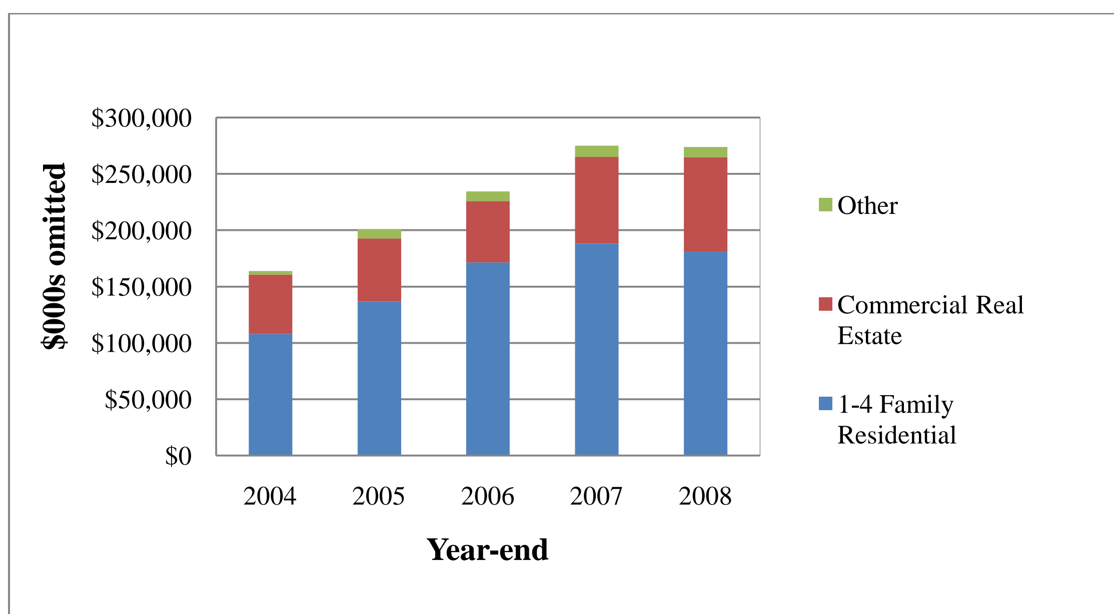
[1] The CAMELS acronym represents six components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5, with 1 having the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

Cause of the Failure

Elmwood failed because its Board of Directors and management pursued a risky loan growth strategy that featured new loan products and out-of-market lending without developing adequate credit risk management controls. The bank pursued this strategy even though its modest earnings and capital position did not provide adequate support to withstand possible asset quality deterioration. The growth strategy, coupled with insufficient credit risk management controls, resulted in poorly underwritten loans. Bank management's inability to adequately address loan portfolio weaknesses led to asset quality deterioration and significant losses. Mounting losses eliminated earnings, depleted capital, and strained liquidity. The State closed Elmwood on October 23, 2009, and appointed the FDIC as receiver after the bank failed to meet a regulatory deadline to restore the bank to *adequately capitalized* or be acquired by or merge with another financial institution.

In 2004, Elmwood's Board of Directors and management implemented a new loan growth strategy to improve marginal earnings that were caused by a slow economy in the bank's market area and overhead expenses that were considerably higher than its peer group. The new loan strategy focused on originating and holding one-to-four family residential loans and purchasing out-of-market commercial real estate (CRE) loan participations.[2] During the 2004 to 2007 period, Elmwood opened three loan production offices (LPOs)—two LPOs were opened in Wisconsin cities outside of the bank's market area, and one was located in Scottsdale, Arizona. As shown in Chart 1, the bank's overall loan portfolio increased from $163.9 million as of December 31, 2004, to $275.0 million at year-end 2007, with the majority of loan growth occurring in one-to-four family residential loans.

Chart 1: Elmwood's Real Estate Loan Growth



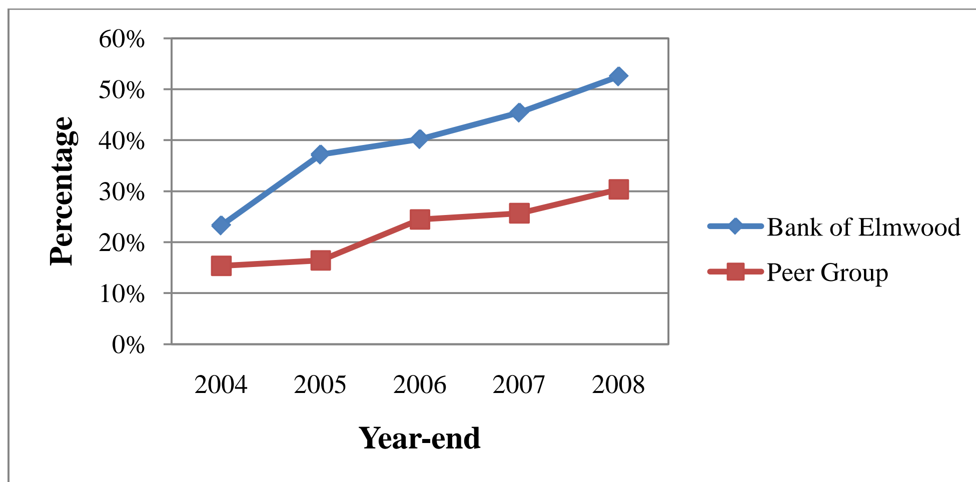
[2] Loan participations involve collaboration among lenders to share in a loan or a package of loans.

According to examiners, Elmwood developed several loan programs to attract investors interested in purchasing or building non-owner occupied properties with little or no down payment. Examiners stated that many of these borrowers had limited experience in home building or rehabilitation. Examiners noted that the bank's loan growth was abetted by a compensation incentive program that rewarded loan officers for generating new loans, but did not establish "compensating quality requirements." A number of these borrowers would eventually prove to be less than creditworthy.

Elmwood grew its CRE portfolio by purchasing loan participations that were concentrated in construction and land development projects. Elmwood purchased these loans without conducting proper due diligence and failed to perform continuous monitoring. Management's inexperience resulted in a failure to fully identify and control the risk associated with out-of-market CRE loans.

Elmwood funded its loan growth with non-core sources, primarily high-rate certificates of deposit (CDs), supplemented by Federal Home Loan Bank (FHLB) borrowings and brokered deposits. As shown in Chart 2, the use of these funding sources led Elmwood to a net non-core funding dependence ratio that was consistently above its peer group. Reliance on non-core funding from investors in high-rate CDs and brokered deposits is considered a risky strategy that can have a significant negative effect on liquidity. These investors have no other relationship with the bank and are only seeking the highest possible return. Therefore, these funds may not be available in times of financial stress or adverse changes in market conditions. Nevertheless, when examiners cautioned Elmwood about its dependence on non-core funding sources, management indicated that it would have no discomfort even if the bank's net non-core funding dependence ratio reached 100 percent.[3]

Chart 2: Net Non-Core Funding Dependence



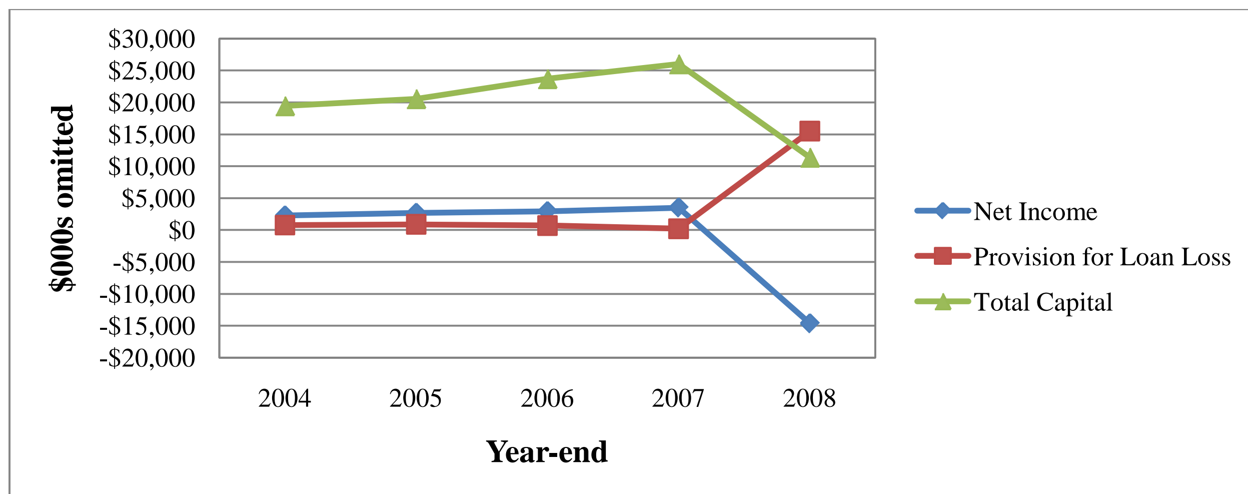
[3] A net non-core funding dependency ratio of 100 percent indicates that a financial institution is funding all long-term assets with volatile funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Elmwood's management emphasized loan growth, but did not enforce sound credit risk management practices. By year-end 2006, Elmwood's credit risk management deficiencies were exposed by deterioration in the bank's CRE participation loans. The projects supporting these loans experienced cost overruns and construction delays, among other things. Credit risk management weaknesses were also evident in the one-to-four family residential loan portfolio. Examiners noted that loan policies appeared adequate, but enforcement of these policies was deficient largely due "to a lax credit culture at the bank." For example, the bank often violated its loan policy by originating loans to individuals with (1) no prior homebuilding experience, (2) insufficient cash flow to service debt, (3) minimal financial reserves, and (4) below average credit histories.

Elmwood's credit risk management deficiencies were compounded by an ineffective loan monitoring system. The bank was unable to evaluate the continued creditworthiness of commercial borrowers because current financial information often was lacking. In addition, Elmwood did not maintain documentation supporting the sufficiency of the bank's collateral, and failed to adequately monitor its CRE participation loans. Elmwood's inability to correct credit risk management deficiencies and take steps to mitigate its deteriorating loan portfolio led to classified assets increasing by approximately $42 million, or 1,058 percent, from $4.0 million in December 2004, to $46.3 million in February 2009.

The growth in classified assets required corresponding increases in Elmwood's allowance for loan and lease losses (ALLL) and provision expense. As shown in Chart 3, the 2008 provision expense of $15.5 million led to a net loss of $14.6 million for the year ending December 31, 2008, and eliminated retained earnings. For the nine-month period ended September 30, 2009, the bank reported a net loss of $4.3 million, which included a provision expense of $2.4 million that significantly reduced capital.

Chart 3: Impact of Provision Expense on Earnings and Capital



FRB Chicago implemented the PCA provisions of the FDI Act and made timely notifications when the bank reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled financial institutions. In

November 2008, after a full scope examination, Elmwood was notified that it was no longer *well capitalized*. As a result, the bank was restricted from accepting, renewing, or rolling over any brokered deposits, further straining the bank's liquidity position.[4] The bank's financial condition continued to deteriorate; and, on May 7, 2009, FRB Chicago notified Elmwood that it was *undercapitalized* and was required to submit an acceptable capital restoration plan. Elmwood's capital restoration plan was deemed unacceptable by FRB Chicago, and the bank was declared *significantly undercapitalized* on June 24, 2009.

The Federal Reserve Board executed a PCA Directive on July 21, 2009, that required Elmwood to (1) raise additional capital to achieve the *adequately capitalized* PCA designation, or (2) be acquired by or merge with another depository institution by August 29, 2009. Elmwood failed to comply, and the State closed the bank on October 23, 2009.

Supervision of Bank of Elmwood

FRB Chicago complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. As show in Table 1, during this period FRB Chicago and the State conducted six full scope examinations and a target examination focused on asset quality. The bank received a CAMELS composite 2 (satisfactory) rating for the examinations conducted from 2004 through 2007. An August 2008 full scope examination conducted by the State resulted in a double downgrade to a CAMELS composite 4 (marginal) rating, and Elmwood's financial condition was deemed highly unsatisfactory. The capital, asset quality, and management CAMELS components were also double downgraded from 2 to 4. A Written Agreement was executed on January 20, 2009, to address weaknesses in management; credit administration; liquidity and funds management; strategic and capital plans; and asset quality, including the ALLL methodology.

On February 9, 2009, FRB Chicago and the State began an asset quality target examination that revealed continued asset quality deterioration and resulted in the bank being downgraded to a CAMELS composite 5 (unsatisfactory) rating. The Federal Reserve Board executed a PCA Directive on July 21, 2009, that required Elmwood to accomplish the following by August 29, 2009: (1) raise additional capital to achieve the *adequately capitalized* PCA designation, or (2) be acquired by or merge with another depository institution. A joint full scope examination begun in August 2009 reaffirmed the bank's CAMELS composite 5 rating, and Elmwood's failure was deemed highly probable.

Overall, our analysis of FRB Chicago's supervision of Elmwood revealed that examiners repeatedly cited the bank's marginal earnings performance, capital levels that were below its peer group, and inadequate credit risk management practices, but, in our opinion, FRB Chicago had opportunities for earlier and more forceful supervisory action.

[4] Section 29 of the FDI Act stipulates that any bank that falls to less than *well capitalized* (as defined under PCA) cannot accept, renew, or roll over brokered deposits, unless a waiver is obtained from the FDIC.

Table 1: Supervisory Overview of Elmwood

Examinations			Agency Conducting the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
3/15/2004	4/20/2004	Full	State	2	2	2	2	3	2	2	
4/18/2005	6/17/2005	Full	FRB Chicago	2	2	2	2	3	2	2	
5/30/2006	8/21/2006	Full	State	2	2	2	2	2	3	2	
5/14/2007	7/12/2007	Full	FRB Chicago	2	2	2	2	3	3	2	
8/11/2008	11/10/2008	Full	State	4	4	4	4	4	4	3	Written Agreement
2/9/2009	5/7/2009	Target	Joint FRB Chicago and State	5	5	5	5	5	4	3	PCA Directive
8/10/2009	10/19/2009	Full	Joint FRB Chicago and State	5	5	5	5	5	5	5	

Supervision History from 2004 through 2007

In March 2004, the State began a full scope examination that resulted in a CAMELS composite 2 (satisfactory) rating, with all components rated 2 except for the earnings component, which was rated 3 (fair). The April 2004 examination report noted that Elmwood's earnings performance "continued to be deficient" because of (1) the slow economy in Racine, Wisconsin, and its negative impact on loan demand; and (2) the bank's disproportionately high level of overhead expenses compared to its peer group. When Elmwood initiated a loan growth strategy to counter the marginal earnings performance, examiners noted that the bank should control further loan growth until it demonstrated that it could produce "sufficient retention of earnings to provide the bank with adequate internal capital generation." The CAMELS component rating for capital previously was a 3, but the State raised it to a 2 because of a recent capital injection. Even though the capital component was assigned a satisfactory rating, examiners noted that the bank's capital ratios remained below peer bank averages, and advised Elmwood to control further asset growth to maintain capital adequacy. Examiners concluded that, despite some loan policy exceptions, the bank's underwriting and credit administration practices were adequate and that the bank maintained the documentation necessary to make informed credit decisions.

In April 2005, FRB Chicago began a full scope examination that resulted in another CAMELS composite 2 rating, and the CAMELS component ratings were unchanged from the prior examination. In its June 2005 examination report, FRB Chicago observed that the bank increased its loan portfolio by approximately 30 percent over the previous two years by strategically expanding into new geographical markets and purchasing CRE loan participations to enhance income. Examiners noted that loan monitoring was deficient because the bank did not maintain relevant financial data on borrowers and projects. The examination report stated

that non-core funding levels were above Elmwood's peer group and that the bank's less than satisfactory earnings resulted in capital levels that were "below peer averages."

In May 2006, the State conducted a full scope examination that maintained Elmwood's CAMELS composite 2 rating. The earnings component rating improved from 3 to 2, primarily due to an increase in interest earned on loans; however, liquidity was downgraded to 3 because of a substantial increase in FHLB borrowings and brokered deposits. Even though the State considered Elmwood's financial condition to be satisfactory, the August 2006 examination report raised concerns that the bank's loan growth strategy strained liquidity and capital. Examiners also cited specific credit administration deficiencies, which they noted could make it difficult for management to detect and promptly correct credit problems.

In May 2007, FRB Chicago conducted a full scope examination that resulted in Elmwood again receiving a CAMELS composite 2 rating.[5] Examiners downgraded earnings to 3 and cited loan loss provision and personnel expenses that "remain above peer group averages." Additionally, the July 2007 examination report highlighted credit administration deficiencies, such as inadequate monitoring of out-of-market CRE participation loans, incomplete financial data on borrowers and projects, and weak loan underwriting standards. Examiners maintained the bank's asset quality component 2 rating despite a significant increase in classified assets and a corresponding rise in past due and non-accrual loans. Three months after the examination report was issued, FRB Chicago increased off-site monitoring of Elmwood due to a deterioration in the bank's loan portfolio, a rapid increase in past due and non-accrual loans, and earnings levels that were insufficient to augment capital.

August 2008 State Examination Resulted in a Double Downgrade to a CAMELS Composite 4 Rating

In August 2008, the State conducted a full scope examination that resulted in a double downgrade to a CAMELS composite 4 (marginal) rating. The capital, asset quality, and management components were also double downgraded to 4, while earnings, liquidity, and sensitivity each received a single downgrade. The examination report issued in November 2008 deemed Elmwood's financial condition as highly unsatisfactory. According to supervisory guidance, institutions with a CAMELS composite 4 rating pose a risk to the DIF, and failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

State examiners attributed Elmwood's asset quality deterioration to unresolved credit risk management weaknesses (from prior examinations), such as significant loan policy exceptions and the lack of relevant financial data on borrowers and projects. Additionally, examiners noted that the bank's lax credit culture was "exacerbated" by a loan incentive program that encouraged generating new loans without considering safe and sound lending practices. According to examiners, 30 percent of the bank's classified assets were related to out-of-market CRE loan

[5] This examination also resulted in FRB Chicago rescinding a prior Board Resolution that largely focused on Bank Secrecy Act compliance and administrative issues. We have not included specific discussion of the Board Resolution in our report because its provisions were not related to the bank's failure or the supervision issues addressed in our report.

participations. Examiners concluded that the bank appeared to accept too much risk, in part because the Board of Directors and management failed to establish adequate risk tolerance guidelines.

Written Agreement Executed in January 2009

In response to Elmwood's troubled condition, a Written Agreement was executed on January 20, 2009. The Written Agreement required the bank to address a variety of issues, including Board of Directors oversight, capital, asset improvement, credit administration, liquidity, and strategic planning. The Board of Directors was also required to retain an independent consultant to assess senior management.

A January 23, 2009, report summarizing the consultant's independent assessment concluded that Elmwood's Chief Executive Officer did not possess the skills needed to oversee and run the day-to-day business operations of the bank. The report also noted that the Chief Financial Officer was not performing essential functions, such as overall financial and operational reporting, liquidity and capital management, risk management, and regulatory issue management. The report further stated that a senior vice-president developed non-compliant mortgage loan products and failed to manage mortgage loan asset quality.

February 2009 Joint Examination Resulted in a Downgrade to a CAMELS Composite 5 Rating and a PCA Directive

In February 2009, FRB Chicago and the State conducted a target examination that focused on asset quality, credit risk, and liquidity. The May 2009 report downgraded the bank to a composite 5 rating. Banks in this group exhibit extremely unsafe and unsound practices or conditions and pose a significant risk to the DIF because failure is highly probable. Examiners expressed concern with poor credit risk management and loan administration and an inadequate loan rating system. According to examiners, Elmwood's unacceptable credit risk and asset quality resulted from management's lax underwriting, insufficient credit analysis, and excessive loan policy exceptions.

Examiners identified classified assets totaling $46.3 million, a fivefold increase from the 2007 FRB examination, and noted that non-performing loans tripled. Examiners criticized management's poor business decisions and inadequate due diligence when implementing its growth strategy. As a result, CRE participation loans and one-to-four family residential loans made to speculative investors constituted the majority of classified assets. Additionally, examiners noted that the ALLL was inadequate because of outdated real estate appraisals, untimely information on CRE loan participations, and outdated borrower financial information.

On July 21, 2009, the Federal Reserve Board executed a PCA Directive requiring Elmwood to accomplish the following by August 29, 2009: (1) raise additional capital to achieve the *adequately capitalized* PCA designation, or (2) be acquired by or merge with another depository institution.

August 2009 Joint Examination Resulted in Another CAMELS Composite 5 Rating

In August 2009, FRB Chicago led a joint full scope examination that resulted in another CAMELS composite 5 rating. The examination report issued in October 2009 concluded that the volume and severity of problems had grown beyond bank management's ability to control or correct. Examiners stated that classified assets remained excessively high and that management was unable to address the bank's weak capital position. In addition, Elmwood failed to comply with several provisions of the Written Agreement pertaining to Board of Directors oversight, credit administration, asset improvement, capital, and liquidity.

According to examiners, the bank's negative earnings (1) resulted from significant loan losses, (2) increased costs associated with collection efforts, (3) were not sufficient to support operations, and (4) further depleted capital. Beginning on August 10, 2009, FRB Chicago examiners maintained a daily presence at Elmwood to monitor the bank's earnings, liquidity, and capital. The State closed Elmwood on October 23, 2009, after the bank failed to meet the PCA Directive requirements for increasing capital or being acquired by or merging with another financial institution.

Conclusions and Lessons Learned

Elmwood failed because its Board of Directors and management pursued a risky loan growth strategy that featured new loan products and out-of-market lending without developing adequate credit risk management controls. The bank pursued this strategy even though its modest earnings and capital position did not provide adequate support to withstand possible asset quality deterioration. The growth strategy, coupled with insufficient credit risk management controls, resulted in poorly underwritten loans. Bank management's inability to adequately address loan portfolio weaknesses led to asset quality deterioration and significant losses. Mounting losses eliminated earnings, depleted capital, and strained liquidity. The State closed Elmwood on October 23, 2009, and appointed the FDIC as receiver after the bank failed to meet a regulatory deadline to restore the bank to *adequately capitalized* or be acquired by or merge with another financial institution.

FRB Chicago complied with examination frequency guidelines for the timeframe we reviewed, 2004 through 2009, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted six full scope examinations and a target examination focused on asset quality. In addition, the bank was placed under two formal enforcement actions, a Written Agreement in January 2009 and a PCA Directive in July 2009.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or loss to the DIF. Our analysis of FRB Chicago's supervision of Elmwood revealed that examiners repeatedly cited the bank's marginal earnings performance, capital levels that were below its peer group, and inadequate credit risk management practices, but, in our opinion, FRB Chicago had opportunities for earlier and more forceful supervisory action.

Elmwood's loan growth strategy was first discussed in a 2004 State examination report that also noted that the bank's earnings performance "continued to be deficient" and capital ratios remained below peer bank averages. State examiners noted that Elmwood should control further loan growth until the bank demonstrated that it could produce "sufficient retention of earnings to provide the bank with adequate internal capital generation." In its 2005 examination report, FRB Chicago observed that the bank increased its loan portfolio by about 30 percent over the previous two years by strategically expanding into new geographical markets and purchasing CRE loan participations to enhance income. However, examiners once again cited weak earnings and capital levels that remained below peer averages. In our opinion, the recurring weaknesses in earnings and capital provided FRB Chicago with an opportunity to suggest that Elmwood refrain from further growth until management satisfactorily addressed the repeat deficiencies.

We also believe that credit risk management weaknesses noted by examiners in 2006 and 2007 provided early warning signs regarding (1) the potential for asset quality deterioration in Elmwood's growing loan portfolio, and (2) management's ability to control the bank's increasing credit risk profile. The examination reports issued during this period highlighted credit administration deficiencies, such as inadequate monitoring of out-of-market CRE participation loans, incomplete financial data on borrowers and projects, and weak loan underwriting standards. Examiners warned that credit administration deficiencies could make it difficult for management to detect and promptly correct credit problems. Additionally, the 2007 examination report noted a significant increase in classified assets and a corresponding rise in past due and non-accrual loans, yet the bank received an asset quality component 2 rating. In our opinion, the weaknesses cited by examiners, coupled with continued marginal earnings and capital levels below peer averages, warranted an appropriate supervisory response in 2007 compelling bank management to immediately correct the identified deficiencies.

While we believe that FRB Chicago had opportunities for earlier and more forceful supervisory actions, it is not possible for us to predict the effectiveness or impact of any corrective measures that might have been taken by the bank. Therefore, we cannot evaluate the degree to which an earlier or alternative supervisory response would have affected Elmwood's financial deterioration or the ultimate cost to the DIF.

Lessons Learned

Although the failure of an individual financial institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Elmwood's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Specifically, Elmwood's failure illustrates the risks posed when a bank with modest earnings and capital levels below peer averages implements a risky loan growth strategy that features new product lines or out-of-market lending. In these situations, examiners should ensure that management has implemented a robust credit risk management infrastructure and is effectively addressing shortcomings in the bank's earnings and capital. Elmwood's failure also demonstrates that banks exhibiting significant growth require heightened supervisory attention and should be subject to an immediate and forceful supervisory response when signs of credit risk management deficiencies first appear.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response is included as Appendix 3. The Director concurred with the conclusions and lessons learned contained in the report. He noted that even though examiners repeatedly cited the bank's marginal earnings performance, capital levels, and inadequate credit risk management practices, there were opportunities for earlier and more forceful supervisory action. He also acknowledged that the report highlights two important supervisory lessons: (1) when a bank with modest earnings and low relative-to-peer capital averages implements a risky loan strategy, examiners should ensure that management has implemented a robust credit risk management infrastructure and are effectively addressing shortcomings in earnings and capital; and (2) when a bank is exhibiting significant growth, there should be heightened supervisory attention, particularly when signs of credit risk management deficiencies first appear.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

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

Board Resolution
A Board Resolution is an informal enforcement action involving commitments made by the bank's Board of Directors that are incorporated into the bank's corporate minutes.

Brokered Deposits
Brokered deposits are deposits that are placed in a savings institution by a broker who gathers funds from others and packages the funds in batches of $100,000. The broker then shops for financial institutions paying the highest rates and invests in multiple $100,000 certificates of deposit, which typically pay the highest rates of interest and are federally insured.

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

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

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

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

Appendix 1 (continued)

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

Liquidity
Liquidity is the ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost.

Loan Participations
Loan participations involve collaboration among lenders to share in a loan or a package of loans.

Net Non-Core Funding Dependence Ratio
The net non-core funding dependence ratio measures the extent to which banks fund assets with non-core funding. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Non-Core Deposits
Non-core deposits include federal funds purchased, Federal Home Loan Bank advances, subordinated notes and debentures, certificates of deposit of more than $100,000, and brokered deposits.

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

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

Appendix 1 (continued)

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

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

Appendix 2 – CAMELS Rating System

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

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

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2 (continued)

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date:	May 11, 2010
To:	Elizabeth A. Coleman, Inspector General
From:	Patrick M. Parkinson, Director, Banking Supervision and Regulation ***/signed/***
Subject:	Material Loss Review Bank of Elmwood

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of the Bank of Elmwood, Racine, Wisconsin, prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report finds that the Bank of Elmwood failed because its Board of Directors and management pursued a risky loan growth strategy that featured new loan products and out-of-marketing lending without developing adequate credit risk management controls. Bank management's inability to adequately address loan portfolio weaknesses led to asset quality deterioration and significant losses. Mounting losses eliminated earnings, depleted capital, and strained liquidity. The Bank of Elmwood was supervised by the Federal Reserve Bank of Chicago (FRB Chicago) under delegated authority from the Board.

We concur with the conclusion and lesson learned contained in the report that even though examiners repeatedly cited the bank's marginal earnings performance, capital levels, and inadequate credit risk management practices, there were opportunities for earlier and more forceful supervisory action. FRB Chicago complied with the examination frequency guidelines for the period reviewed, 2004 through 2009 and conducted regular off-site monitoring. During this time FRB Chicago and the State conducted six full scope examinations and an asset quality target examination. The bank was placed under a Written Agreement in early 2009 and a PCA Directive in July 2009. Examiners noted credit risk management weaknesses in 2006 and 2007. Examination reports during this period highlighted credit administration deficiencies and warned that such deficiencies could make it difficult for management to detect and promptly correct credit problems. The 2007 examination report noted a significant increase in classified assets and a corresponding rise in past due and non-accrual loans. The weaknesses cited by examiners, together with marginal earnings and capital levels below peer averages, could have warranted a formal supervisory response. Although, as the IG report notes, it is not possible to predict the effectiveness or impact of any corrective measures that might have been taken by the bank.

Appendix 3 (continued)

The report highlights two important supervisory lessons. First, when a bank with modest earnings and low relative-to-peer capital averages implements a risky loan strategy, examiners should ensure that management has implemented a robust credit risk management infrastructure and are effectively addressing shortcomings in earnings and capital. Second, when a bank is exhibiting significant growth there should be heightened supervisory attention, particularly when signs of credit risk management deficiencies first appear.

Board staff appreciates the opportunity to comment on the Material Loss Review and welcomes the report's observations and contribution to understanding the reasons for Bank of Elmwood's failure.

Appendix 4 – Principal Office of Inspector General Contributors to this Report

Kyle R. Brown, Project Leader and Senior Auditor

Gerald A. Edwards, Auditor

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

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