Board of Governors of the Federal Reserve System

Material Loss Review of Midwest Bank and Trust Company

Office of Inspector General

December 2010

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

OFFICE OF INSPECTOR GENERAL

December 8, 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 Midwest Bank and Trust Company (Midwest). Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. The FDI Act requires that we

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

Midwest 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 Illinois Department of Financial and Professional Regulation (State). The State closed Midwest in May 2010, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On June 8, 2010, the FDIC Inspector General notified us that Midwest's failure would result in an estimated loss to the DIF of $200.7 million, or 6.5 percent of the bank's $3.1 billion in total assets.

Midwest failed because of the convergence of various factors. The Board of Directors and management pursued an aggressive growth strategy in 2002 and 2003, without establishing credit risk management controls commensurate with the bank's increasing size and risk profile. These weaknesses contributed to the bank developing commercial real estate (CRE) and construction, land, and land development loan (CLD) concentrations. During this time period, examiners also raised concerns about management's effectiveness and capabilities. These deficiencies resulted in a formal enforcement action in March 2004 that, among other things,

required Midwest to enhance its credit risk management and hire a consultant to conduct an independent assessment of management's "functions and performance," including its expertise and qualifications. In response to the independent assessment, the bank overhauled its management team in 2004 and 2005 by, among other things, replacing the Chief Executive Officer, dismissing ineffective senior officers, and adding two new members to the Boards of Directors of Midwest and its holding company. New management pursued "double-digit" loan growth while attempting to materially reduce loan concentrations, raise capital, and diversify the bank's funding sources. For the most part, management achieved only its growth objectives.

In 2007, Midwest developed an investment portfolio risk by increasing its preferred securities holdings in Fannie Mae and Freddie Mac, two government sponsored enterprises (GSEs). The value of these securities declined precipitously following the onset of the financial crisis in the fall of 2007, and, in the first quarter of 2008, the bank took a $17.6 million write-down. The Federal Housing Finance Agency placed these GSEs into conservatorship in September 2008, and Midwest's management subsequently wrote off the remaining $67 million value of these securities. During this time frame, the bank also experienced significant asset quality deterioration in its CRE and CLD loan portfolios. In December 2008, the bank received $84.8 million from the U.S. Department of the Treasury (Treasury) Troubled Asset Relief Program (TARP), but management failed to raise additional private capital. In 2008 and 2009, Midwest experienced significant losses, and Midwest's holding company injected $87 million in additional capital to preserve the bank's *well capitalized* status. These capital injections depleted the holding company's financial reserves and prevented it from further supplementing the bank's capital. By 2010, Midwest became fully exposed to the loan losses associated with its CRE and CLD asset quality deterioration, which rapidly depleted its capital. On May 14, 2010, the State closed Midwest and appointed the FDIC as receiver.

With respect to supervision, FRB Chicago complied with examination frequency guidelines for the timeframe we reviewed, 2003 through 2010, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted 10 examinations and executed 3 formal enforcement actions and 1 informal enforcement action.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or a loss to the DIF. Our analysis of FRB Chicago's supervision indicated that examiners identified key weaknesses, such as the bank's CRE and CLD concentrations, reliance on non-core funding, and reliance on the holding company's capital support, that contributed to the bank's failure, but did not act on multiple subsequent opportunities to take more forceful supervisory action that might have prompted management to resolve these weaknesses. In our opinion, the findings in a 2004 full scope examination did not warrant the upgrade that occurred to Midwest's CAMELS composite rating because the bank had been placed under a formal enforcement action only two weeks prior to the start of the examination. In light of this timeframe, none of the eight major action items contained in the formal enforcement action had been fully resolved, and only three subcomponents could be assessed for progress. FRB Chicago also noted newly identified issues

warranting the Board of Director's attention. In hindsight, we believe that FRB Chicago terminated the formal enforcement action prematurely following a 2005 full scope examination, given how recently the management overhaul and control enhancements had occurred. In our opinion, sufficient time was needed for management to demonstrate that the new controls were effective. However, it is not possible to determine whether alternative supervisory actions would have affected Midwest's subsequent decline.

In our opinion, FRB Chicago did not hold bank management accountable for failing to diversify the bank's loan portfolio and funding sources between 2005 and 2007. During this time, management succeeded in achieving double-digit growth, but failed to address the weaknesses that ultimately contributed to the bank's failure, including CRE and CLD concentrations and reliance on non-core funding and holding company capital support. We believe that a 2007 full scope examination presented the opportunity to downgrade the bank's asset quality and liquidity ratings. In our opinion, the bank's asset quality rating did not reflect an increase in classified assets and other problem loans. Further the bank's liquidity rating did not reflect an increasing dependence on non-core funding and a sharp decline in the bank's primary liquidity ratio.

Further, we believe that a 2008 full scope examination presented another opportunity for stronger supervisory action. In our opinion, the severity of the findings noted during this examination warranted additional CAMELS component rating downgrades and a CAMELS composite downgrade. This examination acknowledged management's failure to diversify the bank's loan portfolio and funding sources—two key strategic objectives of the new management team—but did not downgrade the bank's management component rating. Also, we believe that Midwest's 2 (satisfactory) liquidity component rating did not reflect the gravity of the persistent challenges facing the institution. If these additional component rating downgrades had occurred, four of the six CAMELS components would have received 3 ratings, which would have led to a CAMELS composite rating downgrade to a 3 (fair).

In late October 2008, Midwest's holding company applied for TARP funds under the Capital Purchase Program and FRB Chicago evaluated the request. In applying Treasury's guidance, FRB Chicago concluded that Midwest qualified for presumptive approval status because of the CAMELS composite 2 rating issued within the previous six months. In our opinion, FRB Chicago complied with the process outlined in the guidance and the limited decision-making criteria available at the time. Even if Midwest had received a CAMELS composite 3 rating during the 2008 full scope examination, the bank would have qualified for presumptive approval status based on its acceptable performance ratios.

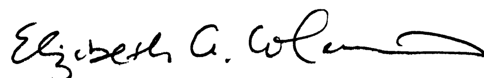
The Fannie Mae and Freddie Mac chartering acts authorize banks to purchase preferred securities issued by these GSEs. In addition, regulatory guidance issued by the Federal Reserve System does not specify investment limits or raise concerns about concentrations in these GSE preferred securities. Ultimately, they were completely written off, which contributed to Midwest's failure. In hindsight, these securities represented a significant risk to the bank's investment portfolio.

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Midwest's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. This failure demonstrates (1) the importance of examiners holding management accountable for failing to address fundamental and persistent weaknesses, (2) the risks associated with an aggressive growth strategy that relies heavily on non-core funding and holding company capital support, and (3) the importance of examiners issuing CAMELS composite and component ratings consistent with the narrative comments included in examination reports.

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director acknowledged our conclusions and concurred with the 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 Office of Inspector General principal contributors to this report are listed in Appendix 4. This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,



Elizabeth A. Coleman
Inspector General

cc: Chairman Ben S. Bernanke
Vice Chair Janet L. Yellen
Governor Elizabeth A. Duke
Governor Sarah Bloom Raskin
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 Midwest Bank and Trust Company

Office of Inspector General

December 2010

Table of Contents

Page

Background 9

Objectives, Scope, and Methodology 9

Cause of the Failure 10

Aggressive Growth Strategy Revealed Weaknesses and Resulted in a Formal Enforcement Action 11

Independent Assessment Resulted in Corporate Governance Changes, and New Management Developed an Aggressive Strategy 12

Management Achieved Growth Targets, but Failed to Address Weaknesses 12

Management Relied Heavily on Non-core Funding to Support Aggressive Growth 14

Asset Quality Worsened in 2008 and Contributed to Significant Write-offs 15

Midwest Received TARP Funds in December 2008 16

Asset Quality Continued to Deteriorate as Economic Conditions Worsened in 2009 16

Supervision of Midwest Bank and Trust Company 18

March 2003 Full Scope Examination Resulted in a Written Agreement.................... 20

March 2004 Joint Full Scope Examination Resulted in a CAMELS Composite Rating Upgrade, but the Written Agreement Remained Active 21

January 2005 Target Examination Focused on Liquidity and Sensitivity to Market Risk.................... 22

May 2005 Joint Full Scope Examination Resulted in a CAMELS Composite 2 Rating and Led to Release from the Written Agreement.................... 22

March 2006 Joint Full Scope Examination Resulted in Another CAMELS Composite 2 Rating 23

April 2007 Joint Full Scope Examination Resulted in Another CAMELS Composite 2 Rating 24

May 2008 Full Scope Examination Resulted in a Board Resolution, but the CAMELS Composite Rating Remained 2 25

Midwest Applied for and Received TARP Funds 26

November 2008 CRE Target Examination Resulted in a CAMELS Composite Downgrade 27

May 2009 Full Scope Examination Resulted in a CAMELS Composite Downgrade to 4; Double Downgrades to CAMELS Component Ratings for Capital, Management, and Earnings; and a Written Agreement 28

January 2010 Asset Quality Target Examination Resulted in Further Downgrades and a PCA Directive 28

Conclusions and Lessons Learned 29

Lessons Learned 31

Analysis of Comments 31

Appendixes 33

Appendix 1 – Glossary of Banking and Regulatory Terms 35

Appendix 2 – CAMELS Rating System 39

Appendix 3 – Division Director's Comments 41

Appendix 4 – Office of Inspector General Principal Contributors to this Report 43

Background

In 1959, Midwest Bank and Trust Company (Midwest) was established as a state chartered bank in Elmwood Park, Illinois, to provide community and commercial banking services to individuals and businesses in the western suburbs of Chicago. In 1983, the bank established a parent holding company, Midwest Banc Holdings, Inc. (Midwest's holding company).[1] In July 1995, Midwest became a state member bank 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 Illinois Department of Financial and Professional Regulation (State). Midwest grew to become a large community bank that focused on commercial real estate (CRE) lending in the Chicago metropolitan area. The bank evolved from an institution with $755 million in total assets in 2001 to $3.7 billion by the end of 2007.

The State closed Midwest on May 14, 2010, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that Midwest's failure would result in a $200.7 million loss to the Deposit Insurance Fund (DIF), or 6.5 percent of the bank's $3.1 billion in total assets at closing. In a letter dated June 8, 2010, the FDIC Inspector General advised our office that the FDIC had determined that Midwest's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, a material loss to the DIF is defined as any estimated loss in excess of $200 million.[2]

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 Federal Reserve System's *Commercial Bank Examination Manual* (CBEM) and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Chicago, the State, and Federal Reserve Board staff. We also reviewed correspondence, surveillance reports, regulatory reports filed by Midwest, examination reports issued from 2003 through 2010, examination work papers prepared by FRB Chicago and the State, and relevant FDIC documents. Appendixes at the end of this report contain a glossary

---

[1] In February 1998, Midwest's holding company made a public offering of its stock.

[2] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, enacted on July 21, 2010, the $200 million materiality threshold applies if the loss occurred during the period January 1, 2010, through December 31, 2011. Prior to the enactment of the Dodd-Frank Act, section 38(k) of the FDI Act defined a material loss to the DIF as the greater of $25 million or 2 percent of the institution's total assets.

of key banking and regulatory terms and a description of the CAMELS rating system.[3] We conducted our fieldwork from August 2010 through October 2010 in accordance with the *Quality Standards for Inspections* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

Midwest failed because of the convergence of various factors. The Board of Directors and bank management pursued an aggressive growth strategy in 2002 and 2003, without establishing credit risk management controls commensurate with the bank's increasing size and risk profile. These weaknesses contributed to the bank developing CRE and construction, land, and land development (CLD) loan concentrations.[4] During this time period, examiners also raised concerns about management's effectiveness and capabilities. These deficiencies resulted in a formal enforcement action in March 2004 that, among other things, required Midwest to enhance its credit risk management and hire a consultant to conduct an independent assessment of management's "functions and performance," including its expertise and qualifications. In response to the independent assessment, the bank overhauled its management team in 2004 and 2005 by, among other things, replacing the Chief Executive Officer (CEO), dismissing ineffective senior officers, and adding two new members to the Boards of Directors of Midwest and its holding company.[5] New management pursued "double-digit" loan growth while attempting to materially reduce loan concentrations, raise capital, and diversify the bank's funding sources. For the most part, management achieved only its growth objectives.

In 2007, Midwest developed a risk in its investment portfolio by increasing its preferred securities holdings in Fannie Mae and Freddie Mac, two government sponsored enterprises (GSEs).[6] The value of these securities declined precipitously following the onset of the financial crisis in the fall of 2007, and, in the first quarter of 2008, the bank took a $17.6 million write-down. The Federal Housing Finance Agency (FHFA) placed these GSEs into conservatorship in September 2008, and Midwest's management subsequently wrote off the remaining $67 million value of these securities.[7] During this time frame, the bank also experienced significant asset quality deterioration in its CRE and CLD loan portfolios. In December 2008, the bank received $84.8 million from the U.S. Department of the Treasury (Treasury) Troubled Asset Relief

---

[3] 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.

[4] CLD loans are the subset of CRE loans that provide funding for acquiring and developing land for future development and/or construction, and provide interim financing for residential or commercial structures.

[5] The bank's and the holding company's Boards of Directors had the same members.

[6] GSEs are privately held corporations with public purposes created by Congress. GSE debt securities carry the implicit backing of the U.S. government, but they are not direct obligations of the U.S. government.

[7] On September 6, 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorship, which is a statutory process designed to stabilize a troubled institution with the objective of returning the entity to normal business operations.

Program (TARP), but management failed to raise additional private capital.[8] In 2008 and 2009, Midwest experienced significant losses, and Midwest's holding company injected $87 million in additional capital to preserve the bank's *well capitalized* status. These capital injections depleted the holding company's financial reserves and prevented it from further supplementing the bank's capital. By 2010, Midwest became fully exposed to the loan losses associated with its CRE and CLD asset quality deterioration, which rapidly depleted its capital. On May 14, 2010, the State closed Midwest and appointed the FDIC as receiver.

Aggressive Growth Strategy Revealed Weaknesses and Resulted in a Formal Enforcement Action

In 2002, Midwest adopted an aggressive growth strategy and merged with two of its affiliated banking entities, which increased the bank's total assets by approximately $800 million. In January 2003, the bank acquired a federal savings association, Fairfield Savings Bank, FSB (Fairfield), which had $197.4 million in total assets. For the 13-month period ending January 31, 2003, Midwest's total assets increased from $755 million to $1.9 billion—a 152 percent increase.

At the same time, the bank relied on volatile, non-core funding, and its capital position trailed its peer group averages. Specifically, Midwest relied heavily on high cost Federal Home Loan Bank (FHLB) borrowings to fund the bank's operations, which strained the bank's net interest margin, a key profitability measure.[9] In addition, the bank's capital position had historically been below its peers, and Midwest's holding company provided ongoing capital that supported asset growth and compensated for earnings weaknesses. In 2002, the bank's capital position increased by $54.7 million, with $50.3 million resulting from the mergers with the affiliates and $4.4 million due to Midwest's holding company capital injections. Management anticipated similar capital growth in 2003 based on the Fairfield merger and further holding company support.

By 2003, the bank's infrastructure and internal controls had not kept pace with its rapid expansion, and FRB Chicago identified a series of credit risk management deficiencies requiring the Board of Directors' attention. Specifically, examiners noted poor documentation of borrowers' repayment capacity and the bank's failure to develop sound loan portfolio management practices. Examiners concluded that the bank's credit risk management practices had not been tailored to the bank's increased size and risk profile—65 percent of the loan portfolio consisted of CRE loans versus a 38 percent peer group average.[10]

---

[8] In October 2008, the Emergency Economic Stabilization Act of 2008 established the Office of Financial Stability within the Treasury and authorized the TARP. The TARP's Capital Purchase Program (CPP) authorized the Treasury to provide up to $250 billion in capital to qualified financial institutions. The CPP was a voluntary program in which the U.S. government, through the Treasury, invested in qualified financial institutions through purchases of preferred stock or senior securities issued by the institutions.

[9] Net interest margin is a performance metric used to evaluate a bank's profitability by measuring the difference between interest income generated in comparison to the interest paid.

[10] Peer group includes insured commercial banks having assets between $1 billion and $3 billion. As of 2007, the bank's peer group included insured commercial banks having assets greater than $3 billion.

In March 2004, the Board of Directors and management signed a formal enforcement action, a Written Agreement, that required the bank to hire a consultant to conduct an independent assessment of "the functions and performance," including the expertise and qualifications, of its Board of Directors and senior management; develop a management plan based on the assessment results; create a risk management plan; and adopt new lending policies and procedures. By May 2004, the bank's CRE loan concentration had increased to 80 percent of total loans, or 462 percent of Midwest's tier 1 capital, and CLD represented 38 percent of the portfolio, or 217 percent of tier 1 capital.

Independent Assessment Resulted in Corporate Governance Changes, and New Management Developed an Aggressive Strategy

In June 2004, the consultant submitted the results of its independent assessment of the Board of Directors and management, which concluded that Midwest's rapid growth revealed management team and control process weaknesses. Specifically, the report concluded that (1) executive management lacked experience when compared with the bank's publicly traded peers, (2) management had not developed a culture of accountability, (3) management emphasized growth and cost containment to the detriment of its infrastructure, and (4) the bank lacked sufficient staffing. In response to the independent assessment, the bank hired a new President and CEO, dismissed ineffective officers, and hired over 30 new mid-to-senior level officers. In addition, Midwest and Midwest's holding company also appointed two new board members with significant prior experience in the financial services industry to improve the effectiveness of their Boards of Directors.

The new management team's strategy continued to focus on banking within the Chicago metropolitan area, but management also adopted an aggressive strategy that attempted to resolve the bank's weaknesses while continuing to grow the institution. Specifically, new management sought to (1) achieve double-digit annual loan growth; (2) diversify the loan portfolio by increasing non-construction mortgage lending (thereby reducing the bank's CRE and CLD concentrations); (3) raise the bank's capital levels; and (4) diversify the bank's funding sources.[11] During a 2005 full scope examination, examiners noted that the management overhaul had resulted in a "much improved and now effective oversight program," and examiners terminated the Written Agreement on September 16, 2005.

Management Achieved Growth Targets, but Failed to Address Weaknesses

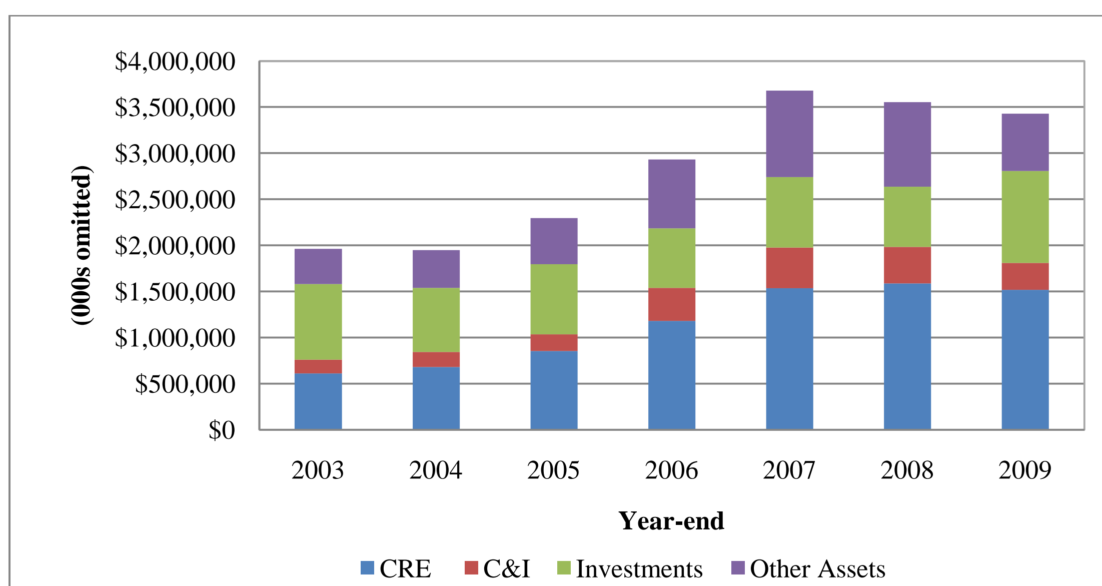
Management achieved its double-digit growth objective as the loan portfolio increased by 18 percent from $1.1 billion in 2004, to $1.3 billion in 2005. However, management did not diversify the bank's loan portfolio. As shown in Chart 1 on the next page, management succeeded in growing the bank's commercial and industrial (C&I) loans from $161.8 million in 2004 to $183.4 million in 2005, but this C&I growth did not keep pace with the more than $80 million increases within both the CRE and CLD portfolios. Midwest's CRE and CLD concentrations actually increased as a percentage of risk-based capital during 2005.

---

[11] Non-construction mortgage lending is not a component of CRE or CLD.

In February 2006, Midwest's holding company set target total asset growth rates for the bank of (1) 20 percent annually by increased lending activities and (2) 50 percent by acquisition over the next 18 months.[12] In July, the holding company acquired Royal American Bank (Royal American)—a state member bank with $556.4 million in total assets—and merged the bank into Midwest. Management made this acquisition, in part, to address Midwest's difficulties in increasing core deposits in the competitive Chicago market. The merger increased Midwest's C&I and CRE portfolios. In 2007, Midwest's holding company continued to pursue its robust growth objectives by merging Midwest with Mount Prospect National Bank (Mount Prospect). As a result of this merger, Midwest's total assets grew by $535 million, which further increased the bank's C&I and CRE loans.

Chart 1: Total Asset Growth



Management's efforts to diversify the bank's loan portfolio did not significantly reduce the CRE concentration. In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. As shown in Chart 2a on the next page, Midwest's CRE concentrations remained relatively constant in 2006 and 2007 following the acquisitions. The bank's CRE concentration as a percent of total risk based capital continued to exceed peer group averages.[13] As shown in Chart 2b, management reduced the bank's CLD concentration from 174.3 percent at year-end 2005, to 155.6 percent as

---

[12] At year-end 2006, Midwest represented 99.6 percent of Midwest's holding company's total assets.

[13] According to the Federal Reserve Board's Supervision and Regulation Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate,* an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported loans for construction, land development, and other land represent 100 percent or more of an institution's total capital; or (2) CRE loans represent 300 percent or more of the institution's total capital and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

of December 31, 2006. Management further reduced the CLD concentration to 128.3 percent by year-end 2007. Nevertheless, Midwest's CLD concentration continued to remain above its peer group averages.

Chart 2a: CRE Loan Concentration

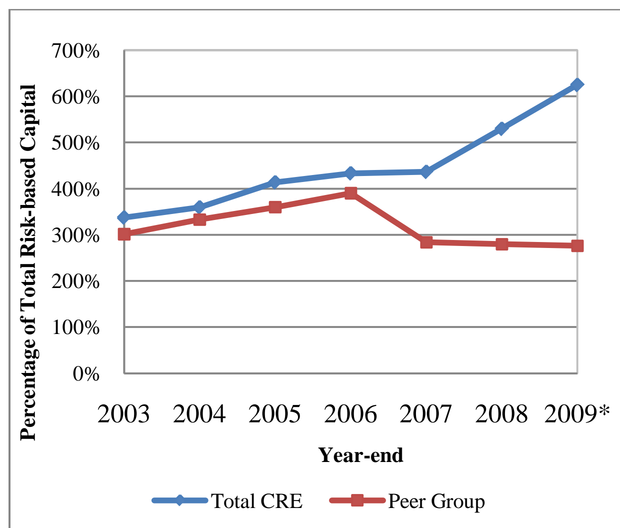
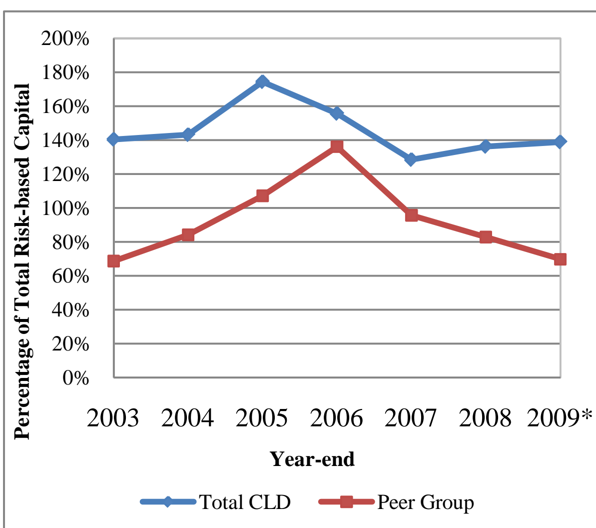


Chart 2b: CLD Loan Concentration



*CRE and CLD concentrations as of 09/30/2009. Due to a 12/18/2009 enforcement action, all assets classified as a "loss" were charged off before year end 2009.

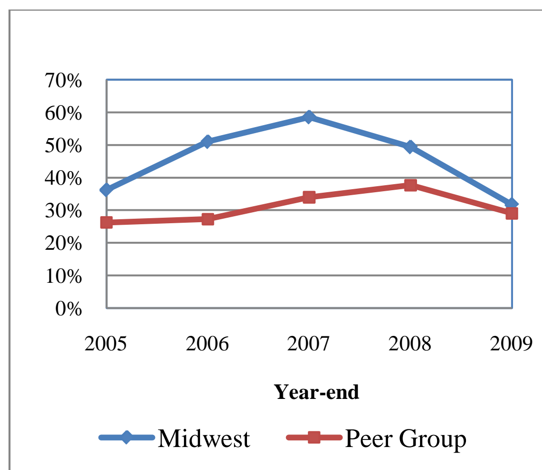
In addition to CRE and CLD concentrations, Midwest accumulated investment holdings that presented risk to the bank's investment portfolio. By the end of 2006, the bank had a $42.0 million position in GSE preferred securities, which represented 15 percent of total risk-based capital. By year-end 2007, the bank increased its GSE holdings to $85 million—24 percent of its total risk-based capital.

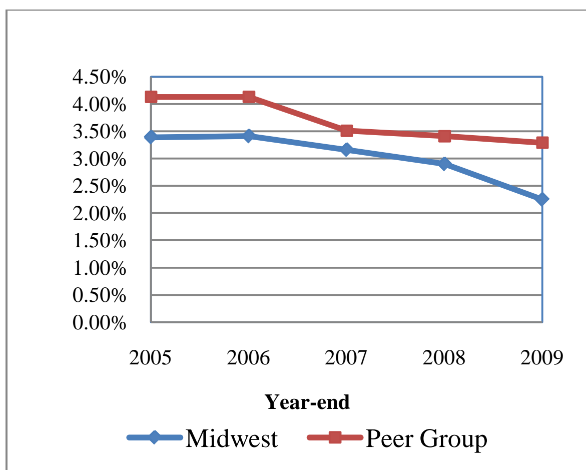
Management Relied Heavily on Non-core Funding to Support Aggressive Growth

In its strategy, management indicated that it sought to diversify the bank's funding sources; however, ultimately it failed to do so. As shown in Chart 3a on the next page, the bank continued to rely heavily on higher cost, non-core funding to support growth—Midwest's non-core funding dependence ratio increased significantly between 2005 and 2007, and remained well in excess of its peers from 2005 through 2008.[14] Chart 3b indicates that the bank's net interest margin steadily declined between 2005 and 2007 due to the bank's increasing reliance on high cost borrowed funds. To compensate for below peer profitability, the holding company injected $45 million in capital support from 2004 to 2007, and the bank remained *well capitalized*.

[14] 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.

Chart 3a: Net Non-core Funding **Chart 3b: Net Interest Margin**





Asset Quality Worsened in 2008 and Contributed to Significant Write-offs

FRB Chicago noted initial signs of Midwest's asset quality deterioration in a July 2007 examination report, and the bank's asset quality deteriorated further following the onset of the financial crisis in the fall of 2007. FRB Chicago observed that the bank's "special mention" loans increased from $23.3 million in 2005, to $76.7 million in 2007, and classified assets increased from $44.6 million to $62.5 million during the same period.[15] According to examiners, weakening local economic conditions, increasing levels of home loan foreclosures and personal bankruptcies, and declining home sales and land values led to further asset quality deterioration in the bank's service area by mid-year 2008. Classified assets—which primarily consisted of CRE and CLD loans—increased 106 percent since the 2007 examination, rising from $62.5 million to $129 million. The increase in classified assets required the bank to raise its loan loss provision expense, which contributed to net losses in 2008.

Due in part to the real estate market downturn that began in the fall of 2007, the value of Midwest's GSE preferred securities dropped precipitously, and the bank took a $17.6 million write-down during the first quarter of 2008. The value of these securities continued to decrease between the first and second quarters of 2008. The bank wrote down the remaining $67 million associated with its GSE securities shortly after the FHFA placed Fannie Mae and Freddie Mac into conservatorship in September 2008.

During the same period, Midwest also wrote down the goodwill that had resulted from prior mergers.[16] Following the mergers with Royal American and Mount Prospect, Midwest had a total of $160 million in goodwill as of December 31, 2007. In 2008, management wrote down a total of $80 million (50 percent) of the goodwill due to weakening economic conditions.

---

[15] Assets categorized as special mention have weaknesses that deserve management's close attention, but do not expose an institution to sufficient risk to warrant adverse classification.

[16] Goodwill is an intangible asset shown on an institution's balance sheet and is often created through acquisitions. The amount of goodwill is the difference in the asset's fair market value and the price paid at the time of acquisition.

The bank's 2008 operating income of $125.7 million did not offset the impact of losses primarily associated with the provision expense, GSE securities, and goodwill write downs. Midwest incurred a $151.1 million net loss as of December 31, 2008. The holding company injected $19 million to cushion the bank's losses and preserve the bank's *well capitalized* status.

Midwest Received TARP Funds in December 2008

In late October 2008, Midwest's holding company applied for funds through the TARP's CPP. FRB Chicago evaluated the bank's application for TARP funds. In a September 2008 full scope examination report, Midwest received a CAMELS composite 2 (satisfactory) rating. As a result, Midwest qualified for a "presumptive approval" under TARP guidance.[17] In evaluating the application and Midwest's prospects for continued viability, FRB Chicago noted that the bank's condition might drop to a CAMELS composite 3 (fair) rating in the near future because of the economy, but examiners did not expect significant deterioration or failure. FRB Chicago also noted that, "notwithstanding the GSE exposure, there are no material safety and soundness concerns related to the ongoing viability of this institution." By the end of October 2008, Treasury approved the holding company's CPP application for TARP funds. In early December 2008, the bank received $84.8 million in TARP funds (transferred from the holding company), which it used to sustain its operations and lending programs.

Before Midwest's holding company submitted its TARP CPP application, management was attempting to raise $125 million in additional capital. In a September 16, 2008, press release, holding company management stated that the additional capital would result in Midwest's capital ratios ranking among the highest of its Chicago peers. Management anticipated that investor demand for the bank's securities might increase following the bank's receipt of TARP funds. However, management's efforts to raise this additional capital failed due to a lack of investor interest in purchasing the bank's securities, even though the bank received government support. By the first quarter of 2009, management acknowledged the likelihood of further losses, and shortly thereafter, the bank's CEO resigned and Midwest appointed an interim CEO.

In May 2009, the bank hired a new CEO, who developed a plan for recapitalizing the bank that reassessed prior loan loss provision expense projections for 2009 and 2010. Based on this reassessment, the new management team increased the bank's estimated capital needs from $125 million to $225 million. Ultimately, the plan failed due to unfavorable market conditions and potential investors' unwillingness to participate.

Asset Quality Continued to Deteriorate as Economic Conditions Worsened in 2009

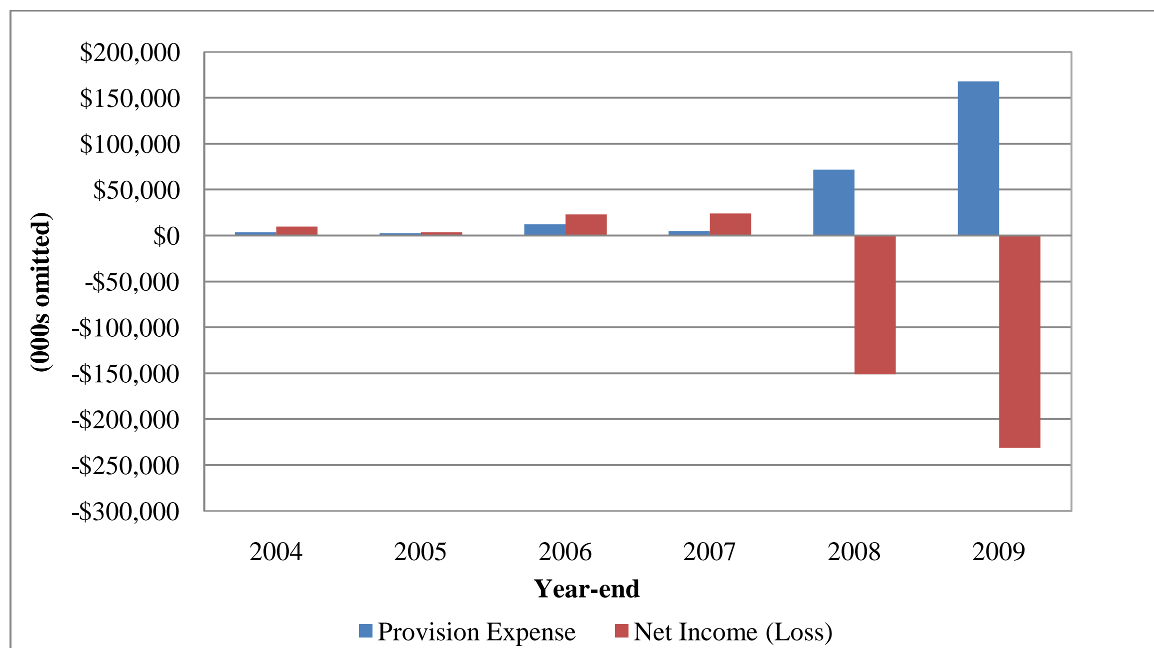
Midwest's classified assets as a percentage of tier 1 capital increased from 36 percent in 2008 to 86 percent in 2009 because of asset quality deterioration. In 2009, examiners noted that CLD loans were $65 million of the bank's classified assets, representing 30 percent of total

---

[17] Under TARP guidance, institutions that were placed in the presumptive approval category had, among other things, a CAMELS composite rating of 1 or 2 issued within the last six months. Institutions with CAMELS composite 2 ratings issued more than six months ago and 3-rated institutions could also qualify for presumptive approval status so long as those institutions had acceptable performance ratios.

classifications. The bank reported loan losses in excess of $80 million, with CLD loans as the largest component at $34.8 million. The growth in classified assets prompted corresponding increases in Midwest's loan loss provision expense. As shown in Chart 4 below, the bank's provision expense more than doubled from $71 million in 2008, to $167.7 million in 2009, and the bank also recorded a $231.0 million loss in 2009. The holding company once again provided capital support, injecting $68 million between January and September 2009 to preserve the bank's *well capitalized* status.

Chart 4: Impact of Provision Expense on Earnings



As illustrated in Table 1 below, Midwest's holding company provided a total of $132 million in capital support for Midwest between 2004 and 2009. Ultimately, Midwest's holding company exhausted its financial resources and was no longer able to serve as a "source of strength" for Midwest, which fully exposed the bank to the losses associated with its CRE and CLD loans.

Table 1: Midwest's Year-end Earnings and Midwest's Holding Company Annual Capital Support (000s omitted)

	2004	2005	2006	2007	2008	2009
Midwest's Earnings	$9,655	$3,641	$22,948	$24,160	($151,125)	($231,030)
Capital Injections from Midwest's holding company	$7,000	$15,000	---	$23,000	$19,000	$68,000

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 in troubled depository institutions. On January 12, 2010, FRB Chicago notified the bank that it had fallen to *adequately capitalized.* This PCA designation prohibited Midwest from accepting, renewing, or rolling over any brokered deposits, which further strained the bank's liquidity. On February 4, 2010, FRB Chicago deemed the bank *undercapitalized* and required it to submit an acceptable capital plan by February 16, 2010. Examiners deemed the bank's initial and revised capital plan submissions to be unacceptable because they lacked firm commitments from outside investors.

On February 23, 2010, the bank received notice that it had become *significantly undercapitalized*. As a result, the Federal Reserve Board issued a PCA Directive on March 30, 2010, that, among other things, required Midwest to accomplish the following within 45 days of the Directive's date: (1) raise additional capital or take other measures to achieve the *adequately capitalized* PCA designation or (2) be acquired by, or merge with, another depository institution.

On April 19, 2010, FRB Chicago informed the Board of Directors that the bank had become *critically undercapitalized*. Mounting losses had eroded the bank's capital as it dropped from *well capitalized* to *critically undercapitalized* in less than five months. The State closed the bank on May 14, 2010, and appointed the FDIC as receiver.

Supervision of Midwest Bank and Trust Company

FRB Chicago complied with examination frequency guidelines and conducted regular off-site monitoring for the time frame we reviewed, 2003 through 2010. During this time frame, FRB Chicago and the State conducted seven full scope examinations and three target examinations and executed one informal and three formal enforcement actions. Prior to our review period, Midwest received CAMELS composite 1 or 2 ratings from 1995 through July 2003.

As shown in Table 2 on page 20, Midwest received a CAMELS composite 3 rating based on a March 2003 joint full scope examination that resulted in a Written Agreement on March 15, 2004. During the subsequent joint full scope examination that began two weeks after the signing of the Written Agreement, examiners upgraded the bank's CAMELS composite rating to 2 and also upgraded the component ratings for asset quality and sensitivity from 3 to 2. In January 2005, FRB Chicago conducted a target examination, in part, to evaluate how well a new management team understood and controlled the inherent risks associated with the bank's derivatives activities.[18] This target examination confirmed the previous examination's component ratings for liquidity and sensitivity to market risk. During a May 2005 joint full scope examination, Midwest received another CAMELS composite 2 rating and the management component rating was upgraded from 3 to 2. As a result of this examination and the changes made by the new management team, FRB Chicago terminated the Written Agreement on September 16, 2005.

---

[18] Derivatives, in general, are financial contracts whose values are derived from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

Joint full scope examinations in 2006 and 2007 maintained the bank's CAMELS composite 2 rating and each of the CAMELS components continued to receive 2 ratings. A May 2008 full scope examination maintained the bank's CAMELS composite 2 rating, but downgraded the component ratings for asset quality and earnings from 2 to 3. As a result of this examination, FRB Chicago recommended an informal enforcement action, and the Board of Directors adopted a Board Resolution on August 26, 2008, that addressed liquidity, credit monitoring, and capital management. In late October 2008, the holding company applied for TARP CPP funds, and before the end of the month FRB Chicago recommended that the application be approved. During a November 2008 target examination, FRB Chicago downgraded the bank's CAMELS composite and liquidity component ratings to 3. In December 2008, the bank received $84.8 million from the TARP's CPP.

A May 2009 joint full scope examination lowered Midwest's CAMELS composite rating to 4 (marginal). This examination downgraded every component rating, with capital, management, and earnings each receiving double downgrades. Based on the results of this examination, FRB Chicago imposed a Written Agreement, which became effective on December 18, 2009. A January 2010 target examination resulted in further downgrades—the CAMELS composite rating went from 4 to 5 (critically deficient) and all component ratings received downgrades to 5, except for management, which remained a 4.

As discussed more fully in the sections that follow, we believe that FRB Chicago identified key weaknesses, such as the bank's CRE and CLD concentrations, reliance on non-core funding, and reliance on the holding company's capital support, that contributed to the bank's failure, but did not act on multiple opportunities to take more forceful supervisory action.

Table 2: Supervisory Overview of Midwest

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	
3/3/2003	8/1/2003	Full	Joint	3	2	3	3	2	2	3	Written Agreement[a]
3/29/2004	5/18/2004	Full	Joint	2	2	2	3	2	2	2	
1/24/2005	3/9/2005	Target[b]	Joint	N/A	N/A	N/A	N/A	N/A	2	2	
5/16/2005	8/18/2005	Full	Joint	2	2	2	2	2	2	2	
3/20/2006	5/18/2006	Full	Joint	2	2	2	2	2	2	2	
4/2/2007	7/12/2007	Full	Joint	2	2	2	2	2	2	2	
5/12/2008	9/5/2008	Full	Joint	2	2	3	2	3	2	2	Board Resolution
FRB Chicago evaluated the holding company's application for TARP CPP funds in October 2008.											
11/3/2008	1/6/2009	CRE Review Target	Joint	3	2	3	2	3	3	2	
5/18/2009	10/14/2009	Full	Joint	4	4	4	4	5	4	3	Written Agreement
1/19/2010	3/31/2010	Asset Quality Target	Joint	5	5	5	4	5	5	5	PCA Directive

[a] Terminated on September 16, 2005.
[b] Target examination focused on liquidity and sensitivity to market risk only. Only these components received ratings.

March 2003 Full Scope Examination Resulted in a Written Agreement

In March 2003, a joint full scope examination resulted in a CAMELS composite 3 rating. The August 2003 examination report noted matters requiring the Board of Directors' attention, including (1) credit risk management, (2) risk management, (3) internal audit, and (4) market risk management. Examiners indicated that the bank's credit, operational, legal, and reputational risks were all "high" and "increasing." FRB Chicago also highlighted the bank's below peer capital position, high funding costs, and reliance on the holding company for capital injections to support growth.

Examiners noted that the bank did not establish fundamental credit risk management practices to ensure sound loan portfolio management. FRB Chicago indicated that the bank did not possess a strong credit risk management reporting system, and its risk management function did not allow for timely identification of emerging problems. Midwest exhibited high credit risk because the bank's CRE and CLD concentrations significantly exceeded its peer group averages by 26 percent and 22 percent, respectively.

FRB Chicago and the State executed a formal enforcement action in the form of a Written Agreement on March 15, 2004. FRB Chicago and the State began drafting the enforcement action in October 2003. The bank received the draft enforcement action in early December 2003. The draft was subject to multiple revisions that took three months to fully resolve. The Written Agreement executed in March 2004 required the Board of Directors to address a variety of issues related to management's expertise and qualifications, board oversight of management and bank operations, lending and credit administration, appraisals, problem loan identification, and audit and internal controls. The enforcement action required the bank to hire a consultant to conduct an independent assessment and prepare a written report evaluating the functions and performance of the holding company's and the bank's Boards of Directors and senior management.

March 2004 Joint Full Scope Examination Resulted in a CAMELS Composite Rating Upgrade, but the Written Agreement Remained Active

In March 2004, FRB Chicago began a joint full scope examination that resulted in a CAMELS composite rating upgrade from 3 to 2. The May 2004 examination report characterized the bank's condition as satisfactory, and examiners identified improvements from the prior examination that warranted component upgrades to asset quality and sensitivity. Despite the upgrades, examiners identified matters requiring attention, including, among other things, (1) a succession plan for all critical management positions, (2) unresolved credit risk management weaknesses, (3) repeat findings related to the lack of a contingency funding plan, and (4) various weaknesses related to managing the investment portfolio. Midwest's holding company injected $7 million during 2003 to support the bank's capital position, and management projected an additional $7 million capital injection for 2004.

Examiners concluded that the bank's risk management practices were not commensurate with its size, complexity, and risk profile. According to the examination report, Midwest "doubled in asset size within the last five years, but infrastructure has not been commensurate with growth, especially risk management and lending areas." Examiners noted Midwest's high credit risk resulting from its CRE and CLD concentrations and previous poor underwriting. Since the previous examination, CRE had increased to 80 percent of the bank's total loans, or 462 percent of the bank's tier 1 capital. CLD loans represented 38 percent of the portfolio, or 217 percent of tier 1 capital. Examiners stated that these risks were spread across a number of borrowing relationships with projects in markets well known to the bank.

Examiners upgraded asset quality because loans classified as "loss" decreased significantly from $5.7 million during the prior examination to $134,000 and loans classified as "doubtful" decreased from $24.6 million to $3.1 million. Despite these significant decreases, loans classified as "substandard" nearly doubled from $33.3 million during the prior examination to $61.8 million, and "special mention" loans increased from $0 to $16 million.[19] Examiners noted improvements in the bank's loan grading and ability to identify problem loans. However, examiners downgraded a few of the loan ratings assigned by management.

---

[19] An asset classified as substandard is inadequately protected by the borrower's current repayment capacity or the collateral pledged, if any.

Examiners identified management weaknesses and recommended that the bank assess its current management structure, composition, and personnel requirements in all business lines. This recommendation was consistent with the recently executed Written Agreement, which required an independent assessment of management.

In our opinion, the findings in this examination did not warrant a CAMELS composite upgrade. The bank had been placed under a formal enforcement action two weeks prior to the start of this examination. In light of this timeframe, none of the eight major action items contained in the Written Agreement had been fully resolved, and only three subcomponents could be assessed for progress. In addition, FRB Chicago noted newly identified issues warranting the Board of Director's attention.

January 2005 Target Examination Focused on Liquidity and Sensitivity to Market Risk

In January 2005, FRB Chicago led a joint target examination, focusing on liquidity and sensitivity to market risk, to assess how well management understood and controlled the inherent risks in the bank's use of derivatives. The target examination maintained the 2 rating for both of these CAMELS components, but examiners did not issue a CAMELS composite or other component ratings. In addition to the CAMELS ratings, examiners also upgraded their assessment of the bank's risk management practices for liquidity from "marginally acceptable" to "acceptable" because of recently implemented enhancements.

Examiners classified the bank's liquidity and market risk as stable based on a number of positive steps taken by management in the third and fourth quarters of 2004. Examiners concluded that the bank's contingency funding plan largely addressed the prior repeat findings. In addition, management had limited its use of derivatives and closed specific contracts that examiners characterized as presenting "excessive" risk. Management repositioned the bank's investment portfolio to higher-yielding, shorter-duration assets, which resulted in costs and charges of $20.2 million and decreased the bank's 2005 net income.

May 2005 Joint Full Scope Examination Resulted in a CAMELS Composite 2 Rating and Led to Release from the Written Agreement

In May 2005, FRB Chicago and the State conducted a joint full scope examination that maintained the bank's CAMELS composite 2 rating and upgraded the management component rating from 3 to 2. In response to the independent assessment of management required by the Written Agreement, the bank hired a new President and CEO, dismissed ineffective officers, and hired over 30 new mid-to-senior level officers. In addition, the August 2005 examination report stated that the holding company intended to raise $50 million to increase Midwest's capital levels.

During this examination, FRB Chicago labeled the bank's credit risk "moderate to high," even though the bank's CRE and CLD concentrations were high in comparison to its peer institutions. New management indicated that it intended to address the bank's concentration risk by increasing the bank's small business and consumer lending activities. CRE loan classifications had declined since the previous examination, and new management made progress in

remediating problem loan relationships. Examiners also observed improved oversight of the bank's lending activities by a new Chief Credit Officer and a new manager of construction lending. FRB Chicago noted improved and acceptable credit risk management practices based on recently implemented lending policies. However, FRB Chicago observed that the bank's loan portfolio grew 23 percent during the previous 12-month period and exceeded its peer growth rate of 18 percent.

The examination acknowledged management's success in repositioning the bank's investment portfolio and stated that the associated costs were isolated occurrences and that the bank's core earnings were satisfactory. Furthermore, examiners indicated that Midwest's capital would remain at satisfactory levels without holding company capital support. Accordingly, examiners deemed the new management team and its control enhancements satisfactory and released the Written Agreement on September 16, 2005.

In our opinion, FRB Chicago terminated the Written Agreement too early given how recently the management overhaul and control enhancements had occurred. In hindsight, we believe that waiting for recently implemented remedial actions, such as comprehensive lending policies and related controls, to demonstrate sustained effectiveness may have been a more prudent supervisory approach.

March 2006 Joint Full Scope Examination Resulted in Another CAMELS Composite 2 Rating

In March 2006, FRB Chicago began a joint full scope examination that resulted in another CAMELS composite 2 rating. Each of the CAMELS component ratings also received a 2. Examiners concluded that the bank was in satisfactory condition in part because classified assets decreased by $5.9 million. FRB Chicago stated that the bank's capital position had become "slightly better than peer" following the holding company's capital injection of $15 million in the third quarter of 2005.

Examiners noted that Midwest's holding company had announced its plans to merge Royal American into Midwest.[20] According to examiners, the merger would result in loan portfolio diversification, additional lending expertise, and expanded alternatives for succession planning. Management projected that the merger would increase the bank's earnings by $6.1 million in the following year. FRB Chicago indicated in the May 2006 examination report that examiners would monitor Midwest to ensure that the bank established risk management practices commensurate with the anticipated growth.

The bank attained its double-digit loan portfolio growth target in 2005—23 percent—and management anticipated similar results by year-end 2006. FRB Chicago stated that this loan portfolio growth resulted in a CRE concentration of 467 percent of total capital. Examiners noted that management had implemented some of the controls in Supervision and Regulation

---

[20] FRB Chicago had approved the merger prior to the examination, and the bank anticipated the State's approval of the transaction in May 2006.

Letter 07-01, but suggested that the bank establish concentration sub-limits and improved reporting. The examination report did not address the bank's progress towards achieving its goal of diversifying the loan portfolio by increasing small business and consumer lending.

Examiners noted that the bank had increased its reliance on borrowed funds due to Chicago's "keenly competitive" market for deposits. Management indicated that the merger with Royal American would help to increase the bank's core deposits. However, management expected Midwest's reliance on non-core funding to continue to increase during 2006, but remain within the bank's established risk limits.

April 2007 Joint Full Scope Examination Resulted in Another CAMELS Composite 2 Rating

In April 2007, FRB Chicago and the State commenced a joint full scope examination that resulted in another CAMELS composite 2 rating. Once again, all of the CAMELS components received a 2. The July 2007 examination report noted that the merger with Royal American resulted in the appointment of a new Chief Operating Officer and Chief Investment Officer. Examiners described the bank's capital as "sufficient relative for the risk profile" and noted that earnings improved despite sizeable loan losses in 2006. Examiners stated that the holding company continued to serve as a source of strength for the bank and that management had "proven its ability to raise capital and access capital markets." Earnings increased from $3.6 million in 2005 to $22.9 million in 2006 because of the merger with Royal American and the lack of one-time charges. Examiners highlighted management's successful growth initiatives by noting that internal and merger-related growth increased the loan portfolio by 44 percent.

However, the bank's continued dependence on non-core funding remained an issue, and examiners cited the bank's inability to raise core deposits in a competitive market without relying on acquisitions. Management increasingly relied on pledging investment portfolio assets to support the borrowing activities necessary to fund growth. According to examiners, increased pledging activity strained a ratio that the bank used to monitor its liquidity.[21] During this examination, FRB Chicago noted that the ratio decreased from 11.2 percent to 5.5 percent, but exceeded management's 5 percent minimum guideline. Despite the considerable decline, examiners continued to rate liquidity a 2. In our opinion, FRB Chicago should have downgraded the bank's liquidity rating given the increasing dependence on non-core funding and the sharp decline in the primary liquidity ratio.

Examiners also noted a decline in the bank's asset quality and continued to rate this CAMELS component 2. The examination report referred to the bank's "significant increase" in classified assets from 19 percent to 23 percent of tier 1 capital plus the allowance for loan and lease losses (ALLL) as "manageable," but acknowledged that the increase in capital associated with the Royal American merger minimized the percentage increase in classified assets. Examiners indicated that the bank's past due and nonaccrual loans exceeded peer group averages primarily

---

[21] Management created and monitored a "basic surplus ratio" to assess the difference between liquid assets and estimated short-term liabilities.

as a result of one large problem credit relationship for $26.6 million that had a negative effect on asset quality. During this examination, "special mention" loans more than tripled to $76.7 million from $23.3 million in 2005, and represented 28 percent of the bank's capital.

Furthermore, FRB Chicago noted that management reduced the bank's CLD concentration from 174 percent to 156 percent of total risk-based capital, but the bank's CRE concentration increased from 414 percent during December 2005 to 433 percent at December 2006. Despite management's limited success in reducing credit concentrations, examiners noted management's "satisfactory" monitoring of the bank's concentration risk. In our opinion, this examination's CAMELS component rating of 2 for asset quality did not reflect the increase in classified and special mention assets or the bank's concentration risk.

Management continued to pursue its growth by acquisition strategy by merging with Mount Prospect in October 2007. According to examiners, the merger resulted in total asset growth of approximately $535 million.

May 2008 Full Scope Examination Resulted in a Board Resolution, but the CAMELS Composite Rating Remained 2

In May 2008, FRB Chicago began a joint full scope examination that maintained the bank's CAMELS composite 2 rating, but downgraded component ratings for asset quality and earnings from 2 to 3. The September 2008 examination report noted that classified assets more than doubled and special mention assets nearly doubled since the previous examination. These developments exposed the bank to higher risk and greater potential for loss. In addition, Midwest's earnings decreased because of declining interest rates and the bank's higher cost of funds.

Examiners observed several matters that required the Board of Directors' attention. FRB Chicago required the bank to (1) provide a monthly report of all special mention, substandard, and nonaccrual loans greater than $500,000; (2) increase its provision expense to maintain the ALLL at a satisfactory level; and (3) enhance its liquidity risk monitoring and reporting. As a result of this examination, FRB Chicago recommended an informal enforcement action, and the Board of Directors adopted a Board Resolution on August 26, 2008. Among other things, the Board Resolution required management to report to the Board of Directors (1) the level of brokered certificates of deposit as a percent of total deposits, (2) problem loans, and (3) capital adequacy.

In 2007, the holding company had provided the bank with $23 million in capital, which helped to preserve Midwest's *well capitalized* status while minimizing the impact of anticipated losses. In March 2008, Midwest reported a $3 million net loss after the bank incurred $7.1 million in restructuring charges associated with prepaying its high cost FHLB borrowings, took a $10.8 million write-down on a large loan relationship, and wrote off $17.6 million of the value of its GSE preferred securities holdings. The net loss led to the earnings component downgrade. Despite the decline in the CAMELS component rating for earnings and signs of further asset quality deterioration, examiners stated that the bank's capital remained sufficient to support the organization's risk profile.

The examination report identified increased levels of home loan foreclosures, declining home sales, declining land values, and increasing personal bankruptcies in the Chicago area. Examiners stated that the bank remained concentrated in CRE, although management merged with Royal American and Mount Prospect to diversify its loan portfolio. Classified assets increased 106 percent since the previous examination. According to examiners, a prolonged downturn in the economy could place additional stress on the bank. Nevertheless, the examination report indicated that the bank's composite credit risk was "moderate" with an increasing risk trend.

Examiners also stated that the bank's inherent liquidity risk increased based on loan growth, decreasing core deposits, increasing reliance on wholesale funding sources such as brokered deposits, and increased asset pledging of the investment portfolio. Examiners highlighted the bank's challenges in maintaining its core deposits and that the bank had exceeded its internal limit on the use of brokered deposits. Due to the bank's tightening liquidity position, Midwest began relying on deposit promotions.

This examination did not acknowledge the bank's accumulation of $85 million of GSE preferred securities. The CBEM does not impose limits on a bank's purchase of Fannie Mae or Freddie Mac equity securities.[22] As a result, examiners did not consider the accumulation of these securities as a risk. Further, the GSEs had the implied support of the U.S. government. Ultimately, they were completely written off. In hindsight, these securities represented a significant risk to the investment portfolio.

In our opinion, the severity of the findings noted during this examination warranted additional CAMELS component rating downgrades and a CAMELS composite downgrade. FRB Chicago acknowledged management's failure to diversify the loan portfolio and the bank's funding sources—two key strategic objectives of the new management team—but did not downgrade the bank's management component rating. Also, we believe that the bank's 2 rating for the liquidity CAMELS component did not reflect the gravity of the persistent challenges facing the institution. If these additional component rating downgrades had occurred, four of the six CAMELS components would have received 3 ratings, which would have led to a CAMELS composite rating downgrade to 3.

Midwest Applied for and Received TARP Funds

In late October 2008, Midwest's holding company applied for TARP funds under the CPP, and FRB Chicago evaluated the application. In assessing Midwest's application, FRB Chicago followed Treasury's guidance entitled *Process for Evaluation of QFI* [Qualified Financial Institutions] *Participation in the TARP Capital Purchase Program.* In applying this guidance,

---

[22] Table 4, *Permitted Stock Holdings of Members Banks,* in Section 2020.1 of the CBEM refers to the National Housing Mortgage Association Act of 1934 (the "Fannie Mae Chartering Act") to indicate that there are no limits on a bank's stock holdings in Fannie Mae equity securities. The CBEM does not specifically acknowledge the Federal Home Loan Mortgage Corporation Act (the "Freddie Mac Chartering Act") as containing a similar provision. Freddie Mac preferred securities are also a permissible investment for state member banks under the Freddie Mac Chartering Act.

FRB Chicago concluded that Midwest qualified for presumptive approval status because of the CAMELS composite 2 rating issued within the previous six months. In our opinion, FRB Chicago complied with the process outlined in the guidance and the limited decision-making criteria available at the time.[23] Even if Midwest had received a CAMELS composite 3 rating during the previous examination, the bank would have qualified for presumptive approval status based on its acceptable performance ratios.[24]

November 2008 CRE Target Examination Resulted in a CAMELS Composite Downgrade

FRB Chicago began a joint CRE target examination in November 2008 that downgraded Midwest's CAMELS composite rating from 2 to 3. In addition to assessing the bank's CRE portfolio, this examination also evaluated the bank's liquidity and earnings. Examiners downgraded the bank's liquidity component rating from 2 to 3, noting that liquidity had become stressed and had not shown signs of improvement. FRB Chicago chose not to recommend an additional enforcement action because examiners believed that management was taking appropriate action.

The examination noted that management had developed a specific plan to reduce the bank's reliance on non-core funding as a result of the May 2008 examination. FRB Chicago noted, however, that the bank's liquidity became "very tight" because of "several external events" that resulted in the bank losing access to key funding sources, so management increased its reliance on brokered certificates of deposits and other borrowings, specific types of non-core funding. Examiners concluded that liquidity had tightened significantly since the previous examination and that the bank's dependence on non-core funding was "very high" relative to its peers. Based on the results of this examination, management again committed to diversifying its funding sources, and examiners reiterated the need for continued monthly liquidity reporting.

Examiners stated that Midwest had experienced a further decline in loan portfolio quality similar to most banks in the Chicago area with CRE concentrations, but not to the point where the supervisory rating or approach should be adjusted. Examiners concluded that there was moderate reliance on CRE lending for revenue, but it did not pose a risk to the bank's future viability or earnings. While the decline in asset quality posed a risk to capital, steps had been taken to increase capital and mitigate the risk. According to examiners, management provided sufficient capital to mitigate the current risk and the probability of a continued decline in asset quality.

---

[23] In September 2009, the Federal Reserve Board's Office of Inspector General issued a report entitled *Audit of the Board's Processing of Applications for the Capital Purchase Program under the Troubled Asset Relief Program* that reached similar conclusions.

[24] Examples of these performance ratios include (1) classified assets/net tier 1 capital plus ALLL, (2) CLD loans/total risk-based capital, and (3) non-performing loans plus other real estate owned/net tier 1 capital plus ALLL.

May 2009 Full Scope Examination Resulted in a CAMELS Composite Rating Downgrade to 4; Double Downgrades to CAMELS Component Ratings for Capital, Management, and Earnings; and a Written Agreement

In May 2009, the State led a joint full scope examination that downgraded the bank's CAMELS composite rating to 4. In addition, every CAMELS component rating received a downgrade, with capital, management, and earnings each receiving double downgrades to 4, 4, and 5, respectively. Examiners noted "serious deterioration" in the bank's overall financial performance. The October 2009 examination report indicated that several significant events in 2008 resulted in a substantial loss, which depleted the bank's capital. These events included (1) a write-down of GSE preferred securities holdings, (2) a write-down in the value of the bank's goodwill, and (3) an increased provision expense. Examiners noted that TARP CPP funds "essentially replaced much of the capital loss" associated with these events.

Examiners noted an unacceptable level of classified and special mention assets and emphasized that the bank's credit risk practices require "immediate enhancement." Examiners identified several downgrades to the loan ratings assigned by the bank's management. FRB Chicago noted capital deficiencies and indicated that the capital position could not absorb losses associated with the economic downturn. Since the previous examination, the bank appointed a new CEO and made a series of senior management changes. Examiners noted that the new management shifted the bank's focus to "survival mode" by emphasizing raising capital and attempting to merge with or be acquired by another institution. The examination report highlighted the importance of new management's plan to ensure the "long term viability of the bank." Examiners questioned Midwest's holding company's ability to raise additional capital and stated that the holding company did not have the available financial resources necessary to support Midwest.

The examination report noted that asset quality had seriously deteriorated since the previous examination as well as in the past two years. The prolonged economic downturn accompanied by the decline in real estate values adversely affected many borrowers and contributed to increased risk and loan losses. Examiners also noted that the bank's concentrations in CRE and CLD loans were "seriously high and require continued attention."

As a result of this examination, FRB Chicago implemented a formal enforcement action in the form of a Written Agreement, which required the Board of Directors to address a variety of issues, including oversight of management and bank operations, concentrations of credit, lending and credit administration, earnings and budget, and capital planning.

January 2010 Asset Quality Target Examination Resulted in Further Downgrades and a PCA Directive

In January 2010, FRB Chicago began a joint target examination that focused on the bank's capital plan and asset quality and resulted in further downgrades. FRB Chicago downgraded the bank's CAMELS composite rating to 5 and all components ratings except for management received 5 ratings. In the March 2010 examination report, examiners noted the bank's "excessive" classified assets in relation to capital and the consequences associated with management's failure to diversify the loan portfolio.

Examiners noted further asset quality deterioration and additional losses that threatened the bank's viability. FRB Chicago emphasized the need for immediate financial support from external sources. Examiners acknowledged management's efforts towards restructuring the bank's capital, but no potential investors or strategic partners had been identified. During the examination, the bank was formally notified on February 23, 2010, that it had become *significantly undercapitalized*.[25] Before FRB Chicago finalized the examination report, the Federal Reserve Board issued a PCA Directive on March 30, 2010, that, among other things, required Midwest to (1) raise additional capital or take other measures to achieve the *adequately capitalized* PCA designation or (2) be acquired by or merge with another depository institution. The examination report noted the need for a substantial capital injection to assure the bank's continued viability. Management failed to raise additional capital, and the State closed the bank on May 14, 2010, and appointed the FDIC as receiver. The Treasury noted in a July 2010 quarterly report to Congress that the TARP funds provided to Midwest would not be recovered.

Conclusions and Lessons Learned

Midwest failed because of the convergence of various factors. The Board of Directors and management pursued an aggressive growth strategy in 2002 and 2003, without establishing credit risk management controls commensurate with the bank's increasing size and risk profile. These weaknesses contributed to the bank developing CRE and CLD loan concentrations. During this time period, examiners also raised concerns about management's effectiveness and capabilities. These deficiencies resulted in a formal enforcement action in March 2004 that, among other things, required Midwest to enhance its credit risk management and hire a consultant to conduct an independent assessment of management's "functions and performance," including its expertise and qualifications. In response to the independent assessment, the bank overhauled its management team in 2004 and 2005 by, among other things, replacing the CEO, dismissing ineffective senior officers, and adding two new members to the Boards of Directors of Midwest and its holding company. New management pursued double-digit loan growth while attempting to materially reduce loan concentrations, raise capital, and diversify the bank's funding sources. For the most part, management achieved only its growth objectives.

In 2007, Midwest developed a risk in its investment portfolio by increasing its preferred securities holdings in Fannie Mae and Freddie Mac, two GSEs. The value of these securities declined precipitously following the onset of the financial crisis in the fall of 2007, and in the first quarter of 2008 the bank took a $17.6 million write-down. The FHFA placed these GSEs into conservatorship in September 2008, and Midwest's management subsequently wrote off the remaining $67 million value of these securities. During this time frame, the bank also experienced significant asset quality deterioration in its CRE and CLD loan portfolios. In December 2008, the bank received $84.8 million from the Treasury's TARP, but management failed to raise additional private capital. In 2008 and 2009, Midwest experienced significant losses, and Midwest's holding company injected $87 million in additional capital to preserve the

[25] The State also issued a Section 51 Notice and a Cease and Desist Order on February 23, 2010. The Section 51 Notice required, among other things, that Midwest increase its capital ratios. The Cease and Desist Order required, among other things, that Midwest cease accepting uninsured deposits.

bank's *well capitalized* status. These capital injections depleted the holding company's financial reserves and prevented it from further supplementing the bank's capital. By 2010, Midwest became fully exposed to the loan losses associated with its CRE and CLD asset quality deterioration, which rapidly depleted its capital. On May 14, 2010, the State closed Midwest and appointed the FDIC as receiver.

With respect to supervision, FRB Chicago complied with examination frequency guidelines for the timeframe we reviewed, 2003 through 2010, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted 10 examinations and executed 3 formal enforcement actions and 1 informal enforcement action.

Fulfilling our mandate under section 38(k) of the FDI Act provides the opportunity to determine, in hindsight, whether additional or alternative supervisory action could have been taken to reduce the likelihood of the bank's failure or a loss to the DIF. Our analysis of FRB Chicago's supervision indicated that examiners identified key weaknesses, such as the bank's CRE and CLD concentrations, reliance on non-core funding, and reliance on the holding company's capital support, that contributed to the bank's failure, but did not act on multiple subsequent opportunities to take more forceful supervisory action that might have prompted management to resolve these weaknesses. In our opinion, the findings in the 2004 full scope examination did not warrant the upgrade that occurred in Midwest's CAMELS composite rating because the bank had been placed under a formal enforcement action only two weeks prior to the start of the examination. In light of this timeframe, none of the eight major action items contained in the formal enforcement action had been fully resolved, and only three subcomponents could be assessed for progress. FRB Chicago also noted newly identified issues warranting the Board of Director's attention. In hindsight, we believe that FRB Chicago terminated the formal enforcement action prematurely following the 2005 full scope examination, given how recently the management overhaul and control enhancements had occurred. In our opinion, sufficient time was needed for management to demonstrate that the new controls were effective. However, it is not possible to determine whether alternative supervisory actions would have affected Midwest's subsequent decline.

In our opinion, FRB Chicago did not hold management accountable for failing to diversify its loan portfolio and the bank's funding sources between 2005 and 2007. During this time, management succeeded in achieving double-digit growth, but failed to address the weaknesses that ultimately contributed to the bank's failure, including CRE and CLD concentrations and reliance on non-core funding and holding company capital support. We believe that the 2007 full scope examination presented the opportunity to downgrade the bank's asset quality and liquidity ratings. In our opinion, the bank's asset quality rating did not reflect the increase in classified assets and other problem loans. Further the bank's liquidity rating did not reflect the increasing dependence on non-core funding and the sharp decline in the bank's primary liquidity ratio.

Further, we believe that the 2008 full scope examination presented another opportunity for stronger supervisory action. In our opinion, the severity of the findings noted during this examination warranted additional CAMELS component rating downgrades and a CAMELS composite downgrade. This examination acknowledged management's failure to diversify the

bank's loan portfolio and funding sources—two key strategic objectives of the new management team—but did not downgrade the bank's management component rating. Also, we believe that Midwest's 2 liquidity component rating did not reflect the gravity of the persistent challenges facing the institution. If these additional component rating downgrades had occurred, four of the six CAMELS components would have received 3 ratings, which would have led to a CAMELS composite rating downgrade to 3.

In late October 2008, Midwest's holding company applied for TARP funds under the CPP and FRB Chicago evaluated the request. In applying Treasury's guidance, FRB Chicago concluded that Midwest qualified for presumptive approval status because of the CAMELS composite 2 rating issued within the previous six months. In our opinion, FRB Chicago complied with the process outlined in the guidance and the limited decision-making criteria available at the time. Even if Midwest had received a CAMELS composite 3 rating during the 2008 full scope examination, the bank would have qualified for presumptive approval status based on its acceptable performance ratios.

The Fannie Mae and Freddie Mac chartering acts authorize banks to purchase preferred securities issued by these GSEs. In addition, regulatory guidance issued by the Federal Reserve System does not specify investment limits or raise concerns about concentrations in these GSE preferred securities. Ultimately, they were completely written off, which contributed to Midwest's failure. In hindsight, these securities represented a significant risk to the bank's investment portfolio.

Lessons Learned

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Midwest's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. This failure demonstrates (1) the importance of examiners holding management accountable for failing to address fundamental and persistent weaknesses, (2) the risks associated with an aggressive growth strategy that relies heavily on non-core funding and holding company capital support, and (3) the importance of examiners issuing CAMELS composite and component ratings consistent with the narrative comments included in examination reports.

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 acknowledged our conclusions and concurred with the lessons learned.

APPENDIXES

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)
A valuation reserve established and maintained by charges against the bank'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. The reserve must be sufficient to absorb probable losses inherent in the institution's loan and lease portfolio.

Brokered Deposits
A deposit purchased from a broker acting as an agent for depositors. The broker pools certificates of deposit from many small investors and markets them to financial institutions, usually in blocks nearing $100,000, and negotiates a higher rate for certificates of deposit placed with the purchaser. Federal law prohibits undercapitalized banks and thrifts from accepting brokered deposits.

Classified Assets
Loans that exhibit well-defined weaknesses and a distinct possibility of loss. Classified assets are 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. An asset classified as "loss" is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted.

Commercial Real Estate (CRE) Loans
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.

Concentration
A significant amount of direct or indirect extensions of credit and contingent obligations that possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations.

Construction and Land Development (CLD) Loans; also known as Construction, Land, and Land Development (CLD) Loans
A subset of commercial real estate loans, secured by real estate (including non-agricultural vacant land), for (1) on-sight construction of industrial, commercial, residential, or farm buildings, and (2) land development, including pre-construction preparatory work such as laying sewer and water pipes.

Appendix 1 (continued)

Core Deposits
Deposits that are largely derived from a bank's regular customer base and, therefore, are typically the most stable, least costly, and least interest-rate sensitive source of funding.

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 Written Agreements, temporary Cease and Desist Orders, Cease and Desist Orders, prohibition and removal orders, and Prompt Corrective Action Directives; while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Liquidity
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.

Nonaccrual
Nonaccrual status means loans with overdue interest payments and uncertainty regarding collection of principal; no interest income is recognized on these loans for reporting purposes.

Non-Core Funding
Funding that can be very sensitive to changes in interest rates, such as brokered deposits, certificates of deposit greater than $100,000, federal funds purchased, and borrowed money.

Preferred Stock
A form of equity ownership that usually pays a fixed dividend, gives the holder a claim on corporate earnings superior to common stock owners, and generally has no voting rights. Preferred stock also has priority over common stock in the distribution of assets in the case of liquidation of a bankrupt company.

Prompt Corrective Action (PCA)
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*.

Tier 1 Capital
The sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible

assets, interest only strips receivables and nonfinancial equity investments that are required to be deducted, and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

Underwriting
Detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history; and the lender's evaluation of the borrower's credit needs and ability to pay.

Written Agreement
A formal supervisory enforcement action that is generally issued when a financial institution or an institution-affiliated party has multiple deficiencies that are serious enough to warrant formal action or that have not been corrected under an informal action. It is an agreement between a financial institution and the Federal Reserve Board or a Federal Reserve Bank that may require the financial institution or the institution-affiliated party to (1) stop engaging in specific practices or violations or (2) take action to correct any resulting conditions. The agreement may also require the financial institution to provide ongoing information, such as progress reports. This enforcement action is the least severe of the formal enforcement actions.

Appendix 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: December 7, 2010

To: Elizabeth A. Coleman, Inspector General

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

Subject: Material Loss Review of Midwest Bank and Trust Company

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Midwest Bank and Trust Company (Midwest) of Elmwood Park, Illinois, prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act, as amended. The report finds that Midwest failed due to a convergence of several factors – an aggressive growth strategy in 2002 and 2003, without establishing appropriate credit risk management controls, which contributed to concentrations in commercial real estate and construction, land, and land development loans. The report notes that examiners raised concerns about management's effectiveness and capabilities. Over the course of several years, management was not able to raise sufficient private capital to offset loan losses and several other strategic decisions, such as reliance on non-core funding to support the aggressive loan strategy, ultimately resulted in the bank being closed on May 14, 2010. Midwest was supervised by the Federal Reserve Bank of Chicago (FRB Chicago) under delegated authority from the Board.

FRB Chicago complied with examination frequency guidelines for the time period that was reviewed, 2003 through 2010. During this time FRB Chicago and the State conducted seven full scope examinations and three target examinations and conducted regular off-site monitoring. Further, supervisors executed one informal and three formal enforcement actions with the bank and implemented all applicable PCA provisions. The report recognizes that examiners identified key weaknesses that contributed to the bank's failure, but concludes that they did not act on opportunities to take more forceful supervisory action that might have prompted management to resolve identified weaknesses. The report states that it is not possible to determine whether alternative supervisory actions would have affected Midwest's eventual decline.

Banking Supervision and Regulation staff concurs with the lessons learned in the report. Specifically, staff concurs with the report's observations that there are significant risks associated with an aggressive growth strategy that relies heavily on non-core funding, CAMELS composite and component ratings need to be consistent with the narrative comments in examination reports, and the importance of examiners holding management accountable for failing to address fundamental and persistent weaknesses.

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

Saurav B. Prasad, Project Leader and Auditor

Sopeany P. Keo, Auditor

Timothy P. Rogers, OIG Manager

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