Board of Governors of the Federal Reserve System

Material Loss Review of Irwin Union Bank and Trust

Office of Inspector General

April 2010

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

OFFICE OF INSPECTOR GENERAL

April 29, 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 Irwin Union Bank and Trust (IUBT). The FDI Act requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution when the loss to the Deposit Insurance Fund (DIF) is material—that is, it exceeds the greater of $25 million or 2 percent of the institution's total assets. The FDI Act specifically requires that we

- review the 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.

IUBT and its bank holding company, Irwin Financial Corporation, were both headquartered in Columbus, Indiana. The bank and bank holding company were founded in 1871 and 1972, respectively. The 2001 to 2002 time frame marked a significant period of change for IUBT as it transitioned from a community bank conducting commercial lending activities in three states through its Irwin Union Bank business line, to a large, complex banking organization engaged in consumer and commercial lending activities nationwide. This transition involved moving nonbank affiliates from the holding company to IUBT. In 2001, Irwin Home Equity, which conducted consumer lending activities on a nationwide basis, and Irwin Commercial Finance, which engaged in commercial lease financing activities in the United States and Canada, became nonbank subsidiaries of IUBT. In 2002, the bank also added Irwin Mortgage Corporation as a nonbank subsidiary involved in mortgage banking activities nationwide. Upon completing the restructuring process in 2002, IUBT became a geographically dispersed banking organization with subsidiaries headquartered in California, Washington, Canada, New York, and Indiana.

IUBT was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System, and by the Indiana Department of Financial Institutions (State). The State closed IUBT in September 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver. On October 29, 2009, the FDIC Inspector General notified us that IUBT's failure would result in an estimated loss to the DIF of $552.4 million, or 20.5 percent of the bank's $2.7 billion in total assets.

IUBT failed because of the convergence of several factors. The Board of Directors and management pursued an aggressive growth strategy between 2000 and 2005 that relied upon high-risk business models. Management also depended on volatile non-core funding sources to support the bank's growth strategy, which emphasized high-risk, high-yielding assets, such as 125 percent combined loan-to-value ratio loans. Meanwhile, management maintained few sources of liquidity support, which further increased IUBT's risk profile. During the 2000 to 2005 growth period, the Board of Directors and management failed to ensure that the bank's key corporate control functions and risk management practices kept pace with the bank's expansion, increasingly complex operations, and escalating risk profile. The Board of Directors' and management's aggressive growth strategy resulted in IUBT's total assets almost tripling between 2000 and 2005. For five consecutive years (that is, 2004 through 2008), however, the bank's net income decreased.

In 2007, reduced secondary market demand for mortgages hampered, and eventually eliminated, Irwin Home Equity's ability to sell its loans. The subsidiary was forced to hold the loans that it had originated to sell, including 125 percent combined loan-to-value ratio loans, in a declining real estate environment, which exposed IUBT to significant asset quality deterioration. In addition, the Irwin Union Bank business line developed a significant commercial real estate concentration by 2007 that compounded IUBT's exposure to real estate market declines. As the value of IUBT's assets continued to deteriorate, the Board of Directors and management adopted a strategy of selling more profitable business lines, such as Irwin Commercial Finance-Canada and Irwin Commercial Finance-Equipment, and branch offices to preserve the bank's capital. IUBT's remaining assets continued to deteriorate and deplete capital, which raised concerns about the bank's viability and eventually resulted in IUBT losing access to key funding sources. On September 18, 2009, the State closed IUBT because of the imminent danger of a liquidity shortfall and appointed the FDIC as receiver.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or loss to the DIF. Our analysis of FRB Chicago's supervision of IUBT indicated that examiners identified key weaknesses in 2002 and 2003 regarding corporate governance, risk management systems, and internal controls, but missed multiple subsequent opportunities to take more forceful supervisory action.

The fundamental risk management weaknesses, corporate governance issues, and key compliance deficiencies raised by FRB Chicago during examinations in 2002 and 2003 were early warning signs regarding IUBT's Board of Directors' and management's capability to effectively manage a geographically dispersed, large, and complex banking organization. Based on the 2002 and 2003 examination findings, FRB Chicago issued two informal enforcement actions. In 2003 and 2004, IUBT was unable to fully resolve the issues noted in the informal enforcement actions, and unresolved issues noted during the continuous supervision process began to accumulate. We believe that FRB Chicago had multiple opportunities between 2002 and 2009 to take additional and stronger supervisory actions.

For example, we believe that the fundamental corporate governance issues and comprehensive liquidity risk management weaknesses noted during the January 2002 examination provided an early warning sign that management was not effectively managing the risks associated with adding a new bank subsidiary engaged in high loan-to-value lending. In our opinion, the examination findings warranted a stronger supervisory action, including an additional downgrade of the management CAMELS component rating to reflect that management was less than satisfactory. We also believe that FRB Chicago should have considered requesting that management refrain from additional growth or corporate restructurings affecting IUBT until the bank fully addressed the fundamental flaws noted during this examination. We believe that strong supervisory action would have alerted management to the urgent need to address these weaknesses before pursuing further changes or additional growth in the lines of business.

A 2005 full scope examination cited that management’s failure to enhance its market risk management capabilities contributed to a decrease in the bank’s annual earnings and, in our opinion, warranted a stronger supervisory response. During the 2005 examination, FRB Chicago also noted new and recurring violations of laws and regulations in the bank’s mortgage lending business lines, which we believe warranted a stronger enforcement action. In addition, a 2006 full scope examination once again revealed IUBT’s difficulties in resolving items contained in informal enforcement actions and raised by the continuous supervision process. We believe that IUBT’s inability to fully resolve, in a complete and timely manner, prior informal supervisory actions and issues noted during the continuous supervision process warranted an earlier formal enforcement action.

In late 2007, when economic conditions caused a liquidity disruption that reduced the bank’s access to the funding necessary to operate its home equity lending business, FRB Chicago reiterated the risk associated with IUBT’s dependence on uninterrupted liquidity in the secondary markets as a significant issue. Examiners raised the same concern almost five years earlier in a 2003 examination report, but did not hold the Board of Directors and management accountable for addressing that risk in the intervening years. We believe that an earlier and stronger supervisory action, such as a liquidity component ratings downgrade or a formal enforcement action related to liquidity risk management, might have addressed this fundamental liquidity planning weakness.

We believe that IUBT’s failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Specifically, IUBT’s failure illustrates the importance of supervisors

- confirming effective Board of Director and management oversight before a bank makes key strategic and operational changes, such as adding new, high-risk business lines;

- ensuring that a bank's risk management practices and internal control processes keep pace with the institution's growth, increasingly complex operations, and heightened risk profile;

- focusing on the key risks within each business line and ensuring that the Board of Directors and management comprehend, manage, and mitigate those risks;

- assigning CAMELS composite and component ratings consistent with the significance of comments raised in the narrative sections of examination reports to ensure that management understands the urgency of implementing the required corrective action measures; and

- assuring that examination reports are forward looking and anticipate potential risk issues that management should address, in addition to raising concerns and observations based on events that have already occurred.

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

We appreciate the cooperation that we received from FRB Chicago and Board staff during our review. The 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

Elizabeth A. Coleman
Inspector General

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

Board of Governors of the Federal Reserve System

Material Loss Review of Irwin Union Bank and Trust

Office of Inspector General

April 2010

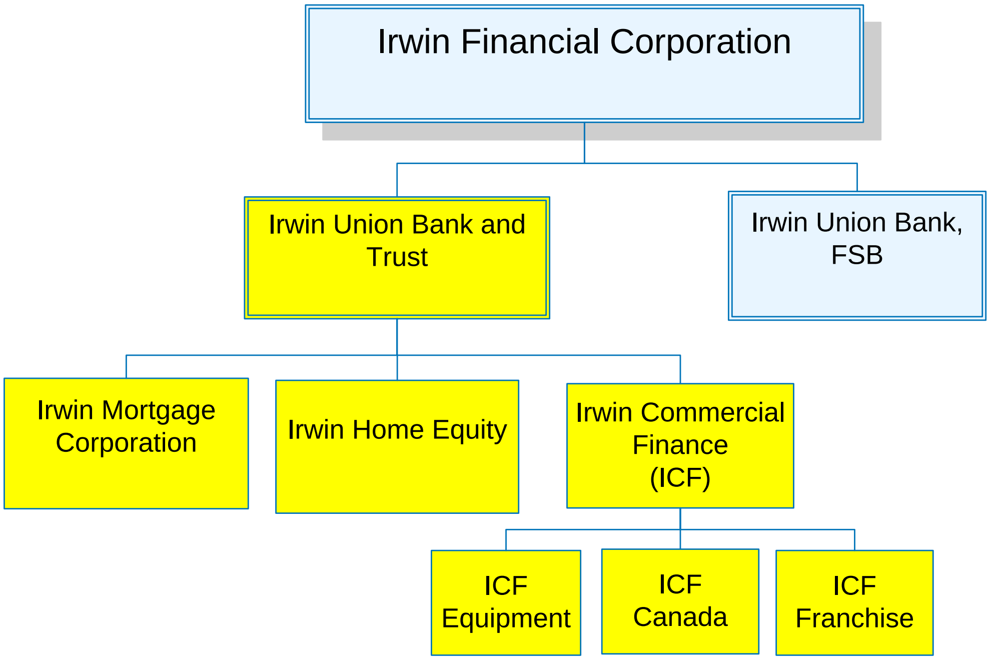
Table of Contents

Background

Irwin Union Bank and Trust (IUBT) and its bank holding company, Irwin Financial Corporation (IFC), were both headquartered in Columbus, Indiana. The bank and bank holding company were founded in 1871 and 1972, respectively. IUBT became a state member bank of the Federal Reserve System in August 1997. At the time, IUBT was a community bank conducting commercial lending activities in three states through its Irwin Union Bank business line. In 2000, IFC established a federal savings bank, Irwin Union Bank, FSB (Irwin FSB), to expand IUBT's commercial banking activities. Irwin FSB was supervised by the Office of Thrift Supervision (OTS).

The 2001 to 2002 time frame marked a significant period of change for IUBT as it transitioned from a community bank, to a large, complex banking organization engaged in consumer and commercial lending activities nationwide. IFC made this transition by moving nonbank affiliates from the holding company to the bank. In 2001, Irwin Home Equity, which conducted consumer lending activities on a nationwide basis, and Irwin Commercial Finance, which engaged in commercial lease financing activities in the United States and Canada, became nonbank subsidiaries of IUBT. In 2002, IUBT added Irwin Mortgage Corporation as a nonbank subsidiary involved in mortgage banking activities nationwide.[1] Upon completing the restructuring process in 2002, IUBT became a geographically dispersed banking organization with subsidiaries headquartered in California, Washington, Canada, New York, and Indiana. Chart 1 is an organizational chart depicting IFC's structure as of 2002.

Chart 1: IFC Organizational Chart



[1] Financial institutions conducting mortgage banking activities have the option to hold or sell the loans that they originate. Banks sell loans to gain flexibility in managing interest rate exposure, increase liquidity, and generate fee income.

IUBT's consumer lending subsidiaries, Irwin Mortgage Corporation and Irwin Home Equity, relied on an "originate-to-distribute" business model that involved generating mortgage loans and home equity loans, and selling those loans in the secondary markets. With regard to commercial lending activities, Irwin Commercial Finance engaged in lease financing and leasehold improvement financing for franchisees.[2] Further, IUBT's Irwin Union Bank business line engaged primarily in commercial lending activities.

IUBT 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 Indiana Department of Financial Institutions (State). The State closed IUBT and the OTS closed Irwin FSB on September 18, 2009, and the Federal Deposit Insurance Corporation (FDIC) was named receiver.[3] The FDIC estimated that the IUBT's failure would result in a $552.4 million loss to the Deposit Insurance Fund (DIF), or 20.5 percent of the bank's total assets of $2.7 billion. In a letter dated October 29, 2009, the FDIC Inspector General advised us that the FDIC had determined that IUBT's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), a loss to the DIF is considered material if it exceeds the greater of $25 million or 2 percent of the institution's total assets.

Objectives, Scope, and Methodology

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

- review the institution's supervision, 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 *Bank Holding Company Supervision Manual*, the *Commercial Bank Examination Manual*, and relevant supervisory guidance. We interviewed staff and collected data from the Federal Reserve Board; FRB Chicago; and the State. We also reviewed correspondence, Reports of Examination (examination reports) issued between 2001 and 2009, and examination work papers prepared by FRB Chicago. Appendixes at the end of this report include a glossary of key banking and regulatory terms, and a description of the

[2] Irwin Commercial Finance's activities were not a major contributing factor to IUBT's failure, so the report contains limited discussion concerning this subsidiary.

[3] The Department of the Treasury Office of Inspector General is responsible for conducting a material loss review of Irwin FSB, which is expected to be completed by June 30, 2010.

CAMELS rating system.[4] We conducted our fieldwork from November 2009 through March 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

IUBT failed because of the convergence of several factors. The Board of Directors and management pursued an aggressive growth strategy between 2000 and 2005 that relied upon high-risk business models. Management also depended on volatile non-core funding sources to support the bank's growth strategy, which emphasized originating and selling high-risk assets, such as 125 percent combined loan-to-value (CLTV) ratio loans. Meanwhile, management maintained few sources of liquidity support, which further increased IUBT's risk profile. During this growth period, the Board of Directors and management failed to ensure that the bank's key corporate control functions and risk management practices kept pace with the bank's expansion, increasingly complex operations, and escalating risk profile. The Board of Directors' and management's aggressive growth strategy resulted in IUBT's total assets almost tripling between 2000 and 2005, but the bank's net income decreased for five consecutive years from 2004 through 2008.

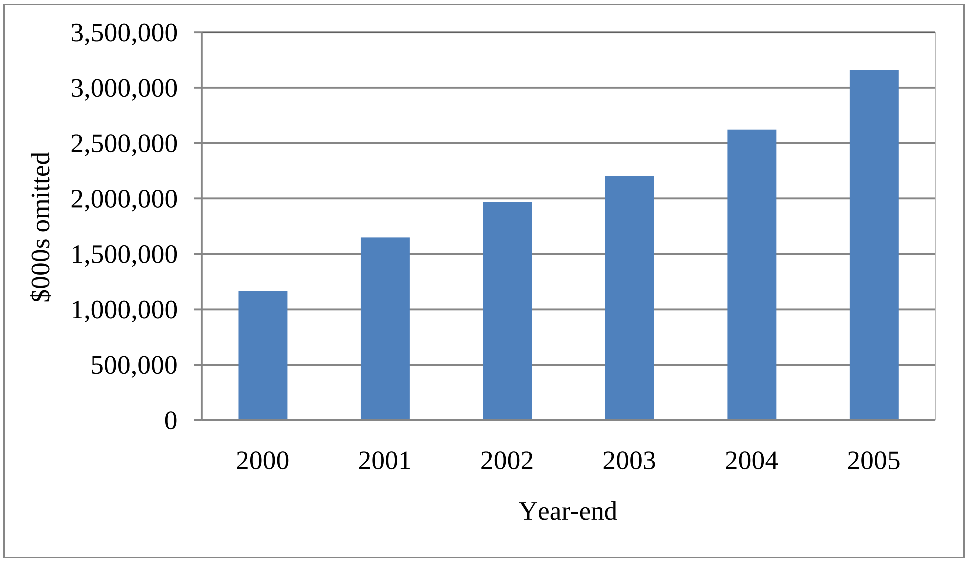
In 2007, reduced secondary market demand for mortgages hampered, and eventually eliminated, Irwin Home Equity's ability to sell its loans. This development forced the subsidiary to hold loans that it had originated to sell, including 125 percent CLTV ratio loans, in a declining real estate environment, which exposed IUBT to significant asset quality deterioration. In addition, the Irwin Union Bank business line developed a significant commercial real estate (CRE) concentration by 2007 that compounded IUBT's exposure to real estate market declines. As the value of IUBT's assets continued to deteriorate, the Board of Directors and management adopted a strategy of selling branch offices and business lines, such as Irwin Commercial Finance-Canada and Irwin Commercial Finance-Equipment, and branch offices to preserve the bank's capital. IUBT's remaining assets continued to deteriorate and deplete capital, which raised concerns about the bank's viability and eventually resulted in IUBT losing access to key funding sources. On September 18, 2009, the State closed IUBT because of the imminent danger of a liquidity shortfall and appointed the FDIC as receiver.

Despite Aggressive Growth Strategy, Net Income Declined

As previously stated, IFC established Irwin FSB in 2000 to expand IUBT's commercial banking activities. Irwin FSB was headquartered in Louisville, Kentucky, and had branch offices in nine states—Arizona, California, Florida, Kentucky, Missouri, Nevada, Ohio, New Mexico, and Wisconsin. With the assistance of Irwin FSB employees, IUBT operated the Irwin Union Bank business line, which provided commercial loans, cash management, and personal banking products. As shown in Chart 2, from 2000 to 2005, the Irwin Union Bank business line increased its nationwide commercial banking activities approximately 170 percent.

[4] 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 and 5 having the greatest concern.

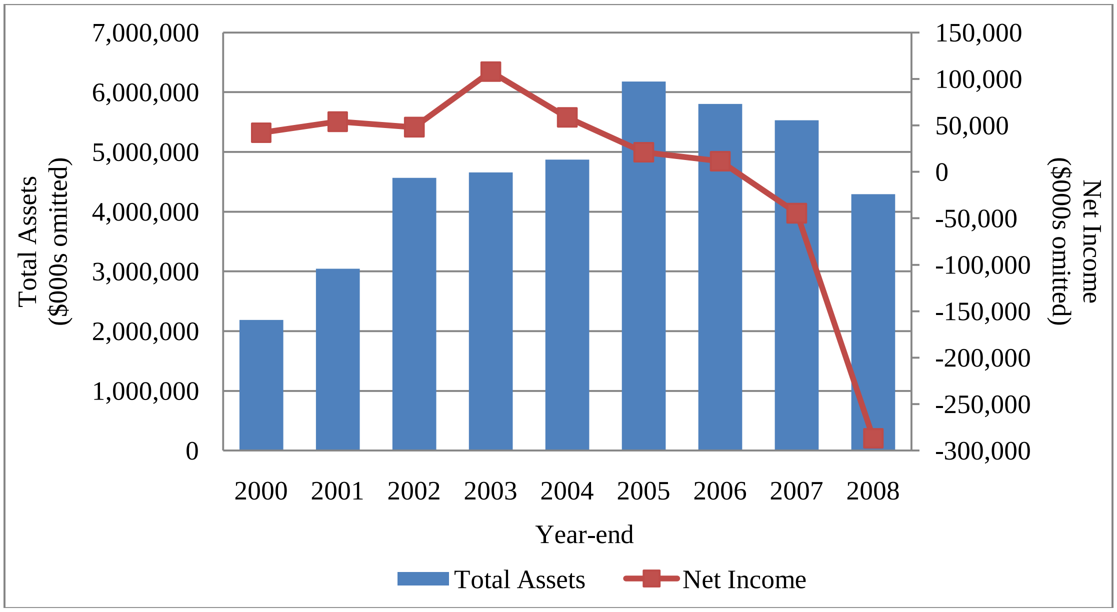
Chart 2: The Irwin Union Bank Business Line's Total Assets from 2000 to 2005



As shown in Chart 3 below, IUBT's total assets almost tripled during the six-year period from 2000 through 2005. Irwin Home Equity and Irwin Commercial Finance, which were added as IUBT subsidiaries in 2001, had total assets of $602 million and $267 million, respectively. Coupled with Irwin Union Bank's growth, these entities boosted the bank's total assets by 39 percent to more than $3.0 billion by December 31, 2001. The 2002 addition of Irwin Mortgage Corporation as an IUBT subsidiary further increased the bank's total assets to almost $4.6 billion. In 2003 and 2004, IUBT's total assets remained relatively constant. In 2005, Irwin Home Equity and Irwin Union Bank experienced significant growth, with Irwin Home Equity's total assets increasing by more than $600 million and Irwin Union Bank's total assets increasing by approximately $550 million. This significant growth increased IUBT's total assets to almost $6.2 billion by December 31, 2005.

In contrast to its growth in total assets, IUBT's net income decreased in 2004. As shown in Chart 3 below, IUBT posted record earnings in 2003, generating net income of $107.9 million, but subsequently experienced significant and sustained declines in net income through 2008.

Chart 3: IUBT's Total Assets and Net Income from 2000 through 2008



Inherently Risky Business Model Compounded by Dependence on Non-core Funding and Liquidity Risk Management Practices

The Board of Directors and management pursued high-risk business models at Irwin Mortgage Corporation and Irwin Home Equity. Both of these subsidiaries used originate-to-distribute strategies that consisted of creating home mortgages and home equity loans to be sold in the secondary market.[5] Lenders that pursue this originate-to-distribute strategy do so to (1) package and sell their loans to avoid the interest rate risk associated with holding loans to maturity, and (2) generate the funding necessary to support additional mortgage origination activities. In terms of liquidity, the business model and strategy provide an opportunity for self-sufficiency, presuming uninterrupted secondary market demand for mortgage loans. This presumption represents the key risk in the business model.

In the event of a disruption in secondary market demand for mortgage loans, the originate-to-distribute model would by default become an "originate-to-hold" model if the lender remained in the business. A demand disruption would present a series of new risks and challenges that would require a comprehensive risk management plan outlining how to adapt to the resultant decrease in liquidity and increase in credit risk exposure associated with holding previously originated loans to maturity. If this occurred, the underwriting and credit quality of the loans remaining on the balance sheet would become increasingly important.

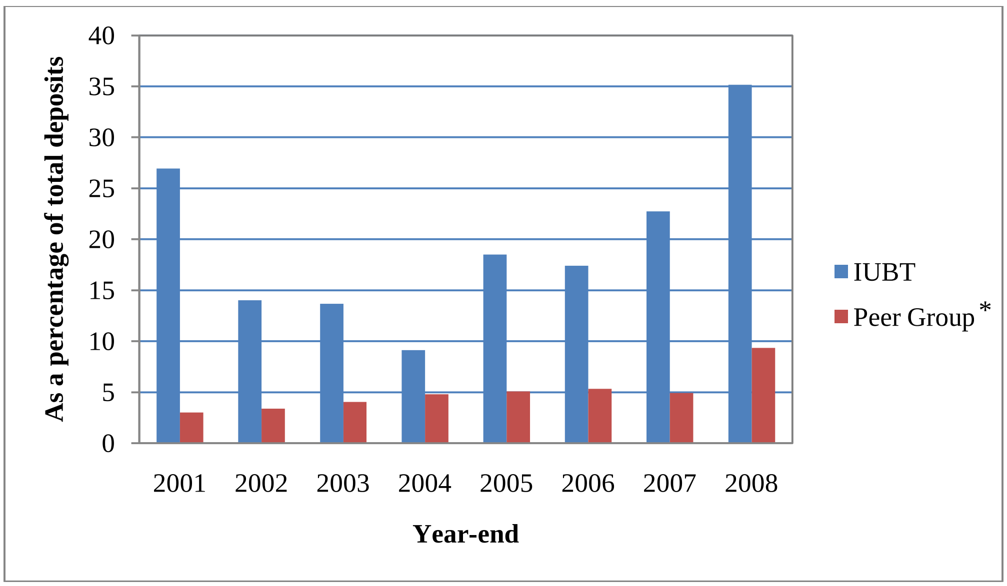
In 2003, FRB Chicago noted that management had not identified additional funding sources that could sustain Irwin Home Equity's and Irwin Mortgage Corporation's businesses in the event of

[5] In 2001, Superior Bank, a federal savings bank that pursued an originate-to-distribute strategy and engaged in high loan-to-value ratio lending for subprime customers, failed. This failure reinforced that there were inherent risks associated with pursuing this business model.

a secondary market disruption. Examiners listed multiple factors that might affect IUBT's access to the funds necessary to operate the mortgage and home equity businesses, including "a sufficiently healthy economy."

Despite examiners' concerns in 2003 about management's reliance on the secondary market to provide liquidity, IUBT did not diversify its funding sources. Management increased its long-term core deposits in 2004, but could not sustain that positive trend in 2005 and did not focus on core deposit growth in the subsequent years. In addition, depositor concentrations also increased IUBT's liquidity risk profile—a single, commercial customer maintained a $300 million deposit and the bank held $550 million in Indiana public funds. Because of the lack of core deposits and core deposit growth, management became highly reliant on wholesale funding, such as brokered deposits and Federal Home Loan Bank borrowings, to provide the liquidity necessary to support IUBT's growth strategy. As shown in Chart 4 below, the bank's reliance on brokered deposits far exceeded its peers. In 2002, FRB Chicago noted that this funding approach created a risk that a decline in IUBT's financial condition could cause multiple lenders to curtail the bank's funding.

Chart 4: IUBT's Reliance on Brokered Deposits Compared to Peer Group



*Banks with average assets in excess of $3 billion.

IUBT's liquidity management practices provided further evidence that the Board of Directors and management did not adequately plan for a possible disruption in the secondary loan market. In 2002, FRB Chicago noted that IUBT management had established few internal sources of potential liquidity, because the bank maintained a low level of assets in its investment portfolio. In addition, a high percentage of the bank's investment portfolio had previously been pledged as collateral and, therefore, could not be sold in the event of an urgent need for liquidity.

Concentrations in Risky Mortgages and Commercial Real Estate Loans

IUBT's subsidiaries also presented significant risk to the bank because of concentrations in high-risk product offerings and risky assets.

Irwin Home Equity Developed a Concentration in 125 Percent CLTV Ratio Loans

Irwin Home Equity offered refinance and debt consolidation loans with a maximum CLTV ratio of 125 percent. A borrower could receive as much as 125 percent of his/her home's value regardless of whether Irwin Home Equity had the first or second lien position on the property. This product creates high credit risk because of the lack of collateral support. When home values remain constant, lenders in the first lien position risk losing as much as 25 percent of the value of each loan if a sale or foreclosure occurs, but risk losing more than 25 percent if the real estate market declines. Therefore, lenders in the first lien position offering this product hope that housing values will rise to the point where the home's value would satisfy the outstanding loan balance in the event of a sale or foreclosure. Lenders taking the second lien position face additional risks because the proceeds from a sale or foreclosure must pay off the first mortgage before any proceeds become available to satisfy the second mortgage.

In 1999, the Federal Reserve Board issued Supervision and Regulation (SR) Letter 99-26, *Interagency Guidance on High LTV Residential Real Estate Lending*, which highlights the increased credit risks associated with high loan-to-value (LTV) lending and emphasizes the need for heightened risk management of this activity.[6] SR Letter 99-26 encourages lenders to implement risk limits to avoid concentrations and actively monitor their loan portfolios to assure that concentrations do not develop. Irwin Home Equity management did not heed the guidance; instead, it allowed significant concentrations to develop in its high-risk product offerings. By 2005, 56 percent of the Irwin Home Equity portfolio consisted of 125 percent CLTV ratio loans. During a 2005 examination, FRB Chicago indicated that the 125 percent CLTV products had "notably higher losses" than the 100 percent CLTV product offered by Irwin Home Equity. As of December 31, 2006, the 125 percent CLTV loans decreased to 46 percent of Irwin Home Equity's portfolio, but continued to represent a significant credit risk to Irwin Home Equity and IUBT.

In general, Irwin Home Equity management focused on lending to prime quality borrowers, but also offered the 125 percent CLTV product to subprime customers who presented a heightened risk of default, which further increased the credit risk associated with these loans. Irwin Home Equity also developed significant concentrations in its managed portfolio.[7] In 2005, 29 percent of the managed portfolio consisted of subprime customers. By December 31, 2006, Irwin Home Equity management had reduced the exposure to subprime customers to 16 percent. However, Irwin Home Equity management had also developed a risky loan program that did not require

[6] SR Letter 99-26 also addresses the need for originate-to-distribute lenders to identify contingent funding sources. SR Letter 06-15, *Interagency Guidance on Nontraditional Mortgage Product Risks,* highlights the need for contingency planning to address how the institution would respond to reduced demand in the secondary market.

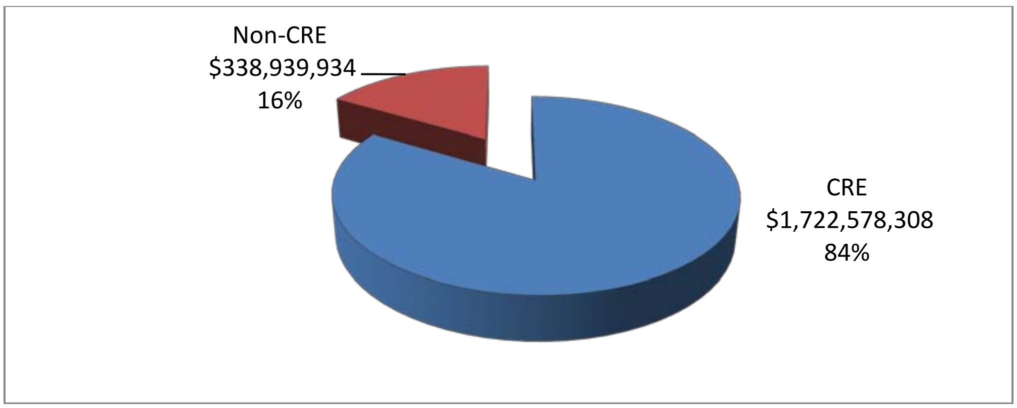
[7] The managed portfolio, among other things, included loans that Irwin Home Equity planned to hold rather than sell in the secondary market.

borrower income verification, which accounted for 13 percent of the managed portfolio by December 31, 2006.

Irwin Union Bank Developed a Commercial Real Estate Concentration

In 2007, examiners noted that IUBT had an increasing credit risk trend due to Irwin Union Bank's concentration in CRE and commercial and industrial loans. By 2008, that trend resulted in a significant CRE concentration. As shown in Chart 5 below, as of August 31, 2008, the Irwin Union Bank business line had more than $1.7 billion in CRE loans, which represented 84 percent of its total loan portfolio. Irwin Union Bank's geographic concentration in the Midwest and the Western United States left IUBT particularly vulnerable to asset quality deterioration in these markets.

Chart 5: Irwin Union Bank Loan Portfolio as of August 31, 2008



Key Control Functions and Risk Management Practices Did Not Keep Pace with IUBT's Growth

IFC's and IUBT's Board of Directors and management failed to implement the corporate control functions, risk management practices, and internal controls necessary to successfully operate a complex banking organization engaged in risky business activities.[8] In 2003, examiners noted that key corporate control functions had not kept pace with IUBT's corporate restructuring, growth, increasingly complex operations, and heightened risk profile. Specifically, examiners raised fundamental concerns about the quality and effectiveness of the bank's internal audit program, ranging from the staff's independence to the adequacy of its risk assessment process and audit testing programs. In terms of auditor independence, FRB Chicago noted that internal audit staff imbedded in business units tended to rely on management's representations without conducting the testing necessary to confirm those representations. Management's failure to implement an effective internal audit testing program limited the likelihood that IFC and IUBT

[8] FRB Chicago supervised both IFC and IUBT, and the full scope examinations contain sections and comments that apply to both entities. Therefore, we refer to both entities in this section.

could self-identify and resolve internal control weaknesses, which greatly increased the bank's operational risk profile.

IUBT Compliance Program Deficiencies

In addition, IUBT's compliance function was not effectively managing the legal and compliance risks associated with consumer lending activities. In 2003, examiners noted a series of violations of law related to consumer lending laws, including the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the flood hazard determination rules. FRB Chicago cited compliance program deficiencies and included corrective action steps in an informal enforcement action issued in 2003. Despite this supervisory action, compliance program deficiencies persisted, and repeat violations of law occurred during subsequent examinations. Management's failure to fully address these deficiencies and these repeat violations of law exposed IFC and IUBT to heightened legal and reputational risk. FRB Chicago eventually issued a Memorandum of Understanding in 2007 to address these deficiencies.

SR Letter 99-26 emphasizes the importance of adequate compliance risk management programs for lenders originating high LTV loans. The violations noted during 2003 should have been an early warning sign regarding management's capability to operate a mortgage subsidiary engaged in high LTV lending. In our opinion, the failure to fully resolve these compliance program concerns was a warning sign regarding the Board of Directors' and management's capabilities to operate subsidiaries engaged in consumer lending activities.

IFC and IUBT Did Not Implement an Effective Model Validation Program in a Timely Manner

IFC's and IUBT's Board of Directors and management also failed to implement an effective model validation program in a timely manner. The importance of having model validation programs was highlighted by the Office of the Comptroller of the Currency (OCC) in a bulletin (OCC Bulletin 2000-16) it issued in 2000. The Board of Directors and management should have made developing an effective program a priority due to the mortgage businesses' reliance on models for risk management and valuation purposes, but the development of this program did not occur in a timely manner. According to examiners, in 2004 management developed a model validation framework consistent with supervisory expectations, but few models had been tested and validated. During the 2006 and 2007 full scope examinations, FRB Chicago once again identified the need for additional enhancements to the model validation program. This key deficiency represented a significant failure that increased the likelihood that the Board of Directors or management might make a decision based on unreliable information.

FRB Chicago Noted Fundamental Issues with Risk Management and Loan Review

In addition to weaknesses in key control functions, examiners noted significant risk management issues at IUBT. In 2004, FRB Chicago observed that IUBT's transition to a high-risk operating model required above average risk management systems, but that management had inadequate systems to identify, monitor, measure, and control risk. In 2005, FRB Chicago noted further fundamental weaknesses in risk management and required the bank's management to evaluate its staffing needs in risk management and loan review to assure that staff had the "requisite expertise to handle day-to-day requirements."

Irwin Mortgage Corporation's Hedging Activities Decreased IUBT's Net Income

At a subsidiary level, Irwin Mortgage Corporation's inability to effectively hedge the market risk associated with its mortgage servicing rights was a key risk management failure that decreased IUBT's net income. A "mortgage servicing right," which is a separate asset from the individual loan, consists of the right to service a mortgage loan by handling the payment processing and managing the escrow account associated with that loan. In general, the value of a mortgage servicing right is based on the estimated future cash flow of the underlying loan. Because many borrowers sell their homes before the mortgage is paid off, the holders of mortgage servicing rights must estimate the rate at which customers will prepay the applicable loan's unpaid principal balance. Lenders typically use a model to support this estimate. Banks conduct a quarterly reassessment of these estimates to determine if any declines in the value of those mortgage servicing rights have occurred.

Lenders use hedging strategies to manage the risks associated with holding mortgage servicing rights, including the risk of interest rate declines and increased borrower prepayments. In 2002, FRB Chicago noted that IUBT's risk management practices had not kept pace with the bank's growth, and implemented an informal supervisory action. The informal supervisory action required management to strengthen its systems and methodology for measuring interest rate risk and validate the existing information used to manage that risk. By 2004, management had only implemented the required enhancements at Irwin Commercial Finance and Irwin Union Bank, even though Irwin Home Equity and Irwin Mortgage Corporate presented heightened interest rate risk to IUBT. In August 2005, FRB Chicago observed the effect of management's failure to implement the required enhancement at Irwin Mortgage Corporation, noting that the mortgage subsidiary had not provided for "sufficient hedge protection in a declining rate environment." This failure resulted in a $49 million charge to IUBT's income during 2005. Rather than fully resolve its market risk and hedging issues, in 2006, IFC and IUBT sold the Irwin Mortgage Corporation subsidiary at a loss.

Asset Quality Deterioration and Tightening Liquidity Contributed to IUBT's Failure

In 2007, examiners stated that IUBT had experienced significant asset quality deterioration across all lines of business. Secondary market demand for mortgage loans evaporated, and Irwin Home Equity was forced to hold the loans it previously originated, thereby exposing Irwin Home Equity and IUBT to significant credit risk. Examiners noted that declining real estate markets eroded collateral support for Irwin Home Equity's 125 percent CLTV product, and caused deterioration in Irwin Union Bank's CRE loans. That same year, IUBT's allowance for loan and lease losses (ALLL) provision expense increased by 285 percent to $99.9 million.

Also in 2007, one of IUBT's key lenders did not renew a $300 million credit line that supported Irwin Home Equity's loan originations, which put further strain on the subsidiary's liquidity. Management made efforts to sustain the bank's liquidity by decreasing loan origination activities, introducing a national certificate of deposit (CD) campaign, increasing brokered deposits, and expanding borrowing capacity at the Federal Home Loan Bank and the Federal Reserve Discount Window. However, the CD campaign did not succeed, and alternative funding sources were not readily available or cost effective. Therefore, IUBT further increased its reliance on brokered deposits and Indiana public funds.

To augment capital and provide additional liquidity, IUBT sold its Irwin Commercial Finance-Equipment and Irwin Commercial Finance-Canada lease financing operations in July 2008. Although the sale resulted in cash proceeds of $296 million, a $250 million withdrawal by IUBT's largest depositor reduced the sale's impact on IUBT's liquidity. Because much of the bank's loan portfolio was either pledged or illiquid, IUBT continued to depend on brokered deposits and public fund deposits. This non-core funding represented more than half of IUBT's total deposits.

In August 2008, examiners noted that IUBT's continued poor profitability, weak and deteriorating asset quality, and shrinking capital base exacerbated the bank's liquidity problems. Through September 30, 2008, IUBT experienced further net losses of $133 million, which examiners attributed to further asset quality deterioration in Irwin Home Equity's 125 percent CLTV ratio home equity loans and CRE losses in the commercial banking business. These losses caused IUBT's total capital to decline by 30.1 percent. Although the bank remained *well capitalized*, examiners noted that IUBT's viability could be affected if the bank dropped to *adequately capitalized* because that status change would result in restrictions on the bank's ability to accept or renew brokered deposits.

In March 2009, examiners commenced a full scope examination that downgraded IUBT's asset quality component rating to 5 (unsatisfactory) based on financial data as of December 31, 2008. Asset quality had continued to deteriorate significantly during 2008, putting "significant pressure on capital, earnings, and liquidity." Examiners noted that IUBT's classified loans reached $517.3 million, or 127.2 percent of IUBT's tier 1 capital plus the ALLL. The classification ratio worsened during the first quarter of 2009, increasing to 139.3 percent. Examiners noted that "management has been unable to stem the corrosive effects of increasing asset quality problems and negative earnings on the capital and liquidity positions." According to examiners, IUBT experienced substantial asset quality deterioration because of a "concentration in real estate related credits, especially in some of the hardest hit real estate markets in the country." On March 20, 2009, IUBT became *adequately capitalized*, which invoked the restrictions of the FDI Act associated with accepting or renewing brokered deposits.

In April 2009, a bank that provided a credit line to IUBT requested additional collateral for the line because of the bank's declining capital position. IUBT could not satisfy the request because it had limited unencumbered assets. In an effort to maintain its *adequately capitalized* status, the bank sold three branches in August 2009. FRB Chicago began an asset quality visitation in August 2009 that resulted in several downgrades to management's internal loan ratings. These downgrades required additional charge-offs that caused IUBT to become *undercapitalized*, which precluded the bank from bidding on or retaining Indiana public funds. On September 2, 2009, the Indiana Treasurer requested that IUBT no longer bid on public funds. On September 15, 2009, the Indiana Treasurer required that IUBT dispose of all Indiana public funds not insured by the FDIC. On September 18, 2009, the State closed IUBT because of the imminent danger of a liquidity shortfall.

Supervision of Irwin Union Bank and Trust

From 2001 through 2009, FRB Chicago conducted 9 full scope examinations, 18 target examinations, 3 supervisory assessments, and 1 visitation of IUBT. After receiving a CAMELS composite 1 (outstanding) rating in 2001 prior to the corporate restructurings at IUBT, the bank received a CAMELS composite 2 (satisfactory) rating from 2002 through June 2007. FRB Chicago took informal supervisory actions against IUBT in 2001, 2002, 2003, and 2005 that encouraged IFC's and IUBT's Board of Directors to adopt Board Resolutions outlining specific required actions for management to take. IFC and IUBT also were subject to a continuous supervision program between 2003 and 2009. As outlined in SR Letter 99-15, *Risk-Focused Supervision of Large Complex Banking Organizations,* the Federal Reserve Board created this approach to constantly monitor large, complex banking organizations' systems and controls for monitoring risk due to the dynamic nature of these organizations' business activities.

A November 2007 supervisory assessment resulted in a downgrade of IUBT's CAMELS composite rating to 3 (fair), because the lack of secondary market demand for mortgage loans had reduced the bank's ability to generate the funds necessary to sustain its business model. A subsequent full scope examination completed in May 2008 further downgraded the bank's CAMELS composite rating to 4 (marginal) and its liquidity component rating to 5. FRB Chicago entered into an informal supervisory action—a Memorandum of Understanding (MOU)—with IFC and IUBT in July 2008. A December 2008 joint asset quality target examination report downgraded IUBT's CAMELS composite rating to a 5, downgraded the bank's earnings component rating to a 5, and resulted in a formal supervisory action (Written Agreement). During a 2009 full scope examination, examiners downgraded the CAMELS component ratings for capital, asset quality, and management to 5, while the component rating for sensitivity received a downgrade from 3 to 4. A subsequent visitation resulted in another formal enforcement action (Cease and Desist Order).

In addition to highlighting the timing of FRB Chicago's supervisory actions, the following table also summarizes the results of all full scope examinations between 2001 and 2009 and selected target examinations, supervisory assessments, and visitations of IUBT. It is important to note that the majority of the full scope examinations were conducted, at least in part, during the first quarter of each year as a retrospective review of the prior calendar year's results. In certain instances, the full scope examinations contained findings and observations applicable to IFC and IUBT. As a result, we have included specific references that apply to both entities in the following sections of our report. Each full scope examination also contained a section outlining FRB Chicago's assessment of the corporation's consolidated risk profile across the standard categories—credit, market, liquidity, operational, legal, and reputational risk. As discussed more fully in the sections that follow, we believe that FRB Chicago identified key weaknesses, early warning signs, and red flags regarding corporate governance, risk management systems, and internal controls, but missed multiple opportunities to take more forceful supervisory action that may have reduced the loss to the DIF.

Table 2: Supervisory Overview of Irwin Union Bank and Trust

Examination			Agency Conducting or Leading the Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
4/2/2001	5/31/2001	Full	Joint FRB Led	1	1	1	1	1	1	2	
10/15/2001	1/18/2002	Full	Joint FRB Led	2	2	2	2	3	3	3	Two Board Resolutions
10/7/2002	4/11/2003	Full	Joint State Led	2	2	2	2	3	2	3	Revised Board Resolution
8/18/2003	12/23/2003	Supervisory Assessment	Joint FRB Led	2	2	2	2	3	2	3	
2/2/2004	4/14/2004	Full	Joint FRB Led	2	2	2	2	2	2	3	
1/31/2005	5/20/2005	Full	Joint FRB Led	2	2	2	2	2	2	2	
8/1/2005	8/16/2005	Supervisory Assessment	Joint FRB Led	2	2	2	2	3	2	3	Revised Board Resolution (adopted in June 2005)
2/6/2006	6/26/2006	Full	Joint FRB Led	2	2	2	3	3	2	3	
2/12/2007	6/11/2007	Full	Joint FRB Led[a]	2	2	2	3	3	2	2	Memorandum of Understanding
11/15/2007	12/26/2007	Supervisory Assessment	Joint FRB Led	3	2	2	3	3	3	2	
2/4/2008	5/6/2008	Full	Joint FRB Led[a,b]	4	3	3	4	4	5	3	Memorandum of Understanding
8/4/2008	12/16/2008	Asset Quality Target	Joint FRB Led[a,b]	5	4	4	4	5	5	3	Written Agreement
3/9/2009	6/23/2009	Full	Joint FRB Led[a,b]	5	5	5	5	5	5	4	
8/10/2009	9/15/2009	Asset Quality Visitation	Joint FRB Led[a,b]	n/a[c]							Cease & Desist Order

[a] The Federal Reserve Board participated in the examination.
[b] FDIC participated on the examination.
[c] No rating was issued.

Two Full Scope Examinations Were Conducted in 2001, with the Second Examination Resulting in Informal Supervisory Actions

In April 2001, FRB Chicago began a joint full scope examination that resulted in IUBT receiving a CAMELS composite 1 (outstanding) rating in a May 2001 examination report. Except for sensitivity to market risk, each CAMELS component received a 1 rating. Examiners found the bank to be in “strong financial condition” and indicated that the “future prospects for the organization remain favorable.” Examiners noted that Federal Reserve guidelines and banking best practices dictate that financial institutions consider the effects of market risk on both earnings and asset values. IUBT received a CAMELS component 2 (satisfactory) rating for sensitivity to market risk because the bank's risk management systems did not measure earnings-at-risk.[9]

In terms of liquidity, examiners concluded that the bank had "strong risk management policies and practices to effectively monitor and control liquidity risk." Examiners acknowledged the bank's dependence on wholesale funding, but stated that "the risk is well understood and appropriately monitored and controlled" and that management had identified "adequate contingent funding sources" to satisfy its peak funding needs.

Examiners noted that the bank's management was "strong" and that the decentralized organizational structure of IFC "fostered an entrepreneurial approach to operating its six integrated lines of business." FRB Chicago indicated that this decentralized approach allowed each line of business to operate with "great autonomy." These findings and the outstanding CAMELS composite rating assigned to IUBT preceded the corporate restructurings that involved Irwin Home Equity and Irwin Commercial Finance becoming subsidiaries.

In July 2001, Superior Bank, FSB, a federal savings association regulated by the Office of Thrift Supervision, located in the Chicago metropolitan area, failed. Similar to Irwin Home Equity, Superior relied on an originate-to-distribute business model and engaged in risky high LTV ratio lending. According to an FRB Chicago official, the Federal Reserve Board recognized these similarities and requested that FRB Chicago begin a second full scope examination of IUBT in late 2001.

In October 2001, FRB Chicago began a joint full scope examination that resulted in a downgrade of IUBT's CAMELS composite rating to 2 in a January 2002 examination report, the month before Irwin Home Equity began operating as a subsidiary of IUBT. Each of the CAMELS component ratings received at least a single downgrade, while both the earnings and liquidity components received double downgrades from 1 to 3. This examination resulted in FRB Chicago taking two informal supervisory actions in the form of Board Resolutions. The first resolution (Resolution 1), adopted in November 2001, required IFC and IUBT to maintain capital ratios in excess of the typical ratios required for *well capitalized* institutions—IUBT and IFC had to maintain total risk-based capital ratios of 12 and 11 percent, respectively. As outlined in greater detail below, in February 2002 the Board of Directors adopted a second resolution (Resolution 2) concerning liquidity risk management, market risk management, model validation, compliance with affiliate transaction restrictions, and corporate governance.

During the examination, FRB Chicago raised specific concerns about earnings and capital. Examiners noted that the bank had "fair" earnings composed primarily of gains from Irwin Home Equity's mortgage banking activities. Examiners expected IUBT's earnings to decline "precipitously" in 2002 based on a prospective change to a key accounting methodology related to the bank's mortgage loan sales.[10] Even with this anticipated earnings decline, management

[9] Earnings-at-risk measures the quantity by which net income might change in the event of an adverse change in interest rates.

[10] The bank changed from gain-on-sale accounting to a financing methodology for its mortgage securitization activities. This transition marked a substantial shift in the timing of income recognition. The gain-on-sale approach involves immediate income recognition at the time of sale, while the financing methodology takes the more conservative approach of recognizing income incrementally over the life of the transaction.

projected 15 percent asset growth in fiscal year 2002. Examiners questioned whether IUBT's operating results and capital formation would be sufficient to maintain the capital ratio benchmarks required by Resolution 1. Examiners noted that "significant higher-risk growth in both the asset and liability sides of the balance sheet has outpaced the organization's risk management infrastructure and internal capital formation."

In terms of liquidity, examiners concluded that the bank's risk management practices were not commensurate with the nature and complexity of the bank's operations. FRB Chicago observed comprehensive weaknesses in the bank's liquidity risk management program and cited deficiencies in Board of Directors' oversight, risk limits, liquidity risk management systems, management reporting, contingency funding plans, and internal controls. Examiners stressed the need for stronger liquidity risk management practices, given IUBT's complexity, rapid growth, and reliance on wholesale funding. IUBT had identified few secondary sources of liquidity and had not developed a contingency funding plan, even though such a plan is a key component of an effective funds management program. Examiners also noted deficient corporate governance surrounding the bank's liquidity risk management practices because the Board of Directors was not receiving sufficient reporting related to IUBT's approach to managing this risk. The 2002 examination report findings related to liquidity risk directly contradicted the previous "strong risk management" policies and practices assessment from the prior examination.

Resolution 2 also required the bank to improve its market risk management practices. Examiners highlighted ongoing weaknesses in the bank's interest rate risk management practices, including potential modeling flaws that called into question the accuracy of reported performance measures.[11] Examiners recommended that improvements to the interest rate risk modeling platform occur as quickly as possible. FRB Chicago also noted concerns regarding a model used to value mortgage servicing rights and key assumptions used to support those valuations. Examiners noted that inaccurate assumptions might affect the value of the asset and require a write-down.

Sections 23A and 23B of the Federal Reserve Act are intended to assure that transactions between a bank and its affiliates are made within certain quantitative and qualitative limits and occur on market terms. The bank's management failed to comply with Section 23A, which restricts the permissible volume of purchase activity from an affiliate to 50 percent of loan production volume. Contrary to this restriction, examiners observed in the 2002 examination report that IUBT purchased approximately 100 percent of Irwin Mortgage Corporation's loan production.[12] These purchases created the appearance that IUBT served solely as a funding mechanism for the affiliate's mortgage operations. In our opinion, this violation was a red flag regarding management's capabilities to operate a large, complex banking organization.

The examination report highlighted additional fundamental corporate governance concerns. Examiners noted that the reporting package management prepared for the Board of Directors only covered IUBT's commercial banking line of business and did not address Irwin Home Equity. Even though Irwin Home Equity had recently become a bank subsidiary, IUBT's

[11] Interest rate risk is a component of market risk.

[12] Irwin Mortgage Corporation was a nonbank affiliate within IFC and had not yet been made a subsidiary of IUBT. That change occurred in 2002.

management and the Board of Directors did not appear to acknowledge the significance of this change and their need to receive reports concerning the subsidiary's performance—particularly important since the new subsidiary engaged in high-risk lending activities. In our opinion, the lack of information provided to the Board of Directors regarding a key subsidiary engaged in high-risk activities was another red flag suggesting IUBT's passive approach to corporate governance.

Despite these fundamental corporate governance, risk management weaknesses, and compliance concerns, examiners only downgraded the management component rating from a 1 to a 2. Examiners highlighted management's responsiveness to the issues raised by regulators, but also emphasized that effective risk management practices are critical given the bank's aggressive growth strategy. In our opinion, the results of this examination provided a series of early warning signs regarding IUBT's Board of Directors' and management's ability to effectively manage a geographically dispersed, large, complex banking organization. These findings should have signaled that the Board of Directors and management were not actively managing the restructured organization and its new activities.

We believe that the fundamental corporate governance issues and comprehensive liquidity risk management weaknesses noted by examiners warranted a stronger supervisory action, including an additional downgrade of the management CAMELS component rating to reflect that management was less than "satisfactory." We also believe that FRB Chicago should have considered requesting that management refrain from additional growth or corporate restructurings affecting IUBT until the bank fully addressed the fundamental flaws noted during this examination.

FRB Chicago Transitioned to a Continuous Supervision Approach and Encouraged a Revised Board Resolution

According to an FRB Chicago official, in 2002 the Reserve Bank determined that the risk management weaknesses and other issues observed during previous examinations warranted continuous supervision of IUBT. In July 2002, FRB Chicago transitioned IUBT to a continuous supervision program on an informal basis, with a new central point of contact from the Reserve Bank's Large and Complex Bank Organizations group. IUBT remained in FRB Chicago's Community Bank Group portfolio under an informal continuous supervision program.

Beginning in October 2002, FRB Chicago participated in a State-led joint full scope examination of IFC and IUBT that maintained IUBT's CAMELS composite 2 rating in an April 2003 examination report. All of the CAMELS component ratings remained consistent with the prior examination results, except for liquidity, which received an upgrade from a 3 to a 2. Examiners noted an increasing risk trend for credit, operational, market, reputational, legal, and overall risk. They indicated that, as a result of prior rapid growth and an increasing risk profile, risk management processes had become strained. Only one risk category, liquidity, did not have an "increasing" risk trend. As a result of the examination and a consumer affairs examination conducted by FRB Chicago, examiners encouraged the bank to adopt an updated Board

Resolution (Resolution 3) addressing market risk, operational risk, consumer risk management, credit risk management, and capital management deficiencies.[13]

Examiners determined that IFC and IUBT complied with the capital requirements contained in Resolutions 1 and 2, and the 23A and 23B requirements contained in Resolution 2. Management had also complied with two of three of the required actions in Resolution 2 related to liquidity risk management; however, IFC and IUBT had not fully complied with any of the five required improvements related to market risk management in Resolution 2.

As part of this examination, FRB Chicago implemented an issue tracking log to monitor the Board of Directors' and management's progress in addressing findings noted during the examination and the continuous supervision process. Examiners indicated that these findings could be corrected "in the normal course of business," and warranted a tracking system separate from the Board Resolutions. At the time of the examination report, FRB Chicago had 33 examination findings and 13 findings that resulted from ongoing supervisory activities at Irwin Home Equity. Seventeen of the 33 examination findings remained unresolved when FRB Chicago issued the examination report, and 11 of those 17 unresolved findings related to market risk management.

The October 2002 examination began to uncover inadequacies in key corporate and bank level control functions. Examiners concluded that the internal audit program had not kept pace with the size and complexity of the consolidated organization. Examiners raised specific concerns about internal audit's reliance on management's assertions without conducting testing. Examiners also highlighted deficiencies in the annual risk assessment process, the scope and coverage of audit testing, and the limited documentation surrounding audit scoping and planning determinations. FRB Chicago requested that the Board of Directors include a requirement in Resolution 3 to address these deficiencies in the corporate audit program.

IUBT's Compliance Function also contained serious deficiencies that FRB Chicago encouraged the Board of Directors to address as part of Resolution 3. An August 2002 compliance and Community Reinvestment Act examination of IUBT and Irwin Home Equity by FRB Chicago revealed "systemic" violations of various consumer banking laws applicable to mortgage lending.[14] Examiners concluded that internal audit testing revealed weaknesses associated with processing flood hazard determinations, but management had not addressed or resolved the issue. Resolution 3 required (1) corrective action to prevent future violations of law and (2) specific improvements to IUBT's compliance program. We believe that the pervasive and systemic violations of law in a key line of business provided an additional early red flag regarding the Board of Directors' and management's ability to effectively manage a geographically dispersed, large, and complex banking organization engaged in multiple lines of business.

[13] Resolution 3, which updated and replaced Resolution 2, was adopted on April 24, 2003, by the Board of Directors.

[14] Examiners subsequently indicated that compliance with these consumer lending laws and regulations presented a high degree of legal and compliance risk.

Examiners also noted the high-risk nature of management's approach to liquidity risk management by indicating that

> adverse-scenario balance sheet estimates place extensive reliance on uninterrupted liquidity within the mortgage and home equity loan portfolios which is predicated upon assumptions associated with an untarnished underwriting reputation, ample time to liquidate, and a sufficiently healthy economy to sustain the market's appetite for purchasing loans.

In addition to management's dependence on the secondary markets for liquidity, examiners noted that IUBT's investment portfolio only contained a small amount of unencumbered assets that could be sold to generate additional liquidity in the event of an urgent need to raise funds.

As noted earlier, examiners observed that IUBT did not effectively manage the market risk associated with its mortgage servicing rights. Examiners noted that the bank had made improvements to its interest rate risk measurement and modeling, but had not made the system changes necessary to implement an earnings-at-risk measurement platform. However, examiners encouraged management not to rush the system implementation, noting that "it is critical that complex solutions involving infrastructure enhancements that address recommendations be implemented correctly the first time around." The examination report contained a six-page appendix listing all required actions related to market risk that were necessary to bring IUBT into compliance with regulatory guidance for market risk management, including SR Letter 95-17, *Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities*, and SR Letter 96-13, *Joint Policy Statement on Interest Rate Risk*. Because of these deficiencies, FRB Chicago encouraged the Board of Directors to implement a resolution requiring a series of improvements to the market risk program.

2003 Supervisory Assessment Maintained Prior CAMELS Ratings

IUBT became subject to a formal continuous supervision program when FRB Chicago created the Large Banking Organization group in January 2003. Banks subject to a continuous supervision program are monitored throughout the year and receive an annual roll-up report of the prior year's supervisory activities as part of the full scope examination. FRB Chicago conducted on-site supervisory activities during 2003 and began a joint off-site supervisory assessment in August 2003 using updated financial information and management interviews to satisfy a requirement to issue an annual update to IUBT's CAMELS ratings. The supervisory assessment issued in December 2003 maintained IUBT's composite and component ratings issued during the 2002 full scope examination, and FRB Chicago noted that the next full scope examination would begin in February 2004.

2004 Full Scope Examination Credited IUBT's Efforts to Improve

In February 2004, FRB Chicago began a joint full scope examination for the 2003 calendar year that maintained IUBT's CAMELS composite 2 rating. IUBT experienced record earnings of $107.9 million during 2003, primarily because of a mortgage refinancing boom. FRB Chicago upgraded the earnings CAMELS component from a 3 rating to a 2 and maintained each of the remaining CAMELS components ratings as satisfactory, except for sensitivity, which maintained a 3 rating. Examiners indicated that many of the increasing risk trends observed during the previous full scope examination had stabilized, but concluded that the composite risk for market and operational risk remained high.

Examiners focused on previously noted concerns, including risk management; corporate governance, including audit, loan review, and compliance; and capital measurement and monitoring. The examination report did not include the summary tables documenting management's progress resolving the required actions noted during the current and prior examinations and the continuous supervision process. However, examiners acknowledged management's efforts to resolve previously noted risk management deficiencies and noted "varying degrees" of compliance with the Board Resolutions.[15] Examiners encouraged the Board of Directors to ensure that management focused on achieving compliance with the resolutions because many critical improvements remained in process.

IUBT's capital exceeded the required minimum thresholds imposed by Resolution 1. However, examiners noted management needed to make further progress implementing the earnings-at-risk capital model. In terms of enhancing corporate and bank level market risk management capabilities, examiners observed some progress towards developing an earnings-at-risk methodology, but the approach had only been implemented for the Irwin Union Bank business line and Irwin Commercial Finance. Management expected the enhancements to be completed for IUBT and all subsidiaries by the end of 2004. Examiners noted that Irwin Mortgage Corporation continued to generate the majority of the market risk because of the volatility of the mortgage servicing rights.

The Board of Directors and management had made incremental progress in addressing the corporate governance weaknesses outlined in the prior supervisory action. Examiners noted that Internal Audit was "improving," even though only one of five required actions in Resolution 3 had been fully resolved and two of the remaining four issues were substantially complete. FRB Chicago observed that Internal Audit served as the "key internal control monitoring mechanism for the corporation," but attributed the significant number of previously noted supervisory issues to Internal Audit's lack of adequate coverage and monitoring. Examiners noted that improvements to the enterprise-wide compliance program had stabilized legal risk, but progress on the required enhancements was not complete. Approximately a year after the Board of Directors adopted Resolution 3 in April 2003, management had fully resolved 3 of 11 issues related to the consumer compliance program and partially resolved the remaining 8 items.

Examiners stated that management's decentralized operating model, the geographic dispersion of the subsidiaries, and the subsidiaries' product offerings presented a high inherent operational risk profile. FRB Chicago observed that IFC and IUBT required above average risk management systems, but examiners indicated that a variety of previously noted issues demonstrated that

[15] During this examination, FRB Chicago noted full compliance with the capital maintenance and management section of Resolutions 1 and 2. In terms of compliance with Resolution 3, management had fully complied with 2 of 4 credit risk management requirements; 1 of 6 market risk requirements; 3 of 11 compliance program enhancements; and 1 of 5 requirements related to Internal Audit.

management had implemented inadequate systems to identify, monitor, measure, and control risk.

FRB Chicago noted that IFC and IUBT's composite credit risk was moderate and stable, and that overall asset quality remained satisfactory with manageable levels of problem assets. Nevertheless, the examination report noted that IUBT's net losses more than doubled from $15.3 million to $34.4 million, primarily because of Irwin Home Equity's 125 percent CLTV product. Examiners indicated that management had taken steps to mitigate the potential for future losses by tightening underwriting standards for the 125 percent CLTV product and eliminating "higher risk borrowers."

2005 Full Scope Examination Noted IUBT's Enhanced Risk Management Capabilities

FRB Chicago began a joint full scope examination in January 2005 for the 2004 calendar year that resulted in IUBT receiving a CAMELS composite 2 rating. Examiners upgraded the sensitivity to market risk component from a 3 rating to a 2 and all other components maintained their 2 ratings. FRB Chicago noted improvement in all risk management programs across the enterprise. In terms of operating results, IUBT's earnings declined from its record levels, but remained sufficient to support balance sheet growth and augment capital.

During this examination, FRB Chicago reintroduced the issue tracking log for examination findings. This tracking log differentiated "required actions" from lower priority "expected actions."[16] At the time of the examination report, 7 required actions and 53 expected actions remained open as of May 2, 2005.[17] Examiners cited management's inability to resolve the previously noted required actions as a matter requiring Board of Directors' attention. FRB Chicago encouraged management to assure that resolving these issues became its highest priority. In addition, examiners noted that the Board of Directors and management had not fully resolved 28 expected actions from prior examinations. Examiners encouraged the Board of Directors and management to place greater emphasis on resolving these issues and observed that

> the timeline for complete resolution of supervisory issues dating back to 2002 has taken longer than anticipated. Not all issues have been closed even though IFC's project plans were complete and designed to address all open issues from the 2002 and 2003 supervisory cycles. Although the number of repeat issues is higher than expected and totals 28, the most significant issues facing the corporation have been addressed.

Examiners upgraded the CAMELS component rating for sensitivity based on the results of a target market risk examination, even though the majority of market risk items contained in Resolution 3 had not been fully addressed and recently implemented market risk models had not been fully validated. In the examination report, FRB Chicago highlighted that it raised the validation of these models as a concern in 2002. Examiners indicated that first quarter earnings

[16] Required actions presented the highest level of supervisory concern and warranted a response from the Board of Directors, while expected actions required a management response.

[17] These numbers represented significant reductions as 3 required actions and 193 expected actions had been closed during 2004. FRB Chicago noted 25 new expected actions between January 1, 2004, and May 2, 2005.

results were negatively impacted by mortgage servicing rights hedging results and that this was the second consecutive quarter that "substantial losses" resulted from mortgage servicing rights hedging activities. Examiners highlighted the need for Board of Directors oversight of these hedging activities given the recent results and the fact that management had not informed the Board of Directors of a recent important hedging strategy change. The examination report noted that, if the results of management's hedging activities did not improve in subsequent quarters, the CAMELS component rating for sensitivity would be readjusted. In our opinion, these examination findings warranted maintaining the component rating for sensitivity as a 3 and a stronger enforcement action, because the requirements of Resolution 3 had not been resolved for more than two years.

In addition, FRB Chicago noted that the compliance program issues raised in Resolution 3 had not been fully resolved. Examiners cited numerous consumer compliance issues ranging from newly identified violations of the fair lending laws to recurring violations of flood hazard determinations rules, the Home Mortgage Disclosure Act, and the Truth in Lending Act. However, FRB Chicago noted "significant improvement in the compliance management program" based in part on compliance program level enhancements and management's planned actions to resolve these issues. In our opinion, the additional violations of law provided further evidence of systemic compliance program issues.

The examination report noted evidence of improvements in credit risk management across all lines of business. Examiners noted a decline in the level of problem assets. Examiners preserved the "moderate" composite credit risk rating because of the concentration in commercial real estate and home-equity loans that was secured by a second lien on residential property, but stated that the overall risk in the portfolio declined because of more conservative underwriting.

According to examiners, the overall composite risk for IFC and IUBT was moderate with a stable risk trend, as was the composite risk for liquidity. During 2004, management pursued a strategy to increase its core deposits for the Irwin Union Bank business line to help diversify its funding sources and decrease reliance on non-core funding sources, such as brokered deposits. FRB Chicago noted that deposit growth had outpaced loan growth and helped create a moderate increase in the investment portfolio. Finally, examiners concluded that IFC and IUBT had ample and diverse sources of funding.

In our opinion, the combination of these examination findings, including management's continued ineffectiveness in managing its market risk and the new and recurring violations of laws and regulations in the bank's consumer lending business, provided further evidence of the poor transition of the nonbank affiliates to the bank operating environment. We believe that FRB Chicago should have concluded during this examination that its informal supervisory actions were not producing the desired results in a timely manner and, as a result, taken stronger enforcement action requiring IUBT to address issues cited in Board Resolutions and prior examinations.

2005 Supervisory Assessment Downgraded IUBT's Earnings and Sensitivity Component Ratings

In August 2005, FRB Chicago conducted a joint supervisory assessment that maintained IUBT's CAMELS composite 2 rating, but downgraded the component ratings for earnings and sensitivity from 2 to 3. These downgrades occurred because of the volatility of the mortgage servicing rights at Irwin Mortgage Corporation and management's continued difficulties in effectively hedging the market risk associated with the mortgage servicing rights. Examiners indicated that management had not provided for "sufficient hedge protection in a declining rate environment." These continued difficulties resulted in a $42 million net impairment charge to earnings during the first six months of 2005. Management indicated that a new hedging structure had been implemented during the third quarter, but examiners noted that its effectiveness had not been proven. Examiners determined that the overall risk to the consolidated organization had increased from moderate to high. Management committed to validating the market risk models by September 30, 2005. In our opinion, the downgrade for sensitivity rectified an unwarranted upgrade during the prior examination, because the prior examination comments related to market risk were inconsistent with the satisfactory assessment.

2006 Full Scope Examination Noted IUBT's Difficulties Resolving Previously Identified Issues

In February 2006, FRB Chicago began a joint full scope examination for the 2005 calendar year that maintained IUBT's CAMELS composite 2 rating, although examiners downgraded the CAMELS component rating for management from a 2 to a 3. IFC and IUBT's overall composite risk remained high, and examiners downgraded the adequacy of overall risk management from "acceptable" to "weak." In June 2005, the IFC and IUBT Boards of Directors adopted an amended resolution (Resolution 4) that included a model risk validation requirement and several items related to consumer compliance program enhancements. During 2005, IUBT's net income declined significantly from $59 million in 2004, to $21 million in 2005, due to a $49 million impairment charge for 2005 associated with Irwin Mortgage Corporation's hedging activities. The significant decline in net income, coupled with 27 percent total asset growth, caused IUBT's risk-based capital to decline on an annual basis to 12.3 percent.

During this examination, FRB Chicago once again identified the need for IFC and IUBT to strengthen risk management practices. Examiners noted that "the board and management must establish a proactive risk management process that self identifies weaknesses, rather than one that responds to regulatory scrutiny." The examination report observed the need to enhance Board of Directors and management oversight, risk monitoring, management information systems, and internal controls. FRB Chicago emphasized that a supervisory action would be implemented if the governance and risk management issues noted during the examination were not "on the path to resolution by year-end."

According to examiners, "key strategic and policy changes have occurred over the last twelve months without sufficient evidence of proper analysis by management and communication to the appropriate board." Examiners emphasized the importance of sound governance and oversight given the "organizational structure and level of complexity embedded in operations." In terms of management information systems, examiners observed that systems had not kept pace with the bank's expansion and identified specific examples where those systems produced unreliable results. In one instance, IUBT management adjusted the capital requirements contained in its dividend policies after relying on the accuracy of output from the economic capital model. The information management relied upon contained a $100 million error, which could have caused the bank to become non-compliant with its internal capital maintenance limits.

In terms of management's progress towards resolving previously identified weaknesses, examiners acknowledged management's efforts but noted that 8 required actions and 51 expected actions remained open. FRB Chicago indicated that this volume of internal control weaknesses was "high relative to other financial institutions" supervised by FRB Chicago. Examiners also noted four new corporate governance matters requiring the Board of Directors' and management's attention. The matters included (1) completing an assessment of the policy development process to assure that it is properly supported with appropriate internal controls and management oversight; (2) conducting a management assessment of IFC support functions to assure proper staffing, expertise, and succession planning; (3) conducting an assessment of risk monitoring and management information systems to assure that the Board of Directors and its committees receive appropriate information; and (4) evaluating and strengthening enterprise-wide compliance, internal audit, and model validation programs.

Examiners once again questioned the effectiveness of key control functions. Regarding the Compliance, Internal Audit, and the Model Validation groups, examiners observed that "without the proper level of support of expertise, the company runs the risk of not being in compliance with laws and regulations and key control functions may not be performed." FRB Chicago noted that it had identified compliance program weaknesses related to high-risk consumer regulations for a third consecutive consumer affairs examination. In addition, examiners highlighted the need for sound testing programs within Compliance, Internal Audit, and Model Validation to assure the effectiveness of the bank's internal controls. Testing to satisfy the requirements of the Sarbanes-Oxley Act revealed a material weakness in the company's internal controls over financial reporting.

Examiners observed that consolidated credit risk was moderate and stable. However, the examination report noted that Irwin Home Equity activities were concentrated in the 125 percent CLTV product, although no risk concentrations existed by geography or credit score. FRB Chicago also noted that a series of non-traditional mortgage products had recently been introduced that presented elevated inherent risk but had no performance history. In terms of liquidity risk management, examiners noted the bank's increasing reliance on non-core funding sources, such as brokered deposits. FRB Chicago noted that management's reliance on the secondary market "could cause funding difficulties if circumstances in the markets, or Irwin [IUBT] specific issues, were to force the institution to hold the assets on the books for an extended period of time."

In our opinion, the continued ineffectiveness of the Board Resolutions and the findings from this examination warranted (1) a stronger supervisory action in the form of a CAMELS composite downgrade to a 3 rating and (2) a stronger enforcement action specifying time frames for required actions. Examiners' observation that the bank's internal control weaknesses exceeded weaknesses at other institutions supervised by FRB Chicago warranted a more forceful supervisory response, especially given the bank's risk profile. As an example, an effective model validation program was imperative for an institution heavily reliant on models to generate information for the Board of Directors and management. Unresolved findings related to model validation dating back to 2002 warranted an enforcement action. In addition, examiners observed that management had not kept the Board of Directors apprised of key policy changes. In our opinion, this finding warranted a stronger supervisory response. Furthermore, a third consecutive consumer compliance examination with repeat findings concerning the effectiveness of the compliance program and additional violations of law on high-risk consumer compliance regulations in a key business activity warranted an immediate supervisory response.

2007 Full Scope Examination Revealed Ongoing Risk Management and Internal Control Deficiencies

In February 2007, FRB Chicago began a joint full scope examination for the 2006 calendar year that maintained IUBT's CAMELS composite 2 rating. The component ratings for the bank remained consistent with the results of the prior examination, except that examiners upgraded sensitivity to market risk to a 2. The overall composite risk remained high, but examiners upgraded the adequacy of risk management from "weak" to "marginally acceptable." The Board of Directors' failure to create an acceptable compliance program that met the required actions in Resolution 4 resulted in FRB Chicago placing IUBT under an MOU exclusively related to the consumer compliance program.

The Board of Directors and management sold the Irwin Mortgage Corporation business line in the fall of 2006 to, we believe, decrease the bank's vulnerability to market risk, rather than resolving the previously discussed risk management weaknesses. This sale resulted in net losses of approximately $36 million because of losses associated with the sale of Irwin Mortgage Corporation's mortgage servicing rights, additional mortgage servicing rights impairment costs, and contract termination and service costs. In addition to these losses, net income from Irwin Home Equity decreased 32 percent in 2006. Examiners noted that stability in the commercial banking business, among other things, helped to mitigate this poor performance.

According to examiners, management expected the Irwin Union Bank business line to remain profitable in 2007. FRB Chicago noted that financial performance remained a supervisory concern, and examiners noted "the overall plan for IFC seems optimistic based on first quarter results and the unknown impact of deterioration in the secondary mortgage market." IUBT's capital remained above the required minimum levels imposed by the board resolution, and examiners noted that a "modest reduction in total assets along with slight growth in total equity has generated higher capital ratios."

Examiners noted that the Board of Directors and management had made some progress in resolving the number of previously noted required and expected actions. In terms of the issues that had been open since May 2006, 4 required actions and 29 expected actions had been resolved. However, FRB Chicago noted 23 new issues during the examination, including 1 required action and 22 expected actions. In sum, there were 5 unresolved required actions and

44 unresolved expected actions. Resolution 4 remained in place because of management's failure to fully resolve a supervisory issue related to market risk management.

As part of the previous examinations' matters requiring Board of Directors' attention, the Board of Directors hired a consulting firm to perform the required assessments and evaluations mentioned above. These assessments resulted in six realignment plans designed to address corporate governance, staffing, risk monitoring and management information systems, audit, compliance, and model validation. IFC's and IUBT's Boards of Directors approved these plans in February 2007.

Despite the progress on developing high level plans, risk management issues and weaknesses continued to persist. For example, examiners detailed a fundamental weakness in the corporate governance practices surrounding financial and regulatory reporting. In this situation, it did not appear that a routine reconciliation between a holding company regulatory report and the bank's annual report occurred before the regulatory report was finalized and submitted. This oversight and the lack of dual controls surrounding the report preparation process, a basic key control, resulted in a $72 million overstatement of IFC's cash flow and required an amended regulatory filing. In addition to the control weaknesses at the corporate level, examiners noted a series of new control weaknesses at Irwin Home Equity related to key model and valuation processes, including (1) significant errors in key models used to estimate future losses, (2) adjustments to the model that had not been supported with appropriate documentation, and (3) Irwin Home Equity's approach for valuing its loans held for sale, which did not comply with SR Letter 01-12, *Interagency Guidance on Certain Loans Held for Sale.*

In terms of asset quality, examiners noted that loan classifications remained moderate and relatively stable over the last year. FRB Chicago stated that "delinquencies and nonperforming levels have also remained largely manageable." However, examiners did note that the loan portfolio remained concentrated in the 125 percent CLTV products. In terms of Irwin Home Equity's portfolio, these loans represented 46 percent of the portfolio as of December 31, 2006. In addition, 16 percent of Irwin Home Equity's managed portfolio related to subprime borrowers, and 13 percent of the managed portfolio consisted of loans that did not require borrower income verification. Examiners noted an increasing credit risk trend because of the "uncertainty in the general economy, and in the housing and subprime markets in particular."

Liquidity and operational risk remained high. Examiners noted that management's reliance on non-core funding increased as the disruption in the secondary market impacted Irwin Home Equity's ability to sell its loans. Core deposit growth had also been "virtually nonexistent" over the last two years. Examiners noted that the bank would "have to seek alternative funding sources." Examiners noted that operational risk remained high, but the sale of Irwin Mortgage Corporation reduced that risk. According to examiners, operational risk management remained weak because of internal control deficiencies.

Market risk to IFC and IUBT decreased from "high" to "moderate" based on the sale of Irwin Mortgage Corporation and the corresponding mortgage servicing rights, but this sale did not eliminate market risk management concerns about IUBT. Examiners observed that management faced similar hedging challenges with residual assets on Irwin Home Equity's balance sheet and certain assets at Irwin Union Bank. FRB Chicago observed that "despite the company's heavy reliance on models for asset valuation and risk monitoring, internal controls and model validations have not been acceptable in previous regulatory examinations."

In our opinion, FRB Chicago failed to devote sufficient attention to the Board of Directors' and management's delays in producing actual results. An unresolved action item dating back to Resolution 2, a significant volume of unresolved actions from prior examinations, and recently discovered fundamental internal control weaknesses warranted a more forceful supervisory response in the form of a formal enforcement action.

2007 Supervisory Assessment Resulted in a CAMELS Composite Downgrade

In November 2007, FRB Chicago and the State began a joint assessment of IUBT's liquidity that downgraded IUBT's CAMELS composite rating and liquidity component rating from 2 to 3. By September 30, 2007, IUBT had experienced net losses of $22 million. Examiners attributed these losses to credit deterioration in all loan and lease portfolios. Because of these losses, IUBT's provision expense for the ALLL increased 183 percent to compensate for the future losses to be recognized at the end of the year. At a subsidiary level, Irwin Home Equity's provision expense more than tripled on an annual basis, increasing from $16 million to $53 million. Notwithstanding deteriorating asset quality and a declining earnings trend that examiners noted posed a risk to capital, IUBT's capital exceeded internal policy limits and regulatory minimums.

The supervisory assessment referred to the results of an FRB Chicago target examination that began in July 2007 of IUBT's Treasury operations and securitization activities to explain FRB Chicago's downgrade of the bank's component rating for liquidity. Following the September 2007 exit meeting for that target examination, the secondary market for mortgage loans experienced liquidity disruptions due to continued deterioration in the credit markets. According to examiners, these disruptions put additional pressure on IUBT's liquidity position, adversely impacted access to key funding sources, and increased the costs associated with other less readily available funding sources. Examiners noted that management's pursuit of the originate-to-distribute business model with little secondary liquidity support presented inherently high liquidity risk. Management relied on non-core funding while maintaining a below average volume of deposits, single depositor concentrations, and a small investment portfolio to provide secondary liquidity support. Examiners stated that this funding model works only as long as secondary market demand for these assets exists.

A key issue noted during the Treasury operations examination was that a major funding source decided not to renew a $300 million credit line that supported Irwin Home Equity's loan origination activities. Examiners noted that "IFC's liquidity risk management structure provides a sound framework for identifying, monitoring, and controlling risk and that management has instituted some leading risk management practices." FRB Chicago concluded "the concerns stem not from weaknesses in IFC's liquidity risk management framework or practices, but instead from the institution's high inherent liquidity risk, the tight liquidity position, the impact of the current market disruption, the company's weak earnings performance, and deteriorating asset quality."

We note that FRB Chicago made observations similar to those in the previous paragraph regarding the company's business model, its reliance on uninterrupted liquidity, and its ineffective adverse scenario planning in 2003, but waited almost five years to downgrade IUBT's liquidity component rating to 3. In our opinion, examiners should not have waited for a liquidity disruption to hold management accountable for its poor planning and strategic decision-making. Rather than being forward looking, the full scope examinations conducted during this five-year period focused on the prior year results and observations made during the examination. FRB Chicago did not devote sufficient attention to assuring that management had developed plans for responding to possible future liquidity disruptions. By not anticipating the consequences associated with a liquidity disruption and the transition to an originate-to-hold model, IUBT became exposed to significant credit risk associated with Irwin Home Equity's 125 percent CLTV ratio loans.

We believe that taking a stronger supervisory action sooner, such as a liquidity component rating downgrade or a formal enforcement action related to liquidity risk management, might have addressed this fundamental liquidity planning weakness during the intervening time period between 2003 and this supervisory assessment.

2008 Full Scope Examination Resulted in Further Downgrades and a Memorandum of Understanding

In February 2008, FRB Chicago and the State, with FDIC participation, began a joint full scope examination of IUBT for the 2007 calendar year that resulted in further downgrades. IUBT's CAMELS composite rating decreased from a 3 to a 4, and every component rating received a downgrade or double downgrade. FRB Chicago noted that the declining economic environment had clearly affected the organization's condition, but that the "strategic choices and the lack of risk mitigation actions to manage the institution through this difficult environment have led to serious safety and soundness concerns." Examiners informed management that a supervisory action would be forthcoming.

The tone of this examination report changed significantly from previously issued reports that acknowledged management's partial progress towards resolving noted issues. This report attributed the bank's condition to the Board of Directors' and management's ineffectiveness, with examiners noting "a loss of confidence" in the Board of Directors and management. Examiners noted that the Board of Directors and management had established and promoted inherently risky business models and strategies, especially at Irwin Home Equity and Irwin Mortgage Corporation, that laid the foundations for the bank's current problems. FRB Chicago also noted management's failure to proactively implement sound risk management practices that could prevent issues from becoming regulatory concerns. Examiners observed many examples of management reacting to, rather than anticipating and resolving, risk. This reactive management approach led FRB Chicago to conclude that "poor Board [of Directors] and senior management oversight has led to the institution's current overall weak condition."

Examiners highlighted IUBT's declining earnings as a concern because the bank lost $44.5 million in 2007. The examination report emphasized management's difficulties in forecasting the bank's operating results for the previous three years. During that time frame, management's forecasts differed from actual results by $80.9 million, $82.7 million, and $106.2 million, respectively. FRB Chicago indicated that unrealistic projections made it difficult to make sound strategic choices.

Examiners attributed the double downgrade of the bank's liquidity rating from 3 to 5 to the bank's weak financial condition and resulting inability to maintain existing sources of funds. Additionally, FRB Chicago noted that management's liquidity and funding strategy had resulted in little asset liquidity, single depositor and other funding concentrations, a high level of uninsured deposits, and limited contingent funding sources, which exposed the bank to significant liquidity risk. This assessment directly contradicted the liquidity risk management leading practices observation contained in the prior examination. FRB Chicago also noted that management's heavy reliance on wholesale funding at the expense of core deposit growth, coupled with depositor concentration risk and a small investment portfolio, greatly exacerbated an already vulnerable liquidity position. Examiners predicted that "the loss of one or more key funding sources could create a severe liquidity crisis at the institution."

Examiners characterized IUBT's capital position as "less than satisfactory" based on negative earnings, lack of support from IFC, limited access to the capital markets, and exposure to high-risk assets in a declining economic environment. Because of its $44.5 million loss and a $15 million dividend, IUBT's annual results did not augment capital.[18] IUBT's capital ratios declined during the year, but management used asset sales to offset these declines and maintain the bank's *well capitalized* status. Examiners noted that this short-term solution "has negative implications for future earnings, since management is selling liquid, higher quality, profitable assets while retaining assets of lesser quality."[19] FRB Chicago raised concerns about whether the current capital position supported the bank's high and increasing risk profile.

FRB Chicago noted five new matters related to liquidity, capital, asset quality, credit risk, and corporate governance that required the Board of Directors' and management's immediate attention. Examiners noted that management needed to take immediate action to (1) fortify the bank's balance sheet and avoid a severe liquidity crisis, (2) reduce its exposure to high-risk assets to alleviate pressure on the capital position, (3) avoid resuming home equity lending without resolving and eliminating the current high-risk exposure and liquidity vulnerabilities, and (4) enhance the ALLL methodology to assure it was commensurate with IUBT's risk profile. In terms of corporate governance, FRB Chicago reminded each board member of his/her duty to read all supervisory letters addressed to the Board of Directors to keep apprised of current regulatory activity.

In 2007, IUBT experienced significant asset quality deterioration across all lines of business. Examiners noted that declining real estate values in the bank's key markets eroded collateral support for Irwin Home Equity's 125 percent CLTV product and had a particularly negative effect on Irwin Home Equity's subprime borrowers. The real estate declines also affected the

[18] This dividend payment was the bank's last payment, as further payments became subject to regulatory approval prior to payment.

[19] Management sold these assets because the bank needed to remain *well capitalized* to be able to access brokered deposits without prior approval.

bank's commercial lending activities. Although Irwin Mortgage Corporation had been sold, the business generated $30.5 million in losses based on high volumes of loan repurchases and indemnification requests due to poor underwriting and credit decisions made during the real estate boom.

In terms of risk management at the corporate level, FRB Chicago noted that management's efforts toward implementing the six realignment plans approved by IFC's and IUBT's Boards of Directors in February 2007 "have not clearly resulted in measurable benefits to the organization with respect to meaningful risk mitigation."

On July 26, 2008, FRB Chicago and the State entered into an MOU with IFC and IUBT. The MOU obligated IFC and IUBT to (1) submit a plan to strengthen Board of Directors oversight; (2) conduct a management assessment for all senior bank management, including all executive officers, to assess qualifications and prior performance; (3) submit a liquidity/funds management plan; (4) submit a capital plan; (5) enhance the ALLL methodology; and (6) submit a three-year strategic plan. Each of these required actions had a defined time period for completion.

August 2008 Joint Target Examination Resulted in Further Downgrades, and IUBT's Failure to Raise Additional Capital Resulted in a Written Agreement

In August 2008, FRB Chicago began a joint asset quality target examination with the State and the FDIC concerning IUBT's CRE asset quality and credit risk management practices. The examination assessed the impact of the bank's CRE exposure on asset quality, capital, earnings, and liquidity. In addition to conducting this assessment, the joint examination reassessed the regulatory ratings previously assigned to IFC and IUBT. The reassessment resulted in a downgrade of IUBT's CAMELS composite rating and earnings component rating to 5. The component ratings for capital and asset quality were downgraded from 3 to 4. Examiners deemed IFC and IUBT to be in "troubled condition," and FRB Chicago entered in to a Written Agreement with IFC and IUBT on October 10, 2008.

Examiners noted that continued poor profitability, weak and deteriorating asset quality, and a shrinking capital base exacerbated the bank's liquidity problems and called into question the institution's continued viability. Through September 30, 2008, IUBT experienced further losses of $133 million, which examiners attributed to (1) declining asset quality in the 125 percent CLTV home equity loan portfolio and (2) CRE losses in the commercial banking business. Examiners noted that future profitability remained uncertain because the real estate market declines had not shown signs of slowing down.

These losses caused IUBT's total capital to decline by 30.1 percent. However, the bank remained *well capitalized* for PCA purposes as IUBT's total risk-based capital exceeded 11 percent. Examiners highlighted that IUBT falling to *adequately capitalized* would limit the future viability of the bank because of the corresponding restrictions associated with accepting or renewing brokered deposits. FRB Chicago also highlighted that IFC and IUBT had made significant efforts to obtain a $50 million cash infusion before August 31, 2008, as required by the MOU. The failure to obtain this additional capital resulted in the Written Agreement.

IFC's total classifications reached $478.4 million, or 84.5 percent of tier 1 capital plus the ALLL. Examiners noted that the rapid decline in the loan portfolios had overwhelmed current staffing levels in IUBT's Loan Review unit, and examiners identified the need for additional loan rating downgrades to management's internal ratings. Examiners noted the following four issues requiring the Board of Directors' and management's immediate attention: (1) providing adequate staffing in credit risk functions; (2) assuring that the ALLL methodology was consistent with generally accepted accounting principles; (3) assuring that all internal loan ratings were appropriate at all times and accurately reflected in the ALLL; and (4) taking all required charge-offs before year-end.

On October 10, 2008, FRB Chicago and the State entered into a Written Agreement with IFC and IUBT. In general, the Written Agreement contained provisions similar to the MOU, but with adjusted timelines.

Securities and Exchange Commission Guidance on a Key Accounting Treatment Decreased IUBT's Capital Ratios

On February 27, 2009, IFC requested guidance from the Securities and Exchange Commission (SEC) concerning the proper accounting treatment for the home equity loans on IUBT's balance sheet. A disagreement between FRB Chicago, IFC management, and IFC's external auditor prompted this request. On March 20, 2009, the SEC issued guidance that required IUBT to classify the home equity loans as loans held for sale, and to value the loans at the lower of cost or market. The classification resulted in a $28 million impairment charge and a reduction to IUBT's total risk-based capital ratio, decreasing its capital position to *adequately capitalized*. On March 25, 2009, FRB Chicago sent a timely PCA notification which, under the FDI Act, restricted the bank's ability to accept, renew, or roll over any brokered deposit without receiving a formal waiver from the FDIC.

2009 Full Scope Examination Downgraded CAMELS Component Ratings

On March 9, 2009, examiners commenced a full scope joint examination of IUBT for the 2008 calendar year. The examination report maintained IUBT's CAMELS composite 5 rating and downgraded capital, asset quality, management, and sensitivity. All CAMELS components received 5 ratings, except for sensitivity, which received a 4. FRB Chicago concluded that the bank was in an "unsafe and unsound" condition "because the vulnerable liquidity position, inadequate capital levels, weak asset quality, and a continued lack of profitability is threatening the viability of the organization." FRB Chicago noted two matters requiring immediate attention of the Board of Directors and management: (1) fortify the balance sheet to avoid a severe liquidity crisis; and (2) take all steps necessary to execute the organization's recapitalization plan. Examiners indicated that IUBT's failure was a distinct possibility without immediate and significant action to address identified weaknesses. Examiners noted that "management has been unable to stem the corrosive effects of increasing asset quality problems and negative earnings on the capital and liquidity positions."

According to examiners, the statutory restrictions on IUBT's brokered deposit activity further strained the bank's liquidity capacity. FRB Chicago noted that "any number of events could trigger a liquidity crisis at the institution." Examiners cautioned that further capital deterioration might lead to IUBT becoming *undercapitalized*, which would impact the bank's eligibility to bid on, or retain, Indiana public funds.[20] FRB Chicago speculated that the bank becoming *undercapitalized* would likely be catastrophic for its liquidity position.

Examiners deemed IUBT's capital level "critically deficient" and noted that management had been unable to raise capital from external investors. Because of the lack of secondary liquidity support, IUBT management had to consider further asset sales to stem capital erosion and avoid a major deposit outflow. FRB Chicago and the State raised concerns that additional sales of quality assets could further impair IUBT's franchise value and reduce the possibility of an eventual return to profitability.

Asset quality deteriorated significantly during 2008, putting "significant pressure on capital, earnings, and liquidity." Examiners noted that IUBT's loan classifications reached $517.3 million, or 127.2 percent of IUBT's tier 1 capital plus the ALLL. The classification ratio worsened during the first quarter of 2009 to 139.3 percent. According to examiners, IFC's consolidated ratios were even worse because of asset quality deterioration at Irwin FSB. Examiners attributed the substantial asset quality deterioration to the "portfolio concentration in real estate related credits, especially in some of the hardest hit real estate markets in the country."

In terms of compliance with the Written Agreement, FRB Chicago noted that many required actions had been completed, but IFC and IUBT had failed to comply with a key requirement. The Written Agreement required IFC and IUBT to submit a joint capital plan to ensure that each institution maintained sufficient capital. Despite multiple iterations and vetting with the regulatory agencies, FRB Chicago determined that the capital plan was unsatisfactory because it relied upon IFC's receipt of Troubled Asset Relief Program (TARP) funds from the U.S. Treasury, even though IFC had not obtained a written commitment that it would receive such funds.[21] The Board of Directors and management had expended significant effort since October 2008 trying to persuade the government to provide TARP funds to IUBT, even though the bank did not qualify for support because of its CAMELS composite 5 rating.

August 2009 Asset Quality Visitation Declared IUBT *Undercapitalized*

In August 2009, FRB Chicago, the State, and the FDIC began an asset quality visitation of IUBT assessing the adequacy of its credit risk management practices. On September 15, 2009, FRB Chicago and the State placed IFC and IUBT under a Cease and Desist Order as a result of the visitation. The Order required the Board of Directors and management to take affirmative action to assure that IUBT operated in a safe and sound manner, meet the minimum capital ratios outlined in Resolution 1, adopt a liquidity management plan, and refrain from future asset sales. Examiners also delivered a PCA notice to IUBT on September 15, 2009, advising the Board of Directors and management that the bank had become *undercapitalized*.

[20] In March 2009, IUBT had $550 million of Indiana public funds on deposit, of which $40 to $50 million were FDIC insured. The Indiana Public Deposit Insurance Fund (PDIF) had assets of $314.6 million in reserve as of June 30, 2008, to cover $11 billion in Indiana public funds. Hence, PDIF did not have the reserves necessary to cover an IUBT failure.

[21] The Emergency Economic Stabilization Act of 2008 authorized the Department of the Treasury to purchase or insure up to $700 billion in troubled assets of financial institutions through the TARP.

Examiners reviewed all $141.6 million of nonaccrual loans in Irwin Union Bank's commercial loan portfolio. During the review, examiners noted a number of instances where management's internal loan grades required further downgrades. In several instances, the bank should have either recorded a loss or provided reserves based on information available to the bank at that time. These findings and the required charge-offs reduced IUBT's earnings and capital as of June 30, 2009.

In addition, IUBT's *undercapitalized* status meant that it could not bid on, or retain, Indiana public funds. On September 2, 2009, the Indiana Treasurer requested that IUBT no longer bid on public funds. On September 15, 2009, the Indiana Treasurer required that IUBT dispose of all Indiana public funds not insured by the FDIC. The lack of an adequate capital plan and the imminent danger of the bank failing from a liquidity shortfall caused the State to close IUBT on September 18, 2009, and appoint the FDIC as receiver.

Conclusions and Lessons Learned

IUBT failed because of the convergence of several factors. The Board of Directors and management pursued an aggressive growth strategy between 2000 and 2005 that relied upon high-risk business models. Management also depended on volatile non-core funding sources to support the bank's growth strategy, which emphasized high-risk, high-yielding assets, such as 125 percent CLTV ratio loans. Meanwhile, management maintained few sources of liquidity support, which further increased IUBT's risk profile. During the 2000 to 2005 growth period, the Board of Directors and management failed to ensure that the bank's key corporate control functions and risk management practices kept pace with the bank's expansion, increasingly complex operations, and escalating risk profile. The Board of Directors' and management's aggressive growth strategy resulted in IUBT's total assets almost tripling between 2000 and 2005. For five consecutive years from 2004 through 2008, however, the bank's net income decreased.

In 2007, the reduced secondary market demand for mortgages hampered, and eventually eliminated, Irwin Home Equity's ability to sell its loans. This subsidiary was forced to hold the loans that it had originated to sell, including 125 percent CLTV ratio loans, in a declining real estate environment, which exposed IUBT to significant asset quality deterioration. In addition, the Irwin Union Bank business line developed a significant CRE concentration by 2007 that compounded IUBT's exposure to real estate market declines. As the value of IUBT's assets continued to deteriorate, the Board of Directors and management adopted a strategy of selling business lines, such as Irwin Commercial Finance-Canada and Irwin Commercial Finance-Equipment, and branch offices to preserve the bank's capital. IUBT's remaining assets continued to deteriorate and deplete capital, which raised concerns about the bank's viability and eventually resulted in IUBT losing its access to key funding sources. On September 18, 2009, the State closed IUBT because of the imminent danger of a liquidity shortfall and appointed the FDIC as receiver.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or loss to the DIF. Our analysis of FRB Chicago's supervision of IUBT indicated that examiners identified key weaknesses in 2002 and 2003 regarding corporate governance, risk management systems, and internal controls, but missed multiple subsequent opportunities to take more forceful supervisory action.

The fundamental risk management weaknesses, corporate governance issues, and key compliance deficiencies raised by FRB Chicago during examinations in 2002 and 2003 were early warning signs regarding IUBT's Board of Directors' and management's capability to effectively manage a geographically dispersed, large, and complex banking organization. Based on the 2002 and 2003 examination findings, FRB Chicago issued two informal enforcement actions. In 2003 and 2004, IUBT was unable to fully resolve the issues noted in the informal enforcement actions, and unresolved issues noted during the continuous supervision process began to accumulate. We believe that FRB Chicago had multiple opportunities between 2002 and 2009 to take additional and stronger supervisory actions.

For example, we believe that the fundamental corporate governance issues and comprehensive liquidity risk management weaknesses noted during the January 2002 examination provided an early warning sign that management was not effectively managing the risks associated with adding a new bank subsidiary engaged in high loan-to-value lending. In our opinion, the examination findings warranted a stronger supervisory action, including an additional downgrade of the management CAMELS component rating to reflect that management was less than satisfactory. We also believe that FRB Chicago should have considered requesting that management refrain from additional growth or corporate restructurings affecting IUBT until the bank fully addressed the fundamental flaws noted during this examination. We believe that strong supervisory action would have alerted management to the urgent need to address these weaknesses before pursuing further changes or additional growth in the lines of business.

The 2005 full scope examination cited that management's failure to enhance its market risk management capabilities contributed to a decrease in the bank's annual earnings and, in our opinion, warranted a stronger supervisory response. During the 2005 examination, FRB Chicago also noted new and recurring violations of laws and regulations in the bank's mortgage lending business lines, which we believe warranted a stronger enforcement action. In addition, the 2006 full scope examination once again revealed IUBT's difficulties resolving items contained in informal enforcement actions and raised by the continuous supervision process. We believe that IUBT's inability to fully resolve, in a complete and timely manner, prior informal supervisory actions and issues noted during the continuous supervision process warranted an earlier formal enforcement action.

In late 2007, when economic conditions caused a liquidity disruption that reduced the bank's access to the funding necessary to operate its home equity lending business, FRB Chicago reiterated the risk associated with IUBT's dependence on uninterrupted liquidity in the secondary markets as a significant issue. Examiners raised the same concern almost five years earlier in a 2003 examination report, but did not hold the Board of Directors and management accountable for addressing that risk in the intervening years. We believe that an earlier and stronger supervisory action, such as a liquidity component ratings downgrade or a formal enforcement action related to liquidity risk management, might have addressed this fundamental liquidity planning weakness.

Lessons Learned

We believe that IUBT's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. Specifically, IUBT's failure illustrates the importance of supervisors

- confirming effective Board of Director and management oversight before a bank makes key strategic and operational changes, such as adding new, high-risk business lines;

- ensuring that a bank's risk management practices and internal control processes keep pace with the institution's growth, increasingly complex operations, and heightened risk profile;

- focusing on the key risks within each business line and ensuring that the Board of Directors and management comprehend, manage, and mitigate those risks;

- assigning CAMELS composite and component ratings consistent with the significance of comments raised in the narrative sections of examination reports to ensure that management understands the urgency of implementing the required corrective action measures; and

- assuring that examination reports are forward looking and anticipate potential risk issues that management should address, in addition to raising concerns and observations based on events that have already occurred.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. His response is included as Appendix 3. The Director concurred with the report's conclusions and lessons learned, and appreciated the report's observations and contribution to understanding the reasons for IUBT's failure. He noted that examiners identified key weaknesses in 2002 and 2003 regarding corporate governance, risk management systems, and internal controls that were not satisfactorily resolved by IUBT in a complete and timely manner. He also concurred that, in hindsight, there were opportunities between 2002 and 2009 where additional and stronger supervisory actions may have been warranted. The Director also mentioned that the report highlights several important lessons learned, including (1) assuring that a bank's risk management practices and corporate governance processes keep pace with the institution's risk profile, (2) developing forward-looking examination reports that anticipate potential risk issues that management should address, and (3) assuring that management understands the urgency of implementing required corrective actions.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

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

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

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

Concentration
A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group.

Core Deposits
Core deposits are deposits made by customers in a bank's general market area. A bank considers its core deposits to be a reliable 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 Cease and Desist Orders, Written Agreements, and PCA Directives, while informal enforcement actions include commitments, Board Resolutions, and Memoranda of Understanding.

Appendix 1—*continued*

Federal Home Loan Bank
The Federal Home Loan Bank is a government-sponsored enterprise chartered by Congress in 1932. Its purpose is to support residential mortgage lending and community investment at the local level by providing primary direct loans to its more than 8,000 member financial institutions (primarily banks and thrift institutions).

Impairment
Impairment is the amount by which amortized cost exceeds fair value.

Non-core Deposit Sources
Non-core deposit sources are volatile funding sources that include liabilities that either are uninsured or are raised outside the bank's stable, local market.

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

Subprime loans
Subprime loans are loans made to borrowers with the following characteristics: (1) a FICO score of less than 620, (2) a late mortgage payment in the last 12 months (3) a bankruptcy in the last 24 months, and/or (4) a foreclosure in the last 36 months.

Supervision and Regulation (SR) Letters
SR letters are issued by the Federal Reserve Board's Division of Banking Supervision and Regulation. They address significant policy and procedural matters of continuing relevance to the Federal Reserve Board's supervisory effort. SR letters are for distribution to supervised institutions as well as Reserve Banks.

Tier 1 Capital
Tier 1 capital is a regulatory capital measure that may include common shareholder's equity (common stock, surplus, and retained earnings), non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

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

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:	April 27, 2010
To:	Elizabeth A. Coleman, Inspector General
From:	Patrick M. Parkinson, Director, Banking Supervision and Regulation /***signed/***
Subject:	Material Loss Review of Irwin Union Bank and Trust

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review of Irwin Union Bank and Trust ("IUBT"), Columbus, Indiana, prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that IUBT failed because of a convergence of several factors, including the Board of Directors and management's aggressive growth strategy that relied upon high-risk business models and management's dependence on volatile non-core funding sources. Further, the Board of Directors and management failed to ensure that the bank's key corporate control functions and risk management practices kept pace with the bank's expansion, increasingly complex operations, and escalating risk profile. IUBT was supervised by the Federal Reserve Bank of Chicago (FRB Chicago) under delegated authority from the Board.

We concur with the conclusions and lessons learned contained in the report. FRB Chicago and the State of Indiana conducted nine full scope examinations, one asset quality target examination, one asset quality visitation, and made several supervisory assessments between 2001 and 2009. IUBT was subject to four board resolutions, two Memoranda of Understanding, and two formal enforcement actions. We agree that examiners identified key weaknesses in 2002 and 2003 regarding corporate governance, risk management systems, and internal controls that were not satisfactorily resolved by IUBT in a complete and timely manner. And, we concur that in hindsight there were opportunities between 2002 and 2009 where additional and stronger supervisory actions may have been warranted. For example, the report notes that strong supervisory action would have alerted management to the urgent need to address weaknesses before pursuing further changes or additional growth in the lines of business. The report also notes that IUBT's inability to fully resolve prior informal supervisory actions and issues warranted an earlier formal enforcement action. We concur with this finding, but also note that whether an earlier formal enforcement action would have averted the ultimate failure of the bank or altered the cost of resolution to the Deposit Insurance Fund cannot be determined with certainty.

The report highlights several important lessons learned, in particular the importance of assuring that a bank's risk management practices and corporate governance processes keep pace with the institution's risk profile, developing forward-looking examination reports that anticipate potential risk issues that management should address, and that management understands the urgency of implementing required corrective actions.

Board staff welcomes the opportunity to comment on the IG report and appreciates the reports observations and contribution to understanding the reasons for IUBT's failure.

Appendix 4 – Principal Contributors to this Report

Chie N. Hogenmiller, Project Leader and Auditor

Nancy T. Robinson, Auditor

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

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