Office of Inspector General

Review of the Failure of Legacy Bank

Board of Governors of the Federal Reserve System

December 2011

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

OFFICE OF INSPECTOR GENERAL

December 15, 2011

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Mr. Parkinson:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Inspector General of the Board of Governors of the Federal Reserve System (Federal Reserve Board) conducted an in-depth review of the failure of Legacy Bank (Legacy). Legacy began operations in July 1999 as a de novo state member bank headquartered in Milwaukee, Wisconsin. Legacy was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Federal Reserve Board, and by the State of Wisconsin Department of Financial Institutions (State). The State closed Legacy on March 11, 2011, and named the Federal Deposit Insurance Corporation (FDIC) as receiver.

Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurs between January 1, 2010, and December 31, 2011. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal bank agency

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

In addition, the Dodd-Frank Act requires an in-depth review of bank failures that result in losses below the materiality threshold when the Inspector General of the appropriate federal banking agency determines that the loss exhibits "unusual circumstances."

According to the FDIC, the bank's total assets at closing were $225.1 million and its failure resulted in an estimated $43.5 million loss to the DIF. While the loss is beneath the materiality threshold, we conducted an in-depth review after determining that Legacy's failure presented unusual circumstances because examiners concluded that bank officers engaged in unsafe and unsound banking practices and the bank received $5.5 million in funds from the U.S. Department of the Treasury's (Treasury's) Capital Purchase Program (CPP) under the Troubled Asset Relief Program (TARP). When unusual circumstances are identified, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review.

Legacy failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which focused on lending in low-to-moderate income neighborhoods within the city of Milwaukee. The bank was a community development financial institution that provided financial services to customers in an underserved community. Management depended on non-core funding sources to support the bank's growth strategy, which included providing loans to revitalize residential housing and commercial properties in distressed neighborhoods in Milwaukee. This strategy resulted in the bank developing a concentration in commercial real estate (CRE) loans and becoming vulnerable to a downturn in the local economy. Legacy's Board of Directors' and management's failure to implement risk management practices commensurate with the bank's increased risk profile, coupled with a weakening real estate market, led to rapid asset quality deterioration. Mounting losses eliminated the bank's earnings and depleted capital, which prompted the State to close Legacy and appoint the FDIC as receiver on March 11, 2011.

With respect to supervision, FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2006 through 2011, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted four full scope examinations, one target examination, one supervisory assessment and three visitations; executed two enforcement actions; and implemented the applicable PCA provisions.

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 a loss to the DIF. Our analysis of FRB Chicago's supervision of Legacy revealed that FRB Chicago identified the bank's fundamental weaknesses, including ineffective Board oversight, poor internal controls, and a high concentration in CRE loans, but did not take early, forceful supervisory action to address those weaknesses.

We believe that a March 2008 full scope examination presented an opportunity for stronger supervisory action. In the May 2008 examination report, examiners expressed some concern over the bank's future performance because of Legacy's aggressive growth strategy; a heavy reliance on non-core funding sources; declining capital induced by aggressive growth; and a considerable increase in classified assets. Legacy's aggressive growth was supported by management's continuous reliance on non-core funding sources. In addition, while Legacy remained *well capitalized* for PCA purposes, its capital was declining as a result of rapid growth and there was a 250 percent increase in the bank's classified assets. Moreover, examiners noted Legacy's concentration in CRE loans and identified weaknesses in credit risk management regarding real estate concentrations, such as (1) inadequate Board of Directors' oversight, (2) a lack of guidelines and strategies to reduce such concentrations, and (3) insufficient analysis of the potential impact on the bank's CRE loan portfolio in a declining market condition. In our opinion, the findings noted during this examination warranted stronger criticism, including CAMELS composite and component rating downgrades.

In October 2008, Legacy's holding company applied for TARP funds under the CPP, and FRB Chicago evaluated the application. In applying Treasury's evaluation guidance, FRB Chicago concluded that Legacy qualified for presumptive approval status because the bank had a satisfactory CAMELS composite rating at the May 2008 examination report and Legacy's financial performance measures as of June 30, 2008, indicated that there were no significant concerns regarding the bank's viability. We believe that FRB Chicago complied with the process outlined in the Treasury guidance for banks that had been examined during the previous six months and the decision-making criteria available at the time. Even if Legacy had received a CAMELS composite 3 rating during the 2008 full scope examination, the bank would have qualified for presumptive approval status based on its acceptable performance ratios.

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

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Legacy's failure offers lessons learned that can be applied to supervising banks with similar characteristics. In our opinion, Legacy's failure demonstrates the importance of (1) examiners assuring that management implements credit risk management practices commensurate with the bank's strategy and risk profile, including CRE concentration levels and (2) supervisors assigning CAMELS composite and component ratings consistent with the examination's findings and narrative examination comments.

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

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

Sincerely,

Michael P. VanHeuvelen for

Anthony J. Castaldo
Associate Inspector General
for Inspections and Evaluations

cc: Chairman Ben S. Bernanke
Vice Chair Janet L. Yellen
Governor Daniel K. Tarullo
Governor Elizabeth A. Duke
Governor Sarah Bloom Raskin
Ms. Cathy Lemieux

Office of Inspector General

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Background

Legacy Bank (Legacy) began operations on July 29, 1999, as a de novo state member bank, headquartered in Milwaukee, Wisconsin. The bank was wholly owned by Legacy Bancorp, a one-bank holding company. Legacy was a community development financial institution (CDFI) focused primarily on promoting economic development, affordable housing, and financial services to low-to-moderate income and underserved communities in the Milwaukee metropolitan area.[1] Legacy's single branch offered a full array of commercial and consumer banking services. Legacy 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 State of Wisconsin Department of Financial Institutions (State).

The State closed Legacy on March 11, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC's Office of Inspector General notified our office that Legacy's failure would result in an estimated $43.5 million loss to the Deposit Insurance Fund (DIF), or 19.3 percent of the bank's $225.1 million in total assets at closing. Under section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), a material loss to the DIF is defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. However, the Dodd-Frank Act requires an in-depth review of any bank failure that creates a loss to the DIF when the Inspector General of the appropriate federal banking agency determines that the loss exhibits "unusual circumstances." We believe that Legacy's failure presented unusual circumstances because bank officers engaged in unsafe and unsound practices and the bank received $5.5 million in funds from the U.S. Department of the Treasury's (Treasury's) Capital Purchase Program (CPP) under the Troubled Asset Relief Program (TARP). We have provided our report to the Office of Inspector General's investigations section for further review and analysis.

Objectives, Scope, and Methodology

When a loss to the DIF presents unusual circumstances, section 38(k) of the FDI Act requires that the Inspector General of the appropriate federal banking agency prepare a report in a manner that is consistent with the requirements of a material loss review. The material loss review provisions of section 38(k) require that the Inspector General of the appropriate federal banking agency

- review the agency's supervision of the failed institution, including the agency's implementation of prompt corrective action (PCA);

[1] A CDFI is a specialized financial institution that raises capital from banks, foundations, and government agencies and works in market niches underserved by traditional financial institutions. These institutions provide development services that support financial transactions.

- ascertain why the institution's problems resulted in a material loss to the DIF; and

- make recommendations for preventing any such loss in the future.

To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Chicago, the State, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by Legacy, examination reports issued from 2006 through 2011, examination work papers prepared by FRB Chicago and the State, and relevant FDIC documents.[2] Appendixes at the end of this report contain a glossary of key banking and regulatory terms and a description of the CAMELS rating system.[3] We conducted our fieldwork from August 2011 through November 2011 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

Legacy failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which focused on lending in low-to-moderate income neighborhoods within the city of Milwaukee. The bank was a CDFI that provided financial services to customers in an underserved community. Management depended on non-core funding sources to support the bank's growth strategy, which included providing loans to revitalize residential housing and commercial properties in distressed neighborhoods in Milwaukee. This strategy resulted in the bank developing a concentration in commercial real estate (CRE) loans and becoming vulnerable to a downturn in the local economy. Legacy's Board of Directors' and management's failure to implement risk management practices commensurate with the bank's increased risk profile, coupled with a weakening real estate market, led to rapid asset quality deterioration. Mounting losses eliminated the bank's earnings and depleted capital, which prompted the State to close Legacy and appoint the FDIC as receiver on March 11, 2011.

Aggressive Growth Strategy

Legacy pursued an aggressive growth strategy, with annual growth ranging from 15 percent to 44 percent between 2002 and 2008. As shown in Chart 1, the bank's total assets nearly quadrupled from $56.7 million in 2002 to $226.1 million by year-end 2008. Legacy's growth resulted from an expanding commercial loan portfolio. According to examiners, the bank

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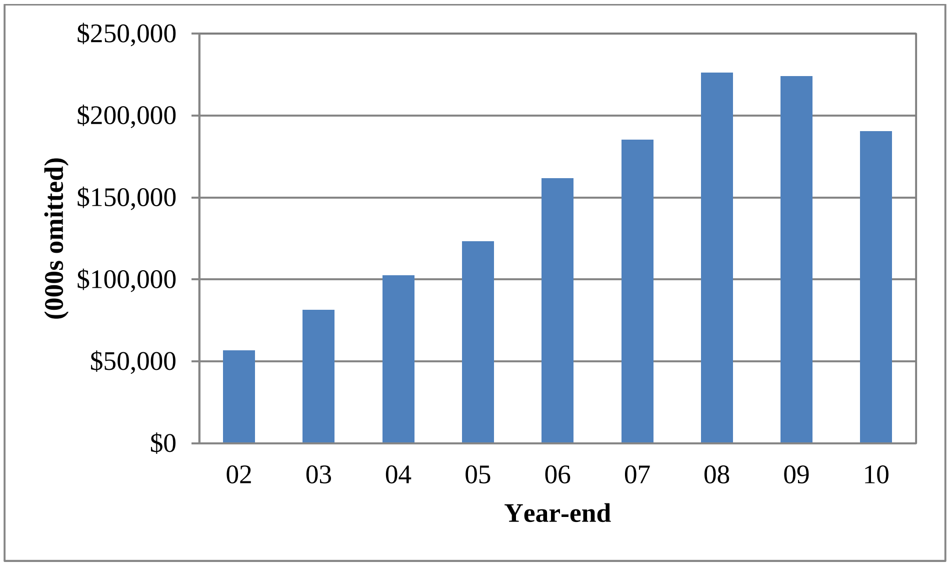
[2] As part of our review, we evaluated whether FRB Chicago complied with the capital and examination frequency requirements in the supervisory guidance for de novo banks outlined in Supervision and Regulation (SR) Letter 91-17, *Application and Supervision Standards for De Novo State Member Banks***.** We concluded that FRB Chicago complied with the requirements outlined in the SR letter. Based on this conclusion, we did not extend our analysis of FRB Chicago's supervision to Legacy's initial examination.

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

continued to seek additional growth in 2008, as management planned to double the current size of the bank by 2012.

Chart 1: Total Assets



Aggressive Growth Resulted in a CRE Loan Concentration

Legacy's aggressive loan growth resulted in a CRE loan concentration that consistently and significantly exceeded supervisory thresholds.[4] Examiners stated that, between 2005 and 2006, Legacy shifted its focus from traditional small business lending through commercial and industrial loans to expanding its CRE lending activities with a majority of the loans used for revitalizing residential housing and commercial properties in the bank's community. According to examiners, the bank's loan portfolio became heavily concentrated in residential, non-owner occupied rental property loans. As shown in Chart 2, the bank's CRE loan concentration as a percentage of total risk-based capital increased from 480 percent in 2006 to 500 percent in 2008 and exceeded its peer group average.[5] In 2009 and 2010, the bank's declining capital caused its CRE concentration level to spike further. In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans.

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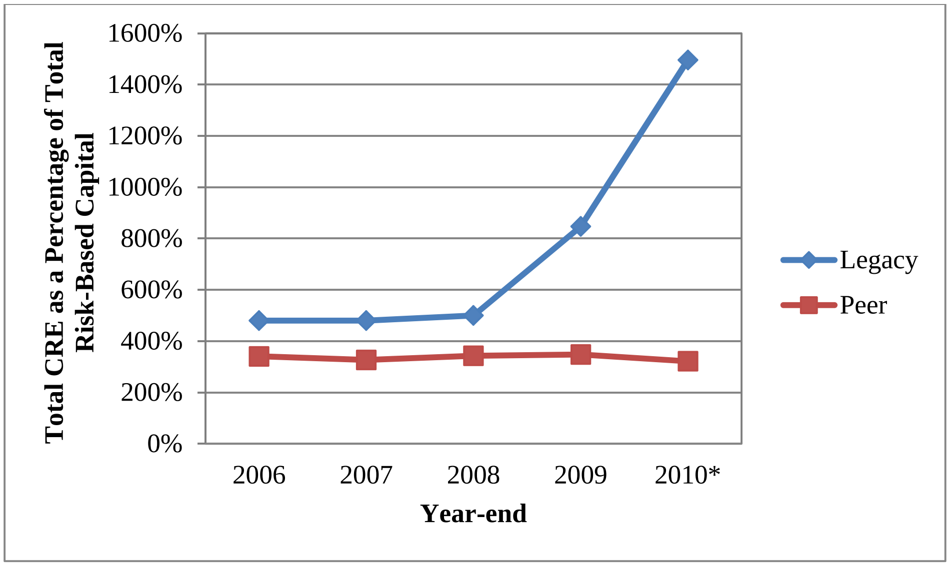
[4] According to the Federal Reserve Board's SR Letter 07-1 (issued in January 2007), *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported loans for construction, land development, and other land represent 100 percent or more of an institution's total capital; or (2) total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

[5] Legacy was in peer group 6 from 2006 to 2010. Peer group 6 consisted of all insured commercial banks having assets between $100 million and $300 million in a metropolitan area with two or fewer full-service offices.

Chart 2: Total CRE Loan Concentration



***Total CRE concentration as of 09/30/2010**

Inadequate Oversight and Poor Internal Controls Resulted in Weak Risk Management

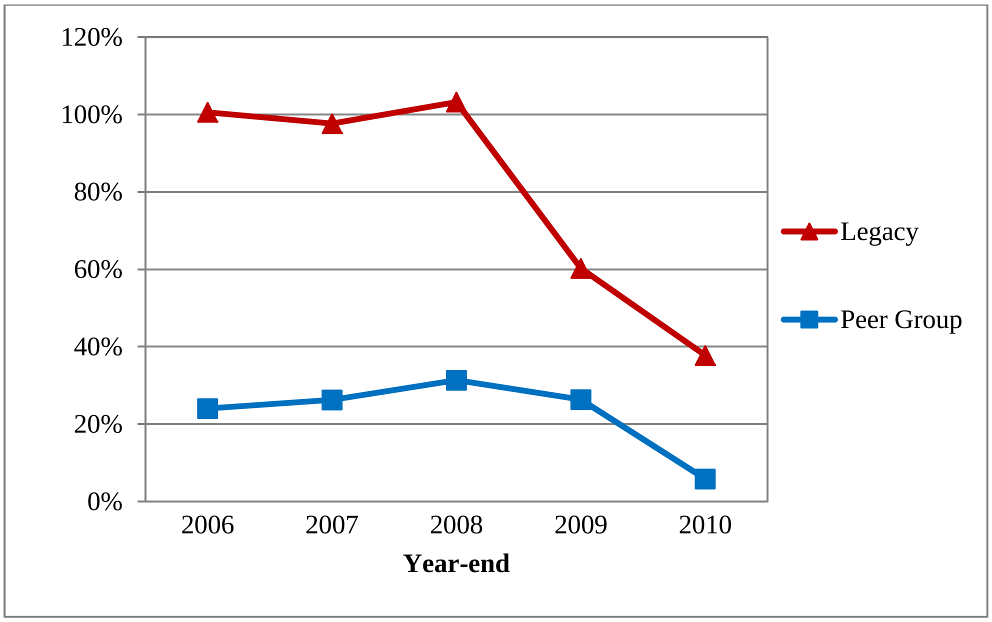
According to examiners, Legacy's Board of Directors' oversight, internal controls, and policy guidance were critically deficient and did not provide adequate controls to manage and mitigate risk. Although the bank's CRE concentration exceeded the threshold described in SR Letter 07-01, management failed to implement the CRE risk management practices set forth in the SR letter. Examiners noted weaknesses in credit risk management regarding real estate concentrations, such as (1) inadequate Board of Directors' oversight, (2) a lack of guidelines and strategies to reduce such concentrations, and (3) insufficient analysis of the potential impact on the bank's CRE loan portfolio in a declining market condition. Examiners also criticized Legacy's weak internal controls that resulted in numerous technical exceptions to the bank's underwriting standards and large overdrafts for extended periods of time. Examiners commented that the bank's weak internal controls also allowed senior management to engage in unsafe and unsound banking practices. Such practices included a senior management official purchasing bank owned real estate using loan proceeds, which violated Regulation O, and an alleged contravention of the bank's Loan Committee approval process by a bank executive who concealed the delinquent status of a customer loan in order to gain loan renewal.[6] In addition, examiners indicated that inconsistency and inaccuracy in management reporting hindered proper identification of concentrations. We believe that the absence of appropriate risk management practices in a weak control environment further increased Legacy's risk profile and vulnerability to declines in the real estate market.

[6] Section 215.4(a)(1) of Regulation O generally prohibits a member bank from extending credit to any insider of the bank unless the extension of credit is made on substantially the same terms as those prevailing at the time for comparable transactions with other persons who are not covered by the regulation and who are not employed by the bank and does not involve more than the normal risk of repayment or present other unfavorable features.

Management Relied Heavily on Non-core Funding Sources

Legacy depended heavily on non-core funding sources such as brokered deposits and Federal Home Loan Bank (FHLB) borrowings to finance its operations and support aggressive growth. According to examiners, the bank faced challenges attracting core deposits due to its mission and geographical location. As noted in Chart 3, from 2006 to 2010, Legacy's reliance on non-core funding sources significantly exceeded its peer group averages. In addition, examiners concluded that the bank's contingency funding plan needed improvement. Lack of a robust contingency funding plan along with continued reliance on non-core funding sources further increased the bank's risk profile.

Chart 3: Net Non-core Funding Dependence Ratio



Legacy Received TARP Funds in January 2009

In October 2008, Legacy's holding company requested funds through the TARP's CPP. FRB Chicago applied Treasury's guidance, *Process for Evaluation of QFI* [Qualified Financial Institutions] *Participation in the TARP Capital Purchase Program*, and concluded that Legacy qualified for "presumptive approval" status. Based on Treasury's guidance, FRB Chicago used the institution's CAMELS composite rating from an examination within the last six months to make that determination.[7] FRB Chicago also supplemented the analysis with the financial performance ratios calculated from the bank's June 30, 2008, financial information. FRB Chicago concluded that the bank's satisfactory CAMELS composite rating indicated there were no significant concerns regarding the bank's viability. Further, the bank was not subject to any

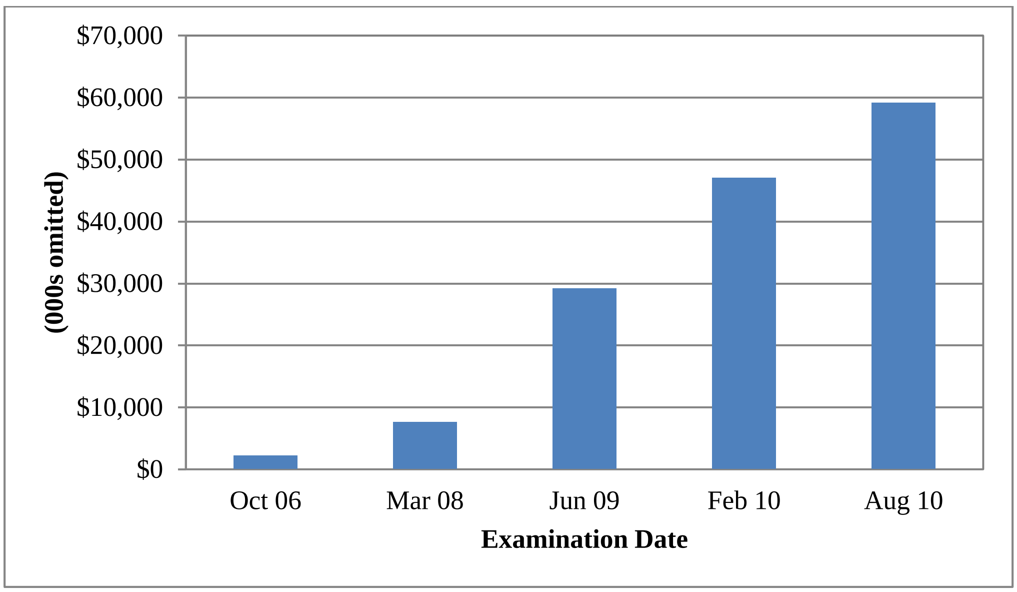
[7] Under the TARP guidance, institutions that were placed in the presumptive approval category had (a) a CAMELS composite rating of 1; (b) a CAMELS composite rating of 2 within the last six months; or (c) a CAMELS composite rating of 2 or 3 with acceptable performance ratios.

enforcement actions at the time of the application. On January 30, 2009, the holding company received $5.5 million in TARP funds, which it injected into Legacy to augment capital.

Declining Local Economy Led to Increased Classified Assets

Declining economic conditions in the bank's market areas resulted in significant asset quality deterioration. According to examiners, Legacy's loan portfolio began to exhibit signs of stress as borrowers with residential rental properties in distressed neighborhoods within the greater Milwaukee area encountered increased vacancies triggered by high unemployment. As shown in Chart 4, Legacy's classified assets increased from $2.2 million in 2006 to $7.7 million in 2008. Classified assets continued to increase rapidly in subsequent years; between 2008 and 2010, the bank's classified assets increased 669 percent, from $7.7 million to $59.2 million.

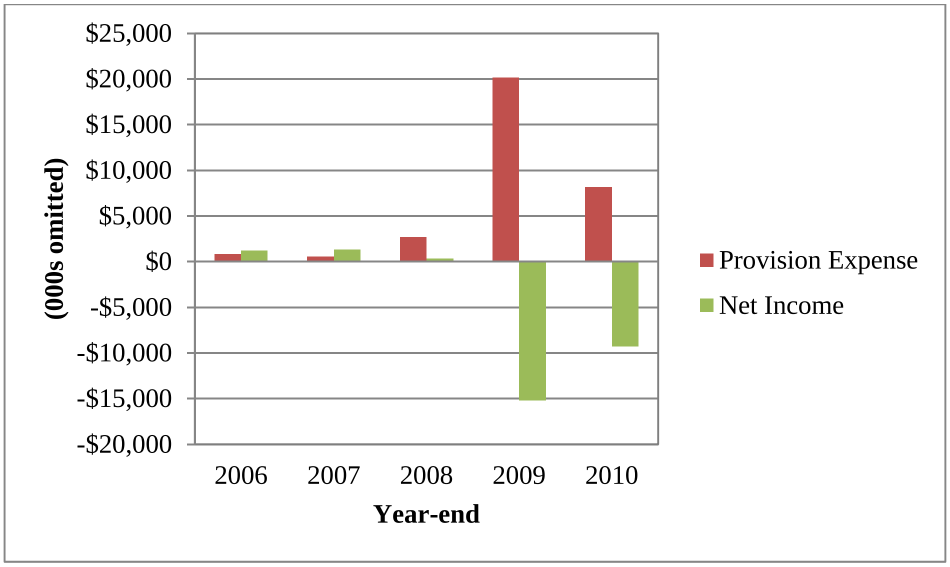
Chart 4: Classified Assets



Asset Quality Deterioration Resulted in Increased Loan Loss Provisions and Depleted Capital

The growth in classified assets required corresponding increases in Legacy's loan loss provisions and adversely affected the bank's earnings. As shown in Chart 5, Legacy's profitability dropped substantially during 2009 and 2010. A 2009 loan loss provision of $20 million depleted the bank's earnings and resulted in a net loss of $15 million, and a 2010 loan loss provision of $8 million led to a net operating loss of $9 million. These net losses significantly eroded Legacy's capital.

Chart 5: Impact of Provision Expense on Earnings



FRB Chicago implemented the PCA provisions of the FDI Act and made timely notifications to the bank when it reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled financial institutions. In August 2010, FRB Chicago notified Legacy that the bank fell from *well capitalized* to *adequately capitalized* under the PCA guidelines, due to the large loss recognized in June 2010.

In September 2010, FRB Chicago notified the bank it had become *significantly undercapitalized* as a result of further losses and required Legacy to submit a capital restoration plan. In October 2010, the bank submitted a capital restoration plan; however, it was deemed unacceptable. Legacy was unable to meet the deadline for a revised capital plan, and in November 2010, the Federal Reserve Board issued a PCA Directive that required Legacy to (1) raise additional capital to achieve the *adequately capitalized* PCA designation, or (2) be acquired by or merge with another depository institution. Legacy's financial condition continued to deteriorate; and in December 2010, FRB Chicago deemed the bank *critically undercapitalized.* Legacy failed to comply with the PCA Directive, and the State closed the bank on March 11, 2011.

Supervision of Legacy Bank

FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2006 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Chicago and the State conducted four full scope examinations, one target examination, one supervisory assessment, and three visitations; executed two enforcement actions—a Written Agreement and a PCA Directive; and implemented the applicable provisions of PCA.

Our analysis of FRB Chicago's supervision of Legacy revealed that examiners identified the bank's fundamental weaknesses, including ineffective Board oversight, poor internal controls, and a high concentration in CRE loans, but did not take early and forceful supervisory action to address those weaknesses.

Table 1: Legacy Supervisory Overview

Examination			Agency Conducting Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
4/10/2006	4/26/2006	Visitation	FRB	n/a							
10/30/2006	12/11/2006	Full	State	2	2	2	2	2	2	2	
3/10/2008	5/23/2008	Full	FRB	2	2	2	2	2	2	2	
2/18/2009	3/16/2009	Supervisory Assessment	FRB	3	2	3	3	3	3	2	
6/22/2009	11/16/2009	Full	Joint	4	4	4	4	5	4	2	Written Agreement
2/1/2010	5/18/2010	Asset Quality Target	Joint[a]	5	5	5	5	5	5	4	
3/17/2010	3/23/2010	Visitation	Joint[b]	n/a							
8/9/2010	11/5/2010	Full	Joint[a]	5	5	5	5	5	5	5	PCA Directive
11/29/2010	1/15/2011[c]	Visitation	Joint[b]	n/a							

[a] FDIC participated in this joint examination.
[b] FDIC participated in this joint visitation.
[c] Based on the exit meeting with Legacy's officials.

FRB Chicago Conducted a Visitation in April 2006

FRB Chicago conducted a visitation in April 2006 to assess Legacy's progress toward addressing deficiencies in credit and operational risk management and consumer compliance identified in 2005. While examiners concluded that the bank's Board of Directors and senior management satisfactorily addressed credit risk management deficiencies in a timely manner, examiners encouraged the bank to (1) update its allowance for loan and lease losses (ALLL) methodology to ensure comprehensive impairment analysis of Legacy's loan portfolio and (2) enhance its real estate evaluation process on loans under $250,000 where a formal appraisal was not required.

Examiners also determined that Legacy appropriately addressed all 2005 examination findings in operational risk management by improving its tracking documentation of audit findings, risk assessment process, and controls over regulatory reporting. Examiners reminded management to reinforce these newly implemented procedures and adjust them as necessary. In addition, examiners acknowledged Legacy's initial progress in improving its consumer compliance programs, but stated that additional work was necessary.

October 2006 State Full Scope Examination Resulted in a CAMELS Composite 2 Rating

In October 2006, the State conducted a full scope examination that assigned the bank a CAMELS composite 2 (satisfactory) rating, and all CAMELS components received 2 ratings. The December 2006 examination report stated that Legacy's overall condition was satisfactory. Legacy's assets continued to grow rapidly, primarily because of strong loan growth, which represented a 29.6 percent growth rate that far exceeded management's projections. According to examiners, Legacy's growth was supported primarily by non-core funding sources, such as brokered deposits and FHLB borrowings. In addition, examiners noted that asset growth outstripped the bank's ability to retain earnings to augment capital; therefore, Legacy relied on capital injections from its parent company. Although asset quality remained favorable and classified assets decreased slightly from $2.3 million at the previous examination to $2.2 million, examiners warned that the bank's loan portfolio would require close monitoring to avoid potential losses. The State also cited management's inconsistency in applying the bank's newly implemented real estate evaluation process for loans under $250,000, including numerous technical exceptions and missing loan documentation.

March 2008 FRB Full Scope Examination Resulted in Another CAMELS Composite 2 Rating

In March 2008, FRB Chicago conducted a full scope examination that preserved Legacy's prior CAMELS composite and component ratings. The May 2008 examination report described the bank's financial condition as satisfactory. Examiners noted that Legacy's risk management policies and procedures improved and were generally acceptable for the bank's risk profile. Examiners also stated that Legacy's earnings were sufficient to augment capital and support moderate growth without relying on government grants and awards.

While citing positive trends in the bank's performance, examiners predicted challenges resulting from changing market conditions due to (1) Legacy's aggressive growth strategy; (2) a declining capital position; (3) a heavy reliance on non-core funding sources; and (4) a considerable increase in classified assets. Although FRB Chicago rated Legacy's capital as "adequate," examiners noted Legacy's capital level had declined as a result of aggressive loan growth and encouraged management to formalize capital guidelines to monitor and ensure capital adequacy. Examiners also noted that management supported Legacy's aggressive growth with non-core funding sources because of the bank's difficulties increasing core deposits. Examiners stated that management's continued reliance on non-core funding sources was not sustainable.

Examiners rated Legacy's asset quality CAMELS component a 2 despite signs of declining asset quality. The bank's classified assets increased 250 percent, from $2.2 million at the 2006 examination to $7.7 million. Examiners rated Legacy's credit risk management "marginally acceptable" and noted moderately high inherent credit risk with an increasing trend. The bank had a large concentration in CRE loans, which represented 479 percent of the bank's total risk-based capital. Examiners noted several weaknesses in credit risk management regarding real estate concentrations, such as (1) inadequate Board of Directors' oversight, (2) a lack of guidelines and strategies to reduce such concentrations, and (3) insufficient analysis of the potential impact on the bank's CRE loan portfolio in a declining market condition. Examiners also cited inaccurate and inconsistent management information reporting, numerous technical exceptions in credit underwriting, and an unsafe and unsound practice of allowing large overdrafts for extended periods of time. In addition, the May 2008 examination report stated that Legacy's external auditors reported a "significant deficiency" in the bank's internal controls over financial reporting, specifically missing impairment analysis for certain loans. Examiners reiterated the importance of strong credit risk management practices—effective oversight, ongoing communication, and appropriate performance measurements and guidelines—which would enable the Board of Directors and management to respond timely and effectively to changing economic conditions.

In our opinion, the March 2008 full scope examination presented an opportunity for stronger supervisory action. We believe that the findings noted during this examination warranted stronger criticism, including CAMELS composite and component rating downgrades.

Legacy Received TARP Funds in January 2009

In October 2008, the bank's holding company applied for funds through the TARP's CPP, and FRB Chicago evaluated the application. FRB Chicago followed Treasury's guidance, entitled *Process for Evaluation of QFI Participation in the TARP Capital Purchase Program*. In applying this guidance, FRB Chicago concluded that Legacy qualified for presumptive approval status because of the CAMELS composite 2 rating issued within the previous six months. In our opinion, FRB Chicago complied with Treasury's guidelines and the limited decision-making criteria available at the time. Even if Legacy had received a CAMELS composite 3 rating during the previous examination, the bank would have qualified for presumptive approval status based on its acceptable performance ratios.[8]

February 2009 FRB Chicago Supervisory Assessment Revealed Deteriorating Asset Quality, Resulting in a CAMELS Composite Downgrade

As a result of on-going monitoring of the general economic trends and Legacy's condition, FRB Chicago determined that there was strong evidence of the bank's deteriorating condition and conducted a supervisory assessment in February 2009. Examiners reviewed Legacy's financial information, which indicated substantial deterioration in asset quality and earnings and a continued reliance on non-core funding sources. Examiners downgraded Legacy's CAMELS composite rating to a 3 (fair) and the asset quality, management, earnings, and liquidity component ratings to 3. The capital and sensitivity to market risk components remained at 2. Examiners expressed heightened concerns over declining asset quality and attributed Legacy's deteriorating condition to a downturn in the local economy. Examiners also noted that actions

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

taken by management may have been "insufficient to prevent further deterioration" and urged the bank to take additional steps to improve its credit management.

June 2009 Joint Full Scope Examination Resulted in Another CAMELS Composite Downgrade and a Written Agreement

In June 2009, the State led a joint full scope examination, which resulted in a CAMELS composite downgrade to 4 (marginal). Legacy's capital, asset quality, management, and liquidity components received 4 ratings; the earnings component was double downgraded to 5; and sensitivity to market risk remained a 2. In the November 2009 examination report, examiners observed that the recession had adversely affected the bank's financial condition considerably, with classified assets more than tripling since the March 2008 examination. Examiners commented that Legacy's credit risk management program was not sufficient to control the risk and anticipated further credit losses.

Examiners considered asset quality "critically deficient" as classified assets increased from $7.7 million at the March 2008 examination to $29.3 million. Examiners expressed concern about Legacy's continued CRE concentration, with 52 percent of the bank's loan portfolio consisting of CRE loans. According to examiners, Milwaukee's real estate market significantly declined in value and, as deteriorating economic conditions left residential, non-owner occupied rental properties vacant, borrowers' resources to service the loans became scarce, resulting in increased delinquencies.

Legacy's earnings were also critically deficient because of increased loan loss provisions. The bank applied for two federal government grants to provide funding to the ALLL and received one grant while awaiting confirmation of the second grant.[9] Examiners projected that without the second grant the bank would likely incur a net operating loss. In addition, examiners noted that Legacy's capital increased due to a $5.5 million capital injection obtained through the TARP CPP program. However, considering the bank's increased risk profile and declining economic conditions, examiners rated Legacy's capital "less than satisfactory." Examiners also commented that Legacy's deteriorating financial condition and management's continued reliance on non-core funding sources threatened the bank's liquidity.

As a result of this examination, FRB Chicago and the State implemented a formal enforcement action in the form of a Written Agreement on April 27, 2010, which required the Board of Directors to address a variety of weaknesses, including the oversight of management and bank operations, credit risk management and administration, the loan review program, overall loan improvement, the ALLL, a capital plan, liquidity and funds management, lessening reliance on brokered deposits, submission of a strategic plan and budget, and anticipated cash flow.

[9] Legacy received $1 million in a Financial Assistance Award and $700,000 in a Bank Enterprise Award from programs under the Treasury in 2009.

February 2010 Joint Asset Quality Examination Resulted in a Joint Visitation in March 2010 and a Downgrade to a CAMELS Composite 5 Rating

In February 2010, FRB Chicago led a joint target examination that resulted in a CAMELS composite rating downgrade to 5 (critically deficient). All CAMELS components received 5 ratings except the sensitivity to market risk component, which was downgraded to 4. Examiners labeled Legacy's condition "critically deficient" and expressed heightened concern over the bank's viability.

Legacy's loan classifications increased $17.8 million in eight months, or 61 percent, from $29.3 million to $47.1 million. Examiners attributed the increase to loans to borrowers with residential rental properties in distressed neighborhoods where high unemployment led to increased vacancies. Examiners criticized Legacy's credit risk management practices and stated that inadequate oversight of the bank's lending activities fostered "a culture of undisciplined credit administration" and resulted in concentration risk, deficient credit analysis and underwriting, and increased loan losses. Examiners noted that management had not established a realistic plan to effectively manage problem loans or implemented a consistent loan analysis system to identify and measure risk in the bank's loan portfolio. In addition, examiners commented that inconsistency in management reporting and inadequate policies and procedures hindered management's collection efforts.

Earnings and capital were critically deficient because of increased loan loss provisions and resultant capital erosion. Although Legacy was *well capitalized* during the examination, examiners commented that rapidly deteriorating asset quality and depleting capital necessitated immediate capital augmentation. Examiners also noted increased liquidity risk due to the bank's continued high reliance on non-core funding sources and urged management to enhance its contingent funding capacity and reduce non-core funds.

Examiners learned of alleged insider abuse during the examination, which prompted FRB Chicago to begin a joint visitation in March 2010. Examiners focused on lending activities related to one customer and whether a bank executive concealed the delinquent status of the customer's loan to gain Loan Committee approval for renewal. The March 2010 visitation memorandum stated that although the bank executive's lending activities regarding the loan customer appeared suspicious, there was insufficient evidence to prove that the alleged insider abuse actually occurred. Nonetheless, the Board of Directors relieved the bank executive of the duties associated with the position in April 2010. According to the May 2010 examination report, examiners also identified a violation of Regulation O by another senior management official. With respect to the relevant loan, the official allegedly used the proceeds to purchase other real estate owned by Legacy. Examiners attributed the incidents to the bank's weak internal controls and required management to implement improved controls to monitor transactions.

August 2010 Joint Full Scope Examination Maintained Legacy's CAMELS Composite Rating, Resulting in a PCA Directive

In August 2010, FRB Chicago led a joint full scope examination that resulted in another CAMELS composite 5 rating, with all CAMELS components receiving 5 ratings. Shortly before the examination, FRB Chicago notified Legacy that its PCA designation declined from *well capitalized* to *adequately capitalized* and further dropped to *significantly undercapitalized* during the examination. The November 2010 examination report indicated that the bank was "in imminent danger of failure" because the Board of Directors' and management's efforts to augment capital had been unsuccessful.

Asset quality remained critically deficient and continued to threaten the bank's viability. Legacy's classified assets increased $12.1 million since the February 2010 target examination, from $47.1 million to $59.2 million. Additionally, examiners noted that credit risk management remained unsatisfactory and, while acknowledging management's action taken to date, urged the bank to continue efforts to mitigate risk.

Legacy's liquidity also remained critically deficient, with increased risk. According to examiners, the bank had limited access to diversified funding sources and was subject to restrictions on brokered deposits and national rates due to its PCA designation.[10] Examiners expressed concerns over "a potential funding crisis" and stated that examiners would continue to monitor liquidity risk carefully for any indication of a liquidity shortage because of the bank's volatile and limited liquidity resources.

Examiners criticized Legacy's poor Board of Directors and senior management oversight, weak credit and liquidity risk management practices, and heightened concentration risk in local real estate lending. Examiners also commented that the bank's lack of sound credit analysis and underwriting, ineffective asset and liability management, and weak internal controls contributed to Legacy's deteriorating condition. Deficient oversight and weak internal controls were also evidenced by a lack of accurate financial information. Following the resignation of the bank's Chief Financial Officer in September 2010, an external consultant discovered numerous errors in the bank's financial information, requiring regulatory report re-filings and amended financial reports.

In November 2010, the Federal Reserve Board issued a PCA Directive that directed Legacy to (1) increase the bank's equity to return the bank to *adequately capitalized*; (2) enter into or close a contract to be acquired by another depository institution; or (3) take other necessary measures to make the bank *adequately capitalized*.

[10] When a bank becomes *adequately capitalized* under the PCA guidelines, the bank is prohibited, under the FDI Act, from accepting, renewing, or rolling over any brokered deposits, and there are limits on interest rates that the bank can offer on certain deposits.

November 2010 Joint Visitation Focused on ALLL and a Follow-up Review of Possible Insider Abuse

FRB Chicago led a joint visitation that began in November 2010. Examiners conducted a brief review of the bank's ALLL, assessing the adequacy of the work provided by the bank's external consultant. Examiners determined that the consultant's review of Legacy's ALLL was unsatisfactory and resulted in an inadequately funded loan reserve. Additionally, examiners performed a follow-up review of alleged insider abuse by a bank executive. Examiners stated that a lack of adequate policies and procedures, coupled with inadequate supporting documentation, made it difficult to determine whether a transaction was erroneous or a violation of bank policy. This visitation did not result in a full resolution of the alleged insider abuse, but revealed the severity of the bank's internal control weaknesses and deficient policies and procedures. Examiners expressed concerns over actions by other bank employees and noted that distressed banks with weak internal controls are vulnerable to improper actions by employees—Legacy's risk of insider abuse had increased. However, FRB Chicago concluded that further investigation of potential insider abuse was not feasible during the visitation due to pressing supervisory concerns about the bank's viability. FRB Chicago referred the case to the appropriate authorities.

In December 2010, an additional loan provision resulted in Legacy becoming *critically undercapitalized* under PCA guidelines. Despite some prospects for additional capital, management's efforts to raise capital never materialized. The State closed the bank on March 11, 2011, and appointed the FDIC as receiver.

Conclusions and Lessons Learned

Legacy failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which focused on lending in low-to-moderate income neighborhoods within the city of Milwaukee. The bank was a CDFI that provided financial services to customers in an underserved community. Management depended on non-core funding sources to support the bank's growth strategy, which included providing loans to revitalize residential housing and commercial properties in distressed neighborhoods in Milwaukee. This strategy resulted in the bank developing a concentration in CRE loans and becoming vulnerable to a downturn in the local economy. Legacy's Board of Directors' and management's failure to implement risk management practices commensurate with the bank's increased risk profile, coupled with a weakening real estate market, led to rapid asset quality deterioration. Mounting losses eliminated the bank's earnings and depleted capital, which prompted the State to close Legacy and appoint the FDIC as receiver on March 11, 2011.

With respect to supervision, FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2006 through 2011, and conducted regular off-site monitoring. During this period, FRB Chicago and the State conducted four full scope examinations, one target examination, one supervisory assessment, and three visitations; executed two enforcement actions; and implemented the applicable PCA provisions.

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 a loss to the DIF. Our analysis of FRB Chicago's supervision of Legacy revealed that FRB Chicago identified the bank's fundamental weaknesses, including ineffective Board oversight, poor internal controls, and a high concentration in CRE loans, but did not take early and forceful supervisory action to address those weaknesses.

We believe that the March 2008 full scope examination presented an opportunity for stronger supervisory action. In the May 2008 examination report, examiners expressed some concern over the bank's future performance because of Legacy's aggressive growth strategy; a heavy reliance on non-core funding sources; declining capital induced by aggressive growth; and a considerable increase in classified assets. Legacy's aggressive growth was supported by management's continuous reliance on non-core funding sources. In addition, while Legacy remained *well capitalized* for PCA purposes, its capital was declining as a result of rapid growth and there was a 250 percent increase in the bank's classified assets. Moreover, examiners noted Legacy's concentration in CRE loans and identified weaknesses in credit risk management regarding real estate concentrations, such as (1) inadequate Board of Directors' oversight, (2) a lack of guidelines and strategies to reduce such concentrations, and (3) insufficient analysis of the potential impact on the bank's CRE loan portfolio in a declining market condition. In our opinion, the findings noted during this examination warranted stronger criticism, including CAMELS composite and component rating downgrades.

In October 2008, Legacy's holding company applied for TARP funds under the CPP, and FRB Chicago evaluated the application. In applying Treasury's evaluation guidance, FRB Chicago concluded that Legacy qualified for presumptive approval status because the bank had a satisfactory CAMELS composite rating at the May 2008 examination report and Legacy's financial performance measures as of June 30, 2008, indicated that there were no significant concerns regarding the bank's viability. We believe that FRB Chicago complied with the process outlined in the Treasury guidance for banks that had been examined during the previous six months and the decision-making criteria available at the time. Even if Legacy had received a CAMELS composite 3 rating during the 2008 full scope examination, the bank would have qualified for presumptive approval status based on its acceptable performance ratios.

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

Lessons Learned

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that Legacy's failure offers lessons learned that can be applied to supervising banks with similar characteristics. In our opinion, Legacy's failure demonstrates the importance of (1) examiners assuring that management implements credit risk management practices commensurate with the bank's strategy and risk profile, including CRE concentration levels, and (2) supervisors assigning CAMELS composite and component ratings consistent with the examination's findings and narrative examination comments.

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. The Director concurred with the lessons learned contained in the report and acknowledged the importance of assigning CAMELS ratings that are consistent with examination findings and narrative comments. Specifically, the Director concurred with our assessment that Reserve Bank staff had opportunities to take earlier and more aggressive supervisory action when risk management weaknesses were identified. His response is included as Appendix 3.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)

A valuation reserve established and maintained by charges against the bank's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. The reserve must be sufficient to absorb probable losses inherent in the institution's loan and lease portfolio.

Classified Assets

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

Commercial and Industrial Loans

Loans to a corporation, commercial enterprise, or joint venture that are not ordinarily maintained in either the real estate or consumer installment loan portfolios. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the bank operates, most commercial and industrial loans will primarily be made in the form of a seasonal or working-capital loan, term business loan, or loan to an individual for a business purpose.

Commercial Real Estate (CRE) Loans

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

Concentration

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

Appendix 1 (continued)

Enforcement Actions

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

Federal Home Loan Bank

One of 12 banks chartered by Congress in 1932 to provide low-cost credit to residential housing lenders. Federal Home Loan Banks help meet the borrowing needs of communities by providing credit products and services to member financial institutions. Each bank is privately owned by its members, which include commercial banks, savings institutions, credit unions, thrift and loan companies, and insurance companies.

Liquidity

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

Net Non-core Funding Dependence Ratio

A ratio that measures the extent to which a bank is funding longer-term assets with non-core funding. The net non-core funding dependence ratio is calculated by dividing the difference between an institution's non-core liabilities and short-term investments by long-term assets. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Non-core Funding

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

Prompt Corrective Action (PCA)

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

Appendix 1 (continued)

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.

Underwriting

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

Written Agreement

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

Appendix 2 – CAMELS Rating System

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

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

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2 (continued)

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Division Director's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of Banking Supervision and Regulation

Date: December 9, 2011

To: Anthony Castaldo, Associate Inspector General for Inspections and Evaluations

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

Subject: In-Depth Review of Legacy Bank, Milwaukee, Wisconsin

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The staff of the Division of Banking Supervision and Regulation has reviewed the draft In-Depth Review Report (Report) of Legacy Bank (Legacy), Milwaukee, Wisconsin, prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act. The report finds that Legacy failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy that resulted in a high concentration of commercial real estate loans, which made the bank vulnerable to a downturn in the local economy. Legacy was supervised by the Federal Reserve Bank of Chicago (FRB Chicago) under delegated authority from the Board.

FRB Chicago complied with examination frequency guidelines for the time period that was reviewed, 2006 through 2011. During this time FRB Chicago and the Wisconsin Department of Financial Institutions conducted four full scope examinations, one target examination, one supervisory assessment, three visitations, and conducted regular off-site monitoring. Further, supervisors executed two formal enforcement actions with the bank and implemented all applicable PCA provisions. The report recognizes that examiners identified key weaknesses that contributed to the bank's failure, but the report concludes that examiners did not act on opportunities to take earlier and more forceful supervisory action that might have prompted management to resolve identified weaknesses.

Banking Supervision and Regulation staff concurs with the lessons learned in the report. Staff acknowledges the importance of assigning CAMELS composite and component ratings that are consistent with examination findings and narrative comments. Moreover, staff concurs with the report's observations that Reserve Bank staff had opportunities to take earlier and more aggressive supervisory action when risk management weaknesses were identified. The report reinforces the importance of ensuring that a bank's risk management practices are commensurate with its strategy and risk profile.

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

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