Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-010

Material Loss Review of Bank of Lincolnwood, Lincolnwood, Illinois

December 2009

Office of
Inspector General

Executive Summary

Material Loss Review of Bank of Lincolnwood, Lincolnwood, Illinois

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Why We Did The Audit

On June 5, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR), Division of Banking, closed the Bank of Lincolnwood (Lincolnwood), Lincolnwood, Illinois, and named the FDIC as receiver. On June 19, 2009, the FDIC notified the Office of Inspector General (OIG) that Lincolnwood's total assets at closing were $217.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $81.4 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Lincolnwood.

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

Lincolnwood was a state-chartered nonmember bank insured since February 20, 1954. The bank was headquartered in Lincolnwood, Illinois, and had one branch that was also located in Lincolnwood. The bank was a wholly owned subsidiary of Lincolnwood Bancorp, Inc. Lincolnwood engaged principally in commercial real estate (CRE) and acquisition, development, and construction (ADC) lending within its local marketplace.

Audit Results

Causes of Failure and Material Loss

Lincolnwood failed because the bank's Board and management did not implement adequate (1) risk management practices pertaining to a significant concentration in ADC loans, (2) controls related to loan underwriting and credit administration, and (3) risk analysis and recognition practices. Also contributing to Lincolnwood's losses was management's failure to take timely and effective action to address apparent violations and contraventions of interagency policy. Further, the Board and management paid insufficient attention to controls over insider activity, a contributing factor in the bank's failure. Finally, Lincolnwood's reliance on volatile funding sources for its loan portfolio played a lesser, yet important role, in the bank's failure.

Examiners repeatedly expressed concern about Lincolnwood's risk management practices in the years preceding the institution's failure and made a number of recommendations for improvement. However, the actions taken by Lincolnwood's Board and management were not timely or adequate. In a declining real estate market, Lincolnwood could not withstand significant ADC loan losses, which led to quick and substantial erosion of the bank's capital and earnings, and significantly impaired the bank's liquidity position. Ultimately, on June 5, 2009, the IDFPR closed Lincolnwood due to the bank's overall poor financial condition and inability to raise capital at the required level, and named the FDIC as receiver.

The FDIC's Supervision of Lincolnwood

The FDIC's supervisory efforts identified key risks and made recommendations related to the performance of Lincolnwood's management, the bank's ADC and relationship concentrations, loan underwriting and credit administration deficiencies and weak risk management practices, reliance on non-

core deposits and unsatisfactory liquidity levels, and inadequate capital position. Examiners also reported apparent violations of law and contraventions of policy associated with the institution's lending practices and insider transactions. The FDIC, in conjunction with IDFPR, also pursued enforcement actions to correct problems as the result of the 2005, 2008, and 2009 examinations. However, earlier and stronger supervisory action could have been taken, in light of the significant risk that the bank's business strategy presented during the 2005 and 2008 examinations. Such action may have resulted in management being more responsive to examiner concerns regarding risks and mitigated, to some extent, the losses incurred by the DIF.

With respect to PCA, we concluded that the FDIC properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for Lincolnwood.

Management Response

After we issued our draft report, we met with management officials to further discuss our results. The officials indicated that there were no corrections or additions needed to the report.

On December 14, 2009, the Director, DSC, provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of Lincolnwood's failure. With regard to our assessment of the FDIC's supervision of Lincolnwood, DSC stated that the January 2008 examination resulted in the recommendation for a Memorandum of Understanding, which became effective in October 2008. At the September 2008 visitation, the examiner reviewed Lincolnwood's corrective actions, noted continued problems and deterioration, and recommended that a full-scope examination start in February 2009. As a result of that examination, a formal enforcement action, effective in April 2009, was issued requiring Lincolnwood's Board and management to address weak risk management practices and formulate a contingency liquidity plan.

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Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226 Office of Inspector General

DATE: December 16, 2009

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

/Signed/

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

SUBJECT: *Material Loss Review of Bank of Lincolnwood, Lincolnwood, Illinois* (Report No. MLR-10-010)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Bank of Lincolnwood (Lincolnwood), Lincolnwood, Illinois. On June 5, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR), Division of Banking, closed the institution and named the FDIC as receiver. On June 19, 2009, the FDIC notified the OIG that Lincolnwood's total assets at closing were $217.4 million and the material loss to the Deposit Insurance Fund (DIF) was $81.4 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); ascertains why the institution's problems resulted in a material loss to the DIF; and makes recommendations to prevent future losses.

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38 of the FDI Act. This report presents the FDIC OIG's analysis of Lincolnwood's failure and the FDIC's efforts to ensure Lincolnwood's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and

[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices, including internal control systems, and compliance with applicable laws and regulations, and (2) issues related guidance to institutions and examiners.

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

Background

Lincolnwood was a state-chartered nonmember bank insured by the FDIC on February 20, 1954. Lincolnwood was headquartered and operated a main office and one branch in Lincolnwood, Illinois. Lincolnwood was a full-service community bank that specialized in residential and commercial real estate (CRE) loans, including residential acquisition, development and construction (ADC) loans. The institution was wholly-owned by a one-bank holding company, Lincolnwood Bancorp, Inc., in Lincolnwood, Illinois. Table 1 provides details on Lincolnwood's financial condition, as of December 2008, and for the 4 preceding calendar years.

Table 1: Financial Condition of Lincolnwood

Financial Measure	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets ($000)	$217,729	$210,218	$237,702	$233,109	$224,276
Total Loans ($000)	$181,147	$189,461	$210,846	$186,881	$190,476
Total Deposits ($000)	$201,134	$190,405	$215,366	$212,867	$206,080
Net Income (Loss) ($000)	($975)	$4,242	$6,540	$5,059	$4,055

Source: OIG analysis of Uniform Bank Performance Reports (UBPR) for Lincolnwood.

Causes of Failure and Material Loss

Lincolnwood failed because the bank's Board and management did not implement adequate (1) risk management practices pertaining to a significant concentration in ADC loans, (2) controls related to loan underwriting and credit administration, and (3) risk analysis and recognition practices. Also contributing to Lincolnwood's losses was management's failure to take timely and effective action to address apparent violations and contraventions of interagency policy. Further, Board and management paid insufficient attention to controls over insider activity, a contributing factor in the bank's failure. Finally, Lincolnwood's reliance on volatile funding sources for its loan portfolio played a lesser, yet important role, in the bank's failure.

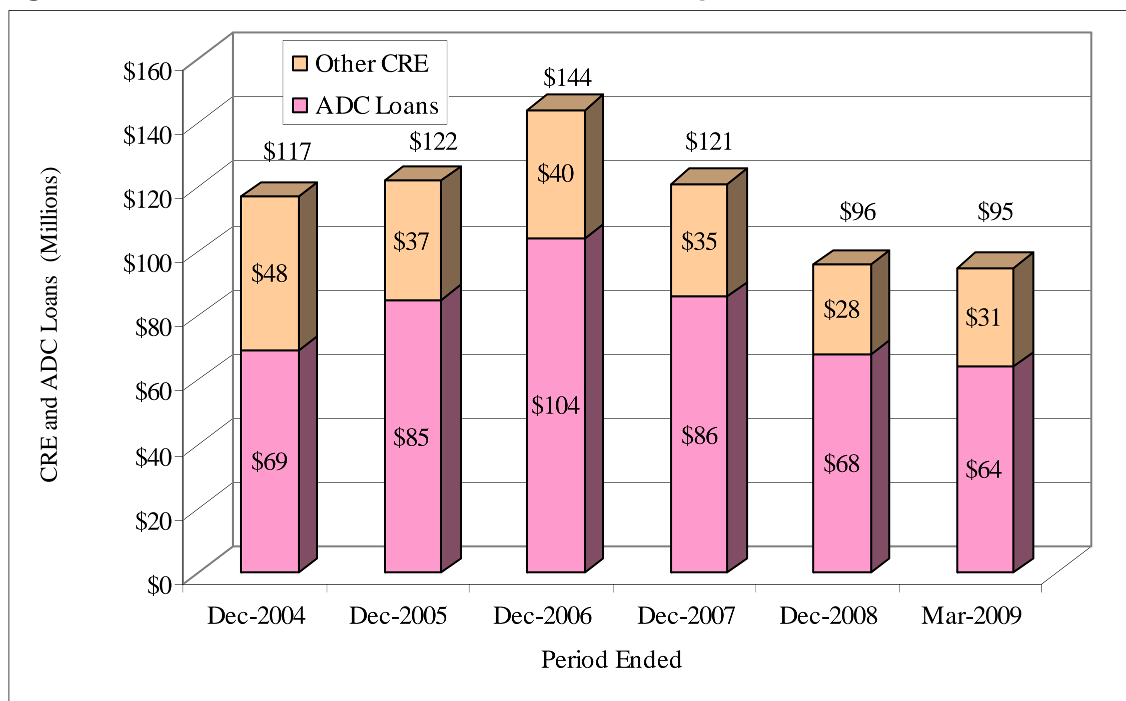
Examiners repeatedly expressed concern about Lincolnwood's risk management practices in the years preceding the institution's failure and made a number of recommendations for improvement. However, the actions taken by Lincolnwood's Board and management were not timely or adequate. In a declining real estate market, Lincolnwood could not

withstand significant ADC loan losses, which led to quick and substantial erosion of the bank's capital and earnings, and significantly impaired the bank's liquidity position. Ultimately, on June 5, 2009, the IDFPR closed Lincolnwood due to the bank's overall poor financial condition and inability to raise capital at the required level, and named the FDIC as receiver.

Loan Concentrations

Lincolnwood's management failed to effectively measure and monitor the high risk associated with its loan portfolio, which was concentrated in high-risk CRE loans, and specifically centered in ADC loans. Figure 1 illustrates the composition of Lincolnwood's CRE and ADC loan portfolio from December 2004 through March 2009.

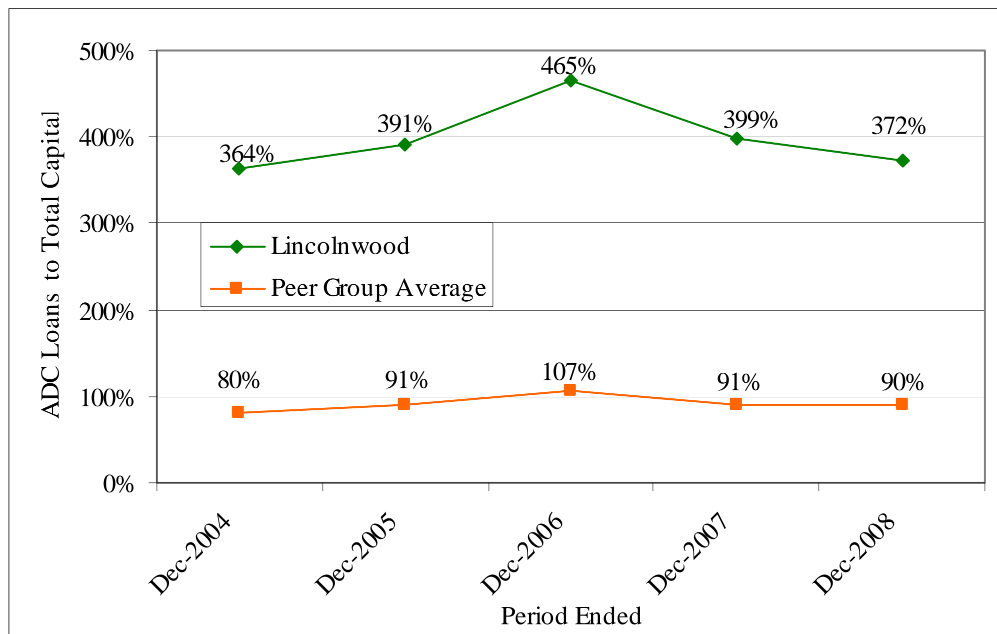
Figure 1: Lincolnwood's CRE and ADC Loan Composition



Source: Consolidated Reports of Condition and Income (Call Report) for Lincolnwood.

Although Lincolnwood developed and maintained a high concentration in CRE loans, the significant losses associated with its loan portfolio were centered in the bank's ADC concentration. In addition, Lincolnwood's ADC concentration as a percentage of total capital was significantly above the bank's peer group averages from 2004 through 2008, as shown in Figure 2.

Figure 2: Lincolnwood's ADC Loan Concentration Relative to Peer Group



Source: UBPRs for Lincolnwood.

According to Financial Institution Letter (FIL)104-2006, entitled, *Concentrations in Commercial Real Estate, Sound Risk Management Practices*, dated December 12, 2006, CRE loan concentrations can pose substantial potential risks and can inflict large losses on institutions. Since ADC loans are a subset of CRE loans, the guidance emphasizes the need for increased supervisory concern for banks with significant ADC concentrations and states that institutions with total reported loans for construction, land development, and other land representing 100 percent or more of the institution's total capital may warrant greater supervisory scrutiny.[3]

Further compounding the bank's concentration risk was the speculative nature of its ADC lending associated with residential properties that were not pre-sold or pre-leased, and that were dependent on the market to absorb the properties when completed. In addition, in 2007 and 2008, the bank had several large relationship concentrations, each of which exceeded 25 percent of Tier 1 Capital.[4] For example, the February 2009 examination report[5] identified a relationship concentration which consisted of five loans, under various entities, totaling $15.6 million that were, in effect, secured by three residential

[3] Previous guidance issued by the FDIC included FIL-110-98, dated October 8, 1998, entitled *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, defines ADC lending as a highly specialized field with inherent risks that must be managed and controlled to ensure that the activity remains profitable.

[4] As stated in the Concentrations section of examination reports, concentrations of obligations, direct and indirect, are determined, in part, by the following guideline: concentrations of 25 percent or more of Tier 1 Capital by individual borrower, small interrelated group of individuals, single repayment source or individual project.

[5] The February 2009 examination report was drafted but not finalized and issued to Lincolnwood prior to its failure. Unless otherwise noted in this report, references to examination dates will refer to the month and year of the examination start dates.

properties and a residential lot. This concentration was adversely classified by examiners and noted as an example of management's failure to diversify risk. The level of risk related to ADC and relationship concentrations was a significant factor in the bank's loan quality problems when the real estate market deteriorated.

Loan Underwriting and Credit Administration

Weaknesses in Lincolnwood's loan underwriting and credit administration contributed to the significant deterioration of the bank's asset quality. Lincolnwood's Board and management failed to establish and follow adequate controls related to these areas. As early as the April 2005 examination, examiners noted numerous underwriting and credit administration weaknesses. Further, examiners reminded management that delays in correcting weaknesses and continued poor oversight may further weaken credit administration and increase the overall risk to the institution. Such weaknesses included:

<u>Loan Underwriting</u>

- When prepared, loan presentations to the Board lacked pertinent information and relevant credit factors needed to make informed and appropriate credit decisions. Specifically, examiners noted that one or more of the following items was missing from loan presentations: the purpose of the loan, capacity of the borrower or guarantor to repay the debt, debt-to-income calculations, and collateral protection.

- Failure to obtain or properly document the review of appraisals before loan origination.

- Loan files that lacked officer memoranda to document important discussions or actions, thus making it difficult to ascertain whether any material events affecting credit quality had occurred since the loan origination.

- Lack of feasibility analyses for evaluation of large complex credits.

- Lack of shock analyses and global cash flow analyses on borrowers with multiple projects or properties.

<u>Credit Administration</u>

- Inappropriate use of interest reserves for loans where the underlying real estate project was not performing as expected.

- Failure to develop an adequate loan review and grading system to identify problem loans.

- Lack of documentation of a process to reconcile internal loan ratings with the external loan review results.

- Failure to obtain appraisals for loan renewals.

Risk Analysis and Recognition Practices

A significant number of risk analysis and recognition weaknesses also contributed to the bank's asset quality problems. Lincolnwood had a high level of past due and nonaccrual loans, which led to further deterioration in the bank's loan quality and contributed to significant loan losses.

Other risk analysis weaknesses included the:

- failure to properly report nonaccrual loans and downgrade credits when appropriate and perform portfolio-level stress testing or sensitivity analysis, and
- lack of a formal method to monitor the loan portfolio and address renewals and extensions of loans within the bank's loan policy.

Further, Lincolnwood's management did not consistently employ an Allowance for Loan and Lease Losses (ALLL) methodology in compliance with the December 13, 2006, *Interagency Policy Statement on Allowance for Loan and Lease Losses*. This policy states that each institution must analyze the collectibility of its loans and maintain an ALLL at an appropriate level. At the January 2008 and February 2009 examinations, examiners concluded that Lincolnwood's ALLL was insufficient to protect against the level of potential loss in the bank's loan portfolio.

Apparent Violations and Contraventions of Interagency Policy Statements

According to the Examination Manual, it is important for a financial institution's Board to ensure that bank management is cognizant of applicable laws and regulations, develops a system to effect and monitor compliance, and when violations do occur, makes corrections as quickly as possible. In addition, the Examination Manual states that the underlying rationale for laws and regulations is the protection of the general public by establishing boundaries and standards within which banking activities may be conducted.

Examiners cited apparent violations and contraventions in each of the bank's examinations from 2004 through 2009 that involved unsafe and unsound practices and deficiencies in appraisals, real estate lending, external auditing programs, and the bank's ALLL methodology. In addition, Lincolnwood had not had an external audit performed since year-end 2004. Such audits help ensure that banks maintain a system of independent review and provide appropriate and timely communication to the Board and bank management. Lincolnwood's Board and management failed to take timely and effective action to address these findings, as evidenced by the number of repeat apparent violations and contraventions.

Implementation of Examiner Recommendations

Prior to Lincolnwood's failure, FDIC and IDFPR examiners repeatedly expressed concerns about the institution's financial condition and risk management practices and made recommendations for improvement. However, actions taken by Lincolnwood's

Board and management were not always timely or effective to adequately address examiner concerns.

- **April 2005 examination**. Examiners concluded that several deficiencies identified at prior regulatory examinations had received little, if any, attention by bank management. Examiners noted that recommendations related to measuring and monitoring procedures for Sensitivity to Market Risk had not been implemented despite management's promised corrective action.

- **January 2008 examination**. Examiners concluded that the bank's responsiveness to examiner recommendations was insufficient. Although management had taken action to address some of the examiners' recommendations, the bank had not addressed recommendations pertaining to apparent violations and contraventions that had been identified as far back as the April 2005 and May 2006 examinations.

- **February 2009 examination**. Examiners concluded that although the January 2008 examination included a recommendation for bank management to improve loan procedures, limits, and monitoring, Lincolnwood's management had shown a total disregard for the recommendation and several other prior recommendations. For example, examiners repeated recommendations related to concentration monitoring made at the January 2008 examination.

Insider Activity

The primary responsibility for ensuring compliance with laws and regulations related to insider transactions rests directly with the Board and bank management. Based on examination reports and examiner interviews, Lincolnwood's Board and management's lack of attention to controls negatively impacted the bank's ability to conduct insider activities in a safe and sound manner and was a contributing factor to the bank's failure. According to examiners, those insider activities included:

- excessive compensation,

- the payment of dividends,

- payments made to credit cards and bank accounts related to bank officials,

- the lack of documentation or inadequate documentation to support loans made and wire transfers, and

- fees paid to consultants.

Apparent violations of Regulation O were noted in the 2008 examination and were of specific concern due to citations of preferential terms to insiders. Examiners for the February 2009 examination suggested that the Board immediately implement controls that would govern insider lending. Examiners stated that at various times over the years,

management was uncooperative and not receptive to examiner recommendations and comments on preventing violations of insider lending laws and regulations. Specifically, during the February 2009 examination, examiners spent an inordinate amount of time researching numerous transactions that lacked formal disclosure of insider interests or involvement. As discussed earlier, Lincolnwood had not had an external audit performed since year-end 2004, which left no mechanism for an independent review of insider activity that would be reported to the Board. The apparent violations and insider abuses might have been identified earlier, if such an independent review had been conducted.

Reliance on Wholesale Funding Sources

While not a primary contributing factor to the bank's failure, Lincolnwood became increasingly dependent on non-traditional, volatile funding sources, particularly time deposits of $100,000 or greater and brokered deposits, to fund its loan portfolio. Lincolnwood decided to begin funding its operations with brokered deposits during 2005 because of an inability to attract local deposits. Lincolnwood's reliance on brokered deposits more than doubled from $22 million in 2005 to $50 million by 2008, as shown in Table 2. Further, 31 percent of the brokered deposits at year-end 2008 were scheduled to mature within 1 year.

According to the Examination Manual, these funding sources present potential risks, such as higher costs and increased volatility. Lincolnwood's management permitted the bank's loan concentrations and funding structures to exist without developing and implementing adequate controls to identify, measure, monitor, and control the associated risk. In addition, in multiple examinations, examiners recommended that the bank develop a written contingency liquidity plan (CLP) to improve the monitoring of liquidity and dependency levels.

Table 2: Lincolnwood's Non-Core Funding Sources

Period Ended	Time Deposits of $100,000 or More ($000s)	Brokered Deposits ($000s)
December 2004	$37,890	$0
December 2005	$56,912	$21,896
December 2006	$76,786	$36,450
December 2007	$40,252	$23,198
December 2008	$34,053	$49,724

Source: OIG Analysis of UBPRs for Lincolnwood.

The FDIC's Supervision of Lincolnwood

The FDIC's supervisory efforts identified key risks and made recommendations related to the performance of Lincolnwood's management, the bank's ADC and relationship concentrations, loan underwriting and credit administration deficiencies and weak risk management practices, reliance on non-core deposits and unsatisfactory liquidity levels, and inadequate capital position. Examiners also reported apparent violations of law and

contraventions of policy associated with the institution's lending practices and insider transactions. The FDIC, in conjunction with IDFPR, also pursued enforcement actions to correct problems as the result of the 2005, 2008, and 2009 examinations. However, earlier and stronger supervisory action could have been taken, in light of the significant risk that the bank's business strategy presented during the 2005 and 2008 examinations. Such action may have resulted in management being more responsive to examiner concerns regarding risks and mitigated, to some extent, the losses incurred by the DIF.

Supervisory History

The FDIC and IDFPR provided ongoing supervision of Lincolnwood through risk management examinations, on-site visitations, offsite reviews, and supervisory actions. Table 3 summarizes key information related to Lincolnwood's on-site examinations and visitations conducted by the FDIC and IDFPR, including the bank's Uniform Financial Institutions Rating System (UFIRS) ratings.[6]

Table 3: Lincolnwood's Examination and Visitation History from 2004 to 2009

Examination and Visitation Start Date	Date Examination Report Transmitted to Lincolnwood	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
03/01/2004	04/21/2004	IDFPR	222212/2	None
04/04/2005[a]	06/14/2005	FDIC	233223/3	Memorandum of Understanding (MOU)
	09/16/2005	FDIC	222223/2	None – MOU issued in June 2005 was withdrawn by the FDIC
08/17/2005 (Visitation)	Not Applicable	FDIC	No Rating	None
05/08/2006	08/17/2006	IDFPR	222222/2	None
1/07/2008	05/30/2008	FDIC	344232/3	MOU (effective 10/31/2008)
09/22/2008 (Visitation)	Not Applicable	FDIC	No Rating	None
02/23/2009	Not Issued	IDFPR/ FDIC	555555/5	FDIC PCA Letter (issued 03/25/2009)
				FDIC section 8e Removal (Proposed)
				Illinois section 51 (effective 03/31/2009)
				Cease and Desist Order (C&D) (effective 04/21/2009)

Source: Reports of Examination (ROE) for Lincolnwood and DSC supervisory documentation.

[6] Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

On-site Visitations

Of the three visitations conducted at Lincolnwood from 2005 to 2008, two were related to safety and soundness and are discussed below.

- **August 2005.** During this visitation, Lincolnwood management provided additional information to the FDIC for examiner review of loans that had been adversely classified during the April 2005 examination. Based on those classifications and other deficiencies, examiners for the April 2005 examination rated management, asset quality, and the bank's composite rating as "3"; and proposed an MOU. The results of the visitation substantiated the adverse classification determinations in the examination report transmitted to Lincolnwood on June 14, 2005. Notwithstanding, the FDIC upgraded the component and composite ratings from "3" to "2" and the bank's condition to "adequate", and reissued the April 2005 examination report on September 16, 2005 without an MOU. DSC examination documentation and correspondence did not document the basis for upgrading the examination ratings and withdrawing the MOU.

- **September 2008.** The FDIC conducted this visitation to follow up on the deficiencies identified during the January 2008 examination and assess the corrective actions taken by Lincolnwood. The visitation results showed a continuing deterioration of the bank's loan portfolio, reduced earnings, and lower capital levels, indicating elevated risk for the institution. Underwriting problems were also identified for new loans, and examiners determined that bank management had not been proactive in managing nonaccrual loans and overdrafts.

Offsite Reviews

FDIC examiners also conducted two offsite reviews of Lincolnwood during April 2008 and June 2008. Those reviews indicated that there was a probability that Lincolnwood's composite rating would be downgraded due to deterioration in the bank's real estate loan portfolio. Subsequently, the bank's composite rating and all of the component ratings were downgraded at the February 2009 examination.

Supervisory Actions

The FDIC and IDFPR took various supervisory actions as a result of three of the five examinations performed from 2004 to 2009**,** including making recommendations in the examination reports related to areas of the bank's operations where improvements were needed and imposing informal and formal actions. A brief description of the these actions follows.

- **2005 Proposed MOU.** The FDIC and IDFPR issued an MOU to Lincolnwood with the transmittal of the examination report for the April 2005 examination. The MOU included provisions and guidelines that would assist Lincolnwood in restoring the bank to a fully satisfactory condition. Lincolnwood's Board and

management disagreed with the FDIC's examination ratings and conclusions and met with FDIC staff at the FDIC Chicago Regional Office on July 29, 2005. As a result of this meeting, the FDIC performed a visitation in August 2005 to review additional information related to the adversely classified assets that were central to the less than satisfactory asset quality rating given by examiners during the April 2005 examination. As discussed above, the MOU was withdrawn following the visitation.

- **2006 and 2008 examination recommendations.** The FDIC and IDFPR identified risks and made recommendations to address risk management practices pertaining to the institution's ADC loan concentration, reliance on non-core funding sources, loan underwriting and credit administration practices, apparent violations of laws and regulations and contraventions of interagency policy, and insider transactions.

- **October 2008 MOU.** The January 2008 examination report, issued to the bank on May 30, 2008, included an MOU that outlined corrective actions related, but not limited to:

  - capital levels,
  - CRE concentration,
  - deteriorated asset quality with adverse classifications,
  - loan review and delinquencies,
  - lending policy and interest reserves,
  - ALLL methodology,
  - apparent violations and contraventions of policy, and
  - liquidity and a CLP.

- **April 2009 C&D.** Examiners for the February 2009 examination determined that the bank's condition had become critically deficient due to ineffective bank management, deficient capital levels, loan portfolio losses and deterioration, extremely weak liquidity levels, and the lack of earnings.

  The FDIC, IDFPR, and Lincolnwood's Board met on March 31, 2009 at the FDIC's Chicago Regional Office. Lincolnwood's Board was informed of the results of the ongoing examination and provided with a draft, jointly-issued C&D to correct deficiencies; a Notice of Intent to Take Possession and Control Pursuant to section 51 of the Illinois Banking Act presented by IDFPR; and a C&D issued by IDFPR to restrict Lincolnwood from accepting, renewing, or rolling over uninsured deposits.

  Lincolnwood signed the C&D on April 7, 2009, which became effective on April 21, 2009. Lincolnwood's Board also accepted the resignation of one of the bank's senior managers on April 7, 2009, thereby precluding the use of either PCA or a section 8e Removal Order to require removal by the FDIC. The FDIC's

examiners remained on-site at Lincolnwood to monitor liquidity and operations until the bank's closure.

On June 5, 2009, the IDFPR closed Lincolnwood due to its overall poor financial condition and the bank's inability to raise capital at the required level, and named the FDIC as receiver.

Supervisory Response to Lincolnwood's Risks

A stronger supervisory response after the 2005 and 2008 examinations appears to have been warranted based on Lincolnwood's risk profile and its lack of adequate and timely action to address loan concentrations, weak risk management practices, and safety and soundness deficiencies. An informal supervisory action was proposed after the 2005 examination but was ultimately withdrawn. After the January 2008 examination, it was not until March 2009 before a formal supervisory action was taken to address Lincolnwood's condition, which by that time had deteriorated to the point where the probability of the bank's failure was high. Examination coverage of the key risks at Lincolnwood follows.

April 2005 Examination

Lincolnwood had an elevated risk profile as evidenced in both the original and revised April 2005 examination reports. Examiners rated bank management less than satisfactory in both examination reports and detailed numerous deficiencies related to the bank's Board, management, and asset quality, some of which had been previously reported by examiners but not corrected by bank management. As a result of this examination, the FDIC issued an MOU to address deficiencies and risks related to bank management, concentrations, asset quality, loan review, and the ALLL methodology.

As previously discussed, a follow-up visitation by the FDIC was conducted in August 2005. While the ratings were upgraded and the MOU withdrawn, many of the deficiencies and concerns reported by examiners in the original and revised 2005 examination report remained basically unchanged. Had the MOU remained in effect as a result of the April 2005 examination, the FDIC would have more closely monitored Lincolnwood's operations given that the bank would have been required to provide quarterly progress reports to the FDIC outlining the corrective actions planned or taken by the bank to address deficiencies.

May 2006 Examination

The IDFPR May 2006 examination found the overall condition of Lincolnwood to be satisfactory and assigned it uniform composite and component performance ratings of "2". However, the examination report cited deficiencies that had been previously identified; new concerns regarding the bank's condition, indicating a continued lack of sufficient attention to examiner concerns; increased deterioration in the bank's asset quality; and continued growth in high-risk ADC lending. Specifically, this examination report stated that the bank's (1) loan concentrations had increased since the April 2005

examination, increasing the risk profile of the bank, (2) adversely classified assets totaled $4.8 million, representing a substantial increase from 0.27 percent as of December 31, 2004 to 22 percent as of March 31, 2006, and (3) loans classified as special mention totaled $4.9 million. In addition, the delinquency ratio for loans had increased to 7.78 percent and was considered high compared to the bank's peer group ratio of 1.27 percent.

Further, the report stated that the bank's risk management practices were not adequate relative to economic conditions and asset concentrations, and included multiple recommendations for bank management to:

- reduce individual and portfolio CRE concentration levels to reduce the bank's rising risk level and avoid potential credit problems;
- improve credit administration, the ALLL methodology, and funds management practices; and
- correct apparent violations of laws and regulations.

Also, as previously shown in Figure 2, between December 2005 and December 2006, Lincolnwood's ADC concentration increased from 391 percent to 465 percent of total capital compared to 91 percent to 107 percent for the bank's peer group—further increasing the bank's risk profile. The risks identified in the 2006 examination report seem to be in contrast with the broader definition of a "2" rating for the management and asset quality components, which indicate that (1) bank management is satisfactory with respect to risk management practices relative to the institution's size, complexity, and risk profile and (2) weaknesses in asset quality and credit administration practices warrant a limited level of supervisory attention.

No Examinations or Visitations in 2007

Lincolnwood remained on an 18-month examination schedule given its composite "2" rating and other factors in 2006, versus a 12-month examination schedule required for institutions assigned equal to or worse than a composite "3" rating. Consequently, a risk management examination was not performed in 2007, since the FDIC's April 2005 and IDFPR's May 2006 examinations had rated the bank's condition as satisfactory and no active enforcement actions were in place. The lack of an examination or visitation during this period provided the opportunity for further deterioration in the bank's overall operations and asset quality that was not detected and addressed by the FDIC and IDFPR. By December 2007, although the bank's ADC concentration had decreased to 399 percent of total capital, when compared to the bank's peer group's level of 91 percent (Figure 2), the bank's level of concentration still presented significant risk to Lincolnwood and was nearly three times greater than the 2006 supervisory criteria of 100 percent.

January 2008 Examination

The January 2008 examination report stated that Lincolnwood's Board and bank management needed to address various aspects of the bank's operations, including:

- the concentration of ADC loans;
- the deterioration in asset quality and adverse classifications, which totaled 153 percent of capital;
- loan delinquencies;
- the inappropriate use of interest reserves;
- inadequate loan review processes;
- insider loans and abuses;
- inadequate ALLL methodology and funding; and
- the need for improved liquidity and an adequate CLP.

Lincolnwood's Board and management were also criticized for not taking action to effectively correct prior examination criticisms and recurring apparent violations and policy contraventions. The examination further determined that the bank's capital levels were strained due to the loan deterioration and concentration and found that Lincolnwood's liquidity position was diminishing.

FDIC examiners discussed a variety of supervisory enforcement actions including a C&D, a section 39 supervisory enforcement plan, civil money penalties, and an MOU, and decided to issue an MOU to address Lincolnwood's problems and deteriorating financial condition. The MOU required that Lincolnwood's Board provide quarterly progress reports to the FDIC and IDFPR. According to examiners, the FDIC prefers that a financial institution agree to MOU provisions and sign the agreement shortly after the bank receives it. However, this did not happen in the case of Lincolnwood. Specifically, the FDIC transmitted the examination report and MOU to Lincolnwood on May 30, 2008, and extensive negotiations regarding the MOU provisions occurred. Those negotiations ended when Lincolnwood's Board signed the MOU on October 31, 2008 – about 5 months after the January 2008 examination had been completed.

<u>February 2009 Examination</u>

The FDIC and IDFPR issued a joint C&D, effective April 21, 2009, based on the results of the February 2009 examination. The C&D was agreed to and signed by Lincolnwood's Board on April 7, 2009 and contained 16 major provisions that included the following:

- prohibitions against certain lending activities,
- requirements to increase the ALLL,
- restrictions on the payment of dividends,
- prohibitions on transferring assets to insiders,
- restoration of capital,
- development of a liquidity plan,
- obtaining FDIC written approval for additions to the Board and management, and
- hiring an independent party to operate the bank.

FDIC examiners remained on-site at Lincolnwood to monitor liquidity and operations until the bank closure on June 5, 2009.

Overall Assessment of Supervisory Actions

We recognize that the FDIC's supervisory and enforcement actions issued in October 2008 and April 2009 addressed deficiencies at the bank. However, significant deterioration in Lincolnwood's asset quality had occurred before these actions were taken, and were compounded by the effects of poor risk management practices, and the ADC loan concentration. In retrospect, stronger supervisory action at earlier examinations, particularly the April 2005 and January 2008 examinations, may have been prudent to address risks identified at those examinations that, ultimately, led to the bank's failure.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized. The FDIC properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for Lincolnwood.

Table 4 shows Lincolnwood's PCA capital ratios between December 31, 2004 and December 31, 2008. Lincolnwood's capital category increased from *Adequately Capitalized* in 2004 to *Well Capitalized* during the first quarter of 2005 after the bank received a significant capital injection from its bank holding company. Lincolnwood remained in the *Well Capitalized* category until the February 2009 examination determined that the bank's capital level had fallen to *Critically Undercapitalized* due to capital adjustments that were required to adequately fund the bank's ALLL and address other losses that had occurred.

Table 4: Lincolnwood's Capital Ratios

Period Ending	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	Capital Category
Well Capitalized Minimum PCA Thresholds	5% or more	6% or more	10% or more	
Lincolnwood's Capital Levels				
Dec-04	7.83%	8.57%	9.33%	Adequately Capitalized
Dec-05	9.19%	9.70%	10.65%	Well Capitalized
Dec-06	8.53%	9.13%	10.09 %	Well Capitalized
Dec-07	9.11%	9.73%	10.89%	Well Capitalized
Dec-08*	1.91%	2.17%	3.47%	Critically Undercapitalized

Source: UBPR and ROEs for Lincolnwood.

* These ratios were adjusted during the February 2009 examination to account for additional funding needed for the bank's ALLL and for losses. The bank's PCA category was *Well Capitalized* based on the data originally filed in its Call Report as of December 31, 2008. After the February 2009 examination began, Lincolnwood amended the bank's December 2008 Call Report to make adjustments for additional ALLL amounts based on interim examination results. Those adjustments lowered the bank's PCA category to A*dequately Capitalized.* After the examination was completed and results were analyzed, the bank's capital category was lowered to *Critically Undercapitalized.*

On November 14, 2008, Lincolnwood submitted a request for funds from the Troubled Asset Relief Program (TARP).[7] On March 25, 2009, the FDIC issued a PCA notification letter to Lincolnwood based on the results of the joint FDIC and IDFPR February 2009 examination that lowered the bank's PCA capital category from W*ell Capitalized* to C*ritically Undercapitalized*. The bank was determined to be *Critically Undercapitalized* due to restatements of capital needed for adversely classified assets, restated 2008 earnings, and other adjustments identified during the examination. In addition to being subject to the requirements and prohibitions contained in the PCA letter, Lincolnwood was (1) assigned a "5" capital component rating, (2) issued a Notice of Intent to Take Possession and Control Pursuant to section 51 of the Illinois Banking Act by the IDFPR, and (3) subjected to a joint section 8b C&D enforcement action.

On April 24, 2009, Lincolnwood submitted a Capital Restoration Plan to the FDIC and the IDFPR in accordance with the provisions of the PCA letter and C&D. The bank's Capital Restoration Plan included three strategies to raise an additional $20 million to $22 million in capital. Lincolnwood subsequently withdrew its TARP application on May 29, 2009. The bank was unsuccessful in raising the additional capital under the terms of the section 51 Notice, and failed on June 5, 2009.

[7] TARP was established under the Emergency Economic Stabilization Act of 2008. Under the TARP, the Department of the Treasury will purchase up to $250 billion of preferred shares from qualifying institutions as part of the Capital Purchase Program.

Corporation Comments

After we issued our draft report, we met with management officials to further discuss our results. The officials indicated that there were no corrections or additions needed to the report.

On December 14, 2009, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Lincolnwood's failure. With regard to our assessment of the FDIC's supervision of Lincolnwood, DSC stated that the January 2008 examination resulted in the recommendation for an MOU, which became effective in October 2008. At the September 2008 visitation, the examiner reviewed Lincolnwood's corrective actions, noted continued problems and deterioration, and recommended that a full-scope examination start in February 2009. As a result of that examination, a formal enforcement action, effective in April 2009, was issued requiring Lincolnwood's Board and management to address weak risk management practices and formulate a CLP.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted this performance audit from July 2009 to December 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of Lincolnwood's operations from December 31, 2003 until its failure on June 5, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination reports prepared by the FDIC and the IDFPR examiners from 2004 to 2008.

- Reviewed the following:

    - Bank data and correspondence maintained at DSC's Chicago Regional and Field Offices.

    - Documentation of FDIC offsite monitoring activities.

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed available Lincolnwood records maintained by DRR for information that would provide insight into the bank's failure.

    - Pertinent DSC policies and procedures.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:
    - DSC management in Washington, D.C. and the Chicago Regional Office.
    - FDIC examiners from the DSC Chicago Field Office, who participated in examinations or reviews of examinations of Lincolnwood.
- Interviewed officials from the IDFPR to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.
- Researched various banking laws and regulations, including State of Illinois laws.

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

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

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

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Memorandum of Understanding (MOU)	The memorandum of understanding is a means of seeking informal corrective administrative action from institutions considered to be of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.

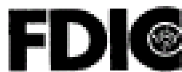
Glossary of Terms

Term	Definition
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
IDFPR	Illinois Department of Financial and Professional Regulation
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments



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

December 11, 2009

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Bank of Lincolnwood, Lincolnwood, Illinois

Pursuant to Section 38(k) of the Federal Deposit Insurance act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Bank of Lincolnwood (Lincolnwood) which failed on June 5, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on November 24, 2009.

The Report concludes Lincolnwood failed because the Board and management failed to implement adequate risk management oversight of acquisition, development, and construction (ADC) loan concentrations, loan underwriting and credit administration, and risk analysis and recognition practices. The Report cites the Board and management's failure to take corrective action for apparent violations and contraventions of interagency policies as contributing factors in Lincolnwood's failure, as well as their insufficient attention to insider activity. Further, the Report states that Lincolnwood's reliance on volatile funding sources played a lesser, but important, role in the Lincolnwood failure.

As part of the supervisory program, the FDIC and the Illinois Department of Financial Professional Regulation (IDFPR) conducted on-site risk management examinations in April 2005, May 2006, January 2008, and February 2009; and visitations in August 2005 and September 2008. Examiners recommended improvements in concentration monitoring, loan underwriting and credit administration, and risk assessment and recognition practices.

The January 2008 examination resulted in the recommendation of a Memorandum of Understanding that became effective in October 2008. At the September 2008 visit, the examiner reviewed Lincolnwood's corrective actions, noted continued problems and deterioration, and recommended a full scope examination be started in February 2009. Lincolnwood's interim progress report indicated improvement; however, the joint examination with the IDFPR resulted in the issuance of a formal enforcement action that became effective in April 2009. The formal action required the Board and management to address weak risk management practices and to formulate a liquidity contingency plan. FDIC and the IDFPR appropriately monitored Lincolnwood until the time that it was closed.

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