Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-028

Material Loss Review of InBank, Oak Forest, Illinois

March 2010

Office of Inspector General

Executive Summary

Material Loss Review of InBank, Oak Forest, Illinois

Report No. MLR-10-028
March 2010

Why We Did The Audit

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review of InBank, Oak Forest, Illinois.

On September 4, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR) closed InBank and named the FDIC as receiver. On September 25, 2009, the FDIC notified the OIG that InBank's total assets at closing were $211.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $61.1 million. As of January 29, 2010, the estimated loss to the DIF had decreased to $53.7 million. The OIG was required by section 38(k) of the Federal Deposit Insurance Act to conduct a material loss review of the failure of InBank and retained KPMG for this purpose.

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

InBank was a state nonmember bank, wholly-owned by ISB Financial Corporation, a one-bank holding company. The bank, established in 1970 and originally chartered under the name Interstate Bank of Oak Forest, changed its name to InBank in March 2008. InBank operated in Cook County, Illinois. The main office was located in Oak Forest and two branches were located in Chicago and Tinley Park.

InBank's loan portfolio was concentrated in commercial real estate, in particular acquisition, development and construction (ADC) loans in its local market. While primarily pursuing a traditional business plan, InBank first became concentrated in ADC lending in 1996. The bank historically relied on internally-generated deposits to fund its operations; however, InBank's asset growth became more dependent on brokered deposits from 2004 to 2009.

Audit Results

Causes of Failure and Material Loss

InBank's failure can be attributed to poor management and inadequate Board of Directors (Board) oversight, a high concentration in ADC lending, poor loan underwriting, weak credit administration practices, and reliance on volatile funding sources. In the April 2008 Report of Examination, examiners noted that management needed to properly identify, measure, monitor, and control increased risks and deterioration in the loan portfolio. The bank's deterioration continued and, by May 2009, examiners indicated that a decline in the bank's financial condition was largely the result of a high credit risk loan portfolio, resulting from weak loan underwriting and inadequate monitoring. Specifically, the bank's excessive lending to leveraged builders and developers in the Chicago area exposed it to a substantial risk of loss from declining economic conditions. In addition, liquidity risk had increased due to the bank's deteriorated financial condition and the high level of brokered deposits.

The FDIC's Supervision of InBank

FDIC and IDFPR examinations and a visitation of InBank identified key risks, including credit administration weaknesses, inadequate loan underwriting, a high ADC loan concentration, and volatile funding sources, all of which eventually contributed to the bank's failure. The examinations were conducted according to the statutory schedule, and offsite reviews were carried out according to established procedures. Also, as the bank's financial condition deteriorated, the FDIC and the IDFPR entered into a Memorandum of Understanding (MOU) with InBank in October 2008, and subsequently issued a Cease and Desist Order in August 2009.

Due to adverse changes in the economy in 2007 and InBank's risk management weaknesses, the financial condition of the bank had significantly deteriorated by the time of the April 2008 FDIC examination. In retrospect, the FDIC could have increased its supervisory attention to the bank between the October 2006 IDFPR examination and the 2008 examination. More detailed supervisory attention prior to April 2008 may have influenced InBank's Board and management to limit the risks assumed during this period. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate actions to address examiners' concerns. Additionally, a formal supervisory action may have been warranted as a result of the December 2008 FDIC visitation, which revealed further financial deterioration and the failure of bank management to fully comply with the provisions of the MOU agreed to in October 2008.

Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. However, capital levels turned out to be a lagging indicator of InBank's financial well-being. Other factors, including management, asset quality, and funding, identified in earlier examinations, were better indicators that the bank's viability was in question.

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 22, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of InBank's failure and the FDIC's supervision of the bank. DSC stated that it recognizes that strong supervisory attention is necessary for institutions with high ADC concentrations and volatile funding sources, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

FDIC
Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: March 25, 2010

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 InBank, Oak Forest, Illinois*
(Report No. MLR-10-028)

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. The report did not contain recommendations, thus a response was not required. However, the Division of Supervision and Consumer Protection provided a written response on March 22, 2010. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Mike Lombardi, Audit Manager, at (703) 562-6328. We appreciate the courtesies extended to the audit staff.

Attachment

cc: M. Anthony Lowe, Regional Director, DSC
Christopher E. Drown, Chief, Office of Internal Control and Review, DSC
James H. Angel, Jr., Director, OERM

Table of Contents

Part I

Report by KPMG LLP

KPMG

Material Loss Review
InBank
Oak Forest, Illinois

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

March 25, 2010

KPMG LLP

2001 M Street, NW
Washington, DC

Table of Contents

KPMG

KPMG LLP

2001 M Street, NW
Washington, DC 20036

March 25, 2010

Executive Summary

Stephen M. Beard
Assistant Inspector General for Material Loss Reviews
Federal Deposit Insurance Corporation
3501 North Fairfax Drive
Arlington, VA 22226

Material Loss Review Report for InBank, Oak Forest, Illinois

Dear Mr. Beard:

This is our performance audit report on the results of the Material Loss Review for InBank, Oak Forest, Illinois. The objectives of this performance audit were to (1) determine the causes of InBank's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of InBank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Causes of Failure

InBank's failure can be attributed to poor management and inadequate Board of Directors (Board) oversight, a high concentration in Acquisition, Development and Construction (ADC) lending, poor loan underwriting, weak credit administration practices and volatile funding sources. Management and the Board pursued a business strategy based on a highly concentrated loan portfolio, without establishing the appropriate practices to mitigate the corresponding risks.

Evaluation of Supervision

Through its supervisory efforts, the FDIC identified key risks in InBank's management practices and operations and brought these risks to the attention of the institution's Board and management team through regular discussions and correspondence, examination reports, a visitation, and informal and formal supervisory actions. Regulators conducted four onsite examinations from April 2005 to May 2009, and one visitation in December 2008.

Due to adverse changes in the economy in 2007, and the combination of InBank's risk management weaknesses and a high ADC loan concentration, the financial condition of the bank had significantly deteriorated by the April 2008 examination. In retrospect, more supervisory attention in the 18 months before that examination may have influenced InBank's Board and management to limit the risks assumed during this period. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate actions to address examiners' concerns.

Prompt Corrective Action

The FDIC followed PCA guidance. However, capital levels turned out to be a lagging indicator of the institution's financial well-being. Other factors including management, asset quality, and funding, identified in earlier examinations, were better indicators that the bank's viability was in question.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). These standards require that we plan and perform the performance 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.

The information included in this report was obtained during our fieldwork, which occurred during the period from December 2009 through February 2010.

Very truly yours,

KPMG LLP

Background

On September 4, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR) closed InBank and named the FDIC as receiver. On September 25, 2009, the FDIC notified the Office of Inspector General (OIG) that InBank's total assets at closing were $211.4 million and the estimated loss to the Deposit Insurance Fund (DIF) was $61.1 million. As of January 29, 2010, the estimated loss to the DIF had decreased to $53.7 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act to conduct a material loss review of the failure of InBank, and retained KPMG for this purpose.[1]

InBank was a state non-member bank wholly-owned by ISB Financial Corporation (ISB), a one-bank holding company. ISB also owned 80 percent of a non-bank subsidiary established to facilitate the issuance of trust preferred securities. The bank was established in 1970 and was chartered under the name Interstate Bank of Oak Forest. In March 2008 it changed its name to InBank. The bank operated in Cook County, Illinois, and the main office was in Oak Forest. Two other branches were located in Chicago and Tinley Park.

InBank's loan portfolio was concentrated in Commercial Real Estate (CRE), in particular Acquisition, Development and Construction (ADC) loans in its local market. While primarily pursuing a traditional business plan, InBank first became concentrated in ADC lending in 1996. To fund its operations, the bank historically relied on core deposits. However, from 2004 to 2009, asset growth became more dependent on brokered deposits.

Table 1 provides details on InBank's financial condition as of December 2008, and for the three preceding calendar years.

Table 1: Financial Condition of InBank

Financial Data ($000)	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets	214,332	195,340	198,895	181,393
Loans (Net of Allowance for Loan and Lease Losses)	170,190	154,679	147,630	133,886
Real Estate Loans	157,769	147,734	139,661	125,875
Total Deposits	190,950	172,422	161,548	153,378
Brokered Deposits	67,623	46,748	27,532	18,731
Return on Average Assets	0.38%	1.37%	1.51%	1.61%
Past Due Ratio	8.12%	4.35%	0.00%	0.26%
Asset Growth Rate	9.72%	(1.79%)	9.65%	9.21%
Loan Growth Gate	10.03%	4.77%	10.27%	13.94%

Source: Uniform Bank Performance Report (UBPR) for InBank, December 31, 2008.

[1] In conducting this performance audit and preparing this report, KPMG relied primarily on information provided by the FDIC OIG and the Division of Supervision and Consumer Protection (DSC). Appendix I, Objective, Scope, and Methodology, describes in greater detail the procedures used by KPMG.

Causes of Failure and Material Loss

InBank's failure can be attributed to poor management and inadequate Board of Directors (Board) oversight, a high concentration in ADC lending, poor loan underwriting, weak credit administration practices and volatile funding sources. Management and the Board pursued a business strategy based on a highly concentrated loan portfolio, without establishing the appropriate practices to mitigate the corresponding risks.

In the April 2008 Report of Examination (ROE), examiners noted that management needed to properly identify, measure, monitor and control increased risks and deterioration in the loan portfolio. However, the bank's deterioration continued and by May 2009 examiners indicated that the decline in the bank's financial condition was largely the result of a high credit risk loan portfolio, resulting from weak loan underwriting and inadequate monitoring. Specifically, the bank maintained an excessive amount of loans to leveraged builders/developers in the Chicago area, exposing the bank to a substantial risk of loss in declining economic conditions. In addition, liquidity risk had increased due to the bank's deteriorated financial condition and the high level of brokered deposits.

Management and Board Oversight

InBank's management and Board failed to properly identify, measure, monitor, control, and mitigate growing risks associated with the highly concentrated ADC loan portfolio. The presence of a dominant senior official combined with the lack of independent directors contributed to an operating environment without proper checks and balances. In addition, the regulators noted several violations of banking laws and FDIC Rules and Regulations.

Identify, Measure, Monitor, Control, and Mitigate Credit Risks

In the March 2002 FDIC examination, examiners noted management's failure to document repayment analyses, which was also criticized at the two previous examinations. Furthermore, independent reports by the bank's auditor cited similar findings. Management was strongly encouraged to develop a formal underwriting process for analyzing the repayment capacity of borrowers. During this examination, examiners identified credit concentrations in construction and vacant real estate land for development. Management was encouraged to proactively monitor the concentrations to lessen the potential risk in the event of an economic decline in this industry. This proactive monitoring was strongly suggested given the size of the concentrations and the potential for rising interest rates.

During the April 2005 FDIC examination, a number of loan administration deficiencies were noted. However, examiners indicated that management had been able to adequately manage delinquencies and loan losses, and classified[2] loans continued to be low. Examiners concluded that risks to the institution were generally identified and monitored. In the October 2006 State examination, although risk management practices were deemed appropriate, issues concerning credit administration, the Allowance for Loan and Lease Losses (ALLL) methodology and the adequacy of the audit program were noted. By the April 2008 examination, examiners found that management's oversight of the bank and risk management practices were less than satisfactory. An effective risk management program had not been developed to adequately identify and monitor problem credits and overall asset quality deterioration.

The December 2008 FDIC visitation report noted that management's oversight of the bank and risk management practices were not satisfactory. Asset quality continued to deteriorate, and management was establishing interest reserves for borrowers with no liquidity. Relationships exhibiting signs of weakness were not included in the problem loan report. By the May 2009 Joint examination, regulators considered management and the Board inadequate due to the hazardous lending practices that caused the financial deterioration noted since the previous examination. The critical condition of the loan portfolio existed due to the continued failure to effectively manage, identify and correct deficient credit operations.

Board Independence

The December 2008 visitation report noted that, although the bank's risk exposure had increased since the April 2008 examination, management was still searching outside the institution for assistance in correcting credit problems that seemingly were beyond their abilities. Given the structure of the Board, which consisted mostly of insiders and one outside director, examiners suggested that the bank begin to search for an outside director to challenge decisions brought before the Board.

In the May 2009 Joint ROE, the composition of the Board and senior management was noted as an immediate concern. Previous examinations had criticized the lack of external directors and emphasized the need to bring independence and additional points of view to the Board. As of the examination date, the Board composition still included four management members and only one outside director.

The May 2009 Joint ROE also noted that a senior official brought the majority of the credits into the bank and dominated the direction of the bank's officers and directors. Loan decisions were rendered on new and renewed credits with limited or no financial analysis. Loans brought by this individual accounted for approximately 75 percent of the examination's classified loans. Furthermore, during this examination, members of the Board and staff met with examiners to express their concerns with the unsafe operating conditions of the bank as a result of this individual's actions. Nevertheless, a further

---

[2] Includes assets and off-balance sheet items rated as Substandard, Doubtful or Loss in the regulatory risk rating grades. See Interagency Policy – "Uniform Retail Credit Classifications and Account Management Policy" June 2000.

review by examiners indicated that the Board typically voted unanimously to approve these credits without proper analysis.

Based on the information above, it is clear that there was not enough independent influence on the Board. This lack of independence, coupled with the influence exerted by a dominant senior official, were essential contributing factors to the poor oversight that ultimately caused InBank's failure.

Violation of Laws, Rules and Regulations

In recent examinations, the regulators noted several violations of banking laws and FDIC Rules and Regulations. Table 2 provides a summary of those violations related to safety and soundness noted by examiners from 2005 until the last examination in May 2009.

Table 2: Summary of InBank's Violations of Laws, Rules and Regulations[3]

Applicable Laws, Rules, and Regulations	Description	Examination Date			
		May-09	April-08	October-06	April-05
Illinois Banking Act Chapter 205 Section 16(2)(a)	The number of directors may not be fewer than 5 nor more than 25.	x			x
Illinois Banking Act Section 16(6)	The Board of Directors shall cause suitable books and records of all the bank's transactions to be kept.	x			
Illinois Banking Act Section 32	The liabilities outstanding at one time to a state bank of a person for money borrowed, including the liabilities of a partnership or joint venture in the liabilities of the several members thereof, shall not exceed 25% of the amount of the unimpaired capital and unimpaired surplus of the bank.	x			
FDIC Rules and Regulations Section 323.4	All appraisals for applicable transactions shall, at a minimum, contain sufficient information to support the institution's decision to engage in the transaction and analyze and report appropriate deductions and discounts for proposed construction or renovation.		x		
FDIC Rules and Regulations Section 323.4(a)	Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, unless principles of safe and sound banking require compliance with stricter standards.		x		
FDIC Rules and Regulations Appendix A – Part 364	Guidance for establishing standards for safety and soundness relating to: Loan Documentation, Credit Underwriting, and Asset Quality.	x			
FDIC Rules and Regulations Section 326.8(b)(1)	Each institution is required to develop and provide for the continued administration of a program that is reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements under the Bank Secrecy Act.				x

Source: ROEs for InBank

[3] While there were no safety and soundness violations cited in the October 2006 State ROE, there were apparent compliance violations of FDIC Rules and Regulations and the USA PATRIOT Act noted.

During the May 2009 Joint examination, regulators noted non-compliance with the Illinois Banking Act Section 16(6) which states in part, "The Board of Directors shall cause suitable books and records of the bank's transactions to be kept." The following violations of this provision were identified:

- Loan risk ratings were inaccurate. This misrepresentation included 79 loan downgrades at this examination from the bank's internal loan grading report as of December 2008 and 50 downgrades from the April 2008 report.
- Lack of global cash flows for those larger borrowers that had numerous outstanding debts with other lending institutions.
- Extension of unsecured credit to borrowers whereby their financial condition was not available or reviewed to warrant lending.
- Capitalization of expenses on loans upon renewal. This was evident on most loan relationships classified with ongoing concerns.
- Inadequate construction monitoring reports for assessing the condition of projects at various points of completion.
- Insider expenses did not have any specific details in relation to their stated purpose. The ability to determine if the event was a legitimate bank expense was undeterminable in most cases.
- Credits renewed with reduced interest rates were not classified as Troubled Debt Restructuring (TDR).

The number and extent of these violations provide further evidence of InBank's poor management and Board oversight that led to the failure of the bank, despite repeated concerns raised during various examinations.

Loan Concentration

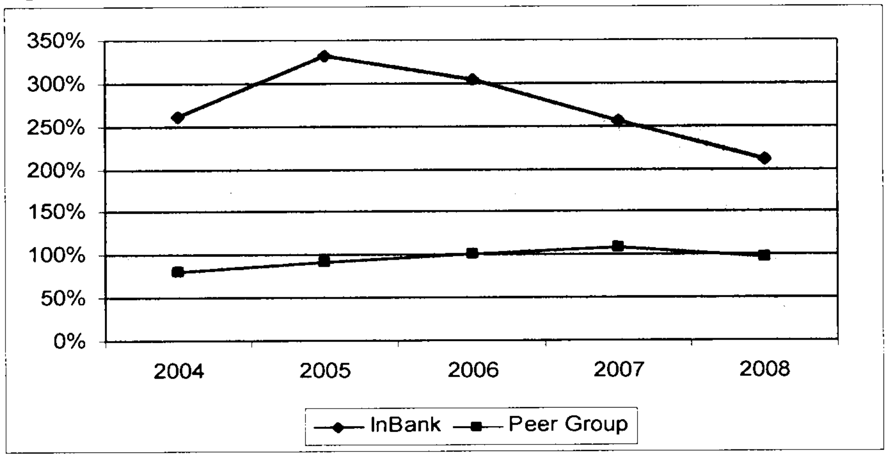
At the March 2002 examination, the bank's concentration in construction and real estate land development was 387 percent of Tier 1 Capital plus the ALLL. Examiners recommended establishing a maximum limit for total exposure of construction/land development credits in relation to capital, loans, and assets. Examiners also recommended amending the Loan Policy to include limitations on concentrations of credit.

The August 2003 ROE indicated that the bank maintained a high concentration of credit in loans to finance real estate construction, development, or renovation. Examiners noted that such concentrations increased the bank's risk profile and subjected the bank to the risk of increased loan losses due to a downturn in the real estate development market.

Figure 1 illustrates InBank's concentration in ADC lending compared to its peer group.[4]

[4] The peer group for InBank consisted of all insured commercial banks having assets between $100 million and $300 million in a metropolitan area that has three or more full service offices.

Figure 1: ADC Loans as a Percentage of Total Capital Compared to Peer Group



Source: UBPR for InBank.

The April 2005 examination revealed that loans for construction, development, or renovation represented 300 percent of Tier 1 Capital plus the ALLL, and the overall CRE concentration was 627 percent of Tier 1 Capital plus the ALLL. Examiners recommended breaking out the concentration totals so that Board members could monitor concentration levels. The October 2006 State examination listed a CRE concentration of 611 percent of Tier 1 Capital plus the ALLL, of which ADC lending represented 516 percent[5] of Tier 1 Capital plus the ALLL. By the April 2008 examination, the CRE concentration continued to be high at 604 percent of Tier 1 Capital plus the ALLL, with 276 percent specifically in ADC loans. Approximately 95 percent of the adversely classified loans identified during this examination, which totaled $30.9 million, came from the ADC portfolio. During the Joint examination in May 2009, InBank's CRE loans represented 550 percent of Tier 1 Capital plus the ALLL. Residential construction loans comprised 213 percent of Tier 1 Capital plus the ALLL. Two lending relationships reviewed exceeded 25 percent of reported Tier 1 Capital plus the ALLL. Examiners noted that a significant portion of these loans were for speculative condominium construction projects in Chicago. Examiners concluded that the bank's risk management procedures were not effective in controlling the level of credit risk in this portfolio.

Interagency guidance titled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), issued on December 12, 2006 established levels of concentrations that may warrant further supervisory analysis. The Joint Guidance states that "An institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or

[5] On September 30, 2006, the bank received a $5 million capital injection from its parent company, which dropped this rate down to 303 percent of Tier 1 Capital plus the ALLL by year end, as shown in Figure 1.

- Total commercial real estate loans as defined in this guidance represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months."

Based on the information presented above, InBank's concentration in CRE and ADC lending was excessive compared to its peers and to the thresholds established by regulatory guidelines. This made the bank particularly vulnerable to a downturn in the real estate market, and was a major contributing factor to the bank's failure in 2009.

Loan Underwriting

From 2002 through 2009, examiners repeatedly identified problems with InBank's loan underwriting practices. In the March 2002 examination, the following weaknesses were noted:

- Failing to document a borrower's cash flow or debt service ability;
- Focusing on secondary repayment sources without evaluating the primary sources of repayment;
- Utilizing stale pro-forma data when determining repayment analysis; and
- Relying upon a borrower's adjusted gross income from tax returns without reviewing the consistency of each income component or the causes of fluctuating income between consecutive years.

The April 2005 examination identified multiple loan underwriting deficiencies including Loan to Value calculations based only on the purchase price of the property without including funds disbursed to rehabilitate the property. In addition, examiners noted that cash flow analysis was insufficient, with many loans missing documentation on the borrower's repayment capacity. Global cash flow analysis was not typically performed and specific information on a borrower's debt at other institutions was not obtained by the bank. Examiners also noted concerns with the time frame on the amortization for income-producing properties and the assumptions made on appraisal review worksheets.

In the following year, the October 2006 State examination noted that additional effort was needed to perform global cash flow analysis on borrowers, and obtain and review financial statements in a timely manner. The April 2008 examination pointed out that lax credit administration had resulted in the deterioration of the loan portfolio. An example cited was a situation in which the mortgage banking department processed a "stated income/stated assets" loan to a customer who also had a commercial credit application stating a significantly lower income. In addition, cash flow analysis included monies that were not recurring (e.g., proceeds from the sale of real estate).

The May 2009 Joint examination noted that poor loan underwriting and monitoring contributed to the excessive problem loan level. In addition, during this examination the following weaknesses were identified:

- Poorly documented loan presentation sheets;
- Inadequate repayment analysis;
- Weak appraisal review practices;
- Capitalization of expenses to loans; and
- Lack of officer memorandums in files.

Poor loan underwriting was repeatedly noted as a concern by examiners. InBank's failure to correct weaknesses in this area coupled with a high credit risk loan portfolio contributed to the bank's failure.

Credit Administration Practices

Examiners expressed numerous concerns with the bank's credit administration practices. These concerns included important aspects of the credit administration function such as the identification of problem loans, the loan grading system, the ALLL methodology, and monitoring of construction loans.

Loan Grading and Problem Loans

The October 2006 State ROE indicated that the adversely classified items coverage ratio[6] had increased from 9 percent as of December 31, 2005 to 27 percent as of September 30, 2006. The ROE also indicated that as of September 30, 2006, the past due and nonaccruals ratio[7] of 3.63 percent was higher than the peer average. Examiners noted that additional loans needed to be added to the watch list.[8] Furthermore, discrepancies were noted in the assigned loan ratings on various problem credits.

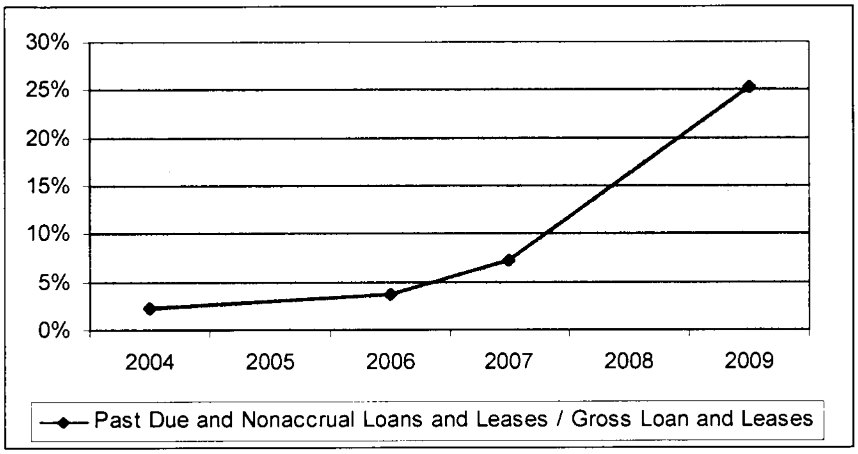
The April 2008 examination noted that adversely classified items represented 150 percent of Tier 1 Capital plus the ALLL. The past due and nonaccrual loan ratio was high at 7.2 percent, which was an increase from 3.63 percent in the prior examination. Examiners noted that the loan review and grading system was inadequate and approximately 60 percent of the adversely classified credits had been assigned a "Pass" rating by the bank, meaning that the bank was underestimating the risk of the loan portfolio. Examiners suggested that the risk rating system should be enhanced.

Figure 2 shows the level of past due and nonaccrual loans and leases as a percentage of gross loans and leases, with data as of each onsite examination date.

---

[6] This ratio calculates total classified assets as a percentage of Tier 1 Capital plus the ALLL.
[7] This ratio represents the sum of past due and nonaccrual loans as a percentage of the loan portfolio.
[8] The watch list is one of the primary tools banks use to track, manage, and report problem loans.

Figure 2: InBank's Past Due and Nonaccrual Loans and Leases as a Percentage of Gross Loans and Leases



Source: ROEs for InBank.

During the Joint examination in May 2009, examiners indicated that the loan rating system was deficient as inaccurate ratings were assigned. At this examination, 50 loans were downgraded by examiners from an internal rating of "Pass" to "Substandard" or worse. The reasons for the numerous downgrades included: lack of external loan review prior to 2009, inadequate staffing in the loan department, and weak loan presentations. The ROE noted that the lending staff lacked expertise in analyzing and identifying credit risk, and these operational credit weaknesses were not identified by bank management. Many loans were renewed or extended with inaccurate loan ratings as a result of weak loan underwriting presentations which failed to detail the project, analyze the repayment capacity of the borrower and guarantor, include global repayment analysis, and provide support for the recommended rating. Further, during the examination it was discovered that various credit relationships should have been identified as TDRs because of the concessions provided to distressed borrowers, usually in the form of lower interest rates.

As noted above, loan grading was criticized at various times during recent examinations. Ultimately, the lack of an adequate independent loan grading methodology was an important factor among the causes of the bank's failure.

ALLL Methodology

The October 2006 State examination noted that management needed to revisit the ALLL methodology. According to examiners, management was not properly accounting for the impaired portion of the criticized loans. At the time of the examination, a 5 percent risk allocation was being applied to all credits on the watch list. Examiners referred management to FIL-63-2001 titled *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations*. As a result of this deficiency, management needed an additional loan loss provision of $1.6 million to replenish the ALLL.

At the April 2008 ROE, examiners noted that the ALLL methodology was evolving and examiners recommended that management refer to Financial Accounting Standard (FAS) 5 and FAS 114 guidance.[9] Examiners indicated that management should review the FAS 5 allocation to determine if higher amounts were needed to address factors such as the bank's increase in delinquencies, the lack of an appropriate loan review system, and an inadequate grading system.

According to the May 2009 Joint examination, internal loan ratings were inaccurate and resulted in the ALLL being underfunded. A $19 million provision was needed to replenish the ALLL. Examiners noted that the inaccurate loan ratings were a direct result of the lack of independent loan reviews prior to 2009.

As a result of the weaknesses in the loan grading system, InBank had ongoing difficulties calculating an allowance expense commensurate with the underlying risks in the loan portfolio. The underfunded ALLL resulted in a commensurate overstatement of reported capital. When loan ratings were downgraded and the ALLL replenished, the capital protection of the bank turned out to be less robust than what it appeared prior to the 2009 examination.

Monitoring of Construction Loans

At the April 2005 examination, examiners observed that an inspection report performed by a senior official contained a discrepancy concerning the percentage of work completed. One inspection report indicated a lower percentage of work completed than the previous report. A senior official at the bank agreed to institute a review process of inspection reports to eliminate discrepancies. The April 2008 examination found that the administration of the construction portfolio needed improvement. At the time, there was no review of the construction budget at inception and there was a lack of officer memoranda regarding updates on construction projects.

The May 2009 Joint examination noted weak construction loan monitoring, which led to many out-of-balance positions.[10] Examiners indicated that reviewed loan files lacked credit memos detailing changes from original project plans and recent discussions with the borrower. Further, examiners noted that memos were not completed to provide justification and approval to replenish interest reserves, or to allow unit sales proceeds to be re-allocated to interest reserves or other costs. The bank produced a Global Construction Loan Report which examiners determined lacked critical information such as level of pre-sales, out-of-balance positions, sales price for units, interest reserves, months remaining on reserves, and borrower's capacity to service the loan until units were sold.

---

[9] Accounting Standard Codification (ASC) Subtopics 450-20 (formerly FAS 5) and ASC 310-10-35 (formerly FAS 114) provide accounting guidance for loss contingencies on a pool basis and the impairment of loans on an individual basis, respectively.

[10] When acquisition, construction, and carrying costs exceed remaining loan proceeds, the loan is said to be "out-of-balance".

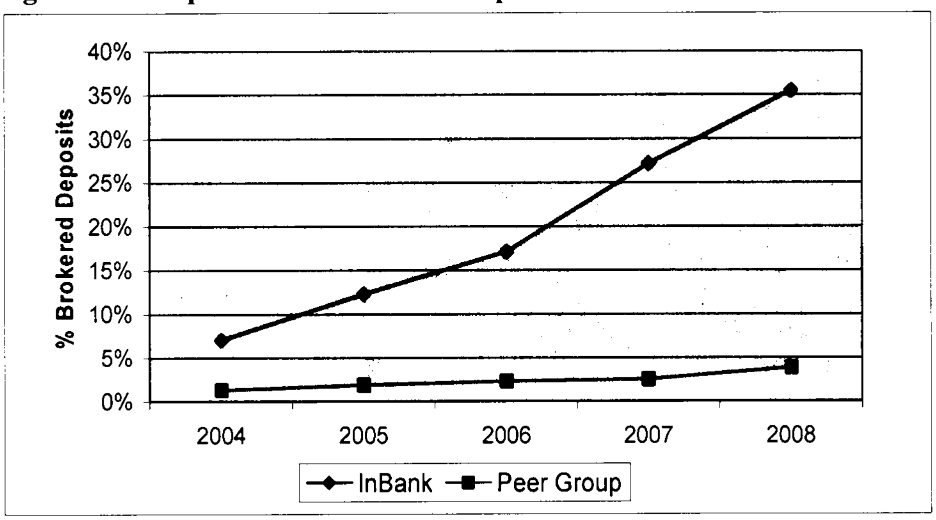
In the end, poor loan monitoring efforts by bank management were a major factor in the deterioration of the ADC portfolio which eventually led to the failure of the bank.

Funding

InBank's funding sources started shifting towards non-core funding beginning in 2005 and continued through 2008. The April 2005 examination noted that the overall liquidity position was adequate to support current and anticipated funding needs. Brokered deposits with laddered maturities represented 6.7 percent of total deposits. At the October 2006 State examination, examiners noted that the liquidity position was satisfactory, but close supervision was warranted. The State ROE also noted that management continued to rely on potentially volatile funds. Brokered deposits accounted for approximately 16 percent of total deposits and the non-core dependency ratio[11] stood at 20 percent.

Figure 3 illustrates InBank's brokered deposits as a percentage of total deposits and the increase in comparison to its peer group.

Figure 3: Comparison of Brokered Deposits for InBank and Its Peer Group



Source: UBPR for InBank.

In the April 2008 ROE, examiners noted that the level of liquid assets had declined and increasing reliance on volatile funding sources continued. Examiners indicated that funding of asset growth was primarily through brokered deposits and other time deposits over $100,000. Brokered deposits equaled 27 percent of total deposits.

[11] This ratio measures the degree to which the bank is funding longer-term assets (loans, securities that mature in more than one year, etc.) with non-core funding. Non-core funding includes funding that can be very sensitive to changes in interest rates such as brokered deposits, Certificates of Deposit greater than $100,000, and borrowed money. Higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

By the May 2009 Joint examination, the bank was considered *Critically Undercapitalized* for Prompt Corrective Action (PCA) purposes, which under section 29 of the Federal Deposit Insurance (FDI) Act and the FDIC's implementing regulation prevented the renewal or origination of brokered deposits. As of March 31, 2009, the net non-core funding dependency ratio was high at 39 percent and brokered deposits comprised 37 percent of total deposits. At the time, approximately $76 million in time deposits matured within 12 months and 61 percent of those deposits were brokered. Further, examiners expressed concerns about the Funds Management Policy, which did not adequately address contingency funding.

The increased dependence of the bank on brokered deposits, as demonstrated in Figure 3, in combination with the short-term maturity of its obligations, created an unsustainable liquidity condition that was a contributing factor to the bank's failure.

The FDIC's Supervision of InBank

The FDIC's and IDFPR's examinations and visitation of InBank identified key risks including credit administration weaknesses, inadequate loan underwriting, a high ADC loan concentration, and volatile funding sources, all of which eventually contributed to the bank's failure. The examinations were conducted according to the statutory schedule and offsite reviews were carried out according to established procedures. Also, the FDIC and the IDFPR pursued an informal supervisory action in 2008, as the bank's financial condition deteriorated, and a formal action in 2009.

Due to adverse changes in the economy in 2007, and the combination of InBank's risk management weaknesses and a high ADC loan concentration, the financial condition of the bank had significantly deteriorated by the April 2008 examination. In retrospect, the FDIC could have increased its supervisory attention to the bank in the 18 months before that examination with, for example, an on-site visitation. Doing so may have influenced InBank's Board and management to limit the risks assumed during this period. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate actions to address examiners' concerns. Moreover, the FDIC could have instituted a formal supervisory action as a result of the December 2008 visitation, which revealed further financial deterioration and the failure of bank management to fully comply with all provisions of the Memorandum of Understanding (MOU) agreed to in October of that same year.

Supervisory History

Between 2005 and 2009, the FDIC and IDFPR conducted one visitation and four safety and soundness examinations. InBank entered into a compliance MOU with the FDIC and IDFPR after the 2005 examination, agreeing to correct Bank Secrecy Act (BSA) violations, and to put procedures in place to prevent recurrence of the violations and deficiencies. According to the October 2006 State ROE, the MOU provisions were satisfactorily abated, which resulted in the lifting of the agreement in September 2005.

As a result of the deteriorated financial condition by the time of the April 2008 examination, InBank was again subject to an MOU on October 8, 2008. Subsequently, a Cease and Desist Order (C&D) was issued on August 7, 2009. Table 3 summarizes InBank's examination history from 2005 through 2009.

Table 3: InBank's Examination History from 2005 to 2009

Examination Date	On-Site Supervisory Effort	Supervisory Ratings (UFIRS)*	Informal or Formal Action** Taken
4/18/2005	FDIC Examination	122122/2	MOU 05/24/2005
10/30/2006	State Examination	222122/2	None
4/21/2008	FDIC Examination	243222/3	MOU 10/8/2008
12/9/2008	FDIC Visitation	343333/3	None
5/11/2009	Joint Examination	555555/5	C&D 08/7/2009

Source: Reports of Examinations, Visitation Report, Supervisory History.
*Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity 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.
**Informal supervisory actions often take the form of Bank Board Resolutions (BBR) or MOUs. Formal enforcement actions often take the form of PCA or C&Ds, but under severe circumstances can also take the form of insurance termination proceedings.

In 2008 and 2009, the FDIC and IDFPR pursued one informal action and one formal action to address concerns identified in the bank. A brief description of these actions follows.

- **MOU.** In response to the April 2008 examination, InBank entered into an MOU effective October 8, 2008. The MOU addressed ALLL levels, loan grading, loan review systems, lending policy, reduction of the bank's risky assets, and capital ratios, among other matters.
- **C&D.** InBank was *Critically Undercapitalized* for PCA purposes by the May 2009 Joint examination. In response to the critical capital levels and other concerns from this examination, the FDIC and IDFPR pursued a C&D, which was signed on August 7, 2009. The C&D stipulated, among other things, an increase in the capital level, reduction of delinquencies and classified assets, implementation of new lending and collection policies, a contingency funding plan, and the addition of two independent directors to the Board.

Supervisory Responses to Risks Identified at InBank

Through its supervisory efforts, the FDIC and IDFPR identified and documented key risks at the bank as described in the *Causes of Failure and Material Loss* section of this report. However, by the time the FDIC and IDFPR instituted an informal supervisory action in October 2008, the viability of the institution was already seriously in question as a consequence of the high level of classified loans and eroding capital protection.

October 2006 State Examination

At the October 2006 State examination, risk management practices were deemed appropriate. The ROE indicated that management had demonstrated a satisfactory ability to administer the bank's affairs despite an increasing risk profile, as adversely classified loans pushed the capital coverage ratio to 27 percent from 9 percent in the prior examination. In addition, several concerns were identified with credit administration; compliance with laws, rules and regulations; and the adequacy of the internal audit program. Furthermore, liquidity risk and sensitivity to market risk were described as elevated, though manageable, as management continued to rely on volatile funds.

Examiners indicated that management needed to revisit their methodology for determining the adequacy of the ALLL, and referred management to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses*. As a result of the level of classified loans at the examination, it was also determined that an additional loan loss provision of $1.6 million was needed.

In the ROE, examiners suggested that bank management needed to put additional effort into the following activities: 1) global cash flow analysis for borrowers, 2) obtaining and reviewing financial statements, and 3) additions to the loan watch list and changes to loan ratings.

As was the case in previous examinations, examiners again cited issues regarding BSA compliance and violations of FDIC Rules and Regulations. Examiners noted that the Board should reassess their commitment to BSA oversight. In addition, examiners recommended some enhancements to the internal audit program. These included appointing an audit coordinator or liaison, ensuring the audit coordinator or liaison remained impartial and independent of management, and conducting a risk assessment that included all areas of the bank.

As of September 30, 2006 CRE concentrations represented 611 percent of Tier 1 Capital plus the ALLL and ADC concentrations represented 516 percent of Tier 1 Capital plus the ALLL. In the ROE, examiners did not express concerns about these concentration levels other than pointing out that they continued to be the largest segment of the loan portfolio.

Despite concerns related to credit administration, the ALLL, and the internal audit function as noted by examiners in the ROE, and the level of loan concentrations, the bank's CAMELS composite was rated a "2." The *Risk Management Manual of Examination Policies* (Examination Manual) states that institutions rated "2" are "fundamentally sound...There are no material supervisory concerns and as a result, the supervisory response is informal and limited." As a result of this satisfactory rating, the bank continued on an 18-month examination cycle. No onsite supervisory activities were performed throughout 2007.

Offsite Monitoring

The offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that offsite review findings are factored into examination schedules and other supervisory activities. Offsite Reviews must be completed and approved 3½ months after each Report of Condition and Income (Call Report) date. This generally provides 45 days to complete the offsite reviews once Call Report data is finalized.

The system-generated Offsite Review List includes only institutions rated "1" and "2" that are either:

- Identified by the Statistical CAMELS Offsite Rating (SCOR) system as having a 35 percent or higher probability of downgrade to "3" or worse[12], or
- Identified in the Growth Monitoring System (GMS) as having a growth percentile of 98 or 99[13].

Between the October 2006 and the April 2008 examinations, InBank was identified for offsite review by the FDIC three times. These reviews noted consistently high Real Estate Stress Test (REST)[14] scores and high probabilities of downgrade for asset quality, management, and the composite ratings. Specifically, the June 30, 2007 offsite review indicated that nonaccrual loans were 2.90 percent of gross loans compared to a peer average of 0.57 percent, placing InBank in the 94th percentile of the distribution. Meanwhile, loans 30 to 89 days past due were 11.04 percent of gross loans (99th percentile). Furthermore, InBank had a REST score of 5.0, which pointed to the highly vulnerable position of the bank due to its ADC-concentrated loan portfolio. At this time, the Statistical CAMELS Offsite Rating (SCOR) probability of downgrade for the Asset Quality component was 92 percent and for the Management component was 79 percent. As a result of this offsite review, examiners contacted bank management. A senior official at the bank stated that most of the problems were related to one client and they were confident the situation would be resolved that year.

The September 30, 2007 offsite review again identified REST at 5.0, the volume of nonaccrual loans at 3.45 percent of gross loans (96th percentile), and loans past due 30 to 89 days at 8.15 percent of gross loans (99th percentile). The bank had not been able to improve its position relative to its peers. At the December 31, 2007 offsite review, it was noted that both the Return on Assets and the Tier 1 Capital ratio were declining.

---

[12] SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
[13] GMS is an offsite rating tool that identifies institutions experiencing rapid growth and/or having a funding structure highly dependent on non-core funding sources.
[14] REST scores are based on a simulation of what would happen in a real estate crisis, and are considered high when 3.5 or higher.

Supervisory Oversight on Loan Concentrations. Despite the fact that the Joint Guidance does not prescribe limits for loan concentrations, after its publication in 2006, it may have been appropriate as part of offsite monitoring during 2007 to compare InBank's most recent concentration levels to the prescribed criteria described earlier in this report (see page I-8). This analysis may have indicated the need for additional supervisory scrutiny and led to the detection of deteriorating assets before the bank reached the critical state identified in April 2008.

April 2008 FDIC Examination

By April 2008, the financial condition of the bank had significantly deteriorated. Examiners noted that the elevated adverse loan classifications (150 percent of Tier 1 Capital plus the ALLL) required an improvement of credit risk management practices. Examiners indicated that management needed to properly identify, measure, monitor, and control developing risks, including adjusting credit grades in a timely manner. Further violations of laws and FDIC Rules and Regulations were noted and examiners again suggested that management should adopt procedures to assure future compliance with laws and regulations.

At the time of this examination, CRE loans represented 604 percent of Tier 1 Capital plus the ALLL and the ADC concentration was at 276 percent of Tier 1 Capital plus the ALLL. Examiners noted that 95 percent of the classified assets were within the ADC loan portfolio. They recommended that given the inherent risk in this level of CRE lending and supervisory guidance (Joint Guidance), the bank should establish a more robust risk management system.

Several credit administration concerns were noted and recommendations were made during this examination. In the context of significant ADC concentrations, FDIC examiners suggested that an analysis of construction feasibility and project risk at initiation and throughout the loan term should be performed. Other suggestions included: analysis of construction projects' hard and soft costs; analysis of factors such as the construction schedule and permit status; and review of other risk indicators, such as recapitalization of interest reserves, lagging or reduced sales, and diversion of proceeds to the borrower or guarantor.

Examiners further noted that the loan review program was inadequate. This was a concern not noted in the prior examination. FDIC examiners suggested that InBank take the following steps in order to implement an adequate independent loan review process:

- Promptly identify loans having potential credit weaknesses, and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely actions can be taken and credit losses minimized;
- Provide essential information to determine the adequacy of the ALLL;
- Assess the adequacy of and adherence to internal credit policies and loan administration procedures, and monitor compliance with relevant laws and regulations;

- Evaluate the activities of lending personnel; and
- Provide senior management and the Board with an objective and timely assessment of the overall quality of the loan portfolio.

To improve the loan rating system, examiners recommended including several additional variables such as: debt service coverage ratio, loan-to-value ratio, experience of borrower, risk of construction project, and financial ratios of borrower. During this examination, the ALLL methodology was described as evolving.

As a result of this examination, the Asset Quality component was downgraded from a "2" to a "4" and the Management component rating was downgraded from a "2" to a "3." An MOU was instituted in October of 2008 to address examiners' concerns. Some of the credit administration weaknesses that prompted the downgrade of the Asset Quality component from "2" to a "4" had been noted in prior examinations.

December 2008 FDIC Visitation

The FDIC conducted an onsite visitation in December of 2008 in order to assess the progress towards meeting the MOU provisions agreed to in October. Examiners found that management had made limited progress in addressing risks present in the loan portfolio and asset quality had further deteriorated. As an example, nonaccrual loans and leases as a percentage of gross loans grew from 4.35 percent to 6.51 percent and the past due ratio also increased from 7.16 percent to 9.24 percent. The Tier 1 Capital leverage ratio had decreased from 9.13 percent to 8.40 percent. In addition, InBank had failed to adhere to some of the MOU provisions. This visitation resulted in interim downgrades to the Capital, Earnings, Liquidity, and Sensitivity to Market Risk components from "2" to "3." The Management component was still rated a "3."

Supervisory Action May Have Been Prudent. According to the Examination Manual, "to effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking... when corrective action is not taken until conditions have deteriorated; it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant." Given the deterioration of the bank found during this visitation, it may have been prudent at this juncture for the FDIC to institute a formal supervisory action that would have prompted bank management to more promptly curtail risky activities.

May 2009 Joint Examination

At the time of the May 2009 examination, the condition of the bank had severely deteriorated. Adversely classified assets represented 420 percent of capital and, after an increase in the loan loss provision due to credit downgrades during the examination, the Tier 1 Capital ratio fell to negative 0.46 percent. The critical condition of the bank was attributed by examiners to the continued failure of management and the Board to effectively manage, identify, and correct deficient operations. Examiners noted that a senior official originated the majority of the credits and dominated the direction of the bank, as discussed previously in this report. As a result of the examiners' findings, all CAMELS components were downgraded to a "5."

Examiners noted that the ALLL analysis failed to identify needed provisions mainly due to inaccurate loan ratings. In addition, several repeat recommendations we noted to improve the following processes:

- Credit administration;
- Construction monitoring;
- Global cash flow analysis; and
- Credit rating systems.

Examiners also noted that underwriting and loan presentation sheets at renewal failed to identify borrower repayment weaknesses. Borrowers and guarantors often lacked the adequate cash flow or liquid assets to meet debt service requirements. Moreover, the bank was making unsecured loans to developers with minimal liquidity who were highly leveraged.

As a result of the examination findings, a C&D was signed on August 7, 2009. The C&D noted that InBank was:

- Operating with management whose policies and practices were detrimental to the Bank and jeopardized the safety of its deposits;
- Violating laws, rules and regulations; and
- Operating with a Board which had failed to provide adequate supervision over and direction to the management of the bank to prevent unsafe and unsound banking practices.

By not acting sooner, the FDIC missed opportunities to address developing problems at an earlier stage.

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. 12 Code of Federal Regulations (CFR) Part 325 of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. However, capital levels turned out to be a lagging indicator of the institution's financial well-being. Other factors including management, asset quality, and funding, identified in earlier examinations, were better indicators that the bank's viability was in question.

Table 4 illustrates InBank's capital level categories as of each examination date. The bank was considered *Well Capitalized* for PCA purposes from the April 2005 examination until the April 2008 examination when the institution's condition had already seriously deteriorated.

Table 4: Summary of Capital Level Categories for InBank

Key Capital Ratios (as %'s)	Well Capitalized Thresholds*	3/31/09	12/31/07	6/30/06	12/31/04
Total Risk-Based Capital Ratio	10%	(.57)	11.88	12.44	11.39
Tier I Risk-Based Capital Ratio	6%	(.57)	11.26	11.51	10.34
Tier 1 Leverage Ratio	5%	(.46)	9.42	9.94	7.84
Capital Category		Critically Under-capitalized	Well Capitalized	Well Capitalized	Well Capitalized

Source: ROEs for InBank.
* Minimum capital requirements to be considered *Well Capitalized* for PCA purposes.

By the May 2009 Joint examination, examiners noted that capital was critically deficient and incapable of absorbing or protecting the bank against losses. External capital was needed to recapitalize the bank. Non-loan losses of $1.1 million were noted and the ALLL required a provision of $19.7 million. After these adjustments, the Tier 1 Capital ratio fell to a negative 0.46 percent.

On June 22, 2009 the FDIC issued a PCA Directive. Pursuant to FDIC Regulations,[15] the Directive constituted written notice of InBank's capital category, which was *Critically Undercapitalized* as of the date of the Directive. In accordance with FDIC Regulations,[16] InBank was required to file a written capital restoration plan by July 17, 2009.

On August 7, 2009 a C&D was signed, effective August 17, 2009, which stated that within 90 days from the effective date of the C&D, the bank should maintain its level of Tier 1 Capital ratio at a minimum of 9 percent and its level of total Risk-Based Capital ratio at a minimum of 12 percent. The bank was unable to raise the required capital and on September 4, 2009, the IDFPR closed InBank due to its deteriorating asset quality and eroding capital, and named the FDIC as receiver.

[15] 12 Code of Federal Regulations (C.F.R.) § 325.102(b)(3)
[16] 12 C.F.R. § 325.104(a)

Objectives, Scope, and Methodology

Objectives

We performed this performance audit to satisfy the requirements of 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 evaluated whether capital was an adequate indicator of safety and soundness and the FDIC's compliance with PCA guidelines.

We conducted this performance audit from December 2009 to February 2010 in accordance with Generally Accepted Government Auditing Standards (GAGAS). 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, as described in the Scope and Methodology section, 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 InBank from March 2002, until its failure on September 4, 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 utilized the following techniques:

- Analyzed examination and visitation reports prepared by the FDIC and the IDFPR examiners from March 2002 to May 2009.
- Reviewed the following documentation:
  - Financial institution data and correspondence maintained at DSC's Chicago Regional Office and Chicago Field Office, as provided to KPMG by DSC.

- Reports prepared by the Division of Resolutions and Receiverships and DSC relating to the bank's closure.

- Pertinent DSC policies and procedures.

- Interviewed the relevant FDIC officials having supervisory responsibilities pertaining to InBank, which included DSC examination staff in the Chicago Region.

- Interviewed appropriate 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 Illinois state laws.

KPMG relied primarily upon the materials provided by the FDIC OIG and DSC, including information and other data collected during interviews. KPMG did not perform specific audit procedures to ensure the information and data were complete and accurate. KPMG is, however, aware that Circular 12000.1, Cooperation with the Office of Inspector General, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

Interviews were conducted to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the FDIC and the bank. KPMG relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

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, ROEs, and interviews of examiners to understand InBank'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 ROEs, 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 OIG's 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 are discussed, where appropriate, in this report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Appendix 2

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 Reports) 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.
Capital Directive (Directive)	A capital directive is a final order issued by the FDIC to a State nonmember bank that fails to maintain capital at or above its minimum capital requirements
Cease and Desist Order (C&D)	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated by the regulators when they have determined that 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.
Global Cash Flow Analysis	An analysis of the borrower's and guarantor's total cash flows which should consider inflows, as well as both required and discretionary cash outflows from all activities. This may involve integrating multiple partnerships and corporate tax returns, business financial statements, K-1 forms, and individual tax filings.

Term	Definition
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
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 corrective supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
Uniform Bank Performance Report (UBPR)	The UBPR is an 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
ASC	Accounting Standard Codification
BBR	Bank Board Resolution
BSA	Bank Secrecy Act
C&D	Cease and Desist Order
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CFR	Code of Federal Regulations
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FAS	Financial Accounting Standard
FDI	Federal Deposit Insurance
GAGAS	General Government Auditing Standards
GMS	Growth Monitoring System
IDFPR	Illinois Department of Financial and Professional Regulation
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
REST	Real Estate Stress Test
ROE	Report of Examination
SCOR	Statistical CAMELS Offsite Rating
TDR	Troubled Debt Restructuring
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

OIG Evaluation of Management Response

OIG Evaluation of Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 22, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of InBank's failure and the FDIC's supervision of the bank. DSC stated that it recognizes that strong supervisory attention is necessary for institutions with high ADC concentrations and volatile funding sources, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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

March 22, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of InBank, Oak Forest, Illinois (Assignment No. 2010-006)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of InBank which failed on September 4, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on March 5, 2010.

The Report concludes InBank failed due to poor management and inadequate Board oversight, a high concentration in acquisition, development, and construction (ADC) loans, poor loan underwriting, weak credit administration practices, and reliance on volatile funding sources. Also noted was the bank's excessive volume of loans to leveraged builders and developers in the Chicago area, resulting in increased delinquencies and non-performing assets when the local real estate market began experiencing deterioration.

The Report notes that examinations and offsite reviews were carried out according to established policies. Due to declining trends, DSC increased oversight of InBank through off-site reviews and telephone contacts during 2007. During the April 2008 FDIC examination, examiners recognized a significant deterioration of InBank's condition, leading the FDIC and Illinois Department of Financial and Professional Regulation to enter into an informal enforcement action with InBank. DSC conducted an on-site visitation in December 2008, resulting in additional component ratings downgrades, and affirming the composite "3" rating assigned at the earlier 2008 examination. During the subsequent joint examination in May 2009, examiners found that InBank's condition had continued to deteriorate significantly, which led to a formal enforcement action. The Board was unable to raise additional capital and InBank subsequently failed.

As noted in the Report, DSC issued timely guidance to all insured institutions, and examiners made appropriate recommendations to InBank management concerning elevated concentration risks. DSC recognizes that strong supervisory attention is necessary for institutions with high ADC concentrations and volatile funding sources, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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