Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-021

Material Loss Review of Mutual Bank, Harvey, Illinois

February 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On July 31, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR) closed Mutual Bank and named the FDIC as receiver. On August 28, 2009, the FDIC notified the OIG that Mutual Bank's total assets at closing were $1.7 billion and the estimated material loss to the Deposit Insurance Fund (DIF) was $693.8 million. As of December 31, 2009, the estimated loss had decreased to $656.2 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 Mutual Bank.

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

Mutual Bank was a state-chartered, nonmember bank established by the IDFPR and insured by the FDIC effective December 15, 1962. Mutual Bank was a minority depository institution, with its main office located in Harvey, Illinois, a suburb of Chicago. The bank maintained 10 branches in Illinois, and one branch each in New York, New Jersey, and Texas. The institution also operated a small trust department. The bank specialized in residential and commercial real estate (CRE) loans, including acquisition, development, and construction (ADC) loans. Mutual Bank was a wholly-owned subsidiary of First Mutual Bancorp of Illinois, Inc., a one-bank holding company. The Chairman of the bank and his family controlled 95 percent of the holding company.

Audit Results

Causes of Failure and Material Loss

Mutual Bank's Board and management failed to provide the necessary oversight to effectively manage the risks associated with an aggressive growth strategy centered in CRE and ADC lending that included out-of-area loan participations and brokered loans. This growth, in turn, depended upon increasingly volatile funding sources, including an extensive reliance on brokered and large time deposits, which became restricted as economic conditions deteriorated. Overall risks were exacerbated by the bank's poor loan underwriting and credit administration and excessive and inappropriate use of interest reserves. In addition, staffing in key operational areas did not keep pace with the continued growth and complexity of the institution's loan portfolio. According to examiners, also contributing to the failure was the bank President's considerable influence over the bank's growth strategy and operations and a compensation agreement that provided an incentive to pursue increased risk and growth.

Declining earnings, resulting from the deteriorating loan quality in the bank's portfolio, severely eroded the institution's capital. Further evidence to the cause of Mutual Bank's failure can be seen in certain financial indicators. Specifically, between the 2007 and 2008 examinations, the bank's adversely classified assets increased from $54 million to $300 million; loans related to property foreclosures increased from $477,000 to $19.2 million, an increase of almost 4,000 percent; and net charge-offs of

CRE loans increased from $8 million at year-end 2007 to $57 million by year-end 2008. Ultimately, the IDFPR closed Mutual Bank in July 2009 due to insufficient capital to support the bank's operations.

The FDIC's Supervision of Mutual Bank

From May 2004 until the bank failed in July 2009, the FDIC, in conjunction with the IDFPR, provided ongoing supervision of Mutual Bank through five on-site risk management examinations and four visitations. The FDIC also conducted offsite reviews and other offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in Mutual Bank's operations and brought these to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's significant concentration in CRE and ADC loans, weaknesses in loan underwriting and credit administration and the limited resources devoted to those functions, and the bank's increasing reliance on potentially volatile funding sources. Examiners also reported apparent violations of regulations and contraventions of interagency policy associated with the institution's lending practices. Regulators pursued an enforcement action to correct problems identified in the June 2008 examination. However, earlier and more formal supervisory action may have been warranted as a result of the May 2007 examination, in light of the bank's high-risk profile resulting from CRE and ADC concentrations in a declining real estate market and identified risk management deficiencies.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. However, by the time Mutual Bank's capital levels fell below the required thresholds necessary to implement PCA, the bank's condition had deteriorated to the point at which the institution could not raise additional capital in the time period necessary to prevent a liquidity failure, and the bank was subsequently closed on July 31, 2009.

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 February 26, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report.

In its response, DSC reiterated the OIG's conclusions regarding the cause of Mutual Bank's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. DSC also noted that it has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: February 26, 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 Mutual Bank, Harvey, Illinois*
(Report No. MLR-10-021)

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 Mutual Bank, Harvey, Illinois. On July 31, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR) closed the institution and named the FDIC as receiver. On August 28, 2009, the FDIC notified the OIG that Mutual Bank's total assets at closing were $1.7 billion and the estimated material loss to the Deposit Insurance Fund (DIF) was $693.8 million. As of December 31, 2009, the estimated loss had decreased to $656.2 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 Mutual Bank's failure and the FDIC's efforts to ensure that Mutual Bank's Board of Directors (Board) and management operated the bank in a safe and sound manner.

[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.

This report does not contain recommendations. Instead, as major causes, trends, and 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. Appendix 4 contains the Corporation's comments on this report.

Background

Mutual Bank was a state-chartered, nonmember bank established by the IDFPR and insured by the FDIC effective December 15, 1962. Mutual Bank was a minority depository institution, with its main office in Harvey, Illinois, a suburb of Chicago. In early 2004, Mutual Bank acquired Security Bank of DuPage (Security Bank), Naperville, Illinois. Mutual Bank maintained 10 branches in Illinois, and one branch each in New York, New Jersey, and Texas. The institution also operated a small trust department. The bank specialized in residential and commercial real estate (CRE) loans, including acquisition, development, and construction (ADC) loans. Mutual Bank was a wholly-owned subsidiary of First Mutual Bancorp of Illinois, Inc., a one-bank holding company. The Chairman of the bank and his family controlled 95 percent of the holding company.

Table 1 provides details on Mutual Bank's financial condition as of March 31, 2009, and for the 4 preceding calendar years.

Table 1: Selected Financial Information for Mutual Bank

Financial Measure	2005	2006	2007	2008	2009*
Total Assets ($000s)	898,633	1,169,229	1,523,264	1,693,167	1,654,211
Total Loans ($000s)	729,729	908,623	1,142,740	1,404,635	1,351,618
Total Deposits ($000s)	803,102	1,048,641	1,381,317	1,566,311	1,581,860
Total Brokered Deposits ($000s)	291,530	278,125	337,599	530,560	512,496
Brokered Deposits/Total Deposits	36.30%	26.52%	24.44%	33.87%	32.40%
Net Income (Loss) ($000s)	10,002	20,671	16,109	(65,621)	(57,463)

Source: Uniform Bank Performance Reports (UBPR) for Mutual Bank.
*March 31, 2009

Causes of Failure and Material Loss

Mutual Bank's Board and management failed to provide the necessary oversight to effectively manage the risks associated with an aggressive growth strategy centered in CRE and ADC lending that included out-of-area loan participations and brokered loans. This growth, in turn, depended upon increasingly volatile funding sources, including an extensive reliance on brokered and large time deposits, which became restricted as economic conditions deteriorated. Overall risks were exacerbated by the bank's poor loan underwriting and credit administration and excessive and inappropriate use of interest reserves. In addition, staffing in key operational areas did not keep pace with the continued growth and complexity of the institution's loan portfolio. According to examiners, also contributing to the failure was the bank President's considerable influence over the bank's growth strategy and operations and a compensation agreement that provided an incentive to pursue increased risk and growth.

Declining earnings, resulting from the deteriorating loan quality in the bank's portfolio, severely eroded the institution's capital. Further evidence to the cause of Mutual Bank's failure can be seen in certain financial indicators. Specifically, between the 2007 and 2008 examinations, the bank's adversely classified assets increased from $54 million to $300 million; loans related to property foreclosures increased from $477,000 to $19.2 million, an increase of almost 4,000 percent; and net charge-offs of CRE loans increased from $8 million at year-end 2007 to $57 million by year-end 2008. Ultimately, the IDFPR closed Mutual Bank in July 2009 due to insufficient capital to support the bank's operations.

Board Oversight and Risk Management

According to the DSC *Risk Management Manual of Examination Policies* (Examination Manual), the quality of management is probably the single most important element in the successful operation of a bank. The Board formulates sound policies and objectives for the bank, and provides for the effective supervision of its affairs and promotion of its welfare. The primary responsibility of senior management is to implement the Board's policies and objectives in carrying out the bank's day-to-day operations.

Mutual Bank's Board and management failed to implement risk management, loan underwriting, credit administration, and risk monitoring practices commensurate with the bank's growth, funding strategy, and complexity. These weaknesses were exacerbated by insufficient staffing and the bank President's influence over operations and personal compensation plan.

Risk Management Practices

Mutual Bank's growth in CRE loans, and to a lesser degree, ADC, began in 2004 and continued into 2008 despite declining real estate prices in the bank's market areas. According to FDIC officials, many of the strategic credit decisions made by Mutual Bank's senior management appeared to have been made with an excessive emphasis on growth and earnings. In addition, management engaged loan brokers who brought out-of-area deals to the bank that were poorly underwritten and had high-risk characteristics. These deals included hospitality (hotel/motel) and gasoline/convenience store loans in the California, Florida, New York, New Jersey, Maryland, and Texas markets.

From 2004 to 2007, Mutual Bank's management did not sufficiently monitor credit concentrations, effectively identify problem credits in credit reviews, or correct weaknesses in credit underwriting, which included inaccurate cash flow calculations, incomplete loan presentations, and inadequate overdraft procedures.

Financial Institution Letter (FIL)104-2006, entitled, *Commercial Real Estate Lending Joint Guidance*, provides a risk management framework that institutions should implement to effectively identify, measure, monitor, and control concentration risk. That framework includes effective oversight by bank management, including the Board and senior executives; portfolio stress testing and sensitivity analysis; sound loan underwriting and administration; and portfolio management practices.

Loan Underwriting and Credit Administration Practices

Mutual Bank traditionally concentrated its loan portfolio in the hospitality and gasoline/convenience store industries. Rapid loan growth from 2004 through 2008 continued to focus on these industries, and expanded into new geographic markets as a result of loan participations purchased in California, Florida, and Texas and brokered ADC loans in New York, New Jersey, and Maryland. Mutual Bank management considered these credits more as investments than loans, as well as a means to achieve higher yields, and relied on the brokers of these loans for overall control and monitoring.

According to the Examination Manual, institutions purchasing a loan participation must make a thorough, independent evaluation of the transaction and risks involved before committing any funds. Institutions should also apply the same standard of prudence, credit assessment, approval criteria, and “in-house” limits that would be employed if the purchasing organization were originating the loan.

The following are examiner comments regarding Mutual Bank’s weaknesses in the bank’s loan underwriting and credit administration – including those involving participations – in Reports of Examination (ROE) from 2004 to 2008.

- Loan participations contributed to inconsistencies in credit administration, due to the increased loan volume, and further exacerbated existing loan underwriting and credit administration weaknesses.

- Global financial analyses were not consistently completed on all large borrowing relationships. Also, borrower equity contributions noted in the loan presentations were not always achieved or obtained as presented and approved, and sources of borrowers’ equity were not always documented and verified.

- Loan presentations submitted to the bank’s Loan Committee did not always contain critical information necessary for members to make an informed decision on certain credits. In some instances, critical weaknesses or deficiencies were excluded from loan presentations, which, if known to voting parties, could have greatly influenced their decisions to approve, renew, and/or extend additional credit to borrowers.

- Mutual Bank’s appraisal review process needed strengthening. Use of a checklist with simple "yes" and "no" questions provided little to no narrative on the assumptions used or general quality of the appraisal itself. The narrative portions of the reviews did not consistently include discussion of the appropriateness of assumptions used in the appraisals. Further, in some instances, the appraisals were not reviewed until after the loan was funded. Finally, examiners noted concerns with the appraisal company most commonly used by the bank, including the company's questionable support for comparables, capitalization rates, and final values, and the potential lack of objectivity and diversification of appraisal work in general.

- Interest reserves were used as a primary means of debt repayment. In many instances, bank management had also approved the use of bank-funded interest reserves on loans where the scheduled interest and principal payments should have been the responsibility of the borrower. Further, examiners noted that the overall risk level in the portfolio was heightened by the significant volume of loans granted with interest reserves, and numerous credits had been renewed with interest reserves being replenished from new monies advanced. Specifically, Mutual Bank:

    - funded interest reserves to service loans or renewals for real estate with no immediate plans for construction and/or development;
    - used interest reserves to service loan renewals on construction projects that had experienced cost overruns or were not being paid in accordance with the original construction loan agreement; and
    - used interest reserves to service loans secured by income-producing rental properties (residential or commercial) in place of normal amortizing loan terms.

- Although interest reserves may be acceptable under certain conditions, the inappropriate application of this practice served to mask problems within individual projects, minimizing past-due ratios, and potentially exposing the bank to additional credit losses. Management did not maintain a formal monitoring system to track interest reserve balances nor implement any credit risk management practices to identify when loan projects were not performing as expected. Without any formal tracking mechanisms in place to properly monitor the use of interest reserves, the true risk exposure resulting from this practice was unknown.

- Mutual Bank's Loan Policy was silent regarding the use of interest reserves and did not provide guidelines for identifying problem loans, granting liberal credit terms and conditions, limiting the extension of unsecured loans to fund interest payments on other notes, and eliminating the ability to extend new money based on old appraisals when the market environment has changed significantly.

- The Loan Policy should have provided guidance regarding the acceptable usage of interest reserves, to include (1) eligible and ineligible loan types and purposes, (2) minimum collateral coverage requirements, (3) required repayment capacity of the obligor outside of the interest reserve, (4) procedures for the renewal of loans with interest reserves, and (5) guidelines for decisions to terminate interest reserves and/or the capitalization of interest.

Risk Monitoring Systems

Examiners also identified the following weaknesses in Mutual Bank's risk monitoring systems.

- The bank's internal loan-rating system did not recognize a large number of credit rating downgrades despite the presence of higher-risk exposure and payment problem indicators. As a result of the 2008 examination loan review, there were 46 individual loan downgrades, based solely on loans sampled by examiners. Multiple adverse risk factors were identified during the loan review, with little or no action taken by bank management toward modifying risk ratings or alerting senior management of the changing risk condition of a credit. Significant adverse risk factors included timing delays in completing construction projects, recapitalization of interest reserves without completion of a proper credit analysis, failure to document the required equity contribution of borrowers, lagging sales/actual closings within development projects, and improper repayment structures/timelines.

- Mutual Bank's Watch List[3] reporting system did not adequately identify factors that caused the weakening of credits or collection efforts. Consequently, the reporting system lacked sufficient monitoring information related to the (1) estimated completion costs in relation to remaining funding availability, (2) summary of the interest reserve position, (3) sales activity with comparisons to original projections, and (4) borrower and/or guarantor support need and availability.

- Loans with loan-to-value (LTV) ratios in excess of the supervisory limits were not always identified by management as exceptions or reported to the Board. In some cases, the failure to identify these exceptions was due to the reliance on appraised value instead of purchase price on acquisition loans (especially on out-of-area participation loans), the recapitalization of interest reserves with corresponding increases in LTV, and the general lack of oversight of the provisions of this regulation. Examiners considered the overall volume of LTV exceptions to be excessive and demonstrative of the heightened risk in the portfolio.

Staffing Levels to Support Asset Growth

Examiners also cited limited staffing in key support positions as a contributing factor to the deterioration in asset quality and identified loan administration weaknesses within the institution. During the 2006 examination, examiners found that the risk management systems had not kept pace with the bank's asset growth, credit administration weaknesses were more pronounced as a result of this loan growth, and there had been no corresponding increase in staffing to address the bank's growth. Two years later, at the time of the 2008 examination, management practices and staffing were again found to be unacceptable relative to the institution's size, complexity, and risk profile.

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[3] A Watch List is a detailed loan report that represents the bank's internal grading or assessment of quality of its loan portfolio.

Bank management had traditionally operated with limited staffing within the loan department. Branch staffing was limited to one loan officer (with no lending authority) per branch, which severely restricted the ability to adequately monitor collateral or the status of ADC-type credits, particularly for out-of-area loans. Given the size of the loan portfolio, the high-risk and administratively-intensive nature of originated credits, and the limited number of loan officer positions, examiners were alarmed that a formalized credit analyst or risk management department did not exist within the loan operations area.

Bank President's Influence and Compensation

The 2008 examination report stated that Mutual Bank's President exerted a great deal of influence and control over all facets of bank operations and was the driving force behind the bank's expansion into New York, New Jersey, and Texas. According to the report, many of the high-risk loan deals originated by the bank were directly tied to the President. The bank's Executive Vice President told examiners that the President frequently provided borrower information to the loan officers with orders that certain loan deals had to be funded, despite the inherent risks associated with them. Further, the Executive Vice President stated that it was then up to the lending staff to find a way to make the deals work.

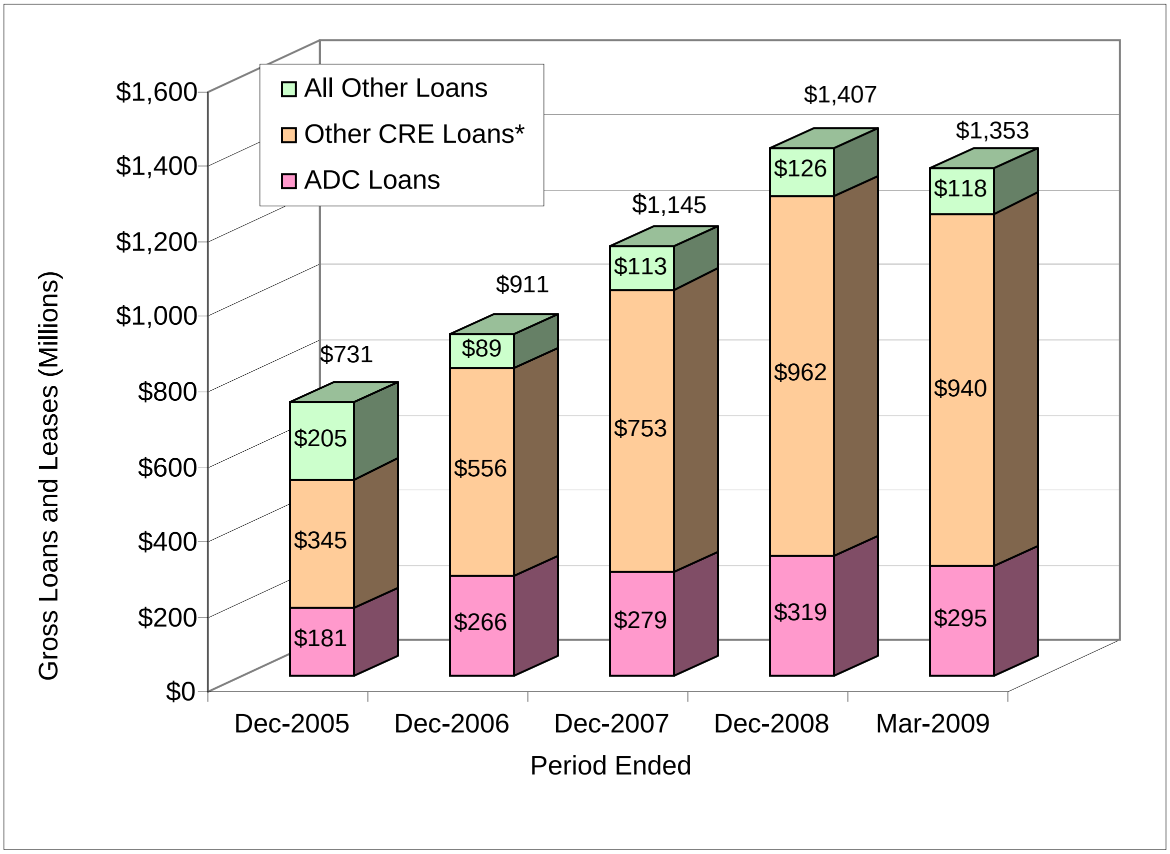
According to FDIC management officials and examiners, the structure of the President's employment contracts provided an incentive to pursue increased risk and growth in the loan portfolio. In 2008, the Board approved and entered into a new 10-year employment contract with the bank President to replace the previous 10-year employment contract that had expired at the end of 2007. The examiners considered the compensation agreement to be inappropriate because the bonus structure was based solely upon the return on assets of the bank, with no controls or limitations related to other key factors, such as asset quality, loan portfolio performance, capital, liquidity, or interest rate risk.

CRE and ADC Loan Concentrations

Mutual Bank's decision to concentrate in CRE and ADC loans was a principal factor leading to the bank's poor financial condition and subsequent failure. Deficient oversight of its high CRE and ADC loan concentrations negatively impacted the bank's ability to effectively manage operations in a declining economic environment. Asset growth rates were in excess of 30 percent annually, peaking at nearly 93 percent in 2004, as a result of Mutual Bank's acquisition of Security Bank. As of December 31, 2003, Security Bank had assets totaling $122 million. Further, asset growth was not limited to the bank's primary market, as growth in later years included significant lending in the Texas, New York, and New Jersey markets. Overall, Mutual Bank's growth resulted in concentrations of high-risk CRE and ADC loans, including to individuals and companies in economically-sensitive industries such as hospitality and gasoline/convenience stores.

Figure 1 illustrates the general composition and growth of Mutual Bank's loan portfolio in the years preceding the institution's failure. Total concentrations of CRE and ADC loans were significant – ranging from 72 percent to 91 percent of gross loans and leases from 2005 to 2009.

Figure 1: Composition of Mutual Bank's Loan Portfolio



Source: OIG analysis of UBPRs and Consolidated Reports of Condition and Income (Call Reports) for Mutual Bank.
* Includes owner-occupied CRE.

Joint guidance issued by the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, dated December 12, 2006, recognizes that there are substantial risks posed by CRE and ADC concentrations. Such risks include unanticipated earnings and capital volatility during an adverse downturn in the real estate market. The December 2006 guidance defines institutions with significant CRE concentrations as those reporting loans for construction, land and development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital, where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. According to the guidance, 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 previous criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk.

As shown in Table 2, Mutual Bank's concentrations in ADC loans consistently represented more than 100 percent of Total Capital from 2005 to 2009, exceeding the criteria for identifying institutions that may have warranted further supervisory analysis once the FDIC's guidance took effect in December 2006. In addition, ADC loans as a percent of the bank's total capital and total loans were significantly above its peer group averages during the same period.

Table 2: Mutual Bank's ADC Concentrations Compared to Peer Group

Period Ended	ADC Loans as a Percent of Total Capital			ADC Loans as a Percent of Total Loans		
	Mutual Bank	Peer Group	Mutual Bank Percentile	Mutual Bank	Peer Group	Mutual Bank Percentile
Dec 2005	193%	104%	82	25%	14%	80
Dec 2006	224%	136%	79	29%	18%	79
Dec 2007	209%	147%	73	24%	19%	68
Dec 2008	271%	139%	86	23%	17%	72
Mar 2009	819%	129%	99	22%	16%	72

Source: UBPR data for Mutual Bank.

Mutual Bank's CRE concentrations in 2007, 2008, and 2009 also exceeded the levels that may be identified for further supervisory analysis, as shown in Table 3. In addition, CRE loans as a percent of the bank's total capital and total loans ranked significantly above the bank's peer group averages from 2007 to 2009 – years in which the guidance was in effect.

Table 3: Mutual Bank's CRE Concentrations Compared to Peer Group*

Period Ended	CRE Loans as a Percent of Total Capital			CRE Loans as a Percent of Total Loans		
	Mutual Bank	Peer Group	Mutual Bank Percentile	Mutual Bank	Peer Group	Mutual Bank Percentile
Dec 2007	415%	302%	75	49%	39%	71
Dec 2008	576%	307%	92	48%	38%	72
Mar 2009	1,855%	295%	99	50%	38%	75

Source: UBPR data for Mutual Bank.
* Percentages for Mutual Bank and peer group exclude owner-occupied CRE.

In the May 2007 examination, examiners identified concentrations of credit in CRE loans totaling 802 percent of Tier 1 Capital. Examiners also singled-out for attention the bank's commercial owner-occupied loans and credits extended to the hospitality industry, representing 198 percent and 149 percent of Tier 1 Capital, respectively. Mutual Bank's CRE and ADC loan concentrations at the December 2007 and subsequent June 2008 examinations continued to exceed the 300 percent and 100 percent supervisory criteria, respectively, as well as the bank's peer group averages. As reported in the June 2008 examination, total CRE lending (including ADC) represented 1,018 percent of total risk-based capital and was in need of close management attention.

Reliance on Non-Core Funding Sources

In the years preceding its failure, Mutual Bank became increasingly dependent on non-core funding sources to support loan growth and maintain adequate liquidity. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. Placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

Historically, Mutual Bank relied heavily on potentially volatile funding sources, particularly promotional, higher-priced Certificates of Deposit (CD), brokered deposits, and Federal Home Loan Bank (FHLB) borrowings to support loan growth. Table 4 provides details on the bank's non-core funding sources during the years prior to its failure.

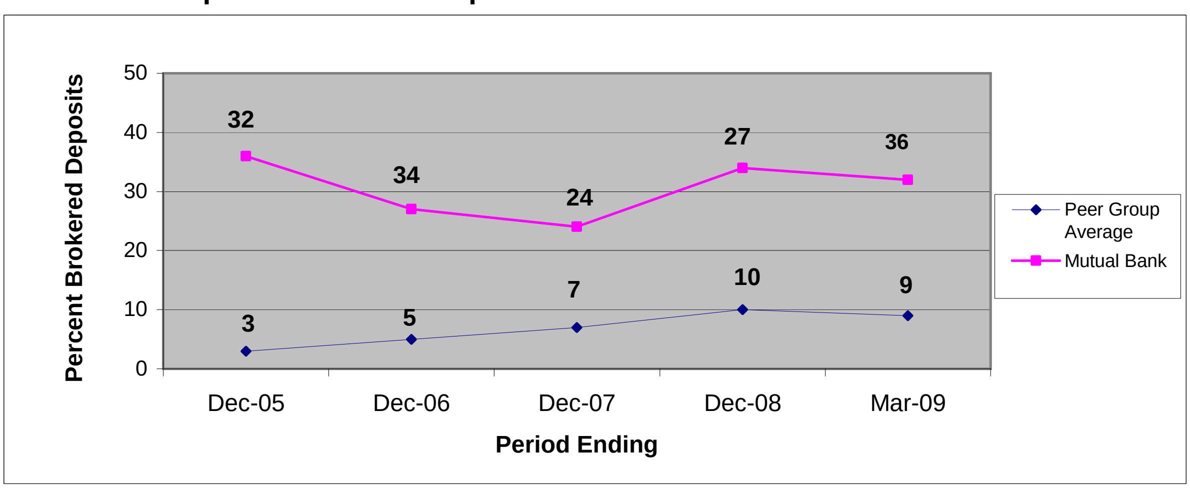
Table 4: Mutual Bank's Non-Core Funding Sources

Period Ended	Time Deposits $100,000 or More ($000s)	Brokered Deposits ($000s)	FHLB Borrowings ($000s)
December 2005	278,432	291,530	5,800
December 2006	408,035	278,125	5,800
December 2007	590,812	337,599	5,800
December 2008	345,790	530,560	15,300
March 2009	322,721	512,496	15,300

Source: UBPR data for Mutual Bank.

In addition, Figure 2 illustrates that Mutual Bank's use of brokered deposits was historically higher than its peer group – levels that placed the bank in the 90th to 97th percentile of its peer group.

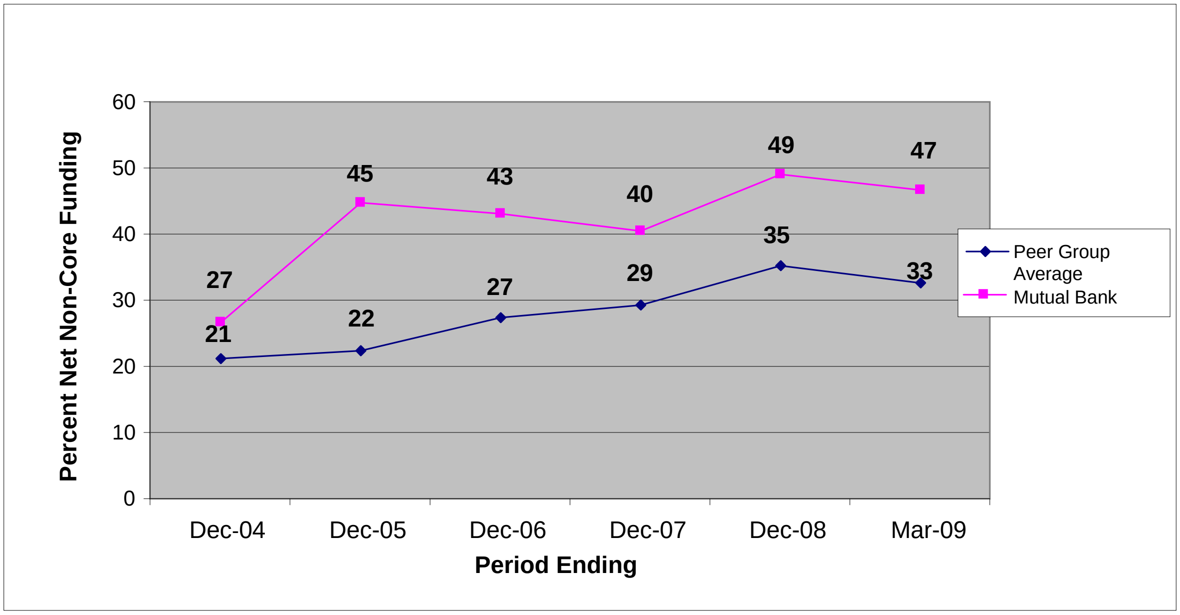
Figure 2: Mutual Bank's Percentage of Brokered Deposits to Total Deposits Compared to Peer Group



Source: UBPR data for Mutual Bank.

Further, Mutual Bank's net non-core funding dependence ratio[4] consistently outpaced its peer group, as illustrated in Figure 3. From December 2005 until March 2009, the institution's net non-core funding dependence ratio ranged from the 78th to 92nd percentile of its peer group.

Figure 3: Mutual Bank's Net Non-Core Funding Dependence Ratio Compared to Peer Group



Source: UBPR for Mutual Bank.

During the June 2008 examination, examiners determined that Mutual Bank's liquidity levels, contingency liquidity planning, and existing funds management practices were inadequate and insufficient to support the bank's operations. Brokered deposits and high-rate CDs totaled $1.2 billion, or 84 percent of total bank deposits. CDs over $100,000 represented approximately 53 percent of total CDs, which further exposed the bank to volatility risk. Additionally, the bank had approximately $123 million in high-rate CDs that were scheduled to mature by the end of 2008. Deteriorating assets and decreasing capital put stress and restrictions on the types of brokered deposit rates the bank could offer when trying to maintain or secure additional funding.

By June 2008, the bank had fallen to *Adequately Capitalized*,[5] thereby negatively impacting the bank's major funding sources of brokered deposits and high rate CDs. Further, given the severity of the bank's asset quality concerns and capital levels,

[4] The net non-core funding dependence ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources that may not be available in times of financial stress.

[5] Institutions pursuant to Section 29 of the Federal Deposit Insurance Act are not allowed to utilize brokered funds without obtaining a brokered deposit waiver. Part 337 of the FDIC's Rules and Regulations also prohibits financial institutions in troubled condition and/or *Adequately Capitalized* from offering deposit rates in excess of 75 basis points above area market rates for similar type deposits.

regulators were concerned that large depositors would begin fleeing to safer investments and of the strong probability that existing unsecured borrowing lines would be reduced or restricted.

The FDIC's Supervision of Mutual Bank

From May 2004 until the bank failed in July 2009, the FDIC, in conjunction with the IDFPR, provided ongoing supervision of Mutual Bank through five on-site risk management examinations and four visitations. The FDIC also conducted offsite reviews and other offsite monitoring activities. Through its supervisory efforts, the FDIC identified risks in Mutual Bank's operations and brought these to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's significant concentration in CRE and ADC loans, weaknesses in loan underwriting and credit administration and the limited resources devoted to those functions, and the bank's increasing reliance on potentially volatile funding sources. Examiners also reported apparent violations of regulations and contraventions of interagency policy associated with the institution's lending practices. Regulators pursued an enforcement action to correct problems identified in the June 2008 examination. However, earlier and more formal supervisory action may have been warranted as a result of the May 2007 examination, in light of the bank's high-risk profile resulting from CRE and ADC concentrations in a declining real estate market and identified risk management deficiencies.

Supervisory History

The FDIC and the IDFPR conducted examinations and visitations of Mutual Bank from May 2004 to April 2009, as summarized in Table 5 on the next page.

Table 5: Mutual Bank's Examination History from May 2004 to April 2009

Examination Start Date	Agency	Supervisory Ratings (UFIRS)*	Supervisory Action
May 7, 2004	FDIC	222222/2	N/A
May 2, 2005	IDFPR	222222/2	N/A
May 30, 2006	FDIC	222222/2	N/A
January 29, 2007	FDIC Visitation	N/A	The purpose of this visitation was to assess asset quality.
May 29, 2007	Joint	232222/2	N/A
December 3, 2007	FDIC Visitation	N/A	The purpose of this visitation was to assess asset quality.
June 2, 2008	Joint	454554/4	Issued a Cease and Desist Order (C&D).
January 5, 2009	Joint Visitation	555555/5	This purpose of this visitation was to assess asset quality and liquidity, and resulted in downgraded ratings.
April 15, 2009	Joint Visitation	N/A	The purpose of the visit was to verify capital injections.

Source: The FDIC's Virtual Supervisory Information on the Net and ROEs for Mutual Bank.
*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: **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.

Visitations

In addition to risk management examinations, the FDIC and the IDFPR conducted four visitations at Mutual Bank.

January 29, 2007. The purpose of this FDIC visitation was to (1) obtain preliminary balances for nonperforming loans at year-end 2006 and (2) assess overall asset quality by reviewing nonperforming loans of $10 million or greater. A substantial spike in noncurrent loans at September 2006 raised concern and prompted the visitation. Asset quality had deteriorated since the May 2006 examination. Examiners concluded that, given that bank management had action plans in place and anticipated that many of the problem credits would be resolved within 3 to 6 months, an accelerated asset quality review was not necessary prior to the next scheduled joint examination.

December 3, 2007. The purpose of this FDIC visitation was to (1) assess the trend in asset quality since the May 2007 joint examination by reviewing nonperforming loans and credit relationships of $10 million or greater and (2) determine if the examination schedule should be accelerated. According to the visitation report, despite all of the credit quality problems, one substantial mitigating factor was the Chairman of the Board's unwavering financial support for the institution – he had contributed $10 million in capital in mid-November 2007. Ultimately, although the visitation identified certain risks in the loan portfolio, such as the Board raising the concentration of credit limits for hotels/motels from 300 to 400 percent of total risk-based capital and out-of-area lending, an accelerated asset quality review was deemed unnecessary because a joint examination was scheduled for June 2008.

January 5, 2009. The purpose of this joint visitation was to evaluate the status of asset quality and liquidity in response to the C&D issued as a result of the June 2008 examination. The scope of the visitation was expanded, however, due to severe deterioration in the bank's overall condition. Consequently, Mutual Bank's composite rating was downgraded to a "5" to reflect its elevated risk profile and troubled condition, which had deteriorated to the point where the future viability of the institution was in question. As a result, as of December 31, 2008, the institution was considered to be *Undercapitalized* for PCA purposes.

April 15, 2009. The purpose of this joint visitation was to verify capital injections, totaling $6.6 million made at the end of the first quarter of 2009.

Offsite Monitoring

The FDIC conducted nine offsite reviews of Mutual Bank between December 2004 and June 2008. As shown in Table 6, the offsite reviews showed that the probability of downgrades in Mutual Bank's asset quality and management component ratings and overall composite ratings increased over time.

Table 6: Rating Downgrade Probabilities for Mutual Bank Identified by Offsite Monitoring

Probability of a Rating Downgrade	Dec 2004	Mar 2005	Sept 2006	Mar 2007	Jun 2007	Sept 2007	Dec 2007	Mar 2008	Jun 2008
Asset Quality	51%	40%	63%	39%	N/A	N/A	N/A	61%	100%
Management	38%	N/A	N/A	27%	58%	42%	67%	82%	99%
Composite Rating	28%	N/A	27%	22%	48%	39%	62%	84%	100%

Source: OIG analysis of Offsite Monitoring Reviews.

In at least one case, as described above, the offsite monitoring resulted in an on-site visitation.

Formal Corrective Action

At the close of the June 2008 examination, the FDIC and the IDFPR informed Mutual Bank management that the bank would be placed under a C&D because its overall condition warranted a corrective program to stabilize the institution and effect necessary improvements. The bank's overall condition was deemed unsatisfactory due to the following conditions:

- Risk management practices were unacceptable relative to the institution's size, complexity, and risk profile. The significant and rapid deterioration in asset quality, primarily located within the loan portfolio, had crippled earnings, reduced capital levels, and exposed the bank to excessive amounts of risk.

- Capital levels no longer provided adequate protection given the institution's existing risk profile.

- The bank's Board and senior management needed to significantly improve risk monitoring and reporting practices and take steps to ensure that adequate staffing existed to effectively manage operations.

- Earnings had been depleted and profitability in 2008 was unlikely.

- Liquidity risk was high, given the extreme volatility and high-rate nature of the bank's primary funding sources.

- Sensitivity to market risk was unacceptable, as the balance sheet was in a state of flux and current earnings and capital levels did not allow for any degree of market risk.

Mutual Bank stipulated to the C&D in December 2008 and it became effective on January 9, 2009. The C&D contained 20 provisions that, among other things, required the bank to submit and adhere to an acceptable capital plan, without specifying a capital level to be maintained, and reduce its reliance on non-core funding. According to FDIC officials, this approach – that is, not specifying a capital requirement that would have put the bank into an *Adequately Capitalized* capital category – allowed the bank to remain *Well Capitalized* for PCA purposes and therefore fund itself while transitioning away from high-cost and brokered deposit sources.

Supervisory Response to Key Risks

Subsequent to Mutual Bank's acquisition of Security Bank in 2004, FDIC and IDFPR examiners identified concerns and made recommendations related to the risks associated with Mutual Bank's CRE loan concentrations, risk management practices, and liquidity management. The following provides a brief synopsis of examination efforts related to those risks from 2004 to 2008.

May 2004, May 2005, and May 2006 Examinations

Examiners concluded in these examinations that the overall financial condition of the bank was satisfactory or acceptable – with Mutual Bank receiving component and composite "2" ratings. However, examination reports noted the level of concentrations in the hotel/motel and gas station/convenience store industries, and the higher level of risk in the portfolio resulting from the concentrations. Further, examiners noted loan underwriting and credit administration weaknesses and risk management systems that had not kept pace with the record asset growth experienced by the bank. With respect to Mutual Bank's use of non-core funding sources to fund growth and operations, examiners repeatedly expressed concerns that the bank relied heavily on potentially volatile liabilities, particularly promotional CDs priced at the middle to near top local market rates, brokered deposits, and FHLB borrowings. In addition, in the 2004 and 2006 reports, examiners recommended that the bank strengthen the monitoring of its funding sources in order to adequately anticipate sources and uses of funds. Notwithstanding these persistent concerns expressed by the examiners, the bank continued to receive satisfactory ratings.

May 2007 Examination

Although the May 2007 examination considered the overall condition of Mutual Bank to be satisfactory, examiners downgraded the bank's asset quality component rating to a "3," which indicated that asset quality or credit administration practices were less than satisfactory. Specifically, the examination report noted that the level of adversely classified items had increased considerably since the last examination. The report also expressed concern with concentrations of credits, reminded bank management of the basic tenet of risk diversification, and noted that underwriting and credit administration practices needed enhancement.

Referencing Mutual Bank's portfolio risk going back to 2004, the 2007 examination report stated:

> The composition of the loan portfolio lends itself to a higher degree of portfolio risk. Since 2004, management has embarked on an aggressive growth plan. This growth has resulted in a substantial amount of out-of-area lending, which is inherently more difficult to monitor, as well as continued lending to the hospitality and gas station/convenience store sectors.

This statement indicates that the regulators were well aware of the risk inherent in Mutual Bank's loan portfolio.

The FDIC and the IDFPR also expressed their concerns regarding the bank's risk in a July 2007 report transmittal letter to Mutual Bank's Board, which stated that although the report indicated the bank's condition was satisfactory, the Board's attention was directed to concerns identified during the examination. The letter specifically noted that the loan portfolio contained a heightened level of risk and that many of the extensions of credit were outside the bank's market area.

Although there was no specific mention of Mutual Bank's non-core funding in the July 2007 transmittal letter, the examination report noted a continued reliance on non-core liabilities to fund longer-term assets. The report concluded, however, that the bank's liquidity position was acceptable and within policy guidelines.

As a result of this examination, the FDIC and the IDFPR requested that the Board address the examination concerns and ". . . provide detailed information and actions taken regarding recommendations for underwriting and credit administration, monitoring of concentrations of credit, the Allowance for Loan and Lease Loss methodology, and Bank Secrecy Act procedures." However, the examination did not result in either a formal or informal supervisory action.

June 2008 Examination

At the end of this examination, Mutual Bank's financial condition was considered unsatisfactory and it was downgraded to a composite "4" rating – a significant reduction from the previous examination's "2" rating. Further, each of the six risk management components were downgraded to a "4" or a "5," indicating the regulators' level of concern. Overall, the FDIC and the IDFPR deemed the bank's risk management practices to be unacceptable relative to the institution's size, complexity, and risk profile. The significant and rapid deterioration in asset quality, primarily located within the loan portfolio, had crippled earnings, reduced capital levels, and exposed the bank to excessive amounts of risk.

Given the institution's existing risk profile, capital levels no longer provided adequate protection. Earnings had been depleted and profitability in 2008 was deemed unlikely. Examiners considered the bank's liquidity risk to be high, given the extreme volatility and high-rate nature of the bank's primary funding sources. As discussed previously, Mutual Bank stipulated to a C&D that became effective on January 9, 2009, which, among other things, required the bank to submit and adhere to an acceptable capital plan.

Although Mutual Bank curtailed its CRE lending in September 2008, this action was too late to keep the bank viable, as evidenced by the fact that the majority of its adversely classified assets and charge-offs were related to its existing CRE loan portfolio. In hindsight, earlier and additional supervisory action in the form of a management component downgrade to a "3," or a Memorandum of Understanding focused on risks associated with Mutual Bank's higher-risk profile and risk management weaknesses, may have been prudent following the May 2007 examination. Such actions may have persuaded Mutual Bank's Board and management to take more timely and meaningful action to address its increasing risk profile, and possibly mitigated losses to the DIF. According to FDIC officials, however, mitigating factors at the time of the examination, including prompt and acceptable corrective assurances from bank management and the overall satisfactory condition of the institution, precluded such actions.

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. Part 325 of the FDIC Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. Based on supervisory actions taken with respect to Mutual Bank, the FDIC implemented applicable PCA provisions of section 38 of the FDI Act in the manner and timeframe required. However, by the time the FDIC was required to implement the PCA provisions, Mutual Bank had already been informed that a C&D was in process that required the bank to develop a plan to significantly improve its capital position.

On three occasions from June 2004 through June 2008, Mutual Bank's PCA category briefly fell to *Adequately Capitalized*, based on quarter-end Call Report information, and the FDIC notified the bank and implemented restrictions regarding the bank's acceptance, renewal, or rolling-over of any brokered deposits. However, in each instance, Mutual Bank management and/or its holding company injected sufficient capital in the bank to return it to a *Well Capitalized* position.

On November 7, 2008, Mutual Bank submitted a $47 million funding application under the U.S. Department of Treasury's Troubled Asset Relief Program (TARP). The bank subsequently withdrew its application on March 2, 2009, after being informed by the FDIC that the bank's application did not meet the standards for approval for TARP funding.

On February 3, 2009, the FDIC formally notified Mutual Bank that based on the results of a January 5, 2009 joint visitation, the institution was considered *Undercapitalized* for purposes of Part 325. The notification included a reminder that the institution was subject to certain restrictions and requirements defined under section 38, including submission of a capital restoration plan. In April 2009, Mutual Bank submitted a capital plan but it was deemed not acceptable by the regulators.

On February 11, 2009, based on the findings of the January 2009 joint visitation, the IDFPR presented Mutual Bank with a written *Notice of Intent to Take Possession and Control Pursuant to Section 51 of the Illinois Banking Act.* According to the notice, the IDFPR had determined that the institution was operating with an unacceptable level of capital protection for its risk profile and required Mutual Bank to increase its Tier 1 Regulatory Leverage Capital Ratio, Tier 1 Risk-Based Regulatory Capital Ratio, and Total Risk-Based Capital Ratio to not less than 5 percent, 6 percent, and 10 percent, respectively. Mutual Bank was notified that if it was not successful in performing satisfactory corrective action by May 12, 2009, the IDFPR would take possession and control of the bank and its assets.

On June 3, 2009, the FDIC formally notified Mutual Bank that based on internal loss calculations as of June 2, 2009, the institution was considered *Critically Undercapitalized* for purposes of Part 325. The notification included a reminder that the institution was subject to certain restrictions and requirements defined under section 38, including submission of a capital restoration plan. As of the June 30, 2009 Call Report, the bank's capital ratios were:

- Total Risk-Based Capital Ratio 1.33 percent
- Tier 1 Risk-Based Capital Ratio 0.67 percent
- Tier 1 Leverage Ratio 0.57 percent

Mutual Bank was unable to develop a viable capital plan and the institution was closed on July 31, 2009.

Corporation Comments

We issued a draft of this report on February 11, 2010. 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 February 26, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

In its response, DSC reiterated the OIG's conclusions regarding the cause of Mutual Bank's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. DSC also noted that it has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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 November 2009 to February 2010, 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 Mutual Bank's operations from May 7, 2004 until its failure on July 31, 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 ROEs and visitation reports prepared by FDIC and IDFPR examiners from May 7, 2004 to April 15, 2009.
- Reviewed the following:
    - Bank data and correspondence maintained at the FDIC's Chicago Regional Office and Chicago Field Office.
    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed available bank records maintained by DRR in Dallas, Texas, for information that would provide insight into the bank's failure.
    - Pertinent DSC policies and procedures.
- Interviewed and/or contacted the following FDIC officials:

  - DSC management in Washington, D.C., and the Chicago Regional Office.

  - DRR officials from the Dallas Regional Office.

  - FDIC examiners from the Chicago Regional Office and Chicago Field Office who participated in examinations or reviews of examinations of Mutual Bank.

- 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.

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 Mutual Bank'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 was 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 with the FDIC 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)	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.

Glossary of Terms

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 Deposit Insurance Fund. Part 325, subpart B, 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 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. 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.
Troubled Asset Relief Program (TARP)	TARP was established under the Emergency Economic Stabilization Act of 2008, which established the Office of Financial Stability within the United States Department of the Treasury. Under TARP, Treasury will purchase up to $250 billion of preferred shares from qualifying institutions as part of the Capital Purchase Program.
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
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CD	Certificate of Deposit
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
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
IDFPR	Illinois Department of Financial and Professional Regulation
LTV	Loan-to-Value
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institution Rating System

Corporation Comments

FDIC

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

February 26, 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 Mutual Bank, Harvey, Illinois (Assignment No. 2009-055)

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 Mutual Bank (MB) which failed on July 31, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on February 11, 2010.

The Report concludes MB failed due to the Board and management's aggressive pursuit of loan growth primarily funded with brokered deposits and large time deposits. MB's management decision to concentrate the loan portfolio in commercial real estate (CRE) and acquisition, development, and construction loans (ADC), its aggressive growth in out-of-area loans and participations, and its reliance on brokered and large deposits were the principal factors leading to MB's deteriorating financial condition and failure. MB's out-of-area brokered loans in CRE, overall weak loan administration, and deterioration of local Chicago area real estate markets resulted in increased delinquencies and non-performing assets. MB was unable to raise sufficient capital to absorb the loan losses and support operations.

As part of DSC's supervisory program, from May 2004 through July 2009, the FDIC and the Illinois Department of Financial and Professional Regulation (IDFPR) jointly and separately conducted five full-scope examinations and four visitations. The FDIC also conducted offsite reviews and other offsite monitoring activities. At the May 2007 examination, examiners downgraded asset quality and noted a heightened risk due to lending outside the local market area and to economically sensitive industries. At the January 2009 joint visitation, examiners found that MB had further deteriorated to a level that raised significant regulatory concern and posed considerable risk, and DSC and IDFPR implemented a formal enforcement action. MB management was unable to correct the deficiencies, and the deposits were transferred to another minority owned institution upon MB's failure.

DSC recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as MB, 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.