February 22, 2012

Mr. Michael S. Gibson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Mr. Gibson:

Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o(k), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Office of Inspector General of the Board of Governors of the Federal Reserve System conducted a material loss review of First Chicago Bank and Trust (First Chicago). Under section 38(k) of the FDI Act, as amended, a material loss to the Deposit Insurance Fund (DIF) was defined as an estimated loss in excess of $200 million. Pursuant to the Dodd-Frank Act, this threshold applies if the loss occurred between January 1, 2010, and December 31, 2011. The FDI Act requires that we

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

First Chicago was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the Illinois Department of Financial and Professional Regulation (State). The State closed First Chicago on July 8, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. On August 22, 2011, the FDIC Office of Inspector General notified our office that First Chicago's failure would result in a $284.3 million loss to the DIF, or 29.9 percent of the bank's $950.8 million in total assets at closing.

First Chicago failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive lending strategy, which focused on commercial real estate (CRE) loans, including construction, land, and land development (CLD) loans. The bank's business strategy included loan growth through CRE lending, supported primarily by non-core funding sources, and resulted in a CRE concentration. A 2006 merger that led to the creation of First Chicago reduced the bank's CRE concentration and helped diversify the bank's loan portfolio. Management planned to further reduce the bank's concentration through loan diversification by increasing lending in commercial and industrial (C&I) loans. However, management's subsequent efforts failed to reduce and adequately manage the bank's credit concentration risks. First Chicago's CRE loan concentration, particularly in CLD loans, made the bank especially vulnerable to real estate market declines. First Chicago's Board of Directors' and management's failure to effectively manage the bank's CRE and CLD credit risk, coupled with a declining real estate market, led to significant asset quality deterioration. Mounting losses depleted the bank's earnings and eroded capital, which prompted the State to close First Chicago and appoint the FDIC as receiver on July 8, 2011.

With respect to supervision, FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2007 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Chicago and the State conducted four full scope examinations, two target examinations, one supervisory assessment, and one CRE review; executed three enforcement actions—a Board Resolution, a Written Agreement, and a PCA Directive; and implemented the applicable provisions of PCA. FRB Chicago also complied with the Federal Reserve Board's Supervision and Regulation (SR) Letter 98-28, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. Our analysis of FRB Chicago's supervision of First Chicago revealed that FRB Chicago identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

We believe that there were a number of instances that presented an opportunity for stronger supervisory responses. In a March 2007 examination, examiners noted First Chicago's high CRE and CLD loan concentrations, and acknowledged management's plan to reduce these concentrations by diversifying the bank's loan portfolio through increased C&I lending. Examiners only suggested that management "consider enhancing its risk management practices over the bank's real estate loan concentrations" as outlined in SR Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate*. At the following examination in April 2008, examiners again cited First Chicago's high concentrations in CRE and CLD loans, but did not compel the bank to adhere to the enhanced credit risk management standards detailed in SR Letter 07-1 to address its credit concentrations. Asset quality and earnings deterioration were noted in an April 2009 supervisory assessment, and in a June 2009 examination, examiners identified multiple weaknesses in First Chicago's assessment of credit risk, such as problem loan identification and concentration monitoring. Therefore, we believe that a stronger supervisory response related to the credit risk management of concentrations was warranted as early as the April 2008 examination.

Weaknesses in First Chicago's credit risk management practices and bank management's inability to manage the resulting effects of asset quality deterioration during stressed economic times contributed to the bank's poor overall financial condition. In April 2009, FRB Chicago and the State conducted a supervisory assessment because examiners determined that there was strong evidence that First Chicago's financial condition changed significantly. Examiners downgraded the CAMELS composite rating to a 3 due to the bank's declining condition. In addition, examiners downgraded the capital and liquidity components to 3 ratings, the asset quality component to a 4 rating, triple downgraded the earnings component to a 5 rating, but maintained the management component rating at a 2. While we recognize that FRB Chicago downgraded First Chicago's management CAMELS component rating in the subsequent examination that began in June 2009, we believe that this supervisory assessment presented an opportunity for stronger criticism of management's performance related to the bank's deteriorating condition.

In June 2009, two months after the supervisory assessment, FRB Chicago began a joint full scope examination that revealed further deterioration in the bank's condition and resulted in a double downgrade of the CAMELS composite rating to a 5. Examiners also double downgraded the management component to a 4 rating to reflect the bank's critically deficient condition and weak risk management practices. First Chicago's overall condition continued to erode, and the bank's CAMELS composite rating remained a 5 following the November 2009 and June 2010 examinations. Examiners found that First Chicago's (1) high volume of nonperforming loans and classified assets, (2) significant reliance on brokered deposits, (3) critically deficient earnings, and (4) depleted capital contributed to its critically deficient condition. In addition, examiners cited management's "significant role" in the bank's heightened risk profile and stated that the bank's failure was "a distinct possibility." Nonetheless, examiners continued to rate the management component a 4. In our opinion, First Chicago's condition and management's inability to timely address identified deficiencies called for stronger criticism, including a management component downgrade.

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

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that First Chicago's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. First Chicago's failure illustrates the importance of (1) timely implementation of a robust credit risk assessment program designed to facilitate the identification and management of concentrations; (2) closely monitoring and assessing management performance; and (3) appropriately assigning management CAMELS ratings commensurate with the issues identified during the examination.

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

We appreciate the cooperation that we received from FRB Chicago and Federal Reserve Board staff during our review. The principal contributors to this report are listed in Appendix 4.

This report will be added to our public web site and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

Anthony J. Castaldo

Anthony J. Castaldo
Associate Inspector General
for Inspections and Evaluations

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

Office of Inspector General

Material Loss Review of First Chicago Bank and Trust

Board of Governors of the Federal Reserve System

February 2012

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Background

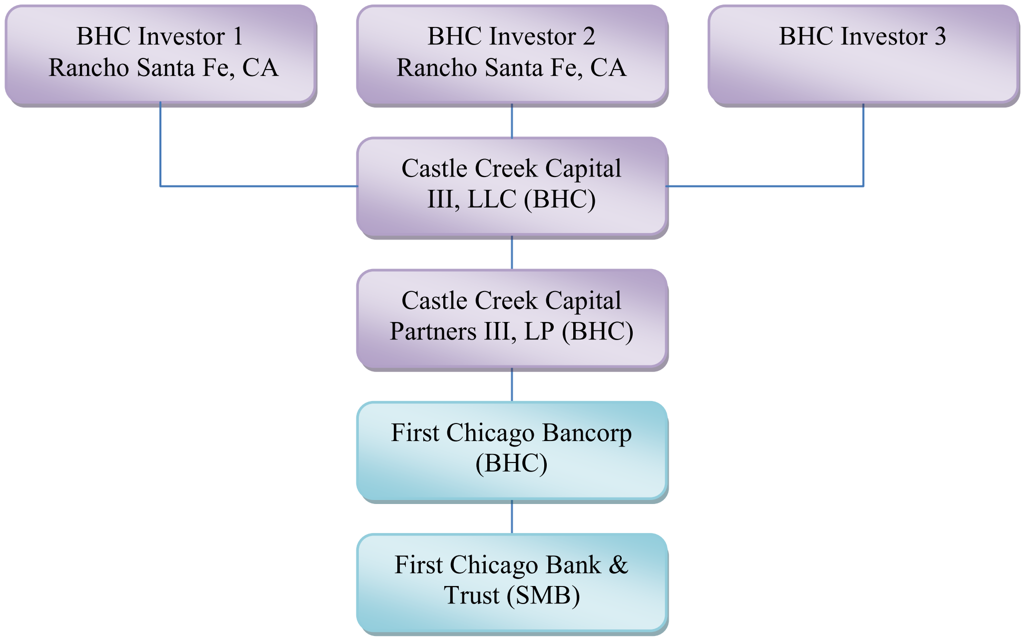
In November 2006, First Chicago Bank and Trust (First Chicago) was created following the merger of Labe Bank and Bloomingdale Bank and Trust (Bloomingdale).[1] Labe Bank was a savings bank established in 1905 in Chicago, Illinois, and became a state member bank (SMB) in 2006. Bloomingdale was an SMB established in 1991, and it operated in Bloomingdale, Illinois. First Chicago was wholly owned by First Chicago Bancorp (Bancorp). First Chicago was supervised by the Federal Reserve Bank of Chicago (FRB Chicago), under delegated authority from the Board of Governors of the Federal Reserve System (Federal Reserve Board), and by the Illinois Department of Financial and Professional Regulation (State).

A large stake in Bancorp was held by Castle Creek Capital (Castle Creek), a bank holding company (BHC) and private equity firm based in Rancho Santa Fe, California.[2] As shown in Figure 1, Castle Creek's principal shareholders were three BHCs. Castle Creek was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco), under delegated authority from the Federal Reserve Board. Castle Creek sought capital in order to invest in community banks in regions that were deemed to have favorable growth prospects. Bancorp was Castle Creek's first investment in the Chicago metropolitan area, and the firm placed executives in key positions to manage First Chicago's operations. First Chicago's business activities focused primarily on commercial real estate (CRE) lending in the greater Chicago area. FRB Chicago conducted its first safety and soundness examination of First Chicago in March 2007.

[1] As described in regulatory documents, Bloomingdale was merged into Labe Bank. Following the merger, Labe Bank changed its name to First Chicago Bank and Trust.

[2] Castle Creek Capital represents Castle Creek Capital Partners III, LP, and Castle Creek Capital III, LLC. Castle Creek Capital Partners III, LP, was created for the explicit purpose of making private equity investments in U.S. banks having total assets between $100 million and $5 billion. Castle Creek Capital III, LLC, managed the investments of Castle Creek Capital Partners III, LP.

Figure 1: First Chicago Ownership Structure



The State closed First Chicago on July 8, 2011, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. The FDIC estimated that First Chicago's failure would result in a $284.3 million loss to the Deposit Insurance Fund (DIF), or 29.9 percent of the bank's $950.8 million in total assets at closing. On August 22, 2011, the FDIC Office of Inspector General notified our office that First Chicago's failure would result in a material loss to the DIF. Under section 38(k) of the Federal Deposit Insurance Act, as amended (FDI Act), a material loss to the DIF was defined, at the time, as any estimated loss in excess of $200 million.[3]

Objectives, Scope, and Methodology

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

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

[3] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, enacted on July 21, 2010, the $200 million materiality threshold applies if the loss occurred during the period January 1, 2010, through December 31, 2011. Section 38(k) of the FDI Act had previously defined a material loss to the DIF as the greater of $25 million or 2 percent of the institution's total assets.

To accomplish our objectives, we reviewed the Federal Reserve System's *Commercial Bank Examination Manual* and relevant supervisory guidance. We interviewed staff and collected relevant data from FRB Chicago, FRB San Francisco, the State, and the Federal Reserve Board. We also reviewed correspondence, surveillance reports, regulatory reports filed by First Chicago, examination reports issued from 2007 through 2011, examination work papers prepared by FRB Chicago, and relevant FDIC documents. Appendixes at the end of this report contain a glossary of key banking and regulatory terms and a description of the CAMELS rating system.[4] We conducted our fieldwork from August 2011 through January 2012 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

Cause of the Failure

First Chicago failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive lending strategy, which focused on CRE loans, including construction, land, and land development (CLD) loans. The bank's business strategy included loan growth through CRE lending, supported primarily by non-core funding sources, and resulted in a CRE concentration. The 2006 merger reduced the bank's CRE concentration and helped diversify the bank's loan portfolio. Management planned to further reduce the bank's concentration through loan diversification by increasing lending in commercial and industrial (C&I) loans. However, management's subsequent efforts failed to reduce and adequately manage the bank's credit concentration risks. First Chicago's CRE loan concentration, particularly in CLD loans, made the bank especially vulnerable to real estate market declines. First Chicago's Board of Directors' and management's failure to effectively manage the bank's CRE and CLD credit risk, coupled with a declining real estate market, led to significant asset quality deterioration. Mounting losses depleted the bank's earnings and eroded capital, which prompted the State to close First Chicago and appoint the FDIC as receiver on July 8, 2011.

Aggressive Lending Strategy Contributed to a CRE Concentration

Before the formation of First Chicago, Labe Bank had an aggressive lending strategy that focused on CRE. Prior to 2005, management focused on expanding CRE lending, which led to the bank's loan portfolio having a concentration in CRE, particularly in CLD and multi-family loans. In 2005, the Board of Directors and management began to aggressively grow the bank. Labe Bank, which became First Chicago in 2006, experienced substantial growth between 2005 and 2008 due to (1) its merger with Bloomingdale, which roughly doubled the size of the bank, and (2) aggressive loan growth.[5]

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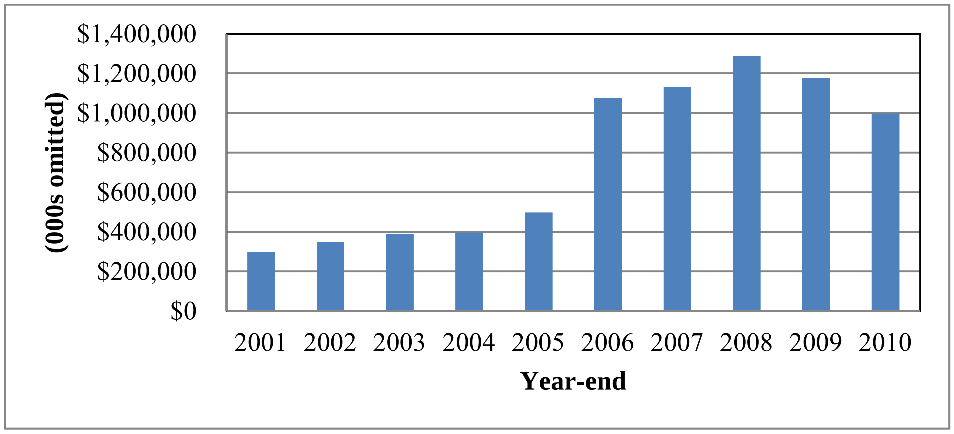
[4] The CAMELS acronym represents six banking supervision components: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component and overall composite score is assigned a rating of 1 through 5,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

[5] At the time of the merger, Bloomingdale primarily focused on C&I lending and had a CRE concentration that was below its peer group average.

As shown in Chart 1, the bank's total assets more than tripled from $396.9 million in 2004 to its peak at approximately $1.3 billion in 2008.[6] This asset growth was primarily supported by non-core funding sources, such as brokered deposits. The brokered deposits increased from $111.7 million in 2006 to $408.5 million in 2008. Examiners noted First Chicago's plan for aggressive growth during FRB Chicago's first examination in March 2007 and highlighted management's plan to increase assets from $2 to $5 billion in five years through internal growth and acquisitions and to become a public company.

Chart 1: Total Assets

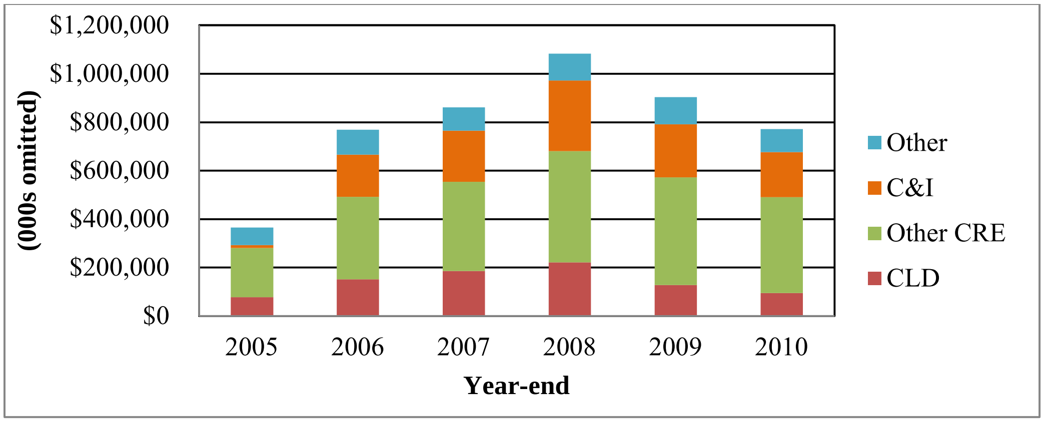


Board of Directors and Management Failed to Reduce the Bank's CRE Concentration

In 2005, the bank increased CRE lending, particularly in multi-family and CLD loans. Growth between 2006 and 2008 was attributed to the merger and increased lending in C&I and CRE, primarily in nonfarm, nonresidential real estate and CLD. The March 2007 examination revealed management's plans to reduce the bank's CRE concentration by continued loan portfolio diversification through increased C&I lending. Despite management's efforts to diversify the loan portfolio, CRE loans increased and remained the largest segment in the portfolio. As shown in Chart 2, CRE growth represented $401 million, or 55.9 percent, of total loan growth of $717.7 million between 2005 and 2008, while C&I represented $279.1 million, or 38.9 percent, of total loan growth.

[6] Figures in this report that pre-date the November 2006 merger pertain to Labe Bank.

Chart 2: Loan Portfolio



As shown in Chart 3a, First Chicago's CRE loan concentration as a percentage of total risk-based capital remained high and consistently exceeded both its peer group average and the thresholds described in the Federal Reserve Board's Supervision and Regulation (SR) Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate*.[7] The bank's CRE concentration declined from 667 percent in 2005 to 545 percent of total risk-based capital in 2006 as a result of the merger. However, the bank's CRE concentration remained high and consistently exceeded its peer group average. As illustrated in Chart 3b, the bank's CLD loan concentration also consistently exceeded its peer group averages and increased from a low of 168 percent in 2006 to 189 percent the following year. Significant losses depleted the bank's capital levels, which caused the bank's CRE and CLD concentrations to spike in 2010. In general, credit concentrations increase a financial institution's vulnerability to changes in the marketplace and compound the risks inherent in individual loans. CLD concentrations are particularly risky because the developer's capacity to repay the loan is typically subject to the success of the underlying construction project.

[7] First Chicago was in two peer groups from 2005 to 2010. Between 2005 and 2006, the bank was in peer group 3, which consisted of all insured commercial banks having assets between $300 million and $1 billion. Between 2007 and 2010, the bank was in group 2, which consisted of all insured commercial banks having assets between $1 billion and $3 billion. According to SR Letter 07-1 (issued in January 2007), an institution presents potential CRE concentration risk if it meets the following criteria: (1) total reported loans for CLD represent 100 percent or more of an institution's total capital; or (2) total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Chart 3a: Total CRE Loan Concentration

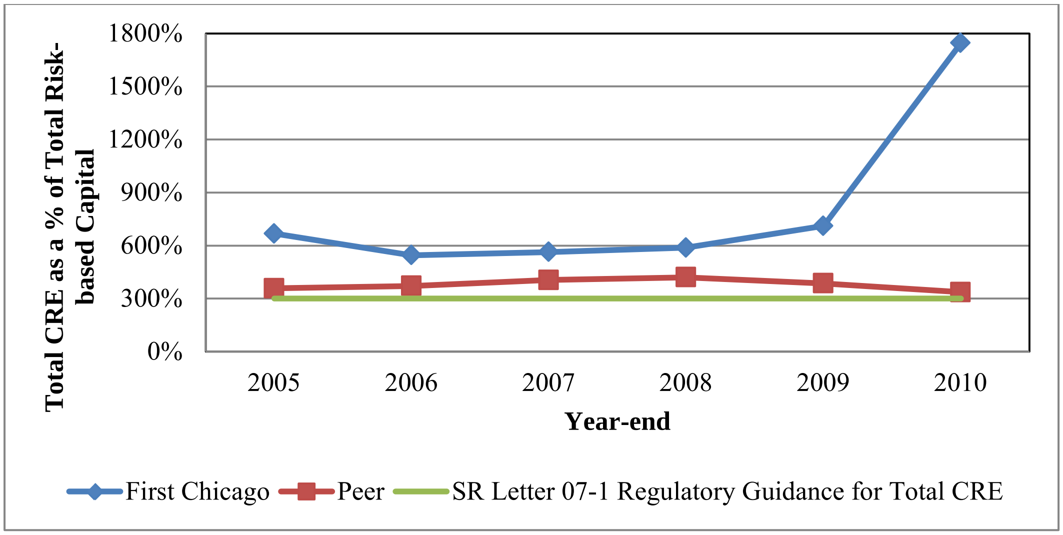
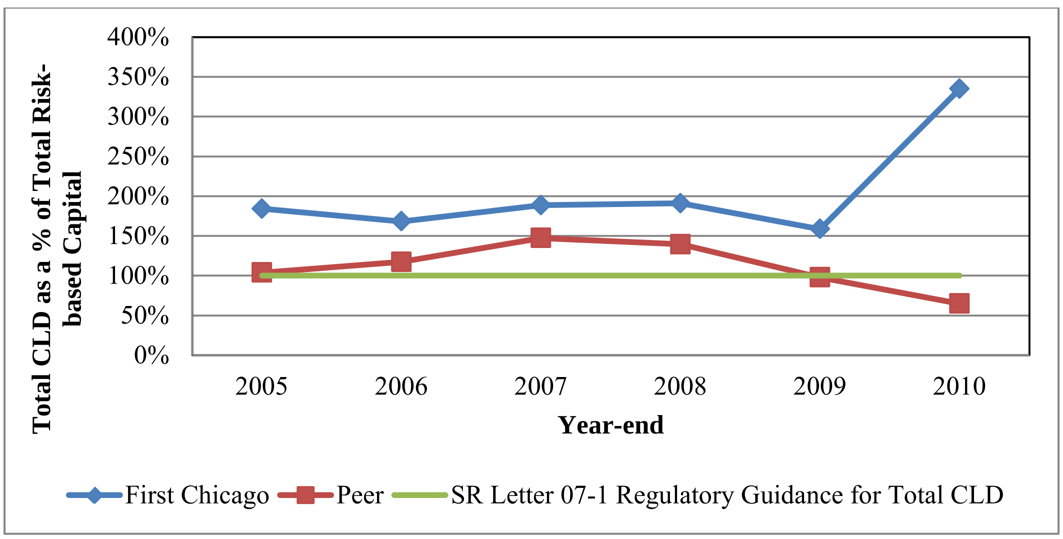


Chart 3b: Total CLD Loan Concentration



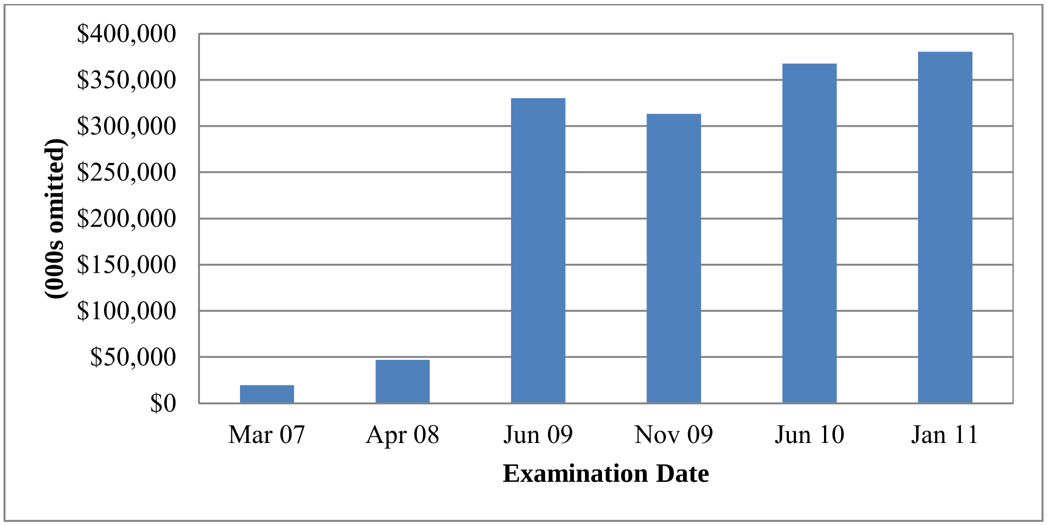
The Board of Directors and management were slow to implement a credit risk assessment program that effectively identified, monitored, and controlled the bank's CRE and CLD concentration risk. Even though the bank's CRE and CLD concentrations exceeded the thresholds in SR Letter 07-1, management failed to fully and expeditiously implement the CRE risk management practices set forth in the SR letter. In multiple examination reports between 2008 and 2011, examiners commented on weaknesses in the bank's credit risk management practices regarding real estate concentrations, such as (1) inadequate credit concentration policy limits, (2) insufficient internal loan stratification reporting, (3) a lack of guidelines and strategies to reduce such concentrations, and (4) insufficient analysis of the potential impact on the bank's CRE loan portfolio in declining market conditions. Additionally, examiners noted operational deficiencies in the bank's loan administration practices, particularly regarding management's loan documentation practices and monitoring of the bank's CLD loan portfolio. We believe these weaknesses hindered management's ability to effectively oversee First Chicago's credit risk and further increased First Chicago's vulnerability to declines in the real estate market.

Decline in Real Estate Market Led to Asset Quality Deterioration

First Chicago's asset quality deteriorated significantly as the local economy slowed and the demand for residential housing declined. Declines in the local real estate market resulted in significant deterioration in the bank's CRE portfolio, particularly in CLD loans, as many borrowers struggled to sell completed construction projects and experienced reduced profitability and cash flow. Significant declines in local housing permits between 2005 and 2009 were reflective of the declining local real estate market conditions cited by examiners. Total housing permits in the Chicago Metropolitan Statistical Area declined by 88.7 percent, from nearly 54,000 in 2005 to approximately 6,100 in 2009.[8]

Examiners noted in a June 2009 examination that First Chicago's response to declining economic conditions was constrained by weak risk management practices that were not commensurate with the bank's high risk lending and funding strategy. Examiners attributed the increase in First Chicago's problem loans to "past liberal underwriting and aggressive lending practices" that were exacerbated by deteriorating real estate market conditions. Weaknesses in management's ability to identify problem loans contributed to a significant increase in classified assets. As shown in Chart 4, classified assets increased by $311 million, or 1,595 percent, between the March 2007 and the 2009 June examinations. Classified assets remained high until the bank's closure in 2011, as management struggled to control the bank's increasing volume of problem loans.

Chart 4: Classified Assets

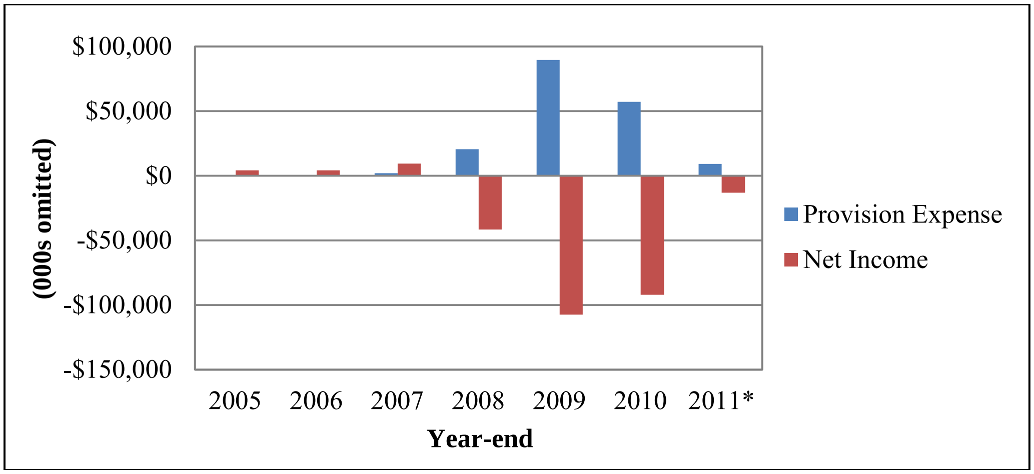


[8] Metropolitan Statistical Areas are geographic areas defined by the Office of Management and Budget to be used by federal statistical agencies in collecting, tabulating, and publishing federal statistics.

Loan Losses and Goodwill Impairment Eliminated Earnings and Depleted Capital

The growth in classified assets required corresponding increases in First Chicago's loan loss provisions and adversely affected the bank's earnings. Given the severity of the bank's asset quality deterioration, examiners required First Chicago to increase its allowance for loan and lease losses (ALLL) by an additional $35 million between 2009 and 2011. As shown in Chart 5, loan loss provisioning contributed to the bank's depleted earnings.

Chart 5: Impact of Provision Expense on Earnings



* As of June 30, 2011

In addition, goodwill from the Bloomingdale merger was significantly impaired due to the bank's poor financial condition.[9] Goodwill write-downs of $40.3 million in 2008 and $44 million in 2009 negatively affected earnings. First Chicago reported net losses of $41.7 million and $107.5 million in 2008 and 2009, respectively. Net losses in 2010 and the first six months of 2011 were primarily due to high provision expenses and lower interest revenues from loans, as loan write-offs significantly reduced the bank's loan portfolio.

FRB Chicago implemented the PCA provisions of the FDI Act and made timely notifications to the bank when it reached various PCA categories. PCA is a framework of supervisory actions intended to promptly resolve capital deficiencies at troubled financial institutions. Significant losses recognized in 2009 eroded the bank's capital, despite $59.5 million in capital injections during 2008 and 2009 from the BHCs. In March 2010, FRB Chicago notified First Chicago that the bank fell from *well capitalized* to *adequately capitalized* under PCA guidelines.

Mounting losses offset a $25 million capital injection in 2010. In February 2011, FRB Chicago notified the bank that it had become *undercapitalized* and required the bank to submit a capital restoration plan. First Chicago was unable to provide an acceptable capital restoration plan to FRB Chicago, and in March 2011, the bank was notified that it fell to *significantly*

[9] Goodwill is an intangible asset shown on an institution's balance sheet and is often created through acquisitions. The amount of goodwill is the difference in the asset's fair market value and the price paid at the time of acquisition. The goodwill impairments acknowledged the bank's declining fair market value.

undercapitalized as the Board of Directors and management failed to control the level of the bank's problem credits and restore the bank back to profitability. The Federal Reserve Board issued a PCA Directive on April 7, 2011, that, among other things, required First Chicago to (1) raise additional capital to achieve the *adequately capitalized* PCA designation, or (2) be acquired by, or merge with, another depository institution. First Chicago's financial condition continued to deteriorate, and in May 2011, FRB Chicago deemed the bank *critically undercapitalized.* First Chicago failed to comply with the PCA Directive, and the State closed the bank on July 8, 2011.

Supervision of First Chicago Bank and Trust

FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2007 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Chicago and the State conducted four full scope examinations, two target examinations, one supervisory assessment, and one CRE review; executed three enforcement actions—a Board Resolution, a Written Agreement, and a PCA Directive; and implemented the applicable provisions of PCA. FRB Chicago also complied with SR Letter 98-28, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*.[10]

Our analysis of FRB Chicago's supervision of First Chicago revealed that FRB Chicago identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

[10] SR Letter 98-28 establishes the criteria for conducting safety and soundness examinations of depository institutions seeking to become, or merge into, a state member bank, as well as the state member bank itself. Specifically, the guidance outlines the eligible bank test and the factors to be evaluated when determining whether pre-member or pre-merger examinations should be conducted. A bank must satisfy each of the following components of a five-part test to qualify as an eligible bank: (1) *well capitalized*; (2) a composite CAMELS rating of 1 or 2; (3) a Community Reinvestment Act rating of "outstanding" or "satisfactory"; (4) a consumer compliance examination rating of 1 or 2; and (5) no major unresolved supervisory issues outstanding, as determined by the Federal Reserve Board or the appropriate Federal Reserve Bank "in its discretion." If an institution does not satisfy these criteria, a pre-membership or pre-merger examination is required. SR Letter 98-28 was superseded by SR Letter 11-2, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks,* on February 2, 2011.

Table 1: First Chicago Supervisory Overview

Examination			Agency Conducting Examination	CAMELS Composite Rating	CAMELS Component Ratings						Supervisory Actions
Start Date	Report Issue Date	Scope			Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity	
3/12/2007	4/30/2007	Full	Joint	2	2	2	2	2	2	2	
4/28/2008	9/23/2008*	Full	Joint	2	2	3	2	2	2	2	Board Resolution
		CRE Review	FRB	n/a							
4/27/2009	5/29/2009	Supervisory Assessment	Joint	3	3	4	2	5	3	2	
6/22/2009	12/4/2009	Full	Joint	5	5	5	4	5	5	4	Written Agreement
11/16/2009	3/25/2010	Target	Joint	5	5	5	4	5	5	4	
6/28/2010	10/22/2010	Full	Joint	5	5	5	4	5	5	4	
1/18/2011	5/9/2011	Target	Joint**	5	5	5	5	5	5	4	PCA Directive

*A CRE Review was performed in conjunction with the full scope examination.
**FDIC participated in this joint examination.

March 2007 Joint Full Scope Examination Resulted in a CAMELS Composite 2 Rating

The March 2007 full scope examination was the first examination after Labe Bank and Bloomingdale merged and formed First Chicago in November 2006, and it resulted in a CAMELS composite 2 (satisfactory) rating. All CAMELS components received 2 ratings. The April 2007 examination report stated that First Chicago's strategic plan contained an aggressive growth strategy to grow the bank from $1.1 billion in assets to $2 to $5 billion within five years and position the bank to become publicly traded. According to examiners, while Labe Bank and Bloomingdale historically relied on non-core funding to promote asset growth, First Chicago planned to decrease its reliance on non-core funding by gathering lower cost core deposits.

The asset quality component was deemed satisfactory with strong credit risk management. Examiners noted an effective loan policy and review system, but stated that the bank operated with high concentrations in CRE and CLD loans, at 539 percent and 167 percent of total risk-based capital, respectively. In addition, the April 2007 examination report also stated that First Chicago planned to reduce CRE concentration by continuing to diversify into C&I lending. Examiners suggested that management "consider enhancing its risk management practices over the bank's real estate loan concentrations" as outlined in SR Letter 07-1. Examiners also noted that although First Chicago's ALLL was adequate, its analysis was not consistent with accounting standards.

Examiners assigned the management component a satisfactory rating, but noted that changes associated with the 2006 merger, such as staff reductions and changes in operating policies, procedures, and information technology systems, contributed to high and increasing operational risk. Examiners commented, however, that the Board of Directors' oversight was strong, with Directors actively involved in the bank's operations. According to examiners, the Board of Directors and senior management possessed strong business, investment, or banking backgrounds and were capable of managing the bank's risks and implementing strategic plans. In addition, examiners stated that Castle Creek management applied its "significant managerial and banking expertise" while working closely with First Chicago's leadership.

April 2008 Joint Full Scope Examination Maintained a CAMELS Composite 2 Rating but Resulted in a Board Resolution

In April 2008, the State led a joint full scope examination that resulted in a CAMELS composite 2 rating. All CAMELS components remained at 2, except for the asset quality component, which received a 3. The September 2008 examination report stated that the overall condition of the bank was satisfactory, with prudent management, adequate earnings, manageable sensitivity to market risk, sufficient liquidity, and a capital level commensurate with First Chicago's overall risk profile.

Asset quality was considered less than satisfactory. Adversely classified assets significantly increased from $19.5 million at the March 2007 examination to $47.1 million. While the ALLL was sufficient, the methodology was again found to be inconsistent with accounting standards. Examiners also noted deficiencies in the credit policy, as it did not address (1) loan concentration limits; (2) ALLL review; (3) problem loan identification; and (4) loan ratings. As with the March 2007 examination, examiners noted First Chicago's high concentrations in CRE and CLD loans and management's plan to reduce such concentrations by increasing C&I lending.

Concurrently, FRB Chicago conducted a CRE review, which focused on the bank's CRE exposures, an assessment of the risk to capital from CRE lending, and an evaluation of the potential risks to First Chicago's liquidity due to deteriorating loan quality. The CRE review report revealed examiners' concerns about the adverse effect of deteriorating residential real estate market conditions on the bank's loan portfolio and First Chicago's future earnings potential. According to examiners, First Chicago's CRE loans comprised over 50 percent of the total loan portfolio. Examiners commented that further deterioration in the local real estate market would expose construction projects in the bank's loan portfolio to potential losses and increase the risk profile of the bank. Examiners also noted tightening liquidity because of the bank's continued reliance on non-core funding sources. First Chicago increased its reliance on non-core funding sources—brokered deposits represented 13.9 percent of total deposits at year-end 2006 and 25.7 percent in March 2008. Examiners concluded that First Chicago's asset quality was an "immediate concern" and suggested that a target review of asset quality be scheduled in six months if the loan portfolio exhibited further deterioration.

Due to the deteriorating asset quality and the findings of the April 2008 examination, First Chicago entered into a Board Resolution with FRB Chicago and the State in October 2008. The Board Resolution included action plans to (1) establish and maintain the necessary procedures to reduce the high level of adversely classified assets and delinquent and nonaccrual loans identified in the September 2008 examination report, (2) correct deficiencies noted as Special Mention in the report, (3) improve loan administration practices, (4) revise lending policy, (5) establish an effective Interest Rate Risk Monitoring Program, and (6) charge off remaining assets classified as "Loss." The resolution did not address the bank's high credit concentration risks, nor did it include plans to implement specific guidelines noted in SR Letter 07-1.

In our opinion, the April 2008 examination presented an opportunity for earlier supervisory response. Given the continued level of the bank's credit concentrations, deteriorating asset quality, and weakened local real estate market conditions, we believe a stronger supervisory response related to credit risk management of concentrations and compliance with corresponding guidelines in SR Letter 07-1 was warranted.

April 2009 Joint Supervisory Assessment Resulted in a Downgrade to a CAMELS Composite 3 Rating

In April 2009, FRB Chicago and the State conducted a supervisory assessment because examiners determined that there was strong evidence that First Chicago's financial condition changed significantly. The bank's CAMELS composite rating was downgraded to a 3 (less than satisfactory), the capital and liquidity components were downgraded to 3 ratings, the asset quality component was downgraded to a 4, and the earnings component was triple downgraded to a 5 rating. The management and sensitivity to market risk components remained 2-rated. The May 2009 report stated that First Chicago's financial condition had deteriorated significantly as a result of continued deterioration in asset quality, a corresponding decline in earnings, and increased risk to capital and tightened liquidity.

Classified assets increased almost 400 percent from \$47.1 million to \$229.7 million in only 12 months. Although examiners noted improvements in credit management reports, the ALLL was found to be inadequate. The bank's earnings were considered critically deficient due to (1) increased loan loss provision expenses, (2) write-down of goodwill, and (3) a decrease in interest income, which resulted in a net loss of \$41.7 million in 2008. According to examiners, management expected additional loan loss provisions and lower interest income in 2009 and projected a net loss.

As a result of negative earnings and deteriorating asset quality, examiners rated First Chicago's capital component a 3 rating and cited that the capital levels were insufficient in relation to the bank's increased risk profile. Examiners also assigned First Chicago's liquidity component a 3 rating due to the bank's continued reliance on non-core funding. Examiners found brokered deposits totaled \$450 million, or 45.6 percent of total deposits, and required management to develop a robust liquidity contingency plan. Despite these significant deficiencies and the corresponding CAMELS component and composite downgrades, examiners maintained the management component at a 2 rating. While we recognize that FRB Chicago downgraded First Chicago's management CAMELS component rating in the subsequent examination in June 2009, we believe that deficiencies identified in the supervisory assessment report warranted stronger criticism of the bank's management practices.

June 2009 Joint Full Scope Examination Resulted in a CAMELS Composite 5 Rating and a Written Agreement

In June 2009, FRB Chicago led a joint full scope examination that resulted in a double downgrade to a CAMELS composite 5 (critically deficient) rating. The capital, asset quality, earnings, and liquidity components were all rated 5, and the management and sensitivity to market risk components received 4 ratings. Examiners expressed serious supervisory concerns about First Chicago's condition and that the bank's severely weakened credit quality threatened the viability of the bank. In the December 2009 examination report, examiners projected further credit deterioration and continued losses for the remainder of 2009 and in 2010.

Asset quality was considered critically deficient and, according to examiners, presented an imminent threat to the bank's viability. Classified assets had risen to $330.1 million, and examiners commented that a sharp decline in real estate values and transactions and inadequate identification and monitoring of loan concentration risks contributed to a significant increase in First Chicago's troubled loans. Examiners also noted First Chicago's continued high concentrations in CRE and CLD loans. Examiners stated that the bank's concentration report was not in compliance with regulatory guidance in SR Letter 07-1 because the report lacked the necessary loan stratification, which hindered management's ability to adequately assess credit risk. Examiners required the bank to set meaningful loan concentration limits for the various types of loans and to include written guidelines to manage or reduce significant CRE concentration risk exposure. In addition, examiners noted weaknesses affecting the adequacy of the ALLL due to a lack of (1) proper concentration monitoring; (2) consideration of concentration risks analysis; (3) incorporation of a loan rating system; and (4) compliance with regulatory guidance.

First Chicago's capital was rated critically deficient in relation to the bank's high risk profile and inability to augment capital from operations. Examiners stated that First Chicago's viability was threatened and strongly encouraged the bank to seek immediate financial assistance. Despite capital injections of $15 million in June 2009 and $25 million in September 2009, the significant increase in problem assets led to loan losses. These losses contributed to net losses of $41.7 million in 2008 and $30.4 million in the first six month of 2009 and severely eroded capital.

Management was considered weak due to the bank's critically deficient condition and weak risk management practices. Examiners stated that the level of deficiencies and risk exposures were excessive and required First Chicago to return the bank to a safe and sound condition. Examiners commented that the Board of Directors and management were unable to mitigate the bank's significant risk exposure in CRE and CLD concentrations as real estate market conditions deteriorated. While examiners acknowledged First Chicago's efforts to improve its capital and liquidity position by reducing the size of the bank's loan portfolio, examiners stated that management's ability to bring the bank back to profitability in the depressed economic times was severely limited.

As a result of this examination, FRB Chicago and the State implemented a formal enforcement action in the form of a Written Agreement on March 8, 2010, that required the Board of Directors to address issues in various areas, including the oversight of management and bank operations, credit risk management and administration, credit concentrations, asset quality improvement, the ALLL methodology, capital adequacy, liquidity and funds management practices, brokered deposit reliance, interest rate risk management, earnings improvement, submission of a realistic budget, information technology and security deficiencies, restrictions on dividends and debts, and compliance with laws and regulations.

November 2009 Joint Target Examination Maintained a CAMELS Composite 5 Rating

In November 2009, FRB Chicago led a joint target examination that focused on evaluating asset quality and credit risk management practices and assessing the adequacy of the ALLL balance and methodology. Examiners found that First Chicago's (1) high volume of nonperforming loans and classified assets, (2) significant reliance on brokered deposits, (3) critically deficient earnings, and (4) depleted capital contributed to its critically deficient condition. The examination resulted in another CAMELS composite 5 rating, with all CAMELS components remaining the same. In the March 2010 examination report, examiners noted excessive credit risk exposure and critically deficient asset quality. Examiners also attributed increased levels of problem loans in the bank's CLD portfolio to First Chicago's high concentration in CRE credits, past liberal underwriting, and aggressive lending practices. Although examiners acknowledged management's efforts to address weaknesses in credit risk management, overall credit risk management practices remained weak and in need of improvement. Examiners found the bank's loan impairment analysis inadequate and risk monitoring for the bank's CRE concentration still noncompliant with SR Letter 07-1. Classified assets also remained excessive at $313.3 million. Examiners considered First Chicago's ALLL balance inadequate and required the bank to increase the ALLL to a level commensurate with the risk profile of the loan portfolio. Examiners questioned First Chicago management's ability to prevent further deterioration under declining economic conditions and the increasing volume of classified assets.

June 2010 Joint Full Scope Examination Resulted in Another CAMELS Composite 5 Rating

In June 2010, FRB Chicago led a joint full scope examination that found that the overall condition of First Chicago remained critically deficient. The October 2010 examination report stated that First Chicago had (1) deficient capital, (2) a vulnerable liquidity position, (3) critically deficient asset quality, and (4) continued lack of profitability. The report concluded that the bank's unsafe and unsound condition was threatening the bank's viability. In the report, examiners also stated that the failure of the bank was "a distinct possibility" and urged management to acquire additional capital and address deficiencies. Examiners attributed significant deterioration in asset quality to the bank's prior weak underwriting and aggressive lending practices, which were exacerbated by declining real estate market conditions. They also expressed significant concern about the bank's large concentrations in CRE and CLD loans and the inadequate ALLL balance and methodology.

Earnings had remained critically deficient due to significant and sustained losses that depleted capital. Examiners noted concerns about continued asset quality deterioration due to First Chicago's large concentration in CRE loans and questioned the bank's future profitability. Furthermore, capital injections of approximately $44 million in 2009 and $25 million in 2010 did not adequately support First Chicago's capital against continuous loan losses. Examiners stated that the bank had only achieved partial compliance with the March 2010 Written Agreement and that certain critical aspects of the agreement had not been achieved, such as maintaining an adequate ALLL.

Examiners noted that the "strategic choices and decisions" made by the Board of Directors and management played a significant role in the bank's weak financial condition. Examiners also criticized the Board of Directors and management for establishing an inherently risky business strategy that resulted in a CRE concentration funded by non-core funding, including brokered deposits; however, examiners did not downgrade the management component rating. In our opinion, the extent of weaknesses identified at this examination, First Chicago's critically deficient condition, and the lack of full compliance with the Written Agreement warranted stronger criticism of the bank's management—specifically risk management practices. We believe that the June 2010 examination presented an opportunity for stronger supervisory action, including a management component downgrade.

January 2011 Joint Target Examination Maintained a CAMELS Composite 5 Rating

In January 2011, FRB Chicago and the State began a target examination of the bank's asset quality and credit risk management. In the May 2011 examination report, examiners maintained First Chicago's CAMELS composite 5 rating, but downgraded the management component to a 5, with all other components remaining the same. Examiners noted asset quality was persistently deficient and declining, as evidenced by increased loan classifications to $380.6 million, and continuing loan losses. Examiners also warned that critically deficient capital levels, attributed to sustained operating losses and deteriorating asset quality, threatened First Chicago's near-term viability. The Board of Directors' and management's oversight was considered critically deficient based on the overall distressed condition of the bank. Examiners found that the Board of Directors and management failed to implement effective risk management practices or adequately respond to changing business conditions.

As a result of continued loan losses, the bank became *significantly undercapitalized* during the examination. On April 7, 2011, a PCA Directive was issued to First Chicago that required the bank to resolve its capital deficiencies. The bank was deemed *critically undercapitalized* due to additional loan losses on May 12, 2011. Management was unable to raise capital, and the State closed the bank on July 8, 2011, and appointed the FDIC as receiver.

Conclusions and Lessons Learned

First Chicago failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive lending strategy, which focused on CRE loans, including CLD loans. The bank's business strategy included loan growth through CRE lending, supported primarily by non-core funding sources, and resulted in a CRE concentration. The 2006 merger reduced the bank's CRE concentration and helped diversify the bank's loan portfolio. Management planned to further reduce the bank's concentration through loan diversification by increasing lending in C&I loans. However, management's subsequent efforts failed to reduce and adequately manage the bank's credit concentration risks. First Chicago's

CRE loan concentration, particularly in CLD loans, made the bank especially vulnerable to real estate market declines. First Chicago's Board of Directors' and management's failure to effectively manage the bank's CRE and CLD credit risk, coupled with a declining real estate market, led to significant asset quality deterioration. Mounting losses depleted the bank's earnings and eroded capital, which prompted the State to close First Chicago and appoint the FDIC as receiver on July 8, 2011.

With respect to supervision, FRB Chicago complied with the examination frequency guidelines for the timeframe we reviewed, 2007 through 2011, and conducted regular off-site monitoring. During the period covered by our review, FRB Chicago and the State conducted four full scope examinations, two target examinations, one supervisory assessment, and one CRE review; executed three enforcement actions—a Board Resolution, a Written Agreement, and a PCA Directive; and implemented the applicable provisions of PCA. FRB Chicago also complied with SR Letter 98-28.

Fulfilling our mandate under section 38(k) of the FDI Act provides an opportunity to determine, in hindsight, whether additional or alternative supervisory actions could have been taken to reduce the likelihood of a bank's failure or a loss to the DIF. Our analysis of FRB Chicago's supervision of First Chicago revealed that FRB Chicago identified the bank's fundamental weaknesses, but did not take early, forceful supervisory action to address those weaknesses.

We believe that there were a number of instances that presented an opportunity for stronger supervisory responses. In the March 2007 examination, examiners noted First Chicago's high CRE and CLD loan concentrations, and acknowledged management's plan to reduce these concentrations by diversifying the bank's loan portfolio through increased C&I lending. Examiners only suggested that management "consider enhancing its risk management practices over the bank's real estate loan concentrations" as outlined in SR Letter 07-1. At the following examination in April 2008, examiners again cited First Chicago's high concentrations in CRE and CLD loans, but did not compel the bank to adhere to the enhanced credit risk management standards detailed in SR Letter 07-1 to address its credit concentrations. Asset quality and earnings deterioration were noted in the April 2009 supervisory assessment, and in the June 2009 examination, examiners identified multiple weaknesses in First Chicago's assessment of credit risk, such as problem loan identification and concentration monitoring. Therefore, we believe that a stronger supervisory response related to the credit risk management of concentrations was warranted as early as the April 2008 examination.

Weaknesses in First Chicago's credit risk management practices and bank management's inability to manage the resulting effects of asset quality deterioration during stressed economic times contributed to the bank's poor overall financial condition. In April 2009, FRB Chicago and the State conducted the supervisory assessment because examiners determined that there was strong evidence that First Chicago's financial condition changed significantly. Examiners downgraded the CAMELS composite rating to a 3 due to the bank's declining condition. In addition, examiners downgraded the capital and liquidity components to 3 ratings, the asset quality component to a 4 rating, triple downgraded the earnings component to a 5 rating, but maintained the management component rating at a 2. While we recognize that FRB Chicago downgraded First Chicago's management CAMELS component rating in the subsequent examination that began in June 2009, we believe that this supervisory assessment presented an opportunity for stronger criticism of management's performance related to the bank's deteriorating condition.

In June 2009, two months after the supervisory assessment, FRB Chicago began a joint full scope examination that revealed further deterioration in the bank's condition and resulted in a double downgrade of the CAMELS composite rating to a 5. Examiners also double downgraded the management component to a 4 rating to reflect the bank's critically deficient condition and weak risk management practices. First Chicago's overall condition continued to erode, and the bank's CAMELS composite rating remained a 5 following the November 2009 and June 2010 examinations. Examiners found that First Chicago's (1) high volume of nonperforming loans and classified assets, (2) significant reliance on brokered deposits, (3) critically deficient earnings, and (4) depleted capital contributed to its critically deficient condition. In addition, examiners cited management's "significant role" in the bank's heightened risk profile and stated that the bank's failure was "a distinct possibility." Nonetheless, examiners continued to rate the management component a 4. In our opinion, First Chicago's condition and management's inability to timely address identified deficiencies called for stronger criticism, including a management component downgrade.

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

Lessons Learned

Although the failure of an individual institution does not necessarily provide sufficient evidence to draw broad-based conclusions, we believe that First Chicago's failure offers lessons learned that can be applied to supervising banks with similar characteristics and circumstances. First Chicago's failure illustrates the importance of (1) timely implementation of a robust credit risk assessment program designed to facilitate the identification and management of concentrations; (2) closely monitoring and assessing management performance; and (3) appropriately assigning management CAMELS ratings commensurate with the issues identified during the examination.

Analysis of Comments

We provided a copy of our report to the Director of the Division of Banking Supervision and Regulation for review and comment. The Director concurred with the conclusions and lessons learned contained in the report and acknowledged the importance of taking aggressive supervisory actions to address uncorrected safety and soundness concerns. His response is included as Appendix 3.

Appendixes

Appendix 1 – Glossary of Banking and Regulatory Terms

Allowance for Loan and Lease Losses (ALLL)

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

Board Resolution

An informal supervisory enforcement action that represents commitments made by a bank’s Board of Directors. The commitments are incorporated into the bank’s corporate minutes.

Classified Assets

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

Commercial and Industrial (C&I) Loans

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

Commercial Real Estate (CRE) Loans

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

Appendix 1 (continued)

Concentration

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

Construction and Land Development (CLD) Loans; also known as Construction, Land, and Land Development (CLD) Loans

A subset of commercial real estate loans, secured by real estate (including non-agricultural vacant land), for (1) on-sight construction of industrial, commercial, residential, or farm buildings, and (2) land development, including pre-construction preparatory work such as laying sewer and water pipes.

Enforcement Actions

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

Non-Core Funding

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

Prompt Corrective Action (PCA)

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

Appendix 1 (continued)

Supervision and Regulation (SR) Letters

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

Underwriting

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

Written Agreement

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

Appendix 2 – CAMELS Rating System

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

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

Composite Rating Definition

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

Composite 1

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

Composite 2

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

Appendix 2 (continued)

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3 – Division Director's Comments

Board of Governors of the Federal Reserve System

Division of Banking Supervision and Regulation

Date:	February 16, 2012
To:	Anthony J. Castaldo – Associate Inspector General for Inspections and Evaluations
From:	Michael S Gibson, Director, Banking Supervision and Regulation ***/signed/***
Subject:	Material Loss Review of First Chicago Bank & Trust

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Material Loss Review for First Chicago Bank & Trust (First Chicago), Chicago, Illinois prepared by the Office of Inspector General in accordance with section 38(k) of the Federal Deposit Insurance Act, as amended. The report finds that First Chicago failed because its Board of Directors and management did not adequately control the risks associated with the bank's aggressive growth strategy, which resulted in a concentration in commercial real estate (CRE), particularly in construction, land, and development (CLD) loans. First Chicago was supervised by the Federal Reserve Bank of Chicago (FRB Chicago) under delegated authority from the Board.

FRB Chicago complied with examination frequency guidelines for the time period that was reviewed, 2007 through 2011. During this time FRB Chicago and the Illinois State Department of Financial and Profession Regulation (State) conducted four full scope examinations, two target examinations and an offsite supervisory assessment review that downgraded capital, asset quality, earnings and liquidity component ratings. In addition, FRB Chicago conducted other regular off-site monitoring and a CRE horizontal review. Further, over this timeframe supervisors executed three enforcement actions with First Chicago, which included one informal and one formal action, and implemented all applicable PCA provisions. The report recognizes that examiners identified the fundamental weaknesses that contributed to the bank's failure, but concludes that they did not take early, forceful supervisory action to address those weaknesses. The report states that it is not possible to determine whether alternative supervisory actions would have affected First Chicago's eventual decline.

Banking Supervision and Regulation staff concurs with the conclusions and lessons learned in the report. First Chicago's failure illustrates the risks associated with a strategic focus on high-risk loan products and expansion into new markets and the importance of establishing appropriate credit risk management practices prior to pursuing such higher risk lending. Moreover, it reinforces the importance of taking aggressive supervisory actions to address uncorrected safety and soundness concerns.

Appendix 4 – Principal Contributors to This Report

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Timothy P. Rogers, Office of Inspector General Manager