Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-032

Material Loss Review of First DuPage Bank, Westmont, Illinois

May 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On October 23, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR) closed First DuPage Bank, Westmont, Illinois (First DuPage) and named the FDIC as receiver. On November 6, 2009, the FDIC notified the Office of Inspector General (OIG) that First DuPage's total assets at closing were $281.5 million and the estimated loss to the Deposit Insurance Fund (DIF) was $58.3 million. As of March 19, 2010, the estimated loss to the DIF had increased to $69 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure.

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

Background

First DuPage was chartered as a state nonmember institution on June 28, 1999. The institution operated a single office in the community of Westmont, which is located approximately 22 miles west of downtown Chicago, Illinois. The institution's lending activities focused primarily on commercial real estate (CRE) within the Chicago metropolitan area, with an emphasis on acquisition, development, and construction (ADC) projects. Much of First DuPage's ADC lending involved the construction and renovation of condominiums. The institution was wholly-owned by First DuPage Bancorp, Inc. (Bancorp), a privately-held one-bank holding company. The Board collectively controlled approximately 25 percent of Bancorp's outstanding stock as of September 30, 2008. No individual shareholder controlled more than 6 percent of Bancorp's stock and the company's shares were widely-held. First DuPage had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act.

Audit Results

Causes of Failure and Material Loss

First DuPage failed primarily because its Board and management did not effectively manage the risks associated with the institution's heavy concentration in CRE loans, particularly ADC loans related to condominium projects. Notably, much of the institution's ADC lending was concentrated in large borrowing relationships that consisted of a limited number of real estate developers and their related interests. First DuPage also implemented lax loan underwriting practices with respect to its ADC loans. Specifically, the institution required little borrower equity and guarantor support when originating many of its large ADC loans and did not perform sufficient global cash flow analyses for some of its large borrowing relationships. Although not a primary cause of failure, weak credit administration and related monitoring practices added to the risk in the loan portfolio. First DuPage's concentration in ADC loans, together with lax underwriting practices, made the institution vulnerable to a sustained downturn in the real estate market.

Weakness in First DuPage's lending markets began to negatively affect the quality of the institution's loan portfolio in late 2007. By the close of 2008, the quality of the loan portfolio had become critically deficient, with the majority of problems attributable to ADC loans. The deterioration in the loan portfolio continued into 2009, and by September 2009, the associated losses and provisions had depleted First DuPage's capital, rendering the institution insolvent. IDFPR closed First DuPage on October 23, 2009 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

The FDIC's Supervision of First DuPage

The FDIC, in coordination with IDFPR, provided ongoing supervisory oversight of First DuPage through regular onsite risk management examinations, visitations, and offsite monitoring activities. The FDIC identified risks in First DuPage's operations and brought these risks to the attention of the institution's Board and management, including through recommendations. Such risks included inadequate concentration risk management practices, lax loan underwriting practices, and weak credit administration and related monitoring in some areas.

In retrospect, more proactive supervisory action at earlier examinations may have been prudent given the risks in the institution's loan portfolio. Such action could have included a visitation following the December 2005 examination to assess the institution's progress in addressing key risks identified by examiners. Had the FDIC conducted a visitation, it may have identified the institution's growing credit concentrations and weakening underwriting practices sooner than it did. By the time of the next examination in April 2007, the risks in these areas had increased substantially. In addition, the FDIC could have lowered the institution's supervisory component ratings for asset quality and/or management below a "2" at the April 2007 examination to reflect the risks in the institution's loan portfolio, including the risks associated with the institution's large borrowing relationships. Finally, the FDIC could have implemented an enforcement action based on the results of the April 2008 visitation. By the time the FDIC implemented an enforcement action in June 2009, the institution was at high risk of failure. More proactive supervisory action may have influenced First DuPage to curb its lax lending practices and strengthen its risk management controls before its lending markets deteriorated, potentially reducing the institution's losses.

With respect to issues discussed in the report, the FDIC recently implemented procedures to better ensure that examiner concerns and recommendations are appropriately tracked and addressed. The FDIC also implemented new procedures to expedite the issuance of formal cease and desist orders under certain circumstances.

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Based on the supervisory actions taken with respect to First DuPage, the FDIC properly implemented applicable PCA provisions of section 38.

Management Response

In its response, DSC reiterated the OIG's conclusions regarding the causes of First DuPage's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. With regard to our assessment of the FDIC's supervision, DSC stated that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations. In addition, DSC stated that guidance has been issued that sets forth broad supervisory expectations and re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. DSC also stated that it has implemented examiner training that emphasizes a forward looking approach when assessing a bank's risk profile. The training reinforces consideration of risk management practices in conjunction with current financial performance, conditions, or trends when assigning ratings.

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DATE: May 3, 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 First DuPage Bank, Westmont, Illinois* (Report No. MLR-10-032)

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 First DuPage Bank (First DuPage), Westmont, Illinois. The Illinois Department of Financial and Professional Regulation (IDFPR) closed the institution on October 23, 2009 and named the FDIC as receiver. On November 6, 2009, the FDIC notified the OIG that First DuPage's total assets at closing were $281.5 million and that the material loss to the Deposit Insurance Fund (DIF) was $58.3 million. As of March 19, 2010, the estimated loss to the DIF had increased to $69 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. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The audit objectives were to (1) determine the causes of First DuPage's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of First DuPage, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of First DuPage's failure and the FDIC's efforts to ensure that the Board of Directors and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as

[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.

major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC 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

First DuPage was chartered as a state nonmember institution on June 28, 1999. The institution operated a single office in the community of Westmont, which is located approximately 22 miles west of downtown Chicago, Illinois. The institution's lending activities focused primarily on commercial real estate (CRE) within the Chicago metropolitan area, with an emphasis on acquisition, development, and construction (ADC) projects. Much of First DuPage's ADC lending involved the construction and renovation of condominiums.

The institution was wholly-owned by First DuPage Bancorp, Inc. (Bancorp), a privately-held one-bank holding company. The Board collectively controlled approximately 25 percent of Bancorp's outstanding stock as of September 30, 2008. No individual shareholder controlled more than 6 percent of Bancorp's stock and the company's shares were widely-held. First DuPage had no affiliates as defined under the Bank Holding Company Act and section 23A of the Federal Reserve Act. Table 1 summarizes selected financial information for First DuPage for the quarter ended September 30, 2009 and for the 6 preceding calendar years.

Table 1: Selected Financial Information for First DuPage

Financial Measure ($000s)	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Sep-09
Total Assets	145,051	222,158	287,598	312,247	312,483	312,260	262,093
Gross Loans and Leases	108,563	183,450	247,064	258,868	262,192	260,152	211,568
Total Deposits	110,140	187,371	254,187	260,877	277,386	276,995	253,992
Net Income (Loss)	560	1,230	3,418	5,507	636	(10,445)	(26,955)

Source: Uniform Bank Performance Reports (UBPR) and Reports of Condition and Income (Call Report) for First DuPage.

Causes of Failure and Material Loss

First DuPage failed primarily because its Board and management did not effectively manage the risks associated with the institution's heavy concentration in CRE loans, particularly ADC loans related to condominium projects. Notably, much of the institution's ADC lending was concentrated in large borrowing relationships that consisted of a limited number of real estate developers and their related interests. First DuPage also implemented lax loan underwriting practices with respect to its ADC loans. Specifically, the institution required little borrower equity and guarantor support when originating many of its large ADC loans and did not perform sufficient global cash flow analyses for some of its large borrowing relationships. Although not a primary cause of failure, weak credit administration and related monitoring practices added to the risk in the loan portfolio. First DuPage's concentration in ADC loans, together with lax underwriting practices, made the institution vulnerable to a sustained downturn in the real estate market.

Weakness in First DuPage's lending markets began to negatively affect the quality of the institution's loan portfolio in late 2007. By the close of 2008, the quality of the loan portfolio had become critically deficient, with the majority of problems attributable to ADC loans. The deterioration in the loan portfolio continued into 2009, and by September 2009, the associated losses and provisions had depleted First DuPage's capital, rendering the institution insolvent. IDFPR closed First DuPage on October 23, 2009 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

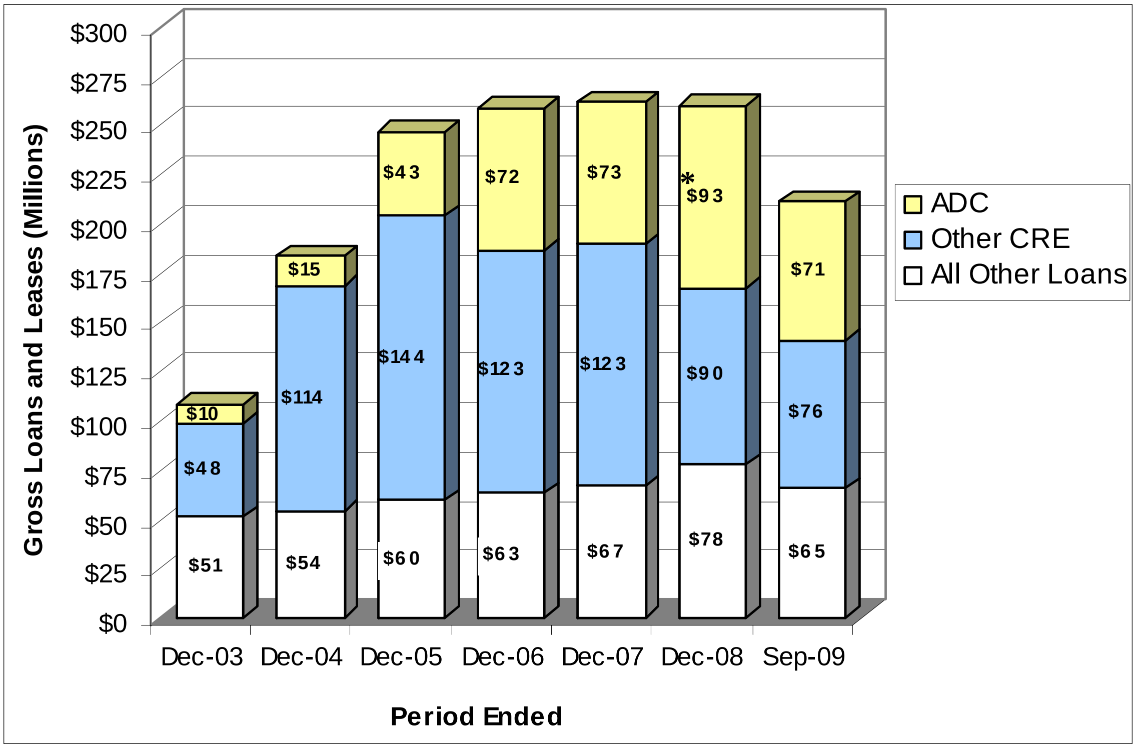
Concentrations in ADC Loans and Large Borrowing Relationships

In the years leading to its failure, First DuPage developed a significant concentration in risky ADC loans. In addition, a significant dollar amount of these ADC loans was concentrated in large borrowing relationships. A brief description of First DuPage's concentration-related risks follows.

ADC Loans

Throughout its history, First DuPage focused its lending activities on real estate, and, in the years leading to its failure, the institution emphasized ADC lending in response to a strong real estate market. Specifically, First DuPage grew its ADC loans from $10 million (or 9 percent of the loan portfolio) as of December 31, 2003 to $93 million (or 36 percent of the loan portfolio) by December 31, 2008. Much of this ADC lending consisted of speculative condominium construction and renovation projects in the Chicago metropolitan area. Further, First DuPage had unsecured loans and lines of credit with several real estate developers that, although not classified as ADC, were used to provide capital for various real estate construction and development projects. Figure 1 illustrates the general composition and growth of First DuPage's loan portfolio in the years preceding the institution's failure.

Figure 1: Composition and Growth of First DuPage's Loan Portfolio



Source: Call Reports for First DuPage.
* The increase in ADC loans during 2008 resulted from borrowers drawing on existing loan commitments rather than the institution originating new ADC loans.

In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued joint guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. Although the guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. 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 following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

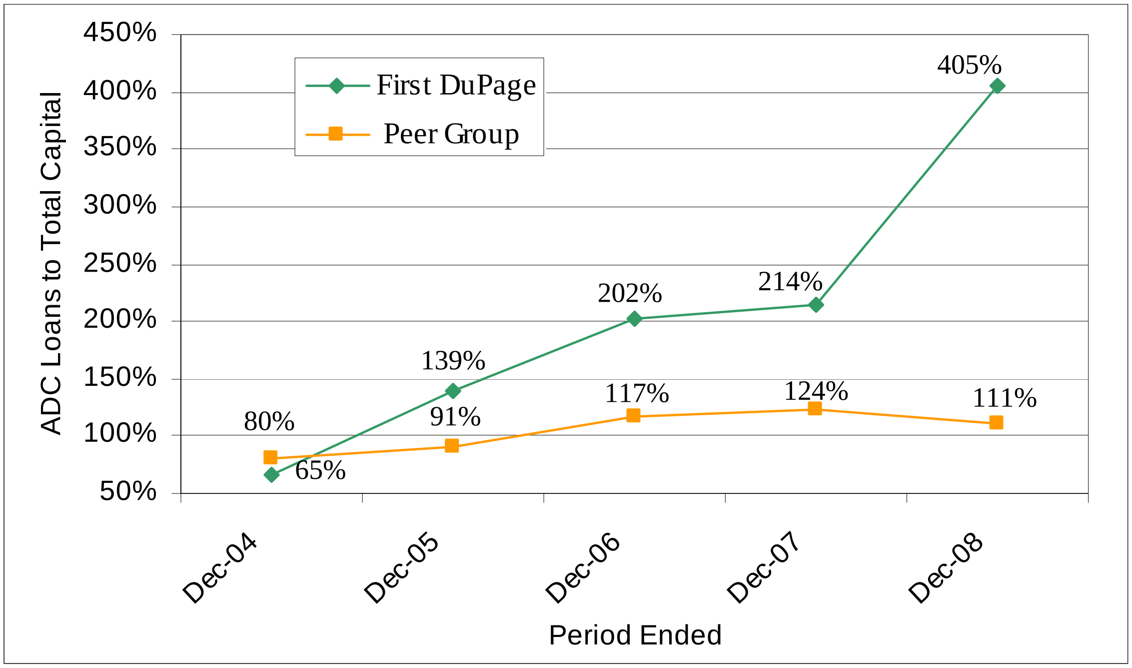
- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or

- Total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

As of December 31, 2007, First DuPage's non-owner occupied CRE loans and ADC loans represented 553 percent and 214 percent, respectively, of the institution's total capital. Both of these levels are higher than the criteria defined in the 2006 guidance as possibly warranting further supervisory analysis. Included within First DuPage's CRE portfolio was a sub-concentration in condominium construction and conversion projects. As of

March 31, 2008, loans pertaining to condominium projects totaled $60.8 million, representing 198 percent of Tier 1 Capital. Figure 2 illustrates the trend in First DuPage's ADC loan concentration relative to its peer group[3] in the years preceding the institution's failure.

Figure 2: First DuPage's ADC Concentration Compared to Peer Group



Source: UBPRs for First DuPage.

<u>Large Borrowing Relationships</u>

Adding to the risk in the loan portfolio were concentrations of credit in large borrowing relationships. Generally, these relationships consisted of small groups of real estate developers and their related interests that had borrowed funds from First DuPage and many other financial institutions to finance their numerous real estate projects. The extensive exposure that these developers had to ADC projects made them particularly vulnerable to a sustained downturn in the real estate market. As of September 30, 2008, First DuPage had six borrowing relationships totaling $89.8 million that individually represented approximately 60 percent or more of Tier 1 Capital. First DuPage's large borrowing relationships accounted for the majority of loan quality problems that developed when the institution's lending markets deteriorated.

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[3] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. First DuPage was assigned to various peer groups between 1999 and its failure. In the years preceding its failure, First DuPage's peer group included all insured commercial institutions with assets between $300 million and $1 billion.

Loan Portfolio Decline

At the time of the April 2007 examination, adversely classified items were a moderate $5.6 million, or 16 percent of Tier 1 Capital and the Allowance for Loan and Lease Losses (ALLL). In October 2007, the President and Chief Executive Officer (CEO) of First DuPage notified the FDIC that weakness in the real estate market was causing some of the institution's borrowers, particularly those who had financed condominium projects, to experience cash flow problems. As a result, the institution was beginning to experience an increase in delinquencies and nonaccrual loans. The institution's loan problems accelerated in 2008, and by the November 2008 examination, adversely classified assets had risen to $98.8 million (or 289 percent of Tier 1 Capital plus the ALLL). Notably, more than $69 million (or 70 percent) of the $98.8 million in adverse classifications pertained to ADC, the majority of which involved condominium projects. Further, $65.6 million (or 66 percent) of the $98.8 million pertained to five large borrowing relationships.

First DuPage recorded net losses of $10.4 million and $26.9 million, respectively, for calendar year 2008 and the first nine months of 2009. These losses, which were largely attributable to ADC loans, reduced First DuPage's Tier 1 capital to negative $7.5 million as of September 30, 2009, rendering the institution insolvent.

ADC Loan Underwriting

Lax loan underwriting practices, particularly with respect to ADC loans, contributed to the loan quality problems that developed when the institution's real estate lending markets deteriorated in 2007 and 2008. A brief description of these practices follows.

Borrower Equity

Appendix A, *Interagency Guidelines for Real Estate Lending Policies*, to Part 365 of the FDIC Rules and Regulations, *Real Estate Lending Standards*, defines minimum borrower equity requirements for real estate loans held by FDIC-supervised institutions. The minimum equity requirements are defined in terms of specific loan-to-value (LTV) ratio limits for various types of real estate loans.[4] The interagency guidelines also provide that (1) the aggregate amount of all loans in excess of the LTV limits should not exceed 100 percent of the institution's total capital and (2) within the aggregate amount, total loans exceeding the LTV limits for commercial, agricultural, multifamily, or other non-1-4 family residential properties should not exceed 30 percent of the institution's total capital. These limits are intended to reduce an institution's credit risk in the event of a sustained downturn in the real estate market.

[4] The guidelines recognize that there may be circumstances in which it is appropriate to originate or purchase loans with LTV ratios that exceed the LTV limits in the guidelines, if justified by other credit factors. In such cases, the loans should be identified in the institution's records and their aggregate amount reported at least quarterly to the institution's Board.

As of September 30, 2005 and April 30, 2007, First DuPage's LTV loan exceptions were 126 percent and 213 percent of total capital, respectively, exceeding the 100 percent limit defined in the interagency guidelines. Furthermore, the vast majority of First DuPage's LTV loan exceptions were for commercial, agricultural, multifamily, or other non-1-4 family residential properties, which are subject to the 30 percent limit of total capital in the interagency guidelines. In many cases, the loan exceptions exceeded the supervisory LTV limits when they were originated between 2004 and 2007. Nearly $31 million (or 35 percent) of adversely classified loans in the November 2008 examination report exceeded the supervisory LTV limits when originated by the institution. In addition, management reports on LTV loan exceptions submitted to the institution's Board were not always accurate because they did not include all exceptions, thus limiting the institution's ability to effectively manage the risks associated with high LTV loans.

Further, examiners noted during the April 2007 examination that First DuPage frequently originated CRE loans based on LTV ratios that were just under the specific LTV limits defined in the interagency guidelines. Such practices introduced additional risk because a relatively small decline in real estate values could result in increased LTV exceptions. Based on concerns raised by examiners in April 2007, the institution began taking steps to reduce the volume of its LTV loan exceptions. However, the institution's success in this regard was limited by a decline in loan collateral values caused by the deteriorating real estate market.

Personal Loan Guarantees

Many of First DuPage's ADC loans were made to Limited Liability Companies (LLC) that had been established by real estate developers for the purpose of managing their properties. Developers often create LLCs for their real estate holdings because of the benefits that the ownership structure offers, such as limited financial liability should the LLC default on its financial obligations.[5] In addition, LLCs are considered separate legal entities for borrowing purposes. Accordingly, their owners are not constrained by state legal lending limits that would apply if the owners borrowed the funds themselves. Because of the limited liability nature of LLCs, it is prudent to obtain a substantial or unlimited personal guarantee when making loans to these entities.

First DuPage accepted limited personal guarantees from developers for many of the ADC loans that the institution made to LLCs. In some cases, these guarantees were as little as 25 percent of the loan amount. First DuPage accepted limited personal guarantees to prevent the developers from exceeding Illinois state legal lending limits that restrict the amount of funds any individual can guarantee at a specific institution. However, the acceptance of limited personal guarantees increased First DuPage's credit risk exposure because it placed greater reliance on collateral for payment protection. Adding to the risk in this area was First DuPage's practice of allowing some of its largest borrowers to guarantee loan amounts that exceeded the institution's internal loan policy limits. Many

[5] In general, owners of LLCs are only liable for their investment in the LLC and not personally responsible for the debts and obligations of the LLC should those debts not be fulfilled.

of the ADC loans for which First DuPage accepted limited personal guarantees subsequently became classified.

Global Cash Flow Analyses

First DuPage performed global cash flow analyses for its largest borrowing relationships. However, these analyses were not always commensurate with the risk that the borrowing relationships posed to the institution. For example, the institution's largest borrowing relationship consisted of a small group of real estate developers who had loans totaling $23.2 million (or 109 percent of total capital) as of September 30, 2008. These developers had financing arrangements at more than 20 other institutions to support their numerous real estate projects and frequently refinanced their projects (often changing lenders and loan terms) and cross-guaranteed each other's loans. The complexity of this borrowing relationship made it extremely difficult for First DuPage to properly assess the group's global financial condition, including the impact that problems on projects financed at other institutions might have on the borrowers' repayment capacity and the completion of projects financed by First DuPage. Further, examiners noted during the November 2008 examination that the institution's loan files did not contain current, accurate, and complete financial information for some of the developers in this relationship.

The lack of sufficient global cash flow analyses for some large borrowing relationships increased First DuPage's risk exposure, particularly when the Chicago real estate market began to decline.

Table 2 identifies the five largest borrowing relationships that were classified by examiners during the November 2008 examination and the extent to which the above loan underwriting weaknesses affected these relationships.

Table 2: Lax Underwriting Practices for Selected Borrowing Relationships at First DuPage

Borrowing Relationship	Number of Loans Held by the Relationship	Total Loan Amounts (millions)	Percent of Total Capital	LTV Exceptions	Limited Personal Guarantees	Insufficient Global Cash Flow Analyses
1	14	$23.9	97%	✓	✓	✓
2	7	$13.0	53%	✓	✓	✓
3	2	$12.7	51%	✓	✓	✓
4	4	$10.4	42%			
5	2	$8.1	33%	✓	✓	
Totals	**29**	**$68.1***	276%			

Source: Reports of examination for First DuPage.
* Of the $68.1 million, $65.6 million (or 91 percent) was adversely classified in the November 2008 examination report.

Credit Administration and Related Monitoring

Although not a primary cause of failure, First DuPage's various credit administration and related monitoring weaknesses contributed to the ADC loan quality problems that developed when the institution's lending markets declined. Such weaknesses included, but were not limited to:

- Inadequate analysis and comparison of initial construction and development projections to actual performance (including analysis of associated deviations).
- Insufficient trigger points for loan risk grade changes, particularly for loans with high risk characteristics, such as high LTV ratios and tight debt service coverage. This resulted in some loans not being recognized as problem credits in a timely manner.
- Failure to obtain current appraisals or perform adequate appraisal reviews on some loans.
- Insufficient procedures for monitoring lending markets to enable management to quickly react to changes in conditions (e.g., zoning, vacancy rates, absorption rates, and economic indicators).
- Lack of feasibility studies and risk analysis (e.g., sensitivity of income projections to changes in interest rates).

The FDIC's Supervision of First DuPage

The FDIC, in coordination with IDFPR, provided ongoing supervisory oversight of First DuPage through regular onsite risk management examinations, visitations, and offsite monitoring activities. The FDIC identified risks in First DuPage's operations and brought these risks to the attention of the institution's Board and management, including through recommendations. Such risks included inadequate concentration risk management practices, lax loan underwriting practices, and weak credit administration and related monitoring in some areas. As discussed below, more proactive supervisory action at earlier examinations may have been prudent given the risks in the institution's loan portfolio. Such action could have included conducting a visitation in 2006 to assess key risks at the institution; lowering key supervisory ratings[6] and expressing concern regarding the institution's large borrowing relationships during the April 2007 examination; and pursuing an enforcement action prior to the November 2008 examination. More proactive supervisory action may have influenced First DuPage to curb its lax lending practices and

[6] 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.

strengthen its risk management controls before its lending markets deteriorated, potentially reducing the institution's losses.

With respect to issues discussed in this report, the FDIC recently implemented procedures to better ensure that examiner concerns and recommendations are appropriately tracked and addressed. The FDIC also implemented new procedures to expedite the issuance of formal cease and desist orders under certain circumstances.

Supervisory History

The FDIC and IDFPR conducted four onsite risk management examinations and two visitations of First DuPage between January 2005 and the institution's failure. Table 3 summarizes key supervisory information for these examinations and visitations.

Table 3: Onsite Examinations and Visitations of First DuPage

Examination Start Date	Type of Examination	Regulator	Supervisory Ratings	Contraventions and/or Violations*	Informal or Formal Actions Taken**
7/20/2009	Visitation	FDIC	NA		June 2009 C&D still in effect.
11/10/2008	Risk Management	FDIC/IDFPR	554544/5	✓	C&D issued June 16, 2009.
4/21/2008	Visitation	FDIC/IDFPR	243321/3	✓	None***
4/30/2007	Risk Management	FDIC	222221/2	✓	None
12/27/2005	Risk Management	IDFPR	212222/2	✓	None
1/03/2005	Risk Management	FDIC	212322/2	☑	None

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information On the Net system for First DuPage.
☑ The only violation cited in the January 2005 examination report was a violation of Part 326 of the FDIC Rules and Regulations pertaining to the Bank Secrecy Act.
* Contraventions and/or Violations consisted of contraventions of Part 365 pertaining to LTV loan exceptions and apparent violations of Part 215 of the Federal Reserve Board's Regulation O pertaining to insider loans
** Informal enforcement actions often take the form of Bank Board Resolutions or Memoranda of Understanding. Formal enforcement actions often take the form of Cease and Desist (C&D) orders, but under severe circumstances can also take the form of insurance termination proceedings.
*** The FDIC lowered First DuPage's supervisory rating and issued a problem bank memorandum to the institution on August 15, 2008.

The FDIC's offsite monitoring procedures generally consisted of contacting the institution's management from time to time to discuss current and emerging business issues and using automated tools[7] to help identify potential supervisory concerns. The FDIC initially became aware of problems at First DuPage when its President and CEO contacted examiners on October 24, 2007 to advise that the institution was experiencing

[7] The FDIC uses various offsite monitoring tools to help assess the financial condition of institutions. Two such tools are the Statistical CAMELS Offsite Rating (SCOR) system and the Growth Monitoring System (GMS). Both tools use statistical techniques and Call Report data to identify potential risks, such as institutions likely to receive a supervisory downgrade at the next examination or institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

an increase in nonperforming assets. A January 2008 offsite analysis of the institution's September 30, 2007 Call Report identified a sharp increase in nonperforming assets and determined that a downgrade in the institution's supervisory composite rating of "2" would likely occur at the next examination. A subsequent offsite analysis of the institution's December 31, 2007 Call Report identified further financial deterioration.

Based on the discussion with First DuPage's President and CEO, and the results of the offsite analyses, the FDIC conducted a joint visitation with IDFPR in April 2008 that focused on the institution's asset quality. During the visitation, examiners determined that First DuPage's asset quality had deteriorated substantially since the prior examination due to the institution's heavy concentration in the deteriorating Chicago real estate market. As a result, examiners downgraded the institution's supervisory composite rating to a "3." By the November 2008 examination, First DuPage's financial condition had become critically deficient. On June 16, 2009, the FDIC and IDFPR issued a C&D that, among other things, required First DuPage to establish appropriate limits on its credit concentrations and develop a plan to reduce those concentrations, where appropriate. The C&D also directed the institution to maintain its Tier 1 Capital and Total Risk Based Capital at levels not less than 9 percent and 13 percent, respectively. These capital ratios are higher than the minimum levels for *Well Capitalized* institutions as defined in Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations, and reflected the institution's elevated risk profile.

On July 20, 2009, the FDIC conducted a joint visitation with IDFPR to assess the financial condition of First DuPage. Based on the results of the visitation, the FDIC concluded that the institution's financial condition was dire and that it would likely fail. IDFPR closed First DuPage on October 23, 2009 because the institution was unable to raise sufficient capital to support its operations or find a suitable acquirer.

Supervisory Response to Key Risks

In retrospect, more proactive supervisory action at earlier examinations may have been prudent given the risks in the institution's loan portfolio.

<u>December 2005 Examination</u>

At the time of the December 2005 examination, economic conditions in First DuPage's lending markets were favorable and the institution's adversely classified assets were a manageable $1.28 million, or 4.4 percent of Tier 1 Capital and the ALLL. Based on this information and management's agreement to address the weaknesses identified during the examination, examiners determined that the overall financial and operational condition of the institution was satisfactory and assigned a supervisory component rating of "1" for asset quality. Notwithstanding the financial condition of the institution at that time, the rating for asset quality did not reflect the increasing risks in the institution's loan portfolio. Such risks included:

- **Rapid Growth.** For the 9 months ended September 30, 2005, the institution experienced growth of approximately 42 percent.

- **Increasing ADC Loan Concentration.** ADC loans represented 140 percent of Tier 1 Capital, up considerably from the prior examination. The institution also lacked key concentration risk management controls, such as loan concentration limits, adequate monitoring, and loan portfolio diversification guidelines.

- **Lax Underwriting Practices.** First DuPage's loan policies and practices were not adequate. Among other things, the loan policy did not include review and approval procedures for LTV exception loans. In addition, LTV exceptions totaled 126 percent of total capital as of September 30, 2005. The vast majority of these exceptions were subject to the 30 percent of total capital limit defined in the interagency guidelines.

On March 14, 2006, First DuPage provided a written response to the December 2005 examination report stating, among other things, that its concentration levels may be reduced over time through normal loan attrition and that it anticipated a significant reduction in its supervisory LTV loan exceptions before year-end 2006. Based on this response, and the supervisory ratings assigned during the examination, the FDIC did not deem it necessary to perform a visitation to assess the institution's progress in addressing the risks identified during the examination. In retrospect, a visitation may have been prudent given the growing risks in the loan portfolio. Had the FDIC conducted a visitation prior to the April 2007 examination, it may have identified the institution's growing credit concentrations and increasing level of supervisory LTV loan exceptions sooner than it did. By the time of the April 2007 examination, risks in these areas had increased substantially, making their remediation more difficult when the real estate market began to decline later that year.

<u>April 2007 Examination</u>

Examiners noted during the April 2007 examination that the institution's ADC loan concentrations had increased to 222 percent of Tier 1 Capital and that the volume of supervisory LTV loan exceptions had risen to an "unacceptably high" level of 213 percent of total capital. Based on these and other risk factors, examiners lowered the supervisory component rating for asset quality from a "1" to a "2." Examiners also recommended in the examination report that First DuPage improve its weak risk management practices (including monitoring, reporting, and administering CRE loans) and develop a plan to reduce its LTV loan exceptions. First DuPage agreed with those recommendations.

Given the increase in First DuPage's ADC loan concentration and the lack of management attention to prior recommendations regarding supervisory LTV loan exceptions, the FDIC could have taken stronger supervisory action to set an appropriate tenor of expectations. For example, the FDIC could have lowered the institution's supervisory component ratings for asset quality and/or management below a "2" and required the institution to provide periodic progress reports detailing its corrective actions. In addition, examiners were not critical of the risks associated with the institution's large borrowing relationships. At the time of the April 2007 examination, these relationships had significant exposure to

ADC projects in the Chicago area and the institution's loan underwriting for these relationships was weak. Criticism of these risks, together with lower supervisory ratings, may have influenced First DuPage to curb its lending to large borrowers following the April 2007 examination, potentially reducing the institution's losses. More than $18 million in ADC loans classified during the November 2008 examination were originated to large borrowing relationships after July 1, 2007.

Of note, the FDIC issued guidance to its examiners on January 26, 2010 that defines procedures for better ensuring that examiner concerns and recommendations are appropriately tracked and addressed. Specifically, the guidance defines a standard approach for communicating matters requiring Board attention (e.g., examiner concerns and recommendations) in examination reports. The guidance also states that examination staff should request a response from the institution regarding the actions that it will take to mitigate the risks identified during the examination and correct noted deficiencies.

2008 Visitation and Examination

Based on the results of the April 2008 visitation, examiners determined that First DuPage's asset quality had deteriorated substantially. In an April 30, 2008 memorandum to the FDIC's Chicago Regional Director, the examiner-in-charge recommended that the institution's supervisory composite rating be downgraded to a "3" and that an informal enforcement action be pursued. However, the rating downgrade was not processed until August 15, 2008, at which time the FDIC and IDFPR formally notified the institution of the results of the visitation. In addition, the FDIC decided not to pursue an enforcement action at that time because a full-scope examination was scheduled for November 2008 and examiners had determined during the April 2008 visitation that the institution was taking action to address known issues and concerns.

Even though the institution was taking actions to address examiner concerns during the April 2008 visitation, pursuing an enforcement action at that time may have been prudent. Such an action would have required the institution to formally report on its condition and progress in addressing key risks and provided the FDIC with additional assurance that management would continue its course of action. Although the FDIC did pursue a formal enforcement action based on the results of the November 2008 examination, the action was not implemented until June 2009. By that time, the institution was likely to fail absent a large capital infusion. In this regard, the FDIC recently implemented new procedures to expedite the issuance of C&Ds under certain circumstances.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38.

Based on the supervisory actions taken with respect to First DuPage, the FDIC properly implemented applicable PCA provisions of section 38. Table 4 illustrates First DuPage's capital levels relative to the PCA thresholds for *Well Capitalized* institutions for the quarter ended September 30, 2009, and for the 4 preceding calendar years.

Table 4: First DuPage's Capital Levels

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
Well Capitalized Thresholds	**5% or more**	**6% or more**	**10% or more**	
First DuPage's Capital Levels				
Dec-05	9.58	10.18	11.34	*Well Capitalized*
Dec-06	10.65	11.26	12.40	*Well Capitalized*
Dec-07	9.59	10.43	11.69	*Well Capitalized*
Dec-08	6.29	7.08	8.33	*Adequately Capitalized*
Sep-09	-2.68	-3.39	-3.39	*Critically Undercapitalized*

Source: UBPRs of First DuPage.

First DuPage was considered *Well Capitalized* for PCA purposes until December 31, 2008. On February 18, 2009 the FDIC notified First DuPage that, based on the institution's Call Report for the quarter ended December 31, 2008, the institution's PCA category had fallen to *Adequately Capitalized*. The FDIC's notification included a reminder that *Adequately Capitalized* institutions are restricted from using brokered deposits absent a waiver from the FDIC. As previously discussed, the FDIC and IDFPR issued a C&D on June 16, 2009 requiring, among other things, that First DuPage maintain capital at a level higher than required for *Well Capitalized* institutions due to its elevated risk profile.

On July 30, 2009, the FDIC notified First DuPage that, based on the results of the July 20, 2009 visitation, the institution had become *Critically Undercapitalized*. The notification stated that First DuPage was subject to all of the mandatory restrictions contained in section 38 and that the FDIC would be required to place the institution into receivership on October 30, 2009, unless the FDIC determined that an alternative action would better carry out the purposes of section 38. The notification also directed First DuPage to provide the following by September 15, 2009: (1) a summary of actions taken to comply with the mandatory restrictions of section 38 and (2) a capital restoration plan. On August 13, 2009, IDFPR provided First DuPage with a written *Notice of Intent to Take Possession and Control Pursuant to Section 51 of the Illinois Banking Act*. Among other things, the notice stated that the institution was operating with an unacceptable level of capital protection and that if First DuPage did not raise sufficient capital by October 16, 2009, IDFPR intended to take possession and control of the institution.

First DuPage explored a number of options to raise needed capital during 2008 and 2009, including contacting various financial institutions, individual investors, and private equity firms. The institution also applied for funds under the U.S. Department of the Treasury's Troubled Asset Relief Program. However, the institution subsequently withdrew its application after it became apparent that its financial condition would prohibit it from qualifying for funds under the program. On September 18, 2009, the FDIC contacted First DuPage to determine the status of the institution's capital restoration plan because one had not yet been received by the Corporation. An institution official advised the FDIC that management's efforts to raise needed capital had not been successful, and that absent open bank assistance from the FDIC, the institution would likely be taken into receivership. First DuPage never submitted a capital restoration plan to the FDIC. IDFPR closed First DuPage on October 23, 2009.

Corporation Comments

We issued a draft of this report on April 15, 2010. DSC management subsequently provided us with additional information for our consideration. We made changes to our report based on this information, as appropriate. On April 28, 2010, the Director, DSC, provided a written response to the draft report. The response is presented in its entirety as Appendix 4 of the report.

In its response, DSC reiterated the OIG's conclusions regarding the causes of First DuPage's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. With regard to our assessment of the FDIC's supervision, DSC stated that strong supervisory attention is necessary for institutions with high CRE and ADC concentrations. In addition, DSC stated that guidance has been issued that sets forth broad supervisory expectations and re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. DSC also stated that it has implemented examiner training that emphasizes a forward looking approach when assessing a bank's risk profile. The training reinforces consideration of risk management practices in conjunction with current financial performance, conditions, or trends when assigning ratings.

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 January to April 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 First DuPage's operations from January 2005 until its failure on October 23, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination reports issued by the FDIC and IDFPR between 2005 and 2009.

- Reviewed the following:

  - Institution data and correspondence obtained from DSC's Chicago Regional Office.

  - Relevant reports prepared by the Division of Resolutions and Receiverships and DSC's Washington, D.C. Office relating to the institution's failure.

  - Pertinent FDIC regulations, policies, procedures, and guidance.

- Interviewed DSC examination staff from the Washington, D.C. Office and the Chicago Regional Office.

Objectives, Scope, and Methodology

- Interviewed IDFPR examiners and managers to obtain their perspectives and discuss their role in the supervision of the institution.

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

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

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

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

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL 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. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Call Report	The report filed by a bank pursuant to 12 U.S.C. 1817(a)(1), which requires each insured State nonmember bank and each foreign bank having an insured branch which is not a Federal branch to make to the Corporation reports of condition in a form that shall contain such information as the Board of Directors may require. 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.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Interest Reserve Account	An interest reserve account allows a lender to periodically advance loan funds to pay interest charges on the outstanding balance of a loan. The interest is capitalized and added to the loan balance. ADC loans often include an interest reserve to carry the project from origination to

Glossary of Terms

Term	Definition
	completion and may cover the project's anticipated sell-out or lease-up period.
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.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as: **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
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 Consolidated Reports of Condition and Income data submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CEO	Chief Executive Officer
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
IDFPR	Illinois Department of Financial and Professional Regulation
LLC	Limited Liability Corporation
LTV	Loan-to-value
OIG	Office of Inspector General
PCA	Prompt Corrective Action
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

FDIC

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

April 28, 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 First DuPage Bank, Westmont, Illinois (Assignment No. 2010-013)

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 First DuPage Bank (First DuPage), Westmont, Illinois which failed on October 23, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on April 15, 2010.

The Report concludes First DuPage failed due to the Board of Directors' (Board) and management's failure to effectively manage the risks associated with the institution's heavy concentration in commercial real estate (CRE) loans, particularly acquisition, development, and construction (ADC) loans related to condominium projects. Much of the institution's ADC lending was concentrated in large borrowing relationships which were centered in a limited number of real estate developers and their related interests. During the booming economy and real estate market, management's appetite for risk increased and underwriting practices weakened. First DuPage's concentration in ADC loans, coupled with lax underwriting practices, made the institution vulnerable to the sudden and sustained downturn in the Chicago real estate market.

The FDIC, in coordination with the Illinois Department of Financial and Professional Regulation (IDFPR) jointly and separately conducted five full-scope examinations, two visitations, and four offsite reviews from 2003 through October 2009. First DuPage experienced significant asset growth between 2003 and 2006, in the thriving Chicago real estate market. The Report acknowledges that the FDIC identified risks in First DuPage's operations and brought these risks to the attention of the Board and management. Management responded to the noted concerns by implementing corrective action plans. However, when First DuPage's management and Board were unable to sufficiently address its problems, the FDIC and IDFPR initiated a formal enforcement order.

Strong supervisory attention is necessary for institutions with high CRE and ADC concentrations. Guidance has been issued that sets forth broad supervisory expectations and re-emphasizes the importance of robust credit risk-management practices for institutions with concentrated CRE exposures. Additionally, DSC has implemented examiner training that emphasizes a forward looking approach when assessing a bank's risk profile. The training reinforces consideration of risk management practices in conjunction with current financial performance, conditions or trends when assigning ratings. Thank you for the opportunity to review and comment on the Report.