Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-042

Material Loss Review of Citizens State Bank, New Baltimore, Michigan

July 2010

Office of Inspector General

Executive Summary

Material Loss Review of Citizens State Bank, New Baltimore, Michigan

Report No. MLR-10-042
July 2010

Why We Did The Audit

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review of Citizens State Bank (CSB), New Baltimore, Michigan.

On December 18, 2009, the Michigan Office of Financial and Insurance Regulation (OFIR) closed CSB and named the FDIC as receiver. On January 20, 2010, the FDIC notified the OIG that CSB's total assets at closing were $167.8 million. As of January 29, 2010, the estimated loss to the Deposit Insurance Fund (DIF) was $30.65 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act to conduct a material loss review of the failure of CSB and retained KPMG for this purpose.

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

Background

CSB was established in 1922 as a state nonmember bank and was wholly-owned by Citizens State Bancorp, Inc., a one-bank holding company. The bank's Board of Directors (Board) controlled 12 percent of the holding company's stock. CSB operated seven branches throughout the Detroit, Michigan metropolitan area—six in Macomb County and one in St. Clair County.

Until 2002, CSB's loan portfolio had primarily consisted of 1-4 family residential loans. As the banking industry and real estate market changed in the early 2000s, CSB's Board reassessed its business strategy and business model. Based upon an external assessment, the Board opted to shift its focus in 2003 to CRE lending in order to remain competitive in the marketplace.

Audit Results

Causes of Failure and Material Loss

CSB's failure can be attributed to (1) inadequate management and Board oversight; (2) a high concentration in CRE lending; (3) weaknesses in internal controls and questionable credit underwriting; and (4) poor credit risk management practices. Some of these practices, and their apparent significant impact on the failure of CSB, are the subject of ongoing investigative activities. Bank management and the Board pursued a business strategy based on a highly concentrated loan portfolio, with limited experience in CRE lending and without establishing the appropriate practices to mitigate the corresponding risks. The bank's financial deterioration was exacerbated by the depressed economic conditions, deteriorating automobile industry, and high unemployment rates prevalent in the Detroit metropolitan area.

The FDIC's Supervision of CSB

Through onsite examinations and a visitation, the FDIC and the OFIR identified key risks in CSB's operations and brought these to management's attention. These risks included inadequate management and Board oversight, high concentrations in CRE lending, weaknesses in internal controls and credit underwriting, and poor credit risk management practices. Examiners also noted the adverse changes in the local Michigan economy. In 2008, the FDIC and the OFIR pursued a Memorandum of Understanding as a result of unsatisfactory practices and conditions noted in the March 2008 examination. The FDIC also issued a Cease and Desist Order as a result of the May 2009 examination. In retrospect, CSB's change in lending strategy consisting of higher CRE concentrations warranted elevated concern by examiners as early as the 2005 FDIC examination. Additionally, regulators may have benefited from on-site follow-up in addition to offsite monitoring following the December 2006 State examination to have greater assurance that the bank was correcting critical credit administration weaknesses.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. CSB was unsuccessful in raising needed capital, and the bank was subsequently closed on December 18, 2009.

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On July 20, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of CSB's failure and the FDIC's supervision of the bank. DSC stated that strong supervisory attention is necessary for institutions with high CRE concentrations. DSC has issued updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: July 20, 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 Citizens State Bank, New Baltimore, Michigan*
(Report No. MLR-10-042)

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. The report did not contain recommendations, thus a response was not required. However, the Division of Supervision and Consumer Protection provided a written response on July 20, 2010. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Ann Lewis, Audit Manager, at (703) 562-6379. We appreciate the courtesies extended to the audit staff.

Attachment

cc: M. Anthony Lowe, Regional Director, DSC
Elaine D. Drapeau, Acting Chief, Office of Internal Control and Review, DSC
James H. Angel, Jr., Director, OERM
Ken Ross, Commissioner, Michigan Office of Financial and Insurance Regulation

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Part I

Report by KPMG LLP

Material Loss Review
Citizens State Bank
New Baltimore, Michigan

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP

2001 M Street, NW
Washington, DC 20036

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KPMG LLP
2001 M Street, NW
Washington, DC 20036

July 19, 2010

Executive Summary

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

Material Loss Review Report for Citizens State Bank, New Baltimore, Michigan

Dear Mr. Beard:

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

Causes of Failure

CSB's failure can be attributed to (1) inadequate management and Board of Directors (Board) oversight; (2) a high concentration in Commercial Real Estate (CRE) lending; (3) weaknesses in internal controls and questionable credit underwriting; and (4) poor credit risk management practices. Some of these practices and their apparent significant impact on the failure of CSB are the subject of ongoing investigative activities. Management and the Board pursued a business strategy based on a highly concentrated loan portfolio, with limited experience in CRE lending and without establishing the appropriate practices to mitigate the corresponding risks. The Bank's rapid financial deterioration was exacerbated by the depressed economic conditions, deteriorating automobile industry, and high unemployment rates prevalent in the Detroit, Michigan area where CSB operated.

Evaluation of Supervision

The FDIC and the Michigan Office of Financial and Insurance Regulation (OFIR) examinations and visitation of CSB identified key risks, including inadequate management and Board oversight, high concentrations in CRE lending, weaknesses in internal controls and credit underwriting, poor credit risk management practices, and the adverse changes in the local Michigan economy. In 2008, the FDIC and the OFIR pursued a Memorandum of Understanding (MOU) as a result of unsatisfactory practices and conditions noted in the March 2008 examination. The FDIC also issued a Cease and Desist Order (C&D) as a result of the May 2009 examination. In retrospect, beginning with the 2005 FDIC examination, the lending strategy consisting of higher CRE concentrations warranted elevated concern. Additionally, regulators may have benefited from an

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("KPMG International"), a Swiss entity.

on-site visitation in addition to off-site monitoring following the December 2006 State examination to have greater assurance that the Bank was correcting critical credit administration weaknesses.

Prompt Corrective Action

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. CSB was unsuccessful in raising needed capital, and the Bank was subsequently closed on December 18, 2009.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the performance audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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

Very truly yours,

KPMG LLP

Why We Did The Audit

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review of CSB.

On December 18, 2009, OFIR closed CSB and named the FDIC as receiver. On January 20, 2010, the FDIC notified the OIG that CSB's total assets at closing were $167.8 million. As of January 29, 2010, the estimated loss to the DIF was $30.65 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act to conduct a material loss review of the failure of CSB, and retained KPMG for this purpose.[1]

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

Background

CSB operated in New Baltimore, Michigan, which is located about 35 miles northeast of Detroit in Macomb County. During the early 2000s, the CRE market in Macomb County started to experience high growth. People from neighboring areas started to migrate to this county, which created a high demand for commercial and residential mortgage real estate loans.

Approximately 70 percent of the population living in Macomb County worked for the top three automotive companies. In the early 2000s, there were signs of stress in the automobile industry, and by the mid 2000s, this industry as well as the national economy had begun to falter. By 2008, Detroit and the surrounding areas faced some of the strongest challenges in the country as the economic outlook for the U.S. deteriorated and unemployment climbed.

CSB was a state non-member bank wholly-owned by Citizens State Bancorp, Inc. (Holding Company), a one-bank holding company, established in 1922. The Board controlled 12 percent of the company's stock. CSB operated seven branches, six of which were in Macomb County and one in St. Clair County.

CSB's loan portfolio had primarily consisted of 1-4 family residential loans until 2002. As the banking industry and real estate market changed in the early 2000s, CSB's Board reassessed its business strategy and business model. After working with an outside consultant to conduct an assessment, the Board opted to shift its focus to CRE lending in order to remain competitive in the marketplace.

The new business strategy coincided with a change in senior management at the Bank. Despite the changes in leadership, the experience of the preponderance of the Board remained in 1-4 family residential lending. To help grow CRE lending, two senior lenders were hired, and both were ultimately appointed to the Board. Table 1 illustrates the financial condition of CSB as of December 31, 2008 and for the four preceding calendar years.

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

Table 1: Financial Condition of CSB

Financial Measure	12/31/08	12/31/07	12/31/06	12/31/05	12/31/04
Total Assets ($000s)	$199,341	$193,044	$207,978	$199,509	$196,671
Net Loans ($000s)	$149,985	$153,341	$165,766	$160,513	$135,529
Total Deposits ($000s)	$174,304	$167,235	$181,933	$173,318	$176,570
FHLB Advances^ ($000s)	$8,800	$3,000	$3,000	$3,000	$0
Past due ratio*	7.74%	3.37%	1.51%	0.55%	0.34%
ADC Loans/Total Capital	107%	61%	90%	82%	92%
CRE Loans/Total Capital	631%	418%	412%	374%	348%
Total Risk Based Capital/Risk weighted assets	9.11%	12.84%	12.67%	12.92%	12.83%

Source: Uniform Bank Performance Reports (UBPRs) for CSB.
^ It is noted that CSB did not rely on brokered deposits as a funding source.
* Amount includes past due 90+ days and nonaccrual.

Causes of Failure and Material Loss

CSB's failure can be attributed to (1) inadequate management and Board oversight; (2) a high concentration in CRE lending; (3) weaknesses in internal controls and questionable credit underwriting; and (4) poor credit risk management practices. Some of these practices and their apparent significant impact on the failure of CSB are the subject of ongoing investigative activities. Management and the Board pursued a business strategy based on a highly concentrated loan portfolio, with limited experience in CRE lending and without establishing the appropriate practices to mitigate the corresponding risks. The Bank's financial deterioration was exacerbated by the depressed economic conditions, deteriorating automobile industry, and high unemployment rates prevalent in the Detroit, Michigan area where CSB operated.

Management and Board Oversight

Historically, CSB operated with a focus on 1-4 family residential loans. As discussed above, management shifted the Bank's emphasis from long-term fixed-rate residential mortgage loans to higher-yielding CRE loans. The newly appointed Bank President and Chief Executive Officer (CEO) in 2003 accelerated the shift in Bank strategy initiated by the prior leadership. While the two senior lenders who played key roles in implementing the strategy had CRE lending experience, CSB's management and Board, as a whole, lacked such experience and that was likely a factor in their inability to properly identify, measure, monitor, control, and mitigate the growing risks associated with CRE loans. While CSB had engaged in some CRE lending in the past, its personnel, processes, and technology appear to have been ill-equipped to underwrite and administer the increase in volume of CRE loans that occurred during the period between 2002 and 2006. The regulators also noted in the Reports of Examination (ROE) apparent violations of banking laws and contraventions with policy. Additionally, the influence of two senior lenders on the Board created a risk that the Board's independence could be compromised.

Management and Board Experience

The departure of two senior lenders with CRE experience, in addition to two other loan officers and one credit analyst, during the time period October 2005 to November 2006, left the Bank understaffed and lacking proper oversight. When the local real estate market began to deteriorate in December 2006, management's inability to successfully manage and control the CRE lending strategy under more adverse economic conditions became evident.

In the 2006 OFIR ROE, examiners noted that loan loss percentages were rising and trends in past due and adverse classifications were negative. Examiners stated the absence of intervention by the Board was attributable to a lack of expertise in the areas of credit risk administration and underwriting. Areas of weaknesses noted included understaffing; lack of knowledge of banking laws and regulations; and lack of prompt identification, action, and appropriate resolution of problem credits.

In the 2008 FDIC ROE, it was noted that management and Board oversight needed improvement given the deterioration of the Michigan economy. Several of the adversely classified assets noted during the examination resulted from previous inadequate oversight of the lending function and poor underwriting practices and credit administration by the former lending staff.

In the May 2009 Joint ROE, the examiners noted that the Bank's Management rating of "4" reflected the unsatisfactory condition of the Bank. The rating was driven by the Bank's poor asset quality, negative earnings, and insufficient capital level. Examiners continued to note that poor supervision of lending staff and weak credit administration during the Bank's period of growth in CRE lending appears to have been a contributing factor in the Bank's ultimate failure.

Apparent Violations and Contraventions of Policy

The regulators also noted in the ROEs apparent violations of banking laws and contraventions of policy throughout the examination period of 2004-2009. The issues noted are further examples of CSB's weak management and Board oversight that contributed to the failure of the Bank. The following are examples of the issues identified:

- Contraventions of Joint Agency Policy Statement on Interest Rate Risk.
- Violation of Section 4205 of Michigan's Banking Code of 1999.
- Violation of Regulation O regarding approval of insider loans.
- Contravention of policy with FDIC Rules and Regulations, Part 365, Appendix A.
- Violation of FDIC Rules and Regulations, Part 323.3(a).

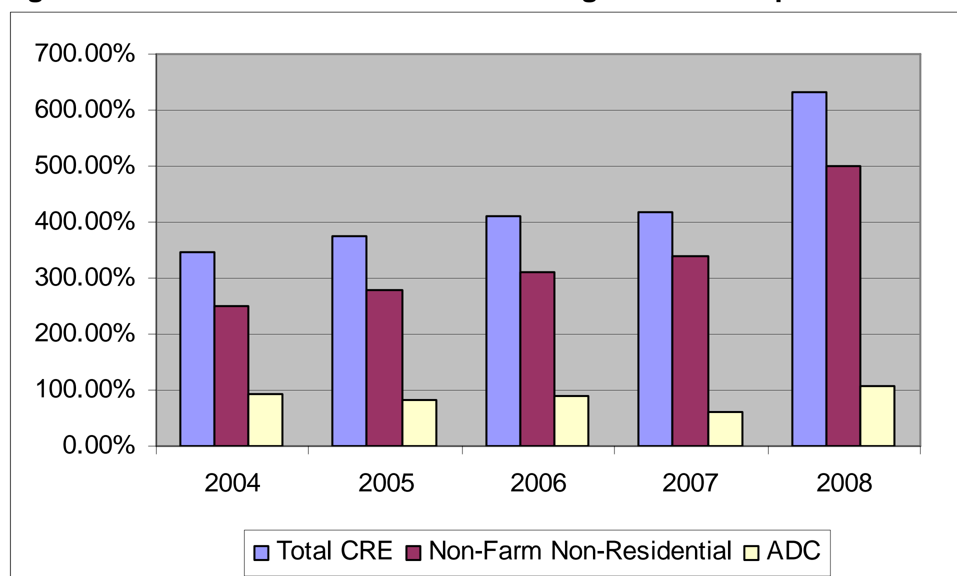
Board Independence

The influence of two senior lenders on the Board created a risk that the Board's independence could be compromised. Their appointment to the Board created a situation where the senior lenders may have been able to influence approvals of loans that they underwrote. Their potential influence created a control weakness in the management and Board oversight process that could have been intentionally or unintentionally exploited.

Concentration in CRE Lending

A high concentration in CRE lending played a significant role in the quality and composition of CSB's loan assets and the Bank's growth. The 2004 OFIR ROE noted that the new management team was putting in place a new philosophy and strategy shift to increase the rate of growth, particularly in the commercial loan portfolio. Figure 1 summarizes CSB's CRE concentrations from 2004 to 2008. [2] As illustrated, CSB's CRE loans as a percentage of total capital increased each year from 2004 to 2008, particularly in the non-farm non-residential category. The 2008 FDIC ROE noted that the Bank monitored concentrations monthly by industry code; however, no stress testing or modeling of concentrations was performed.

Figure 1: CSB's CRE Loans as a Percentage of Total Capital

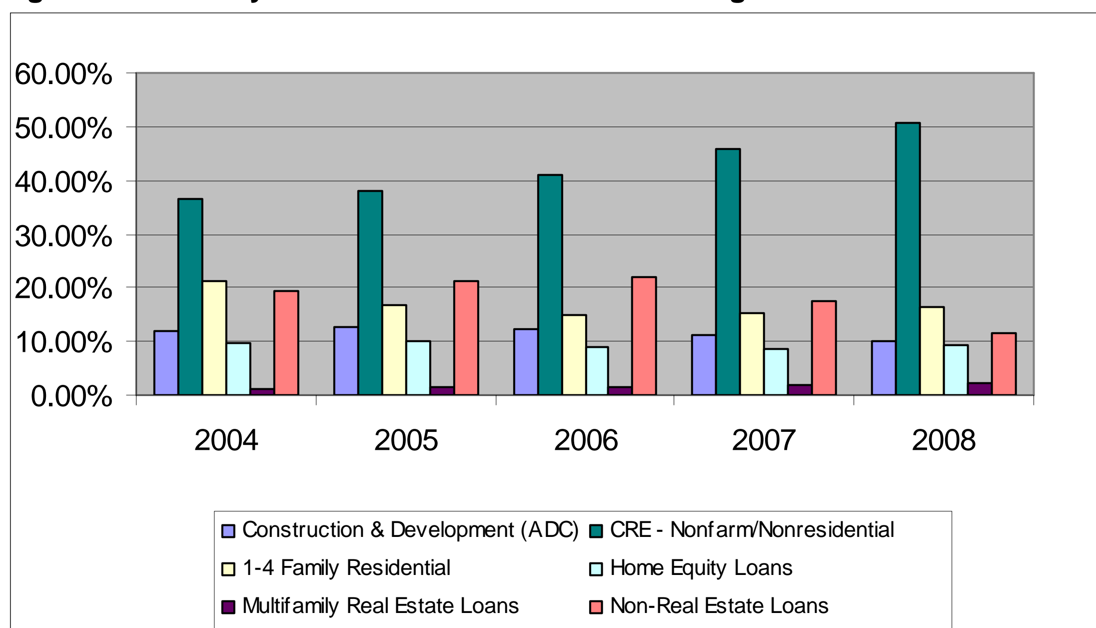


Source: UBPR for CSB, December 31, 2008.
Note: Increases in 2008 are due primarily to a decline in capital and not increases in loan volume.

As a result of the new lending strategy, by 2005, the loan portfolio mix had changed and was heavily weighted in CRE. The August 2005 FDIC ROE noted that the Bank's 1-4 family residential loan concentration had decreased over the prior 3-year period from 47 percent of the average gross loans to 28 percent, while the real estate portfolio during the same time period grew to 52 percent of the gross loans from 33 percent. Figure 2 summarizes CSB's distribution of total loans as of December 2008, and for the 4 preceding calendar years.

[2] CRE concentrations in Figure 1 include owner-occupied CRE. This also applies to Figures 2, 3, and 4 within this report.

Figure 2: Summary of CSB's Loan Mix as a Percentage of Total Loans



Source: UBPR for CSB, December 31, 2008.

The May 2009 Joint ROE noted that CRE and ADC loans continued to pose a significant degree of risk to capital. These loan categories had sustained large losses due to the weakened economic climate in Michigan, with CRE and ADC loans representing 79 percent of classified loans and 95 percent of loans classified as a loss at the 2009 examination.

The Board and management at CSB chose to pursue a lending strategy that consisted of high concentrations of CRE loans and failed to mitigate the risk associated with CRE lending. These weaknesses, combined with the failure to recognize and respond in a timely manner to the changing economic conditions in the real estate market that they were lending in, left the Bank vulnerable to significant losses when the Michigan market turned downward.

Internal Controls and Credit Underwriting

Internal control weaknesses and lax underwriting practices, particularly with respect to CRE loans, contributed to the loan quality problems that developed when the Bank's real estate lending markets started to deteriorate in 2006.

The 2004 OFIR ROE noted that operational risk was moderate to high and the risk management controls were weak. There was no evidence that the Audit Committee had met for 13 months since January 7, 2003, to review the internal audit reports. Findings at the 2004 examination also revealed a number of internal operating deficiencies, raising concerns about Bank controls associated with internal audit and compliance with banking statutes and regulations.

An Internal Audit Summary Report issued prior to 2006 revealed that internal controls were extremely lax. The report indicated that there was inadequate segregation of duties in many areas, as loan officers were able to post transactions directly to the general ledger. Reconcilements were not performed on all general ledger accounts, and suspense account transactions were not reviewed on a regular basis. The report also noted an incident involving

unsound banking practices by a loan officer who was allegedly withdrawing money against a customer's account for personal use, further evidencing the lack of internal controls and segregation of duties.

In a 2008 review of the commercial loans (including loans being reviewed for renewal or foreclosure), management identified certain questionable lending practices used by former lending staff. During this review, it was discovered that the former lending staff had engaged in lending practices that were apparently not known by the Board, and included (1) changing loan terms and conditions subsequent to Board approval; (2) failing to properly perfect the Bank's security interest in loans that relied on collateral as a secondary source of repayment; (3) originating loans that were both unusual in nature and repayment source where management and the Board lacked requisite experience to understand and mitigate underlying credit risk; and (4) commercial loans to borrowers who lacked experience in the businesses they were attempting to operate. Some of these practices and their apparent significant impact on the failure of CSB are the subject of ongoing investigative activities.

The weaknesses in internal controls and credit underwriting affected overall asset quality and led to increases in charge-offs and provisions, negatively affected earnings, and contributed to the failure of the Bank.

Credit Risk Management Practices

Examiners expressed numerous concerns with the Bank's credit risk management practices, including identification of problem loans, the loan grading system, and the Allowance for Loan and Lease Loss (ALLL) methodology – important aspects of the credit administration function. Weaknesses in these areas contributed to the untimely detection of asset quality problems that developed when the real estate markets the Bank was exposed to began to deteriorate in 2006. Examiners noted in the 2006 OFIR ROE that the depressed state and local economy may have been a factor in the Bank's negative asset quality trends, but that weak credit administration practices contributed to the majority of the problems.

Identification of Problem Loans and Loan Grading Methodology

Examiners cited issues regarding CSB's identification of deteriorating credits in an untimely manner and the Bank's loan grading process.

The December 2006 OFIR ROE noted that CSB's loan grading was not adequate. The criterion did not appear to be sufficiently forward-looking and did not allow for adequate differentiation between stable and deteriorating credit relationships. Failure to properly grade loans and promptly identify deteriorating credits were indications that the credit rating system CSB used was inadequate to monitor risk. Examiners identified numerous loans that were internally rated as acceptable despite structural deficiencies or lack of documented cash flow typically associated with credits rated "watch" or worse. Furthermore, examiners noted the Bank's "borderline pass" rating included loan characteristics, such as outdated financial statements and negative trends, which are typical of industry "watch" ratings.

ALLL Methodology

Between 2004 and 2009, examiners repeatedly noted concerns related to the Bank's ALLL methodology. Examiners at the 2004 examination recommended that enhancements be made to the ALLL reserve analysis procedures and referred the Bank to FIL-63-2001 titled *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations*.

Examiners noted during the December 2006 examination that management's ALLL analysis was inadequate due to a failure to comprehensively calculate impairment and support factors used to estimate probable loss in the loan portfolio. Management's failure to identify all impaired loans created a shortfall in the ALLL of at least $900,000. Examiners recommended that management enhance the Bank's ALLL methodology to incorporate (1) the results of internal loan grading, (2) the results of impairment analysis for individual credits, (3) environmental factors to recognize the current economy, and (4) levels and trends of delinquencies and problem assets. Management responded that, as of February 1, 2007, a revised ALLL model had been developed that incorporated two separate methodologies for accounting and reserving for impaired loans. Management also indicated the Loan Policy Manual had been revised to define impaired loans and watch credits under review in the new ALLL model.

At the March 2008 examination, the Bank's ALLL was determined to have an estimated $300,000 shortfall based on increased loss estimates identified at the examination. The May 2009 examination reported that additional provisions to the ALLL were necessary to address the increasing risk in the loan portfolio. Examiners recommended that additional provisions of $5.8 million be reflected as of June 30, 2009; this included $2.2 million that management internally identified as a shortfall as of April 30, 2009.

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

The FDIC's Supervision of Citizens State Bank

The FDIC and OFIR examinations and visitation of CSB identified key risks, including inadequate management and Board oversight, high concentrations in CRE lending, weaknesses in internal controls and credit underwriting, poor credit risk management practices, and the adverse changes in the local Michigan economy. In 2008, the FDIC and OFIR pursued an MOU as a result of unsatisfactory practices and conditions noted in the March 2008 examination. The FDIC also issued a C&D as a result of the May 2009 examination. In retrospect, beginning with the 2005 FDIC examination, the lending strategy consisting of higher CRE concentrations warranted elevated concern. Additionally, regulators may have benefited from an on-site visitation in addition to off-site monitoring following the December 2006 State examination to have greater assurance that the Bank was correcting critical credit administration weaknesses.

Supervisory History

Between 2004 and 2009, the FDIC and the OFIR conducted one visitation and five risk management examinations of CSB. Until 2008, CSB's CAMELS composite rating was a "1" or "2". These ratings suggest that the Bank presented little or no supervisory concern from a safety and soundness perspective; however, the Bank's financial condition appears to have deteriorated rapidly during this time. As a result of the March 2008 examination, CSB became subject to an MOU issued on July 8, 2008. Subsequently, a C&D was issued on September 22, 2009. Table 2 summarizes CSB's examination history during the 5 years leading up to the closure of the Bank.

Table 2: CSB's Examination History from 2004 to 2009

Examination Date	Examination Type	On-Site Supervisory Effort	Supervisory Ratings* (UFIRS)	Informal or Formal Action** Taken
02/09/2004	Examination	State	212222/2	None
08/29/2005	Examination	FDIC	111211/1	None
01/05/2006	Visitation	FDIC	No Ratings	None
12/11/2006	Examination	State	132211/2	None
03/03/2008	Examination	FDIC	343322/3	MOU July 8, 2008
05/11/2009	Examination	Joint	554533/5	C&D October 25, 2009

Source: FDIC Supervisory History for CSB.
*Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component, and an overall composite score, is assigned a rating of "1" through "5", with "1" having the least regulatory concern and "5" having the greatest concern.
**Informal supervisory actions often take the form of Bank Board Resolutions or MOUs. Formal enforcement actions often take the form of PCAs or C&Ds, but under severe circumstances can also take the form of insurance termination proceedings.

Evaluation of Supervisory Action

The FDIC's and the OFIR's examinations and visitation of CSB identified key risks including inadequate management and Board oversight, high concentrations in CRE lending, weaknesses in internal control and credit underwriting, and poor risk management practices, all of which eventually contributed to the Bank's failure. The examinations were conducted according to the statutory schedule and off-site reviews were carried out according to established procedures.

A close review of the examination history reveals that, beginning with the 2005 FDIC examination, the lending strategy consisting of higher CRE concentrations warranted elevated concern. In 2005, CSB received an overall rating of "1" based on the information presented at the time. The Division of Supervision and Consumer Protection (DSC) *Risk Management Manual of Examination Policies* states that "financial institutions with a '1' composite rating are: (1) sound in every respect, (2) the most capable of withstanding the vagaries of business conditions, and (3) resistant to outside influences such as economic instability in their trade area. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern."

The FDIC's supervisory approach to CSB was generally consistent with practices in place at the time. In retrospect, however, the 2005 FDIC examination appears to have represented an opportunity for examiners to incorporate forward-looking factors into the assessment of CSB. Specifically, greater supervisory emphasis on the observations listed below may have influenced CSB's management and Board to take corrective action sooner and improve its risk management and oversight to accommodate the institution's changing risk profile:

- CRE lending as a percent of average gross loans had grown to 52 percent in 2005 from 33 percent in 2002. Residential lending as a percent of average gross loans had shifted to 28 percent from 47 percent. This lending strategy was inherently more risky than the 1-4 residential lending historically pursued by the Bank.
- With the exception of the two senior lending officers appointed to the Board, the composition of the Board and management did not change in conjunction with the new business strategy to manage the increased level of risk. As discussed previously, there appears to have been a reliance on the two senior lenders to manage the identification, underwriting, approval, and monitoring of the CRE portfolio that created a potential weakness in the oversight of lending.

In 2008, the FDIC and the OFIR pursued an informal action as a result of unsatisfactory practices and conditions noted in the March 2008 examination. CSB entered into an MOU effective July 8, 2008. The MOU addressed ALLL levels, classified assets, accounting, administering and disposing of other real estate, the profit plan, and capital ratios, among other matters.

The FDIC instituted a formal supervisory action during the May 2009 examination in the form of a C&D, which revealed further financial deterioration and the failure of Bank management to fully comply with all provisions of the MOU agreed to during the 2008 examination. In response to the inadequate capital levels and other concerns from the May 2009 examination, the FDIC and the OFIR pursued a C&D, which was signed on September 22, 2009 and became effective October 25, 2009. The C&D stipulated, among other things, an increase in the capital level, reduction of delinquencies and classified assets, prohibition of additional loans and classified borrowers, a liquidity plan and budget, and the addition of a chief credit officer and a chief financial officer.

Supervisory Response Related to Management and Board Oversight

The DSC *Risk Management Manual of Examination Policies* states that "the quality of management is often the single most important element in the successful operation of an insured institution, and is usually the factor that is most indicative of how well risk is identified, measured, monitored, and controlled." Examiners assigned a "1" or a "2" rating to the Management component from 2004 through 2006, and downgraded this component to a "3" at the March 2008 examination. The following factors indicate that a stronger supervisory response may have been warranted prior to the 2008 MOU:

- A shift in strategy to a concentration in CRE lending from 1-4 family residential lending and lack of management and Board experience in CRE lending.

- The risk of compromised Board independence resulting from two senior lenders' appointments to the Board.
- Apparent violations of banking laws and contraventions to policy.
- Weaknesses in internal controls and credit underwriting.
- Poor credit risk management practices.

Based on the observations and issues noted above, such a response would have been reasonable in light of the following DSC *Risk Management Manual of Examination Policies* evaluation factors for the Management component rating: (1) the level and quality of oversight and support of all the institution activities by the board of directors and management, (2) the ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products, (3) compliance with laws and regulations, and (4) responsiveness to recommendations from auditors and supervisory authorities.

Supervisory Response Related to CRE Lending

Examiners identified problems with CSB's loan concentrations at various points in time between the 2004 and 2009 examinations. Table 3 summarizes the examiner comments regarding the CRE concentrations from 2004 through 2009.

Table 3: Examiners' Comments Related to CSB's CRE Concentrations from 2004 through 2009

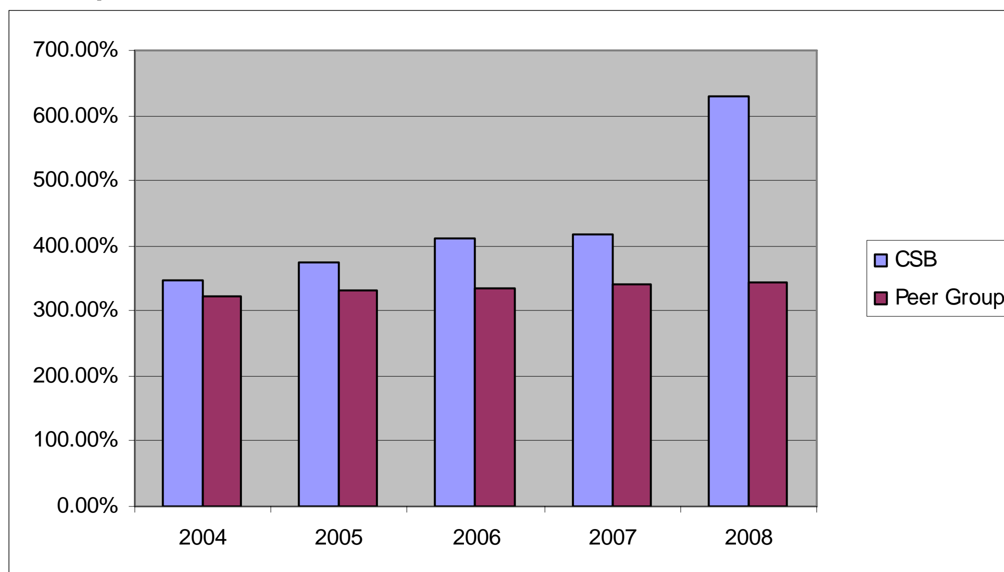
Examination Date and Regulatory Agency	Examination as of Date	Asset Quality Component Rating	CRE Concentration as a Percentage of Total Capital	Examiner Comments
02/09/2004 State	9/30/2003	1	320 percent	Examiners noted a new strategy at the Bank that included increased growth expectation, particularly in the commercial loan portfolio.
08/29/2005 FDIC	6/30/2005	1	405 percent	Examiners noted that the loan concentration in CRE had grown from 33 percent to 52 percent of gross loans since year-end 2002.
12/11/2006 State	9/30/2006	3	380 percent	Examiners did not comment on the CRE concentration level at this examination.
03/03/2008 FDIC	12/31/2007	4	418 percent	In preparation for the 2008 exam, examiners noted in the pre-examination planning (PEP) memorandum that a CRE concentration was identified, with CRE loans exceeding the 300 percent threshold of total Risk-Based Capital at 409 percent. Examiners also noted that the Bank monitors concentrations based on industry codes monthly. No stress

Examination Date and Regulatory Agency	Examination as of Date	Asset Quality Component Rating	CRE Concentration as a Percentage of Total Capital	Examiner Comments
				testing or modeling of concentrations was performed and thus management did not have a contingency plan for such.
05/11/2009 Joint	3/31/2009	5	634 percent	The C&D issued as a result of this examination required CSB to formulate and implement a plan to reduce the loan concentrations of credit.

Source: ROEs and UBPRs for CSB.
Note: Ratio increases in 2009 are primarily due to a decline in capital and not an increase in loan volume.

Figure 3 below shows CSB's CRE concentration levels as a percentage of Total Capital compared to its peer group[3] at the end of each calendar year from 2004 to 2008. As represented, CSB's concentration level exceeded 300 percent since 2004.

Figure 3: CSB's CRE Concentration as a Percentage of Total Capital Compared to Peer Group



Source: UBPRs for CSB.
Note: The increase in concentration in 2008 was primarily due to a substantial decrease in Citizen State Bank's capital level.

Figure 4 illustrates the composition and growth of CSB's loan portfolio from calendar years ended 2002 to 2008. From December 2003 through December 2006, CSB's CRE portfolio grew from $54 million to $94 million, respectively, an increase of 74 percent.

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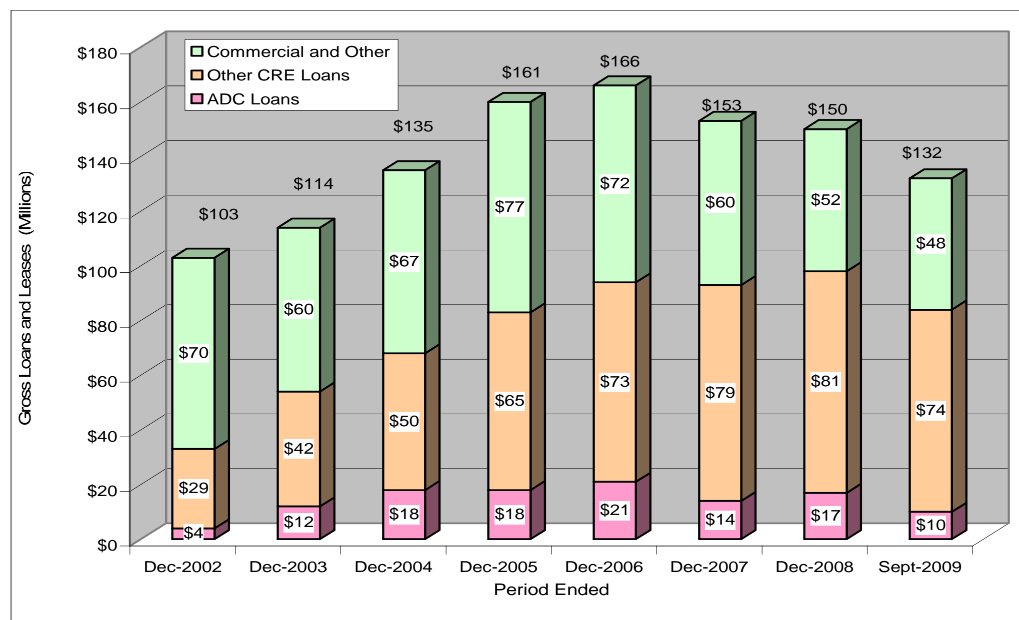
[3] CSB's peer group included all commercial banks having assets between $100 million and $300 million, with 3 or more full service banking offices and located in a metropolitan statistical area.

Figure 4: Composition and Growth of CSB's Loan Portfolio



Source: Call Reports for CSB.

Based on the information in Figures 3 and 4, CSB's concentration in CRE lending appears to have made the Bank particularly vulnerable to a downturn in the real estate market. As previously mentioned, this was a significant factor contributing to the Bank's failure in 2009. CSB's CRE concentration levels would appear to have warranted closer scrutiny as did management's ability to maintain the portfolio in a manner consistent with the safe and sound operation of the Bank.

Supervisory Response Related to Internal Controls and Credit Underwriting

In the 2004 examination, the examiners recommended improvement in the management of operational risk and proper follow-up of internal audit findings. In the 2004 and 2005 ROEs, examiners did not criticize CSB's internal control and credit underwriting weaknesses.

As previously discussed in the Cause of Failure section, an Internal Audit Report issued prior to 2006 revealed weaknesses in internal controls and an incident involving unsound business practices. In the 2006 OFIR ROE, examiners recommended that management review weaknesses in credit underwriting; however, there was not any evidence that examiners took into account the issues noted in the Internal Audit Report in assessing the internal controls at the Bank.

During the 2008 examination, the examiners recommended that the Bank's Loan Policy be revised to incorporate the Bank's current practices with regard to unsecured lending, participation loans, capitalization of interest, usage of loan extensions, and Phase I environmental inspection requirements.

Taking into consideration the operational and internal control weaknesses noted during the 2004 and 2006 examinations, it appears that the examiners did not adequately follow up to

ensure the issues were remediated and recommendations implemented by the Bank. As a result, examiners may have missed an opportunity to recommend or enforce corrective action before economic conditions worsened.

Supervisory Response Related to Credit Risk Management Practices

Loan Grading and Problem Loans

The 2006 OFIR ROE noted observations and recommendations as follows:

- Observations
  - Inadequacies in the Bank's loan grading methodology. The examiner review of the rating methodology resulted in loan ratings that were not consistent with the Bank's internal loan rating, raising questions concerning the validity of the Bank's assigned ratings and thus its ability to properly grade credit and promptly identify problem credits.
  - Noncompliance with the Bank's Loan Policy directives regarding delinquency status and corresponding internal loan grades and accrual status.
  - Weaknesses in the timely identification of delinquent loans and transfer of these particular credits to the collections department during the 2006 examination.

- Recommendations
  - Management review of the loan grading system and incorporate qualitative factors into the loan grading system such as debt service coverage, leverage, collateral value, loan to value, and cash flow.
  - Management review of credit administration practices for consistency with internal policy requirements and report any inconsistencies to executive management and the Board.
  - Management review of the capability of the Bank's tickler system and corresponding procedures to more promptly identify maturing credits in sufficient time.
  - Management revision of the policy guidelines to include a time frame and detail criteria regarding reassignment of delinquent credits from a loan officer to the supervision of collections personnel.

As a result of the critical credit administration weaknesses identified at the 2006 examination, OFIR regulators noted that regulatory follow-up no later than 6 months after the exit meeting date of January 10, 2007 was warranted. We found no documentation supporting a follow-up by OFIR officials in response to the 2006 examination recommendation. However, DSC officials indicated that an FDIC Relationship Manager contacted the President of CSB via telephone in

February 2007 and June 2007.[4] The June 2007 contact addressed the observations noted in the December 2006 examination. Further, as discussed later in this report, although subsequent to the 6-month timeframe recommended by OFIR, the FDIC also conducted off-site monitoring of CSB on two occasions prior to the March 2008 examination.

In addition to such off-site efforts, DSC's *Risk Management Manual of Examination Policies* indicates a visitation may be used to determine progress in correcting deficiencies noted at a previous examination. In that regard, given the significance of the 2006 examination observations and recommendations in this area, it appears that increased regulatory attention may have been warranted in the form of a visitation. A visitation may have provided greater assurance that the CSB Board and management were adequately addressing regulatory concerns because it would have (1) involved reviewing documents to determine the extent to which corrective actions have been taken; and (2) prompted a memorandum to Bank management and the Board to communicate findings, including any concerns regarding lack of progress.

The MOU issued in July 2008 included the following provisions related to the deteriorating asset quality:

- Within 60 days from the date of the Memorandum, the Bank shall formulate, adopt and submit to the Regional Director and the Acting Chief Deputy Commissioner for review and comment a written plan of action to lessen the Bank's risk position in each asset which was classified "Substandard" and "Doubtful" in the Report, and which aggregated $500,000 or more. Such plan shall include, but not be limited to, the following: a) dollar levels to which the Bank will strive to reduce each line of credit within 6 and 12 months from the effective date of this Memorandum; and b) provisions for the submission of monthly written progress reports to the Bank's board of directors for review and notation in the board of director's minutes.
- 60 days from the date of the Memorandum, the Bank shall initiate steps to correct the deficiencies in those loans listed as Special Mention in the 2008 FDIC ROE.

The C&D issued in October 2009 required the Bank to adhere to the following requirements in response to the deteriorating asset quality:

- Within 30 days from the effective date of the order, adopt, implement, and adhere to, a written plan to reduce the Bank's risk position in each asset in excess of $250,000, which was more than 90 days delinquent or classified "Substandard" or "Doubtful" in the 2009 Joint ROE.

ALLL Methodology

The 2004 OFIR ROE noted that management adequately identified problem credits and provided for loss exposure in the Bank's ALLL; however, examiners did recommend that certain

[4] As part of the Relationship Manager Program established by the FDIC, each FDIC-supervised institution has a designated Relationship Manger. The objectives of the program include: to improve communication with the institution, to increase flexibility for risk-focused supervision, and to provide a comprehensive Report of Examination that includes all supervisory ratings and addresses material findings in all areas.

enhancements be made to the reserve analysis procedures and provided the Bank with the *Interagency Policy Statement on Allowance for Loan and Lease Losses*, which provides definitive guidance related to ALLL levels.

At the August 2005 examination, the FDIC recommended that the Bank document ALLL methodology procedures and guidelines in policy format, including which impairment measurement methods to be generally used. Additionally, the examiners recommended that the Bank implement guidelines for assessing the analysis aspect of the ALLL methodology as prescribed in the *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* dated July 2, 2001.

The 2006 OFIR ROE cited inadequacies in CSB's ALLL analysis that resulted in a $900,000 shortfall in the ALLL provision. The examiners recommended that management enhance the Bank's ALLL methodology to incorporate the results of internal loan grading and reflect the results of impairment analysis for individual credits, as well as incorporate environmental factors to recognize the current economy, level and trend of delinquencies, and trend of problem assets.

The 2008 FDIC ROE noted a $300,000 shortfall in the ALLL provision. While the shortfall may have been attributed to the timing of developments in the first quarter of 2008 that were not reflected in the Bank's ALLL calculation, examiners provided additional recommendations to help the Bank achieve more timely recognition of potential ALLL shortfalls and achieve better alignment with outstanding ALLL guidance.

The C&D issued in October 2009 required the Board to review the adequacy of the Bank's ALLL, provide for an adequate ALLL, and accurately report the same. The minutes of the Board meeting were to outline the findings of the review, the recommended amount of increase in the ALLL, and the basis for determining the amount of ALLL provided. In making these determinations, the Board considered the Federal Financial Institutions Examination Council (FFIEC) *Instructions for the Reports of Condition and Income* and any analysis of the Bank's ALLL provided by the FDIC or OFIR.

Off-site Reviews

The *Case Manager Procedures Manual* states that the "off-site review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted accordingly." The FDIC generates an Off-site Review List (ORL) each quarter and performs off-site reviews for each bank that appears on the list. Off-site reviews must be completed and approved 3½ months after each Call Report date[5]. This generally provides 45 days to complete the off-site reviews once Call Report Data is finalized. In the case of CSB, off-site review did not play a significant role in the supervisory approach to the institution.

One of the measures used to produce the ORL is the Statistical CAMELS Off-site Rating (SCOR) model, which uses statistical techniques to measure the likelihood that an institution will receive a rating downgrade at the next examination. The output of the SCOR model is derived

[5] The FDIC also utilizes other off-site monitoring tools in addition to the ORL.

from historical examination results as well as Call Reports. Given the nature of some of the early issues identified at CSB relating to loan grading and ALLL methodology, the Call Report data used for the SCOR model may not have accurately represented certain aspects of the Bank's financial condition. For example, the 2006 State Examination noted that the Bank's ALLL analysis was inadequate due to a failure to comprehensively calculate impairment and support factors used to estimate probable loss in the loan portfolio. Such loan administration would have masked the actual ALLL and condition of the loan portfolio and negatively impacted the effectiveness of examination planning and the overall supervisory approach.

CSB was identified for off-site review twice in 2007 and once in 2008. The reviews were conducted in accordance with policy and, as such, focused on numerical measures of risk with little or no emphasis on unsafe or unsound practices, such as the loan grading and ALLL issues previously mentioned. The results of the off-site review did not significantly change the FDIC's approach to supervising and monitoring the Bank. Table 4 below provides a summary of off-site reviews of CSB.

Table 4: Summary of Off-site reviews of CSB

Date	Risk Level	Risk Trend	SCOR*	REST**	Comments
9/30/2007	Medium	Increasing	2.78	3.84	Asset quality was less than satisfactory with an Adversely Classified Items Coverage Ratio of 20.79 percent as of the exam date. Management indicated that the absence of a senior lender, understaffing in the lending area, and problems specifically associated with two former lenders have contributed to the current asset quality situation. Given the higher risk loan portfolio and a declining trend in profitability, the off-site reviewer noted that continued quarterly monitoring was warranted.
12/31/2007***	Medium	Increasing	3.01	3.85	The potential downgrades on SCOR included Asset Quality (43 percent), Management (74 percent), and Earnings (84 percent). Adversely classified assets were 78 percent of T1 Capital + ALLL, up from 20 percent at the 2006 State examination. The off-site reviewer noted that the Bank would be subject to some type of enforcement action and monitored quarterly.
3/31/2008	Medium	Increasing	3.85	n/a	The potential downgrades on SCOR included Capital (82 percent), Asset Quality (90 percent), Management (91 percent), and Earnings (99 percent) At year-end 2007, the ROA declined to 0.06 percent after adjustments for provisions (loan & lease losses) and pension-related expenses. Given the Bank's overall deteriorating condition, especially in the areas of asset quality and profitability, the off-site reviewer noted that continued quarterly monitoring was warranted and the Bank would remain on the normal exam schedule.

Source: Off–site review sheets for CSB.

* - SCOR is a financial model that uses statistical techniques, off-site data, and historical examination results to assign an off-site CAMELS rating and to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination. For "1" and "2" rated institutions, SCOR assigns a probability of downgrade to a "3" or worse. For 3-rated institutions, SCOR assigns a probability of downgrade to "4" or "5". For "4" rated institutions, SCOR assigns a probability of downgrade to "5".
**- Real Estate Stress Test (REST) scores are based on a simulation of what would happen in a real estate crisis, and are considered high when "3.5" or higher.
*** - OSR noted that on-site examination was in process during completion of OSR. The on-site examination was not triggered by the OSR.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. CSB was unsuccessful in raising needed capital, and the Bank was subsequently closed on December 18, 2009.

Table 5 details CSB's capital levels, PCA category, and actions taken at the various examinations since 2004.

Table 5: Summary of CSB's PCA Capitalization Categories

Examination Date	Well Capitalized Threshold*	5/11/09	3/3/08	12/11/06	8/29/05	2/9/04
As of Date		3/31/09	12/31/07	9/30/06	6/30/05	9/30/03
Total Risk Based Capital Ratio	10.00%	4.68	13.04	12.45	12.12	11.35
Total Tier 1 Risk Based Capital Ratio	6.00%	3.42	12.14	11.41	11.31	10.48
Tier 1 Leverage Capital Ratio	5.00%	2.93	10.50	10.00	9.99	7.58
Capital Category		Significantly Undercapitalized	Well Capitalized	Well Capitalized	Well Capitalized	Well Capitalized
Action Taken		C&D	MOU	None	None	None

Source: ROEs and DSC Supervisory Documentation.
* Minimum capital requirements to be considered *Well Capitalized* for PCA purposes.

On March 13, 2009, the FDIC issued a PCA letter notifying the Bank that its capital category for purposes of PCA had fallen within the *Adequately Capitalized* capital category based on the preliminary analysis of the December 31, 2008 Call Report. In accordance with PCA requirements, the FDIC recommended in the letter that the Bank review the restrictions concerning brokered deposits that apply to adequately capitalized institutions found in Section 29 of the FDI Act and Section 337.6 of the FDIC Rules and Regulations. We noted that CSB did not rely on brokered deposits as a funding source.

On August 6, 2009, the FDIC issued a PCA letter notifying the Bank that its capital category for purposes of PCA had fallen within the *Significantly Undercapitalized* capital category based on the analysis of the June 30, 2009 Call Report. The FDIC notified management in the letter that the Bank became subject to the mandatory requirements of Section 38 of the FDI Act, including the submission of a capital restoration plan and restrictions on asset growth, acquisitions, new activities, new branches, payment of dividends or making any other capital distribution, management fees, or senior executive compensation.

On October 8, 2009, the FDIC issued a PCA letter notifying the Bank that its capital category for purposes of PCA had fallen within the *Critically Undercapitalized* capital category based on the analysis of financial information the Bank submitted on October 2, 2009. The FDIC noted in the

letter that the Bank became subject to the mandatory requirements of Section 38 of the FDI Act, including the submission of a capital restoration plan and restrictions on asset growth, acquisitions, new activities, new branches, payment of dividends or making any other capital distribution, management fees, or senior executive compensation.

The FDIC noted that the Bank would be placed in receivership by December 31, 2009 unless it was determined that a different action would better carry out the purpose of Section 38. Additionally, the letter noted that the Bank was required to obtain written approval before engaging in any of the following activities:

(1) Entering into any material transaction other than in the usual course of business, including any investment, expansion, acquisition, sale of assets, or other similar action with respect to which the depository institution is required to provide notice to the appropriate Federal banking agency;
(2) Extending any credit for any highly leveraged transaction as defined in Part 325 of the FDIC's regulations;
(3) Amending the institution's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order;
(4) Making any change in accounting methods;
(5) Engaging in any covered transaction (as defined in section 23A(b) of the Federal Reserve Act (12 U.S.C. 371c(b));
(6) Paying excessive compensation or bonuses;
(7) Paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the institution's normal market areas; or
(8) Making any principal or interest payment on subordinated debt beginning 60 days after becoming *Critically Undercapitalized*.

CSB submitted the required capital restoration plan on August 31, 2009. On September 11, 2009, the FDIC sent CSB a letter informing the Bank that the capital restoration plan was not acceptable and was rejected due to significant deficiencies. Some of the deficiencies included, but were not limited to, the following:

- No information was provided to support that there are parties interested in purchasing the Holding Company stock or that a merger partner could be found;
- Omission of financial projections including pro forma statements over the life of the plan;
- Omission of interim target capital levels;
- The plan did not provide an analysis of the effect of the capital plan on the risk profile, particularly in light of any sale of liquid assets or branches;
- The plan did not include an assessment of the likelihood of success and an explanation of why particular strategies were chosen over alternatives;
- The plan did not discuss how actions will affect credit risk, funding risk, and interest rate risk; and
- The plan did not reflect return to an adequate capitalization within a reasonable time period.

On October 13, 2009, the Bank submitted an amended capital restoration plan. In the amended plan, CSB noted that there was no interest in the market for a possible merger or sale to another bank. They also indicated that efforts to obtain capital commitments from other sources were on-going but no commitments had been obtained as of the date of the amended plan submission. Based on that information, the Bank concluded that a bulk recapitalization plan or internal capital replenishment were the remaining options for a capital restoration plan. Ultimately, neither of these capital restoration options occurred, and the Bank was subsequently closed on December 18, 2009.

Based on the supervisory actions taken as noted above, the FDIC properly implemented applicable PCA provisions of section 38.

Objectives, Scope, and Methodology

Objectives

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

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38. We evaluated whether capital was an adequate indicator of safety and soundness and the FDIC's compliance with PCA guidelines.

We conducted this performance audit from March to May 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, as described in the Scope and Methodology section, provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of CSB from February 2004 until its failure on December 18, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by FDIC and OFIR examiners from February 2004 to May 2009.

- Reviewed the following documentation:

    - Financial institution data and correspondence maintained at the DSC's Chicago Regional Office and Detroit Field Office, as provided to KPMG by DSC.

    - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the Bank's closure.

  - Pertinent DSC policies and procedures.

- Interviewed the relevant FDIC officials having supervisory responsibilities pertaining to CSB, which included DSC examination staff in the Detroit Field Office.

- Interviewed appropriate officials from the OFIR to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the Bank.

- Researched various banking laws and regulations, including state laws.

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

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

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

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

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

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

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

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

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

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)	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	Consolidated Reports of Condition and Income (also known as the Call Reports) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Cease and Desist Order (C&D)	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated 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.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et seq, implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt corrective supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.

Glossary of Terms

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

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CRE	Commercial Real Estate
CSB	Citizens State Bank
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GAGAS	Generally Accepted Government Auditing Standards
MOU	Memorandum of Understanding
OFIR	Office of Financial and Insurance Regulation
OIG	Office of Inspector General
ORL	Off-site Review List
PCA	Prompt Corrective Action
PEP	Pre-examination Planning
REST	Real Estate Stress Test
ROAA	Return on Average Assets
ROE	Report of Examination
SCOR	Statistical CAMELS Off-site Rating
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Part II

OIG Evaluation of Management Response

OIG Evaluation of Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On July 20, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

DSC reiterated the OIG's conclusions regarding the causes of CSB's failure and the FDIC's supervision of the bank. DSC stated that strong supervisory attention is necessary for institutions with high CRE concentrations. DSC has issued updated guidance re-emphasizing the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations.

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

July 20, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Citizens State Bank, New Baltimore, Michigan (Assignment No. 2010-030)

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 Citizens State Bank (CSB), New Baltimore, Illinois, which failed on December 18, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on June 22, 2010.

CSB failed primarily because management and the board of directors (Board) failed to provide effective oversight and adequate risk management policies and practices as they pursued a business strategy concentrated in commercial real estate (CRE) lending. These weak risk management practices were centered on poor internal controls, weak underwriting and credit administration. Significant losses in the loan portfolio ultimately depleted earnings and eroded capital.

From 2004 through December 2009 the FDIC and the Michigan Office of Financial and Insurance Regulations (OFIR) jointly and separately conducted five examinations, one visitation, three offsite reviews and two relationship manager bank contacts. Examiners identified key risks and brought them to the Board's and management's attention through examination reports and other correspondence. In 2006, the OFIR downgraded asset quality due to weakness in the loan portfolio and credit administration attributed primarily to CSB's former lending staff. Management took corrective action with the addition of a new senior lender and improved loan controls; however, these efforts proved to be insufficient. The March 2008 FDIC examination revealed significant deterioration in CSB's overall condition with a substantial level of asset quality problems, component and composite ratings were downgraded, and an informal enforcement action was issued. The May 2009 joint examination disclosed additional deterioration which resulted in further rating downgrades and issuance of a formal enforcement action. CSB was unable to realize improvement and raise necessary capital to remain viable.

DSC recognizes that strong supervisory attention is necessary for institutions with high CRE concentrations. DSC has updated guidance re-emphasizing the importance of robust credit risk management practices for institutions with concentrated CRE exposures and setting forth broad supervisory expectations.

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