Office of Inspector General

Office of Material Loss Reviews
Report No. IDR-11-001

In-Depth Review of the Failure of George Washington Savings Bank, Orland Park, Illinois

October 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

The Illinois Department of Financial and Professional Regulation (IDFPR) closed George Washington Savings Bank (GWSB), Orland Park, Illinois on February 19, 2010, and named the FDIC as receiver. On March 12, 2010, the FDIC notified the OIG that George Washington's total assets at closing were $437 million and the estimated loss to the Deposit Insurance Fund (DIF) was $141.3 million. As of September 3, 2010, the estimated loss to the DIF had decreased to $136.5 million.

This assignment was initiated as a material loss review. However, on July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), which amends section 38(k) of the Federal Deposit Insurance Act (FDI Act). The Financial Reform Act increases the material loss review (MLR) threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Further, the Financial Reform Act calls for the OIG to perform in-depth reviews of failures when losses are not material but they involve unusual circumstances. At the time the Financial Reform Act was enacted, our fieldwork and the draft report were substantially complete. As a result, although the estimated loss no longer met the threshold requiring an MLR, we decided to complete the audit and issue this report.

Consistent with both Acts, the objectives of this review were to (1) determine the causes of GWSB's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of GWSB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

Background

GWSB, established as a federal savings and loan in 1890, converted to a state-chartered savings bank in 1993 and was wholly-owned by George Washington Bancorp, Inc., a one-bank holding company. The bank was headquartered in Orland Park, Illinois and had three branch offices located in the Chicago metropolitan area. In 2002, after a change in management including Board Members and bank officers, GWSB changed its lending focus from 1-4 family residential real estate loans to acquisition, development, and construction (ADC) and other commercial real estate (CRE) loans.

Audit Results

Causes of Failure and Loss

GWSB failed because of losses associated with CRE and ADC loan concentrations that management failed to adequately control and that ultimately depleted earnings and eroded capital. In 2002, GWSB began developing significant concentrations in CRE, particularly ADC lending. However, management did not implement adequate loan underwriting and credit administration procedures commensurate with the bank's increasing risk profile. When the real estate market began to decline in 2007, the lack of diversification in GWSB's portfolio, coupled with the weak risk management practices, led to the rapid deterioration in asset quality. Despite actions taken by the Board and management to address its deteriorating condition, the IDFPR determined that GWSB was not viable because of poor asset quality, poor earnings, and inadequate capital.

The FDIC's Supervision of GWSB

Between 2005 and 2009, the FDIC and the IDFPR conducted safety and soundness examinations of GWSB under an 18-month examination cycle in accordance with the FDI Act. During this time, with the exception of the 2006 examination, examiners consistently reported the bank's high CRE and ADC concentrations and made numerous recommendations to strengthen the bank's risk management practices. Although examiners reported the high CRE and ADC concentrations and weak risk management practices, these concerns were not reflected in the bank's ratings until problem loans had begun to adversely affect the bank's financial condition. Offsite monitoring activity in 2009 resulted in acceleration of the next onsite examination and led to the pursuit of a formal supervisory action. However, the bank's condition became critically deficient before formal action was taken.

In hindsight, the FDIC and the IDFPR could have taken earlier and stronger supervisory action prior to 2009 that may have been more effective in getting management to address issues identified by examiners and mitigate the associated risks. Specifically, the FDIC could have more aggressively followed up on issues identified in the 2005 examination and later could have downgraded Asset Quality and Management component ratings and pursued supervisory action earlier.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008, the FDIC reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Further, the FDIC recently completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addresses the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. GWSB was unsuccessful in raising needed capital and the bank was subsequently closed on March 12, 2010.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On October 8, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. DSC reiterated the OIG's conclusion regarding the causes of GWSB's failure. With regard to our assessment of the FDIC's supervision of GWSB, DSC's response summarized supervisory activities between 2005 and 2010 described in our report, including offsite activities and supervisory actions. Further, DSC's response described the FDIC's 2009 examination findings, also discussed in our report, related to GWSB's practice of extending loan maturities or granting new loans to problem borrowers. DSC stated that the bank's activities masked the level of loan problems and impacted the FDIC's ability to recognize the extent of asset quality problems prior to the onsite examination. DSC's response also recognized that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations, such as GWSB, and referenced supervisory guidance that DSC has issued to re-emphasize the importance of robust credit risk-management practices and to set forth broad supervisory expectations.

Contents

	Page
Background	2
Causes of Failure and Loss	2
Concentrations in CRE and ADC Lending	3
Risk Management Policies and Practices	5
The FDIC's Supervision of GWSB	8
Supervisory History	9
Supervisory Response to Key Risks	9
Supervisory Lessons Learned	13
Implementation of PCA	14
Corporation Comments	15
Appendices	
1. Objectives, Scope, and Methodology	16
2. Glossary of Terms	19
3. Acronyms	23
4. Examiner Comments in Reports of Examination	24
5. Corporation Comments	25
Tables	
1. Financial Information for GWSB, 2005 to 2009	2
2. GWSB's Examination History, 2005 to 2009	9
Figures	
1. GWSB's Loan Composition, 2005 to 2009	3
2. GWSB's Charge-off on Loans and Leases from December 31, 2007 to December 31, 2009	4

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

Office of Material Loss Reviews
Office of Inspector General

DATE: October 14, 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: *In-Depth Review of the Failure of George Washington Savings Bank, Orland Park, Illinois*
(Report No. IDR-11-001)

The Illinois Department of Financial and Professional Regulation (IDFPR) closed George Washington Savings Bank (GWSB), Orland Park, Illinois on February 19, 2010, and named the FDIC as receiver. On March 12, 2010, the FDIC notified the OIG that GWSB's total assets at closing were $437 million and the estimated loss to the Deposit Insurance Fund (DIF) was $141.3 million. As of September 3, 2010, the estimated loss to the DIF had decreased to $136.5 million.

This assignment was initiated as a material loss review. However, on July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), which amends section 38(k) of the Federal Deposit Insurance Act (FDI Act). The Financial Reform Act increases the material loss review (MLR) threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Further, the Financial Reform Act calls for the OIG to perform in-depth reviews of failures when losses are not material but they involve unusual circumstances. At the time the Financial Reform Act was enacted, our fieldwork and the draft report were substantially complete. As a result, although the estimated loss no longer met the threshold requiring an MLR, we decided to complete the audit and issue this report.

Consistent with both Acts, the objectives of this review were to (1) determine the causes of GWSB's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of GWSB, including the FDIC's implementation of the *Prompt Corrective Action* (PCA), provisions of section 38 of the FDI Act.

This report presents our analysis of GWSB's failure and the FDIC's efforts to ensure that the Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss and in-depth reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of key terms; including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, otherwise known as the CAMELS ratings. Appendix 3 contains a list of acronyms. Appendix 4 presents examiner comments on reports of examination from 2005 to 2009. Appendix 5 contains the Corporation's comments on this report.

Background

GWSB, established as a federal savings and loan in 1890, converted to a state-chartered savings bank in 1993 and was wholly-owned by George Washington Bancorp, Inc., a one-bank holding company. The bank was headquartered in Orland Park, Illinois and had three branch offices located in the Chicago metropolitan area. In 2002, after a change in management, including Board Members and bank officers, GWSB changed its lending focus from 1-4 family residential real estate loans to acquisition, development, and construction (ADC) and other commercial real estate (CRE) loans. Table 1 provides details on GWSB's financial condition as of December 31, 2009 and for the 4 preceding calendar years.

Table 1: Financial Information for GWSB, 2005 to 2009

Financial Measure	Dec 2009	Dec 2008	Dec 2007	Dec 2006	Dec 2005
Total Assets ($000s)	413,673	405,571	380,974	343,890	294,947
Total Loans ($000s)	304,243	351,575	311,822	237,400	219,525
Total Deposits ($000s)	395,310	347,110	308,717	288,069	247,389
Net Loan Growth Rate	-18.06%	12.53%	31.73%	7.82%	27.03%
Net Income (Loss) ($000s)	-29,435	1,612	5,006	4,566	2,847

Source: Uniform Bank Performance Reports (UBPR) for GWSB.

Causes of Failure and Loss

GWSB failed because of losses associated with CRE and ADC loan concentrations that management failed to adequately control and that ultimately depleted earnings and eroded capital. In 2002, GWSB began developing significant concentrations in CRE, particularly ADC lending. However, management did not implement adequate loan underwriting and credit administration procedures commensurate with the bank's increasing risk profile. When the real estate market began to decline in 2007, the lack of

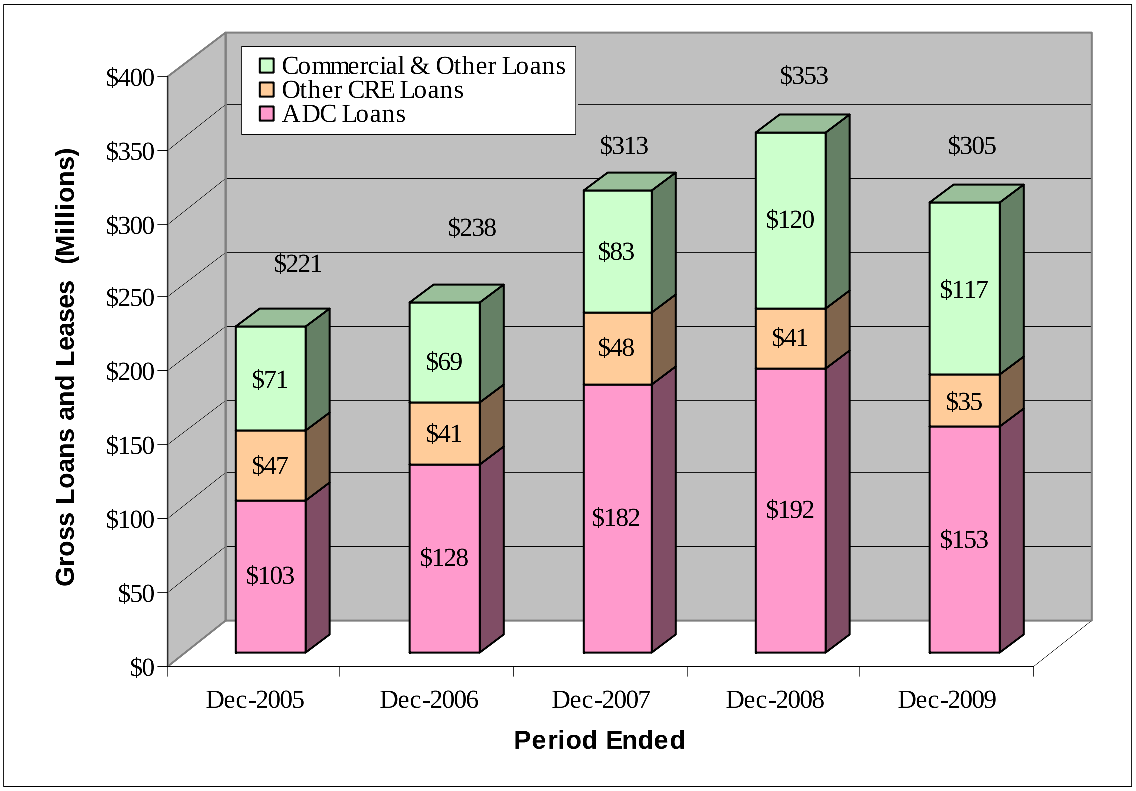
[1] A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of our report.

diversification in GWSB's portfolio, coupled with the weak risk management practices, led to the rapid deterioration in asset quality. Despite actions taken by the Board and management to address its deteriorating condition, the IDFPR determined that GWSB was not viable because of poor asset quality, poor earnings, and inadequate capital.

Concentrations in CRE and ADC Lending

During 2002, GWSB's management decided to change the bank's focus from 1-4 family residential lending to ADC and other CRE lending. From December 31, 2002 to December 31, 2003, the bank's ADC lending increased from \$2.5 million to \$20.9 million, and commercial mortgage lending increased from \$2.5 million to \$7.2 million. GWSB's change in focus significantly increased the bank's risk profile. However, as discussed later, management did not institute sound risk management practices commensurate with the bank's loan portfolio. Figure 1 illustrates GWSB's loan composition, which by 2005 consisted primarily of ADC and other CRE loans.

Figure 1: GWSB's Loan Composition, 2005 to 2009



Source: Reports of Condition and Income (Call Reports) for GWSB.

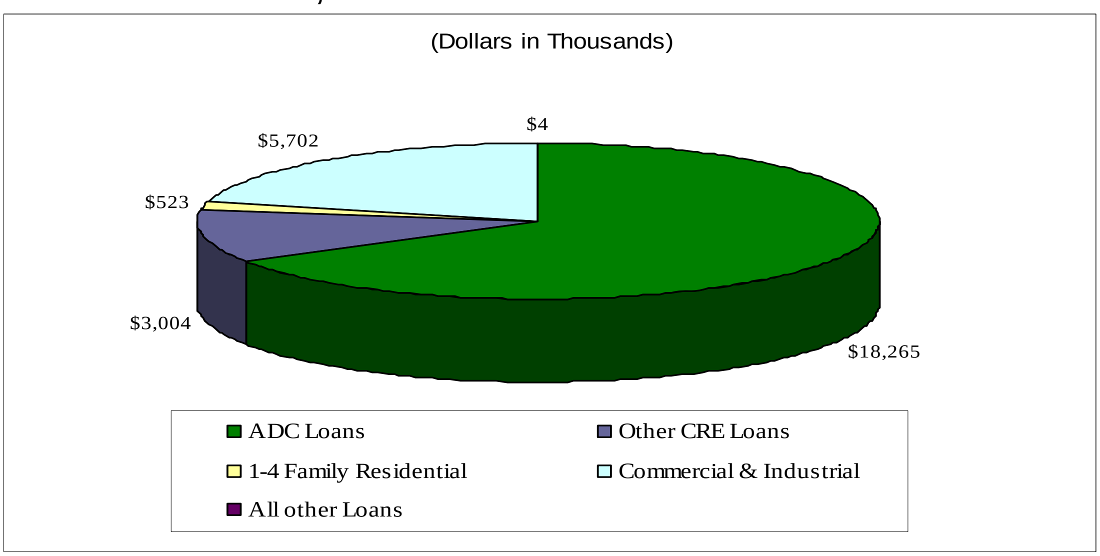
As shown in Figure 1, about 68 percent of GWSB's loan portfolio was ADC and CRE loans by 2005. The composition of the portfolio remained generally the same through 2009, with ADC and other CRE loans reaching a high of 74 percent of the portfolio during that time. In addition, GWSB's lending in CRE and ADC loans was significantly higher than that of its peer group. GWSB's peer group averages for CRE and ADC lending from year-end 2005 to 2009 ranged from 142 percent to 229 percent of Total

Capital for CRE and 38 percent to 54 percent for ADC lending. GWSB maintained CRE concentrations exceeding 400 percent of Total Capital and ADC concentrations in excess of 300 percent of Total Capital during the same period.

On December 12, 2006, federal banking regulatory agencies issued *Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), to reinforce existing regulations and guidelines for real estate lending and safety and soundness.[2] The Joint Guidance focuses on those CRE loans for which cash flow from real estate is the primary source of repayment (i.e., ADC lending). The Joint Guidance states that the agencies had observed an increasing trend in the number of institutions with concentrations in CRE loans and noted that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market.

Indeed, the significant level of GWSB's ADC loans to leveraged builders/developers in the Chicago area exposed the bank to substantial risk. According to the June 2008 examination report, the decline in the Chicago real estate market in 2007 started a significant upward trend in classified credits. Specifically, GWSB's Adversely Classified Items Coverage Ratio,[3] grew from 7.6 percent as of September 30, 2006 to 43.55 percent as of March 31, 2008. By the October 2009 examination, this ratio had increased significantly to 471 percent and asset quality was determined to be critically deficient. As shown in Figure 2, from December 31, 2007 to December 31, 2009, the vast majority of the bank's loan charge-offs, $18.3 million of $27.5 million, involved ADC loans.

Figure 2: GWSB's Charge-off on Loans and Leases from December 31, 2007 to December 31, 2009



Source: Reports of Condition and Income for GWSB.

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[2] The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).
[3] The Adversely Classified Items Coverage Ratio is a measure of the level of asset risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and may also indicate less ability to absorb the consequences of bad loans.

Risk Management Policies and Practices

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), an institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk. In addition, the Joint Guidance reiterates that concentrations in CRE lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the past. According to the Joint Guidance:

- strong risk management practices are an important element of a sound CRE lending program, particularly when an institution has a concentration in CRE loans;
- financial institutions with CRE concentrations should ensure that risk management practices appropriate to the size of the portfolio, as well as the level and nature of concentrations, and the associated risk to the institution are implemented; and
- financial institutions should establish a risk management framework that effectively identifies, monitors, and controls CRE concentration risk.

Further, Financial Institution Letter (FIL)-22-2008, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, issued March 17, 2008, provides key risk management processes for institutions with CRE concentrations, including maintaining prudent, time-tested lending policies with a strong credit review and risk rating system to identify deteriorating credit trends early and maintaining updated financial and analytical information for borrowers. For example, institutions should emphasize global financial analysis of obligors, which involves analyzing borrowers' complete financial resources and obligations. The guidance further states that inappropriately adding extra interest reserves on loans where the underlying real estate project is not performing as expected can erode collateral protection and mask loans that would otherwise be reported as delinquent.

A significant cause of the decline in asset quality experienced by GWSB was management's poor risk management practices, including weak loan underwriting and poor credit administration practices. Although the economic decline in GWSB's lending area was a contributing factor in the deterioration of its asset quality, the weaknesses in the bank's underwriting and credit administration practices significantly impacted the ability of the bank to identify, measure, monitor, and control the inherent risk in its loan portfolio. As a result, the bank was ill-prepared to address the challenges resulting from that decline.

Loan Underwriting

Insufficient loan underwriting standards and lax credit administration exacerbated the risks undertaken by management and contributed to the extensive loan losses. In numerous instances, management relied on faulty appraisals, incomplete analysis of the financial capacity of borrowers/guarantors, and inaccurate construction budgets when they underwrote these loans. As GWSB's speculative construction portfolio increased and the economy started to decline, weaknesses in GWSB's loan underwriting practices became more exposed. Examiners identified a variety of weaknesses in the bank's loan underwriting practices, including the following:

- **Inadequate Global Cash Flow Analysis.** The 2005, 2008, and 2009 examinations reported that the bank did not conduct adequate global cash flow analysis on borrowers prior to extending credit. Specifically, the bank did not obtain information such as comparative financial statements, income statements, cash flow statements, and other pertinent statistical support, including the borrowers' list of contingent liabilities. Examiners concluded that, lacking such information, management could not adequately assess borrowers' repayment capacity.

- **Inadequate Borrower Equity.** A key factor in determining the extent of risk in a project is the equity contribution of the borrower. The 2009 examination identified five loans totaling $24 million, for which the borrower's equity into the project was less than 3 percent of the loan amount. According to GWSB's Credit Policy, the borrower on a commercial construction project was supposed to have a minimum of 20 percent equity into the project.

- **Improper Loan Approval.** The 2009 examination report identified over 290 loans where borrowers received extensions of maturities or additional loan funds without proper review and approval by the Executive Loan Committee. According to GWSB's Credit Policy, changes to loans exceeding the individual loan officer's loan authority and all loan renewals should have been approved by the Executive Loan Committee. The examination report stated that, in many instances, GWSB's management granted loan extensions to mask past due loans at month-, quarter-, and year-end reporting dates. As a result, the Board and senior management did not identify problem loans in a timely manner or new loan funds being extended to problem borrowers.

- **Reliance on Faulty Appraisals.** The 2009 examination report further stated that the bank relied on stale or incomplete appraisals when originating loans. In many instances, management granted additional funds without obtaining new appraisals. As a result, additional funds were granted without any consideration to collateral coverage. Additionally, the examination report stated that management had an inadequate appraisal review system. As such, significant errors in appraisals were not identified by management, which resulted in the extension of loan funds based on substantially overstated appraised values. The decline in the real estate market, especially the condominium market in Chicago, further compounded the issue.

Credit Administration

In addition to weak underwriting practices, examiners also identified numerous credit administration deficiencies during examinations of GWSB from 2005 to 2009. The following summarizes some of the problems cited that ultimately contributed to deterioration in asset quality.

- GWSB did not develop a tickler system for credit file documentation or formal triggers for loan rating downgrades and upgrades. As a result, examiners noted numerous technical exceptions, such as stale financial statements and insurance, during the 2005 examination. Further, large loans classified as Special Mention and Substandard did not include current building insurance, and loan files did not have current financial statements.

- GWSB's Loan Policy contained limits for various types of commercial loans as a percentage of Tier One Capital that ranged from 200 percent to 400 percent. Examiners noted that the policy limits were too high to represent any meaningful attempt to control concentration risk.

- Management did not implement appropriate controls over loan collateral. In several instances, examiners questioned whether management had adequately perfected liens on the collateral. Additionally, in some instances, management did not obtain updated accounts receivable aging reports and/or valuations of miscellaneous collateral.

- GWSB did not adequately monitor construction projects. Initial budgeted projections were not routinely compared to actual performance. Examiners noted that target completion dates were missed and costs had exceeded budgeted projections on construction loans during the 2009 examination.

- Management failed to properly identify and report loans that exceeded supervisory loan-to-value limits as outlined in Appendix A of Part 365 of the FDIC Rules and Regulations. Therefore, high-risk loans were not appropriately identified and monitored.

- GWSB's geographical zone concentration report contained a comprehensive breakdown of the types of its CRE loans by zone; however, there was no summation of these types to determine the overall dollar amount by category.

- GWSB's management failed to implement an appropriate loan grading system, which resulted in management not properly identifying the risks in the loan portfolio. As discussed below, the deficiencies identified in the bank's loan grading system also impacted the adequacy of the Allowance for Loan and Lease Losses (ALLL).

<u>Allowance for Loan and Lease Losses</u>

On December 13, 2006, the federal financial institution regulatory agencies issued an *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL Policy Statement) that reiterated key concepts and requirements related to generally accepted accounting principles[4] and existing supervisory guidance. Specifically, the ALLL Policy Statement describes the nature and purpose of the ALLL; the responsibilities of boards of directors, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound credit grading system. The Policy Statement indicates that an institution's process for determining the ALLL should be based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio that considers all significant factors that affect collectability. That analysis should include an assessment of changes in economic conditions and collateral values and their direct impact on credit quality. If declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity.

In 2009, examiners reported that the main reason for GWSB's inadequate ALLL was management's inability to identify problem loans due to an inadequate loan monitoring system. Also, the bank's ALLL policy guidance, as contained in its Credit Policy, was insufficient for assessing the adequacy of the ALLL. The policy guidance did not provide procedures for determining when a loan is impaired or for calculating impairment pursuant to FAS 114. The policy also did not address methods for segmenting loans by type pursuant to FAS 5.

The FDIC's Supervision of GWSB

Between 2005 and 2009, the FDIC and the IDFPR conducted safety and soundness examinations of GWSB under an 18-month examination cycle in accordance with the FDI Act.[5] During this time, with the exception of the 2006 examination, examiners consistently reported the bank's high CRE and ADC concentrations and made numerous recommendations to strengthen the bank's risk management practices. Although examiners reported the high CRE and ADC concentrations and weak risk management practices, these concerns were not reflected in the bank's ratings until problem loans had begun to adversely affect the bank's financial condition. Offsite monitoring activity in 2009 resulted in acceleration of the next onsite examination and led to the pursuit of a formal supervisory action. However, the bank's condition became critically deficient before formal action was taken.

In hindsight, the FDIC and the IDFPR could have taken earlier and stronger supervisory action prior to 2009 that may have been more effective in getting management to address issues identified by examiners and mitigate the associated risks. Specifically, the FDIC

[4] Statement of Financial Accounting Standards (FAS) No. 5, *Accounting for Contingencies* and FAS No. 114, *Accounting by Creditors for Impairment of a Loan*.
[5] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full scope, on-site examinations of every state nonmember bank at least once every 12-month period and allows for 18-month intervals for certain small institutions (total assets of less than $500 million) if certain conditions are satisfied. GWSB met the conditions for the 18-month examination cycle.

could have more aggressively followed up on issues identified in the 2005 examination and later could have downgraded Asset Quality and Management component ratings and pursued supervisory action earlier.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008, the FDIC reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Further, the FDIC recently completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addresses the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

Supervisory History

From 2005 to 2009, the FDIC conducted three examinations and the IDFPR conducted one examination of GWSB. In addition to onsite examinations, the FDIC conducted offsite monitoring, which generally consisted of periodic contact with bank management to discuss current or emerging issues or concerns. FDIC officials also contacted bank officials as part of its pre-examination planning process. Further, the FDIC used various offsite monitoring tools, including the offsite review list (ORL), to monitor GWSB between examinations. Specifically, GWSB was flagged on the FDIC's ORL based on December 31, 2008 Call Report data, which resulted in a June 2009 FDIC offsite review that is discussed later in this report. Until the June 2009 offsite review, GWSB was considered a well-performing institution and consistently received composite "1" or "2" CAMELS ratings.

Table 2: GWSB's Examination History, 2005 to 2009

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
12/29/2005	09/30/2005	FDIC	222221/2	None
12/13/2006	09/30/2006	IDFPR	111111/1	None
06/09/2008	03/31/2008	FDIC	232222/2	None
10/19/2009	09/30/2009	FDIC	555555/5	Cease and Desist Order (C&D)

Source: Reports of Examination for GWSB.
Note: IDFPR issued this C&D effective against GWSB as of December 4, 2009.

Supervisory Response to Key Risks

Examiners consistently identified GWSB's concentrations and made recommendations for the bank to improve its underwriting and credit administration practices as detailed in Appendix 4. However, in hindsight, a more forward-looking assessment of GWSB's risk profile, especially the bank's exposure to an economic downturn, may have been prudent.

2005 Supervisory Activities

In the December 2005 examination, examiners assigned GWSB a composite “2” CAMELS rating, concluding that the financial condition of the bank was satisfactory, even as the bank’s risk characteristics had changed from a traditional savings bank focused on mortgage lending to that of an institution heavily concentrated in construction lending.

Examiners found Asset Quality and Management to be satisfactory and assigned both components a “2” rating. The level of CRE loans was 551 percent of Tier 1 Capital and was mainly comprised of construction loans. The bank had a low level of adversely classified loans, but examiners identified a number of deficiencies in loan underwriting and credit administration. Examiners noted that approximately two-thirds of the construction lending involved speculative residential construction loans and, as such, noted that management needed to make every effort to proactively manage these loans and the bank’s exposure in that area. Recommendations were made for management to (1) identify risk limits for construction lending in geographic sub-markets by collateral type, (2) improve loan presentations, (3) analyze borrower repayment capacity using global cash flow analysis, and (4) prepare officer memorandums for the credit files.

Further, examiners recommended that management increase oversight of the institution’s CRE concentration, especially the large speculative construction portfolio. Examiners stressed that given the increased risk as the bank was growing, the Board’s monitoring of this risk needed to be improved. Management was also advised that staffing for the size and complexity of the institution needed to be addressed.

Examiners recommended that due to the numerous underwriting and credit administration weaknesses, the concentration in speculative construction loans, and the potential for increased risk within the loan portfolio from economic changes, that the FDIC conduct a targeted visitation of asset quality, liquidity, and information technology concurrent with the IDFPR examination planned for 2006.

2006 Supervisory Activities

Although the 2005 examination recommended that the FDIC conduct a targeted visitation concurrent with the state’s 2006 examination, the FDIC did not do so. FDIC officials explained that it is not customary to perform joint examinations on “2” rated institutions with assets less than $1 billion and the FDIC made a risk-based decision not to perform a visitation and instead rely on the IDFPR examination. The IDFPR December 2006 examination rated GWSB a composite “1” and did not report any serious weaknesses in the bank’s operations. The report noted that ADC loans comprised 595 percent of Tier 1 Capital, and recommended loan administration enhancements pertaining to credit memorandums and status memorandums for construction and development projects. However, there were no additional matters of material supervisory concern pertaining to the lending function or other components noted in the IDFPR report.

IDFPR's composite rating for GWSB appeared to be in contrast with the FDIC's findings a year earlier in terms of the bank's risk profile and risk management practices. Further, based on reading and comparing this examination report to the prior and subsequent examinations, the IDFPR and the FDIC appear to have missed an opportunity in 2006 to emphasize to GWSB's Board and management the risk associated with the increasing ADC concentrations and their responsibility to develop strong risk management practices to mitigate those risks. Although not customary as mentioned earlier, FDIC officials acknowledged in retrospect that it would have been beneficial to have had an FDIC examination team assisting with the 2006 examination, as was recommended in 2005.

2008 Supervisory Activities

The FDIC's June 2008 examination found that the overall condition of the institution was satisfactory; however, the examination report emphasized that asset quality had begun to deteriorate as a result of a downturn in the real estate market and the bank's heavy concentration in CRE and speculative residential construction loans. The Adversely Classified Items Coverage ratio had significantly increased from 7.60 percent at December 2006 to 43.55 percent as of March 2008. As a result, the FDIC downgraded the bank's Asset Quality component rating from a "1" to a "3". Further, the FDIC downgraded each of the bank's other component ratings, including Management, and the composite rating to "2". Additionally, examiners reported loan documentation deficiencies and weaknesses in the bank's concentration reporting process and CRE policy limits and made recommendations for the bank to improve practices for analyzing borrowers' financial conditions. Further, examiners made recommendations related to the bank's lending policies and procedures, concentration reporting, use of interest reserves, and ALLL methodology and reporting. FDIC officials explained that, at the time the examination was conducted, a number of construction projects had recently been completed or were nearing completion and sufficient time had not elapsed for performance and impairment issues to develop and become evident.

In hindsight, although examiners downgraded Asset Quality, given the weak practices identified and the focus of recommendations, a lower Management rating may have been warranted. A "2" rating indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled. In comparison, a "3" rating indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled. GWSB's weaknesses and risk profile appear to be more consistent with the definition of a "3" Management rating. Further, pursuit of an informal supervisory action may have been prudent in order to increase supervisory oversight and solicit a more formal commitment from management to correct weaknesses.

The next full-scope examination after the June 2008 examination was to commence in early 2010 based on GWSB's 18-month examination cycle. However, the results of an offsite review (targeted FDIC analysis of financial data and other information provided by GWSB) in June 2009 resulted in the FDIC accelerating the start of the onsite examination by several months.

2009 Supervisory Activities

June 2009 Offsite Review. The FDIC's Offsite Monitoring Review Program flagged several line items in GWSB's December 31, 2008 Call Report data because of negative trends related to non-accrual loans and the Adverse Classified Items Coverage Ratio. In addition, earnings had declined and capital levels had decreased. Accordingly, the FDIC initiated an offsite review during which examiners reviewed March 2009 Call Report data to gauge the extent of further deterioration. The offsite review recommended downgrading the bank's composite rating to a "3". In response to the recommendation, the FDIC immediately took action to confirm the bank's condition and ratings by expediting the next full-scope examination that was originally scheduled to begin in January or February 2010 to October 2009.

October 2009 FDIC Examination. Examiners found that GWSB's overall condition was critically weak and downgraded the bank's composite rating to a "5". The examination report concluded that management's practice of promoting rapid growth in high-risk construction and development projects without appropriate underwriting controls resulted in massive loan losses. The significant level of construction and development loans to leveraged builders and developers in the Chicago area had exposed the bank to substantial risks. Significant deficiencies related to loan administration and underwriting were identified, which contributed to the deterioration in the bank's financial condition.

Specifically, examiners found asset quality to be critically deficient as the volume and severity of adverse classifications were at unacceptable levels. As discussed earlier in this report, examiners attributed the deterioration primarily to insufficient oversight of the bank's loan portfolio by the Board and senior management, as well as weak credit administration practices and the economic recession. Examiners reported that management had allowed CRE loans to grow by over 45 percent during the prior 3 years without proper policies and procedures being implemented, including the failure to: implement an appropriate loan grading system, obtain sufficient borrower equity, acquire executive loan committee approval on extensions and granting of additional funds, appropriately monitor construction loans, adequately monitor and perfect liens on collateral, sufficiently valuate collateral, and monitor and analyze borrower and/or guarantor financial capacity.

Further, examiners criticized GWSB's management for not implementing appropriate risk management practices. Problem loans were not adequately identified, and management had not sufficiently provided for an adequate ALLL. Management also failed to control the level of asset concentrations, and the lack of diversification had significantly impacted the volume of problem loans. Management was found to be in non-compliance with Appendix A of Parts 364 and 365 of the FDIC Rules and Regulations, which addresses operational and managerial standards for safety and soundness, supervisory loan-to-value limits, and guidance for real estate lending policies. FDIC officials explained that management's efforts, discussed earlier in this report, to mask past-due loans by granting loan extensions without proper approval impacted the examiners' ability to recognize the extent of asset deterioration before the 2009 onsite examination and helped to explain the rapid pace of deterioration once the practice was discovered by examiners. These activities are the subject of an ongoing investigation.

Earnings performance was found to be extremely poor and insufficient to support operations. Rising levels of nonaccrual loans and increased loan loss provisions had depleted earnings. Contributing to the decline in earnings was the high cost of funds, with the bank's cost of interest-bearing deposits to be significantly above peer levels. As of September 30, 2009, a net operating loss of $12 million was reported.

GWSB's liquidity was of significant concern due to the heightened risk profile of the institution. Although the bank's dependence on non-core funding was manageable and the bank did not utilize brokered deposits, severe asset quality deterioration had weakened the bank's liquidity position to the point where it was in jeopardy of not being able to meet liquidity needs.

December 2009 C&D. Based on the results of the October 2009 examination, the IDFPR issued a C&D to GWSB that required the Board within 60 days:

> …to contribute and maintain capital in an amount necessary to eliminate the impairment and unsafe and unsound condition; to provide an adequate level of protection based on its financial condition, management, earnings prospects, and risk profile; and to assure maintenance of insurance of deposit accounts by the FDIC. At a minimum, capital shall be contributed and maintained to meet the following requirements:
>
> a. Increase its Tier 1 leverage capital ratio to not less than 5 percent;
> b. Increase its Tier 1 risk-based regulatory capital ratio to 6 percent; and
> c. Increase its total risk-based capital ratio to not less than 10 percent.

In addition, the FDIC notified the bank of its intent to issue a C&D. However, proceedings to close the bank began in early 2010 and, therefore, the FDIC's C&D was not officially executed.

Supervisory Lessons Learned

According to the Examination Manual, the quality of an institution's management, including its Board of Directors and executive officers, is perhaps the single most important element in the successful operation of a bank. The Board has overall responsibility and authority for formulating sound policies and objectives for the bank and for effectively supervising the institution's affairs. The Examination Manual further states that:

> …to effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking…when corrective action is not taken until conditions have deteriorated it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

In hindsight, GWSB's aggressive pursuit of CRE loans and, in particular, speculative construction lending, may have warranted greater supervisory concern. As discussed earlier, the risks associated with the high CRE and ADC concentrations and weak loan underwriting and credit administration practices were evident during each of the FDIC's examinations conducted since GWSB changed its focus to CRE lending in 2002. In that regard, earlier and stronger supervisory action prior to 2009 may have been more effective in obtaining management's commitment and follow-through to address deficiencies identified by examiners and mitigate the associated risks. Such actions may have involved earlier component and composite rating downgrades and pursuit of an informal supervisory action, such as a bank board resolution or memorandum of understanding, to ensure the bank corrected its operational deficiencies.

The FDIC has taken steps to increase supervisory attention to banks that have risk profiles similar to GWSB. On January 26, 2010, the FDIC issued guidance to its examiners 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.

Finally, the FDIC recently completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as the financial institution's current financial performance or trends in assigning ratings as allowable under existing examination guidance.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved. Based on the supervisory actions taken with respect to GWSB, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

Based on its September 30, 2009 Call Report, GWSB became *Adequately Capitalized*. In a letter dated November 24, 2009, the FDIC informed the bank that it was required to obtain a non-objection from the FDIC before obtaining brokered deposits. Additionally, on December 2, 2009, the FDIC notified GWSB that it was *Critically Undercapitalized* as a result of the most recent examination dated October 19, 2009 and advised the bank to develop policies and procedures to ensure compliance with requirements contained in Section 38, including submission of a capital restoration plan and restrictions on asset growth, acquisitions, new activities, new branches, payment of dividends or other capital distributions, management fees, and senior executive compensation. However, GWSB failed to submit a formal written capital restoration plan and was subsequently closed on February 19, 2010.

Troubled Asset Relief Program. GWSB applied for funds under the Troubled Asset Relief Program (TARP) on April 28, 2009. However, after being advised that the application would not be approved, GWSB withdrew the TARP application on September 1, 2009.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On October 8, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 5 of this report. DSC reiterated the OIG's conclusion regarding the causes of GWSB's failure. With regard to our assessment of the FDIC's supervision of GWSB, DSC's response summarized supervisory activities between 2005 and 2010 described in our report, including offsite activities and supervisory actions. Further, DSC's response described the FDIC's 2009 examination findings, also discussed in our report, related to GWSB's practice of extending loan maturities or granting new loans to problem borrowers. DSC stated that the bank's activities masked the level of loan problems and impacted the FDIC's ability to recognize the extent of asset quality problems prior to the onsite examination. DSC's response also recognized that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations, such as GWSB, and referenced supervisory guidance that DSC has issued to re-emphasize the importance of robust credit risk-management practices and to set forth broad supervisory expectations.

Objectives, Scope, and Methodology

Objectives

We performed this performance audit to satisfy the requirements of section 38(k) of the FDI Act as amended by the Financial Reform Act which was signed into law on July 21, 2010. The Financial Reform Act amends section 38(k) of the FDI Act by increasing the MLR threshold from $25 million to $200 million for losses that occur for the period January 1, 2010 through December 31, 2011. Further, the Financial Reform Act includes provisions that call for the OIG to perform an in-depth review of failures when losses are not material but they involve unusual circumstances. In-depth reviews are required to be performed and reported in a manner consistent with that of an MLR.

At the time the Financial Reform Act was enacted, we had completed our fieldwork and were in the process of preparing a draft MLR report. Although the estimated loss for GWSB no longer met the threshold requiring an MLR, the OIG decided to complete the audit and issue this report as an in-depth review.

Consistent with the Financial Reform and FDI Act provisions described above, the objectives of this review were to (1) determine the causes of GWSB's failure and the resulting loss to the DIF and (2) evaluate the FDIC's supervision of GWSB, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from February 2010 to August 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 GWSB's operations from December 31, 2005 until its failure on February 19, 2010. 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 prepared by the FDIC and the IDFPR examiners from 2005 to 2009.

- Reviewed the following:

    - Bank data and correspondence provided from the FDIC DSC Chicago regional and field offices.

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

- Pertinent DSC policies and procedures and various banking laws and regulations.

- Interviewed the following FDIC officials:

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

  - FDIC examiners from the DSC Chicago and Champaign, Illinois Field Offices, who participated in examinations or reviews of examinations of GWSB.

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, Reports of Examination (ROEs), and interviews of examiners to understand GWSB's management controls pertaining to causes of failure and loss as discussed in the body of this report.

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

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this in-depth 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.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions, and these reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and that provide interim financing for residential or commercial structures.
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.
Bank Board Resolution (BBR)	A Bank Board Resolution is an informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 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.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.

Glossary of 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.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	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.

Glossary of Terms

Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
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).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector. TARP was established under the Emergency Economic Stabilization Act of 2008, which established the Office of Financial Stability within the Department of the Treasury. Under TARP, Treasury will purchase up to $250 billion of preferred shares from qualifying institutions as part of the Capital Purchase Program.

Glossary of Terms

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

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
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
GWSB	George Washington Savings Bank
IDFPR	Illinois Department of Financial and Professional Regulation
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Examiner Comments in Reports of Examination

ROE Dates	2005	2006	2008	2009
Deficiency/Risk				
Concentration in CRE and ADC Loans	✓	✓	✓	✓
Inadequate/Enhance Loan Underwriting	✓		✓	✓
High Unfunded Loan Commitments	✓		✓	✓
Interest Reserves/Justification for Replenishing			✓	✓
Inadequate or Enhance Appraisal Program/Review				✓
High Loan-to-Value			✓	✓
Weak/Enhance Credit Administration	✓	✓	✓	✓
No aggregate limits or exceeded internal limits on CRE/ADC in relation to capital	✓		✓	
Increase oversight/monitoring/tracking of CRE/ADC concentration	✓		✓	✓
Track & Report to Board loan extension/renewal, construction projects out of balance, loan policy exception	✓			
Loan presentation weaknesses	✓			
Inadequate or the lack of global cash flow analysis/repayment capacity/borrower equity	✓		✓	✓
Interest rate shock analysis	✓			
Update status memos/monitor construction and development projects	✓	✓	✓	✓
Insufficient review and approval by the Loan Committee for extensions of maturities and granting of additional funds			✓	✓
Revise or Adhere to loan policy	✓		✓	
Numerous loan technical exceptions such as outdated financial statements/insurance/collateral verification		✓	✓	✓
Inadequate/Enhance loan grading/monitoring system and ALLL methodology	✓		✓	✓
Violations			✓	✓
Legal Lending Limit-State/Part 365 Contravention			✓	✓
Part 323-Appraisal Violation				✓
Part 364-Interagency S&S-Loan Documentation/Credit Underwriting/Asset Quality Contravention				✓
Asset Losses				
Significant Loan Deterioration			✓	✓

Source: ROEs for GWSB.

Corporation Comments

FDIC

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

October 8, 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, In-Depth Review of the Failure of George Washington Savings Bank, Orland Park, Illinois (Assignment No. 2010-041)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted an in-depth review of the failure of George Washington Savings Bank (GWSB), Orland Park, Illinois, which failed on February 19, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on September 9, 2010.

GWSB failed primarily because of significant losses concentrated in commercial real estate (CRE) and acquisition, development, and construction (ADC) lending without implementing adequate loan underwriting and credit administration procedures commensurate with the bank's risk profile. The lack of diversification in GWSB's portfolio and poor risk selection, coupled with weak risk management practices, led to rapid deterioration in asset quality. Significant losses in the loan portfolio ultimately depleted earnings and eroded capital.

From 2005 through February 2010, the Illinois Department of Financial and Profession Regulations (IDFPR) conducted one examination and the FDIC conducted three examinations, along with offsite monitoring activities. FDIC examiners consistently reported high CRE/ADC concentrations and made recommendations to strengthen the bank's risk management practices. The 2008 FDIC examination found deterioration in asset quality and resulted in a downgrade in the component to a "3" rating. Declining trends noted in 2009 offsite monitoring activities led the FDIC to accelerate the next examination by several months. The 2009 FDIC examination found numerous extensions of loan maturities and/or new loan funds had been granted to problem borrowers without the approval of GWSB's Executive Loan Committee. These activities masked the level of loan problems and impacted the ability of FDIC's offsite review to recognize the full extent of asset quality problems prior to the onsite examination. Based on the results of the 2009 examination both the IDFPR and FDIC pursued formal enforcement action.

DSC recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations, such as GWSB. DSC issued *Interagency Guidance on CRE Monitoring* in 2006 and a Financial Institution Letter to banks on *Managing Commercial Real Estate Concentrations in a Challenging Environment* in 2008 that re-emphasized the importance of robust credit risk-management practices for institutions with concentrated CRE exposures and set forth broad supervisory expectations.

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