Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-026

Material Loss Review of Mainstreet Bank, Forest Lake, Minnesota

March 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On August 28, 2009, the Minnesota Department of Commerce (MDC) closed Mainstreet Bank (Mainstreet), Forest Lake, Minnesota, and named the FDIC as receiver. On September 25, 2009, the FDIC notified the Office of Inspector General (OIG) that Mainstreet's total assets at closing were $435.9 million and the estimated loss to the Deposit Insurance Fund (DIF) was $94 million. As of February 28, 2010, the estimated loss had increased to $97.9 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of Mainstreet.

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

Mainstreet opened for business on March 15, 1903 as Chisago County State Bank and The County Bank, and was insured by the FDIC on January 1, 1934. The bank assumed its current name when it merged with Southview Bank, an affiliate, in November 2001. Mainstreet was wholly-owned by BancMidwest Corporation, which also owned White Rock Bank, Cannon Falls, Minnesota. In February 2008, BancMidwest Corporation acquired selected assets of First Bank and Trust, Hudson, Wisconsin and merged it into Mainstreet. Mainstreet operated seven branches in Minnesota and one in Wisconsin.

The majority of Mainstreet's lending was in commercial real estate (CRE), with a particular focus on residential acquisition, development, and construction (ADC) loans. Mainstreet increasingly relied upon large time deposits, brokered deposits, Federal Home Loan Bank (FHLB) borrowings, and federal funds purchased to fund its loan growth.

Audit Results

Causes of Failure and Material Loss

Mainstreet's Board and management failed to provide adequate oversight and implement sound risk management practices relative to the bank's pursuit of growth centered in CRE and ADC lending, which included broker-originated loans. Ineffective oversight resulted in an inadequate loan policy, weak loan underwriting and credit administration practices, and an underfunded provision for Allowance for Loan and Lease Losses (ALLL). As rapid growth outpaced core deposits, the bank became increasingly dependent upon access to volatile funding sources such as brokered deposits, FHLB borrowings, and large time deposits. These funding sources became restricted when a downturn in the local economy resulted in a deterioration in Mainstreet's asset quality. Ultimately, the MDC closed Mainstreet on August 28, 2009, declaring the bank insolvent.

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The FDIC's Supervision of Mainstreet

The FDIC and the MDC conducted annual on-site examinations of Mainstreet consistent with requirements and monitored the bank's condition through the use of various offsite monitoring mechanisms. Beginning in 2004, examiners consistently reported that Mainstreet had high CRE and ADC concentrations and expressed concerns regarding the bank's loan risk rating system and ALLL methodology. However, the bank's overall financial condition was considered satisfactory until the 2008 examination. By then, asset quality had rapidly deteriorated due to the decline in the real estate market.

The FDIC downgraded the institution's ratings in 2008 and pursued an enforcement action aimed at correcting identified problems. These supervisory actions, and Mainstreet's efforts to address them, were not successful in preventing the bank's failure. The supervisory approach to Mainstreet was consistent with prevailing practices at the time for a bank with Mainstreet's risk profile. A lesson learned, however, is that earlier and more formal supervisory action to mitigate the risk associated with CRE and ADC concentrations, funded with non-core and other potentially volatile deposits, may have been prudent. Specifically, examiners could have recommended that the Board diversify the bank's loan portfolio and required progress reports.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. As part of a December 2008 Cease and Desist Order, the FDIC required Mainstreet to submit a Capital Restoration Plan and the bank did so on March 11, 2009. On April 28, 2009, the FDIC sent a letter to the bank stating that the plan was unacceptable. On June 12, 2009, Mainstreet submitted a revised Capital Restoration Plan that included the bank selling four of its branches and other real estate owned; the holding company selling White Rock Bank; increasing the ALLL; and the bank obtaining an investor. However, on August 12, 2009, the FDIC informed Mainstreet that the revised plan was unacceptable as it provided little assurance that the bank's capital would be restored in a timely manner. On November 17, 2008, Mainstreet submitted an application for $13.5 million in funding under the Troubled Asset Relief Program. Mainstreet subsequently withdrew its application on February 25, 2009. On August 28, 2009, the MDC closed Mainstreet due to its insolvency.

Management Response

We issued a draft of this report on March 4, 2010. After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 23, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report.

In its response, DSC reiterated the OIG's conclusions regarding the cause of Mainstreet's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. DSC also noted that strong supervisory attention is necessary for institutions with high ADC and CRE concentrations and volatile funding sources, such as Mainstreet, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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

Office of Material Loss Reviews
Office of Inspector General

DATE: March 25, 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 Mainstreet Bank, Forest Lake, Minnesota* (Report No. MLR-10-026)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the FDIC Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Mainstreet Bank (Mainstreet), Forest Lake, Minnesota. The Minnesota Department of Commerce (MDC) closed Mainstreet on August 28, 2009 and named the FDIC as receiver. On September 25, 2009, the FDIC notified the OIG that Mainstreet's total assets at closing were $435.9 million and the estimated loss to the Deposit Insurance Fund (DIF) was $94 million. As of February 28, 2010, the estimated loss had increased to $97.9 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); ascertains why the institution's problems resulted in a material loss to the DIF; and makes recommendations to prevent future losses.

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Mainstreet's failure and the FDIC's efforts to ensure that Mainstreet's Board of Directors (Board) and management operated the institution in a safe and sound manner.

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[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.

The report does not contain recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations, as warranted. Appendix 1 contains details on our objectives, scope, and methodology; Appendix 2 contains a glossary of terms; and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

Mainstreet opened for business on March 15, 1903 as Chisago County State Bank and The County Bank, and was insured by the FDIC on January 1, 1934. The bank assumed its current name when it merged with Southview Bank, an affiliate, in November 2001. Mainstreet was wholly-owned by BancMidwest Corporation, which also owned White Rock Bank, Cannon Falls, Minnesota. In February 2008, BancMidwest Corporation acquired selected assets of First Bank and Trust (First Bank), Hudson, Wisconsin and merged it into Mainstreet.[3] Mainstreet operated seven branches in Minnesota and one in Wisconsin.

The majority of Mainstreet's lending was in commercial real estate (CRE), with a particular focus on residential acquisition, development, and construction (ADC) loans. Mainstreet increasingly relied upon large time deposits, brokered deposits, Federal Home Loan Bank (FHLB) borrowings, and federal funds purchased to fund its loan growth. Table 1 provides details on Mainstreet's financial condition as of June 30, 2009 and for the 4 preceding calendar years.

Table 1: Selected Financial Information for Mainstreet, 2005 to 2009

Financial Measure	Jun-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	458,533	481,434	425,035	366,804	330,610
Total Deposits ($000s)	432,818	429,381	324,784	314,451	286,487
Gross Loans and Leases ($000s)	230,528	287,866	341,773	313,571	291.613
Brokered Deposits ($000s)	47,425	49,683	26,244	28,740	28,340
FHLB Borrowings ($000s)	24,000	24,497	58,780	15,141	12,684
Net Income (Loss) ($000s)	(23,930)	(18,398)	3,692	5,744	5,226

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

BancMidwest Corporation provided capital to support the bank's growth, including capital injections of $1.4 million and $3.5 million in 2007 and 2008, respectively. However, as capital ratios continued to decline in support of provisions to the Allowance for Loan and Lease Losses (ALLL), BancMidwest Corporation was not able to provide additional support to the bank.

[3] FDIC officials stated that the loans from First Bank did not have a negative impact on Mainstreet's loan portfolio.

Causes of Failure and Material Loss

Mainstreet's Board and management failed to provide adequate oversight and implement sound risk management practices relative to the bank's pursuit of growth centered in CRE and ADC lending, which included broker-originated loans. Ineffective oversight resulted in an inadequate loan policy, weak loan underwriting and credit administration practices, and an underfunded ALLL. As rapid growth outpaced core deposits, the bank became increasingly dependent upon access to volatile funding sources such as brokered deposits, FHLB borrowings, and large time deposits. These funding sources became restricted when a downturn in the local economy resulted in deterioration in Mainstreet's asset quality.

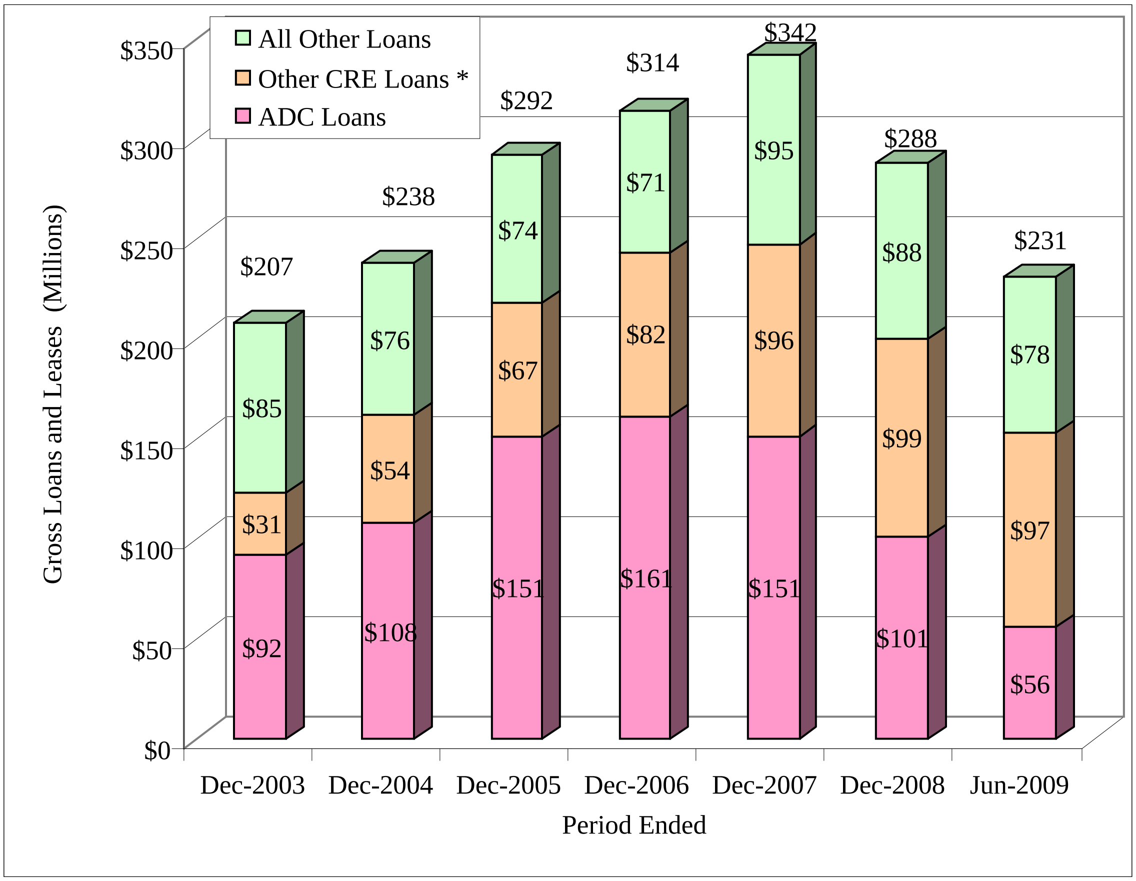
Further evidence of why Mainstreet failed was the level of adversely classified assets. Specifically, adversely classified assets significantly increased from 2.37 percent of Tier 1 Capital and reserves in 2003, to 150 percent in 2008, and more than 466 percent in 2009. Ultimately, the MDC closed Mainstreet on August 28, 2009, declaring the bank insolvent.

Concentrations in CRE and ADC Loans

In 2001, Mainstreet's management made a strategic decision to pursue growth centered in CRE and ADC lending, which, in hindsight, was a key factor in the bank's failure. In addition, the Board's decision to obtain broker-originated mortgages, without implementing sound loan underwriting and credit administration practices, led to a serious deterioration in asset quality as the real estate market declined. Mainstreet's asset growth was considerable – increasing from $58.7 million at the end of 2000 to over $425 million by the end of 2007. According to FDIC documentation, approximately $70 million of the asset growth resulted from the 2001 merger with Southview Bank.

The figure on the next page illustrates the general composition and growth of Mainstreet's loan portfolio in the years preceding the institution's failure. Total concentrations of CRE and ADC loans ranged from 59 percent to 77 percent of gross loans and leases over the period 2003 to 2009, peaking in 2006.

Figure: Composition of Mainstreet's Loan Portfolio



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

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

As shown in Table 2, Mainstreet's concentrations in ADC loans consistently represented more than 100 percent of total capital from 2003 to 2009, exceeding the criteria for identifying institutions that may have warranted further supervisory analysis once the interagency guidance took effect in December 2006. In addition, ADC loans as a percent of the bank's total capital and total loans were significantly above its peer group averages during the same period.

Table 2: Mainstreet's ADC Concentrations Compared to Peer Group

Period Ended	ADC Loans as a Percent of Total Capital			ADC Loans as a Percent of Total Loans		
	Mainstreet	Peer Group	Mainstreet Percentile	Mainstreet	Peer Group	Mainstreet Percentile
Dec 2003	419%	69%	99	44%	10%	98
Dec 2004	440%	81%	99	45%	11%	98
Dec 2005	526%	104%	99	52%	14%	98
Dec 2006	502%	117%	99	51%	16%	97
Dec 2007	433%	124%	97	44%	16%	94
Dec 2008	437%	111%	97	35%	14%	93
Jun 2009	(1,139%)*	98%	N/A	24%	13%	84

Source: UBPR data for Mainstreet.
*Percentage is negative because of negative capital.

Mainstreet's CRE concentrations from 2003 to 2009 also exceeded the levels for institutions that may be identified for further supervisory analysis, as shown in Table 3. In addition, CRE loans as a percent of the bank's total capital and total loans ranked significantly above the bank's peer group averages from 2007 to 2009 – years in which the guidance was in effect.

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

Period Ended	CRE Loans as a Percent of Total Capital			CRE Loans as a Percent of Total Loans		
	Mainstreet	Peer Group	Mainstreet Percentile	Mainstreet	Peer Group	Mainstreet Percentile
Dec 2003	559%	309%	91	59%	44%	76
Dec 2004	660%	323%	96	68%	45%	88
Dec 2005	760%	358%	99	75%	49%	90
Dec 2006	761%	371%	99	78%	50%	92
Dec 2007	708%	377%	97	72%	51%	86
Dec 2008	865%	380%	98	70%	50%	86
Jun 2009	(3,123%)**	364%	N/A	66%	49%	82

Source: UBPR data for Mainstreet.
* Percentages for Mainstreet and peers include owner-occupied CRE.
**Percentage is negative because of negative capital.

According to Board meeting minutes, Mainstreet's Board and senior management recognized that the real estate market was declining in 2006 but did not curtail the bank's pursuit of growth. On the contrary, the bank opened a new loan production office in 2007. The Board minutes also stated that, even though the bank had experienced a 20-percent to 25-percent delinquency rate in its loan portfolio and losses were expected to reach 10 percent in 2007, the Board was convinced that being in the broker-originated loan market was a good business strategy because the fees and interest income earned on that portion of the portfolio had been far greater than the losses experienced or anticipated. However, as borrowers defaulted on loans, the bank's other real estate owned (OREO)[4] increased from zero in 2003 to more than $37 million by June 2009. Further, as shown in Table 4, adversely classified assets grew significantly in 2008 and 2009, with broker-originated loans accounting for 62 percent and 47 percent of those classifications, respectively. Past-due and nonaccrual loans also increased from 1.48 percent in 2003 to nearly 30 percent in 2009.

Table 4: Mainstreet's Adversely Classified Assets

Examination Year	Adversely Classified Assets*	Past-Due and Nonaccrual Loans**
2003	2.37%	1.48%
2004	16.36%	1.43%
2005	13.12%	2.30%
2006	23.54%	3.45%
2008	150.04%	8.15%
2009 Visitation	330.50%	27.57%
2009	466.20%	29.70%

Source: Reports of Examination (ROE) for Mainstreet.
*Ratio is a percentage of Tier 1 Capital and reserves.
**Ratio is a percentage of total loans.

During the 2006 examination, examiners cautioned management about the bank's high CRE concentrations, stating that "the high levels could expose the bank to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market." At the 2008 examination, examiners concluded that the bank's risk management practices relative to CRE were inadequate. In the 2009 examination report, examiners stated that the high level of CRE and ADC loans, combined with the downturn in residential real estate, had caused the bank's poor condition and that former senior management[5] had failed to implement necessary risk mitigation practices.

Oversight and Risk Management Practices

Mainstreet's Board and senior management did not implement sound risk management practices, which contributed to a high level of nonperforming assets. The 2009 examination report stated that the Board was lax in waiting until the fourth quarter of 2008 to take necessary and urgent remedial steps identified at the 2008 examination to address the bank's distressed financial condition and substantial management weaknesses.[6] Further, the report stated that the Board's delay in addressing the unsafe and unsound practices had further crippled the bank's prospects for viability. Examiners cited Mainstreet for weak risk management practices in the areas of loan policy guidance, loan underwriting and credit administration practices, and ALLL methodology.

[4] OREO is property taken over by a bank through loan foreclosures.
[5] In November 2008, a new President/Chief Executive Officer was hired and several officer positions were changed.
[6] FDIC examiners met with bank management on May 20, 2008 to present the findings from the March examination and issued the examination report on July 10, 2008.

Loan Policy

Mainstreet's Board did not establish appropriate controls and procedures in the bank's loan policy to effectively manage its CRE concentrations. However, it was not until the 2008 examination that examiners made recommendations for improving the bank's loan policy to include, among other things, strong real estate appraisal review procedures, the establishment of concentration limits, accurate high loan-to-value (LTV) monitoring and reporting, and global financial analysis[7] of borrowers.

The bank submitted a revised loan policy to the FDIC on March 11, 2009 that included provisions on CRE lending. However, it still lacked specific guidance on the (1) format, frequency, and documentation methodology for on-site inspections; (2) capacity of borrowers to repay loans; and (3) analysis of guarantor financial support.

Loan Underwriting and Credit Administration Weaknesses

Mainstreet did not implement sound loan underwriting and credit administration practices, which contributed to the asset quality problems that developed in the institution's CRE portfolio. During the 2008 examination, examiners noted the following weaknesses:

- liberal lending practices and risk selection with broker-originated mortgages,
- undue reliance on pre-qualification letters for secondary market financing,
- inadequate consideration of repayment capacity and collateral,
- inadequate risk management of CRE concentrations,
- capitalization of interest/use of interest reserves, and
- inadequate internal audit program.

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, one of which is to maintain updated financial and analytical information for borrowers and states that global financial analysis of obligors should be emphasized. FIL-22-2008 also 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.

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. Examiners first commented on the bank's lack of objective criteria for loan grading at the 2004 examination. The 2008 examination noted that internal loan grading had not been revised despite a 2005 examination recommendation to include objective criteria, and continued

[7] Global financial analysis involves analyzing a borrower's complete financial obligations.

to be based entirely on subjective criteria. Examiners also noted in the 2008 examination report that the bank's risk rating system impeded the Board from accurately identifying risk within the loan portfolio because the system was unreliable in stratifying and quantifying risk and did not provide sufficient information for establishing an appropriate ALLL. The 2009 examination again found the loan grading system to be inadequate.

Mainstreet was also found to be in contravention to Appendix A to Part 365 of the FDIC Rules and Regulations (*Interagency Guidelines for Real Estate Lending Policies*), which specifies that loans in excess of the supervisory LTV limits should be identified in the bank's records and their aggregate amount reported to the Board at least quarterly. In 2008, 16 loans exceeded the LTV limits and were not included in the report to the Board. A small number of loans was also found to be in excess of LTV limits at the 2003 examination.

Allowance for Loan and Lease Losses

Mainstreet's methodology for determining the ALLL did not fully comply with interagency policy. According to FIL-105-2006, *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, dated December 13, 2006, each institution must analyze the collectability of its loans and maintain an ALLL at a level that is appropriate and in accordance with Generally Accepted Accounting Principles (GAAP).[8] According to the 2008 examination report, the bank's ALLL was underfunded because management failed to consistently identify risk and assign accurate risk ratings. Although management had assessed the appropriateness of the ALLL on a monthly basis, the Board had not provided formal policy guidelines regarding the methodology for determining an appropriate ALLL and did not effectively incorporate GAAP Financial Accounting Standard No. 5 "Accounting for Contingencies" or No. 114 "Accounting by Creditors for Impairment of a Loan." As a result, the bank had to amend the March 31, 2008 Call Report to account for the additional provision of $3.3 million to the ALLL. The 2009 examination also reported that the ALLL was underfunded and required an additional provision of at least $10.9 million and the methodology was still not in compliance with accounting standards.

Reliance on Volatile Funding Sources

In the years preceding its failure, Mainstreet became increasingly dependent on non-core funding sources to support loan growth and maintain adequate liquidity. When properly managed, such funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, non-core funding sources also present potential risks, such as higher costs and increased volatility. According to the Examination Manual, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to

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[8] The policy provides key concepts and requirements pertaining to the ALLL included in GAAP and existing supervisory guidance. It describes the nature and purpose of the ALLL; the responsibilities of Boards, 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 loan grading system.

these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

Beginning in 2004, Mainstreet began to increasingly rely on non-core, potentially volatile liabilities, including large time deposits, brokered deposits, FHLB borrowings, and federal funds purchased to fund strong loan growth that had outpaced core deposits. In addition, the bank used an Internet deposit listing service to obtain high-rate core deposits, which are also considered volatile. According to the Examination Manual, although out-of-area deposits obtained from an Internet listing service are included in core deposits under the UBPR definition, such deposits should not be viewed as stable funding sources.

Table 5 provides details on the bank's core and non-core funding sources during the years prior to its failure.

Table 5: Mainstreet's Funding Sources

Period Ended	Core Deposits ($000s)*	Time Deposits $100,000 or More ($000s)	Brokered Deposits ($000s)	FHLB Borrowings ($000s)
December 2003	171,094	26,995	N/A	25,812
December 2004	203,048	40,299	N/A	3,725
December 2005	254,372	32,115	28,340	12,684
December 2006	270,504	43,947	28,740	15,141
December 2007	272,137	52,646	26,244	58,780
December 2008	350,404	78,975	49,683	24,497
June 2009	351,114	81,704	47,425	24,000

Source: UBPR data for Mainstreet.
*Core deposits may include some deposits of less than $100,000 obtained through the bank's use of an Internet listing service and brokered deposits representing time deposits of less than $100,000.

At the 2004 examination, examiners characterized the bank's liquidity position as "tight" but concluded that it was satisfactory because adequate non-core funding sources were available. However, examiners noted that the bank's net non-core funding dependency ratio exceeded the bank's peer group, indicating that the bank was relying on short-term liabilities to fund longer-term assets. Further, examiners stated that the bank had not established policy guidelines for its primary, secondary, and dependency liquidity ratios.

At the 2005 examination, examiners again found liquidity to be adequate but noted that the bank was increasing its use of non-core funding. The 2006 examination reported that the bank's liquidity position was satisfactory, with moderate reliance on non-core funding; however, examiners stated that balance sheet liquidity was somewhat limited as a result of the high level of loans in relation to total assets.

The 2008 examination report stated that the bank's net non-core funding dependency ratio was high and examiners expressed concern regarding the bank's reliance on non-core funding given the bank's unsatisfactory condition. Examiners noted that two correspondent banks had revoked Mainstreet's access to unsecured federal funds, and access to brokered deposits would likely be restricted as a result of the bank's *Adequately Capitalized* capital category. Further, the FHLB capped Mainstreet's borrowing ability at 25 percent of total assets and was considering reducing the cap to 20 percent. Examiners also stated that the bank was operating outside of its Asset/Liability Management Policy parameters, which stated that the bank's volatile dependence should not exceed 10 percent. Specifically, in January 2008 and February 2008, the ratios were 20.52 percent and 19.59 percent, respectively.

At the 2009 examination, examiners described the bank's liquidity position as tenuous due to its rapidly deteriorating condition and large operating losses that had depleted capital. As a result, the bank's access to funding was severely impacted by suspensions and restrictions on borrowing lines and the bank's inability to renew Internet certificates of deposit (CD) and brokered deposits.

The FDIC's Supervision of Mainstreet

The FDIC and the MDC conducted annual on-site examinations of Mainstreet consistent with requirements[9] and monitored the bank's condition through the use of various offsite monitoring mechanisms. Beginning in 2004, examiners consistently reported that Mainstreet had high CRE and ADC concentrations and expressed concerns regarding the bank's loan risk rating system and ALLL methodology. However, the bank's overall financial condition was considered satisfactory until the 2008 examination. By then, asset quality had rapidly deteriorated due to the decline in the real estate market.

The FDIC downgraded the institution's ratings and pursued an enforcement action aimed at correcting identified problems. These supervisory actions, and Mainstreet's efforts to address them, were not successful in preventing the bank's failure. The supervisory approach to Mainstreet was consistent with prevailing practices at the time for a bank with Mainstreet's risk profile. A lesson learned, however, is that earlier and more formal supervisory action to mitigate the risk associated with CRE and ADC concentrations, funded with non-core and other potentially volatile deposits, may have been prudent. Specifically, examiners could have recommended that the Board diversify the bank's loan portfolio and required progress reports on the bank's diversification efforts.

[9] 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. Mainstreet met the conditions for the 18-month examination cycle after the 2006 examination.

Supervisory History

Historically, Mainstreet was considered a well-performing institution and consistently received composite "2" supervisory ratings. From 2003 to 2009, the FDIC and the MDC conducted six safety and soundness examinations of Mainstreet, alternating these examinations with the exception of a final joint examination. In addition, prior to the final joint examination, the FDIC conducted a visitation in January 2009.

At the 2006 examination, examiners identified a significant increase in adversely classified assets and downgraded the asset quality component to a "2." Examiners warned management that the high CRE and ADC concentrations could expose the bank to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market but did not make any recommendations regarding diversifying the bank's loan portfolio or decreasing concentrations. By the 2008 examination, the bank's condition had seriously deteriorated and adversely classified assets represented an excessive 150 percent of Tier 1 Capital and the ALLL. Consequently, examiners assigned the bank a composite "4" rating. The FDIC pursued a Cease and Desist Order (C&D) in August 2008 and the bank's Board stipulated to the C&D in December 2008.

The C&D, which became effective on December 11, 2008, required the bank to, among other things:

- Engage an independent consultant to assess the current management and have qualified management in place as outlined in the management assessment.
- Reduce adversely classified assets, including restricting advances to adversely classified borrowers.
- Reduce concentrations of credit.
- Revise the bank's loan policies and procedures.
- Maintain an adequate ALLL.
- Maintain sufficient capital levels.
- Develop a business/strategic plan and profit and budget plan.
- Adhere to restrictions on brokered deposits.
- Correct violations and contraventions of guidelines and policy.
- Submit progress reports.

Despite efforts by the bank to address its problems during 2008 and 2009, the condition of the bank continued to deteriorate, and Mainstreet received a composite "5" rating at both the January 2009 visitation and April 2009 joint examination. Table 6 summarizes Mainstreet's supervisory history during this period, including the supervisory actions taken.

Table 6: Mainstreet's Examination History, 2003 to 2009

Examination Start Date	Agency	Supervisory Ratings (UFIRS)*	Supervisory Action
10/20/03	FDIC	212222/2	N/A
10/13/04	MDC	212222/2	N/A
10/31/05	FDIC	212222/2	N/A
11/08/06	MDC	222222/2	N/A
03/24/08	FDIC	444443/4	Issued C&D.
01/12/09	FDIC Visitation	554544/5	Monitored compliance with the C&D.
04/20/09	MDC/FDIC	554544/5	Continued to monitor compliance with the C&D.

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

Offsite Monitoring

The FDIC's offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. The FDIC generates an offsite review list each quarter and performs offsite reviews for each bank that appears on the list. Offsite reviews must be completed and approved 3½ months after each Call Report date. This generally provides 45 days to complete the offsite reviews once Call Report data are finalized. The system-generated offsite review list includes only institutions rated "1" and "2" that are either:

- identified by the Statistical CAMELS Offsite Rating (SCOR)[10] system as having a 35 percent or higher probability of downgrade to "3" or worse, or

- identified in the Growth Monitoring System (GMS)[11] as having a growth percentile of 98 or 99.

In 2004 and 2005, the FDIC conducted offsite reviews of Mainstreet due to its loan growth. However, the FDIC did not contact the bank's management because, in each instance, a recently completed examination report indicated that Mainstreet's risk management practices were effective. Just prior to the 2005 FDIC examination, Mainstreet was again targeted for review due to the high volume of CRE loans. As part of the examination pre-planning, examiners discussed the bank's CRE lending activities

[10] SCOR is a financial model that uses statistical techniques, offsite data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
[11] GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.

with the bank's president and planned to include an assessment of CRE lending practices during the examination.

In June 2007, an examiner contacted the bank regarding its CRE loans. Bank management responded that: (1) the bank was planning to reduce its loan portfolio in 2007 and not incur new loan growth in 2008, (2) earnings were down due to nonaccrual loans and foreclosures, (3) one of the biggest risks was credit quality, and (4) acquiring core deposits was difficult. Nevertheless, examiners concluded that a supervisory response was not necessary. Later the same month, Mainstreet appeared on the FDIC offsite review list because of the high volume of nonaccrual loans and, to a lesser extent, the high volume of OREO. The FDIC contacted Mainstreet's management on September 5, 2007 and after discussion concluded that the bank's risk profile was stable. Therefore, no change in supervisory status or additional follow-up was deemed necessary prior to an FDIC examination that was scheduled for the second quarter of 2008. Additionally, the FDIC "determined that no specific follow-up was necessary because of the favorable responses provided by bank management, including comments that the volume of problem loans had peaked and collateral margins were strong." The FDIC continued to monitor Mainstreet through its offsite review list each quarter, stating that the bank's risk level was medium and increasing, and accelerated the examination originally scheduled for May 2008 to March 2008.

Supervisory Response to Key Risks

FDIC and MDC officials stated that their supervisory approach to Mainstreet was influenced by the good relationship they had with bank management, bank management's history of operating the institution in safe and sound manner, the low level of adversely classified assets, good earnings, and ADC loans that were pre-sold with permanent financing in place in a healthy real estate market. As a result, examiners did not recommend that Mainstreet management diversify the bank's loan portfolio or decrease its concentrations. However, stronger supervisory action may have been warranted at the 2005 and the 2006 examinations given Mainstreet's risk profile. Although both examinations found the institution's performance to be satisfactory, examiners identified risks within the bank's operations that, as discussed throughout this report, ultimately led to Mainstreet's failure.

The 2005 FDIC Examination

Examiners made a repeat recommendation in 2005 for bank management to include objective criteria in the bank's loan risk rating system and noted that it was unclear from documentation whether the ALLL was being funded at a level commensurate with the risk within the loan account. This condition could have resulted in an underfunded loan loss reserve being reported in Call Reports. With respect to the bank's increasing reliance on non-core funding to support loan growth, examiners did not caution management about the volatile nature of such funds. In addition, examiners reported that the bank had CRE concentrations representing 73 percent of total loans and 824 percent of Tier 1 Capital, yet, they did not recommend that management reduce concentrations or diversify the bank's loan portfolio.

Further, examiners did not make any recommendations regarding the bank's loan policy that had been revised in June 2005. Our review of the revised policy found that, among other things, it lacked concentration limits, underwriting guidance on broker-originated loans, specific guidance on assessing borrowers' creditworthiness, and real estate appraisal review procedures. However, at the 2008 examination, examiners cited these same weaknesses in the bank's loan policy.

The 2006 MDC Examination

Examiners downgraded the bank's asset quality component rating to a "2" in 2006 because of a significant increase in adversely classified assets, and a delinquency rate of approximately 9.4 percent in residential construction loans compared to total loans. In addition, $3.7 million in adversely classified ADC loans were in foreclosure and considered potential OREO, or were transferred as OREO, during the examination. Examiners stated that the bank's balance sheet liquidity was somewhat limited due to the high level of loans in relation to total assets but was adequate given the bank's access to non-core funding sources. Again, examiners did not caution management about the volatile nature of such deposits.

Examiners also noted that the bank's ADC and CRE concentrations were 547 percent and 795 percent of total capital, respectively. Although examiners stated that the high concentrations could expose the bank to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market, they did not recommend that management reduce concentrations or diversify the loan portfolio. A senior MDC official told us that MDC could have been more critical of the concentrations at the 2006 examination and even as early as the 2004 examination.

Examiners stated that management was experienced and had developed good risk management policies and practices for all areas of the bank and made no specific comments on the loan policy and/or broker-originated loans.

The 2008 and 2009 Examinations

At the 2008 examination, examiners attributed the bank's weak financial condition to its liberal lending practices and risk selection with broker-originated mortgages, as well as real estate development lending. Examiners also stated that (1) Board and management performance was unsatisfactory, (2) an excessive volume of adversely classified assets contributed to the deterioration in asset quality, (3) an additional provision to the ALLL would further impact poor earnings, (4) capital was inadequate in relation to the bank's risk profile, and (5) liquidity was deficient.

Broker-originated loans were not mentioned in examination reports prior to the 2008 examination. FDIC officials told us during interviews that the bank did not become heavily involved in broker-originated loans until 2007. However, our review of the Board meeting minutes found that the bank had been engaged in this activity since 2003 and had funded 1,275 broker-originated loans totaling $318.7 million between 2003 and 2005. As stated earlier in the report, broker-originated loans accounted for a significant percentage of the adversely classified assets at the 2008 and 2009 examinations.

In addressing why broker-originated loans were not mentioned in earlier examinations, FDIC regional officials stated that:

> The Bank did fund a large volume of brokered construction loans. Before the downturn in the real estate market, the Bank normally funded these loans through the construction phase, and the loans would ultimately be paid off through end-purchaser or secondary market financing. When the real estate market deteriorated, the refinancing did not occur (the bank relied too heavily on pre-qualification letters without firm take-out commitments), and the Bank was forced to retain them on its balance sheet. At the time of the 2008 examination, $68 million of these loans were retained on the balance sheet.

By the time of the 2009 examination, the bank's condition had further deteriorated. Examiners stated that the Board and management had not demonstrated the ability to correct long-standing problems, address emerging issues, or implement appropriate risk mitigation practices, and that the bank needed an immediate capital injection to be viable.

<u>Asset Quality Ratings and Assessment of Supervisory Action</u>

According to the Examination Manual, several factors should be considered prior to assigning the asset quality rating. They include the:

- adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices;
- diversification and quality of the loan and investment portfolios;
- existence of asset concentrations; and
- ability of management to properly administer its assets, including the timely identification and collection of problem assets.

Given the risks identified, the "1" and the "2" asset quality ratings at the 2005 and 2006 examinations, respectively, may not have been consistent with the UFIRS definitions. Specifically, the "1" rating in asset quality indicates strong asset quality and credit administration practices with weaknesses considered minor in nature and risk exposure modest in relation to capital protection. The "2" rating in asset quality indicates satisfactory asset quality, with weaknesses requiring limited supervisory attention and risk exposure commensurate with capital protection.

Mainstreet did not adequately address examiners' concerns in 2004 and 2005 regarding the bank's risk rating system and ALLL methodology, which resulted in significant levels of adversely classified assets and a seriously deficient ALLL at the 2008 and 2009 examinations. Consistent with the progressive nature of FDIC's supervision, a downgrade in the asset quality component in 2005 may have prompted closer scrutiny and a further downgrade to a "3" in asset quality at the 2006 examination, indicating elevated supervisory concern. At that time, the MDC and/or the FDIC could have initiated an informal action such as a Bank Board Resolution or a Memorandum of Understanding, either of which would have prompted follow-up between examinations.

Although the C&D issued in December 2008 addressed serious deficiencies within Mainstreet, it was not timely given that serious deterioration in the bank's asset quality had already occurred. In hindsight, earlier and stronger supervisory action at the 2005 and 2006 examinations may have been warranted for Mainstreet given its concentrations, broker-originated loans, inadequate risk rating system and ALLL methodology, increasing reliance on volatile funding, and overall poor risk management practices.

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. PCA establishes a system of restrictions and mandatory and discretionary supervisory actions that are to be triggered depending on an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-charted nonmember banks that are not *Adequately Capitalized*. In addition to including provisions in the C&D on minimum capital requirements, the FDIC followed PCA guidance and appropriately notified the bank of its capital position and corresponding requirements, as follows:

- On July 10, 2008, the FDIC notified Mainstreet that it was *Adequately Capitalized* based on the findings from the March 24, 2008 FDIC examination, and recommended that management review the restrictions concerning brokered deposits found in Section 29 of the FDI Act and Section 337.6 of the FDIC Rules and Regulations that apply to *Adequately Capitalized* institutions.[12]

- On October 31, 2008, the FDIC notified Mainstreet that it was *Adequately Capitalized* based on the September 30, 2008 Call Report data and included notification on brokered deposit restrictions.

- On February 2, 2009, the FDIC notified Mainstreet that it was *Undercapitalized* based on the December 31, 2008 Call Report data and advised the Board and management that the bank was subject to restrictions on asset growth, acquisitions, new activities, new branches, dividends, other capital distributions, and management fees. The FDIC also required the bank to submit a Capital Restoration Plan by March 16, 2009.

[12] However, in its June 30, 2008 Call Report, the bank reported itself as *Well Capitalized* as a result of a $3.5 million capital injection. Therefore, according to the FDIC, the bank was *Well Capitalized* until October 30, 2008, when it filed its September 30, 2008 Call Report.

- On May 1, 2009, the FDIC notified Mainstreet that it was *Significantly Undercapitalized*.

- On June 3, 2009, the FDIC notified Mainstreet that it was *Critically Undercapitalized* as a result of the April 20, 2009 joint FDIC/MDC examination and informed bank management of restrictions on asset growth, dividends, other capital distributions, renewing or accepting brokered deposits, and management fees.

As part of the December 2008 C&D, the FDIC required Mainstreet to submit a Capital Restoration Plan and the bank did so on March 11, 2009. On April 28, 2009, the FDIC sent a letter to the bank stating that the plan was unacceptable. On June 12, 2009, Mainstreet submitted a revised Capital Restoration Plan that included the bank selling four of its branches and OREO; the holding company selling White Rock Bank; increasing the ALLL; and the bank obtaining an investor. However, on August 12, 2009, the FDIC informed Mainstreet that the revised plan was unacceptable as it provided little assurance that the bank's capital would be restored in a timely manner.

On November 17, 2008, Mainstreet had submitted an application for $13.5 million in funding under the Troubled Asset Relief Program (TARP).[13] Mainstreet subsequently withdrew its application on February 25, 2009. On August 28, 2009, the MDC closed Mainstreet due to its insolvency.

Corporation Comments

We issued a draft of this report on March 4, 2010. After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On March 23, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report.

In its response, DSC reiterated the OIG's conclusions regarding the cause of Mainstreet's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. DSC also noted that strong supervisory attention is necessary for institutions with high ADC and CRE concentrations and volatile funding sources, such as Mainstreet, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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[13]TARP was established under the Emergency Economic Stabilization Act of 2008. The Act established the Office of Financial Stability within the United States Department of the Treasury (Treasury). Under TARP, Treasury will purchase up to $250 billion of senior preferred shares from qualifying institutions as part of the Capital Purchase Program.

Objectives, Scope, and Methodology

Objectives

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

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

We conducted the audit from December 2009 to March 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

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

- Analyzed examination and visitation reports prepared by the FDIC and the MDC from 2003 to 2009.

- Analyzed available examination work papers prepared by the FDIC from 2008 and 2009.

- Reviewed the following:

    - Bank data contained in UBPRs and Call Reports.
    - Correspondence maintained at the DSC's Kansas City Regional Office and Minneapolis Field Office.
    - Reports prepared by the Division of Resolutions and Receiverships and DSC related to the bank's closure.
    - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

    - DSC management in Kansas City, Kansas and Minneapolis, Minnesota.

Objectives, Scope, and Methodology

- FDIC examiners from the Minneapolis Field Office who participated in Mainstreet examinations.

- Interviewed a senior MDC official from Minneapolis, Minnesota, to discuss his historical perspective of the institution, its examinations, and other activities regarding the MDC's supervision of the bank.

We performed our audit field work at OIG offices in Arlington, Virginia, and Dallas, Texas.

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

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

We obtained data from various FDIC systems, but we determined that the 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 was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG program audits of DSC operations.

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	General valuation allowances that have been established through charges against earnings to absorb losses on loans and lease financing receivables. Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
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	The report filed by a bank pursuant to 12 U.S.C. 1817(a)(1), which requires each insured State nonmember bank and each foreign bank having an insured branch which is not a Federal branch to make to the Corporation reports of condition in a form and that shall contain such information as the Board of Directors may require. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
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.
Federal Home Loan Bank (FHLB)	The Federal Home Loan Bank System provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to its members. Advances are available to members with a wide variety of terms to maturity, from overnight to long-term, and are collateralized. Advances are designed to prevent any possible loss to FHLBs, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail. To protect their position, FHLBs have a claim on any of the additional eligible collateral in the failed bank. In addition, the FDIC has a regulation that reaffirms FHLB priority, and FHLBs can demand prepayment of advances when institutions fail.

Glossary of Terms

Loan-to-Value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.
Memorandum of Understanding (MOU)	An informal corrective administrative action for institutions considered to be of supervisory concern but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, this action is to be considered for all institutions rated a composite "3."
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.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
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
CD	Certificate of Deposit
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GAAP	Generally Accepted Accounting Principles
LTV	Loan-to-Value
MDC	Minnesota Department of Commerce
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
ROE	Report of Examination
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

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

March 22, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Mainstreet Bank, Forest Lake, Minnesota (Assignment No. 2009-073)

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 Mainstreet Bank, Forest Lake, Minnesota (MB) which failed on August 28, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on March 4, 2010.

The Report concludes MB failed due to the Board and management's aggressive pursuit of loan growth centered in residential acquisition, development, and construction (ADC) loans, which included broker originated loans. These loans were primarily funded with brokered deposits, Federal Home Loan Bank borrowings, and large time deposits. MB management's liberal lending practices and decision to concentrate the loan portfolio in commercial real estate (CRE); its aggressive growth in residential ADC lending and participations; and its reliance on brokered and large deposits were the principal factors leading to MB's deteriorating financial condition and failure. MB's overall weak loan administration and deterioration of the local Minneapolis-St. Paul metropolitan real estate markets resulted in increased delinquencies and an excessive volume of low quality assets. MB's decision to expand by adding a commercial loan office in the fourth quarter of 2007, and purchasing assets from another bank in February 2008, contributed to a higher risk profile and unprofitability.

As part of DSC's supervisory program, from 2005 through August 2009, the FDIC and the State of Minnesota Department of Commerce Division of Financial Institutions jointly and separately conducted four full-scope examinations. At the March 2008 examination, examiners downgraded asset quality and noted a heightened risk due to high concentrations in large construction and land development lending. As a result of the March 2008 examination, DSC issued a formal enforcement action. At the January 2009 joint examination, examiners found that MB was only viable with an immediate capital injection, which MB was unable to raise.

As noted in the Report, DSC issued timely guidance to all insured institutions, and examiners made specific recommendations to MB's management concerning elevated risk resulting from CRE concentrations. DSC recognizes that strong supervisory attention is necessary for institutions with high ADC/CRE concentrations and volatile funding sources, such as MB, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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