Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-019

Material Loss Review of Founders Bank, Worth, Illinois and Rock River Bank, Oregon, Illinois

February 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On July 2, 2009, the Illinois Department of Financial and Professional Regulation (IDFPR) closed Founders Bank (Founders), Worth, Illinois and Rock River Bank (Rock River), Oregon, Illinois and named the FDIC as receiver. On August 12, 2009, the FDIC notified the Office of Inspector General (OIG) that Founders' total assets at closing were $911 million and the estimated loss to the Deposit Insurance Fund (DIF) was $173 million and Rock River's total assets at closing were $73 million and the estimated loss to the DIF was $27 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failures. Because both institutions were under common ownership and followed a similar business model, we addressed both failures in one report.

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

Background

Founders and Rock River were part of a complex chain banking organization consisting of nine FDIC-insured institutions under the collective control of the Lyle Campbell family and their related interests (referred to as the Campbell Group). All of the institutions within the Campbell Group were considered affiliates based on section 23A of the Federal Reserve Act made applicable to insured nonmember banks by section 18(j) of the FDI Act, which establishes certain requirements, restrictions, and prohibitions with regard to transactions among the banks.

Founders was established in 1961 as a state-chartered nonmember institution. The institution operated 12 branches in the suburban areas of Chicago, Illinois and was wholly-owned by the Founders Group, Inc., a two-bank holding company that provided managerial and operational services to other institutions in the Campbell Group. Prior to 2005, Founders' assets consisted primarily of commercial real estate (CRE) loans and government securities. Founders began purchasing complex structured credit products known as collateralized debt obligations (CDO) in late 2005. Founders also began purchasing out-of-area acquisition, development, and construction (ADC) loan participations from an affiliate in 2006.

Rock River was established in 1935 as a state-chartered nonmember institution. The institution operated four branches in northern Illinois and was wholly-owned by Rock River Bancorp, Inc., a one-bank holding company located in Oregon, Illinois. Rock River's assets traditionally consisted of CRE loans and government securities. Similar to Founders, Rock River began purchasing CDOs and ADC loan participations in 2005.

Audit Results

Causes of Failures and Material Losses

Founders and Rock River failed primarily because their Boards and management did not effectively manage the risk associated with significant investments in risky CDOs. Between the fourth quarter of 2005 and July 2007, Founders and Rock River purchased approximately $41 million and $7.7 million, respectively, in CDOs without establishing and implementing appropriate risk management controls. Of note, neither institution performed appropriate pre-purchase analysis or established formal investment policies that addressed CDOs before investing in these securities. In addition, the institutions did not establish prudent limits on their CDO investments, nor did they effectively monitor or manage the securities after purchase. When the downturn in the banking industry occurred in 2008, the CDOs quickly lost value and became illiquid, threatening the viability of both institutions.

Also contributing to the failures of Founders and Rock River was a deterioration in the institutions' CRE and ADC loan portfolios. Both institutions had CRE concentrations that included out-of-area ADC loan participations for which the institutions had not performed proper due diligence. Weaknesses in the ADC loan participations, together with a concentration in CRE loans, made both institutions vulnerable to a sustained downturn in the real estate market. Although not a primary cause of failure, Founders and Rock River also funded poorly underwritten loans to insiders of the Campbell Group and to outside officers of the failed Strategic Capital Bank that added to the institutions' losses. IDFPR closed Founders and Rock River because the institutions were operated in an unsafe and unsound manner and were unable to raise sufficient capital to provide adequate protection for their depositors.

The FDIC's Supervision of Founders and Rock River

The FDIC, in coordination with IDFPR, provided ongoing supervisory oversight of Founders and Rock River through regular on-site risk management examinations, targeted reviews, and offsite monitoring activities. Although not required, the FDIC also performed an on-site central review in August 2008 of the managerial and operational services provided by the Founders Group, Inc. to other institutions in the Campbell Group. Through its supervisory efforts, the FDIC identified risks at Founders and Rock River and brought these risks to the attention of the institutions' Boards and management.

A key lesson learned with respect to the failures of Founders and Rock River is that when institutions make significant investments in complex structured credit products without appropriate risk management controls, such practices become unsafe and unsound and require a strong supervisory response. In the cases of Founders and Rock River, both institutions had significant concentrations in CDOs with credit risk ratings equal to, or slightly above, the lowest investment grade that is generally permissible for insured institutions. Although examiners recommended in 2005 and 2006 that Founders and Rock River establish investment policies to address their CDO investments, the actions taken by the institutions to address those recommendations were not timely or adequate. A stronger supervisory response could have included conducting visitations, targeted reviews, or follow-up between regular examinations to assess the progress of recommended corrective actions; requiring the institutions to increase their capital holdings; and/or downgrading the institutions' supervisory ratings and pursuing enforcement actions, if appropriate.

The FDIC's central review of the Campbell Group represented a proactive supervisory strategy for identifying key risks in the Campbell Group that might not have otherwise been identified through individual examinations or other offsite monitoring activities. Given the effectiveness of the strategy in this case, the FDIC may find it beneficial to clarify its procedures for conducting chain bank reviews to describe more clearly this type of on-site central review and under what circumstances the review should be performed. In addition, with respect to the heavy volume of out-of-area loan participations purchased in 2006 and continuing through April 2008, examiners could have expressed concern regarding the lack of due diligence by Founders and Rock River and recommended that the institutions implement stronger risk management controls in this area at examinations conducted in 2006 and 2007.

Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered based on an institution's capital levels. Based on the supervisory actions taken with respect to Founders and Rock River, the FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act.

Management Response

The Director, Division of Supervision and Consumer Protection (DSC), provided a written response to a draft of this report on February 12, 2010. In the response, DSC concurred with our conclusions regarding the causes of failures. With regard to our assessment of the FDIC's supervision of Founders and Rock River, DSC summarized several supervisory actions taken in relation to the institution's activities. DSC also noted that stronger supervisory follow-up to assess the progress of recommended corrective actions would have been prudent for both institutions, particularly with respect to managing the risks inherent in the CDO portfolios. In that regard, DSC stated that it has issued updated guidance addressing risk management of investments in structured credit products that provides clarification to existing guidance and strongly urges insured institutions to revisit this existing guidance.

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FDIC

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

Office of Material Loss Reviews
Office of Inspector General

DATE: February 12, 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 Founders Bank, Worth, Illinois and Rock River Bank, Oregon, Illinois*
(Report No. MLR-10-019)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failures of Founders Bank (Founders), Worth, Illinois and Rock River Bank (Rock River), Oregon, Illinois. Both institutions were closed on July 2, 2009 by the Illinois Department of Financial and Professional Regulation (IDFPR), which appointed the FDIC as receiver. On August 12, 2009, the FDIC notified the OIG that Founders' total assets at closing were $911 million and the estimated loss to the Deposit Insurance Fund (DIF) was $173 million and Rock River's total assets at closing were $73 million and the estimated loss to the DIF was $27 million. Because both institutions were under common ownership and followed a similar business model, we have addressed both failures in this report.

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

The objectives of our review were to (1) determine the causes of failure for Founders and Rock River and the resulting material losses to the DIF and (2) evaluate the FDIC's supervision[2] of the institutions, including the FDIC's implementation of the PCA

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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.

provisions of section 38 of the FDI Act. This report presents the FDIC OIG's analysis of the failure of Founders and Rock River and the FDIC's efforts to ensure that the Boards of Directors (Boards) and management operated each institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our material loss 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 DSC'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; Appendix 3 contains a list of acronyms; and Appendix 4 contains information pertaining to the ownership of Founders and Rock River. Appendix 5 contains the Corporation's comments on this report.

Background

Founders and Rock River were part of a complex chain banking organization consisting of nine FDIC-insured institutions under the collective control of the Lyle Campbell family and their related interests (referred to herein as the Campbell Group). The FDIC and the Board of Governors of the Federal Reserve System determined that the Campbell Group was under the presumptive control of the Campbell family because various members of the family served on the Boards, held various management positions, and/or had a direct or indirect ownership interest in each institution or its holding company. All of the institutions within the Campbell Group were considered affiliates based on Section 23A of the Federal Reserve Act made applicable to insured nonmember banks by Section 18(j) of the FDI Act.[3] Six of the nine institutions in the Campbell Group were closed on July 2, 2009. Table 1 provides selected financial and regulatory information pertaining to these six institutions.

Table 1: Selected Information for Failed Institutions in the Campbell Group

Institution Name	Total Assets (millions)	Estimated Loss to the DIF (millions)	Loss Percentage (related to Total Assets)	Primary Federal Regulator
Founders	$911.1	$173.0	19.0%	FDIC
Rock River	$73.4	$27.2	37.1%	FDIC
John Warner Bank	$66.9	$9.9	14.8%	FDIC
Elizabeth State Bank	$56.7	$11.1	19.6%	FDIC
The First State Bank of Winchester	$31.0	$5.5	17.7%	FDIC
First National Bank of Danville	$153.9	$20.1	13.1%	Office of the Comptroller of the Currency (OCC)
Total	**$1,293.0**	**$246.8**	**19.1% (average)**	

Source: Financial reports prepared by the FDIC's Division of Finance as of August 12, 2009.

[3] See the glossary for more information regarding Section 23A's definition of affiliates.

Founders

Established in 1961 as a state-chartered nonmember institution, Founders was the largest of the nine institutions in the Campbell Group. Founders operated a total of 12 branch offices in the southern suburban areas of Chicago, Illinois, and was wholly-owned by the Founders Group, Inc., a two-bank holding company which also owned the First National Bank of Danville. The Founders Group, Inc. provided key managerial and operational services to other institutions in the Campbell Group on a consolidated basis. Such services included accounting, capital management, information technology, internal audit, and investment management. Prior to 2005, Founders' assets consisted primarily of commercial real estate (CRE) loans and U.S. Treasury, agency,[4] and municipal securities. As discussed more fully in this report, Founders began investing in complex structured credit products known as collateralized debt obligations (CDO) in late 2005. Founders also began purchasing out-of-area acquisition, development, and construction (ADC) loan participations from an affiliate institution in the Campbell Group in 2006.

The FDIC and IDFPR considered the management team at Founders to be experienced and capable, as reflected in the supervisory component ratings[5] of "1" assigned for management at every examination between 1998 and 2007. Table 2 summarizes selected financial information pertaining to Founders as of June 30, 2009 and for the 4 preceding calendar years.

Table 2: Selected Financial Information for Founders

Financial Measure	Jun-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	889,172	930,707	972,975	954,508	895,579
Total Loans ($000s)	585,259	614,883	641,154	617,274	577,539
Total Deposits ($000s)	832,160	791,550	798,348	773,081	728,912
Return on Assets (%)	(7.73)	(.61)	.53	.95	1.11
Tier 1 Leverage Capital Ratio (%)	2.12	5.92	6.58	6.70	7.07

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

Rock River

Established in 1935 as a state-chartered nonmember institution, Rock River operated four branches in northern Illinois. The institution was wholly-owned by the Rock River Bancorp, Inc., a one-bank holding company located in Oregon, Illinois. Rock River's assets traditionally consisted of CRE loans and U.S. Treasury, agency, and municipal securities. Similar to Founders, Rock River began investing in CDOs and purchasing

[4] Agency securities are issued by U.S. government-sponsored agencies, such as the Government National Mortgage Association, Federal National Mortgage Association, and Federal Home Loan Mortgage Corporation. Such securities may be explicitly or implicitly backed by the U.S. Government.

[5] Pursuant to the Uniform Financial Institutions Rating System (UFIRS), federal and state regulators assign supervisory ratings to financial institutions based on the results of safety and soundness examinations and other supervisory activities. Ratings consist of a "composite" rating reflecting the institution's overall financial condition and operations and six "component" ratings 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. Ratings are assigned on a scale of 1 to 5, with 1 representing the least supervisory concern and 5 representing the greatest supervisory concern.

ADC loan participations from an affiliate in the Campbell Group in 2005. The FDIC and IDFPR considered Rock River's management to be experienced and capable, as reflected in the management component ratings of "1" or "2" assigned by examiners from the late-1980s through 2007. Table 2 summarizes selected financial information pertaining to Rock River as of June 30, 2009 and for the 4 preceding calendar years.

Table 3: Selected Financial Information for Rock River

Financial Measure	Jun-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	74,808	77,332	87,303	74,098	69,647
Total Loans ($000s)	49,598	54,038	53,176	39,880	37,294
Total Deposits ($000s)	74,896	66,364	60,216	54,834	53,240
Return on Assets (%)	(13.75)	(.64)	.75	.25	.70
Tier 1 Leverage Capital Ratio (%)	0	6.01	7.17	6.85	8.86

Source: UBPRs for Rock River.

Causes of Failures and Material Losses

Founders and Rock River failed primarily because their Boards and management did not effectively manage the risk associated with significant investments in risky CDOs. Between the fourth quarter of 2005 and July 2007, Founders and Rock River purchased approximately $41 million and $7.7 million, respectively, in CDOs without establishing and implementing appropriate risk management controls. Of note, neither institution performed appropriate pre-purchase analysis or established formal investment policies that addressed CDOs before investing in these securities. In addition, the institutions did not establish prudent limits on their CDO investments, nor did they effectively monitor or manage the securities after purchase. When the downturn in the banking industry occurred in 2008, the CDOs quickly lost value and became illiquid, threatening the viability of both institutions.

Also contributing to the failures of Founders and Rock River was a deterioration in the institutions' CRE and ADC loan portfolios. Both institutions had CRE concentrations that included out-of-area ADC loan participations for which the institutions had not performed proper due diligence. Weaknesses in the ADC loan participations, together with a concentration in CRE loans, made both institutions vulnerable to a sustained downturn in the real estate market. Although not a primary cause of failure, Founders and Rock River also funded poorly underwritten loans to insiders of the Campbell Group and to outside officers of the failed Strategic Capital Bank (Strategic)[6] that added to the institutions' losses.

By March 2009, the losses and provisions associated with Founders' and Rock River's CDO investments and CRE loans had eliminated the institutions' earnings and depleted their capital. IDFPR closed Founders and Rock River on July 2, 2009 because the

[6] Our report entitled, *Material Loss Review of Strategic Capital Bank*, Champaign, Illinois (Report No. MLR-10-007) provides information regarding the causes of Strategic's failure and the FDIC's supervision of the institution.

institutions were operated in an unsafe and unsound manner and were unable to raise sufficient capital to provide adequate protection for their depositors.

Investments in CDOs

Overall investment policy and related decision-making for institutions within the Campbell Group was centrally managed by a single Investment Officer working in the Founders Group, Inc. In addition to serving as the Campbell Group's Investment Officer, this individual also held Board positions at other institutions within the chain, including Founders and Rock River. In an effort to improve asset yields within the Campbell Group, the Investment Officer began purchasing CDOs in the fourth quarter of 2005 and allocating these securities to institutions throughout the chain. By March 31, 2007, a total of 18 CDOs with a value of over $89 million had been purchased. Table 4 summarizes the value of CDOs held by the six institutions[7] in the Campbell Group that have failed, as well as the percentage of Tier 1 Capital that these securities represented at each institution.

Table 4: Value of CDOs Held by Failed Institutions in the Campbell Group as of March 31, 2007

Institution Name	Book Value of CDOs (in millions)	CDO Holdings as a Percentage of Tier 1 Capital
Founders	**$41.3**	**62%**
Rock River	**$7.7**	**144%**
Elizabeth State Bank	$8.1	165%
The First State Bank of Winchester	$3.0	126%
John Warner Bank	$11.1	173%
First National Bank of Danville	$18.1	123%
Total	**$89.3**	

Source: Analysis of CDO holdings prepared by the Division of Resolutions and Receiverships (DRR).

The majority of CDOs purchased by Founders and Rock River were collateralized by Trust Preferred Securities (TruPs), instruments often issued by financial institutions, their holding companies, and insurance companies for the purpose of raising capital. The remaining CDOs were collateralized by real estate investment trusts (REIT) which held CRE properties and ADC investments. Importantly, over 80 percent of the CDOs purchased by the Campbell Group had a credit risk rating that was equal to, or slightly above, the lowest investment grade that is generally permissible for insured institutions. Legal requirements generally provide that when institutions acquire investment securities, the securities must carry an investment grade rating, or if not rated, the securities must have the credit equivalent of investment grade.[8]

[7] Two of the three open institutions in the Campbell Group also hold CDOs. However, the CDO holdings at these institutions represent a lower percentage of Tier 1 Capital than the institutions listed in Table 4.
[8] Part 362, *Activities and Investments of Insured State Banks*, of the FDIC Rules and Regulations generally prohibits investment activities that are not permissible for national banks, with certain exceptions. See the OCC's *Activities Permissible for a National Bank, Cumulative*, dated April 2009, for more information.

The low credit rating assigned to the CDOs reflected the relatively low priority for payment and collateral (often referred to as a "tranche") that the holders of the securities had in the event that the underlying obligators defaulted on their payments. The figure below illustrates the three basic tranches associated with a CDO as well as the credit ratings that are often assigned by major credit rating agencies to each tranche. The figure also depicts the relative priority in the event of default, credit risk, and expected yields associated with each tranche. A key point is that the lower the CDO tranche, the riskier the investment.

Figure: Example of a Typical CDO Tranche Structure and Associated Risks

Tranche	Credit Rating	Priority in the Event of Default	Credit Risk	Expected Yield
Senior	AAA	Highest	Lowest	Lower
Mezzanine	AA, A, BBB	↑	↓	↓
Equity	BB, B, CCC	Lowest	Highest	Higher

Source: OIG analysis of publicly available information from credit rating agencies.

The Investment Officer determined that the CDOs purchased and allocated to the institutions in the Campbell Group represented an acceptable risk because the underlying TruPs were diversified among hundreds of regulated institutions and the securities carried an investment grade. During 2006, when the majority of the CDOs were purchased, insured institutions were experiencing record profits, and failures within the banking industry were at an historic low. However, the decision to purchase the CDOs represented a departure from the conservative investment approach at Founders and Rock River of purchasing low-risk government and agency securities. Notably, the risks, terms, ratings, yields, liquidity, and underlying assets of the CDOs were significantly different from the majority of the institutions' prior investments. However, neither institution adequately strengthened its investment management controls to address the increased risk associated with the CDOs. Among other things, the Boards and management of Founders and Rock River did not:

- Perform appropriate pre-purchase risk analysis before acquiring the CDOs. Such an analysis would have included assessing the performance of the CDOs under a variety of possible scenarios (e.g., changes in underlying payment deferrals and defaults) using a methodology consistent with the complexity of the securities.

- Establish formal investment policies that addressed CDOs before purchasing the securities.

When institutions change their investing practices to take on more credit risk without appropriate credit due diligence, limits, and guidelines (including higher capital when needed), such practices become unsafe and unsound. The further down the credit quality spectrum an institution invests, the more critical it becomes to supplement ratings from credit rating agencies with internal credit analysis. External credit ratings are often lagging indicators of credit quality.

OCC Bulletin, entitled *Unsafe and Unsound Investment Portfolio Practices*, dated May 22, 2002.

- Establish an investment committee to assess and manage the risk associated with the CDOs until February 2009. Prior to that time, CDO investment decisions for institutions in the Campbell Group (including Founders and Rock River) were made by the Investment Officer.

- Establish appropriate limits (e.g., a percentage of each institutions' Tier 1 Capital) on the amount of CDOs that could be purchased.

- Develop a viable "exit strategy" in the event that CDO market conditions became adverse.

- Implement adequate methodologies to value the CDOs.

The Federal Financial Institutions Examination Council's publication, entitled *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, effective May 26, 1998, states that the institution's Board is responsible for approving major policies for conducting investment activities and establishing associated risk limits. To properly discharge its oversight responsibilities, the Board should review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits. The Board should also have an adequate understanding of investment activities. This is particularly important for products that have unusual, leveraged, or highly variable cash flows. Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. The Board minutes for Founders and Rock River contained limited information pertaining to the CDOs prior to 2008.

Based on recommendations contained in the October 2006 examination report for Founders, the Investment Officer for the Campbell Group revised the organization's investment policy to incorporate CDO investment guidelines and practices. However, the revision to allow CDO investments occurred in August 2007, after all 18 CDOs had been purchased. Further, the investment policy, as amended, allowed each institution in the Campbell Group to purchase CDOs in an amount of up to 175 percent of Tier 1 Capital. This high limit presented an elevated risk and was set at this level to ensure that all institutions in the Campbell Group would be in compliance with the investment policy. Further, the revision did not fully address CDO due diligence and monitoring, including documentation requirements. In addition, although information regarding investment activities continued to be provided to the Boards of Founders and Rock River, the directors did not perform an investment portfolio risk assessment or a comprehensive portfolio review that an investment committee would typically perform.

During the fall of 2007, some of the CDOs purchased by the Campbell Group, particularly those collateralized by REITs, began to lose value due to defaults by the underlying obligors. Based on the decline in the CDO markets, the Campbell Group revised its investment policy in April 2008 to prohibit any further investments in CDOs. By July 2008, the majority of the CDOs collateralized by REITs had fallen below investment grade and lost a significant portion of their value. In addition, the CDOs collateralized by TruPs were declining in value because the underlying issuers were either deferring or defaulting on their payments. At that time, the Investment Officer decided that the institutions in the Campbell Group (including Founders and Rock River) would hold the CDOs with the cautious expectation that the CDO market would eventually improve and become liquid.

By the close of 2008, the decline in the CDO market and the illiquidity of the securities made it difficult to determine their value. For calendar year 2008, Founders and Rock River recognized losses of $2.1 million and $0.6 million, respectively, pertaining to their CDO investments. Founders and Rock River recognized additional losses of $28 million and $4.3 million, respectively, for their CDO investments as of March 31, 2009. These losses resulted in Founders falling from a *Well Capitalized* to a *Significantly Undercapitalized* position for purposes of PCA. However, because Rock River's CDOs represented a much larger percentage of its Tier 1 Capital than Founders, Rock River fell from a *Well Capitalized* to a *Critically Undercapitalized* position.

CRE Concentrations and ADC Loan Participations

Much of Founders' and Rock River's lending pertained to real estate, particularly CRE. As of December 31, 2007, approximately 68 percent of Founders' $644.1 million loan portfolio and 57 percent of Rock River's $53.2 million loan portfolio consisted of CRE loans. As reflected in Table 5, Founders and Rock River had high concentrations in CRE loans relative to total capital as compared to their peer groups.[9] These concentrations made the institutions vulnerable to a sustained downturn in the real estate market.

Table 5: Founders' and Rock River's CRE Concentrations Compared to Peer Groups

Year Ended	Founders CRE Relative to Total Capital	Peer Group Average and Percentile Ranking	Rock River CRE Relative to Total Capital	Peer Group Average and Percentile Ranking
Dec – 08	550%	380% (81 percentile)	438%	148% (96 percentile)
Dec – 07	525%	377% (79 percentile)	453%	146% (98 percentile)
Dec – 06	532%	371% (81 percentile)	368%	147% (94 percentile)
Dec – 05	570%	358% (87 percentile)	301%	144% (89 percentile)

Source: UBPRs for Founders and Rock River.

In addition, between 2006 and 2008, Founders and Rock River purchased out-of-area loan participations from an affiliate institution within the Campbell Group. Most of the participations pertained to ADC. By June 30, 2008, Founders held 32 loan participations from the affiliate, totaling about $87 million (or 132 percent of its total capital). As of September 30, 2008, Rock River held 5 loan participations from the affiliate, totaling approximately $7 million (or almost 100 percent of its total capital). Based on our review of the 2008 examination reports and working papers, relevant institution records, and

[9] 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. Founders' peer group included institutions with assets between $300 million and $1 billion and Rock River's peer group included institutions with assets between $50 million and $100 million.

DRR records for Founders, Rock River, and the affiliate institution, we noted the following with respect to the out-of-area ADC loan participations:

- Little to no due diligence was performed by Founders or Rock River prior to acquiring the loan participations from the affiliate. Many of the loan participations were poorly underwritten (e.g., insufficient financial information on borrowers, reliance on outdated appraisals, and inappropriate use of interest reserves).

- Several of the loan participations were for speculative land and land development projects.

According to the DSC *Risk Management Manual of Examination Policies* (Examination Manual), institutions purchasing loan participations must make a thorough, independent evaluation of the transactions and the risks involved before committing any funds. Institutions should also apply the same standards of prudence, credit assessment, approval criteria, and “in-house” limits that would be employed if the purchasing organization were originating the loan. However, because of their common ownership in the Campbell Group, Founders and Rock River relied on the underwriting of the affiliate institution that originated the loans rather than making independent assessments of the loans prior to purchase.

When Founders’ and Rock River’s local and out-of-area lending markets declined in 2007 and 2008, both institutions experienced deterioration in the quality of their loan portfolios. Of the $88 million in loans that examiners adversely classified at Founders’ October 2008 examination, the vast majority pertained to CRE loans (including $15 million in ADC loan participations). Similarly, the majority of the $5.5 million in loans that examiners adversely classified at Rock River’s October 2008 examination pertained to CRE loans (including a $1.4 million ADC loan participation). Based on our review of DRR records, we found that the majority of the approximately $94 million in loan participations purchased by Founders and Rock River were either non-performing and/or considered special mention as of December 2009.

Loans to Insiders and Outside Officers of Strategic

Founders and Rock River made a number of poorly underwritten loans to insiders within the Campbell Group and to outside officers of Strategic, which failed on May 22, 2009. Although not a primary cause of failure, these loans added to the losses at both Founders and Rock River.

Loans to Insiders

A central review[10] of the Campbell Group performed by the FDIC in August 2008 found that the institutions within the chain collectively held over $15 million of insider loans as of June 30, 2008. Of this amount, Rock River held three loans totaling $1.8 million.[11] All three of Rock River's insider loans were approved on an unsecured basis and with minimal documentation and financial analysis. Examiners adversely classified one of these three loans valued at $900,000 in the October 2008 examination and noted an apparent violation of the Federal Reserve Board's Regulation O due to the elevated risk of repayment when the loan was approved. Examiners also noted an apparent violation of Part 337 of the FDIC Rules and Regulations in connection with another of the three insider loans valued at $800,000. The apparent violation of Part 337 was noted because the loan exceeded the amount permitted by the regulation. All three insider loans were charged off as loss in 2009.

Loans to Outside Directors of Strategic

In March 2008, Founders funded loans totaling $12.3 million to five officers of Strategic for the purpose of purchasing shares in Strategic Capital Bancorp, Inc., the holding company of Strategic. The underwriting of these loans was significantly deficient. Among other things, the loans provided 100 percent financing for the shares, with the shares securing the loans. However, Founders accepted a share price of $300 provided by the borrowers without performing an independent valuation of the shares. In addition, although Founders' loan policy limited advances for stock loans to 50 percent of the stock's book value, the advance for the Strategic stock was 175 percent of book value. In July and September 2008, all but $1.2 million of the $12.3 million in loans were sold to the First National Bank of Danville, another institution in the Campbell Group. In May 2009, $8.9 million of the $12.3 million in loans were charged off, including the $1.2 million that Founders held.

The FDIC's Supervision of Founders and Rock River

The FDIC, in coordination with IDFPR, provided ongoing supervisory oversight of Founders and Rock River through regular on-site risk management examinations, targeted reviews, and offsite monitoring activities. Although not required by regulation or policy, as referenced above, the FDIC also performed a 2-week, on-site central review in August 2008 of the managerial and operational services provided by the Founders Group, Inc. to other institutions in the Campbell Group. This review was instrumental in identifying a number of key risks affecting institutions in the Campbell Group, including Founders and Rock River. Through its supervisory efforts, the FDIC identified risks at Founders and Rock River and brought these risks to the attention of the institutions' Boards and management.

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[10] Central review was the name given by the FDIC to a consolidated review of certain operations and functions within the Campbell Group.
[11] According to the central review, Founders did not hold any insider loans as of June 30, 2008.

A key lesson learned with respect to the failures of Founders and Rock River is that when institutions make significant investments in complex structured credit products without appropriate risk management controls, such practices become unsafe and unsound and require a strong supervisory response. Although examiners recommended in 2005 and 2006 that Founders and Rock River establish investment policies to address their CDO investments, the actions taken by the institutions to address these recommendations were not timely or adequate.

In addition, the FDIC's central review of the Campbell Group represented a proactive, supervisory approach for identifying potential risks that might not have otherwise been identified through individual examinations or other offsite monitoring activities. Given the effectiveness of the strategy in this case, the FDIC may find it beneficial to clarify its procedures for conducting chain bank reviews to describe more clearly this type of on-site central review and under what circumstances the review should be performed. Finally, with respect to the heavy volume of out-of-area loan participations purchased in 2006 and continuing through April 2008, examiners could have expressed concern regarding the lack of due diligence by Founders and Rock River and recommended that the institutions implement stronger risk management controls in this area at earlier examinations.

Supervisory History

The FDIC and IDFPR conducted four on-site risk management examinations of both Founders and Rock River between 2005 and the institutions' failures. Notably, the FDIC accelerated the examination schedule for Rock River in 2008 to help ensure effective coordination with the examination of Founders, including consistent treatment of examination findings. Tables 6 and 7 summarize key supervisory information pertaining to these examinations.

Table 6: On-site Examinations of Founders

Examination Date	Regulator Conducting the Examination	Supervisory Ratings	Informal or Formal Action* Taken
10/06/08	FDIC	555544/5	C&D
09/10/07	IDFPR	221212/2	None
10/02/06	FDIC	211122/1	None
09/06/05	IDFPR	211121/1	None

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for Founders.
* Informal corrective actions often take the form of Bank Board Resolutions or Memorandums of Understanding. Formal corrective actions often take the form of Cease and Desist orders (C&D), but under severe circumstances can also take the form of insurance termination proceedings.

Table 7: On-site Examinations of Rock River

Examination Date	Regulator Conducting the Examination	Supervisory Ratings	Informal or Formal Action Taken
10/20/08	FDIC	555544/5	C&D
12/03/07	IDFPR	212212/2	None
11/13/06	FDIC	112212/2	None
12/12/05	IDFPR	111222/1	None

Source: OIG analysis of examination reports and information in the FDIC's Virtual Supervisory Information on the Net system for Rock River.

The FDIC's offsite monitoring procedures generally consisted of (1) contacting the institution's management from time to time to discuss current and emerging business issues and concerns, (2) using automated tools[12] to help identify potential supervisory concerns, and (3) conducting Chain Organization Reviews of the Campbell Group in November 2006 and November 2009. The purpose of the Chain Organization Reviews, which are required to be performed every 3 years according to the FDIC's *Case Manager Procedures Manual*,[13] was to assess the overall risk profile and financial condition of, and help formulate a supervisory strategy for, institutions in the Campbell Group. The November 2006 review found that the institutions in the Campbell Group had a history of sound financial performance and that their asset quality was satisfactory to strong. Although the review noted that the Campbell Group had an elevated level of debt, the review determined that the debt was manageable based on the organization's earnings and cash flow.

Unlike the Chain Organization Review, which is an offsite monitoring procedure, the FDIC's central review entailed a more in-depth, on-site assessment of potential risks in the Campbell Group. The purpose of the central review was to achieve efficiencies in the individual examinations of institutions in the Campbell Group, identify potential risks warranting further review in upcoming examinations, and ensure consistent treatment of examination findings. The central review was instrumental in identifying the rapid deterioration in CDO investments, the high level of unsecured and poorly underwritten loans to insiders, and the loosening of underwriting practices. Based on concerns identified during the central review, the FDIC, in coordination with the OCC, conducted targeted, on-site reviews of the Campbell Group's CDO investments in December 2008 and February 2009. These reviews identified serious deficiencies in the methodology used to value the CDOs and determined that the securities had lost a significant portion of their value. The results of the targeted reviews were provided to the examination teams assigned to each Campbell Group institution, including Founders and Rock River.

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

[13] The *Case Manager Procedures Manual* states that Chain Organization Reviews must be performed for chain banking organizations with less than $3 billion in total assets at least every 3 years. Reviews for chain banking organizations with total assets greater than $3 billion should be performed annually.

As noted in the Background section of the report, all of the institutions in the Campbell Group were considered to be affiliates for purposes of Section 23A of the Federal Reserve Act. Regulators recognize that transactions among affiliates may not be subject to the same type of analysis that exists in transactions between independent parties due to the influence of common ownership or management between the parties. As such, the examinations of Founders and Rock River were required to determine whether the institutions' transactions with affiliates were compliant with applicable regulatory requirements and not detrimental to the safety and soundness of the institutions. Each FDIC examination report since 2005 for the failed institutions included a section on relationships with affiliates, but did not identify instances of noncompliance with Section 23A.

Based on the results of the October 2008 examinations of Founders and Rock River, the FDIC determined that the financial conditions of the institutions were critically deficient. On April 27, 2009, IDFPR presented Founders and Rock River with a written *Notice of Intent to Take Possession and Control Pursuant to Section 51 of the Illinois Banking Act*.[14] The notices stated that IDFPR had determined that the institutions were operating with an unacceptable level of capital protection for their risk profile and that their Boards' supervision of the institutions was inadequate. The notices stated that if these deficiencies were not corrected by June 26, 2009, IDFPR would take possession and control of the institutions and their assets. The FDIC also prepared C&Ds to address the problems at Founders and Rock River and presented the C&Ds on April 27, 2009. However, the C&Ds were not executed prior to the IDFPR appointing the FDIC as receiver for the institutions. IDFPR closed Founders and Rock River on July 2, 2009 because the institutions were operated in an unsafe and unsound manner and were unable to raise sufficient capital.

Supervisory Oversight of CDOs

The first mention of CDOs in an examination report of Founders or Rock River occurred in the December 2005 examination report for Rock River. The report noted that although the institution had purchased $2.25 million in CDOs (representing 35 percent of Tier 1 Capital), its investment policy did not specifically address these instruments. The report recommended that Rock River expand its investment policy guidance to address CDOs and establish CDO limits relative to total investments and capital. The October 2006 examination report for Founders noted that the institution had approximately $29 million in CDOs (representing 42 percent of Tier 1 Capital). Similar to Rock River, Founders' investment policy did not address CDOs. The October 2006 examination report recommended that Founders' investment policy be expanded to include:

- The types of CDOs approved for investment.

- Exposure guidelines (such as percentage of capital) relating to each type of CDO.

[14] IDFPR issued a separate C&D to Founders on April 27, 2009 requiring the institution to cease and desist from soliciting or knowingly accepting uninsured deposits. The order directed Founders to submit weekly reports to IDFPR on its uninsured depositors. IDFPR did not issue a C&D to Rock River.

- Credit quality guidelines for CDO investments.

- Geographic and industry diversification guidelines.

- Due diligence and monitoring procedures, including documentation requirements.

According to the October 2006 examination report, the Investment Officer for the Campbell Group agreed to enhance the investment policy to address the above recommendations.

Examiners assigned supervisory component ratings of "1" for asset quality at the December 2005 and October 2006 examinations of Rock River and Founders and did not conduct visitations or other follow-up prior to the next examinations to assess the institution's corrective actions pertaining to the CDOs. By March 31, 2007, Founders' CDO investments had increased to $41.2 million (or 62 percent of Tier 1 Capital) and Rock River's CDO investments had increased to $7.7 million (or 144 percent of Tier 1 Capital). Such concentrations were among the highest of all FDIC-supervised institutions examined by the Chicago Regional Office. According to a survey conducted by the Chicago Regional Office, only nine of the 1,050 FDIC-supervised institutions in the region had CDO investments representing more than 25 percent of Tier 1 Capital as of September 2007. Five of these nine institutions were part of the Campbell Group and included Founders and Rock River.

The November 2006 and December 2007 examination reports for Rock River did not specifically mention the institution's CDO holdings and examiners assigned supervisory component ratings of "1" for asset quality. The September 2007 examination report for Founders also did not specifically mention the institution's CDOs. However, examiners lowered Founders' asset quality component rating from a "1" to a "2" during the September 2007 examination based on weakening loan underwriting and credit administration practices. The above referenced examination reports were not critical of the institutions' CDO investments because the securities continued to hold an investment grade and were generally performing well at the time of the examinations.

In August 2007, Founders and Rock River adopted a formal investment policy developed by the Investment Officer for the Campbell Group that specifically addressed CDOs. However, as previously discussed in this report, the policy was not adequate. In addition, as reflected in Table 8 on the following page, Tier 1 Leverage Capital ratios at Founders and Rock River were well below the institutions' peer groups and steadily declined during the years that the institutions were assuming more risk through their CDO purchases.

Table 8: Trends in Tier 1 Leverage Capital Ratios for Founders and Rock River

Year Ended	Founders	Peer Group	Rock River	Peer Group
Dec – 05	7.07%	8.88%	8.86%	9.77%
Dec – 06	6.70%	9.02%	6.85%	9.82%
Dec – 07	6.58%	9.06%	7.17%	9.78%
Dec – 08	5.92%	8.76%	6.01%	9.67%

Souce: UBPRs for Founders and Rock River.

In April 2008, based on the deterioration in the CDO markets, the Investment Officer for the Campbell Group changed the organization's investment policy to prohibit any further CDO purchases. By July 2008, some of the CDOs held by the Campbell Group had fallen below investment grade and almost all of the securities were declining in value. The FDIC's August 2008 central review identified a substantial deterioration in the value of the CDOs held by institutions throughout the Campbell Group, including Founders and Rock River. Because all but one of the institutions in the Campbell Group held CDOs, the FDIC determined that assessing the securities in a centralized manner (rather than on an examination-by-examination basis) would be prudent. In addition, due to the complexity of the securities, examiners coordinated extensively with FDIC capital markets specialists in the Chicago Regional Office and the Washington, D.C. Office to support their assessment of the CDOs.

In December 2008 and February 2009, the FDIC and the OCC jointly performed targeted reviews to assess the pricing and accounting treatment of CDOs held by the Campbell Group. Based on the results of these reviews, examiners adversely classified the majority of CDOs and notified the Campbell Group of serious concerns regarding the methodologies used to value the securities. Examiners recommended, among other things, that the Campbell Group provide supporting information for the critical assumptions used to value the CDOs and obtain independent third-party valuations. After several months of discussion and analysis involving the FDIC and the OCC, Founders and Rock River recognized significant losses in their CDO investments as of March 31, 2009. Based on our review of DRR records and discussions with DRR staff, the institutions' CDO investments have since become largely worthless.

The role that CDOs played in the failures of Founders and Rock River offers an important lesson learned regarding the risks associated with complex structured credit products. That is, when institutions make significant investments in such products without appropriate risk management controls, such practices become unsafe and unsound and require a strong supervisory response. Although examiners recommended in 2005 and 2006 that Founders and Rock River establish investment policies to address their CDO investments, the actions taken by the institutions to address those recommendations were not timely or adequate. A stronger supervisory response in the cases of Founders and Rock River could have included conducting visitations, targeted reviews, or follow-up between regular examinations to assess the progress of recommended corrective actions; requiring the institutions to increase their capital positions to mitigate the risk of loss associated with the CDOs; and/or downgrading the institutions' supervisory ratings and pursuing enforcement actions, if appropriate.

In recognition of the risks associated with CDOs, the FDIC issued Financial Institution Letter (FIL)-20-2009, entitled *Risk Management of Investments in Structured Credit Products*. The purpose of the FIL, which was issued on April 30, 2009, was to reiterate and clarify supervisory guidance to FDIC-supervised institutions regarding the purchase and holding of complex structured credit products. The FIL states that a number of insured institutions with portfolio holdings in private-label mortgage-backed securities, CDOs, or asset-backed securities are facing heightened losses as a result of significant investments in these products. The FIL also states that certain structured credit products, particularly private-label mortgage-backed securities and CDOs, have experienced deteriorating collateral performance, price declines, and credit rating downgrades and that management due diligence regarding purchases of these products was often lacking. The FIL discusses the various supervisory concerns related to these securities, such as pre-purchase analysis, suitability determination, risk limits, credit ratings, valuation, ongoing due diligence, adverse classification, and capital treatment.

Central Review

The FDIC's central review of the Campbell Group represented a valuable and proactive step in the supervision of institutions in the Campbell Group. In addition to achieving efficiencies in the scope of work performed in individual on-site examinations, the review also identified key risks that might not have otherwise been identified through individual examinations or other offsite monitoring activities such as the Chain Organization Reviews. For example, management officials at Founders advised examiners in late 2007 that the institution's affiliation with the Campbell Group afforded unlimited supplemental capital should the need arise. In addition, the December 2007 examination report for Rock River states that the institution's relationship with the Campbell Group is considered a positive one because it provides access to additional capital. However, the central review identified extensive insider lending throughout the Campbell Group and an overall high level of debt that raised serious doubts about the ability of the Campbell Group to raise capital. This information was provided to the examination teams at each Campbell Group institution to assist them in assessing capital adequacy.

The central review also provided valuable insight into key management decisions in the Campbell Group that affected institutions throughout the chain, including Founders and Rock River. Such decisions included CDO purchases and valuations and the allocation of loan participations from an affiliate institution to other institutions in the Campbell Group. FDIC officials advised us that, as a matter of practice, DSC regional offices conduct central reviews such as the one performed of the Campbell Group when the relationships between a chain bank organization's entities make it appropriate to do so. The FDIC may find it beneficial to clarify its procedures for conducting chain bank reviews to more clearly describe this type of on-site central review and under what circumstances the review should be performed.

Supervisory Oversight of CRE Concentrations and ADC Loan Participations

With respect to CRE concentrations, examination reports for Founders issued between 2005 and 2008 consistently noted the institution's concentration in CRE and included recommendations to improve its concentration risk management practices. However, prior to 2008, examiners determined that the risks associated with Founders' CRE concentration were adequately managed and that various factors, including not having the concentration centered in one type of collateral and having a large number of credits secured by owner-occupied properties, mitigated the risk associated with the concentration. Regarding Rock River, examiners did not consider the institution's CRE concentration to be a significant concern as reflected in the institution's asset quality ratings of "1" prior to 2008. Although examiners determined that Founders' and Rock River's loan underwriting and credit administration practices were generally adequate prior to 2008, the CRE concentrations made the institutions vulnerable to a sustained downturn in the real estate market.

With respect to the out-of-area loan participations, the October 2006 and September 2007 examination reports for Founders did not identify specific concerns with these loans. However, the October 2008 examination report stated that Founders had purchased a large amount of loan participations from an out-of-area affiliate institution. The report noted that because these loan participations were secured by real estate, their value had declined substantially. Regarding Rock River, the December 2005 and November 2006 examination reports did not identify concerns related to the loan participations. However, the December 2007 examination report noted that the risk in Rock River's loan portfolio had become somewhat elevated due to the size of the loan participations that the institution had acquired. Prior to 2008, examiners did not express significant concern regarding the loan participations at Rock River and assigned supervisory component ratings of "1" for the institution's asset quality.

The majority of loan participations purchased from the affiliate were accepted by the Boards of Founders and Rock River without conducting adequate due diligence (i.e., independent assessments). The DSC Examination Manual states that institutions within a chain banking organization may be susceptible to poor loan participation practices and provides that "particular emphasis should be given to the volume and frequency of inter-institution transactions such as loan participations." Given the volume of loan participations purchased by Founders and Rock River between 2006 and 2008 from the Campbell Group affiliate, examiners could have expressed concern regarding the lack of due diligence by Founders and Rock River and recommended that the institutions implement stronger risk management controls in this area during the 2006 or 2007 examinations.

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, *Capital Maintenance*, of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered based on an institution's capital levels. Based on the supervisory actions taken with respect to Founders and Rock River, the FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act. However, PCA's role was limited because capital was a lagging indicator of the institutions' financial health.

Founders and Rock River were considered *Well Capitalized* for PCA purposes until March 31, 2009, when both institutions recognized significant losses related to their CDO investments. These losses caused a reduction in the institutions' capital and, as a result, Founders fell to *Significantly Undercapitalized* and Rock River fell to *Critically Undercapitalized*. Tables 9 and 10 illustrate the capital positions of Founders and Rock River relative to the PCA thresholds for *Well Capitalized* institutions for the period December 31, 2006 through March 31, 2009.

Table 9: Founders' Capital Levels

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
PCA Threshold	**5% or more**	**6% or more**	**10% or more**	
Dec-06	6.70%	8.45%	10.61%	Well Capitalized
Dec-07	6.58%	8.16%	10.59%	Well Capitalized
Dec-08	5.92%	7.69%	10.30%	Well Capitalized
Mar-09	2.83%	3.27%	5.73%	Significantly Undercapitalized

Source: UBPRs for Founders.

Table 10: Rock River's Capital Levels

Period Ended	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	PCA Capital Category
PCA Threshold	**5% or more**	**6% or more**	**10% or more**	
Dec-06	6.85%	9.46%	10.25%	Well Capitalized
Dec-07	7.17%	9.60%	10.25%	Well Capitalized
Dec-08	6.01%	9.21%	10.46%	Well Capitalized
Mar-09	0.56%	0.57%	1.14%	Critically Undercapitalized

Source: UBPRs for Rock River.

Based on the findings of the October 2008 examinations of Founders and Rock River, IDFPR separately presented Founders and Rock River with a written *Notice of Intent to Take Possession and Control Pursuant to Section 51 of the Illinois Banking Act* on April 27, 2009. Among other things, the notices stated that IDFPR had determined that the institutions were operating with unacceptable levels of capital protection for their risk profile. The notices stated that the institutions needed to increase their Tier 1 Regulatory Leverage Capital ratio, Tier 1 Risk-Based Regulatory Capital ratio, and Total Risk-Based Capital ratio to not less than 5 percent, 6 percent, and 10 percent, respectively. If the institutions were not successful in raising sufficient capital by June 26, 2009, IDFPR intended to take possession and control of the institutions.

The FDIC formally notified Founders and Rock River on May 12, 2009 that, based on their Call Reports for the quarter ended March 31, 2009, the institutions were considered *Significantly Undercapitalized* and *Critically Undercapitalized* respectively, for purposes of Part 325. The notifications included a reminder that the institutions were subject to certain restrictions and requirements defined under section 38, including the submission of a capital restoration plan. Founders submitted a capital restoration plan to the FDIC on May 22, 2009. However, the FDIC determined that the plan lack adequate details regarding the institution's capital sources. Rock River did not submit a capital restoration plan to the FDIC. IDFPR closed Founders and Rock River on July 2, 2009 because the institutions were not able to raise sufficient capital or find suitable acquirers.

Corporation Comments

We issued a draft of this report on January 25, 2010. DSC management subsequently provided us with additional information for our consideration. We made certain changes to the report that we deemed appropriate based on the information that DSC management provided. On February 12, 2010, the Director, DSC provided a written response to the draft report. The response is presented in its entirety as Appendix 5 of this report.

The DSC Director's response concurred with our conclusions regarding the causes of failure. With regard to our assessment of the FDIC's supervision of Founders and Rock River, DSC summarized several supervisory actions taken in relation to the institution's activities. DSC also noted that stronger supervisory follow-up to assess the progress of recommended corrective actions would have been prudent for both institutions, particularly with respect to managing the risks inherent in the CDO portfolios. In that regard, DSC stated that it has issued updated guidance addressing risk management of investments in structured credit products that provides clarification to existing guidance and strongly urges insured institutions to revisit this existing guidance.

Objectives, Scope, and Methodology

Objectives

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

Our audit objectives were to (1) determine the causes of Founders' and Rock River's failures and the resulting material losses to the DIF and (2) evaluate the FDIC's supervision of Founders and Rock River, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from November 2009 to January 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 Founders' and Rock River's operations from 2005 until their failures on July 2, 2009. Our review also entailed an evaluation of the regulatory supervision of the institutions during the same period.

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

- Analyzed examination reports and other supervisory documents prepared by the FDIC and IDFPR from 2005 through July 2009.

- Reviewed the following:

    - Institution data and correspondence maintained in DSC's Chicago Regional Office.

    - Relevant reports prepared by DRR and DSC relating to the institutions' closures. We also reviewed records maintained by DRR at its temporary Worth, Illinois office for information that would provide insight into the institutions' failures.

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

Objectives, Scope, and Methodology

- Interviewed DSC personnel in Washington, D.C., and the Chicago Regional Office and DRR personnel in Worth, Illinois.
- Interviewed IDFPR officials to discuss their role and perspective on the supervision of the institutions. We also reviewed relevant IDFPR examination documentation.

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, and interviews of examiners to understand Founders' and Rock River's management controls pertaining to the causes of failures and material losses as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, and testimonial evidence to corroborate data obtained from systems that 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 material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations. 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.
Chain Banking Organization	According to the FDIC *Case Manager's Procedures Manual*, a chain banking organization is a group of insured institutions which are controlled, directly or indirectly, by an individual acting alone, through, or in concert with any other individual(s). The individual(s) must own or control 25 percent or more of the institutions' voting securities; the power to control in any manner the election of a majority of the directors of the institutions; or the power to exercise a controlling influence over the management or policies of the institutions.
Collateralized Debt Obligation (CDO)	General terminology for a broad range of structured finance products. CDOs are similar to collateralized mortgage obligations and asset-backed securities in that they are securitized investments that are subdivided into tiers or tranches, and are backed by an underlying collateral pool. Unlike collateralized mortgage obligations and asset-backed securities, the CDO collateral pool can contain a wide variety of less than homogeneous assets. In its basic form, CDOs reallocate the risk of the underlying collateral pool to investors based on their risk tolerance levels and investment return objectives. CDOs are most commonly issued by commercial banks, insurance companies, money managers, and investment banks.
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.
Credit Ratings Agency	A credit ratings agency is any person engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee by employing either a quantitative or qualitative model, or both, to determine credit ratings; and receiving fees from either issuers, investors, or other market participants, or a combination thereof. These include nationally recognized rating organizations such as AM Best Company, DBRS Ltd., Fitch, Inc., Moody's Investment Services, Inc., Ratings and Investment Information, Inc., and Standard and Poor's Rating Services.

Glossary of Terms

Investment Grade	Investment grade generally means a security that is rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations. In most instances, a security must be "investment grade" to be a permissible investment for FDIC-insured institutions. Bonds that are below investment-grade are sometimes called high yield bonds or junk bonds.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, 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 prompt supervisory actions against depository institutions that are in an unsafe and 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.
Rating	An indicator of the credit risk of one or more securities assigned by a nationally recognized statistical rating organization, such as Moody's Investors Services, Standard & Poor's Corporation, or Fitch Investors Service.
Section 23A of the Federal Reserve Act	Section 23A (1) establishes limits on the amount of ‘‘covered transactions’’ between a member bank and its affiliates (any one affiliate and in the aggregate as to all affiliates); (2) requires that all covered transactions between a member bank and its affiliates be on terms and conditions that are consistent with safe and sound banking practices; (3) prohibits the purchase of low quality assets from an affiliate; and (4) requires that extensions of credit by a member bank to an affiliate, and guarantees on behalf of affiliates, be secured by statutorily defined amounts of collateral.
Structured Credit Product	The term is broadly defined to refer to all structured investment products where repayment is derived from the performance of the underlying assets or other reference assets, or by third parties that serve to enhance or support the structure. Such products include, but are not limited to, asset-backed commercial paper programs, mortgage-backed securities or collateralized mortgage obligations, and other asset-backed securities, such as automobile and credit card-backed securities, structured investment vehicles, and collateralized debt obligations, including securities backed by TruPs.

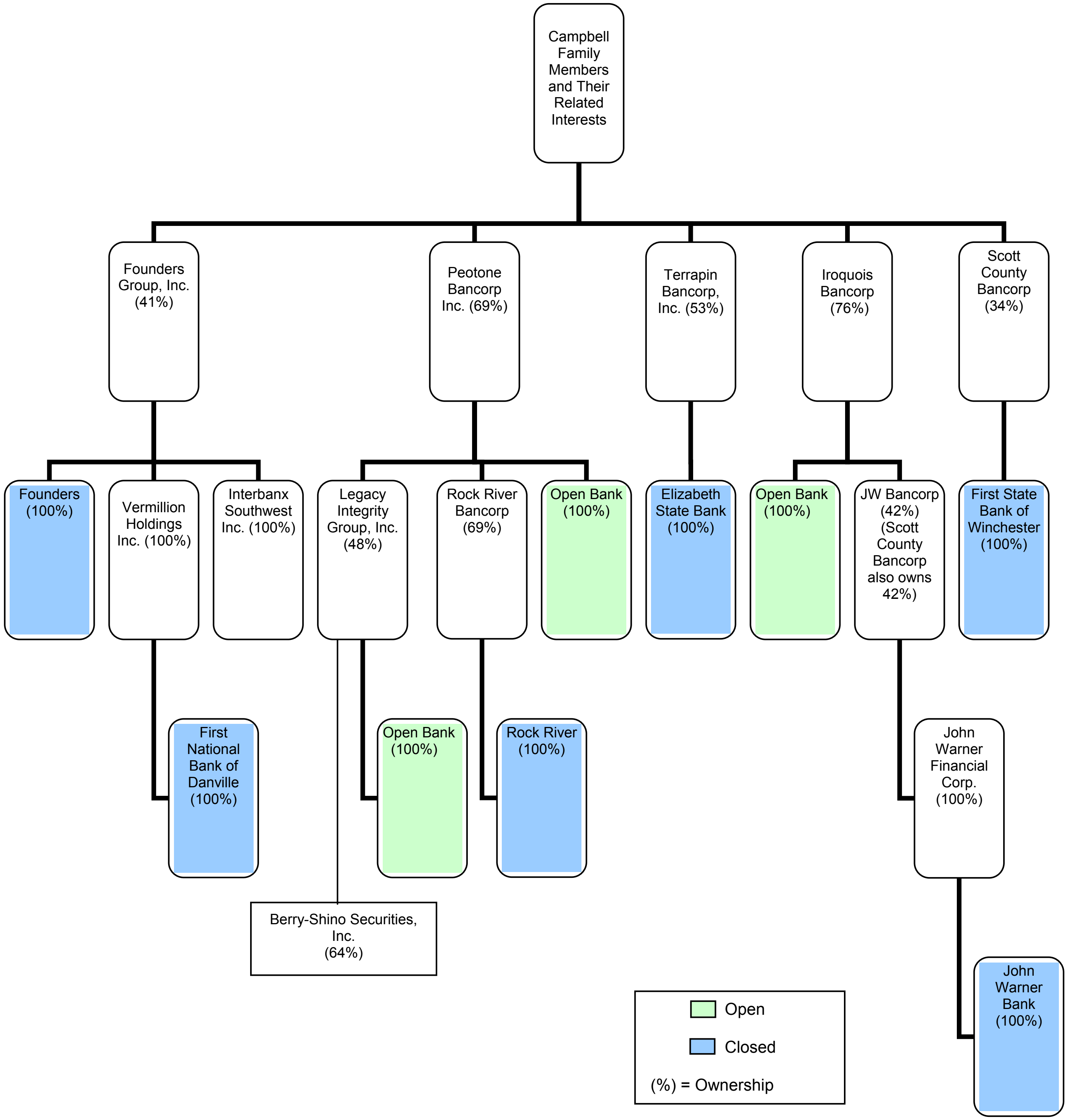
Glossary of Terms

Tranches	Multiple classes of equity and debt that are set in a senior or subordinate position to one another based upon seniority in bankruptcy and timing of repayment. The tranches are divided into three general categories: (1) Senior tranche; (2) Mezzanine tranche; and (3) Equity tranche.
Trust Preferred Security (TruP)	Hybrid instruments possessing characteristics typically associated with debt obligations. Under the basic structure of trust preferred securities a corporate issuer, such as a bank holding company, first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the corporate issuer, and trust preferred securities, which are sold to investors. The business trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The corporate issuer makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. The subordinated debentures have a stated maturity and may also be redeemed under other circumstances. Most trust preferred securities are subject to a mandatory redemption upon the repayment of the debentures.
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 data reported in Reports of Condition and Income submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CDO	Collateralized Debt Obligation
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
IDFPR	Illinois Department of Financial and Professional Regulation
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
PCA	Prompt Corrective Action
REIT	Real Estate Investment Trust
TruP	Trust Preferred Security
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Campbell Group Organization



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

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 Founders Bank, Worth, Illinois, and Rock River Bank, Oregon, Illinois* (Assignment No. 2009-057)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Founders Bank (FB) and Rock River Bank (RRB) which failed on July 2, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on January 25, 2010.

The Report concludes that FB and RRB failed due to their Boards' and senior management's ineffective risk management practices over investment and lending activities. Significant investments in collateralized debt obligations (CDOs) were undertaken without establishing and implementing appropriate risk management controls. Additionally, concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans made FB and RRB vulnerable to the sustained downturn in the real estate market, resulting in increased loan losses and depleted earnings. The ADC portfolio included out-of-territory loan participations purchased for which neither FB nor RRB had performed proper due diligence, thereby heightening their vulnerability and risk.

The FDIC and the Illinois Department of Financial and Professional Regulation (IDFPR) provided on-going supervisory oversight through on-site risk management examinations, targeted reviews, and off-site monitoring between 2004 and 2009, resulting in a downgrade of FB's and RRB's ratings in 2008. The on-site examinations noted regulatory concerns and made recommendations to correct ineffective risk management practices, CRE concentrations, CDO concentrations, and loan underwriting and credit administration deficiencies. The Report concludes that DSC provided a proactive supervisory strategy, reviewing FB's and RRB's complex chain banking organization on a frequency and level of depth consistent with risk.

Stronger supervisory follow-up to assess the progress of recommended corrective actions would have been prudent for FB and FRR, particularly with respect to ensuring that programs were sufficient to manage the risks of their investments in CDOs. DSC has issued a Financial Institution Letter in 2009 on *Risk Management of Investments in Structured Credit Products* that provided clarification to existing guidance and strongly urged insured institutions to revisit this existing guidance.

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