



Office of Inspector General



Office of Material Loss Reviews
Report No. MLR-11-012

**Material Loss Review of ShoreBank,
Chicago, Illinois**

February 2011



Why We Did The Audit

On August 20, 2010, the Illinois Department of Financial and Professional Regulation (IDFPR) closed ShoreBank, Chicago, Illinois and named the FDIC as receiver. On August 27, 2010, the FDIC notified the Office of Inspector General (OIG) that ShoreBank's total assets at closing were \$2.16 billion and the estimated loss to the Deposit Insurance Fund (DIF) was \$329 million. The FDIC revised the estimated loss amount to \$452 million as of January 31, 2011 based on updated asset recovery assumptions and liquidation information. As required by section 38(k) of the Federal Deposit Insurance Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of ShoreBank.

On August 5, 2010, prior to ShoreBank's failure, the Ranking Member of the House Financial Services Committee and the Ranking Member of the Subcommittee on Oversight and Investigations requested that we review private-sector efforts to recapitalize ShoreBank and the FDIC's consideration of ShoreBank's application for funds under the Department of the Treasury's (Treasury) Community Development Capital Initiative (CDCI) program. The Ranking Members requested that we determine whether the Administration or Members of the Congress exerted political influence over the FDIC associated with efforts to recapitalize ShoreBank.

The audit objectives were to (1) determine the causes of ShoreBank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of ShoreBank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38. In addition, to address the Ranking Members' concerns, we determined (3) the timeline of events pertaining to the FDIC's supervision and CDCI consideration for ShoreBank; (4) the extent and nature of FDIC involvement in the ShoreBank investor recapitalization effort; (5) whether the FDIC followed its standard process in reviewing ShoreBank's CDCI application and whether ShoreBank met CDCI eligibility requirements; (6) whether the resolution followed selected FDIC policies and regulations related to marketing the bank, assessing purchaser eligibility, and making a least cost decision; and (7) whether there was any indication of political or inappropriate influence imposed on the FDIC in connection with the supervision, investor recapitalization effort, CDCI consideration, or resolution of ShoreBank.

This report addresses the first two objectives; that is, the report presents our analysis of ShoreBank's failure and the FDIC's supervision of the institution, as required by section 38 of the FDI Act. We will issue a separate report that addresses the remaining objectives involving ShoreBank recapitalization efforts and the Corporation's marketing and resolution of ShoreBank.

We note that, in conjunction with other organizational changes made to enhance the FDIC's ability to carry out its new and enhanced responsibilities under the Financial Reform Act, the Division of Supervision and Consumer Protection (DSC) became the Division of Risk Management Supervision effective February 13, 2011. As a result of the timing of our review and draft report issuance, we refer to DSC throughout the executive summary and the body of this report.

Background

ShoreBank was a state-chartered, non-member bank headquartered in Chicago, Illinois. The institution was established in 1939 as a national bank. In 1973, the Illinois Neighborhood Development Corporation (which later became known as the ShoreBank Corporation (SBC)), acquired control of the bank with the goal of profitably investing in community development activities. A key focus for the new owners was rebuilding the local community that had for a decade been increasingly torn by crime and poverty. The bank converted to a state charter in 1978 and subsequently expanded its operations into Michigan and Ohio.

ShoreBank's lending strategy focused on providing financing for affordable housing and economic development activities in underserved and economically-disadvantaged areas. The institution's customers included small businesses, not-for-profit organizations, churches, and individuals in low- to moderate-income areas, including Chicago's South Side. ShoreBank provided credit for community development efforts to minority-owned businesses and individuals, conservation efforts to businesses developing efficient energy use and alternative energy sources, and international efforts to establish successful loan programs for individuals and small businesses around the world.

ShoreBank was certified by the Treasury's Community Development Financial Institution (CDFI) Fund and was the largest CDFI in the United States. Congress established the CDFI Fund in 1994 to expand the capacity of financial institutions to provide credit, capital, and financial services to underserved populations and communities in the United States. A certified CDFI is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. Typically, CDFIs provide a unique range of financial products and services in economically-distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers; flexible underwriting and risk capital for community facilities; and technical assistance, commercial loans, and investments to small start-up or expanding businesses in low-income areas.

ShoreBank's primary lending area was particularly impacted by the recent economic decline. The U.S. Census Bureau's 2008 American Community Survey reported that the unemployment rate within a four-community area within the south side of Chicago was 23.2 percent, significantly higher than the national average.

Audit Results**Causes of Failure and Material Loss**

ShoreBank failed due to insolvency brought on by the Board and management not implementing adequate risk management practices. ShoreBank provided banking opportunities to underserved and low-income areas but did not sufficiently mitigate risks inherent in its business strategy. In particular, management (1) did not effectively manage the risks associated with its concentrations in Commercial Real Estate (CRE) and Acquisition, Development, and Construction (ADC) loans; (2) employed poor underwriting and credit administration practices; and (3) supported loan growth and ongoing operations with non-core funding sources. Further, ShoreBank management was not responsive to repeated examiner concerns pertaining to these areas, particularly from 2007 until the bank failed.

ShoreBank's asset concentrations and weak risk management practices made the institution vulnerable to a sustained economic downturn in the Chicago real estate market. Deterioration in the bank's loan portfolio began in 2007 and accelerated throughout 2008 and 2009. Ultimately, the losses, provisions, and delinquency associated with the bank's loan portfolio depleted the institution's earnings and capital, and impaired its liquidity position. IDFPFR closed ShoreBank because the institution did not have sufficient capital to continue normal operations. The FDIC also incurred penalties associated with the early termination of secured borrowings held by ShoreBank when it failed that increased DIF losses by about \$100 million.

The FDIC's Supervision of ShoreBank

The FDIC, in conjunction with the IDFPFR, provided ongoing supervisory oversight of ShoreBank through risk management examinations, a visitation, and off-site monitoring. Through its supervisory efforts, the FDIC identified key risks and deficiencies in ShoreBank's risk management practices and operations and brought these concerns to the attention of the institution's Board and management through discussions, correspondence, and examination reports. Key recurring risks included weak risk management practices pertaining to asset concentrations, loan underwriting and credit administration, and a historically high reliance on non-core funding. However, the FDIC considered the key risks to be adequately mitigated prior to 2007.

ShoreBank began experiencing increasingly higher levels of loan delinquencies and losses in 2007, due, in part, to the declining economy. The FDIC and IDFPFR downgraded the Asset Quality rating because of adversely classified items and rising delinquencies. Following the 2008 examination, the FDIC and IDFPFR further downgraded all of the component ratings and the composite rating and imposed a formal enforcement action. In retrospect, earlier and greater emphasis on the bank's risk profile—including its vulnerability to an economic downturn, the repeat nature of certain key risk management weaknesses, and dependence on non-core funding sources—may have been called for in determining the bank's Management and Liquidity ratings and deciding whether an informal action was warranted. Taking a more aggressive supervisory approach earlier could have influenced ShoreBank's Board and management to constrain excessive risk and limit expansion into higher-risk areas, and imposed a more structured means to ensure the Board and management affirmatively responded to examiner concerns at a critical time.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. Of note, in March 2010, the FDIC completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance. The FDIC has also issued supervisory guidance addressing risks associated with CRE and ADC lending and funds management practices. The early use of informal enforcement actions to pursue correction of weak risk management practices is consistent with forward-looking supervision and has been addressed in internal guidance issued to examiners.

The FDIC generally implemented applicable PCA provisions of section 38. The FDIC did not provide written notification to ShoreBank of the adequacy of its capital restoration plan, as required. However, in our view, the lack of written notification was inconsequential to the supervision or failure of the bank.

Management Response

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On February 25, 2011, the Director, Division of Risk Management Supervision, provided a written response to the draft report. In the response, the Director reiterated the causes of ShoreBank's failure and the supervisory activities described in our report. The response also noted that the FDIC issued a Financial Institution Letter (FIL) in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that reemphasized the importance of robust credit risk-management practices in institutions with concentrated CRE exposures.

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Federal Deposit Insurance Corporation

3501 Fairfax Drive, Arlington, Virginia 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: February 25, 2011

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Risk Management Supervision

FROM: */Signed/*
Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of ShoreBank, Chicago, Illinois*
(Report No. MLR-11-012)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of ShoreBank, Chicago, Illinois. The Illinois Department of Financial and Professional Regulation (IDFPR) closed the institution on August 20, 2010, and named the FDIC as receiver. On August 27, 2010, the FDIC notified the OIG that ShoreBank's total assets at closing were \$2.2 billion and the estimated loss to the Deposit Insurance Fund (DIF) was \$329 million. The FDIC revised the estimated loss amount to \$452 million as of January 31, 2011 based on updated asset recovery assumptions and liquidation information. The estimated loss exceeds the \$200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act.

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.

On August 5, 2010, prior to ShoreBank's failure, the Ranking Member of the House Financial Services Committee and the Ranking Member of the Subcommittee on Oversight and Investigations requested that we review private-sector efforts to recapitalize ShoreBank and the FDIC's consideration of ShoreBank's application for funds under the Department of the Treasury's (Treasury) Community Development Capital Initiative (CDCI) program. The Ranking Members requested that we determine whether the Administration or Members of the Congress exerted political influence over the FDIC associated with efforts to recapitalize ShoreBank.

The objectives of this audit were to (1) determine the causes of ShoreBank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of

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This report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our material loss reviews, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.¹ Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of key terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, known as the CAMELS ratings. Appendix 3 contains a list of acronyms. Appendix 4 presents the Corporation's comments on our report.

We note that, in conjunction with other organizational changes made to enhance the FDIC's ability to carry out its new and enhanced responsibilities under the Financial Reform Act, DSC became the Division of Risk Management Supervision effective February 13, 2011. As a result of the timing of our review and draft report issuance, we refer to DSC throughout the executive summary and the body of this report.

Background

ShoreBank was a state-chartered, non-member bank headquartered in Chicago, Illinois. The institution was established in 1939 as a national bank. In 1973, the Illinois Neighborhood Development Corporation (which later became known as the ShoreBank Corporation (SBC)), acquired control of the bank with the goal of profitably investing in community development activities. A key focus for the new owners was rebuilding the local community that had for a decade been increasingly torn by crime and poverty. The

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

bank converted to a state charter in 1978 and subsequently expanded its operations into Michigan and Ohio.

ShoreBank’s lending strategy focused on providing financing for affordable housing and economic development activities in underserved and economically-disadvantaged areas. The institution’s customers included small businesses, not-for-profit organizations, churches, and individuals in low- to moderate-income areas, including Chicago’s South Side. The institution’s lending strategy supported the overall business goal of SBC and its subsidiaries to provide credit for the following activities:

- Community Development--minority-owned businesses, minority individuals, and faith-based and nonprofit organizations benefiting lower-income communities.
- Conservation--businesses developing efficient energy use and alternative energy sources for the protection, increased capacity, and revitalization of land and water.
- International Activities--financial institutions around the world establishing successful loan programs for individuals and small businesses that were often overlooked by mainstream financial institutions in their markets.

ShoreBank operated 12 branches in the Chicago, Illinois area, one branch in Cleveland, Ohio, and one branch in Detroit, Michigan. The institution was wholly owned by its holding company, SBC, located in Chicago. Shareholders of SBC consisted of financial institutions, foundations, insurance companies, faith-based institutions, trusts, and individuals. SBC also controlled one other insured institution, as well as a number of for-profit and not-for-profit subsidiaries. ShoreBank and SBC’s Boards of Directors and officers were comprised of community organizers and former bank regulators, three of whom are former outside members of the FDIC Board of Directors.² Table 1 summarizes selected financial information for ShoreBank.

Table 1: Financial Condition of ShoreBank

Financial Measure (\$000s)	Jun 2010	Dec 2009	Dec 2008	Dec 2007	Dec 2006
Total Assets	2,166,431	2,246,737	2,420,425	2,205,770	1,989,977
Total Loans	1,324,403	1,396,228	1,529,008	1,354,681	1,268,736
Multi-Family Residential Loans	339,063	361,930	380,185	351,255	315,091
Total Deposits	1,547,403	1,603,248	1,540,156	1,327,302	1,309,114
Non-Core Liabilities	1,416,662	1,264,281	1,651,456	1,128,869	1,292,535
Net Income (Loss)	(39,554)	(105,306)	(8,451)	11,158	11,119
Examination Data	01/04/2010	11/10/2008	10/29/2007	10/23/2006	09/26/2005
Adversely Classified Items Coverage Ratio	224.3%	93.1%	42.1%	31.2%	25.9%

Source: Uniform Bank Performance Reports (UBPR), Reports of Condition and Income (Call Reports), and examination reports for ShoreBank.

² One former Board Member was a ShoreBank and SBC Director. A second former Board Member was an SBC Director. A third former Board Member was an SBC officer.

Community Development Financial Institutions

ShoreBank was certified by the Treasury's Community Development Financial Institution (CDFI) Fund and was the largest CDFI in the United States. Congress established the CDFI Fund in 1994 to expand the capacity of financial institutions to provide credit, capital, and financial services to underserved populations and communities in the United States. A certified CDFI is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. Typically, CDFIs provide a unique range of financial products and services in economically-distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers; flexible underwriting and risk capital for community facilities; and technical assistance, commercial loans, and investments to small start-up or expanding businesses in low-income areas.

CDFIs include regulated institutions such as community development banks and credit unions, and non-regulated institutions such as loan and venture capital funds. There were approximately 60 commercial banks certified as CDFIs as of August 2010. Table 1 summarizes selected financial information for ShoreBank.

Table 2: Selected Financial Measures of CDFI Banks and ShoreBank

Financial Measure	CDFI Group Averages		ShoreBank	
	Jun 2010	Jun 2009	Jun 2010	Jun 2009
Total Assets (\$000s)	244,992	225,056	2,166,431	2,655,932
Range of Total Assets	13 million to 2.1 billion	11 million to 2.1 billion		
Net Loans & Leases to Assets	64.9%	67.8%	57.0%	55.6%
Non-Current Loans & Leases to Gross Loans	5.6%	4.3%	24.6%	12.6%
Tier 1 Leverage Capital Ratio	9.1%	10.4%	0.2%	5.0%
Total Risk-Based Capital Ratio	14.5%	15.0%	0.7%	10.4%
Net Non-Core Funding Dependence Ratio	33.2%	33.7%	66.7%	60.0%

Source: OIG analysis of UBPRs for CDFI banks and ShoreBank.

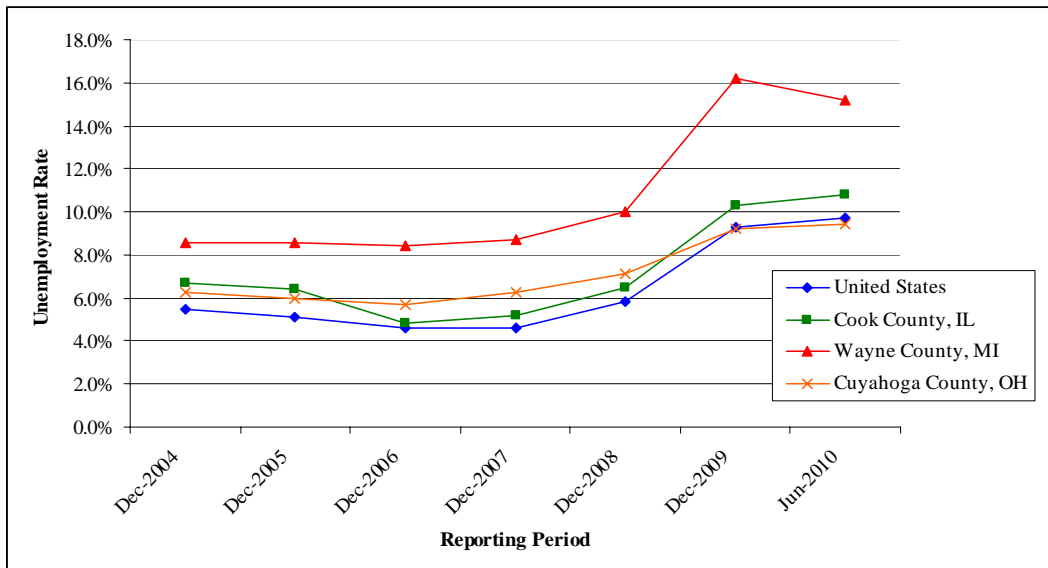
ShoreBank's Economically Challenged Markets

For Community Reinvestment Act (CRA) purposes, ShoreBank designated three assessment areas within which the bank focused its lending efforts. These areas included Cook County, Illinois; the City of Detroit in Wayne County, Michigan; and Cuyahoga County, Ohio. In particular, ShoreBank's lending was most significantly concentrated within Cook County, which included the city of Chicago. Based on the FDIC's October 2006 CRA Performance Evaluation for ShoreBank, from January 2004 through June 2006, 92 percent of both the number and dollar volume of home mortgage and small business loans were extended inside the bank's Illinois assessment area. During the same

period, ShoreBank originated 80 percent of its publicly-reportable mortgage loans³ and 64 percent of its small business loans in low- and moderate-income areas.

ShoreBank’s primary assessment area was particularly impacted by the economic decline. The U.S. Census Bureau’s 2008 American Community Survey reported that the unemployment rate within a four community area in the south side of Chicago was 23.2 percent, significantly higher than the national average. Figures 1 and 2 present information about unemployment rates and mortgage delinquencies for each of the areas within which ShoreBank operated.

Figure 1: National and Local Unemployment Rates

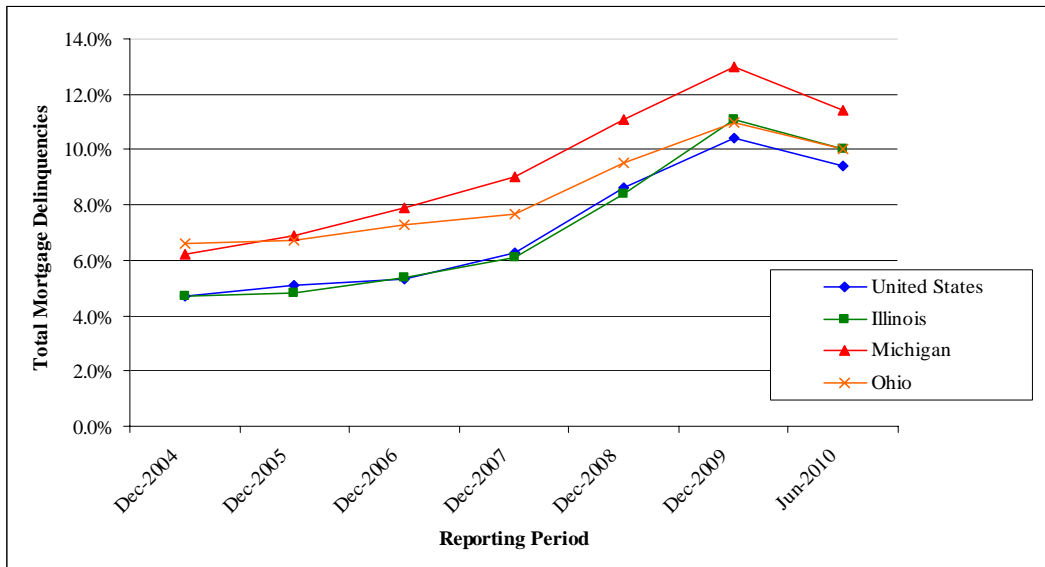


Source: OIG analysis of Bureau of Labor Statistics (Haver Analytics) data – not seasonally adjusted.

As shown, unemployment in all three counties was slightly higher to significantly higher than the national average for most periods. In addition, significant increases in both the local and national unemployment rates were evident throughout 2008 and 2009. Wayne County experienced a dramatic rise in unemployment and a double-digit unemployment rate that was 74 percent higher than the national average, as of December 2009.

³ The Home Mortgage Disclosure Act, enacted by Congress in 1975 and implemented by the Federal Reserve Board's Regulation C, requires lending institutions to report public loan data.

Figure 2: National and State Mortgage Delinquencies



Source: OIG analysis of data obtained from the Mortgage Bankers Association of America (Haver Analytics) – not seasonally adjusted.

Figure 2 illustrates that mortgage loan delinquency rates within ShoreBank’s market areas generally followed national trends, with historically higher delinquency levels experienced in Michigan, and to a certain extent Ohio.

Causes of Failure and Material Loss

ShoreBank failed due to insolvency brought on by the Board and management not implementing adequate risk management practices. ShoreBank provided banking opportunities to underserved and low-income areas but did not sufficiently mitigate risks inherent in its business strategy. In particular, management (1) did not effectively manage the risks associated with its concentrations in Commercial Real Estate (CRE) and Acquisition, Development, and Construction (ADC) loans, (2) employed poor underwriting and credit administration practices, and (3) supported loan growth and ongoing operations with non-core funding sources. Further, ShoreBank management was not responsive to repeated examiner concerns pertaining to these areas, particularly from 2007 until the bank failed.

ShoreBank’s asset concentrations and weak risk management practices made the institution vulnerable to a sustained economic downturn in the Chicago real estate market. Deterioration in the bank’s loan portfolio began in 2007 and accelerated throughout 2008 and 2009. Ultimately, the losses, provisions, and delinquency associated with the bank’s loan portfolio depleted the institution’s earnings and capital, and impaired its liquidity position. IDFP closed ShoreBank because the institution did not have sufficient capital to continue normal operations. The FDIC also incurred penalties associated with the early termination of secured borrowings held by ShoreBank when it failed that increased DIF losses by about \$100 million.

Board and Management Oversight

The *DSC Risk Management Manual of Examination Policies* (Examination Manual) states that the quality of an institution's management, including its Board and executive officers, is perhaps the single most important element in the successful operation of an institution. The Board has overall responsibility and authority for formulating sound policies and objectives for the institution and for effectively supervising the institution's affairs. Executive officers, such as the President and Chief Executive Officer and the Chief Lending Officer, have primary responsibility for managing the day-to-day operations and affairs of the bank.

ShoreBank management and the Board undertook a community-focused, but inherently risky, business strategy that concentrated the bank's operations and lending in economically-challenged geographic market areas. The bank provided a range of loan products to encourage community development and revitalization of low- and moderate-income neighborhoods. This business focus exposed the bank to a significant level of operational and credit risk in the event of a deteriorating economy. Accordingly, strong risk management practices and controls were vital in mitigating the risks inherent in ShoreBank's operations. As discussed in greater detail later in this report, examiners noted that ShoreBank management and the Board:

- Made strategic and operational decisions that resulted in significant CRE and ADC loan concentrations and funded loan growth with non-core funding sources without sufficient risk controls;
- Made loans without adequate underwriting and credit administration practices and controls and exercised inadequate oversight of the bank's loan portfolios;
- Did not establish adequate procedures or effective risk management monitoring systems appropriate for the institution's size, complexity, and risk profile;⁴
- Violated several laws pertaining to real estate appraisals, the Bank Secrecy Act, loans to insiders, and interest rate restrictions and policy statements pertaining to Allowance for Loan and Lease Loss (ALLL) methodologies and interest rate risk; and
- Did not adequately plan for changing or deteriorating business conditions or establish contingency plans for emergency funding situations.

Further, ShoreBank's Board and management did not fully address examiner concerns and recommendations. As early as the October 2004 FDIC examination, examiners reported on the bank's asset concentrations and numerous repeat loan underwriting and

⁴ In this regard, while earlier examinations indicated that ShoreBank management monitored and reported loan concentrations, the joint January 2010 examination report stated that ShoreBank management did not monitor loan concentrations until 2009.

administration deficiencies. Examiners also expressed concerns over the adequacy of the bank's borrower financial analysis, appraisal practices, project monitoring, loan file documentation, ALLL methodology, and staffing sufficiency. Examiners noted similar concerns in subsequent examinations. Management committed to correct individual deficiencies noted in most of the examinations and in some cases did take action to address them. However, management did not effectuate comprehensive and sustained improvements in certain key areas.

FDIC and IDFPF examiners also routinely reported on the bank's significant reliance on non-core funding to support the bank's growth and operations. FDIC examiners recommended that the bank reduce its level of net non-core funding dependence once the bank's financial condition began to significantly deteriorate. During the October 2007 examination, FDIC examiners recommended that ShoreBank develop a Contingency Funding Plan to prepare for potential unplanned liquidity events. Ultimately, ShoreBank took limited corrective action despite the repeat recommendations and a 2009 formal enforcement action.

Finally, we noted that ShoreBank also experienced several senior management changes that could have impaired management continuity and contributed to ShoreBank's inadequate response to examiner recommendations. ShoreBank changed Presidents in August 2006, April 2007, and October 2009.

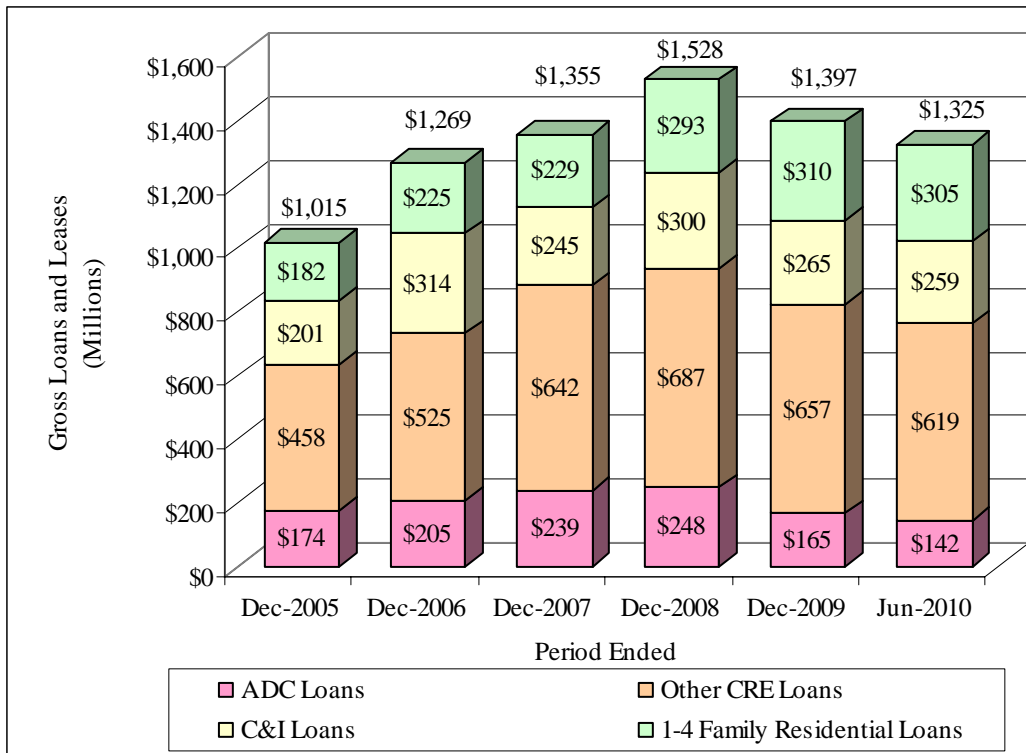
Composition, Growth, and Performance of the Loan Portfolio

ShoreBank maintained a relatively diverse mix of loans in its portfolio. Major loan segments included CRE, ADC, commercial and industrial (C&I), and 1-4 family residential loans. The majority of the loan portfolio pertained to CRE, such as loans for multi-family residential properties, small businesses and not-for-profit entities; and ADC loans, including loans for apartment rehabilitation projects. Notably, ShoreBank's multi-family residential loans accounted for about 29 percent of the loan portfolio at year-end 2005, placing the institution in the 97th percentile of its peer group for these types of loans. The Board and management favored multi-family residential loans because they furthered the bank's mission of promoting development and affordable housing in economically disadvantaged communities and were generally profitable before the downturn in the real estate market.

Between 2005 and 2008, ShoreBank's loan portfolio increased by about 50 percent. While each of the bank's major loan segments experienced growth during this period, much of the growth pertained to CRE loans to businesses and not-for-profit entities. To a lesser extent, the bank increased its ADC lending exposure to larger-scale multi-family development projects, such as condominium construction projects. A number of these projects came to market in 2007 and 2008, just as the real estate market was deteriorating. By late 2008, many of these larger loans showed signs of stress and were headed into delinquency and foreclosure. As the bank's real estate markets deteriorated, ShoreBank began to expand its 1-4 family residential loan portfolio in an effort to replace declining mortgage refinancing opportunities. Figure 3 illustrates the general

composition and growth of ShoreBank’s loan portfolio in the years preceding the institution’s failure.

Figure 3: Composition and Growth of ShoreBank’s Loan Portfolio



Source: OIG analysis of Reports of Condition and Income (Call Report) for ShoreBank.

ShoreBank’s strategy of financing community development in economically disadvantaged areas provided social and environmental benefits. However, it also involved heightened risk factors, such as increased credit, economic, and concentration risk. As discussed later, ShoreBank’s risk management practices, including its loan underwriting, credit administration, and risk analysis and recognition practices were not commensurate with its risk profile. Weaknesses in these areas made ShoreBank vulnerable to a sustained downturn in the real estate market.

CRE and ADC Loan Concentrations

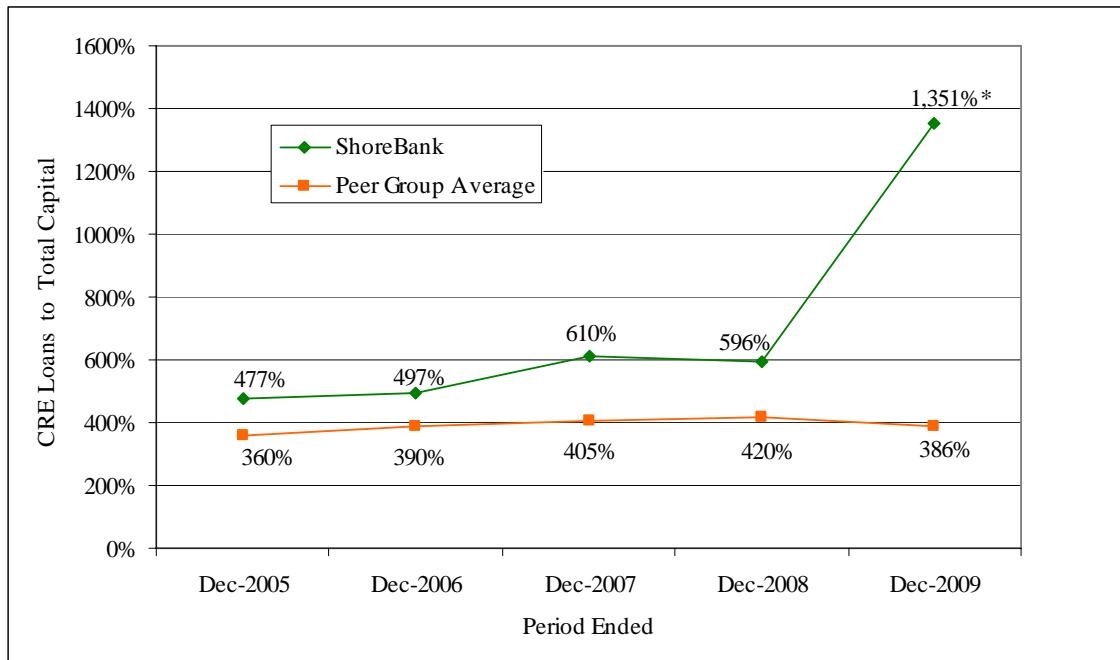
While ShoreBank had a relatively diverse mix of loans in its portfolio, CRE and ADC loans accounted for a significant percentage of the bank’s total capital. In December 2006, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System issued guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The Joint Guidance states that the federal banking agencies have observed an increasing trend in the number of institutions with concentrations in CRE loans and noted that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market.

Although the Joint Guidance does not establish specific CRE lending limits, it does define criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint Guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total CRE loans representing 300 percent or more of total capital where the outstanding balance of the institution’s CRE loan portfolio has increased by 50 percent or more during the prior 36 months; or
- Total loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of total capital.

As of December 31, 2008, ShoreBank’s non-owner-occupied CRE and ADC loans represented 471 percent and 158 percent, respectively, of the institution’s total capital. Both of these levels are higher than the criteria defined in the Joint Guidance as possibly warranting further supervisory analysis. Figure 4 illustrates the trend in ShoreBank’s CRE loans (including both owner- and non-owner-occupied loans) relative to total capital as compared to the bank’s peer group average. As reflected in the figure, ShoreBank’s CRE loan concentration significantly exceeded the bank’s peer group average.

Figure 4: ShoreBank’s CRE Loan Concentrations Compared to Peer Group



Source: OIG analysis of the UBPRs for ShoreBank.

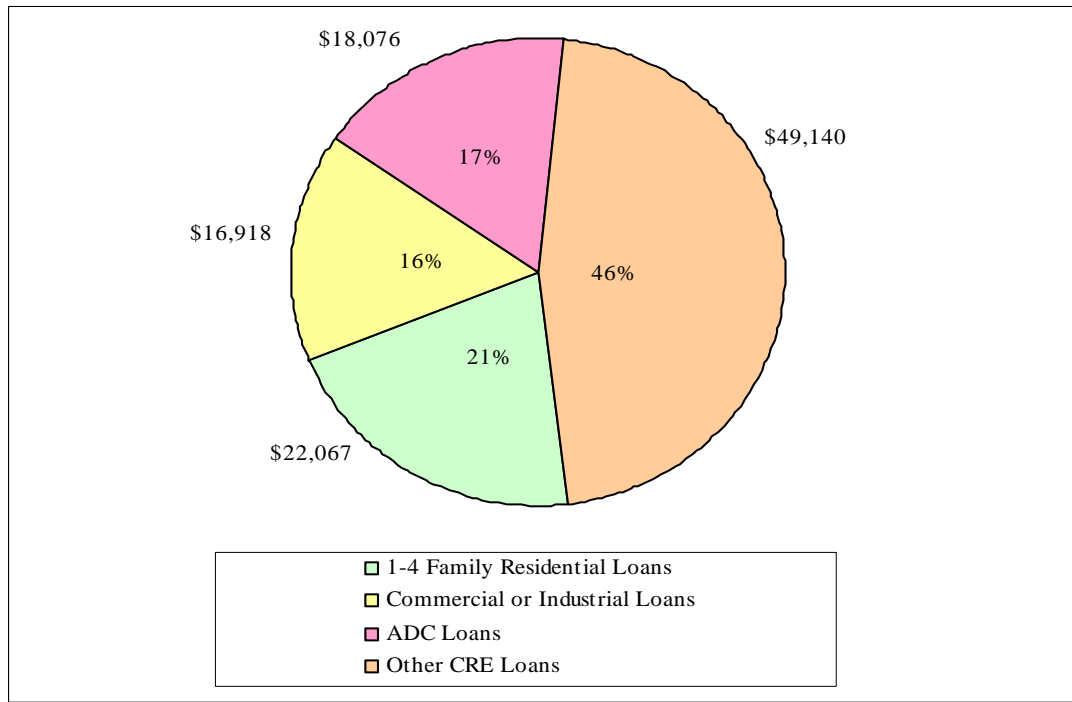
* The increase in the concentration level in 2009 is the result of increasing losses and declining capital levels, rather than loan growth.

Loan Portfolio Decline

At the time of the November 2007 joint examination, ShoreBank's adversely classified assets totaled \$60.6 million, or 42 percent of Tier 1 Capital plus the ALLL. This level of classifications presented a concern for examiners as it was higher than the bank's historical classification level of 20 to 30 percent of Tier 1 Capital plus the ALLL. As a result, examiners strongly encouraged the bank's Board and management to review the loan portfolio to determine whether the institution's credit standards needed to be tightened. By the November 2008 joint examination, ShoreBank's adversely classified assets had increased to \$160.7 million, or 93 percent of Tier 1 Capital plus the ALLL, posing significant risk to the institution. The majority of classifications were centered in CRE and ADC loans. By the January 2010 examination, adversely classified assets had jumped to \$370.6 million, or 224 percent of Tier 1 Capital plus the ALLL. In its final Call Report for the quarter ended June 30, 2010, ShoreBank reported that almost 25 percent of its \$1.3 billion loan portfolio was non-performing.

Figure 5 illustrates the loan losses recognized by ShoreBank across major segments of its loan portfolio from January 2005 through June 2010. Net loan losses during this period totaled about \$106 million and were generally proportional with the size of each loan type, with the majority of losses attributed to CRE multi-family residential loans. As discussed in the next section, examiners expressed repeated concerns about the bank's weak loan underwriting and credit administration practices. However, as reflected in the extent of loan losses, the actions taken by management to address those concerns were not adequate or timely.

Figure 5: ShoreBank's Loan and Lease Losses (in 000s)



Source: OIG analysis of Call Reports for ShoreBank.

Loan Underwriting, Credit Administration, and Risk Analysis and Recognition Practices

As early as the October 2004 examination, examiners identified weaknesses related to underwriting, credit administration, and risk analysis. In broad terms, ShoreBank did not properly identify, measure, monitor, and control risk related to its loan portfolio. As illustrated in Table 3, in some cases, examiners identified similar areas of concern in multiple examinations.

Table 3: Areas of Concern Identified Regarding ShoreBank's Loan Portfolio

Areas of Concern	Examination Dates					
	Oct-2004	Sep-2005*	Oct-2006	Oct-2007	Nov-2008	Jan-2010
Appraisal Practices	✓	✓		✓	✓	✓
Analysis of Borrower's Financial Strength	✓			✓	✓	✓
Analysis and Documentation of Large Borrower Relationships	✓			✓		✓
Loan Documentation and/or Presentations	✓		✓		✓	✓
Loan Underwriting (including, but not limited to, collateral dependent, debt service, and/or interest-only loans)			✓	✓	✓	
Monitoring and Control of Loan Concentrations				✓	✓	✓
Monitoring and Control of Supervisory Loan-to-Value Exceptions			✓	✓	✓	✓
Risk Ratings	✓		✓		✓	✓
Recognition and Accounting of Troubled Debt Restructures and/or Non-Accrual Loans					✓	✓
Allowance for Loan and Lease Losses (methodology and/or adequacy)	✓	✓				✓

Source: OIG analysis of examination reports for ShoreBank.

* The September 2005 examination was an IDFPF examination; the FDIC did not participate in the examination process, but the report was reviewed and accepted by the Chicago Regional Office.

DSC noted that the September 2005 IDFPF examination report indicated that ShoreBank management had generally addressed weaknesses in overall loan administration that had been reported in the 2004 examination. DSC also noted that examiners at the 2006 joint examination concluded that risk management policies and practices for the credit function were generally adequate but raised concerns that were different than those reported in the 2004 examination.

To further illustrate the concerns expressed by examiners during the period covered by our review, listed below are examples of specific findings in loan underwriting, credit administration, and risk analysis and recognition practices and the examination(s) at which they were reported.

Loan Underwriting. The FDIC and IDFPFPR examiners found that ShoreBank did not:

- Ensure that large borrowers and/or guarantors had sufficient financial resources and financial strength to support the credit (January 2010).
- Perform adequate financial analysis of borrowers' repayment capacity, and little evidence existed in the credit files documenting that any analysis had been performed (October 2004, November 2008).
- Obtain or consistently develop an adequate global cash flow analysis, especially on large borrowing relationships (January 2010, November 2008, October 2007).
- Maintain appropriate loan underwriting standards because the bank made loans to borrowers so they could make payments on existing loans (November 2008).
- Structure certain lines of credit with a designated debt repayment period (January 2010).
- Establish an effective appraisal review program and an adequate process for monitoring real estate collateral values. In particular examiners cited apparent violations of Part 323 – *Appraisals*, in multiple examinations (January 2010, September 2005, October 2004).

Credit Administration. FDIC and IDFPFPR examiners found that ShoreBank did not:

- Obtain and/or require updated borrower financial information such as updated rent rolls on collateral-dependent multi-family residential loans (January 2010).
- Ensure receipt of an appraisal before advancing money for condominium conversion projects (October 2004).
- Obtain updated real estate collateral valuations on distressed properties. A vast majority of collateral valuations were “desktop” valuations in which the documentation was limited to an email to the lending officer stating a value, or simply handwritten notes. In many of the desktop valuations, no actual rental information, site inspection, market data, comparable sale information, or other relevant information was included or obtained (November 2008, January 2010).
- Appropriately monitor and limit the level of high loan-to-value loans (November 2008).
- Prevent instances of inappropriate behavior by a single loan officer, such as drawing on open lines of credit to pay delinquent loans within loan relationships without the borrowers' knowledge (November 2008, January 2010).

Risk Analysis and Recognition Practices. FDIC and IDFPFPR examiners found that ShoreBank did not:

- Consistently risk-rate individual loans within the same borrowing relationship (January 2010).
- Establish adequate loan policies and criteria for risk-rating multi-family residential loans. Risk ratings were based solely on the loan's delinquency status and did not consider various risk factors, such as vacancy rates, cash flow performance, extended amortization periods, and loan-to-value positions (November 2008, October 2006).

- Establish loan concentration limits or monitor and report on the bank’s concentration levels (January 2010).
- Adequately account for and place loans in nonaccrual status (January 2010).
- Accurately identify and account for Troubled Debt Restructures.⁵ In 2009, numerous loans were restructured without being identified or accounted for as Troubled Debt Restructures in Call Reports, despite rate and/or other concessions provided to financially-distressed borrowers (January 2010).
- Maintain an adequate ALLL position. Among other things, the bank did not identify and account for several large loan relationships that were Troubled Debt Restructures, adversely classify and identify several significant loan relationships as impaired, or accurately calculate certain impairments (January 2010).

Non-Core Funding Dependence

ShoreBank’s management employed a funding structure that was centered on high-cost, non-core funding to support its operations without implementing appropriate measurement, monitoring, and reporting systems commensurate with the risk profile and business activities of the institution. Of particular note, ShoreBank did not have an adequate Contingency Funding Plan that included provisions for stress testing the bank’s liquidity position under various adverse scenarios. Table 4 presents information about ShoreBank’s funding sources.

Table 4: ShoreBank’s Funding Sources

Period Ended	Core Deposits (\$000s)	Non-Core Funding Sources (\$000s)			
		Time Deposits of \$100,000 or More*	Brokered Deposits	Repurchase Agreements	FHLB Borrowings
Jun-2010	\$1,043,458	\$503,945	\$397,615	\$400,250	\$193,937
Dec-2009	\$1,353,006	\$250,241	\$505,448	\$400,250	\$193,982
Dec-2008	\$1,224,938	\$315,218	\$675,541	\$405,250	\$304,082
Dec-2007	\$1,031,016	\$296,286	\$474,840	\$396,050	\$321,039
Dec-2006	\$586,395	\$722,719	\$495,235	\$205,750	\$312,943
Dec-2005	\$501,896	\$623,802	\$383,945	\$0	\$296,899

Source: OIG analysis of UBPRs for ShoreBank.

* According to DSC, ShoreBank’s time deposits of \$100,000 or more were not high-cost funds and ShoreBank’s cost of such funds was lower than peer institutions.

The Examination Manual states that a heavy reliance on potentially volatile liabilities to fund asset growth is a risky business strategy because the availability and access to these funds may be limited in the event of deteriorating financial or economic conditions, and assets may need to be sold at a loss in order to fund deposit withdrawals and other liquidity needs.

⁵ Troubled debt restructuring takes place when a bank grants a concession to a debtor in financial difficulty. The accounting standards for troubled debt restructurings are set forth in FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FAS 114. Banks are expected to follow proper accounting principles when filing their Call Report.

DSC officials advised us that ShoreBank's higher net non-core funding dependence ratio⁶ was due, in part, to relationship-based deposits that were originated from socially responsible individuals and entities. Some of these relationship-based deposits were brokered deposits. In DSC's view, these relationship-based deposits were more stable than traditional brokered deposits because of the depositors' dedication to ShoreBank's mission. In this regard, the National Community Investment Fund (NCIF) reported that CDFI banks have historically relied on relationship-based brokered deposits originated from socially responsible individuals and institutional depositors.⁷ According to the NCIF, these relationship-based deposits have demonstrated significant stability despite being classified as brokered deposits. However, the NCIF also reported that CDFI banks have faced the potential loss of these deposits as CDFIs' financial conditions deteriorate, and many CDFI banks have been actively engaged in diversifying their deposit sources.

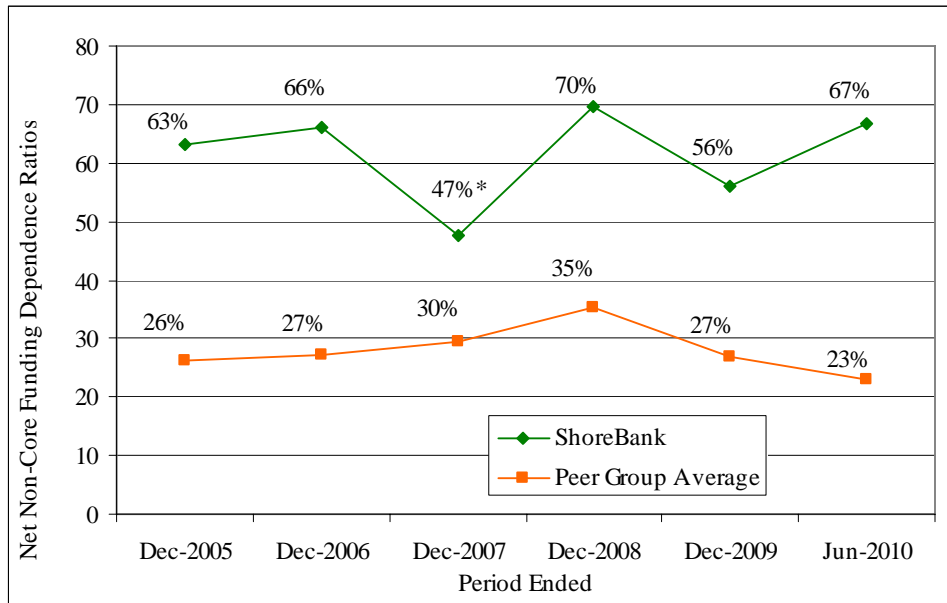
As discussed later, some of ShoreBank's relationship-based deposits were high-cost and interest rate-sensitive. Some of these deposits also had internal restrictions which precluded the depositors from keeping deposits at institutions that were less than *Well Capitalized*. As a result, the volatility and risk associated with the deposits increased as the bank's capital levels decreased.

Figure 6 illustrates the extent to which ShoreBank was highly dependent on non-core funding from December 2005 until its failure. Also of note, ShoreBank's net non-core funding dependence ratio was in the 88th to 99th percentile for its peer group – designated as commercial banks with assets between \$1 billion and \$3 billion. Further, as detailed in the *Background* section of this report, ShoreBank maintained a higher net non-core funding dependence position than the CDFI group average.

⁶ The net non-core funding dependence ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on non-core funding sources that may not be available in times of financial stress or adverse changes in market conditions.

⁷ National Community Investment Fund, *The CDFI Banking Sector: 2009 Annual Report on Financial and Social Performance*. The NCIF is a not-for-profit, private equity trust that invests in banks, thrifts, and credit unions that generate both financial and social returns.

Figure 6: ShoreBank's Net Non-Core Funding Dependence Compared to Peer



Source: OIG analysis of UBPRs for ShoreBank.

* The decline in ShoreBank's December 2007 net non-core funding dependence ratio position was attributed to a systemic reporting weakness related to the Federal Financial Institutions Examination Council's (FFIEC) Call Report data collection and UBPR ratio computations, rather than changes in the bank's financial funding position. Based on our review and assumptions, the bank's ratio should have been computed to be approximately 67 percent. According to FDIC examiners, the variance in the ratio would not have affected their overall assessment of the bank's non-core funding dependence.

Reliance on Brokered Deposits

From December 2005 to December 2008, brokered deposits represented 34 to 44 percent of the bank's total deposit base. During this same time period, the bank's brokered deposits grew 76 percent or \$292 million. ShoreBank also paid rates higher than the peer group average on its time deposits of less than \$100,000, which increased the bank's potential funding risk.

The November 2008 joint examination report indicated that ShoreBank's existing funds management practices were inadequate and insufficient to support the bank's operations, and the bank's deposit volatility was excessive. Examiners reported that ShoreBank had primarily supported the bank's growth and expansion initiatives through the use of costly brokered deposits, public funds, and certificates of deposit (CDs). Examiners also questioned whether management would be able to obtain a sufficient volume of funds on reasonable terms to meet the bank's future liquidity needs. Finally, the examination report noted that declining ratings by nationally recognized statistical rating organizations

might limit the bank's ability to utilize Certificate of Deposit Account Registry Service (CDARS) funding, which was a source of ShoreBank's relationship-based brokered deposits.⁸

Examiners concluded that given the bank's asset quality deterioration and overall financial decline, the bank's extensive use of brokered deposits would likely be curtailed, the ability to offer high-rate CD products would be limited, large depositors might flee to safer investments, and there was a strong probability that existing unsecured borrowing lines would be reduced or restricted. In response, ShoreBank management stated that they believed brokered deposits were cheaper to attract and maintain compared to core deposits that are more costly from an administrative view. Bank management also stated that it would be extremely difficult to raise large sums of core deposits given the neighborhoods and communities that the bank served.

As discussed in more detail later in this report, following the 2008 examination, the FDIC did not include a capital maintenance provision within a July 2009 formal enforcement action that would have restricted the bank's ability to accept, renew, or roll over brokered deposits. The enforcement action did include provisions addressing liquidity and reliance on non-core funding. In addition, the FDIC approved a limited brokered deposit waiver in December 2009 when ShoreBank was *Adequately Capitalized* and otherwise restricted from accepting, renewing, or rolling over such deposits.⁹ As a result, ShoreBank reduced its brokered deposits by 41 percent from December 2008 to June 2010. As shown in Table 4, this decrease was offset somewhat by an increase in Time Deposits of \$100,000 or more. Ultimately, the bank was not able to significantly reduce its non-core funding dependence or reduce its cost of funds prior to failure.

Long-Term Repurchase Agreements

ShoreBank also increased its funding and liquidity risk by selling securities under long-term repurchase agreements. Under such agreements, an institution sells a security to a counterparty and agrees to repurchase the security at a mutually-agreed upon date and price. The agreement provides the institution with an immediate source of liquidity.

The Examination Manual states that the majority of repurchase agreements used by institutions are short-term in nature, and institutions typically use them as short-term, relatively low-cost, funding mechanisms. In addition, properly administered repurchase agreements that are conducted within a comprehensive asset/liability management program are not generally a regulatory concern. However, repurchase agreements that

⁸ CDARS is a brokered deposit-placement service offered by the *Promontory Interfinancial Network, LLC*. The program is designed to allow FDIC-insured institutions to accept deposits of more than \$250,000 and provide full deposit insurance coverage by spreading the funds among as many separate FDIC-insured institutions as necessary so that no institution holds more than \$250,000 for each depositor. Acceptance and continued program participation is based, in part, on the bank's ratings and PCA capital level. One program offered by the CDARS is titled *CDARS for Socially Responsible Investors* that allows large investors to place funds at CDFIs.

⁹ The brokered deposit waiver was limited to CDARS relationship-based brokered deposits.

are not adequately controlled may expose an institution to a risk of loss, and the FDIC will regard such agreements as an unsuitable investment practice.

ShoreBank began to significantly utilize repurchase agreements as a funding source in 2006 and 2007. From December 2006 to June 2010, these funds represented a high-cost funding source. The January 2010 joint examination noted that ShoreBank used repurchase agreements to fund growth and that the majority of the agreements had 5 to 7 years remaining before maturity. As of December 2009, ShoreBank's repurchase agreements accounted for 18.1 percent of the bank's liabilities and ShoreBank was paying more for this funding source than its peers. According to ShoreBank's June 2008 Alternative Funds Management Policy, bank management considered this funding source as low risk and set a permissible funding range of 5 to 20 percent of total assets.

These repurchase agreements also included financial penalties in the event of some form of default. Although ShoreBank did not incur early termination costs, ShoreBank's failure constituted a default and the FDIC, as receiver of ShoreBank, incurred early termination penalties and transaction unwinding fees of \$77 million, which represented 13.5 percent of the loss to the DIF, as of December 2010.¹⁰ Similarly, the FDIC also incurred \$24 million in fees due to the early termination of FHLB advances that were outstanding when the bank failed.

Contingency Funding Plan

ShoreBank did not establish an adequate Contingency Funding Plan. Examiners first recommended that the bank establish a Contingency Funding Plan for any unplanned stress or liquidity events during the October 2007 joint examination. Examiners again reported that ShoreBank had not established an effective Contingency Funding Plan in the November 2008 joint examination report and emphasized that this was a repeated concern from the prior examination. Examiners recommended and included provisions in the July 2009 enforcement action that management immediately develop a Contingency Funding Plan that contemplated a significantly reduced reliance upon the bank's non-core funding sources. The bank's plan was, at a minimum, supposed to:

- Identify alternate funding sources and establish general guidelines for their use.
- Identify the types of stress events that may be faced (e.g., deterioration in asset quality, becoming less than *Well Capitalized*, funding unplanned asset growth, negative publicity, etc...).

¹⁰ According to the FDIC's Division of Resolutions and Receiverships, the appointment of a receiver was an event of default under the terms of the Master Repurchase Agreements that ShoreBank executed with its counterparties. The FDIC, as receiver, steps into the shoes of ShoreBank at closing. When unwinding the term repurchase agreements, the FDIC would be subject to the costs incurred as a result of the early termination of those agreements. The FDIC, as receiver, does not retain long-term repurchase agreements. Under existing law, even if the FDIC wanted to retain the long-term repurchase agreements, after the next business day, the counterparties have the right to seize and liquidate the collateral, retain amounts due as a result of the early termination, and return any excess to the receiver.

- Define responsibilities and decision-making authority so that all personnel would understand their role during a problem-funding situation.
- Detail how management would monitor for liquidity events, typically through stress testing of various scenarios in a pro forma cash flow format.
- Assess the potential for triggering restrictions of the bank's access to brokered and high cost deposits and the resultant effect on the bank's liquidity structure.
- Identify and assess the adequacy of the contingent funding sources, including the conditions and limitations to their use, as well as the circumstances where the institution might employ such facilities.
- Identify the potential assets that may be sold to increase liquidity, including potential purchasers or participants and any formal or informal agreements in place to facilitate such a sale.

In response, ShoreBank's president stated, in part, that the bank's standby liquidity sources (Fed Fund lines, FHLB loans, and wholesale CDs) remained stable but were being treated as less reliable sources. During the 2010 joint examination, examiners noted that ShoreBank's management had made some improvements to the Contingency Funding Plan but concluded that the plan was inadequate and did not fully address prior recommendations.

The FDIC's Supervision of ShoreBank

The FDIC, in conjunction with the IDFPR, provided ongoing supervisory oversight of ShoreBank through risk management examinations, a visitation, and off-site monitoring. Through its supervisory efforts, the FDIC identified key risks and deficiencies in ShoreBank's risk management practices and operations and brought these concerns to the attention of the institution's Board and management through discussions, correspondence, and examination reports. Key recurring risks included weak risk management practices pertaining to asset concentrations, loan underwriting and credit administration, and a historically high reliance on non-core funding. However, the FDIC considered the key risks to be adequately mitigated prior to 2007.

ShoreBank began experiencing increasingly higher levels of loan delinquencies and losses in 2007, due, in part, to the declining economy. The FDIC and IDFPR downgraded the Asset Quality rating because of adversely classified items and rising delinquencies. Following the 2008 examination, the FDIC and IDFPR further downgraded all of the component ratings and composite rating and imposed a formal enforcement action. In retrospect, earlier and greater emphasis on the bank's risk profile—including the bank's vulnerability to an economic downturn, the repeat nature of certain key risk management weaknesses, and the bank's dependence on non-core funding sources—may have been called for in determining the bank's Management and Liquidity ratings and deciding whether an informal action was warranted. Taking a more aggressive supervisory approach earlier could have influenced ShoreBank's Board and management to constrain excessive risk and limit expansion into higher-risk areas, and

imposed a more structured means to ensure the Board and management affirmatively responded to examiner concerns at a critical time.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. Of note, in March 2010, the FDIC completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank’s risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance. The FDIC has also issued supervisory guidance addressing risks associated with CRE and ADC lending and funds management practices. The early use of informal enforcement actions to pursue correction of weak risk management practices is consistent with forward-looking supervision and has been addressed in internal guidance issued to examiners.

Supervisory History

Between 2004 and 2010, the FDIC and IDFPR conducted six examinations and one visitation of ShoreBank. Historically, ShoreBank was considered a well-performing institution. Table 5 summarizes key supervisory information pertaining to these activities.

Table 5: ShoreBank’s Examination History

Examination/Visitation Start Date (Issuance Date)	On-Site Supervisory Effort	Supervisory Ratings (UFIRS)	Supervisory Action
January 4, 2010 (June 25, 2010)	Joint Examination	555555/5	The bank was closed on August 20, 2010.
February 19, 2010 (February 24, 2010)		555555/5	Interim rating change. Consent order amended on March 22, 2010.
April 20, 2009 (June 24, 2009)	Visitation	No rating change	Notified ShoreBank it was in a troubled condition and of related requirements.
November 10, 2008 (April 17, 2009)	Joint Examination	444444/4	Consent order issued on July 14, 2009.
October 29, 2007 (January 23, 2008)	Joint Examination	232222/2	Asset Quality rating downgraded.*
October 23, 2006 (December 4, 2006)	FDIC Examination	222222/2	None.
September 26, 2005 (December 1, 2005)	IDFPR Examination	222222/2	None.
October 18, 2004 (December 12, 2004)	FDIC Examination	222222/2	None.

Source: Examination reports, problem bank memoranda, and formal enforcement actions for ShoreBank.

* The FDIC and IDFPR also required ShoreBank to submit a quarterly Classified Asset Progress Report.

Offsite Reviews

In addition to onsite examinations, the FDIC performed offsite monitoring of ShoreBank. The FDIC's offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies, such as examination schedules, can be adjusted appropriately. The FDIC electronically generates an Offsite Review List (ORL) each quarter and performs offsite reviews for each 1- and 2- rated bank that appears on the list. The ORL includes institutions that are identified by:

- The Statistical CAMELS Offsite Rating (SCOR) system as having a 35 percent or higher probability of downgrade to a composite "3" rating or worse, or
- The Growth Monitoring System (GMS) as having a growth percentile of 98 or 99 in comparison to peer institutions.

Table 6 identifies the risk flags that were identified by the FDIC's automated offsite review programs that prompted a corresponding review of ShoreBank from September 2005 until the institution failed. Appendix 2 includes a description of each offsite review model listed below.

Table 6: ShoreBank's Offsite Review History

Offsite Model	Sep-2005	Jun-2006	Sep-2006	Dec-2006	Jun-2008	Sep-2008	Dec-2008	Mar-2009	Jun-2009
SCOR					✓	✓	✓	✓	
SCOR-LAG					✓	✓	✓	✓	
Real Estate Stress Test (REST)	✓	✓	✓	✓	✓	✓	✓	✓	
GMS	✓	✓	✓	✓					
Consistent Grower	✓	✓	✓	✓	✓	✓	✓	✓	
Multiflag				✓					
Other									✓

Source: OIG analysis of Offsite Review reports for ShoreBank.

As shown, from September 2005 to June 2009, the FDIC's offsite review program identified ShoreBank for offsite review for nine periods. The offsite review documentation explained why the bank was appearing on the ORL and briefly discussed completed or planned examination activity. The FDIC did not substantially change its supervisory strategy as a result of the offsite reviews and relied on the annual examination schedule.

Enforcement Actions

Following the 2008 examination, the FDIC and IDFPF jointly issued a formal enforcement action, which was subsequently amended in 2010 to include a capital maintenance provision.

July 14, 2009 Consent Order: The order became effective on July 24, 2009 and contained 13 provisions that addressed such areas as:

- retaining acceptable management;
- developing a capital plan;
- improving credit quality and loan administration;
- developing a written plan to manage concentrations;
- developing a written plan to address liquidity, dependency on non-core funding, and rate sensitivity;
- developing a contingency funding plan;
- restricting dividends;
- developing a written profit plan and budget;
- establishing a board committee to ensure compliance with the consent order; and
- providing progress reports.

At this time, ShoreBank's capital component was rated a "4" due, in part, to the elevated risk profile of the bank—stemming from severe asset quality problems and significant concentration risk. Financial assistance from shareholders or other external sources was considered a necessity. However, the consent order did not include a capital maintenance provision. Including a capital provision would have decreased ShoreBank's capital designation from *Well Capitalized* to *Adequately Capitalized* and imposed certain operating restrictions. Most notably, ShoreBank would have been prohibited from accepting brokered and higher-rate deposits without a waiver from the FDIC.

According to the November 2008 joint examination report, FDIC examiners held a meeting with ShoreBank senior management in January 2009 to discuss the examination findings. The bank's president expressed significant concern with the FDIC's proposed ratings, the volume of classified assets, and overall deficiencies identified, given the fact that the bank's business plan had gone unchanged for many years. ShoreBank's president also stated that the proposed rating would cause the bank to lose critical deposits that were dependent upon the bank maintaining a *Well Capitalized* position and not being subject to formal regulatory action. The president asserted that the bank would "surely fail" if the FDIC and IDFPD assigned a composite "4" rating.

ShoreBank representatives also requested a meeting with the FDIC Chairman and senior FDIC headquarters officials, and the meeting was held on May 8, 2009. The Chairman and senior officials from DSC and the Legal Division attended the meeting. ShoreBank's purpose for the meeting was to present its plans to address deficiencies identified in the November 2008 examination and its efforts to raise capital. ShoreBank representatives also discussed the harshness of the proposed consent order and requested that the FDIC instead impose a non-public informal enforcement action. The FDIC did not acquiesce and, as discussed above, continued to pursue and ultimately issued a formal enforcement action.

An April 9, 2010 DSC Supervisory History timeline and May 12, 2009 status comments within DSC's Formal and Informal Action Tracking System (FIAT) noted, in part, that

the enforcement action did not include specific capital levels, but rather a capital plan, as a result of the May 8, 2009 meeting. However, interviews with officials who attended the meeting indicated that the capital maintenance provision was not discussed.

Based on our interviews with several FDIC regional and IDFPR officials, the FDIC had detailed and supportable information indicating that ShoreBank would be able to raise additional capital. Those interviews also indicated that Chicago regional, IDFPR, and DSC headquarters officials discussed and debated the merits of a capital maintenance provision and the officials' collective judgment was that the provision was not needed in the order, considering ShoreBank's existing level of capital and prospects for raising additional capital. Chicago regional officials were also concerned that a public order with such a capital maintenance provision would have impaired ShoreBank's ability to access and retain deposits and that certain large ShoreBank depositors might have been required to withdraw their deposits in the event that ShoreBank became less than *Well Capitalized*.

We reviewed other consent orders for banks that were *Well Capitalized* from the Chicago Region to determine how common it is for orders to include capital maintenance provisions. Based on a review of consent orders (issued and terminated) by the Chicago Regional Office for 2009, we found that 1 out of 26 orders (3.8 percent, excluding ShoreBank) did not contain a targeted capital provision. The one order was issued to a bank with a Tier 1 Leverage Capital ratio of 13.1 percent and a Total Risk-Based Capital ratio of 19.5 percent.

While it may be uncommon for FDIC regional offices to issue a formal enforcement action without a capital maintenance provision, it is within their discretion to do so and allowed by FDIC policy. Further, the consent order required ShoreBank to develop a capital plan acceptable to the Regional Director and DSC sufficient for the kind and quality of assets held and risks undertaken. The Regional Director told us that he advised ShoreBank management of DSC's expectations regarding the bank's capital levels and referred management to other consent orders for examples of acceptable capital levels. The Regional Director and the IDFPR Commissioner also conducted weekly calls with ShoreBank to monitor the bank's compliance with the consent order, including progress in meeting the regulators' expectations regarding capital.

March 22, 2010 Amended Consent Order: On March 10, 2010, ShoreBank agreed to consent to an amendment to the order. The amendment added an additional provision to the outstanding July 2009 consent order that required the bank to have and maintain a minimum Tier 1 Leverage Capital Ratio of 9 percent and a minimum Total Risk-Based Capital Ratio of 12 percent. In addition, the bank was required to notify shareholders of the amended order. FDIC regional staff told us the FDIC and IDFPR amended the order to include specific capital levels as ShoreBank's condition continued to deteriorate.

Supervisory Response to ShoreBank's Board and Management Oversight

According to DSC's Examination Manual, a bank's Board and management are assessed on their capability to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations. Generally, directors must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the Board's goals, objectives, and risk limits into prudent operating standards.

As discussed in the *Background* section, three former outside members of the FDIC Board of Directors served as either board members or officials of ShoreBank and/or SBC. Chicago regional officials told us that the former Board Members' involvement in the two organizations did not affect the FDIC's supervision of ShoreBank and nothing came to our attention during our review to suggest that the FDIC supervised ShoreBank differently than other institutions.

During examinations conducted between 2004 and 2007, the FDIC and IDFPR assigned ShoreBank a management component rating of "2" and reported that ShoreBank's Board and management were adequate and provided sufficient oversight of the bank.

- The October 2004 FDIC examination found that while management's overall policies and practices were acceptable, the bank had several areas in need of management's attention. The examination report noted that many of the areas were identified in the prior FDIC examination, and while management had taken corrective action, further action was needed. In addition, examiners reported that while management had historically proven to be generally conservative in its lending practices and losses had been manageable, numerous deficiencies were again noted regarding overall loan administration, particularly in the multi-family residential real estate portfolio.
- The September 2005 IDFPR examination reported that the institution's low risk profile was driven by conservative management strategies, which were satisfactorily administered by the Board and senior management, and conservative underwriting.
- The October 2006 FDIC examination reported that the Board and senior management continued to provide sufficient oversight of the bank. Although a number of loan administration deficiencies were noted, the report stated that management was able to maintain a very favorable loan loss history and adverse classifications remained manageable. Further, the bank's funds management practices remained satisfactory and the bank's risk management and alternative funding policies were adequate. The examiners also reported that ShoreBank was in compliance with all Board-approved ratios, and internal reports provided management with the tools to properly identify, measure, monitor, and control the

bank's liquidity position.

- The October 2007 joint examination reported that the Board and senior management satisfactorily oversaw the bank's operations, management operated the complex community bank in an acceptable manner, and the Board was kept abreast of the bank's activities through a comprehensive Board package and open communication with the operating management team. However, the examination report noted that further efforts were needed to improve ShoreBank's risk management processes related to economic conditions and asset concentrations, credit policies and procedures, and asset/liability management policies and practices. As discussed later, ShoreBank was not responsive to repeated examiner concerns in these key areas.
- In contrast, the November 2008 joint examination found that ShoreBank's Board and senior management were less than acceptable due to the bank's growing amount of asset quality problems and unacceptable management practices. Examiners noted that management was accountable for the decisions that led to the bank's financial deterioration, particularly the bank's credit concentrations that exposed ShoreBank to increased risks. In response to the July 2009 consent order, ShoreBank requested and received the FDIC's approval to replace its existing president and Chairman of the Board.
- The January 2010 joint examination report indicated that ShoreBank's oversight of the multi-family portfolio had improved, but that prior oversight was inadequate and that the bank's overall condition had continued to deteriorate. In addition, examiners concluded that the bank's risk management processes were not adequate. Examiners continued to report significant concerns with loan underwriting and administration and high levels of liquidity risk given the bank's weak condition and significant reliance on wholesale funding. The examiners also concluded that poor risk selection, weak underwriting, and inadequate loan monitoring, coupled with the economic downturn were the major causes of the deterioration in the loan portfolio and the bank's overall financial condition.

In hindsight, management's inability to effectively address areas of regulatory concern over several examination cycles and to respond to changing economic conditions may have warranted increased regulatory attention and action before 2008. A bank's Management component rating should reflect the Board's and management's ability as it applies to all aspects of its banking operations. Management is rated, in part, based upon an assessment of:

- The ability of the Board and management to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.

- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- The overall performance of the institution and its risk profile.

With these factors in mind, a more critical assessment of management during the 2007 examination may have been prudent given that ShoreBank's management had not adequately:

- planned for the potential risks associated with possible changing business conditions;
- established policies and procedures related to concentrations, loan underwriting and administration, and non-core funding dependence;
- established effective risk management monitoring systems appropriate for the institution's size, complexity, and risk profile; and,
- addressed areas of supervisory concern over a period of several examination cycles.

Supervisory Response to ShoreBank's Risk Management of the Loan Portfolio

According to the Examination Manual, asset quality is one of the most critical areas in determining the overall condition of a bank. The primary factor affecting overall asset quality is the quality of the loan portfolio and the credit administration program. Loans are usually the largest of the asset items and can also carry the greatest amount of potential risk to the bank's capital account. The manual also states that management's ability to identify, measure, monitor, and control credit risk is reflected in the bank's asset quality rating. Asset quality is primarily rated upon an assessment of:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
- The diversification and quality of the loan and investment portfolios.
- The existence of asset concentrations.
- The adequacy of loan and investment policies, procedures, and practices.
- The volume and nature of credit documentation exceptions.

As discussed in the following sections, examiners routinely recognized ShoreBank's CRE concentrations and repeatedly noted weaknesses in ShoreBank's loan underwriting and administration practices. However, examiners' level of concern was mitigated due to the bank's low level of loan losses until the 2007 examination.

Supervisory Response to ShoreBank's Loan Concentrations

FDIC and IDFPF examiners reported on ShoreBank's loan concentrations in each examination report:

- The October 2004 and October 2006 FDIC examinations listed the bank's concentration in multi-family residential loans based on the bank's loans to investors (reported as multi-family residential loans) and to developers (reported as ADC loans). Examiners concluded that the risk associated with these concentrations was mitigated by the bank's historical experience of low loan losses.
- The October 2007 joint examination listed the bank's concentration in multi-family residential loans and recommended that bank management and the Board review the 2006 CRE Concentration guidance for compliance.
- The November 2008 joint examination noted ShoreBank's increasing classifications caused by deteriorating economic conditions and expressed significant concern with the bank's CRE, ADC, and multi-family residential loan concentrations. Examiners recommended that the Board and senior management examine the current economic environment and determine whether changes to the bank's overall growth strategy were needed. The FDIC and IDFPF also included a concentrations of credit provision in the July 2009 consent order requiring the bank to formulate, adopt, and implement a written plan to manage concentrations of credit to include (1) written procedures for the ongoing measurement and monitoring of the concentrations of credit and (2) a limit on concentrations commensurate with the bank's capital position, safe and sound banking practices, and the overall risk profile of the bank.
- The January 2010 joint examination found that the bank had revised its credit policy and established various concentration limits. However, we observed that ShoreBank's revised policies did not address the bank's concentrations in CRE loans or ADC loans. Although the bank set a concentration limit for multi-family residential loans, the established limit of 300 percent of capital was higher than the bank's historical holdings for multi-family residential loans. For example, from December 2005 to September 2009, the bank's concentration of multi-family residential loans ranged from 214 to 276 percent of capital. According to DSC, this concern was mitigated by the bank no longer originating new ADC loans.

Supervisory Response to ShoreBank's Loan Underwriting, Credit Administration, and Risk Analysis and Recognition

As early as October 2004, examiners identified weaknesses related to underwriting and credit administration. In addition, as shown earlier in Table 3 in the *Cause of Failure and Material Loss* section of this report, some areas of concern were repeated in multiple

examinations. The significance of these repeat areas of concern was more pronounced because some concerns were centered in the bank's largest portfolio segment, multi-family residential loans in low- to moderate-income areas, and involved collateral dependent loans with appraisal/collateral-valuation issues. Further, deficiencies identified within the bank's internal risk-rating process (for example, risk-rating multi-family loans based solely on delinquency, and not accounting for other risk factors such as vacancy rates, cash flows, extended amortization periods, and high loan-to-values) compounded the effect of these weaknesses.

FDIC and IDFPR examiners reported the following with respect to loan underwriting and credit administration.

- The October 2004 FDIC examination found that ShoreBank's risk management policies and practices for the credit function were not adequate and that numerous deficiencies remained in the administration of the bank's multi-family loan portfolio. The examination report indicated that several of these criticisms were noted at prior examinations.
- The October 2006 FDIC and October 2007 joint examinations continued to identify credit underwriting and administration concerns, particularly within the bank's multi-family residential loan portfolio. Based on these concerns, increasing levels of delinquencies and problem assets, and a deteriorating economic environment, examiners reduced the bank's Asset Quality component rating from a "2" to a "3" during the October 2007 examination.
- The November 2008 joint examination report expressed a higher level of concern over ShoreBank's loan underwriting and administration practices. In particular, examiners determined that asset quality was poor as the level of adversely classified assets had sharply increased and loan underwriting and administration deficiencies continued to exist. As a result, examiners downgraded the bank's Asset Quality component rating to "4" and included a provision in the July 2009 consent order requiring improvement in loan administration policies and practices.
- The January 2010 joint examination report acknowledged that ShoreBank had revised the bank's policies but noted repeated loan underwriting and administration concerns. Examiners reported that poor risk selection, weak underwriting, and inadequate monitoring, coupled with the economic downturn, were the major causes of the deterioration in the loan portfolio.

As discussed above, the FDIC and IDFPR downgraded ShoreBank's Asset Quality component rating to a "3" in October 2007. As noted earlier in this report, additional emphasis on ShoreBank's asset concentration levels and the repeat nature of the underwriting and credit administration weaknesses may have been warranted in assessing management and determining the need for an informal supervisory action. An informal supervisory action may have prompted the Board and management to be more responsive

to examiners' concerns before the economy and ShoreBank's asset quality began to significantly deteriorate.

The FDIC has taken a number of steps to enhance its supervision program based on the lessons learned from financial institution failures during the financial crisis. Of note, in March 2010, the FDIC completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance. The FDIC has also issued supervisory guidance addressing risks associated with CRE and ADC lending. Finally, the early use of informal enforcement actions to pursue correction of weak risk management practices is consistent with forward-looking supervision, and the FDIC has addressed this area in internal guidance issued to examiners.

Supervisory Response to ShoreBank's Non-Core Funding Dependence

DSC's Examination Manual states that in evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. Funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. Liquidity is rated based upon, in part, an assessment of:

- The level of diversification of funding sources, both on- and off-balance sheet.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets.
- The trend and stability of deposits.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Since the October 2004 FDIC examination, examiners reported that ShoreBank had funded asset growth through non-core funding sources and recognized that the bank's reliance on non-core funding sources was necessitated due to the historically low levels of core deposits that were available in ShoreBank's lending areas. Examiners also routinely concluded that ShoreBank's asset/liability funds management policies and practices were adequate, and that the bank's funding practices were consistent with internal guidelines. Notably, however, the October 2007 joint examination reported that ShoreBank's non-core funding dependency could be an issue if the bank experienced significant financial deterioration, and examiners recommended that the bank develop a Contingency Funding Plan.

The November 2008 joint examination found that liquidity levels, contingency planning, and existing funds management practices were inadequate and insufficient to support bank operations. Accordingly, examiners downgraded the bank's Liquidity component rating from a "2" to a "4" and included an asset/liability management plan provision in the July 2009 consent order. This provision required ShoreBank to develop a plan to address the bank's dependency on non-core funding sources, to include establishing a desirable range for the bank's net non-core funding dependence ratio, reducing the level of brokered deposits, and developing a formal Contingency Funding Plan.

The January 2010 joint examination found that ShoreBank's liquidity levels were critically deficient. Examiners noted that ShoreBank had established the following policy guidelines:

- Net non-core funding dependence ratio of 40 percent or less.
- Short-term net non-core funding dependence ratio of 25 percent or less.
- Brokered deposits to total deposits of 35 percent or less.

However, examiners found that ShoreBank was not in compliance with two of the above policy guidelines. In addition, the examiners noted that ShoreBank's brokered deposit policy parameter was still too high, brokered deposit guidelines were inadequate, Internet deposit policy guidelines were not addressed, and limits on FHLB advances or other borrowings had not been established. Examiners also reported that ShoreBank's Contingency Funding Plan was inadequate.

In hindsight, although examiners routinely recognized the bank's historical and highly dependent use of non-core funding, the FDIC could have expressed a greater level of concern and taken earlier supervisory action to further mitigate the potential level of risk present within ShoreBank. Specifically, assigning a "3" rating for the Liquidity component in the October 2007 examination may have been prudent considering:

- ShoreBank's level of dependence on non-core funding and high-cost deposits;
- the absence of a Contingency Funding Plan; and
- the lack of adequate risk identification, measurement, monitoring, and control over the bank's non-core liabilities.

An institution assigned a Liquidity component rating of "3" indicates that liquidity levels or funds management practices are in need of improvement. Institutions rated "3" in this area may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices. According to FDIC senior Chicago regional officials, the bank's non-core funding dependence was viewed to be mitigated, to a certain degree, by the nature of the bank's customer deposit base, which included philanthropists and other socially responsible individuals and institutions that believed in ShoreBank's mission. However, as noted earlier in this report, some of these funding sources became potentially more volatile when ShoreBank's financial position deteriorated due to conditions associated with the deposits remaining in the bank. In addition, examiners stated that ShoreBank was able to effectively manage its non-core

funding dependence and to remain liquid, until the bank experienced financial difficulties, at which time examiners expressed increased concern.

As part of its efforts to enhance the supervision program, the FDIC issued guidance related to liquidity management and the use of potentially volatile or special funding sources by financial institutions that are in a weakened condition in 2008 and 2009, respectively. Specifically, in August 2008, the FDIC issued guidance, FIL-84-2008 entitled *Liquidity Risk Management*, to highlight the importance of contingency funding plans to address relevant stress events and the requirements governing the acceptance, renewal, or rolling over of brokered deposits. FIL-13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*, states that institutions rated “3”, “4”, or “5” that engage in material growth strategies, especially those that are funded with volatile liabilities or temporarily expanded FDIC insurance or liability guarantees, pose a significant risk to the DIF and will be subject to heightened supervisory review and enforcement.

Implementation of PCA

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

The FDIC issued timely notices related to the institution’s capital category, reviewed and monitored the institution’s Call Reports and UBPRs, obtained and reviewed progress reports on enforcement actions, conducted onsite reviews and monitoring of PCA restrictions, and conducted periodic discussions with the institution’s management regarding compliance with the restrictions imposed under each PCA capital category. However, the FDIC’s notification to ShoreBank regarding the adequacy of its capital restoration plan could have been enhanced.

ShoreBank was considered *Well Capitalized* for PCA purposes until October 30, 2009, when the bank filed its September 30, 2009 Call Reports and its Tier 1 Leverage Capital ratio fell below 5 percent, placing ShoreBank within the *Adequately Capitalized* capital category. Subsequently, based on the results of the January 2010 examination, the bank’s December 2009 capital ratios fell within the *Critically Undercapitalized* capital category based on the examiners’ identification of additional losses and determination that additional ALLL provisions were needed. Table 7 illustrates ShoreBank’s capital levels relative to the PCA thresholds for *Well Capitalized* institutions, and the significant decline in ShoreBank’s capital levels from December 2008 to June 2010.

Table 7: ShoreBank’s Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions

Capital Ratio	Well Capitalized Threshold	As of Dec-2008	As of Sep-2009	As of Dec-2009	As of Jun-2010
Tier 1 Leverage Capital	5% or more	5.88%	4.62%	1.82%	0.18%
Tier 1 Risk-Based Capital	6% or more	9.45%	8.31%	3.30%	0.33%
Total Risk-Based Capital	10% or more	10.73%	9.59%	4.61%	0.66%

Source: OIG analysis of UBPRs for ShoreBank, as well as section 38 of the FDI Act and 57 Federal Register 44866-1.

Key Actions in Implementing PCA

The FDIC’s key actions in implementing PCA and monitoring ShoreBank’s adherence to PCA included the following:

- November 25, 2009.** Based on ShoreBank’s September 2009 Call Reports, the FDIC issued a PCA notification letter informing the bank that it was *Adequately Capitalized* based on PCA capital standards. As a result of this capital designation, the bank was subject to various restrictions on deposit rates and the acceptance, renewal, or roll-over of brokered deposits without an FDIC waiver.
- December 16, 2009.** Based on ShoreBank’s November 2009 brokered deposit waiver application, the FDIC provided a limited 90-day waiver for the bank to renew or replace certain brokered deposits totaling \$58 million. The request sought to alleviate the bank’s liquidity needs, and, in approving the request, the FDIC confirmed that the identified deposits were in essence core deposits, and that the depositors had an established long-term relationship with the bank.
- January 12, 2010.** The FDIC denied the bank’s December 2009 request for a waiver to the interest rate requirements of Section 337.6 – *Brokered Deposits*. In particular, the bank was denied a waiver to pay rates in excess of the national rate cap.
- June 25, 2010.** Based on the January 2010 examination, issued in June 2010, the FDIC cited the bank for apparent violations of Part 337.6 - *Brokered Deposits* of the FDIC Rules and Regulations, which states, in part, that an adequately capitalized institution may not accept, renew, or roll over deposits that exceed the national rate paid on deposits of comparable size and maturity by 75 basis points. From October 1, 2009 to January 12, 2010, the bank opened 377 new online savings accounts totaling \$66.3 million that paid rates in excess of the interest rate limit.
- February 23, 2010.** Based on ShoreBank’s amended December 2009 Call Reports, submitted on February 22, 2010, the FDIC provided the bank with a second PCA notification letter that informed ShoreBank that it was *Critically Undercapitalized*¹¹

¹¹ According to Part 325 *Subpart B – Prompt Corrective Action*, an insured depository institution is deemed to be *Critically Undercapitalized* if it has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

for PCA purposes, the lowest PCA capital designation. As a result of this capital designation, the bank was subject to further restrictions, including, but not limited to, asset growth, acquisitions, new activities, new branches, payment of dividends or making any other capital distribution, and management fees or senior executive compensation. In addition, ShoreBank was required to submit a capital restoration plan. Bank management was also notified that the FDIC would be required to place ShoreBank into receivership on May 24, 2010, unless it was determined that a different action would better carry out the purposes of section 38.

- **March 10, 2010.** As discussed elsewhere in this report, the FDIC amended the bank's July 2009 consent order to include a capital maintenance provision.
- **May 18, 2010.** The FDIC extended the period required to place the bank into receivership beyond the 90-day requirement for an additional 90 days, until August 22, 2010. The FDIC granted the extension to provide sufficient time for the Treasury to consider the bank's request for CDCI funds, and for the recapitalization of the bank to be consummated.

Capital Restoration Plans

ShoreBank was required to submit a capital plan based on the July 2009 consent order, and a capital restoration plan based on the February 2010 PCA notification letter. In response to the July 2009 consent order, ShoreBank submitted a capital plan in September 2009; however, due to continuing deterioration of the bank's condition, ShoreBank submitted an amended capital plan in December 2009. ShoreBank's December 2009 capital plan consisted of a strategy to both raise new capital and shrink the balance sheet of the bank. In response, the FDIC reviewed the capital plan during its January 2010 examination, and approximately 6 months later, notified the bank within the January 2010 ROE and accompanying transmittal letter, dated June 25, 2010, that further efforts were needed to develop and implement a successful capital plan.

In response to the February 2010 PCA notification letter, ShoreBank submitted a capital restoration plan in March 2010. According to FDIC senior regional management, the FDIC did not provide formal notification to ShoreBank that commented on the adequacy or inadequacy of the bank's March 2010 capital restoration plan. According to Part 325.104(c), the FDIC is required to provide written notice within 60 days of receiving a capital restoration plan as to whether the plan has been approved. Although FDIC examiners believed the capital restoration plan was adequate, examiners were continuing to perform analysis and hold discussions with other bank regulators regarding ShoreBank's capital requirements for CDCI funding purposes. Accordingly, the FDIC did not provide written notification to ShoreBank. Given ongoing analysis and discussions, in our view, the lack of written notification was inconsequential to the supervision or failure of the bank.

Community Development Capital Initiative

In March 2010, ShoreBank applied for almost \$72 million in funding through the Treasury Department's CDCI program. The CDCI program was part of the Troubled Asset Relief Program.¹² ShoreBank's CDCI application was contingent on ShoreBank raising approximately \$150 million in private capital. We will be discussing ShoreBank's efforts to raise private capital and the banking regulators' consideration of CDCI funding in a separate report. Ultimately, several of the banking regulators concluded that ShoreBank required greater amounts of private capital, and ShoreBank was not able to obtain approval for CDCI funding or fully enact its proposed capital restoration plan. The IDFP closed ShoreBank and named the FDIC as receiver on August 20, 2010, due to the bank's insolvency primarily resulting from deteriorating capital.

Corporation Comments

After we issued our draft report, management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On February 25, 2011, the Director, Division of Risk Management Supervision, provided a written response to the draft report. In the response, the Director reiterated the causes of ShoreBank's failure and the supervisory activities described in our report. The response also noted that the FDIC issued a Financial Institution Letter (FIL) in 2008, entitled *Managing Commercial Real Estate Concentrations in a Challenging Environment*, that reemphasized the importance of robust credit risk-management practices in institutions with concentrated CRE exposures.

¹² Please see the *Glossary* for a description of these programs.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, as amended by the Financial Reform Act, which provides, in general, that if the 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 Financial Reform Act amends section 38(k) by increasing the MLR threshold from \$25 million to \$200 million for losses that occur for the period January 1, 2010 through December 31, 2011. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

On August 5, 2010, prior to ShoreBank's failure, the Ranking Member of the House Financial Services Committee and the Ranking Member of the Subcommittee on Oversight and Investigations requested that we review private-sector efforts to recapitalize ShoreBank and the FDIC's consideration of ShoreBank's application for funds under Treasury's CDCI program. The Ranking Members requested that we determine whether the Administration or Members of the Congress exerted political influence over the FDIC associated with efforts to recapitalize ShoreBank.

Our audit objectives were to (1) determine the causes of ShoreBank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of ShoreBank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. In addition, to address the Ranking Members' concerns we determined (3) the timeline of events pertaining to the FDIC's supervision and CDCI consideration for ShoreBank; (4) the extent and nature of FDIC involvement in the ShoreBank investor recapitalization effort; (5) whether the FDIC followed its standard process in reviewing ShoreBank's CDCI application and whether ShoreBank met CDCI eligibility requirements; (6) whether the resolution followed selected FDIC policies and regulations related to marketing the bank, assessing purchaser eligibility, and making a least cost decision; and (7) whether there was any indication of political or inappropriate influence imposed on the FDIC in connection with the supervision, investor recapitalization effort, CDCI consideration, or resolution of ShoreBank.

This report addresses the first two objectives, that is, our analysis of ShoreBank's failure and the FDIC's supervision of the institution as required by section 38 of the FDI Act. We will issue a separate report addressing the remaining objectives involving ShoreBank recapitalization efforts and the FDIC's marketing and resolution of ShoreBank.

We conducted this performance audit from August 2010 to February 2011 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

Objectives, Scope, and Methodology

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 ShoreBank's operations from 2004 until its failure on August 20, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination reports prepared by the FDIC and the IDFPF examiners from 2004 to 2010.
- Reviewed the following:
 - Bank data and correspondence maintained at DSC's Chicago Regional Office.
 - Reports prepared by DRR and DSC relating to the bank's closure.
 - Institution data in Call Reports and UBPRs.
 - Audit reports prepared by the bank's external auditor.
 - Pertinent DSC policies and procedures and various banking laws and regulations.
- Interviewed the following FDIC officials:
 - DSC management in Washington, D.C. and the Chicago Regional Office.
 - FDIC examiners from the Chicago Regional Office and Downers Grove, Illinois Field Office, who participated in examinations or reviews of examinations of ShoreBank.
- Interviewed IDFPF examiners and managers to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

Objectives, Scope, and Methodology

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand ShoreBank's management controls pertaining to causes of failure and material loss as discussed in the body of this report. In performing the MLR we relied on Call Report data provided by ShoreBank from March 2005 to June 2010. Examiners informed us that they verified the accuracy of basic data on key Call Report schedules, but not all Call Report data from 2005 through 2007. This practice did not affect our audit conclusions.

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. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at <http://www.fdicig.gov>. In addition, the OIG issued an audit report entitled, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), in December 2010. The objectives of the audit were to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including

Objectives, Scope, and Methodology

those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

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

Glossary of Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of Commercial Real Estate that provide funding for acquiring and developing land for future construction, and that provide interim financing for residential or commercial structures.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Commercial Real Estate (CRE) Loans	CRE loans are land development and construction loans (including 1-to-4 family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property and nonfarm nonresidential property, where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property.
Commercial & Industrial (C&I) Loans	Non-real estate secured or unsecured loans made to business enterprises. Examples include, but are not limited to, loans for the purpose of financing capital expenditures and current operations (such as working capital or accounts receivable loans), and loans guaranteed by the Small Business Administration.

Glossary of Terms

Term	Definition
Community Development Capital Initiative	A Troubled Asset Relief Program designed to provide capital assistance to viable community development financial institutions. The program is administered by the Treasury Department's Office of Financial Stability.
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.
Consistent Grower	Consistent Grower is a cumulative growth score for an institution using up to 20 quarters of GMS scores. Individual quarter GMS scores are weighted based on the percentile rank for each period. This weighting process results in a single GMS score that is representative of multiple periods.
Contingency Funding (or Liquidity) Plan	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency funding plans should be regularly tested and updated to ensure that they are operationally sound. DSC uses the term contingency funding plan and contingency liquidity plan interchangeably.
FDIC's Supervision Program	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 institutions. The FDIC's Division of Supervision and Consumer Protection, now the Division of Risk Management Supervision, (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.
Federal Home Loan Bank (FHLB)	FHLBs provide long-and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.

Glossary of Terms

Term	Definition
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to perform on a loan. During underwriting, proper global cash flow must thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow must consider all other relevant factors, including: guarantor's related debt at other financial institutions, future economic conditions, as well as obtaining current and complete operating statements of all related entities. In addition, global cash flow analysis should be routinely conducted as a part of credit administration. The extent and frequency of global cash flow analysis should be commensurate to the amount of risk associated with the particular loan.
Growth Monitoring System (GMS)	GMS is an offsite rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.
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.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of \$200 million.
Memorandum of Understanding (MOU)	A Memorandum of Understanding is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Multi-family Residential loans	Real estate secured loans that include, but are not limited to, properties with five or more residential units in the structure (such as, apartment buildings, cooperative buildings, and mix-use buildings where the primary use is residential with five or more housing units). Loans for multifamily residential property construction, apartment rehabilitation, and condominium conversions are excluded.
MultiFlag	MultiFlag is a model that combines the FDIC's various off-site review risk measures, and based on relaxed thresholds/criteria identifies banks that would not normally be identified by a single measure. Institutions with multiple exceptions—exceeding the criteria of four or more off-site review models—are considered high risk.

Glossary of Terms

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Nonaccrual Status	The status of an asset, often a loan, which is not earning the contractual rate of interest in the loan agreement, due to financial difficulties of the borrower. Typically, interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time. Loans with principal and interest unpaid for at least 90 days are generally considered to be in a nonaccrual status.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Problem Bank Memorandum	A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented and is also used to effect interim rating changes on the FDIC's systems.
Prompt Corrective Action (PCA)	<p>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, <i>Prompt Corrective Action</i>, 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.</p> <p>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.</p>
Real Estate Stress Test (REST)	REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. REST uses statistical techniques to forecast an institution's condition over a 3- to 5-year horizon and provides a single rating from 1 to 5 in descending order of performance quality.

Glossary of Terms

Term	Definition
Risk-Based Capital	A “supplemental” capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank’s qualifying total capital base consists of two types of capital elements, “core capital” (Tier 1) and “supplementary capital” (Tier 2).
Risk-Based Capital Rules	Appendix A to Part 325— <i>Statement of Policy on Risk-Based Capital</i> —defines the FDIC’s risk-based capital rules. Appendix A states an institution’s balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to broad risk categories according to the obligor or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together and this sum is the risk-weighted assets total that, as adjusted, comprises the denominator of the risk-based capital ratio. The institution’s qualifying total capital base is the numerator of the ratio.
Risk-Weighted Assets	Balance sheet assets and equivalent amounts of off-balance sheet items that are placed in four risk categories, multiplied by a specific risk weight for that category, and then added together to become the denominator of the risk-based capital ratio.
SCOR LAG	SCOR LAG is a derivation of SCOR and uses the SCOR ratios for the composite rating. The difference between the two models is that SCOR LAG uses adjusted asset quality ratios by comparing them against a prior period. This model helps to normalize the bank’s performance ratios that may be understated by strong asset growth.
Statistical CAMELS Offsite Rating (SCOR) System	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.
Substandard	One of three types of classifications used by examiners to describe adversely classified assets. The term is generally used to describe an asset that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Glossary of Terms

Term	Definition
Tier 1 (Core) Capital	<p>Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as</p> <p>The sum of:</p> <ul style="list-style-type: none"> • Common stockholder’s equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; <p>Minus:</p> <ul style="list-style-type: none"> • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 2 (Supplemental) Capital	<p>Tier 2 capital is defined in Appendix A to Part 325 of the FDIC Rules and Regulations, and is generally the sum of:</p> <ul style="list-style-type: none"> • Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; • Cumulative perpetual preferred stock, long-term preferred stock and related surplus; • Perpetual preferred stock (dividend is reset periodically); • Hybrid capital instruments; and • Term subordinated debt and intermediate-term preferred stock.
Troubled Asset Relief Program (TARP)	<p>TARP is a program of the United States Department of the Treasury to purchase assets and equity from financial institutions to strengthen the financial sector.</p>
Uniform Bank Performance Report (UBPR)	<p>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.</p>
Uniform Financial Institutions Rating System (UFIRS)	<p>Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank’s performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.</p>

Glossary of Terms

Term	Definition
Wholesale Funding	Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve’s primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services. Financial institutions may use wholesale funding sources as an alternative to core deposits to satisfy funding and liability management needs.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
C&I	Commercial and Industrial
CAMELS	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity and <u>S</u> ensitivity to Market Risk
CDCI	Community Development Capital Initiative
CDFI	Community Development Financial Institution
CRA	Community Reinvestment Act
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
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
FIAT	Formal and Informal Action Tracking System
FIL	Financial Institution Letter
HMDA	Home Mortgage Disclosure Act
IDFPR	Illinois Department of Financial and Professional Regulation
LLC	Limited Liability Corporation
LTV	Loan-to-Value

Acronyms

MOU	Memorandum of Understanding
NCIF	National Community Investment Fund
OIG	Office of Inspector General
ORL	Offsite Review List
PCA	Prompt Corrective Action
RMS	Risk Management Supervision
ROE	Report of Examination
TARP	Troubled Asset Relief Program
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

**Federal Deposit Insurance Corporation**

550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

February 25, 2011

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: /Signed/
Sandra L. Thompson
Director

SUBJECT: FDIC Response to the Draft Audit Report Entitled, Material Loss Review of ShoreBank, Chicago, Illinois (Assignment No. 2010-085)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of ShoreBank, Chicago, Illinois, which failed on August 20, 2010. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report received on February 7, 2011.

ShoreBank failed primarily because the Board and management did not effectively manage the risks associated with its concentrations in commercial real estate (CRE) and acquisition, development, and construction (ADC) loans. They did not sufficiently mitigate risks inherent in their business strategy. They employed poor underwriting and credit administration practices, and supported loan growth and ongoing operations with non-core funding sources.

From 2004 through 2010, the Illinois Department of Financial and Professional Regulation (IDFPR) and the FDIC jointly and separately conducted six full-scope examinations, one visitation, and offsite monitoring activities. Examiners identified key risk management weaknesses and made recommendations for improvement to the Board and management. In 2007 examiners noted deterioration in ShoreBank's loan portfolio and downgraded the asset quality rating. ShoreBank was required to submit quarterly progress reports on efforts to lessen the risk position and dollar volume of problem loans. The 2008 examination noted continued deterioration. ShoreBank's composite rating was downgraded and a formal enforcement action was issued. The 2010 examination found that ShoreBank's Board and management failed to adequately address supervisory recommendations. Ultimately, ShoreBank was unable to raise sufficient capital to remain viable.

In recognition of the threat that institutions with high CRE concentrations, such as ShoreBank, pose, to the Deposit Insurance Fund, RMS has issued guidance to enhance our supervision. A Financial Institution Letter (FIL), *Managing Commercial Real Estate Concentrations in a Challenging Environment*, was issued that re-emphasized the importance of robust credit risk-management practices in institutions with concentrated CRE exposures.

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