Office of Inspector General

Office of Audits and Evaluations
Report No. AUD-15-005

Material Loss Review of Valley Bank, Moline, Illinois

August 2015

Office of Inspector General

Executive Summary

Material Loss Review of Valley Bank Moline, Illinois

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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, provides, in general, that if the Deposit Insurance Fund (DIF) 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 that includes a review of the agency's supervision of the institution. Section 38(k) establishes a material loss review (MLR) threshold of $50 million for losses that occur on or after January 1, 2014.

On June 20, 2014, the Illinois Department of Financial and Professional Regulation (IDFPR) closed Valley Bank, Moline, Illinois (VBI), and the FDIC was appointed receiver. The FDIC's Division of Finance notified the FDIC Office of Inspector General (OIG) on July 9, 2014 that the estimated loss to the DIF was $51.4 million. The OIG engaged KPMG LLP (KPMG) to conduct an MLR, the objectives of which were to (1) determine the causes of VBI's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. The scope of KPMG's work included an emphasis on the FDIC's supervisory efforts to assess and respond to the suitability and performance of VBI's management.

Background

VBI was a state-chartered nonmember bank that was established on January 31, 2002 when the State Bank of Latham, Latham, Illinois merged with the Valley State Bank, Eldridge, Iowa. The combined institution adopted a new name—Valley Bank. VBI's assets were centered in its loan portfolio, which contained significant concentrations of commercial real estate (CRE) loans, including acquisition, development, and construction (ADC) loans. In the years preceding its failure, VBI also developed a considerable exposure to troubled businesses in the media sector, including television and broadcast operations. In addition, the bank maintained an investment portfolio consisting of mortgage-backed securities, collateralized mortgage obligations, municipal securities, and other investments. At the time of its failure, VBI maintained 15 offices, all of which were located in Iowa, except for the bank's main office which was located in Moline, Illinois.

VBI was wholly-owned by River Valley Bancorp, Inc. (River Valley), a multi-bank holding company located in Davenport, Iowa. River Valley also owned substantially all of the outstanding stock of Valley Bank, Fort Lauderdale, Florida (VBF). VBI's Chairman of the Board of Directors (Board) and President and Chief Executive Officer (CEO) also served as the President, CEO, and Board Chairman of River Valley as well as the President, CEO, and Vice Chairman of VBF's Board. This individual, who is referred to herein as the CEO, exercised significant control over the strategic and operational direction of the entire River Valley organization.

Audit Results

Primary Causes of Failure and Material Loss

VBI failed primarily because of lax oversight by its Board and a dominant CEO that implemented a risky business strategy. Under the leadership of the CEO, VBI pursued an aggressive growth strategy centered in CRE loans, including speculative ADC loans that made the bank vulnerable to a sustained downturn in the real estate market. In 2008, after deterioration in VBI's CRE portfolio had been identified, the bank acquired a failing thrift institution that had a considerable amount of distressed CRE loans. Adding to VBI's exposure to the real estate market was a significant investment in Private Label Mortgage Backed Securities (PLMBS) that the bank acquired without conducting a proper pre-purchase analysis. Although these securities had an investment grade at the time of their purchase, they had risky characteristics and lost significant value when the real estate market deteriorated.

As losses associated with VBI's CRE and ADC loans and PLMBS increased, VBI's CEO made a number of poor business decisions in an attempt to return the bank to profitability. For example, the CEO continued to extend credit to certain business customers after they were unable to repay their existing obligations, which had the effect of masking the true financial condition of VBI's loan portfolio, and ultimately increased the losses incurred by the bank. Weak internal controls, particularly in the lending function, also contributed to VBI's problems. Specifically, examiners identified numerous errors in VBI's financial books and records, inappropriate insider transactions, conflicts of interest involving certain directors and officers, and repeat apparent violations of laws and regulations and contraventions of policy. Notably, VBI's Board did not effectively challenge the CEO regarding the bank's risky business strategy and lending practices or hold the CEO accountable for the bank's weak internal controls and unsatisfactory financial performance.

Between 2010 and the first quarter of 2014, VBI reported combined net losses of approximately $51.3 million and provision expenses for loan and lease losses of approximately $70.4 million. These losses and provision expenses eliminated the bank's earnings and impaired its capital. The IDFPR closed VBI on June 20, 2014 because the bank did not have sufficient capital to continue safe and sound operations and had no viable means of raising additional capital.

The FDIC's Supervision of Valley Bank

The FDIC, in coordination with the IDFPR, provided ongoing supervisory oversight of VBI through regular on-site examinations, visitations, and targeted reviews. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination reports and visitation documentation, correspondence, and informal and formal enforcement actions. Such risks included the Board and management's high tolerance for risk, the dominance of the CEO, VBI's significant exposure to CRE and ADC loans, and the bank's weak internal controls, poor lending practices, and deteriorating financial condition. We note that the FDIC has the authority to review the business activities of failed financial institutions, including the activities of bank officials, for possible regulatory action.

The CEO served in positions of high trust and responsibility at VBI and its affiliates despite having a criminal conviction and a troubled career history. As detailed in the report, such service violated section 19 of the FDI Act, which prohibits individuals convicted of certain criminal offenses from participating in the affairs of an insured depository institution without the prior written consent of the FDIC. Although the FDIC had a process in place to mitigate the risk of individuals serving in violation of section 19, the process was not effective in identifying instances of section 19 violations at VBI and its affiliates, resulting in an increased risk to the safety and soundness of the banks. In addition, the FDIC evaluated and favorably resolved two notices required by section 32 of the FDI Act that permitted the CEO to expand his role and authority within the River Valley organization. However, it did not appear that the FDIC's documentation and analysis regarding these notices was sufficient to support the favorable resolutions. Further, in one instance, the FDIC did not pursue obtaining a notice required by section 32 for the CEO's expanded role at VBF.

The FDIC should have taken stronger supervisory action at the February 2011 and April 2012 examinations when it was apparent that prior supervisory efforts to address the CEO's risky business decisions and the bank's deteriorating financial condition were unsuccessful. Such an approach may have instilled urgency in VBI's Board to address management's poor performance, mitigating the losses incurred by the bank and, to some extent, the DIF.

With respect to PCA, KPMG determined that the FDIC implemented supervisory actions that were generally consistent with relevant provisions of section 38.

Recommendations and Corporation Comments

The report contains three recommendations addressed to the Director, RMS. The recommendations are intended to enhance the effectiveness of the FDIC's supervisory controls for ensuring bank compliance with the prohibitions of section 19, addressing risks associated with dominant bank officials, and ensuring information pertaining to key supervisory decisions is recorded in systems of record. The Director, RMS, provided a written response, dated August 11, 2015, to a draft of this report. In the response, the Director concurred with all three of the report's recommendations and described planned and completed actions that were responsive to the recommendations.

In addition, KPMG identified a matter involving an automated tool used by FDIC examiners to assess fraud risk at financial institutions. We are communicating this matter separately to RMS management as an assessment of the tool was not within the scope of this MLR.

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

Office of Audits and Evaluations
Office of Inspector General

DATE: August 12, 2015

MEMORANDUM TO: Doreen R. Eberley, Director
Division of Risk Management Supervision

/Signed/
FROM: Mark F. Mulholland
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Valley Bank, Moline, Illinois*
(Report No. AUD-15-005)

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. Your comments on a draft of this report were responsive to the recommendations. Our evaluation of your response is incorporated into the body of the report.

Consistent with the agreed-upon approach to the Corrective Action Closure (CAC) process, the Office of Inspector General (OIG) plans to limit its review of CAC documentation to those recommendations that we determine to be particularly significant. Such determinations will be made when Corporate Management Control (CMC) advises us that corrective action for a recommendation has been completed. Recommendations deemed to be significant will remain open in the OIG's System for Tracking and Reporting (STAR) until we determine that corrective actions are responsive. All other recommendations will be closed in STAR upon notification by CMC that corrective action is complete, but remain subject to follow-up at a later date.

If you have questions concerning the report, please contact me at (703) 562-6316 or DeGloria Hallman, Auditor-in-Charge, at (703) 562-6473. We appreciate the courtesies extended to the Office of Inspector General and contractor staff.

Attachment

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Part I

Report by KPMG LLP

Material Loss Review of
Valley Bank, Moline, Illinois

Prepared for the
Federal Deposit Insurance Corporation
Office of Inspector General

KPMG LLP
1676 International Drive
McLean, VA 22102

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KPMG LLP
1676 International Drive
McLean, VA 22102

Mark F. Mulholland
Assistant Inspector General for Audits
Federal Deposit Insurance Corporation, Office of Inspector General
3501 Fairfax Drive
Arlington, VA 22226

Material Loss Review of Valley Bank, Moline, Illinois

Dear Mr. Mulholland:

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review (MLR) of Valley Bank, Moline, Illinois (VBI or the bank). This report details the results of our review. The objectives of the MLR were to (1) determine the causes of VBI's failure and resulting material loss to the Deposit Insurance Fund (DIF)[1] and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the Federal Deposit Insurance Act (FDI Act). The scope of our work included an emphasis on the FDIC's supervisory efforts associated with assessing and responding to the suitability and performance of VBI's management.

The information in this report was obtained during fieldwork, which occurred during the period December 2014 through June 2015. In conducting our work and preparing the report, we relied primarily on supervisory records, bank documents, and other information provided by the FDIC's OIG, the Division of Risk Management Supervision (RMS), and the Division of Resolutions and Receiverships (DRR).

We conducted our work as a performance audit in accordance with Generally Accepted Government Auditing Standards. These standards require that we plan and conduct the performance audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Except as noted in Appendix I, we believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. In addition, we identified a matter involving an automated tool used by examiners to assess fraud risk at financial institutions. The OIG plans to communicate this matter separately to RMS management as an assessment of the tool was not within the scope of this performance audit.

Appendix 1 contains additional information about our objectives, scope, and methodology; Appendix 2 presents an overview of River Valley's merger and acquisitions; Appendix 3 contains a glossary of key terms; and Appendix 4 contains a list of acronyms.

Very truly yours,

KPMG LLP

[1] Terms that are underlined when first used in this report are defined in Appendix 2, *Glossary of Key Terms.*

Why a Material Loss Review Was Performed

Section 38(k) of the FDI Act, as amended, provides, in general, that if the DIF 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 that includes a review of the agency's supervision of the institution. The report, which is required to be completed within 6 months of the date on which a material loss becomes apparent, must ascertain why the failed institution's problems resulted in a material loss to the DIF and make recommendations for preventing such losses in the future. Section 38(k) establishes an MLR threshold of $50 million for losses that occur on or after January 1, 2014.

On June 20, 2014, the Illinois Department of Financial and Professional Regulation (IDFPR) closed VBI, and the FDIC was appointed receiver. The FDIC's Division of Finance notified the OIG on July 9, 2014 that the estimated loss to the DIF for the failure was $51.4 million. Because the loss estimate was less than three percent above the MLR threshold, the FDIC OIG elected to monitor the loss estimate through year-end 2014. On February 12, 2015, the Division of Finance confirmed that the loss estimate had not changed. Accordingly, the FDIC OIG engaged KPMG to conduct an MLR of VBI.

Background

VBI was a state-chartered nonmember bank that was established on January 31, 2002 when State Bank of Latham, Latham, Illinois (Latham Bank) merged with Valley State Bank, Eldridge, Iowa (VSB). The combined institution adopted a new name—Valley Bank. At the time of its failure, VBI maintained 15 offices, all of which were located in Iowa, except for the bank's main office which was located in Moline, Illinois.

VBI's assets were centered in its loan portfolio, which contained significant concentrations of commercial real estate (CRE) loans, including acquisition, development, and construction (ADC) loans. In the years preceding its failure, VBI also developed a considerable exposure to troubled businesses in the media sector, including television and broadcast operations. In addition, the bank maintained an investment portfolio consisting of Private Label Mortgage Backed Securities (PLMBS), collateralized mortgage obligations, municipal securities, and other investments. Table 1 on the following page provides selected information about VBI's financial condition as of December 31, 2013 and for the five preceding calendar year ends.

Table 1: Selected Financial Information for VBI, 2008-2013

Financial Data ($000s)	12/31/13	12/31/12	12/31/11	12/31/10	12/31/09	12/31/08
Total Assets	$492,516	$557,675	$597,255	$631,546	$632,827	$703,483
Total Loans	$321,896	$372,130	$376,815	$415,382	$440,275	$480,180
ADC Loans/Total Capital	602%	330%	308%	204%	179%	218%
CRE Loans/Total Capital	1,328%	865%	659%	390%	409%	491%
Net Non-Core Funding Ratio	41.86%	40.32%	40.74%	36.02%	35.37%	38.97%
Net Interest Margin	2.83%	3.22%	3.50%	3.53%	3.20%	3.13%
Return on Average Assets	-1.91%	-1.22%	-4.29%	-0.39%	0.03%	0.31%

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

VBI was wholly-owned by River Valley Bancorp, Inc. (River Valley), a multi-bank holding company located in Davenport, Iowa. River Valley also owned substantially all of the outstanding stock of Valley Bank, Fort Lauderdale, Florida (VBF).[2] VBI served as the lead bank for the River Valley organization and provided services to VBF. VBI's Chairman of the Board of Directors (Board) and President and Chief Executive Officer (CEO) also served as the President, CEO, and Board Chairman of River Valley as well as the President, CEO, and Vice Chairman of VBF's Board. This individual, who is referred to herein as the CEO, exercised significant control over the strategic and operational direction of the entire River Valley organization.

Primary Causes of Failure and Material Loss

VBI failed primarily because of lax oversight by its Board and a dominant CEO that implemented a risky business strategy. Under the leadership of the CEO, VBI pursued an aggressive growth strategy centered in CRE loans, including speculative ADC loans that made the bank vulnerable to a sustained downturn in the real estate market. In 2008, after deterioration in VBI's CRE portfolio had been identified, the bank acquired a failing thrift institution that had a considerable amount of distressed CRE loans. Adding to VBI's exposure to the real estate market was a significant investment in PLMBS that the bank acquired without conducting a proper pre-purchase analysis. Although these securities had an investment grade at the time of their purchase, they had risky characteristics and lost significant value when the real estate market deteriorated.

As losses associated with VBI's CRE and ADC loans and PLMBS increased, VBI's CEO made a number of poor business decisions in an attempt to return the bank to profitability. For example, the CEO continued to extend credit to certain business customers after they were unable to repay their existing obligations, which had the effect of masking the true financial condition of VBI's loan portfolio, and ultimately increased the losses incurred by the bank. Weak internal controls, particularly in the lending function, also contributed to VBI's problems. Specifically, examiners identified numerous errors in VBI's financial books and records, inappropriate insider transactions, conflicts of interest involving

[2] River Valley had previously owned a third bank subsidiary—Freedom Bank, Sterling, Illinois. However, River Valley defaulted on a loan secured by Freedom Bank's stock to an unaffiliated bank and, in September 2013, the unaffiliated bank foreclosed on Freedom Bank's stock. River Valley also held a small percentage of stock in another bank holding company that was sold in 2013. In addition, River Valley owned a number of trusts and inactive non-bank subsidiaries.

certain directors and officers, and repeat apparent violations of laws and regulations and contraventions of policy. Notably, VBI's Board did not effectively challenge the CEO regarding the bank's risky business strategy and lending practices or hold the CEO accountable for the bank's weak internal controls and unsatisfactory financial performance.

Between 2010 and the first quarter of 2014, VBI reported combined net losses of approximately $51.3 million and provision expenses for loan and lease losses of approximately $70.4 million. These losses and provision expenses eliminated the bank's earnings and impaired its capital. The IDFPR closed VBI on June 20, 2014 because the bank did not have sufficient capital to continue safe and sound operations and had no viable means of raising additional capital.

Board Oversight and Management Supervision

The FDIC's *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. According to the Examination Manual, 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 CEO, have primary responsibility for managing the day-to-day operations and affairs of the bank. Further, ensuring appropriate corrective actions are taken in response to regulatory concerns is a key responsibility of the Board.

VBI's Board was not sufficiently engaged in overseeing the affairs of the bank and allowed the CEO to dominate all policy and strategic decision-making. In addition, the Board did not effectively challenge the CEO regarding the bank's risky business strategy and lending practices or hold the CEO accountable for the bank's unsatisfactory financial performance. Further, the Board and CEO did not adequately address concerns raised by examiners. Many of the reports of examination issued between 2009 and the bank's failure contained repeat findings, recommendations, apparent violations of laws and regulations, and contraventions of policy.

VBI's Board also did not ensure that the bank maintained an adequate system of internal controls. The volume and severity of internal control weaknesses cited by examiners increased as the bank's financial condition deteriorated. The April 2013 report of examination, for example, identified weaknesses in such areas as:

- Inaccurate Books, Records, and Audits. Certain VBI records and reports, including liquidity reports, Consolidated Reports of Condition and Income (Call Reports), financial statements, delinquency reports, and progress reports to regulators required by a Consent Order were inaccurate. In addition, losses were not recognized when appropriate because new or updated appraisals were often not used or placed in loan files. Further, problem loans were often not properly identified, placed on nonaccrual status, or categorized as troubled debt restructurings, when appropriate.

- Insider Transactions. The CEO failed to reflect a large personal loan from a director when applying for a loan from the bank. Borrowing from the director violated the bank's Code of Ethical Conduct that expressly prohibited the practice. In addition, the total indebtedness of a director and his related interests exceeded the bank's aggregate limitation, resulting in an apparent violation of the Board of Governors of the Federal Reserve System's (FRB) Regulation O. Further, the CEO granted six loans to another bank officer to purchase Other Real Estate (ORE) through complex transactions with questionable accounting treatment and credit administration practices.

- Improper Transactions with Affiliates. Certain transactions resulted in apparent violations of sections 23A and 23B of the Federal Reserve Act, as well as section 35.2 of the Illinois Banking Act, and generally involved loan participations with affiliated institutions; loans made to certain bank directors; the handling of proceeds from a lawsuit; and the treatment of the bank's income taxes.

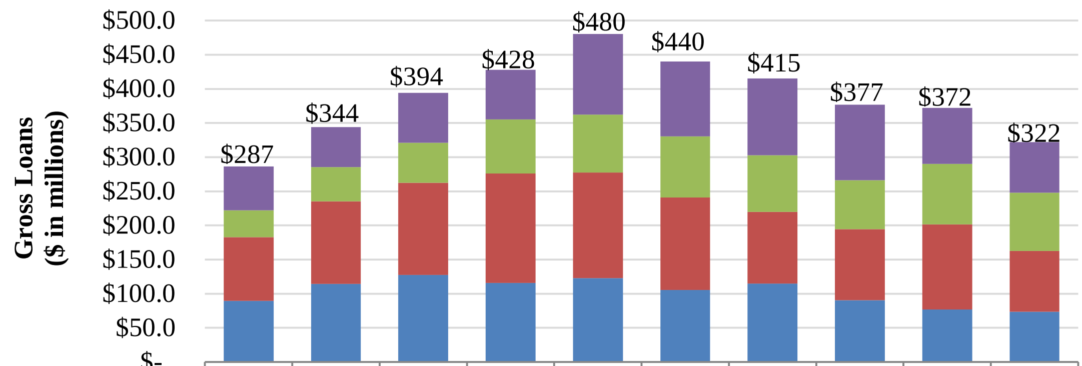
- Conflicts of Interest. A number of officers and employees had undisclosed conflicts of interest that, in some cases, compromised prudent lending practices, circumvented proper internal controls, and violated ethical standards. Of particular note, the CEO entered into an agreement with an individual that was not properly presented to the Board. The agreement called for the individual to perform consulting and related services for certain loans, some of which the individual managed and had an ownership interest in through a separate entity. The arrangement presented an inherent conflict of interest and raised concerns regarding whether the individual would act in the best interests of the bank.

Under pressure from the bank's Board, VBI's CEO resigned effective June 4, 2013. Examiners noted significant improvements in VBI's internal controls following the CEO's departure. However, these improvements could not reverse the substantial losses already embedded in the bank's loan portfolio, which led to the bank's failure.

Loan Growth and Concentrations

VBI pursued an aggressive growth strategy centered in CRE loans, including speculative ADC loans. Many of the bank's ADC loans were made to fund residential development and other construction and land development projects. For the 6-year period ending December 31, 2008, VBI's net loans increased nearly $300 million (or 162 percent). This growth was largely supported by brokered deposits, wholesale funding sources, and debt at the holding company level. Contributing to VBI's growth and risk profile was the purchase and assumption of Horizon Bank, Oskaloosa, Iowa, in 2008. Horizon Bank was a failing thrift institution with a considerable exposure to distressed CRE loans. The figure on the following page illustrates the general composition and growth of VBI's loan portfolio for the calendar years ended 2004 through 2013.

Figure: Composition and Growth of VBI's Loan Portfolio, 2004-2013



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All Other Loans	$64.5	$58.5	$73.2	$72.7	$118.1	$109.9	$112.7	$110.4	$82.2	$74.1
C&I Loans	$39.2	$49.8	$58.4	$79.3	$84.5	$89.4	$82.7	$72.0	$88.2	$85.3
Other CRE	$93.3	$121.3	$134.8	$160.0	$154.5	$135.3	$104.9	$103.7	$124.7	$88.8
ADC	$89.5	$114.2	$127.7	$115.9	$123.0	$105.7	$115.0	$90.7	$77.0	$73.7

Source: KPMG analysis of Call Reports for VBI.

In December 2006, the FDIC, the Office of the Comptroller of the Currency (OCC), and FRB issued joint guidance, entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance). The Joint Guidance defines criteria that the agencies use to identify institutions potentially exposed to significant CRE concentration risk. Specifically, 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.

In March 2008, the FDIC issued Financial Institution Letter (FIL)-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated supervisory expectations with regard to managing risks associated with CRE and ADC concentrations. The guidance reemphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices.

As shown in Table 2 on the following page, VBI had CRE and ADC loan concentrations as a percentage of total capital that significantly exceeded the levels defined in the Joint Guidance as warranting additional supervisory analysis. Further, the bank's CRE and ADC loan concentrations substantially exceeded the bank's peer group averages. However, the bank did not have adequate concentration risk management controls, such as prudent limits and stress testing to economic variables like changes in interest rates, absorption rates, lease rates, vacancy rates, and expense scenarios. VBI's exposure to CRE and ADC loans made the bank vulnerable to a sustained downturn in the real estate market.

Table 2: CRE and ADC Concentrations Compared to Peer Groups

Year-End	CRE Loans as a Percentage of Total Capital			ADC Loans as a Percentage of Total Capital		
	VBI	Peer Group	Percentile	VBI	Peer Group	Percentile
12/31/07	537%	377%	80	225%	124%	82
12/31/08	491%	380%	71	218%	111%	85
12/31/09	409%	356%	64	179%	85%	86
12/31/10	390%	321%	68	204%	61%	95
12/31/11*	659%	294%	95	308%	47%	98
12/31/12*	865%	275%	98	330%	41%	99
12/31/13*	1328%	271%	99	602%	40%	99

Source: KPMG's analysis of Call Reports for VBI.
* The significant increase in VBI's loan to capital ratios between 2011 and 2013 was largely attributable to a decrease in capital rather than new CRE and ADC lending.

Borrower Equity

Appendix A, *Interagency Guidelines for Real Estate Lending Policies*, to Part 365 of the FDIC Rules and Regulations, *Real Estate Lending Standards*[3], defines minimum borrower equity requirements for real estate loans held by FDIC-supervised institutions. The minimum equity requirements are defined in terms of specific loan-to-value (LTV) ratio limits for various types of real estate loans.[4] The limits are intended to reduce an institution's credit risk in the event of a sustained downturn in the real estate market. The interagency guidelines provide that (1) the aggregate amount of all loans in excess of the LTV limits should not exceed 100 percent of the institution's total capital and (2) within the aggregate amount, total loans exceeding the LTV limits for commercial, agricultural, multifamily, or other non-1-4 family residential properties should not exceed 30 percent of the institution's total capital.

As of December 31, 2007, VBI's LTV exceptions for commercial, agricultural, multifamily, or other non-1-4 family residential properties totaled $22.6 million, or 45 percent of total capital, which is well above the 30 percent limit prescribed in Appendix A. By January 1, 2009, this amount had increased to nearly 50 percent of the bank's total capital. In addition, management reports on LTV loan exceptions submitted to the institution's Board often did not identify all loans with LTVs in excess of supervisory limits, resulting in the bank being cited for repeat apparent contraventions of Appendix A.

[3] Codified to 12 C.F.R. § 365.1; amended July 28, 2010.
[4] The guidelines recognize that there may be circumstances in which it is appropriate to originate or purchase loans with LTV ratios that exceed the LTV limits in the guidelines, if justified by other credit factors. In such cases, the loans should be identified in the institution's records and their aggregate amount reported at least quarterly to the institution's Board.

Loan Underwriting and Credit Administration

Reports of examination issued between 2008 and 2010 indicated that VBI's loan underwriting and credit administration practices were generally adequate. However, the reports did include recommendations to improve the bank's lending practices in such areas as loan risk grading, global cash flow analysis for borrowers and guarantors, LTV exception reporting, and real estate appraisal procedures. Examiners became more critical of VBI's lending practices during the February 2011 examination. Among other things, examiners criticized the CEO's decision to significantly increase the bank's credit exposure to troubled businesses in the media sector and to consummate a set of complex loans designed to eliminate troubled PLMBS from the bank's balance sheet.

The April 2012 and April 2013 reports of examination were sharply critical of VBI's lending and credit administration practices. Criticisms included a serious lag in the amount of time to recognize losses within the loan portfolio, the need for comprehensive and realistic repayment analyses, a lack of adequate global cash flow analyses, a deficient Allowance for Loan and Lease Losses (ALLL) methodology and allowances, and a failure to update appraisals for troubled credits and ORE. The reports of examination were particularly critical of loans underwritten and administered by the CEO. For example, the April 2013 report of examination stated that the CEO routinely granted troubled borrowers additional loans so that they could use the funds to pay other loans at the bank, rather than pursue collection actions and recognize losses.

A primary example of the CEO's poor lending decisions involved the bank's loans to troubled businesses in the media sector. Those loans grew from approximately $5 million at the time of the February 2009 examination to over $23 million (excluding loan participations sold) at the April 2012 examination. The loans grew despite the fact that the businesses had previously defaulted on bank debt and were unable to pay their existing obligations. Based on our independent analysis of DRR records, VBI recognized approximately $12.4 million in losses and an additional $8.9 million in reserves for potential future losses associated with these loans.

During the April 2013 examination, the FDIC directed the bank to conduct an audit of the CEO's activities due to events that transpired during the examination. The bank used the services of a third-party professional firm to conduct the audit. Among other things, the audit identified numerous loan file maintenance exceptions, including inaccurate due dates, maturity dates, and/or payment terms for loans to businesses in the media sector; appraisals that were not included in CRE loan files; and inaccurate liquidity reports and ALLL calculations. Further, FDIC examiners found that losses and impairments were not being recognized on troubled loans and ORE and that appraisal practices were not being followed. Following the departure of the CEO in June 2013, examiners noted significant improvements in the bank's loan underwriting and credit administration policies and practices.

Investment Portfolio

Following the downturn in the real estate market, some of the securities in the bank's investment portfolio fell below investment grade and lost significant value. Among these securities were 13 PLMBS totaling $38.3 million (or almost 80 percent of the banks' Tier 1 Leverage Capital) as of December 31, 2008. Although the securities had an investment grade at the time of their purchase, they had risky characteristics, including an attractive yield and underlying mortgages that were granted based on interest-only payments of 120 months and reduced or no documentation. VBI did not conduct a proper pre-purchase analysis on the PLMBS to fully assess their risk. The bank ultimately recognized losses of $14.3 million related to the PLMBS.

Decline in VBI's Financial Condition

A continual migration of loans from performing to non-performing status pressured VBI's earnings and capital in the years leading to the bank's failure. In some cases, borrowers were able to pay their loans from their personal wealth and cash flows, but eventually they became financially strained and needed to borrow from VBI to continue performing on their loans. By the April 2013 examination, adversely classified loans represented 22 percent of VBI's total loan portfolio. The majority of the classifications pertained to several large lending relationships managed by the CEO, who examiners determined was responsible for about $66 million, or 75 percent, of adversely classified loans. Examiners also noted that approximately $23 million of the adverse loan classifications were made to new borrowers following the April 2012 examination.

Examiners noted a high level of adversely classified assets during the March 2014 examination that required the bank to amend its December 31, 2013 Call Report. The amendment, which was filed on April 1, 2014, rendered VBI *Critically Undercapitalized* for PCA purposes. Our independent analysis found that VBI recognized approximately $104 million in charge-offs between 2005 and the bank's failure. Of that amount, approximately $62.9 million appears to have been originated or renewed from 2005 to 2008 when the bank was emphasizing CRE and ADC lending. An additional $30.3 million was originated or renewed from 2009 through 2014. Table 3 summarizes the amount and type of asset classifications cited by examiners during examinations between 2008 and 2014.

Table 3: VBI's Adversely Classified Assets, 2008-2014 Examinations

Classification ($000s)	1/2008	2/2009	3/2010	2/2011	4/2012	4/2013	3/2014
Substandard	$14,336	$68,072	$74,388	$60,790	$49,917	$62,875	$93,284
Doubtful	$0	$0	$0	$0	$188	$14,279	$0
Loss	$1,875	$1,958	$1,070	$4,950	$6,482	$18,806	$3,397
Total	$16,211	$70,030	$75,458	$65,740	$56,587	$95,960	$96,681

Source: KPMG analysis of reports of examination for VBI. Time periods reflect examination as of dates.

The FDIC's Supervision of Valley Bank

The FDIC, in coordination with the IDFPR, provided ongoing supervisory oversight of VBI through regular on-site examinations, visitations, and targeted reviews. Through its supervisory efforts, the FDIC identified risks in the bank's operations and brought these risks to the attention of the institution's Board and management through examination reports and visitation documentation, correspondence, and informal and formal enforcement actions. Such risks included the Board and management's high tolerance for risk, the dominance of the CEO, VBI's significant exposure to CRE and ADC loans, and the bank's weak internal controls, poor lending practices, and deteriorating financial condition. We note that the FDIC has the authority to review the business activities of failed financial institutions, including the activities of bank officials, for possible regulatory action.

The CEO served in positions of high trust and responsibility at VBI and its affiliates despite having a criminal conviction and a troubled career history. As detailed later in this report, such service violated section 19 of the FDI Act, which prohibits individuals convicted of certain criminal offenses from participating in the affairs of an insured depository institution without the prior written consent of the FDIC. Although the FDIC had a process in place to mitigate the risk of individuals serving in violation of section 19, the process was not effective in identifying instances of section 19 violations at VBI and its affiliates, resulting in an increased risk to the safety and soundness of the banks. In addition, the FDIC favorably resolved notices that permitted the CEO to expand his role and authority at VBI's affiliates that were in troubled condition, and in one instance, the FDIC did not pursue obtaining a notice required by section 32 of the FDI Act for the CEO's expanded role at VBF.

The FDIC should have taken stronger supervisory action at the February 2011 and April 2012 examinations when it was apparent that prior supervisory efforts to address the CEO's risky business decisions and the bank's deteriorating financial condition were unsuccessful. Such an approach may have instilled urgency in VBI's Board to address management's poor performance, mitigating the losses incurred by the bank and, to some extent, the DIF. With respect to PCA, we determined that the FDIC implemented supervisory actions that were generally consistent with relevant provisions of section 38 of the FDI Act.

The following sections detail VBI's supervisory history, the FDIC's response to risks associated with the CEO's troubled career history, the FDIC's response to risks associated with VBI's Board and management, and the FDIC's compliance with PCA.

Supervisory History

The FDIC and IDFPR conducted seven on-site examinations and six visitations of VBI between January 2008 and VBI's closing in June 2014. The frequency of these on-site examination activities was consistent with relevant statutory and regulatory requirements.[5] Table 4 summarizes key supervisory information pertaining to the bank's examinations and visitations.

Table 4: Examination History of VBI, 2008-2013

Examination Start Date	Examination or Visitation	Regulator(s)	Supervisory Ratings (UFIRS)	Informal or Formal Action Taken*
1/14/2008	Examination	FDIC	232222/2	
8/25/2008	Visitation	FDIC	No ratings changes	
2/20/2009	Examination	Joint	444443/4	Consent Order Effective 9/28/2009
9/28/2009	Visitation	Joint	No ratings changes	
3/1/2010	Examination	Joint	444443/4	
10/7/2010	Visitation	Joint	No ratings changes	
2/7/2011	Examination	Joint	444443/4	Memorandum of Understanding (MOU) Effective 9/21/2011
10/11/2011	Visitation	Joint	No ratings changes	
4/2/2012	Examination	Joint	444433/4	MOU Terminated 7/3/2012
11/5/2012	Visitation	Joint	No ratings changes	
4/15/2013	Examination	Joint	555555/5	(1) Consent Order Effective 7/11/2013; (2) 2009 Consent Order Terminated Effective 1/14/2014 and replaced with a new Consent Order Effective 1/15/2014
10/28/2013	Visitation	Joint	No ratings changes	
3/24/2014	Examination	Joint	555555/5	IDFPR Cease and Desist Order Effective 4/4/2014

Source: Reports of examination, visitation documentation, correspondence, and information in the FDIC's Virtual Supervisory Information on the Net (ViSION) system for VBI.
* Informal actions often take the form of a Bank Board Resolution or MOU. Formal enforcement actions often take the form of a Cease and Desist Order, Consent Order, or PCA Directive.

As reflected in Table 4, VBI was subject to numerous supervisory actions during the period of our review due to unsafe and unsound banking practices and a sustained deterioration in financial condition. Specifically, the FDIC and IDFPR entered into a Consent Order with VBI's Board in September 2009 to address the risks and concerns identified during the February 2009 examination. Among other things, the Consent Order required VBI to retain qualified management, maintain certain minimum capital levels, and prohibit the extension of credit to adversely classified borrowers without the approval of the bank's Board (and in certain cases, the FDIC). In September 2011, the FDIC and IDFPR entered into an MOU with VBI to address concerns with the bank's investment practices and policies, particularly with respect to the PLMBS. The MOU was terminated

[5] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, on-site examinations of every state non-member bank. The regulation allows the annual examination interval to be extended to 18 months for certain small institutions (i.e., total assets of less than $500 million) if certain conditions are satisfied.

in July 2012 based on the bank's satisfactory efforts to address the provisions of the MOU. The September 2009 Consent Order remained in effect during this period.

The FDIC and IDFPR entered into two separate Consent Orders based on the results of the April 2013 examination. The first Consent Order, which became effective in July 2013, required VBI to appoint a new CEO and employ an independent firm to perform an audit of the bank's books and records. The second Consent Order, which replaced the 2009 Consent Order and became effective in January 2014, included requirements for VBI to add new independent members to its Board, develop a management plan to analyze and assess the bank's management needs, develop a comprehensive loan review and grading system, and implement a written appraisal policy. Further, the IDFPR issued a Consent Order to VBI in April 2014 to cease and desist from soliciting or knowingly accepting any uninsured deposits based upon the bank's impaired capital position and ongoing unsafe and unsound condition.

The FDIC's Response to Risks Associated with the CEO's Troubled Career History

Prior to joining the River Valley organization, the CEO served as the President of the Eastern Iowa Production Credit Association (EIPCA) from 1978 to 1985. In July 1995, the CEO was charged criminally with falsifying records in connection with his tenure at EIPCA. The CEO subsequently negotiated a criminal plea agreement wherein he pled guilty to a lesser misdemeanor charge of 5 U.S.C. Section 552a–*Unauthorized Disclosure of Information*. The conviction followed a 7 year investigation by the United States Attorney's Office of the Northern District of Iowa and the United States Department of Agriculture into allegations of fraud relating to guaranteed loan applications submitted by EIPCA to the Farmers Home Administration. Following the plea agreement, which included a $5,000 fine that was suspended except for $5, 1 year probation, and 150 hours of community service, the CEO resigned from two banking positions that he held at that time—President and CEO of VSB and CEO of First Illinois National Bank, Savanna, IL (FINB).

Section 19 of the FDI Act prohibits individuals convicted of certain criminal offenses from participating in the affairs of an insured depository institution without the prior written consent of the FDIC.[6] The prohibition applies to individuals convicted of a criminal offense involving dishonesty, breach of trust, or money laundering, or who have entered into a pretrial diversion or similar program in connection with a prosecution for such offenses. Absent the FDIC's written consent, such individuals are prohibited from being directly or indirectly affiliated with an insured depository institution; owning or controlling an insured depository institution; or otherwise directly or indirectly participating in the conduct of the affairs of an insured depository institution. The CEO's criminal conviction meant that he was barred from working at an insured depository institution without the FDIC's written consent.

[6] Section 19 imposes a 10 year ban against the FDIC's written consent for individuals convicted of certain financial institution-related crimes, absent a motion by the FDIC and court approval.

In November 1995, after the CEO completed the terms of his plea agreement, VSB and FINB obtained the FDIC's written consent to reinstate the CEO to the same positions that he previously held at those institutions. In August 1999, the OCC placed FINB under a formal agreement and the CEO personally stipulated to a $15,000 Civil Money Penalty (CMP) related to violations of sections 23A and 23B of the Federal Reserve Act and his role in loan losses at FINB. In September 1999, the CEO resigned at the request of FINB's Board. Subsequent to his resignation, the CEO continued to serve as CEO and director at VSB, which merged with Latham Bank in 2002 to become VBI.

Procedures for Waiving Section 19 Prohibitions

Institutions may apply to the FDIC for its written consent to waive the prohibitions of section 19 on behalf of a prospective director, officer, or employee. Such applications are referred to as Sponsorship Applications. In completing a Sponsorship Application, institutions must demonstrate that, notwithstanding the section 19 prohibition(s), an individual is fit to participate in the affairs of the institution without posing a risk to its safety and soundness or impairing public confidence in the institution. Individuals are not permitted to submit an application to the FDIC on their own behalf, unless the FDIC grants them a waiver to do so. This type of application is referred to as an Individual Waiver. Table 5 highlights key distinguishing factors between Sponsorship Applications and Individual Waivers.

Table 5: Sponsorship Applications Versus Individual Waivers

Factor	Sponsorship Application	Individual Waiver
FDIC Office with Delegated Authority to Approve the Application	RMS Regional Office	RMS Washington Office
Permitted Role(s) of the Individual After the Application is Approved	The FDIC's approval is not transferable to another institution. If an individual completes the process at one institution and then moves to another, a new application must be processed, unless the FDIC grants a formal exception.	The FDIC's approval is transferable to any institution. However, the individual is required to disclose his/her conviction to all prospective institutions.
FDIC Notice of Approval	Approvals and denials are not made available to the public. The application is stored in ViSION.	The FDIC's approval or denial is made available to the public. The application is stored in ViSION.

Source: Discussion with RMS officials.

We obtained the FDIC's Statement of Policy for Section 19 of the FDI Act, dated March 31, 1980 and revised December 1, 1998, that defines general procedures to be followed when filing an application pursuant to section 19. The policy statement also describes the factors that the FDIC considers in evaluating these applications. Such factors include, for example, evidence of the individual's rehabilitation (including the individual's reputation since the conviction or program entry), the amount of influence and control the individual will be able to exercise over the management and affairs of the institution, and the ability of bank management to supervise and control the individual's activities. According to the policy statement, the degree of scrutiny accorded an application is directly proportional to the position that the individual will occupy at the institution. Therefore, a more detailed analysis is performed of individuals who would be in a position to influence or control the management or affairs of the institution.

The FDIC's Handling of Section 19 Prohibitions Involving the CEO

The CEO served in violation of section 19 for his entire tenure at VBI because the bank did not seek, and FDIC did not provide, written consent to waive the prohibitions of the statute for the CEO's service at VBI and its affiliates VBF and Freedom Bank. The FDIC did approve Sponsorship Applications for the CEO to serve at VSB and FINB in 1995. However, the applications were not transferable to any other institution. In addition, the FDIC's approval of the Sponsorship Applications in 1995 was not consistent with FDIC policy for handling such matters in one key respect, as explained in the summary of our analysis that follows.

- In November 1995, the FDIC approved two Sponsorship Applications for the CEO to serve as the CEO and director of VSB and the President and CEO of FINB. Supervisory records pertaining to the FDIC's evaluation of the application submitted by VSB reflect detailed consideration of the circumstances pertaining to the CEO's charges as well as concerns regarding his character and integrity. These records also indicate that although the Iowa Superintendent of Banking expressed no objection to the CEO's reinstatement, the predecessor serving in that role did express an objection in a letter dated July 14, 1995. Specifically, the predecessor questioned the CEO's character and integrity due to his failure to fully inform the regulatory agencies regarding the settlement negotiations.

  The FDIC approved the Sponsorship Application based primarily on the CEO's satisfactory banking record in the decade following his service at EIPCA, but before the plea agreement and conviction in July 1995. FDIC policy in place at the time of the application's approval in 1995 required that an individual's record of rehabilitation subsequent to the conviction be considered when evaluating section 19 applications. However, the FDIC's evaluation of the Sponsorship Application did not evidence consideration of the CEO's rehabilitation subsequent to the conviction that triggered the section 19 prohibitions. In assessing evidence of rehabilitation, the FDIC Case Manager Procedures Manual states that an individual's reputation and time that has elapsed since the conviction should be considered, and that the degree of scrutiny should be directly proportional to the position to be occupied by the individual.

  Supervisory records supporting the FDIC's approval of the Sponsorship Application submitted by FINB were not available for our review. Accordingly, we were not able to independently assess the adequacy of the FDIC's evaluation of the application. However, the Director, RMS, indicated that it would be unusual, presently, for the FDIC to make a favorable determination on a section 19 application involving circumstances similar to those of the CEO, absent a lengthy rehabilitation period.

- In January 2002, VSB merged with Latham Bank to form VBI under Latham Bank's charter. In evaluating the merger application, the FDIC considered the CEO's criminal settlement, CMPs, and poor performance which led to his dismissal at FINB. The FDIC determined that the CEO's prior infractions were mitigated by his service at VSB and approved the merger application. Notwithstanding the FDIC's approval of the merger application, neither the CEO nor the bank sought a waiver of the section 19 prohibitions at the time of the merger, and the FDIC did not take steps to require the bank to do so. At the time of the merger in 2002, a section 19 waiver application would have been subject to a more critical assessment as a result of updates made in December 1998 to the FDIC's Statement of Policy for evaluating section 19 applications. For example, the evaluation of a section 19 application at the time of the 2002 merger would have required consideration of management's ability to supervise and control the applicant's activities, as well as the amount of influence and control the applicant would be able to exercise over the management or affairs of the institution.

The FDIC Case Managers and examiners assigned to VBI informed us that it was their understanding that the FDIC had approved an Individual Waiver, rather than Sponsorship Applications, for the CEO in 1995 and that such a waiver would have allowed the CEO to work at VBI, VBF, and Freedom Bank. In June 2013, Chicago Regional Office officials determined that the CEO was ineligible under section 19 to serve as a bank employee or director at VBF and Freedom Bank and notified the Boards of both institutions. RMS Regional Office officials indicated that it was their understanding at that time that the approval of the Sponsorship Application for VSB was transferrable to VBI since VSB was one of the two banks that merged to become VBI. However, we were informed that RMS and Legal Division officials in the Washington, D.C. office subsequently reviewed the matter and determined that the Sponsorship Application for VSB was not eligible to transfer to VBI. Because the CEO had already resigned from VBI, a similar notification regarding his ineligibility to serve at the institution was not made to VBI's Board.

Requirements for Troubled Institutions to Notify the FDIC of Proposed Management Changes

Another control intended to help ensure capable and experienced management at insured institutions is section 32 of the FDI Act. Section 32 requires, in general, that FDIC-supervised institutions and state-licensed, insured branches of foreign institutions provide the FDIC with prior written notice (referred to herein as section 32 notices) of any addition or replacement of a member of the Board or the employment or change in responsibilities of any individual to a position as a Senior Executive Officer if (a) the institution is not in compliance with minimum capital requirements, (b) is in a troubled condition, or (c) the FDIC determines, in connection with its review of a capital restoration plan (CRP) required by PCA, that such notice is appropriate.

In reviewing section 32 notices, the FDIC must make a determination regarding four statutory factors (i.e., competence, experience, character, and integrity) pertaining to the proposed individual. A favorable resolution of the statutory factors by the FDIC results in a letter of non-objection to the institution. An unfavorable resolution may result in a letter of objection or a withdrawal of the notice by the institution. RMS Regional Offices are responsible for reviewing and processing section 32 notices. In situations involving unusual circumstances, the Regional Office may decide to consult with the Washington Office.

In the case of VBI and its affiliates, the FDIC evaluated and favorably resolved two section 32 notices involving the CEO that permitted the CEO to expand his role and authority within the River Valley organization. However, it does not appear that the available documentation and analysis regarding the section 32 notices was sufficient to support the favorable resolutions. Further, the FDIC did not detect the banks' or the CEO's failure to submit waiver applications for the section 19 prohibitions during the evaluations of the section 32 notices. A summary of our analysis follows.

- In 2004, the CEO became Vice Chairman of the Board of VBF, which was in a troubled condition at that time. VBF did not submit, and the FDIC did not require, a section 32 notice.

- In July 2010, Freedom Bank of Sterling, Illinois—an affiliated bank of VBI that was acquired by an unaffiliated party in September 2013—submitted, and the FDIC favorably resolved, a section 32 notice for the CEO to serve as interim President. In January 2011, the FDIC issued a letter of non-objection in response to a section 32 notice submitted by VBF for the CEO to serve as interim President. Based on our analysis of the FDIC's evaluation of the section 32 notices, the FDIC's analyses do not reflect consideration of relevant facts and circumstances regarding the CEO and his impact on the banks' financial condition. Specifically, the FDIC's analyses did not consider the CEO's service at FINB, the criminal conviction, or the fact that VBI's, VBF's, and Freedom Bank's supervisory composite ratings had been downgraded from a "2" to a "4" as a result of the CEO's risky business strategies and lending practices.

Conclusion and Recommendation

Based upon our review of the circumstances outlined above, the FDIC's handling of the applications and notices at VBI and its affiliates was not adequate. The Director, RMS, reviewed the FDIC's handling of section 19 prohibitions and section 32 notices at the time of VBI's pending failure. Consistent with the results of our analysis, the Director determined that the applications and notices were not properly handled. In response to this matter, the FDIC has taken (or plans to take) steps to mitigate the risk of an individual serving in violation of section 19 at an insured bank and to improve monitoring and processing of section 19 applications. Specifically, the Director, RMS, determined that training was warranted to ensure that FDIC staff were properly evaluating applications and notices. Between June and October 2014, RMS provided training for officials in all six regional offices and both area offices to emphasize the importance of critical thinking and problem solving with respect to applications analysis where statutory factors must be considered. In addition, RMS initiated an internal review of applications that require the evaluation of statutory factors to determine whether the issues that occurred at VBI and its affiliates are systemic in nature. The FDIC is also creating a database to track section 19 actions that will appear on the Enforcement Decisions and Orders page of the FDIC's public website. Further, RMS is developing a section in the

FDIC's *Case Manager Procedures Manual* that will address the evaluation of statutory factors.

The steps taken by RMS are positive and should help to ensure that applications and notices are properly evaluated when received. As described below, we identified an additional step that the FDIC can take to mitigate the risk of not detecting in a timely manner a failure on the part of an institution to submit a Sponsorship Application when required.

As part of the examination process, institutions are required to complete an Officer's Questionnaire that contains a series of standard questions. The questionnaire is intended to identify information that might not otherwise come to the attention of examiners during the examination. The institution's CEO is required to attest to the accuracy and completeness of information provided in the Officer's Questionnaire by signing and dating the document. One of the questions in the questionnaire states:

> *List any director, officer, or employee who has been convicted of, or who is presently under indictment for, any criminal offense involving dishonesty or breach of trust. Exclude anyone previously reported to the FDIC in writing.*

In the case of VBI, the CEO accurately responded to this question by stating "None." However, excluding reference to any prior notifications to the FDIC increases the risk that a failure on the part of an institution to seek a waiver of the section 19 prohibitions might not be detected in a timely manner. Modifying the question to require a reference to any conviction or indictment, including those previously reported, could prompt examiners to coordinate with the assigned Case Manager to ensure that any issues raised are appropriately handled by the Regional Office.

We recommend that the Director, RMS:

(1) Revise the Officer's Questionnaire to require that institutions reference any prior notification to the FDIC and/or any other regulatory agency involving a director, officer, or employee who has been convicted of, or who is under indictment for, a criminal offense involving dishonesty or breach of trust.

Supervisory Response to Risks Associated with VBI's Board and Management

One of the most important duties of Board directors is to select and appoint executive officers who are qualified to administer the affairs of the institution. Boards are responsible for providing a framework of objectives and policies within which the CEO and other executive officers can operate. In addition, Board directors must exercise independent judgment when overseeing the affairs of the institution and not be excessively influenced by bank management. When executive officers fail to meet reasonable standards of honesty, competency, executive ability, and efficiency, it is the responsibility of the Board to remove those officers.

The FDIC has determined that dominant bank officials often play a key role in fraud and abuse schemes in financial institutions and in near failures and failures. In addition, the FDIC OIG's *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010, dated December 2010) states that dominant bank officials played a role in many of the failures subject to MLRs during the recent downturn in the banking sector. The OIG report recommended that the FDIC review its existing examination guidance related to dominant bank officials and determine whether a reiteration of the guidance and/or communication and clarification of expectations would be beneficial. In response, the FDIC issued an internal policy stating that a dominant official coupled with other risk factors, such as ineffective internal controls, a lack of Board independence or adequate oversight, and questionable or risky business strategies, are of concern and require enhanced supervision. The policy defines procedures that examiners should follow when dominant bank official influences are present. Among other things, the policy states that examiners should include appropriate comments in the report of examination, consider the associated risks when assigning supervisory ratings, ensure mitigating controls are established that include an appropriate level of Board independence and oversight, and (to the extent warranted) pursue informal or formal corrective actions.

<u>The FDIC's Actions to Address Management's Performance at VBI</u>

Regulatory concerns pertaining to VBI's CEO existed since the bank was initially established. In January 2002, FDIC and IDFPR officials met with the CEO and a director of the bank's Board to discuss potential inappropriate payment of expenses by FINB's holding company for what appeared to be personal expenses incurred by the CEO. The regulators informed the CEO that they would closely review affiliate transactions and insider dealings and expenses and recommended that VBI establish a compliance committee to minimize violations. Additionally, in June 2002, the IDFPR informed FDIC examiners of anonymous allegations of questionable and potentially illegal activities at VSB involving the CEO. RMS officials informed us that the allegations were reviewed by FDIC examiners in a subsequent visitation and examination and that the allegations were not substantiated (refer to Appendix 1 for additional information on this matter).

Notwithstanding their concerns with the CEO, examiners considered the performance of VBI's Board and management to be satisfactory prior to the February 2009 examination. The January 2008 report of examination, for example, stated that VBI had a capable management team and that the CEO was assisted by a competent staff. However, the report did express concern that the CEO was dictating the policies of VBI and the future direction of the entire River Valley organization and that the Board and management had not addressed a number of recommendations from the prior examination.

During the February 2009 examination, examiners downgraded VBI's supervisory composite and management component ratings to a 4 due to the bank's deteriorating financial condition. Based on the results of the examination, the FDIC and VBI entered into a Consent Order that included a management provision requiring the bank to have and retain qualified management. Specifically, the provision required VBI's Board to assess the qualifications of the bank's management regarding its ability to comply with the Consent Order; operate the bank in a safe and sound manner; comply with applicable laws, rules, and regulations; and restore all aspects of the bank to a safe and sound condition. In response to the management provision, VBI's Board reviewed the bank's senior management team and determined that they had the requisite experience and capabilities to meet the requirements of the entire Consent Order. As a result, the Board made no changes to the management team.

The March 2010 and February 2011 reports of examination noted continued deterioration in VBI's financial condition and a troubling appetite for risk, particularly with respect to the CEO's lending and investment decisions. Based on the results of the February 2011 examination, the FDIC provided VBI's Board with a proposed order to replace the 2009 Consent Order. The proposed order contained stronger provisions, including requirements for VBI's Board to increase its participation in the affairs of the bank, seek new independent directors, and analyze and assess the bank's management and staffing performance and needs. However, the proposed order was not ultimately issued and the 2009 Consent Order was left in place. The FDIC also entered into an MOU with VBI's Board that focused on concerns pertaining only to the investment portfolio.

The April 2012 report of examination was sharply critical of VBI's management, noting that the bank's credit decisions, particularly those made by the CEO, continued to raise supervisory concern. The report described "severe financial and loan underwriting concerns" and stated that the CEO must be held to credit administration standards established in the bank's loan policy. In addition, the report noted that VBI had received supervisory composite and management component ratings of 4 during the last four consecutive examinations and had only achieved partial compliance with the 2009 Consent Order. The letter to VBI's Board transmitting the report of examination stated "It is disturbing to note that violations of all three of the Federal Reserve's basic banking statutes related to Regulation O, and sections 23A and 23B are cited in the report of examination, and the dollar amounts and time durations involved are astoundingly high." The transmittal letter added that this was "…an extremely poor reflection on the Board, and questions the effectiveness of daily operational management and the bank's internal controls..." Examiners again proposed replacing the 2009 Consent Order with an order containing stronger provisions. However, the new order was not ultimately issued.

During the April 2013 examination, examiners downgraded VBI's supervisory composite and component ratings to a 5. VBI's CEO resigned effective June 4, 2013. The report of examination stated that the CEO's dominance over all areas of the bank, especially the lending function, was the driving force behind the bank's problems. The report added that the deterioration in VBI's asset quality following the prior examination was due mainly to the CEO's hazardous lending activities and that the practices that led to the 2009 Consent Order had not ceased. Further, VBI's Board and management had neglected to address prior examination findings and recommendations.

Based on the results of the April 2013 examination, the FDIC and VBI entered into a new Consent Order effective July 11, 2013 that required (among other things) the bank to hire a new CEO and conduct an audit of the bank's books and records. The FDIC also replaced the 2009 Consent Order with another Consent Order that became effective January 15, 2014. In addition, examiners initiated a targeted review of allegations of ongoing unsafe and unsound practices and breach of fiduciary duty by the CEO. As noted earlier, examiners noted significant improvements in VBI's lending practices and internal controls following the CEO's departure in June 2013. However, these improvements could not reverse the substantial losses already embedded in the bank's loan portfolio, which led to the bank's failure.

In our view, the FDIC should have taken stronger supervisory action at the February 2011 and April 2012 examinations when it was apparent that prior supervisory efforts to address the CEO's risky business decisions and the bank's deteriorating financial condition were unsuccessful. Stronger supervisory action could have included lowering VBI's management and/or composite ratings to a 5; assessing CMPs; and/or replacing the 2009 Consent Order with a new order containing stronger provisions to address management's poor performance. Such provisions could have included requiring the Board to restrict the CEO's lending authority; requiring greater participation and oversight on the part of the Board; and/or requiring the addition of new, independent directors. Such a tenor would have been consistent with the FDIC's forward looking approach to bank supervision, which requires institutions with weak risk management practices to be subject to a proactive supervisory response when risks are not being properly managed. Such an approach may have instilled a sense of urgency in VBI's Board to address the poor performance of VBI's management, mitigating the losses incurred by the bank and, to some extent, the DIF.

Conclusion and Recommendations

FDIC examiners generally implemented the procedures contained in the Corporation's internal policy on dominant bank officials during the supervision of VBI. However, given the unique supervisory challenges presented by dominant bank officials, it would be beneficial for the FDIC to review its existing policy to determine whether it is having the intended effect, specifically in regards to the importance of the Board's role and involvement. In addition, RMS officials in the Chicago Regional Office informed us that the 2009 Consent Order was not replaced following the February 2011 and April 2012 examinations for several reasons, most notably that the provisions of the existing order were considered sufficient to address the primary concerns at the bank; management was striving to comply with the order; and the CEO had made assurances to raise additional capital. Notwithstanding these reasons, in the case of VBI, additional capital may actually have enabled the bank to further its unsafe and unsound lending practices absent a change in management and stronger oversight from the Board.

The FDIC did not document its rationale for deciding not to replace the 2009 Consent Order following the February 2011 and April 2012 examinations. Recording information pertaining to key supervisory decisions, such as not pursuing proposed Consent Orders, would help ensure that relevant information is readily available to supervisory staff, particularly when staff change positions or depart. It could also reduce the amount of time and effort needed to locate information and respond to inquiries.

We recommend that the Director, RMS:

(2) Review the FDIC's supervisory policy and approach for addressing risks associated with dominant bank officials to ensure that:

   a) examination coverage of and reporting on the Board's composition and involvement in overseeing the policies and activities of the bank is sufficiently emphasized and/or required; and

   b) expectations are clear when prior supervisory actions do not have the intended effect.

(3) Reinforce to Case Managers and other Regional Office staff the importance of recording and retaining information regarding the basis for key supervisory decisions, including when supervisory actions are considered or recommended, but ultimately not taken.

Implementation of PCA

Section 38 of the FDI Act, *Prompt Corrective Action*, establishes a framework of mandatory and discretionary supervisory actions pertaining to all insured depository institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions" as an institution's capital level declines. The purpose of section 38 is to resolve the problems of insured depository institutions at the least possible cost to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations[7] defines the capital measures used in determining the supervisory actions to be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of CRPs and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor institution compliance with CRPs, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to VBI, the FDIC properly implemented the applicable PCA provisions of section 38. Table 6 on the following page provides a summary of VBI's capital ratios relative to the PCA thresholds for *Well Capitalized* institutions during examinations and at other key points in time. A chronological description of the changes in the bank's capital categories and the FDIC's implementation of PCA follow the table.

[7] On January 1, 2015, a phase-in period began for community banks whereby Part 325 will be superseded by Part 324, *Capital Adequacy of FDIC-Supervised Institutions*. Because VBI failed on June 20, 2014, the requirements of Part 325 applied to VBI. Accordingly, our audit focused on the FDIC's compliance with Part 325.

Table 6: VBI's Capital Ratios

Event	Total Risk-Based Capital	Tier 1 Risk-Based	Leverage Ratio	PCA Capital Category
Well Capitalized Threshold	**≥10%**	**≥6%**	**≥5%**	
1/14/2008 Examination	10.02	9.08	7.54	*Well-Capitalized*
2/20/2009 Examination	7.99	7.12	7.06	*Undercapitalized*
3/1/2010 Examination*	11.18	9.92	7.57	*Adequately Capitalized*
2/7/2011 Examination	12.24	10.99	8.04	*Adequately Capitalized*
4/2/2012 Examination	10.61	9.35	6.64	*Adequately Capitalized*
4/15/2013 Examination	6.97	5.68	4.24	*Undercapitalized*
11/5/2013 PCA Notification	5.69	4.38	2.93	*Significantly Undercapitalized*
3/24/2014 Examination	0.61	0.30	0.18	*Critically Undercapitalized*
4/3/2014 PCA Notification	3.58	2.24	1.49	*Critically Undercapitalized*

Source: KPMG's analysis of reports of examination and activities relevant to PCA for VBI. Capital thresholds and categories were obtained from the FDIC's Risk Management Manual of Examination Policies.
* VBI became *Adequately Capitalized* because the 2009 Consent Order included a capital provision. Part 325 of the FDIC Rules and Regulations states that for an institution to be considered *Well Capitalized*, it must not be subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the FDIC pursuant to Section 8 of the FDI Act, International Lending Supervision Act of 1983, section 38 of the FDI Act, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

VBI was considered *Well Capitalized* for PCA purposes until the February 2009 examination, when the bank's capital ratios fell to *Undercapitalized*. Before the February 2009 examination concluded, VBI's capital ratios improved to *Adequately Capitalized*, negating the need for a CRP. In September 2009, the FDIC issued a Consent Order that required VBI to maintain capital ratios of 7.5 percent for Tier 1 Capital and 11 percent for Total Risk-Based Capital, and to increase these ratios to 8 percent and 12 percent, respectively, by March 31, 2010.

Based on asset reductions and a capital injection in June 2009, VBI's capital ratios returned to *Well Capitalized* during the March 2010 examination. However, the bank continued to be classified as *Adequately Capitalized* for PCA purposes because the bank was still subject to the September 2009 Consent Order which contained a capital provision. The FDIC notified VBI on July 31, 2013 that the bank had fallen to *Undercapitalized* based on the results of the April 2013 examination. As a result, the bank submitted a CRP on September 10, 2013. The FDIC subsequently determined that the CRP was unacceptable, resulting in the bank becoming subject to all of the restrictions accorded to *Significantly Undercapitalized* banks. VBI's capital ratios fell to *Significantly Undercapitalized* based on the bank's September 30, 2013 Call Report filing. VBI submitted additional CRPs in October and December 2013. However, these plans were also deemed unacceptable by the FDIC.

Based on the results of the March 2014 examination, VBI filed an amended Call Report for December 31, 2013 that rendered the bank *Critically Undercapitalized*. Examiners noted that the bank submitted a revised CRP during the March 2014 examination, citing that the CRP plan lacked substantial points on recapitalizing VBI and that there were no viable options for recapitalization given the current ownership, debt structure, and critically deficient capital position of the bank. The FDIC continued to coordinate with VBI regarding its efforts to raise needed capital to return the bank to a safe and sound condition. However, these efforts were not successful. On April 4, 2014, the IDFPR issued a *Notice of Intent to Take Possession and Control* of VBI to the bank's Board due to the institution's critically deficient capital position and overall unsafe and unsound condition. The notice required VBI to increase its Tier 1 Capital ratio to not less than five percent within 30 days. The bank failed to increase its capital ratios, and as a result, the IDFPR closed the bank on June 20, 2014.

Objectives, Scope, and Methodology

Objectives

The performance audit objectives were to (1) determine the causes of VBI's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. We conducted our work from October 2014 through June 2015 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. Except as described below, we believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of the performance audit covered the period from the time of the January 2008 examination until the bank's failure on June 20, 2014. We also evaluated the regulatory supervision of the bank during the same time period. Our work included an emphasis on the FDIC's supervisory efforts associated with assessing and responding to the suitability and performance of VBI's management given the unusual circumstances described in this report that date back to as early as 1995.

To determine the causes of VBI's failure and the resulting material loss to the DIF, we reviewed relevant reports, correspondence, and other analyses prepared by RMS, DRR, and the IDFPR. For example, we reviewed reports of examination and visitation documentation, UBPRs, and a supervisory history prepared by RMS. We also reviewed certain reports and analyses prepared by VBI and certain professional service firms. In addition, we interviewed current and former RMS officials in RMS' headquarters offices, the Chicago Regional Office, and the Princeton, Illinois, Field Office, as well as IDFPR officials to obtain their perspectives on the principal causes of VBI's failure. Further, we met with DRR officials in the Dallas Regional Office and reviewed selected bank records maintained by DRR.

To evaluate the FDIC's supervision of VBI, including the implementation of PCA, we assessed whether the supervisory approach and actions taken with respect to the bank were commensurate with its risk profile and relevant laws, regulations, policies, and guidelines. Specifically, we:

- researched various banking laws and regulations to understand the requirements that were relevant to VBI in the context of the issues that contributed to the bank's failure;

- identified and reviewed RMS policies and procedures, including the *Risk Management Manual of Examination Policies* and the *Formal and Informal*

Actions Procedures Manual, that were relevant to VBI and the supervisory actions taken with respect to the bank;

- analyzed reports of examination and visitation documentation, as well as selected examination working papers, correspondence, and data maintained in ViSION and other information systems, to identify the timing and nature of supervisory actions taken to address risks at the bank;

- reviewed bank data, such as Call Reports and UBPRs for VBI;

- interviewed FDIC officials who had supervisory responsibility for VBI, most notably officials from the RMS Chicago Regional Office and examination staff from the Princeton, Illinois, Field Office, to obtain clarification and context regarding key supervisory activities and determinations; and

- contacted IDFPR officials to obtain their perspectives on the supervision of VBI.

We obtained data from various FDIC systems, but determined that information system controls were not significant to the audit objectives and, therefore, we did not evaluate the effectiveness of information system controls. We relied primarily upon hard-copy and electronic information provided by the FDIC OIG, RMS, and DRR as well as testimonial evidence provided during interviews. We did not perform specific audit procedures to assess the reliability of this information. In addition, we are aware that FDIC Circular 12000.1, *Cooperation with the Office of Inspector General*, dated October 1, 2013, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must provide authorized representatives of the OIG complete, prompt, and unrestricted access to all files, documents, premises, and employees, except as limited by law, including access to all Corporation and Receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, information systems, and other sources of information available to any part of the FDIC when requested during the course of the OIG's official duties.

Regarding compliance with laws and regulations, we performed certain tests to determine whether the FDIC had complied with relevant PCA provisions in section 38 of the FDI Act. We also assessed compliance with aspects of the FDIC Rules and Regulations, including the examination frequency requirements defined in section 337.12. The results of our compliance tests are discussed in this report, where appropriate.

We assessed the risk of fraud and abuse in the context of our audit objectives in the course of evaluating audit evidence. As noted earlier in the report, we obtained and reviewed allegations of fraudulent activity at VSB that were provided to FDIC examiners in 2002. In response, the FDIC performed a limited scope visitation to follow-up on alleged wrongdoings, and deferred a more thorough review and investigation of all allegations to an examination in August 2002. RMS officials informed us that the allegations were fully reviewed by FDIC examiners at the August 2002 examination and that the allegations were not substantiated. Documentary evidence of the FDIC's full review and ultimate disposition of the allegations at the August 2002 examination was not available for our review. As a result, we were not able to independently assess or conclude on the FDIC's handling of the allegations. Further, in regards to the bank applications covered in this report, supervisory records supporting the FDIC's approval of the section 19 application submitted by FINB in 1995 were not available for our review. Accordingly, we were not able to independently assess the FDIC's evaluation of the application. Notwithstanding these limitations regarding the sufficiency and appropriateness of audit evidence, we believe that the preponderance of evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In addition, we identified a matter involving an automated tool used by FDIC examiners to assess fraud risk at financial institutions. The OIG plans to communicate this matter separately to RMS management as an assessment of the tool was not within the scope of this performance audit.

Related Coverage of Financial Institution Failures

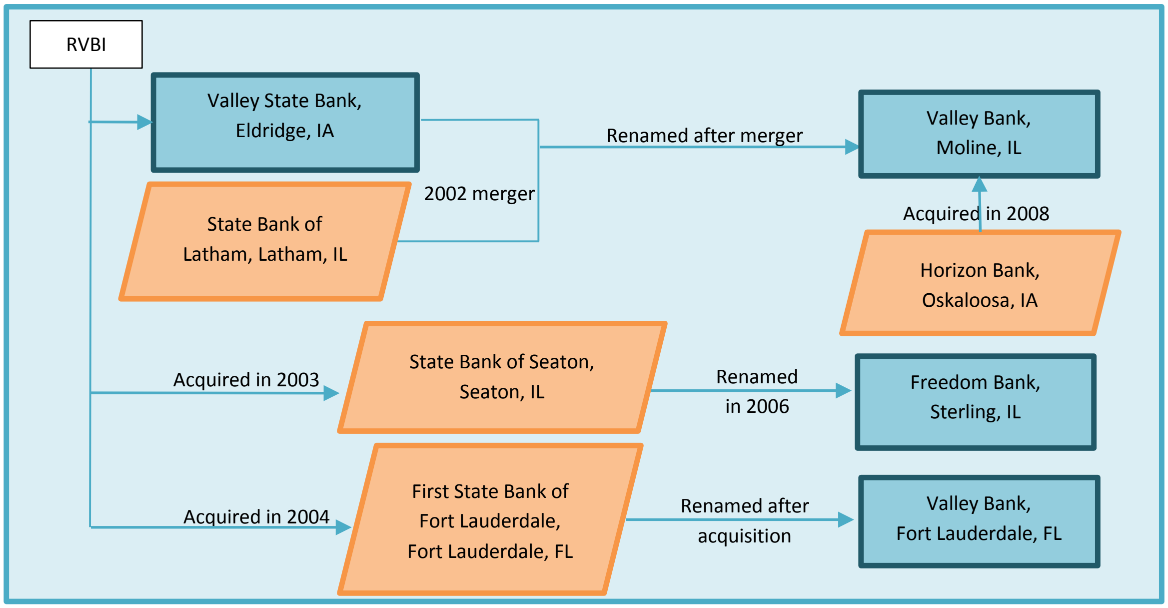
On May 1, 2009, the OIG issued a memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that resulted in a material loss to the DIF. The memorandum indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since the issuance of the memorandum, the OIG has issued additional MLR reports and these reports can be found at 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 those in response to the May 2009 memorandum and (2) identify trends and issues that have emerged from subsequent MLRs.

Further, the OIGs of the FDIC, the Department of the Treasury, and the FRB issued an evaluation report in September 2011, entitled, *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which assessed the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *Prompt Corrective Action*, and section 39, *Standards for Safety and Soundness*) in the banking crisis. In addition, in October 2012, the FDIC OIG conducted a study entitled, *Acquisition, Development, and Construction Loan Concentration Study* (Report No. EVAL-13-001), which evaluated how certain banks with ADC loan concentrations survived the recent crisis and the supervisory actions taken for these institutions by the FDIC. The study identified factors that may help banks mitigate risks historically associated with ADC loan concentrations during periods of economic stress. The FDIC OIG also issued an evaluation report to the Congress, entitled *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (Report No. EVAL-13-002), in January 2013. This report addressed a number of topics relevant to institution failures, such as the evaluation and use of appraisals, the implementation of the FDIC's policy statement on CRE loan workouts, risk management enforcement actions, and examiner assessments of capital.

We considered each of the reports and the study described above in planning and conducting our MLR of VBI.

Overview of River Valley's Merger and Acquisitions

The following graphic illustrates River Valley's merger and acquisition activities between 2002 and 2014.



Source: KPMG analysis of FDIC supervisory records.

Glossary of Key Terms

Term	Definition
Acquisition, Development, and Construction (ADC) Loans	ADC loans are a component of CRE lending that provides funding for acquiring and developing land for future construction and that provides interim financing for residential or commercial structures. ADC lending generally involves a greater degree of risk than permanent financing for finished residences or commercial buildings. Associated risks include adverse changes in market conditions between the time an ADC loan is originated and the time construction is completed, as well as the inherent difficulty of accurately estimating the cost of construction and the value of completed properties in future periods. Due to these and other risk factors, ADC loans generally require a greater level of effort to effectively evaluate and monitor than other types of loans.
Adversely Classified Assets	Adversely classified assets are assets subject to criticism and/or comment in a report of examination. These 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 are responsible for ensuring that their institutions have controls in place to consistently determine the ALLL in accordance with stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Capital Restoration Plan (CRP)	Section 325.104(a)(1) of the FDIC Rules and Regulations requires a bank to file a written CRP with the appropriate FDIC Regional Director within 45 days of the date that the bank receives notice or is deemed to have received notice that the bank is *Undercapitalized*, *Significantly Undercapitalized,* or *Critically Undercapitalized*, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.
Civil Money Penalty (CMP)	A CMP is a fine or the payment of money to the Department of the Treasury by a respondent as punishment for wrongdoing. It serves to create a disincentive for such conduct by those who hold positions of trust at insured depository institutions. According to the FDIC's Formal and Informal Actions Procedures Manual, a recommendation to assess CMPs should be made when (1) a violation, practice, or breach causes substantial harm to depositors or to the institution, (2) a violation, practice, or breach is willful, flagrant, or shows bad faith on the part of the institution; or (3) previous supervisory actions (such as MOUs or cease-and-desist orders) have been ineffective in eliminating or deterring a

Term	Definition
	violation. CMPs are imposed to punish the wrongdoer and to create, by example, a disincentive for such conduct by others who hold positions of trust at insured depository institutions.
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.
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, geographic region, or affiliated group. Collectively, these assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution. The FDIC Risk Management Manual of Examination Policies defines a concentration as (1) an exposure to any industry, product line, or type of collateral representing more than 100 percent of Tier 1 Capital and (2) an exposure to an individual borrower or small interrelated group of individuals aggregating more than 25 percent of Tier 1 Capital.
Consent Order or Cease-and-Desist Order	A Consent Order or Cease-and-Desist Order is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or violation. A Consent Order is a Cease-and-Desist Order that has been stipulated to by the bank's Board. A Cease-and- Desist Order may be terminated by the regulators when they have determined that the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Consolidated Reports of Condition and Income (Call Reports)	Consolidated Reports of Condition and Income (also known as Call Reports) are reports that are required to be filed by each insured depository institution pursuant to the FDI Act. These reports are used to calculate deposit insurance assessments and to monitor the condition, performance, and risk profile of individual banks and the banking industry.
Deposit Insurance Fund (DIF)	The DIF is a fund administered by the FDIC, the goal of which is to (1) insure deposits and protect depositors of FDIC-insured institutions and (2) resolve failed FDIC-insured institutions at the least possible cost (unless a systemic risk determination is made). The DIF is primarily funded from deposit insurance assessments.

Term	Definition
Division of Resolutions and Receiverships (DRR)	DRR is a division within the FDIC that has primary responsibility for resolving failing financial institutions and managing the resulting receiverships.
Division of Risk Management Supervision (RMS)	RMS is a division within the FDIC that has primary responsibility for issuing supervisory guidance to FDIC-supervised institutions and examiners and for performing examinations of FDIC-supervised institutions to assess their overall financial condition, management of policies and practices, and compliance with applicable laws and regulations.
Global Cash Flow Analysis	A global cash flow analysis is a comprehensive evaluation of borrower capacity to repay a loan. During underwriting, a global cash flow analysis may be performed to thoroughly analyze projected cash flow and guarantor support. Beyond the individual loan, global cash flow considers other relevant factors, including: the guarantor's related debt at other financial institutions, current and complete operating statements of all related entities, and future economic conditions. 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.
Loan Participation	A loan participation is a transfer of an undivided interest in all or part of the principal amount of a loan from a seller, known as the "lead," to a buyer, known as the "participant," without recourse to the lead, pursuant to an agreement between the lead and the participant. "Without recourse" means that the loan participation is not subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant upon the borrower's default on the underlying loan.
Loan-To-Value (LTV)	LTV is a ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit, plus any readily marketable collateral or other acceptable collateral.
Memorandum of Understanding (MOU)	An MOU is an informal agreement between a financial institution and the institution's regulators. A state banking agency may be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's financial condition or risk management practices.
Net Non-Core Funding Ratio	The Net Non-Core Funding Ratio is calculated as non-core liabilities less short-term investments divided by long term assets. This ratio is based on the premise that non-core liabilities are better suited to fund short-term investments rather than long-term assets.
Nonaccrual	The term nonaccrual refers to the status of an asset, often a loan, which is not earning the contractual rate of interest in the loan

Term	Definition
	agreement due to financial difficulties of the borrower. Typically, interest accruals are 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.
Other Real Estate (ORE)	ORE consists of real property held for reasons other than to conduct bank business. Banks usually acquire ORE through foreclosure after a borrower defaults on a loan secured by real estate.
Peer Group	FDIC-insured institutions are assigned to 1 of 15 peer groups based on the institution's asset size, number of branches, and whether the institution is located in a metropolitan or nonmetropolitan area. From 2004 until 2014, VBI's peer group consisted of insured commercial banks having assets between $300 million and $1 billion.
Private Label Mortgage Backed Securities (PLMBS)	PLMBS are debt obligations that represent claims to the cash flows from pools of mortgage loans. The mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization. Some private institutions, such as brokerage firms, banks, and homebuilders, also securitize mortgages, known as "private-label" mortgage backed securities.
Regulation O of the Federal Reserve	Regulation O of the Federal Reserve covers Insider Transactions and states, among other things, that no member bank may extend credit to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit of the member bank specified.
Risk-Based Capital	Risk-based capital ratios measure regulatory capital as a percentage of both on- and off-balance-sheet credit exposures with some gross differentiation based on perceived credit risk. Part 325 Appendix A—*Statement of Policy on Risk-Based Capital*—defines the FDIC's risk-based capital rules.
Section 23A and Section 23B of the Federal Reserve Act	Section 23A and Section 23B of the Federal Reserve Act identifies the restrictions on transactions with affiliates, which include the prohibition for a bank and its subsidiaries to purchase low-quality assets from an affiliate.
Section 32 of the Illinois Banking Act	Section 32 of the Illinois Banking Act addresses Aggregation of Loans. It outlines various factors in determining whether loans to separate persons should be combined for legal lending limit

Term	Definition
	purposes. This section states that a loan to one person shall be considered a loan to a second person if the credit worthiness of the one person does not justify the loan or extension of credit without the reliance on the credit worthiness of the second person. Additionally, Section 32 of the Illinois Banking Act limits the liabilities outstanding to a state bank of a person directly or of a person indirectly as a guarantor. The direct lending limit shall not exceed 25 percent of the amount of unimpaired capital and surplus of the bank.
Section 35.2 of the Illinois Banking Act	Similar to Sections 23A and 23B of the Federal Reserve Act, this regulation also covers restrictions on transactions with affiliates, which include the prohibition for a bank and its subsidiaries to purchase low-quality assets from an affiliate.
Tier 1 Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.2(v), as **The sum of**: • Common stockholder's equity; • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Troubled Condition	A bank is considered to be in a "troubled condition" if, among other things, it has a composite rating of "4" or "5," or is subject to a Cease-and-Desist Order or written agreement issued by either the FDIC or the State banking authority that requires action to improve the financial condition of the bank.
Troubled Debt Restructuring (TDR)	A restructured or modified loan is considered a TDR when the institution, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the institution would not otherwise consider. To make this determination, the lender assesses whether (a) the borrower is experiencing financial difficulties, and (b) the lender granted a concession.
Uniform Bank Performance Report (UBPR)	The UBPR is an analysis of bank 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.

Term	Definition
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the 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, is assigned a rating of "1" through "5," with "1" having the least regulatory concern and "5" having the greatest concern.
Virtual Supervisory Information on the Net (ViSION)	ViSION is an FDIC information system that provides access to a broad range of information related to insured financial institutions in support of the Corporation's insurance and supervision programs. RMS personnel use the system to perform supervisory-related functions, such as tracking applications, accessing examination information, and monitoring enforcement actions. Analysts in the Division of Insurance and Research also rely on information in ViSION to perform insurance-related functions, such as analyzing trends in the banking industry and calculating deposit insurance assessment rates for financial institutions.

Acronyms

ADC	Acquisition, Development and Construction
ALLL	Allowance for Loan and Lease Losses
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk
CEO	Chief Executive Officer
CMP	Civil Money Penalty
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
EIPCA	Eastern Iowa Production Credit Association
FDI	Federal Deposit Insurance
FIL	Financial Institution Letter
FINB	First Illinois National Bank, Savanna, Illinois
FRB	Federal Reserve Bank
IDFPR	Illinois Department of Financial and Professional Regulation
LTV	Loan-to-Value
MLR	Material Loss Review
MOU	Memorandum of Understanding
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
ORE	Other Real Estate
PCA	Prompt Corrective Action
PLMBS	Private Label Mortgage Backed Securities
RMS	Division of Risk Management Supervision
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
VBF	Valley Bank, Fort Lauderdale, Florida
VBI	Valley Bank, Moline, Illinois
ViSION	Virtual Supervisory Information on the Net
VSB	Valley State Bank, Eldridge, IA

Part II

Corporation Comments and OIG Evaluation

Corporation Comments and OIG Evaluation

Subsequent to the issuance of KPMG's draft report, RMS officials provided additional information for KPMG's consideration, and KPMG revised its report to reflect this information, as appropriate. The Director, RMS, provided a written response, dated August 11, 2015, to a draft of KPMG's report. The response is provided in its entirety on pages II-2 and II-3. In the response, the Director, RMS, concurred with all three of the report's recommendations.

A summary of the Corporation's corrective actions is presented on page II-4. The planned and completed actions are responsive to the recommendations and the recommendations are resolved.

Corporation Comments

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

August 11, 2015

TO: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

FROM: Doreen R. Eberley /**Signed**/
Director

SUBJECT: Response to the Draft Audit Report Entitled, Material Loss Review of Valley Bank, Moline, Illinois (Assignment No. 2014-043)

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 (FDIC) Office of Inspector General (OIG) conducted a Material Loss Review of Valley Bank, Moline, Illinois, which failed on June 20, 2014. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report (Report) received on July 9, 2015. RMS concurs with the three recommendations included in the Report. The actions RMS will and has taken to address the recommendations are briefly outlined below.

OIG's Audit Recommendation 1: *Revise the Officer's Questionnaire to require that institutions reference any prior notification to the FDIC and /or any other regulatory agency involving a director, officer, or employee who has been convicted of, or who is under indictment for, a criminal offense involving dishonesty or breach of trust.*

RMS will update the Officer's Questionnaire to ensure that all directors, officers, and employees with convictions or indictments for a criminal offense involving dishonesty or breach of trust are identified at every examination. RMS will complete this action by March 31, 2016.

OIG's Audit Recommendation 2: *Review the FDIC's supervisory policy and approach for addressing risks associated with dominant bank officials to ensure that:*

a) Examination coverage of and reporting on the Board's composition and involvement in overseeing the policies and activities of the bank is sufficiently emphasized and/or required; and
b) Expectations are clear when prior supervisory actions do not have the intended effect.

RMS is presently drafting expanded examiner guidance related to examinations of banks with dominant officials. RMS will ensure the expanded guidance addresses the concerns identified in this Report, including the areas described above. RMS will complete this action by December 31, 2015.

<u>OIG's Audit Recommendation 3:</u> *Reinforce to case managers and other Regional Office staff the importance of recording and retaining information regarding the basis for key supervisory decisions, including when supervisory actions are considered or recommended, but ultimately not taken.*

RMS has reinforced to case managers the policy requirement to record and maintain current and complete information pertaining to enforcement actions in the Formal and Informal Action Tracking (FIAT) system in the Virtual Supervisory Information On the Net system. RMS conducted a national case manager training initiative that concluded in January 2015, which reinforced policy requirements for enforcement actions, including identifying best practices to address and correct common errors associated with FIAT. RMS will additionally reinforce the importance of recording and retaining information regarding the basis for key supervisory decisions and actions, including instances where supervisory actions are considered or recommended but ultimately not taken, in the current update to the case manager procedures manual. RMS will complete this action by December 31, 2015.

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

Summary of the Corporation's Corrective Actions

This table presents corrective actions taken or planned by the Corporation in response to the recommendations in the report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	RMS will update the Officer's Questionnaire to ensure that all directors, officers, and employees with convictions or indictments for a criminal offense involving dishonesty or breach of trust are identified at every examination.	3/31/2016	$0	Yes	Open
2	RMS will issue expanded examiner guidance related to examinations of banks with dominant officials that addresses the concerns identified in this report, namely emphasizing the Board's composition and oversight of the bank and setting expectations when supervisory actions have not had the intended effect.	12/31/2015	$0	Yes	Open
3	RMS has reinforced to Case Managers the policy requirement to record and maintain current and complete information pertaining to enforcement actions in ViSION. RMS also plans to reinforce the importance of recording and retaining information regarding the basis for key supervisory decisions and actions, including instances where supervisory actions are considered or recommended but ultimately not taken, in an update to the Case Manager Procedures Manual.	12/31/2015	$0	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Recommendations will be closed when (a) Corporate Management Control notifies the OIG that corrective actions are complete or (b) in the case of recommendations that the OIG determines to be particularly significant, when the OIG confirms that corrective actions have been completed and are responsive.