Office of Inspector General

Office of Program Audits and Evaluations
Report No. AUD-17-005

Material Loss Review of Seaway Bank and Trust Company, Chicago, Illinois

August 2017

Office of Inspector General

Executive Summary

Material Loss Review of Seaway Bank and Trust Company, Chicago, Illinois

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Why We Did The Audit

Section 38(k) of the Federal Deposit Insurance (FDI) Act requires the Inspector General (IG) of the appropriate federal banking agency to complete a review and prepare a report when the Deposit Insurance Fund (DIF) incurs a material loss with respect to an insured depository institution for which the FDIC is appointed Receiver. For losses that occur after January 1, 2014, the FDI Act defines a material loss as any estimated loss to the DIF in excess of $50 million. The Illinois Department of Financial and Professional Regulation (IDFPR) closed Seaway Bank and Trust Company, Chicago, Illinois (Seaway), and appointed the FDIC as Receiver on January 27, 2017. Seaway's total assets at closing were $279.9 million, and the estimated loss to the DIF was $57.2 million.

The objectives of this audit were to (1) determine the causes of Seaway Bank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Seaway, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act.

Background

Originally founded as Seaway National Bank of Chicago on January 2, 1965, the institution changed its name to Seaway Bank and Trust Company and converted to a state nonmember institution on December 30, 2007. Seaway was a Minority Depository Institution (MDI) and Community Development Financial Institution (CDFI). As such, Seaway's goal was to promote the economic viability of minority and under-served communities, particularly the African American communities in Chicago and Milwaukee. Seaway operated nine offices in Cook County, Illinois, within the Chicago metropolitan area and one office in Milwaukee County, Wisconsin. Eight of the bank's 10 offices were located within one mile of a low- or moderate-income census tract. These communities were significantly affected by the 2008 financial crisis.

In an effort to grow the bank, Seaway acquired two failed banks—First Suburban National Bank, Maywood, Illinois (First Suburban Bank) in October 2010 and Legacy Bank, Milwaukee, Wisconsin, (Legacy Bank) in March 2011—under the FDIC's Shared-Loss Agreement (SLA) program. Notably, Legacy Bank was an MDI and CDFI and its customer base and community were similar to that of Seaway. The failed bank acquisitions increased Seaway's loan portfolio by about 68 percent.

SLAs were one of the strategies the FDIC employed during the 2008 financial crisis to help fulfill its goal of resolving failed institutions in the least costly manner to the DIF. Under an SLA, the FDIC agrees to absorb a significant portion of the losses (typically 80 percent) experienced by an assuming institution (AI) on a specified pool of assets. In exchange, the AI is expected to prudently manage the SLA assets and maximize asset recoveries. This structure is intended to reduce the FDIC's burden of managing receivership assets, keep failed bank assets in the private sector, and reduce resolution costs. An SLA sets forth the requirements regarding the AI's management of the SLA assets and procedures for filing claims for loss reimbursements from the FDIC. The FDIC's Division of Resolutions and Receiverships (DRR) administers and oversees the SLA program.

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Audit Results

Causes of Failure and Material Loss

Seaway failed as a result of poor corporate governance and risk management practices by the Board and management. Seaway's Board and management were unable to effectively address a number of problems that began escalating, following the death of the bank's long-time Chairman in April 2013, when his widow assumed a 51-percent controlling interest in Seaway's holding company. Examiners uncovered accounting problems during the 2013 examination related to the assets Seaway acquired in 2010 and 2011 from the FDIC as Receiver. Further, examiners determined that the Board was unaware of the true financial condition and performance of the bank for most of 2013. The Board took a series of steps in 2014 to address the examination findings, including dismissing the officials responsible for the bank's deteriorated financial condition and accounting problems. However, Seaway then faced another problem – finding qualified candidates willing to work for what had become a troubled institution.

The Board's inability to fill key vacancies in 2014 created a management void from that point forward. The management void hampered the Board's efforts to effectively address SLA-related issues and an increasing number of non-performing loans within its portfolio. Problem assets were concentrated in bank-originated commercial real estate loans, particularly faith-based and SLA loans. Further, without a cohesive management team in place, the bank's risk management practices became inadequate relative to its condition. Moreover, the Board relied heavily on consultants, which created excessive overhead expenses and negatively impacted earnings. From 2013 through its failure in January 2017, losses associated with bank-originated and SLA assets, coupled with high overhead expenses, critically depleted Seaway's capital and viability.

The FDIC's Supervision of Seaway

From 2009 through 2017, the FDIC conducted timely and regular examinations, visitations, and offsite monitoring activities of Seaway, as required. The FDIC regularly offered Seaway technical assistance under the MDI program, as required. The FDIC complied with statutory requirements and FDIC policy guidance in allowing Seaway to purchase SLA assets in 2010 and 2011. The FDIC's assessment of Seaway's condition and assignment of component and composite ratings was consistent with supervisory guidance and reflected the increasing deterioration in the bank's management, assets, earnings, and capital. The FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act.

In our view, it would have been prudent for the Division of Risk Management Supervision (RMS) to have participated in the IDFPR's 2012 examination or conducted a separate visitation in 2012. While it was permissible by the FDIC Rules and Regulations to forego participation in this examination, RMS missed an opportunity to see firsthand how Seaway was managing and accounting for the SLA assets at a critical time. Our conclusion takes into consideration a number of factors that were significant in 2012, including existing examiner concerns about asset quality and earnings and the importance of properly valuing and accounting for the SLA assets. In this regard, Generally Accepted Accounting Principles (GAAP) allowed Seaway one year from each SLA acquisition to properly value the SLA assets and conform its books and records to applicable accounting standards. Although RMS conducted visitations shortly after each SLA acquisition, Seaway had not adjusted its SLA accounting records to conform with GAAP requirements at that time. RMS assessed

Seaway's accounting in October 2013, but, in our opinion, should have done so no later than March 2012, approximately one year after Seaway's second SLA acquisition.

Management Response

The RMS Director provided a written response, dated August 11, 2017, to a draft of this report dated July 14, 2017. That response is presented in its entirety in Appendix 5.

In its response, the RMS Director reiterated the OIG's conclusions regarding Seaway's cause of failure and the FDIC's supervision of the bank. The response also stated that in retrospect, it may have been beneficial for the FDIC to have participated in the IDFPR's 2012 examination of Seaway or conducted a separate visitation.

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

Office of Program Audits and Evaluations
Office of Inspector General

DATE: August 15, 2017

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

/Signed/

FROM: E. Marshall Gentry
Assistant Inspector General for Program Audits and Evaluations

SUBJECT: *Material Loss Review of Seaway Bank and Trust Company, Chicago, Illinois* (Report No. AUD-17-005)

Section 38(k) of the Federal Deposit Insurance (FDI) Act requires the Inspector General (IG) of the appropriate federal banking agency to complete a review and prepare a report when the Deposit Insurance Fund (DIF)[1] incurs a material loss with respect to an insured depository institution for which the FDIC is appointed Receiver. For losses that occur after January 1, 2014, the FDI Act defines a material loss as any estimated loss to the DIF in excess of $50 million. The Illinois Department of Financial and Professional Regulation (IDFPR) closed Seaway Bank and Trust Company, Chicago, Illinois (Seaway), and appointed the FDIC as Receiver on January 27, 2017. Seaway's total assets at closing were $279.9 million, and the estimated loss to the DIF was $57.2 million.

Accordingly, to meet our review responsibilities under section 38, the objectives of this audit were to (1) determine the causes of Seaway Bank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Seaway, including implementation of the Prompt Corrective Action (PCA) provisions of section 38 of the FDI Act. The scope of our review included 2009 through January 2017, when Seaway failed. Reviewing this period allowed us to evaluate Seaway's history before and after it acquired failed bank assets and changes that occurred to the bank's Board of Directors (Board) and management. Appendix 1 contains additional details on our objectives, scope, and methodology.

This report presents our analysis of Seaway's failure and the FDIC's efforts to ensure the bank's Board and management operated the institution in a safe and sound manner. The report does not contain any formal recommendations, but our analysis of the FDIC's supervision identifies lessons learned from this failure for the FDIC's consideration. Specifically, we concluded that it would have been prudent for the Division of Risk Management Supervision (RMS) to have participated in the IDFPR's 2012 examination or conducted a separate visitation in 2012. While it was permissible by the FDIC Rules and Regulations to forego participation in this

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

examination, RMS missed an opportunity to see firsthand how Seaway was managing and accounting for its acquisition of failed bank assets at a critical time.

Although we are not making recommendations in this report, we will periodically analyze major causes, trends, and common characteristics of institution failures that are identified in our material loss reviews (MLR). When appropriate, we will communicate the results of our analyses to FDIC management and may make related recommendations.

Background

Originally founded as Seaway National Bank of Chicago on January 2, 1965, the institution changed its name to Seaway Bank and Trust Company and converted to a state-chartered institution on December 30, 2007. Seaway was wholly owned by Seaway Bancshares, Incorporated, (SBI), Chicago, Illinois, a one-bank holding company. Ownership of SBI was concentrated in two individuals and the majority owner served as the bank's Executive Chair of the Board. SBI operated as a shell corporation and was not a source of strength for the bank.

Seaway was a Minority Depository Institution (MDI) and Community Development Financial Institution (CDFI). As such, Seaway's goal was to promote the economic viability of minority and under-served communities, particularly the African American communities in Chicago and Milwaukee. Seaway operated nine offices in Cook County, Illinois, within the Chicago metropolitan area and one office in Milwaukee County, Wisconsin. Eight of the bank's 10 offices were located within one mile of a low- or moderate-income census tract. These communities were significantly affected by the 2008 financial crisis.

What is an MDI?

- Any federally insured depository institution where 51 percent or more of the voting stock is owned by minority individuals.
- Additionally, institutions are considered MDIs if a majority of the board of directors is minority and the community that the institution serves is predominately minority.

What is a CDFI?

- A specialized institution that works in market niches that are underserved by traditional financial institutions.
- CDFIs provide (1) mortgage financing for low-income and first-time homebuyers and not-for-profit developers; (2) flexible underwriting and risk capital for community facilities; and (3) technical assistance, commercial loans, and investments to small, start-up, or expanding businesses in low-income areas.

Source: FDIC documentation.

FDIC guidance issued in 2007 regarding MDIs notes that organizers and shareholders of an MDI may not deem high profitability as essential. Instead, promoting community development, consumer services, and banking services to the unbanked or under-banked segment of its community may drive many of the organization's decisions. Seaway's Board and management pursued a traditional community bank business model that focused on consumer, small business, multi-family, and faith-based loans.

In an effort to grow the bank, Seaway acquired two failed banks—First Suburban National Bank, Maywood, Illinois (First Suburban Bank) in October 2010 and Legacy Bank, Milwaukee, Wisconsin, (Legacy Bank) in March 2011—under the FDIC's Shared-Loss Agreement (SLA) program. SLAs were one of the strategies the FDIC employed during the 2008 financial crisis to help fulfill its goal of resolving failed institutions in the least costly manner to the DIF. Under an SLA, the FDIC agrees to absorb a significant portion of the losses (typically 80 percent) experienced by an assuming institution (AI) on a specified pool of assets. In exchange, the AI is expected to prudently manage the SLA assets and maximize asset recoveries. This structure is intended to reduce the FDIC's burden of managing receivership assets, keep failing bank assets in the private sector, and reduce resolution costs. An SLA sets forth the requirements regarding the AI's management of the SLA assets and procedures for filing claims for loss reimbursements from the FDIC. The FDIC's Division of Resolutions and Receiverships (DRR) administers and oversees the SLA program.

In the First Suburban Bank transaction, Seaway acquired approximately $144.0 million in total assets, of which $116.6 million (81 percent) were subject to loss-sharing. In the Legacy Bank transaction, Seaway acquired approximately $165.9 million in total assets, of which $120.0 million (72 percent) were subject to loss-sharing. Notably, Legacy Bank was an MDI and CDFI and its customer base and community were similar to that of Seaway. The FDIC's loss share coverage period spanned 5 years for Seaway's commercial SLA assets and 10 years for its single-family SLA assets. Seaway acquired the failed bank assets at a discount and the FDIC guaranteed 80 percent of Seaway's losses on the SLA assets. Table 1 presents a snapshot of Seaway's financial condition for the 8 years ending December 31, 2016.

Table 1: Selected Financial Data for Seaway, 2009 - 2016

Financial Data ($000)	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
Total Assets	$385,715	$516,257	$597,406	$552,983	$556,539	$419,968	$370,062	$297,809
Total Loans	$194,083	$262,663	$293,194	$286,369	$286,727	$265,158	$233,535	$202,272
Total Deposits	$338,858	$464,520	$526,137	$490,092	$505,971	$330,458	$292,537	$256,505
Total Equity Capital	$33,388	$36,020	$44,911	$46,663	$38,264	$42,540	$28,963	($5,791)
FHLB Borrowings*	$1,000	$0	$11,000	$1,000	$0	$15,000	$24,850	$42,700
Brokered Deposits	$2,293	$50,518	$59,768	$59,662	$52,716	$23,033	$1,578	$1,592
Net Income (Loss)	$1,919	$5,750	$4,344	$4,460	$970	($2,082)	($11,570)	($25,702)

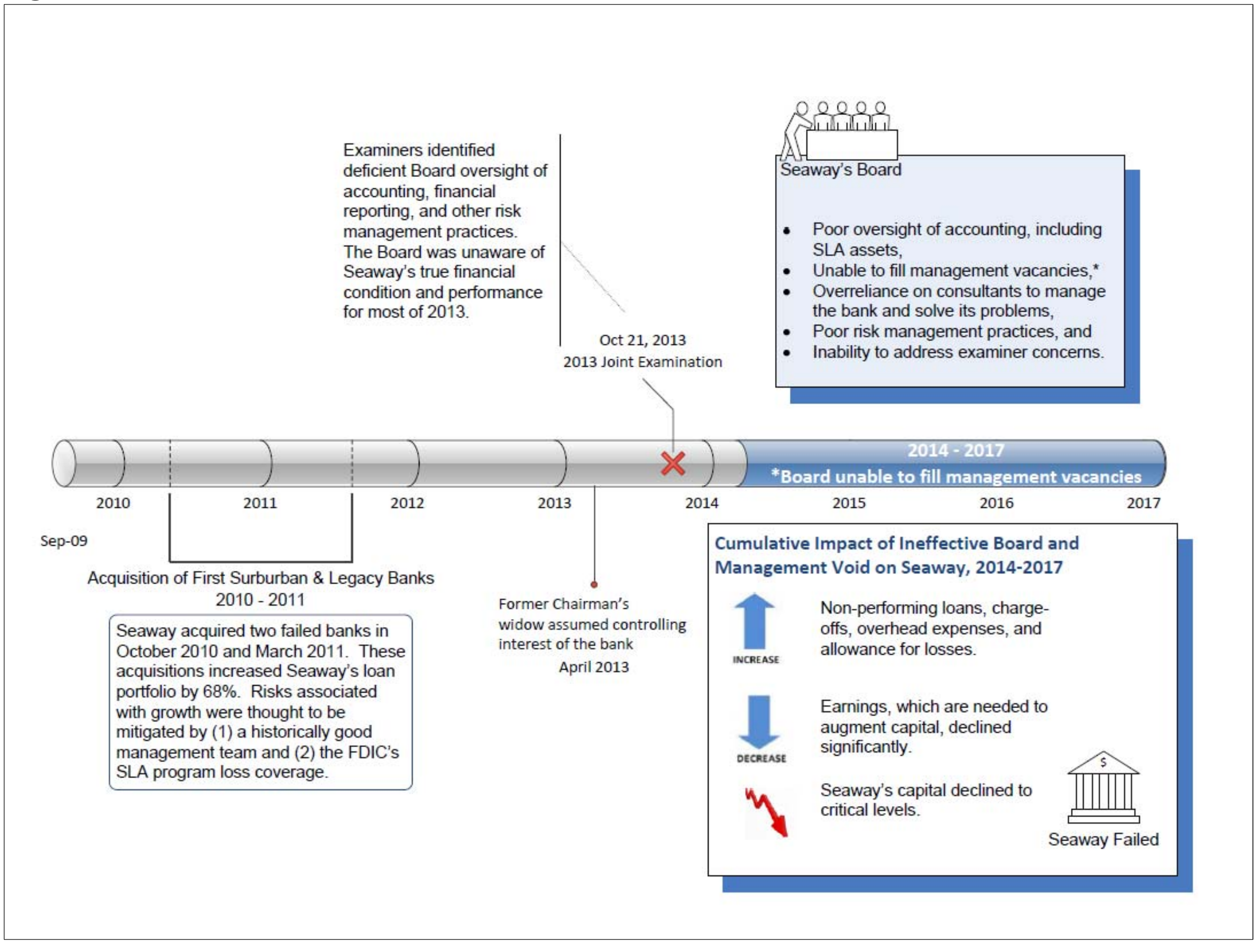
Source: Uniform Bank Performance Reports (UBPR) for Seaway. As noted in Appendix 1, we could not rely on the financial data from 2013 through the bank's failure in 2017.
*Federal Home Loan Bank (FHLB) borrowings with maturity dates of less than 1 year.

In April 2013, following a prolonged illness, Seaway's long-time former Chairman and controlling shareholder died and his widow assumed a 51-percent controlling interest. As discussed in the *Cause of Failure* section below, 2013 proved to be a turning point for the bank.

Causes of Failure and Material Loss

Seaway's Board and management bore the ultimate responsibility for the bank's poor condition and failure. Specifically, Seaway's Board and management were unable to effectively address a number of problems that began escalating in April 2013. Figure 1 is a timeline of key events between 2009 and 2017 that factored in Seaway's failure.

Figure 1: Cause of Failure Timeline, 2009 - 2017



Source: Office of Inspector General (OIG) analysis of FDIC Reports of Examination and other supervisory documents.

The following sections describe the cause of Seaway's failure in more detail.

Ineffective Board and Management Void

RMS'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 probably the single most important element in the successful operation of a bank." The Examination Manual also states that "the continuing health, viability, and vigor of the bank are dependent upon an interested, informed and vigilant board of directors." Up until October 2013, examiners viewed Seaway's long-term Chairman and management team as competent and well regarded. Further, a 2011 independent management study found that Seaway's leadership team was competent and stable but it also noted that its growth by acquisition strategy had added organizational stress to an "already challenging business arena."[2]

[2] When Seaway acquired Legacy Bank, it committed to obtaining a third-party management study. The study was completed in October 2011.

In 2013, it became evident that the Board was not engaged or attentive to bank operations and the management structure was not effective at supervising the bank's operational functions. Seaway's Board and management were largely ineffective from 2013 through its failure.

Board's Inadequate Oversight of Seaway's Financial Condition and SLA Assets

In 2013, examiners concluded that inadequate oversight was the reason that the Board was unaware of Seaway's true financial condition and performance for most of that year.

Management did not properly account for SLA assets in 2013 and this resulted in inaccurate financial reporting, which masked the bank's actual performance. Further, the bank's auditors refused to issue financial statement audits for 2013 and 2014, and a balance sheet audit for 2015 remained open, reportedly due to management's unresponsiveness to the auditors' requests.

Impact of SLA Assets on Seaway

- **Loan Portfolio**. Seaway's loan portfolio increased by 68 percent — from $194 million to $325 million from December 31, 2009 to June 30, 2011.
- **Impact on Seaway's Risk Profile**. The FDIC's loss share coverage was viewed to mitigate risks associated with SLA transactions. As discussed later, Seaway mismanaged the claims process and sustained higher losses than expected.

Source: FDIC documentation.

Filing accurate Consolidated Reports of Condition and Income (Call Report) and maintaining accurate financial statements is required by the FDIC Rules and Regulations and is fundamentally important as regulators and the public rely on these reports for transparent information on a bank's condition.[3] Examiners noted in 2015 that inaccurate Call Reports are an indicator of deficient management financial reporting and result in questions regarding the integrity of an institution's financial condition.

SLA accounting is complicated and requires subjective assumptions to determine the fair value of the assets.[4] A critical input in estimating the fair value of SLA assets is to determine their probability of default and loss to the bank in the event of default. If these assumptions are flawed, expected cash flow projections will be inaccurate and result in questionable calculations for loss impairments and an inaccurate valuation of the SLA indemnification asset. In other words, the cash flow analysis supports needed accounting entries to ensure losses are recognized

[3] Part 304 of the FDIC Rules and Regulations pursuant to section 7(a) of the FDI Act requires every state nonmember bank to file its Call Report in accordance with instructions of these reports. Part 363 implements section 36 of the FDI Act and establishes audit and reporting requirements for insured depository institutions with total assets of $500 million or more and their independent public accountants.

[4] Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 805, *Business Combinations*, and ASC Topic 820, *Fair Value Measurements and Disclosures*, are the principal sources of guidance on business combinations and related measurements under Generally Accepted Accounting Principles (GAAP) as of the acquisition date of the failed institutions. Subsequent accounting guidance for SLA assets is addressed in ASC Subtopic 310-30, *Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality*, and ASC Subtopic 310-20, *Receivables – Nonrefundable Fees and Other Costs.*

in a timely manner. Timely and accurate recognition of losses is important not only for financial reporting purposes but also factors into when a bank should file loss share claims.

Following its acquisition of SLA assets in 2010 and 2011, Seaway engaged a consulting firm to account for and conduct quarterly cash flow valuations for the SLA assets, which is a suggested best practice in interagency SLA guidance.[5] Seaway's consultant developed and implemented a valuation model for this purpose, which appeared to produce accurate results. Importantly, the interagency guidance notes that the use of outside resources does not relieve management of its responsibility to ensure that fair value estimates are measured in accordance with GAAP. Management must sufficiently understand the basis for measurement and valuation techniques used by outside parties to determine the appropriateness of these techniques, the underlying inputs and assumptions, and the resulting fair value estimates.

In early 2013, management brought the SLA accounting function and the consultant's valuation model in-house. At that time, Seaway did not (1) have staff with sufficient loss share management experience, (2) correctly configure the model, and (3) have internal audit processes in place to review and validate the model's outputs. The consequences of Seaway's management decision to bring this function in-house were dire. Specifically, according to the 2013 examination report, errors in calculating the value of the associated SLA indemnification asset began in the first quarter of 2013 when the bank brought accounting for the SLA assets in-house. Despite inexplicable results produced by the software (see text box) Seaway did not take action to validate the model's outputs until urged by examiners in 2013.

Example of SLA Valuation Errors

Management did not question the bank's loss share modeling software, which produced extremely questionable results. Seaway reported an unexpected loss of $3.1 million in the first quarter of 2013. After recording the results of the second quarter cash flow valuation, the bank reported year-to-date net income of $3.7 million. This fluctuation in net income indicated that the bank lost over $3.0 million in the first quarter and earned over $6.0 million in the second quarter, without any material change in its business practice. In the fourth quarter of 2013, examiners requested Seaway to verify these figures. Seaway's contractor determined that Seaway inappropriately configured the software, resulting in SLA valuation errors.

Source: 2013 examination report.

In summary, inadequate management and Board oversight resulted in inaccurate financial reports, which showed the bank to be operating profitably and accumulating capital through the third quarter of 2013. Seaway corrected prior period errors in the fourth quarter of 2013, revealing that the bank had a net operating loss of $4.4 million.

Board's Inability to Fill Key Management Positions

At the bank's April 2014 organizational meeting, three new outside directors were added to the Board. In addition, the controlling shareholder (the former Chairman's widow), was appointed

[5] *Interagency Supervisory Guidance on Bargain Purchases and FDIC- and National Credit Union Administration-Assisted Acquisitions,* dated June 7, 2010.

to Executive Chair of the Board.[6] As such, she assumed greater responsibility over the bank's operations and remediation efforts, including assisting with the bank's strategic plans, reviewing financial results and reports, and leading the bank's business development activities. After assuming control in 2013, she was appointed as a non-Executive Chair of the Board and Business Development officer. Although she had executive leadership experience in budget and financial reporting, she did not have any banking experience. Primarily as a result of findings from the 2013 examination, the Board terminated the following three most senior executive management officials between June and August 2014:

- President/Chief Executive Officer (CEO)
- Chief Financial Officer/Chief Operating Officer (CFO/COO), and
- General Counsel.

At the time these officials were dismissed, the bank had identified potential candidates to replace the President/CEO and CFO/COO but was unable to fill the CFO/COO position. The CFO/COO was responsible for directing audits, recordkeeping, and accounting activities for Seaway and provided direction and supervision to operational and administrative departments. The CFO/COO position was vacant for 15 months—from June 2014 until October 2015. Examiners noted that this vacancy was especially troubling considering the significant deficiencies in the bank's financial reporting and control. Appendix 2 contains more detailed information about management turnover.

Executive officers, such as CEOs, have primary responsibility for managing the day-to-day operations and affairs of a bank. The President/CEO that Seaway hired in August 2014 was terminated by the Board in September 2015 because his expertise was not a good fit for the bank's technical needs and he was unable to remediate the bank's critical problems. The Executive Chair of the Board assumed the role of Interim President from September 2015 until the bank failed because the Board was unable to attract a qualified candidate for the vacated position. Examiners explained that the Board actively sought to fill these positions, but a number of factors made it difficult, including the bank's poor condition and competition for talent when other banks were also looking for experienced executives. Examiners also reported that Seaway had inadequate staffing resources to effectively oversee operations, establish and maintain appropriate operational practices, and ensure accurate and timely financial reporting.

Board's Heavy Reliance on Consultants

To fill the management void caused by the vacancies, the Board increasingly relied on consultants to run the bank's day-to-day operations and assist with making strategic decisions. Specifically, consultants helped the bank manage the SLA portfolio and prepare loss claims, comply with loan administration and compliance matters, correct operational and financial reporting deficiencies, collect on non-performing assets, and comply with Community Reinvestment Act (CRA) requirements. The consultants, however, did not have authority to

[6] These changes were subject to review by the FDIC because by this time Seaway was considered a problem bank. The FDIC's evaluation of these changes is explained further in the *Supervision* section of this report.

implement corrective actions directly, and examiners concluded that their services were of limited value as they did not improve the bank's condition. Further, the 2015 examination noted the following significant deficiencies, each of which had been assigned to a consultant:

- Inaccurate Consolidated Reports of Condition and Income (Call Report),
- The lack of a realistic budget, and
- An ineffective capital restoration plan.

In addition, in 2015, examiners noted that Seaway's Bank Secrecy Act (BSA) program continued to have internal control and other weaknesses despite assistance from third-party consultants. For example, Seaway was not in compliance with all pertinent rules and regulations, was not monitoring certain transactions, and had not timely implemented corrective actions due to insufficient BSA staffing resources. While not a cause of failure, the BSA weaknesses reflected poorly on Seaway's Board and management.

The use of consultants elevated Seaway's overhead expenses, which, in turn, reduced earnings. Consulting fees more than doubled between the 2014 and 2015 examinations accounting for 26 percent of total overhead expenses as of September 30, 2015. As shown in Table 2, Seaway's overhead expenses as a percentage of average assets were historically above its peer group but increased significantly beginning in 2014.

Table 2: Seaway's Total Overhead Expenses as a Percentage of Average Assets Compared to Peers, 2009 - 2016

Total Overhead Expenses as a Percent of Average Assets	2009	2010	2011	2012	2013	2014	2015	2016
Seaway	4.56	4.14	4.63	4.21	4.86	6.83	9.67	11.09
Peers	2.97	2.94	2.93	2.93	2.93	2.89	2.86	2.84

Source: Seaway UBPR reports.

Inadequate Response to Regulatory Concerns

The Examination Manual states that the "board should establish policies, procedures, and controls designed to ensure compliance with legal and regulatory directives [and] prompt detection of noncompliance, timely implementation of corrective measures, and adequate training of officers and employees to prevent infractions." The Board failed to adequately implement several corrective actions identified in a 2014 consent order (CO) and a 2015 report from an outside consultant. Examiners noted that 16 of 26 provisions warranted additional efforts during the 2015 examination. Specifically, the bank:

- Failed to ensure it had adequate and dedicated staff to manage the SLA assets. SLA activities were complex and among the most substantial in the bank but only constituted part-time responsibilities of various staff members. The bank lacked a single point of contact that was accountable for the SLA assets.

- Was in apparent violation of eight federal or state laws and in contravention of various requirements in the FDIC's Rules and Regulations.

- Needed to enhance its risk governance guidelines in scrutinizing budgets or audits, setting targets, and holding the bank's executive management accountable.

- Lacked a knowledgeable BSA compliance officer, and was in violation of certain BSA laws and regulations.

Costly Strategic Decision in 2015

In November 2015, the Board authorized management to bid on approximately $65 million of distressed assets from another Chicago-based bank, despite Seaway's weak financial condition. Because of a contract dispute with the other bank regarding the period of time allowed before Seaway would service the assets, Seaway refused to sign the loan sale agreement by the stated expiration date. Subsequently, the other bank declared the contract in default and took possession of a $6.5 million deposit that Seaway had placed with an escrow agent as security for its bid. Seaway incurred legal fees in an attempt to recover the deposit and had not recovered it at the time of the bank's failure. The FDIC and IDFPR did not learn of the transaction until after Seaway bid on the assets. Upon learning of the transaction, RMS officials informed Seaway that it may not have had sufficient capital to execute the deal. Seaway informed RMS officials that it could not execute the deal in any event because of the dispute regarding the transfer of the servicing of the assets.

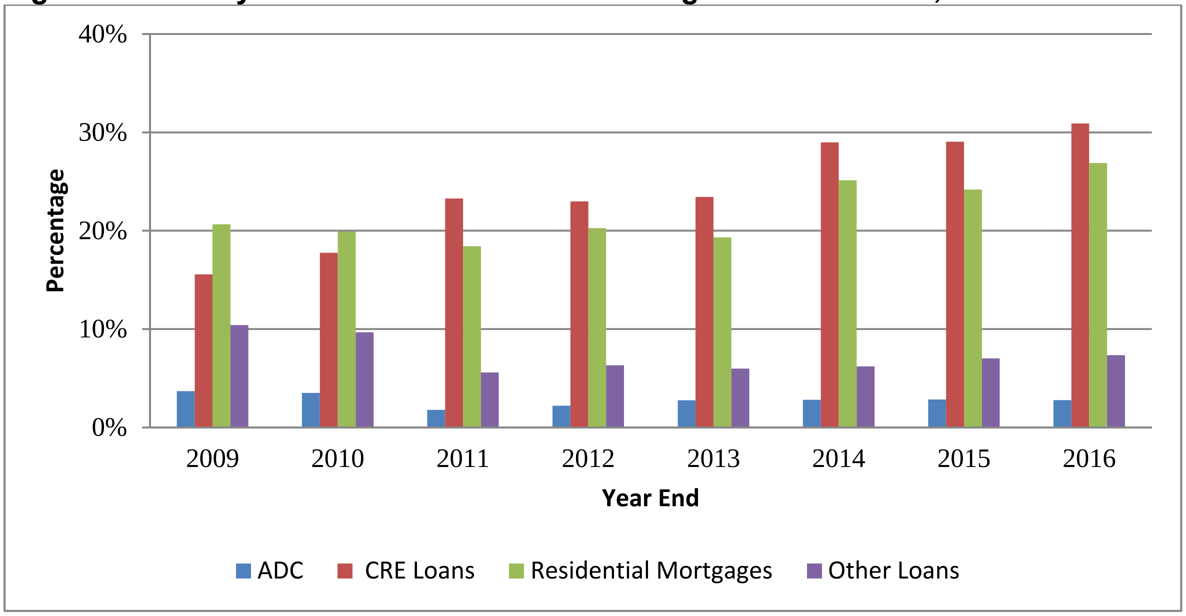
Poor Asset Quality and Risk Management Practices

RMS's Examination Manual states that "[A]sset quality is one of the most critical areas in determining the overall condition of a bank. The primary factor affecting overall asset quality is the quality of the loan portfolio and the credit administration program." The Examination Manual further notes that "[E]conomic downturns can adversely affect borrowers' repayment potential and lessen a bank's collateral protection." MDIs had lower returns and greater losses than community banks leading up to and during the crisis. Higher percentages of past due loans (e.g., loans more than 30 days past due) and nonperforming loans (e.g., loans past due more than 90 days or nonaccrual loans) require greater provisions for loan and lease losses, which lowers earnings.

Deterioration in Loan Portfolio

Prior to its acquisition of SLA assets, examiners rated the bank's asset quality as less than satisfactory ("3"), noting alarmingly high past-due loan percentages, increases in delinquencies and adversely classified assets. From 2009 to 2010, Seaway's loan portfolio primarily consisted of 1-4 family residential mortgages and commercial real estate (CRE) loans, which included faith-based loans. Following the SLA acquisitions in 2010 and 2011, Seaway's CRE loan volume increased. CRE loans represented approximately 16 percent of total assets in 2009 and steadily increased to approximately 31 percent of total assets in 2016. Figure 2 presents the composition of Seaway's loan portfolio over time relative to total assets.

Figure 2: Seaway's Loan Portfolio as a Percentage of Total Assets, 2009 - 2016



Source: UBPRs for Seaway.

Faith-based loan concentrations. Seaway's faith-based loan concentration far exceeded that allowed by its policy, which was generally limited to 25 percent of the bank's equity capital. Faith-based loan concentrations ranged from 93 to 207 percent of Tier 1 Capital from 2009 through 2015.[7] The 2014 examination report noted that examiners were unsure how long the bank was non-compliant with its policy. Examination reports expressed concerns about the bank's faith-based loan concentration since at least 2009 forward, which comprised our scope period.

Seaway's faith-based loans accounted for a significant portion of its classified assets and were risky because repayment depended on congregation contributions, and the communities that Seaway served were significantly impacted by the 2008 financial crisis. Further, there is typically limited marketability of the collateral (e.g., church structures) and collection efforts are often slowed because of a reluctance to foreclose. The FDIC expects banks that operate with concentrations to display an increased level of oversight and requires commensurate capital and allowance for loan and lease losses (ALLL) funding to mitigate risks.

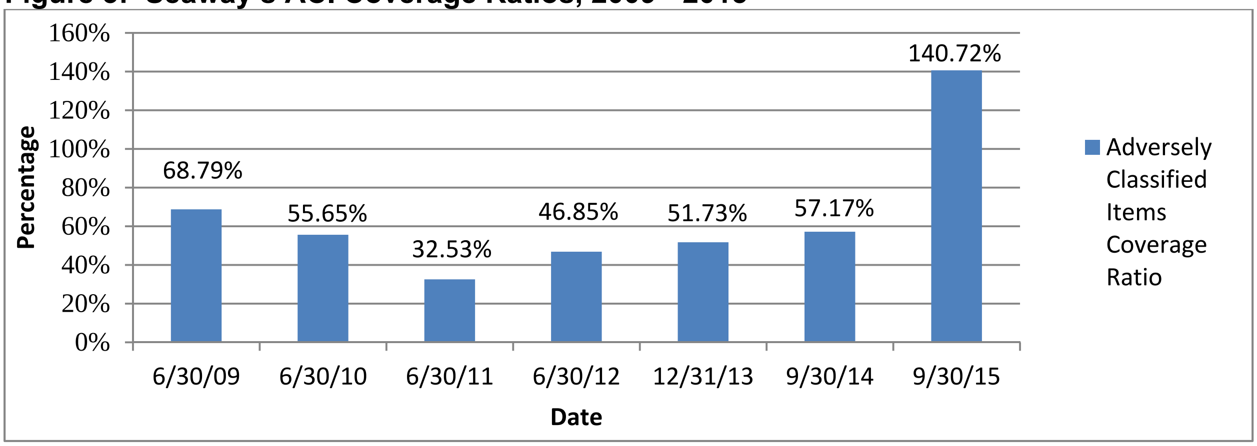
Loan Delinquencies. Seaway's level of nonperforming loans rose rapidly from $18 million in 2009 to $27 million in 2010. These high levels continued to grow after Seaway acquired the SLA loans, doubling from $27 million to nearly $58 million (19.8 percent of the bank's total loan portfolio) from 2010 to 2011. At the time of the 2015 examination, nonperforming loans totaled $31.5 million and represented 46 percent of total loans. According to the Examination Manual, a high volume of overdue loans "almost always indicates liberal credit standards, weak

[7] Faith-based loan concentrations for 2013 were not available.

servicing practices, or both" and reflects poorly on management. Further, examiners noted that the bank's loan collection efforts were insufficient.

Adversely Classified Assets. A bank's Adversely Classified Items (ACI) coverage ratio is a measure of the credit risk and ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and less ability for the bank's capital to absorb any losses associated with those assets. From 2009 to 2014, loan classifications were centered primarily in CRE, which included a high-percentage of faith-based loans. The dramatic increase in adverse classifications from 2014 to 2015 resulted from the expiration of the FDIC's loss share coverage on a portion of its commercial SLA assets. Upon the expiration of loss share coverage, examiners adversely classified a portion of Seaway's SLA assets due to delinquency and non-performance.[8] Figure 3 shows Seaway's ACI ratios improved in 2011. This was primarily due to loan charge-offs, previously classified loans no longer at the bank, and an increase in capital.

Figure 3: Seaway's ACI Coverage Ratios, 2009 - 2015



Note: 2016 data was not available.
Source: Reports of examination.

Ineffective Management of Problem Loans and Poor Credit Administration

Deficiencies in loan administration practices included poor loan collections, untimely recognition of loan losses, inadequate real estate appraisal and evaluation processes, and poor credit administration practices pertaining to the SLA assets.

Specifically, Seaway's management did not timely charge off impaired or delinquent loans or adhere to its policy to charge off loans when they were 120 days past due. The bank's appraisal and evaluations policy needed improvement, to include developing criteria to determine whether an existing appraisal or evaluation remained valid to support a subsequent transaction.

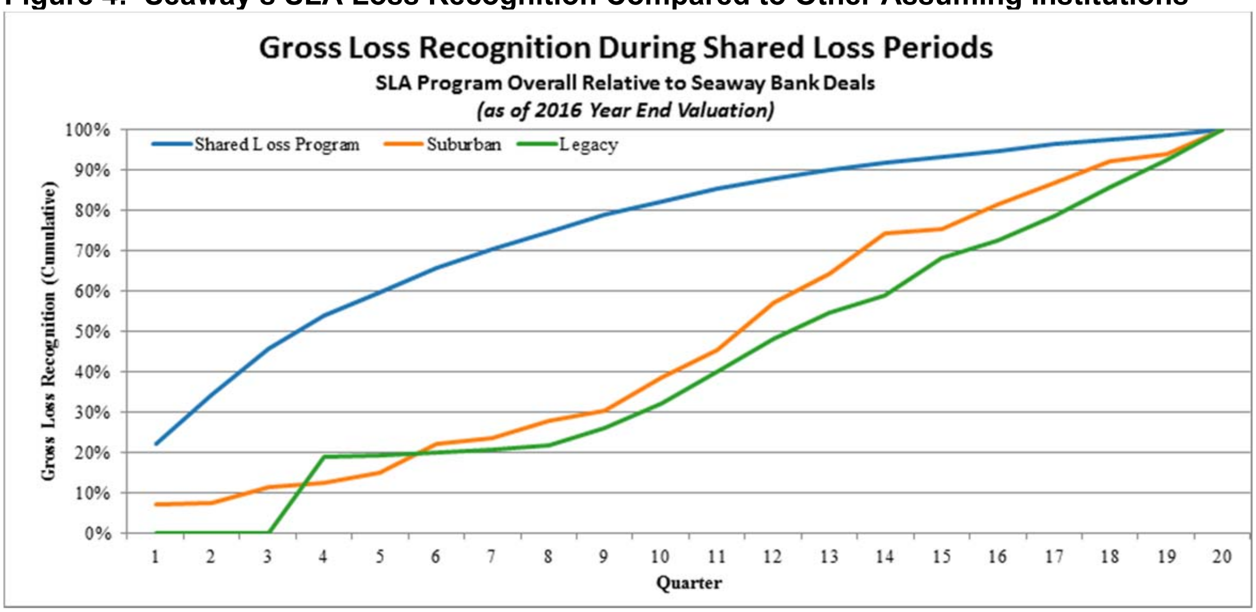
[8] In most cases, the portion of an SLA asset subject to the FDIC's loss share coverage (typically 80 percent) is not subject to adverse classification during the period of time the asset is covered by the FDIC's conditional SLA guarantee.

Examiners found that the collateral values underlying many of the bank's adversely classified loans were supported by outdated appraisals that were not necessarily accurate.

In 2014, examiners noted that the bank's credit administration practices had jeopardized the FDIC's loss share protection for its SLA assets, especially for its commercial SLA assets. Examiners reported that approximately 45 percent of the bank's SLA assets were significantly past due. A DRR review of Seaway's SLA claims noted that the bank had weak documentation and analysis practices and used unacceptable collateral valuation methods. Examiners recommended enhanced credit administration practices to ensure compliance with the SLA agreements and timely resolution of SLA assets. If an AI does not comply with the SLA agreement, the FDIC may not reimburse the AI for losses on its SLA assets.

Most AIs filed SLA claims expeditiously to receive reimbursement claims from the FDIC. However, as illustrated in Figure 4, Seaway significantly lagged behind in filing SLA claims in comparison to other AIs. FDIC officials attributed this to Seaway's untimely recognition of losses. An AI must recognize a loss prior to filing a reimbursement claim. Seaway officials also informed FDIC officials that they were waiting for litigation matters to resolve before filing claims in connection with some SLA assets.

Figure 4: Seaway's SLA Loss Recognition Compared to Other Assuming Institutions



Source: Figure provided by DRR.

Deficient Earnings and Capital Depletion

The Examination Manual states that "[F]rom a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings are the initial safeguard against the risks of engaging in the banking business, and represent the first line of defense against capital depletion resulting from shrinkage in asset value."

Beginning in 2009, examiners did not view Seaway's earnings as able to fully support operations and provide for the accretion of capital in relation to the bank's overall condition. But despite inherent risks in its portfolio due to market dynamics and broader economic conditions, the bank remained profitable. By 2013, Seaway's earnings were considered deficient due to high overhead expense and an elevated volume of nonperforming assets. From 2013 through its failure in January 2017, losses associated with bank-originated and SLA assets, coupled with high overhead expenses, critically depleted Seaway's capital and viability.

The Board's efforts to shrink the bank's asset size to preserve capital added to earnings performance problems, and the bank became unprofitable in 2014. The Board pursued opportunities to raise capital but was ultimately unsuccessful. The bank's holding company borrowed $7.5 million from a prospective investor and injected $7.4 million into the bank on June 30, 2016. However, the Board was not able to obtain additional capital, and the bank became *Undercapitalized* as of May 10, 2016 and *Critically Undercapitalized* as of October 31, 2016.

The FDIC's Supervision of Seaway

The following section details Seaway's supervision history, which includes the FDIC's (1) supervisory strategy, including the degree of technical assistance provided under the MDI program and pursuit of enforcement actions; (2) evaluation of Seaway's acquisition of two failed banks; (3) supervisory response to key risks, including management, asset quality, earnings, and capital; and (4) implementation of PCA.

Supervisory History

The FDIC and IDFPR conducted seven full-scope safety and soundness examinations and six visitations of Seaway from September 2009 through October 2016. In addition to the examinations and visitations, the FDIC and IDFPR conducted a BSA examination in June 2014. Table 3 summarizes Seaway's examination history.

Table 3: Examination History of Seaway, 2009 - 2016

Examination Start Date	Examination or Visitation	Agency	Supervisory Ratings (UFIRS)	Enforcement Action
9/21/2009	Examination	FDIC	232322/2	None
9/13/2010	Examination	IDFPR	232322/2	Board Resolution for Corrective Action effective June 17, 2010 to address deficiencies in 2009 examination.
12/14/2010	Visitation	FDIC	232322/2	None
7/12/2011	Visitation	FDIC	232322/2	None
9/26/2011	Examination	FDIC/IDFPR	232323/2	None
10/01/2012	Examination	IDFPR	232322/2	None
10/21/2013	Examination	FDIC/IDFPR	434434/4	None
6/2/2014	BSA Examination	FDIC/IDFPR	434434/4	None
8/11/2014	Visitation	FDIC/IDFPR	434444/4	None
10/20/2014	Examination	FDIC/IDFPR	334434/4	CO effective December 19, 2014, to address deficiencies noted in 2013 examination.
6/15/2015	Visitation	FDIC/IDFPR	334434/4	2014 CO still in effect
11/16/2015	Examination	FDIC/IDFPR	555545/5	2014 CO still in effect
05/02/2016	Visitation	FDIC/IDFPR	555545/5	2014 CO still in effect
10/24/2016	Visitation	FDIC/IDFPR	555545/5	2014 CO still in effect

Source: Reports of Examination, visitation reports, and enforcement actions for Seaway.

Examination Frequency

Section 337.12 of the FDIC Rules and Regulations implements section 10(d) of the FDI Act and governs the frequency of examinations for insured state nonmember banks and state savings associations. According to the Examination Manual, "[E]very effort should be made to coordinate examination schedules with state authorities to take advantage of state resources, to minimize duplications of effort, and to lessen business disruptions to institutions." The Examination Manual further states that "…alternate examinations should be accepted only for the following institutions: composite 1- or 2-rated institutions, and stable and improving composite 3-rated institutions if the composite rating is confirmed by an offsite review and no adverse trends are noted from other available information."

The FDIC's frequency of full-scope examinations was consistent with relevant statutory and regulatory requirements. In addition, as illustrated in Table 3, RMS conducted visitations in December 2010 and July 2011, shortly after each of Seaway's SLA acquisitions to assess its progress in managing the assets and conforming its books and records to applicable accounting standards. GAAP allowed Seaway up to one year from each SLA acquisition to value the SLA assets and update its books and records accordingly.[9] Seaway was not required to, nor did it perform these functions in time for the 2010 and 2011 visitations.

The IDFPR conducted the 2012 examination and examined Seaway's compliance with the SLAs as part of the examination and identified some issues, but generally concluded that Seaway was complying with the SLA agreements. The FDIC accepted IDFPR's examination, meaning it did not question or have concerns with the examination results. However, we concluded that it would have been prudent for RMS to have participated in this examination or performed a separate visitation in 2012 to assess Seaway's accounting for the SLA assets. We made this conclusion based on:

- The inherent risks created by Seaway's acquisition of the SLA assets, especially given Seaway's large increase in size (68 percent increase in assets) as a result of the two acquisitions.

- Potential risks to the DIF given the FDIC's loss share coverage.

- Seaway's dependence on the FDIC's SLA loss coverage to mitigate risks associated with its significant growth as a result of the acquisitions.

- The FDIC's responsibility for the SLA program and expertise in assessing compliance with the accounting treatment of SLA assets, which is very complex.

- Seaway's less-than-satisfactory asset quality and earnings ratings that required management's attention.

- The timing of the examination relative to timeframes under accounting standards to properly value the SLA assets. Seaway's measurement period for computing the fair value of the SLA assets ended in March 2012. The FDIC could have participated in the 2012 examination or conducted a separate visitation to ensure Seaway was properly accounting for the SLA assets, rather than waiting until the October 2013 examination.

FDIC officials informed us that RMS did not participate in the 2012 examination because of Seaway's satisfactory composite rating in the 2011 examination and the level of supervisory attention needed on other troubled institutions in the region at that time. FDIC officials also pointed out that significant SLA accounting issues did not surface until 2013 when Seaway brought the accounting for SLA assets in-house. IDFPR identified some SLA accounting and compliance matters in the 2012 examination.

[9] FASB ASC Topic 805 uses the term measurement period to describe this period of time. The measurement period is the period of time after the acquisition date, not to exceed one year, which is required to identify and measure the fair value of the identifiable assets acquired, and noncontrolling interests in the acquiree. The measurement period ends as soon as the AI receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.

Although RMS was not required to participate in the 2012 IDFPR examination, in our view, RMS's participation in that examination or a separate visitation may have established stronger supervisory expectations with regard to the management and accounting of SLA assets. Further, an additional RMS on-site presence might have brought about more discussion with Seaway's management about needed controls.

Enforcement Actions

As noted in Table 3, the FDIC took two enforcement actions from 2010 through 2014:

June 17, 2010 Board Resolution for Corrective Action. The resolution included provisions to address the bank's deteriorated asset quality, earnings, and ALLL and develop and implement a profit plan. The bank submitted progress reports, as required by the resolution. The 2010 examination found that management was in general conformance with the resolution and it was terminated on April 11, 2011.

December 19, 2014 CO. Seaway stipulated to a CO issued by the FDIC and IDFPR due to the bank's poor financial condition and significant weaknesses identified in the 2013 safety and soundness examination and a 2014 BSA examination. The purpose of a CO is to remedy unsafe or unsound practices or violations and to correct conditions resulting from such practices or violations. COs generally contain provisions that require a bank to take, or prohibit a bank from taking, specific actions relating to inappropriate practices, violations, or conditions. An unsafe or unsound condition is a condition that, if continued, would result in abnormal risk of loss or damage to the bank or the DIF. The CO issued to Seaway contained 26 provisions regarding Seaway's deficient management; loan administration; deteriorated financial condition; risk exposures; and non-compliance with laws, rules, and regulations, including BSA. Seaway provided required progress reports to the FDIC but never fully complied with the CO. The CO remained in place until the bank failed.

FDIC's Technical Assistance under the MDI Program

The FDIC's MDI Program is aimed to promote increased communication with MDIs and trade associations that represent MDIs, and provide opportunities for MDIs to request FDIC technical assistance and participate in conferences and training events. Designated regional coordinators provide oversight of the MDI Program in their specific region, serve as contact persons for MDI matters, and provide quarterly reports to corporate headquarters.

Consistent with the requirements of the MDI Program, the FDIC regularly offered Seaway on-site technical assistance from 2009 to 2016 to review areas of concern or topics of interest to the bank to assist management in understanding and implementing examination recommendations. The FDIC offered advice on matters such as SLA compliance, accounting practices, financial reporting, and risk management procedures. The FDIC also offered Seaway opportunities to meet with the FDIC's regional management and participate in regional and national conferences to provide MDIs the opportunity to focus on issues unique to their institutions. Table 4 summarizes technical assistance the FDIC provided to Seaway.

Table 4: Technical Assistance Provided by FDIC, 2009 - 2016

Date	Technical Assistance Topic(s)
1/16/2009	Information Technology, BSA/Anti-Money Laundering (AML) Program, Interest Rate Risk and Commercial Rate Real Estate Lending.
4/8/2009	Asset Quality, Other Real Estate Owned, ALLL, Sensitivity to Market Risk and Liquidity, BSA/AML Program, and Information Technology.
1/12/2010	Interest Rate Risk, Modeling Assumptions, and Risk Management.
8/18/2011	SLAs, troubled debt restructuring, and regulatory focus for upcoming examinations.
9/26/2011	SLA compliance.
1/3/2012	SLA compliance.
8/31/2012	Seaway's appraisal policy.
2/26/2014	The bank's financial condition, FDIC's anticipated supervisory strategy going forward, and due diligence.
11/16/2015	Call Report during the 2015 Examination.
10/14/2016	Preparation of September 30, 2016 Call Reports and SLA accounting.
10/24/2016	September 30, 2016 Call Report.
11/22/2016	September 30, 2016 Call Report.

Source: Documentation from the Chicago Regional Office.

RMS officials informed us that in general, MDIs do not fully utilize the MDI program or take advantage of RMS's technical assistance offers. According to RMS, MDIs may be reluctant to ask for technical assistance because they do not want to be viewed negatively or believe RMS could further scrutinize areas where MDIs request technical assistance. RMS was pursuing ways to improve its communication and interaction with MDIs.[10]

Seaway's SLA Acquisitions and FDIC Reviews

Prior to each of Seaway's SLA acquisitions, the FDIC (1) confirmed that Seaway met minimum eligibility criteria to purchase the SLA assets and (2) assessed the risk to the DIF posed by Seaway's SLA purchases. After Seaway's acquisitions, RMS examined Seaway's SLA operations during examinations and visitations. DRR completed reviews related to Seaway's process for filing loss share claims and provided technical assistance.

[10] FDIC 2016 report to Congress: *Preservation and Promotion of Minority Depository Institutions.*

SLA Assets - FDIC's Assessment of Eligibility Requirements and Risk to the DIF

To be eligible for purchasing failed bank assets, the FDIC requires AIs to meet certain eligibility requirements, which essentially ensure that the institution is fundamentally sound, has a capable management team, sufficient capital, and satisfactory CRA and BSA/AML ratings (see the text box for a listing of key requirements).

> **FDIC's Key Eligibility Criteria for Bidding on Failed Bank Assets**
>
> - Composite CAMELS rating of "1" or "2,"
> - Component *Management* rating of "1" or "2,"
> - Capital category of at least *Adequately Capitalized* for PCA purposes,
> - Adequate loss reserves,
> - *Satisfactory* CRA performance rating,
> - Satisfactory BSA/AML record, and
> - AI must generally be larger than the acquiree.
>
> Source: FDIC Bidders list criteria.

Seaway met the eligibility criteria prior to acquiring both SLAs. In addition to meeting the eligibility criteria, FDIC guidance requires RMS to prepare a *Risk to the Fund* memorandum to evaluate successful bidders. This analysis is designed to capture the FDIC's assessment of how the proposed transaction would impact the institution and the DIF. FDIC guidance requires, at a minimum, that the memorandum assess:

- The resolution, including any unique characteristics;
- Performance ratings, including CAMELS[11] and CRA and those pertaining to consumer protection and offsite monitoring activities;
- Factors that could impact the bank's financial stability;
- Management's competence, capabilities, and experience;
- Capital position and any plans for raising additional capital;
- Whether the transaction would impact competition in the surrounding area;
- Whether the bank is an MDI;
- Whether any other regulators have objections to the acquisition;
- The bank's ownership structure; and
- The impact of acquired assets.

RMS completed its assessment in accordance with its policy and concluded that Seaway had the capacity to purchase both SLAs without causing an undue risk to the DIF. In making this determination, RMS relied on Seaway's historical performance and management's assertions about the bank's ability to staff the SLA oversight function. Specifically, the assessment included reviewing Seaway's examination results, including Consumer Compliance and CRA examination results and data from the FDIC's offsite monitoring tools as well as analyzing the impact of the acquisition on total assets and capital ratios. The FDIC also confirmed that the IDFPR had no objection to either SLA transaction. Table 5 summarizes the FDIC's assessment of the respective transactions.

[11] CAMELS are the six components of the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance. UFIRS is defined in Appendix 2, *Glossary of Terms*.

Table 5: FDIC's Assessment of DIF Risks

Acquisition of First Suburban Bank	Acquisition of Legacy Bank
✓ Management was proactive in assessing declines in asset quality and determining downgrades within its loan portfolio. ✓ Seaway's underwriting, loan administration, and policies and procedures were acceptable and its external and internal audit functions were comprehensive and effective. ✓ Seaway's executive management was competent because of its experience operating a historically CAMELS composite 2-rated institution. ✓ Seaway had sufficient capital to support this transaction and it would not materially impact the bank's asset quality or overall condition.	✓ Seaway's management had established ongoing third-party relationships to assist with the accounting and loan work-outs associated with the first SLA acquisition and was well-prepared to undertake a second acquisition. ✓ Seaway committed to obtain an independent third-party staffing study to identify potential management gaps resulting from the bank's asset growth and geographic expansion. This study was performed in October 2011 and concluded that Seaway's management team was competent and stable and its performance was solid. It also concluded the bank was understaffed and in need of certain managerial functions. ✓ Seaway had sufficient capital to support the transaction and the SLA assets were not expected to have a material impact on Seaway's asset quality.

Source: First Suburban and Legacy Bank's *Risk to the Fund* memoranda dated October 22, 2010 and March 10, 2011, respectively.

RMS's assessment of the Legacy Bank transaction considered the impact of total assets of both transactions on Seaway's loan portfolio and concluded that management was well-prepared for the transaction because of its ongoing third-party relationships to assist with accounting and loan workouts. RMS considered the second SLA to be less complex than the first one because the FDIC removed $40 million of problem loans from the portfolio and the failed bank only had one physical location. However, FDIC officials informed us that this portfolio turned out to be more complex and Seaway sustained greater losses than anticipated.

Prior to both acquisitions, RMS offsite monitoring reports predicted Seaway would be downgraded to a "3" composite rating. RMS concluded that the risk of downgrades predicted by these reports was mitigated by Seaway's management and board, which it viewed as effective and capable of working out problem assets. Additionally, RMS officials informed us that these offsite monitoring reports (1) often predicted downgrades that did not materialize, (2) were not as effective as on-site reviews, (3) were heavily based on a bank's asset quality and earnings and did not consider a bank's management, and (4) were only one of several tools used by RMS that should not be relied upon in isolation.

Notably, the FDIC significantly underestimated the SLA losses in connection with First Suburban Bank and Legacy Bank by 53 and 70 percent, respectively. This underestimation could have been attributable to the SLA assets being significantly worse than the FDIC's original valuations and/or Seaway's poor management of these assets. These results were contrary to the FDIC's overall experience with the SLA program. Program-wide, the FDIC overestimated SLA losses. For example, as of April 2017, DRR's SLA median loss estimates were 21-percent higher than actual losses, indicating that the SLA program as a whole has performed better than the FDIC's original projections.[12]

RMS Oversight Activities

RMS provided SLA technical assistance and regularly conducted examinations and visitations that assessed Seaway's management of the SLA assets. Table 6 shows key findings from examinations and visitations.

Table 6: SLA Findings in RMS Examination and Visitation Reports

Examination / Visitation	Key SLA Findings
December 2010 Visitation	RMS found that Seaway remained *Well Capitalized*, profitable, and relatively liquid even with the addition of the troubled SLA assets. RMS also concluded the bank would need to apply diligent workout strategies and collection efforts for the SLA assets. The bank was in the process of developing SLA policies and procedures.
July 2011 Visitation	Bank executives informed RMS that the bank's assimilation of the SLA assets was going well and there were no unforeseen difficulties, although working out the SLA loans would be challenging. Seaway retained all of the failed bank's loan officers, added an additional loan workout specialist, and planned to add at least one additional staff member.
September 2011 Joint Examination	FDIC examiners found that Seaway appeared to be in substantial compliance with the loan administration and collection provisions in connection with the SLAs.
October 2012 State Examination	The State examiners had several discussions with bank personnel about their accounting for the SLA assets and instructed Seaway to memorialize decisions regarding its accounting treatment for the SLA assets. The State examiners also noted concerns regarding Seaway's collections on SLA assets and compliance with the SLA agreements.
October 2013 Joint Examination	Examiners concluded that Seaway had not effectively administered or accounted for the SLA assets, and its books and records and 2013 quarterly Call Reports were inaccurate. Seaway did not have the expertise to administer the SLA assets or a process to identify or correct SLA accounting errors. As a result, Seaway did not question inexplicable accounting entries.
August 2014 Visitation	Seaway continued to expend significant resources to correct SLA deficiencies noted at the 2013 examination. SLA accounting matters continued to significantly impact Seaway's balance sheet, earnings, and capital positions. The bank's SLA accounting entries were still not accurate. Examiners noted the bank was in contravention of the FDIC Rules and Regulations and the Illinois Banking Act as a result of its inability to produce timely and accurate financial statements and general ledger entries.
October 2014 Joint Examination	Seaway addressed some SLA accounting matters and made commendable efforts to correct multiple years of inappropriate SLA oversight. Seaway restated its Call Reports dating back to March 31, 2013 as a result of the SLA accounting changes. Examiners noted that Seaway faced significant challenges in managing its SLA assets.
November 2015 Joint Examination	Examiners recommended that Seaway obtain an independent review of its accounting for its SLA assets and revise its SLA policies and procedures.

Source: FDIC and State examination and visitation reports.

[12] This loss estimate is based on all SLAs initiated since November 2008 and terminated as of April 19, 2017.

DRR Oversight Activities

DRR conducted five reviews from 2011 through 2016 to assess Seaway's compliance with SLA provisions and whether loss claims met required criteria for FDIC reimbursement. A 2015 review identified unsupported claims of $275,790 and deficiencies pertaining to SLA asset management, administrative practices, staffing, and non-compliance with other requirements. A 2016 review identified unsupported claims totaling $487,929 and several unacceptable asset management practices, including insufficient staffing and a failure to pursue recoveries and collections.

DRR specialists made six site visits to assist Seaway's SLA staff from July 2012 through December 2014. The specialists offered guidance on filing SLA loss share certificates, correcting data integrity issues, charging off SLA assets, and Seaway's efforts to address numerous deficiencies. In December 2014, DRR specialists provided Seaway's Board, loan committee, and special asset officers with presentations on the SLA program that included accounting for and charging off SLA assets in conformance with the SLA agreements. After each compliance review, DRR employees discussed findings and corrective actions with Seaway officials.

From August 2012 through the bank's failure, DRR specialists held weekly phone calls with Seaway officials due to significant weaknesses in how the bank filed loss claims. DRR specialists trained new Seaway staff on SLA documentation requirements to support charge-offs, addressed data integrity issues, and assisted the bank with other SLA compliance matters in connection with filing loss claims.

Supervisory Response to Key Risks

From 2009 through 2017, the FDIC identified key risks in Seaway's operations and brought these risks to the attention of the institution's Board and management. The FDIC's assessment of Seaway's condition and assignment of component and composite ratings was consistent with supervisory guidance. Examiners began downgrading Seaway's component and composite ratings in 2013 because of significant management deficiencies, including an inability to accurately account for Seaway's SLA assets, an increase in adversely classified assets, and deteriorated earnings and capital. The following section summarizes our assessment of examination ratings and supervisory actions for four key areas—management, asset quality, earnings, and capital – from 2009 through 2016.

Supervision of Management

The FDIC's evaluation of Seaway's management was consistent with management evaluation factors in RMS's Examination Manual, and the FDIC completed required reviews under section 32 of the FDI Act.[13] As shown in the text box, examiners viewed management as satisfactory until 2013. This rating reflects the fact that examiners believed Seaway effectively identified, measured, monitored, and controlled significant risks and problems. Specifically, examiners found that management:

Management: 2009 - 2016		
Examinations / Visitations		**Management Ratings**
2009-2012	2	Satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile.
2013-2014	4	Deficient management and board performance or risk management practices that are inadequate considering the nature of the institution's activities. The level of problems and risk exposure is excessive.
2015-2016	5	Critically deficient management and board performance or risk management practices. Management and the Board have not demonstrated the ability to correct problems and implement appropriate risk management practices.
Source: Seaway reports of examination and RMS's Examination Manual.		

- Prudently managed the bank's affairs;
- Proactively addressed declining asset quality and downgraded loans, as appropriate;
- Enhanced its monitoring and collection procedures in an effort to curtail further deterioration and losses within the bank's self-originated loan portfolio;
- Was responsive to examiners' concerns; and
- Worked diligently to integrate the failed institutions' operational and accounting systems into its systems and appeared to be in compliance with SLA requirements.

In 2013, examiners downgraded the bank's *Management* component rating upon discovering deficiencies in the bank's financial reporting process and SLA oversight. As discussed in the *Cause of Failure* section of this report, management failed to properly account for the SLA assets, which resulted in inaccurate financial statements.

In 2014, examiners noted that Seaway took positive actions to improve SLA accounting. Nevertheless, the bank was still unable to produce accurate 2013 financial statements. The 2014 and 2015 examinations criticized Seaway's inability to forecast the impact on the bank from the upcoming expiration of the FDIC's loss coverage on commercial SLA assets in October 2015 and March 2016. Examiners criticized the bank for its inability to secure sufficient and qualified management and its heavy reliance on consultants. Examiners also noted material deficiencies pertaining to loan administration and the bank's BSA program.

[13] 12 United States Code, section 1831i.

In 2015, examiners downgraded Seaway's *Management* rating to "5" due to its inability to correct problems and implement appropriate risk management practices. The 2015 examination reiterated several deficiencies noted in prior examinations.

Section 32 Reviews. Section 32 of the FDI Act (herein referred to as section 32) is intended to help ensure insured depository institutions have capable and experienced executive management under certain conditions (see text box), including when an institutions is designated to be in a troubled condition. The FDIC notified Seaway of its designation as a troubled institution in a letter dated March 11, 2014. Upon that notification, the FDIC was required to review any additions or replacements of Board members or the employment or change in responsibilities of anyone who was, would become, or performed duties of, a senior executive officer. The FDIC's assessment involves four statutory factors — competence, experience, character, and integrity — pertaining to a 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.

Section 32 Requirements

Section 32 requires, in general, that FDIC-supervised institutions provide the FDIC with prior written notice (herein referred to 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 required by PCA, that such notice is appropriate.

Source: FDIC Rules and Regulations, subpart L.

The FDIC met its responsibilities under section 32 of the FDI Act. Specifically, the FDIC evaluated and favorably resolved section 32 notices involving eight Board members or executives. In each instance, the FDIC documented its non-objection to the positions and services for the positions that were filled from 2014 to 2016. One of the section 32 notices was for the Executive Chair of the Board, which the FDIC processed on June 12, 2014. When this individual subsequently assumed the role of Interim President in October 2015, RMS officials informed us that a second section 32 review was not necessary because the individual's responsibilities essentially did not change.

Supervision of Asset Quality

Asset Quality: 2009 - 2016		
Examinations / Visitations	**Asset Quality Ratings**	
2009-2014	3	Asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern.
2015-2016	5	Critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.
Source: Seaway reports of examination and RMS's Examination Manual.		

In 2009 and 2010 (prior to the SLA acquisitions), examiners rated the bank's asset quality as "3" because of high levels of past due loans and adversely classified assets. In 2011, adverse classifications had declined from the prior two examinations, but remained slightly elevated. Approximately 75 percent of the bank's past-due and nonaccrual loans were SLA assets. Examiners concluded that the FDIC's 80-percent loss coverage on SLA assets mitigated the risks with the bank's SLA assets. We considered this conclusion to be reasonable based on the FDIC's historical experience with the SLA program.

From 2012 through 2014, Seaway's asset quality had further deteriorated due to increases in adverse classifications. The bank was slow to collect on delinquent loans made to faith-based organizations, which comprised a substantial percentage of the bank's adversely classified assets. The 2013 examination report noted that the bank's Board should develop and implement a plan to reduce the bank's high volume of non-earning and problem assets. In 2014, examiners identified numerous loan administration deficiencies, including inadequate real estate appraisal and evaluation processes, poor loan collections, untimely recognition of losses, and poor oversight of the bank's faith-based loan portfolio. Additionally, examiners noted that the bank's Appraisal and Evaluations Policy needed improvement, including criteria for determining whether an existing appraisal or evaluation remained valid to support a subsequent transaction.

In 2015, examiners determined that Seaway's asset quality further deteriorated to critically deficient, as its volume of adversely classified assets and non-performing loans remained excessive. Concentration levels of faith-based loans remained excessive, and the bank's ALLL was inadequate. Examiners recommended that Seaway develop and implement a comprehensive profit plan and budget to return the bank to profitability, monitor the bank's financial performance, and make forward-looking decisions. Seaway's management could not adequately address its asset quality issues. For example, Seaway was unable to grow its loan portfolio, create new business lines, or reduce classified assets, as outlined in its profit plan. Moreover, examiners criticized the bank's poor administration of its SLA portfolio because it created a risk that the FDIC would not reimburse the bank for its losses on SLA assets. If a bank does not properly administer its SLA loan portfolio, it may not be eligible for FDIC reimbursement on SLA losses.

Supervision of Earnings

Earnings: 2009 - 2016		
Examinations / Visitations		**Earnings Ratings**
2009-2012	3	Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.
2013-2014	4	Earnings are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels.
2015-2016	5	Earnings are critically deficient.
Source: Seaway reports of examination and RMS's Examination Manual.		

Historically, the combined effects of high levels of non-accruing loans and lower yielding investment securities placed downward pressure on the bank's net interest margin. Additionally, the bank's net interest margin suffered from the problematic SLA loan portfolios. Despite these challenges, the bank was marginally profitable from 2009 through 2012, based on its audited financial statements.

In 2013, examiners downgraded the bank's earnings to "4." Earnings were insufficient to support the bank's operations and maintain appropriate allowance and capital levels. Excessive overhead expenses and provisions for loan losses, which were more than $7 million, significantly contributed to a 2013 net loss for the bank. In 2014, examiners noted that earnings remained deficient. The bank's significant reliance on third-party consultants for operational support contributed to significant growth in overhead expenses. Examiners stated that the bank also had difficulty projecting future earnings due to material adjustments to prior period earnings associated with the SLA accounting-related issues and the lack of a 2015 budget. Examiners noted that a budget and profit plan were critical for the Board to monitor performance and make forward-looking decisions.

Examiners downgraded Seaway's earnings component in 2015 primarily because of costs to remedy the bank's data integrity flaws, internal audit deficiencies, internal control weaknesses, and asset quality concerns. Consultant expenses remained elevated, which contributed to a doubling of overhead expenses since the prior examination. The bank had not developed a 2016 budget forecasting how it would return to profitability.

Supervision of Capital

The Examination Manual states that an FDIC-supervised institution "is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks." Seaway's capital levels remained satisfactory between 2009 and 2012. However, by 2013, examiners concluded that Seaway's capital was deficient because net operating losses significantly reduced the bank's capital levels. The bank's capital position was threatened by the bank's continued weak asset quality, among other things. Examiners recommended that management develop a plan to preserve and strengthen capital.

In 2014, examiners upgraded Seaway's capital rating to "3" because of a reduction in the bank's total assets, which improved Seaway's capital ratios. Although the capital rating increased, examiners concluded that the bank's capital was insufficient in comparison to its risk profile. Examiners noted the bank's capital position faced an elevated risk due to several factors, including weak management oversight, a net loss for 2014, no approved 2015 budget, poor oversight of the bank's faith-based loan portfolio, poor credit administration, and heightened liquidity risk. Further, because Seaway was operating under a CO with a capital maintenance provision, it remained *Adequately Capitalized* for PCA purposes and examiners encouraged the bank to review FDIC restrictions for *Adequately Capitalized* banks.

In 2015, examiners downgraded capital to "5" and the bank was in need of an immediate capital infusion. Poor earnings and losses contributed to the bank's capital position. Adversely classified assets increased to 141 percent of total capital due to credit deterioration and the expiration of the FDIC's loss share coverage on a portion of its SLA assets.

In June 2016, Seaway's holding company provided a $7.4 million capital injection, which temporarily maintained Seaway's *Undercapitalized* position for PCA purposes. An October 2016 visitation identified several additional losses and accounting errors indicating the bank's capital position was substantially worse than reflected in its September 30, 2016 Call Report.

Implementation of PCA

Section 38, *Prompt Corrective Action*, of the FDI Act establishes a framework of mandatory and discretionary supervisory actions pertaining to all institutions. The section requires regulators to take progressively more severe actions, known as "prompt corrective actions," as an institution's capital level deteriorates. The purpose of section 38 is to resolve problems of insured depository institutions at the least possible cost to the DIF.

Part 324, *Capital Adequacy of FDIC-Supervised Institutions*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 324 also establishes procedures for the submission and review of capital restoration plans and for the issuance of directives and orders pursuant to section 38. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved.

Based on the supervisory actions taken with respect to Seaway, the FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act. Seaway was considered *Well Capitalized* for PCA purposes from 2009 until December 19, 2014, when a CO took effect resulting in a change to the bank's PCA designation to *Adequately Capitalized* because the CO required Seaway to maintain specific capital levels.[14] Per a notification letter dated May 10, 2016, the FDIC informed Seaway that it was *Undercapitalized*, based on its March 31, 2016 Call

[14] Section 324.403(b)(1)(v) 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, the International Lending Supervision Act of 1983, or the Home Owners' Loan Act, or section 38 of the FDI Act, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

Report. Table 7 summarizes Seaway's capital ratios relative to the PCA thresholds for *Well Capitalized* institutions during examinations and at other key points in time.

Table 7: Seaway's Capital Ratios and Categories, 2009 - 2016

Examination or Event Date	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Tier 1 Leverage Capital Ratio	PCA Capital Category
***Well Capitalized* Thresholds**	**≥10%**	**≥6% (prior to 1/1/15)** ***≥8% (since 1/1/15)***	**≥5%**	
9/21/2009 Examination	18.03%	16.75%	9.21%	*Well Capitalized*
09/13/2010 Examination	17.82%	16.56%	8.26%	*Well Capitalized*
09/26/2011 Examination	18.30%	12.58%	7.21%	*Well Capitalized*
10/01/2012 Examination	18.81%	17.54%	7.30%	*Well Capitalized*
10/21/2013 Examination	13.44%	12.12%	5.36%	*Well Capitalized*
10/20/2014 Examination	15.22%	13.89%	6.53%	*Well Capitalized*
11/16/2015 Examination	14.63%	13.35%	7.24%	*Adequately Capitalized* *
05/10/2016 PCA Notification	6.82%	5.53%	3.73%	*Undercapitalized*
10/28/2016 PCA Notification	-----	-----	-----	*Significantly Undercapitalized*
10/31/2016 PCA Notification	4.53%	3.27%	1.93%	*Critically Undercapitalized*

Source: OIG analysis of Seaway examination reports, enforcement actions, and PCA activities.
* Although Seaway's ratios met the *Well Capitalized* thresholds, Seaway was subject to a CO requiring specific capital levels and was therefore classified as *Adequately Capitalized*.

The FDIC May 10, 2016 notification letter required the bank to file a capital restoration plan. The FDIC received Seaway's plan on October 14, 2016 and on October 28, 2016, the FDIC sent another notification letter informing Seaway that its capital restoration plan was inadequate and that the bank was *Significantly Undercapitalized*. Finally, on October 31, 2016, the FDIC sent a third notification letter informing Seaway that it was *Critically Undercapitalized*, based on its September 30, 2016 Call Report.

Corporation Comments and OIG Evaluation

After we issued our draft report, dated July 14, 2017, management provided technical comments for our consideration, and we revised this report to address those comments, as appropriate. The RMS Director provided a written response, dated August 11, 2017, to the draft report. That response is presented in its entirety in Appendix 5.

In its response, the RMS Director reiterated the OIG's conclusions regarding Seaway's cause of failure and the FDIC's supervision of the bank. The response also stated that in retrospect, it may have been beneficial for the FDIC to have participated in the IDFPR's 2012 examination of Seaway or conducted a separate visitation.

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to (1) determine the causes of Seaway'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.

Scope and Methodology

The scope of our review covered examinations and visitations performed and supervisory actions taken from 2009 until Seaway failed on January 27, 2017. We selected this time period to ensure coverage of Seaway's financial position prior to its acquisition of SLA failed bank assets in 2010 and 2011.

To accomplish our objectives, we reviewed:

- The FDIC's *Failing Bank Case* and *Supervisory History* for Seaway and FDIC and IDFPR examination reports, visitation reports, correspondence, and other relevant documentation.
- Pertinent regulations, policies, procedures, and guidance, including RMS's *Risk Management Manual of Examination Policies* (Examination Manual), and the FDIC's Financial Institution Supervisory and Enforcement Action guidance.
- Seaway's annual audit reports, UBPRs, and Call Report data.
- Reports and analyses prepared by consulting firms hired by Seaway.
- SLA documentation in connection with Seaway's acquisition of two failed banks, including
  - DRR's least cost analysis,
  - DRR compliance reviews,
  - RMS guidance describing the criteria AIs have to meet to be eligible to purchase failed bank assets,
  - RMS's *Risk to the Fund* memoranda, and
  - Guidance on accounting for failed bank acquisitions.
- Data prepared by the FDIC's Division of Insurance and Research, such as employment data, to gain an understanding of Chicago's economic conditions and trends during our scope period.

We interviewed RMS officials from the FDIC's Chicago Regional and Field Offices, DRR officials, and IDFPR officials. We obtained their perspectives on the principal causes of Seaway's failure, the FDIC's supervisory approach, MDI and other technical assistance that the FDIC provided to Seaway, and the FDIC's assessment of Seaway's ability to manage the SLA assets.

We performed certain procedures 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 examination frequency requirements defined in Part 337.12 and section 32 requirements defined in subpart L.

Objectives, Scope, and Methodology

We obtained data from various FDIC systems, such as the FDIC's Virtual Supervisory Information on the Net (ViSION) and the Regional Automated Document Distribution and Imaging System (RADD). We determined that information system controls pertaining to these systems were not significant to the audit objectives. Therefore, we did not evaluate the effectiveness of information system controls. We relied primarily upon examination reports, memoranda, and other correspondence, as well as testimonial evidence, to validate system-generated information.

Seaway's financial data for 2013 through its failure in 2017 may not have been accurate. Accordingly, the financial information in this report from 2013 forward may not be accurate. However, we included the best available data for purposes of presenting Seaway's financial condition in this report.

We assessed the risk of fraud and abuse in the context of our audit objectives in the course of evaluating audit evidence. We reviewed available bank and FDIC documentation, inquired with OIG investigations personnel, and interviewed FDIC and IDFPR officials about any ongoing investigations or possibility of fraud within the bank.

We conducted our work from February 2017 through July 2017 in accordance with *Generally Accepted Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provided a reasonable basis for our findings and conclusions based on our audit objectives.

We performed our work at the FDIC's offices in Arlington, Virginia, and at the Chicago Regional and Field Offices.

Related Coverage of Financial Institution Failures

The OIG issued a number of MLR and related reports that can be found at www.fdicig.gov. We considered the following reports in planning and conducting our MLR of Seaway:

- *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), December 2010. The objectives of the FDIC OIG 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 a May 2009 OIG memorandum and (2) identify trends and issues that have emerged from subsequent MLRs.

- *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), September 2011. The OIGs of the FDIC, the Department of the Treasury, and the Board of Governors of the Federal Reserve System issued this evaluation report. This report 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.

Objectives, Scope, and Methodology

- *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (Report No. EVAL-13-002), January 2013. This FDIC OIG 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.

Appendix 2

Management Turnover at Seaway

Position	Position Title	Term
Executive Chairman	Executive Chairman	1983 - April 2013
	Acting Chairman	2011 - April 2013
	Non-executive Chair	April 2013 - June 2014
	Executive Chair	June 2014 - bank closure
Directors	Three New Directors	June 2014 - bank closure
President/CEO	1st President/CEO	1981 - August 2014
	2nd President	August 2014 - October 2015
	Interim President	October 2015 - bank closure
CFO/COO	1st CFO/COO	1988 - June 2014
	2nd CFO/COO	October 2015 - bank closure
Senior Vice President/Chief Lending Officer	1st Chief Lending Officer	1989 - August 2015
	2nd Chief Lending Officer	October 2016
General Counsel	General Counsel	1990 - August 2014
	Temporary Legal Counsel	September 2015
Controller	1st Controller	Unknown - January 2015
	2nd Controller	February 2015 - bank closure
Chief Credit Officer (new position)	1st Chief Credit Officer	January 2015 - July 2016
	2nd Chief Credit Officer	May 2016 - bank closure
Head of Internal Audit	1st Head of Internal Audit	April 2011 - October 2015
	2nd Head of Internal Audit	October 2015 - bank closure

Source: Reports of Examination, visitation reports and Seaway's Board minutes.

Glossary of Terms

Term	Definition
Assuming Institution (AI)	A healthy bank or thrift institution that purchases some or all of the assets and assumes some or all of the liabilities of a failed institution in a purchase and assumption transaction.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Adversely Classified Items (ACI) Coverage Ratio	A measure of the level of credit risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and may also indicate less ability to absorb the consequences of bad loans.
Allowance for Loan and Lease Losses (ALLL)	An estimate of uncollectible amounts used to reduce the book value of loans and leases to the amount that an institution expects to collect. ALLL is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Board Resolution for Corrective Action	An informal commitment adopted by a financial institution's Board of Directors (often at the request of the FDIC) directing the institution's personnel to take corrective action regarding specific noted deficiencies. This type of resolution may also be used as a tool to strengthen and monitor an institution's progress with regard to a particular component rating or activity.
Bank Secrecy Act (BSA)	Congress enacted the BSA of 1970 to prevent banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. The BSA requires financial institutions to maintain appropriate records and to file reports for certain activities, such as cash transactions over $10,000. These reports are used in criminal, tax, or regulatory investigations or proceedings.

Glossary of Terms

Term	Definition
Consolidated Report of Condition and Income (Call Report)	Includes basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Capital Restoration Plan	Section 38(e)(2) of the FDI Act requires FDIC insured institutions with an undercapitalized PCA category to submit an acceptable Capital Restoration Plan to the appropriate federal banking agency. The Capital Restoration Plan shall specify (1) the steps the insured depository institution will take to become adequately capitalized; (2) the levels of capital to be attained during each year in which the plan will be in effect; (3) how the institution will comply with the restrictions or requirements then in effect under section 38; (4) the types and levels of activities in which the institution will engage; and (5) other information required by the appropriate federal banking agency.
Charge-off	An actual credit loss on an individual retail credit that is recorded when an institution becomes aware of the loss.
Commercial Real Estate (CRE) Loans	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.
Community Development Financial Institution (CDFI)	A financial institution that works in market niches that are underserved by traditional financial institutions. Typically, CDFIs provide a unique range of financial products and services in economically-distressed target markets, such as (1) mortgage financing for low-income and first-time homebuyers and not-for-profit developers; (2) flexible underwriting and risk capital for community facilities; and (3) technical assistance, commercial loans, and investments to small start-up or expanding businesses in low-income areas.
Community Reinvestment Act (CRA)	Requires the FDIC to assess an institution's record of helping to meet the credit needs of the local communities in which the institution is chartered.

Glossary of Terms

Term	Definition
Concentration	A significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution. Seaway's examination reports listed two types of concentrations as assets comprising (1) 25 percent or more of Tier 1 capital by an individual borrower, small interrelated group of individuals, single repayment source, or individual project; or (2) 100 percent or more of Tier 1 capital by industry, product line, type of collateral, or short-term obligations of one financial institution or affiliated group.
Consent Order (CO)	A formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A CO may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Deposit Insurance Fund (DIF)	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 cost (unless a systemic risk determination is made). The DIF is primarily funded by deposit insurance assessments.
Division of Resolutions and Receiverships (DRR)	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)	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.
Material Loss	Any estimated loss to the DIF in excess of $50 million for losses that occur on or after January 1, 2014 (as defined by sections 38(k)(2)(A) and 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act).

Glossary of Terms

Term	Definition
Minority Depository Institution (MDI)	Any federally insured depository institution where 51 percent or more of the voting stock is owned by minority individuals. This includes institutions collectively owned by a group of minority individuals, such as a Native American Tribe. Ownership must be by United States citizens or permanent legal residents to be counted in determining minority ownership. In addition to institutions that meet the ownership test, institutions will be considered MDIs if a majority of the Board of Directors is minority and the community that the institution serves is predominately minority. MDIs often promote the economic viability of minority and under-served communities.
Nonaccrual Loan	A loan that is not earning the contractual rate of interest in the loan 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.
Offsite Review Program	The FDIC's Offsite Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. RMS examiners perform quarterly offsite reviews for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.
Prompt Corrective Action (PCA)	Part 324, Subpart H (Prompt Corrective Action) was issued by the FDIC pursuant to section 38 of the FDI Act. Its purpose is to establish the capital measures and levels that are used to determine supervisory actions authorized under section 38 of the FDI Act. Subpart H also outlines the procedures for the submission and review of capital restoration plans and other directives pursuant to section 38. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*.
Shared-Loss Agreement (SLA)	A financial agreement wherein the FDIC agrees to absorb a portion of the loss on a specified pool of assets sold to an AI. An SLA includes an estimated loss for the final resolution of the SLA assets.

Glossary of Terms

Term	Definition
SLA Loss Share Certificate	A certificate submitted by an AI at least quarterly to the FDIC for reimbursement of FDIC-covered losses on SLA assets.
SLA Indemnification Asset	The present value of estimated payments from the FDIC for losses on SLA assets.
Tier 1 Capital (Equity Capital)	The sum of Common Equity Tier 1 capital and Additional Tier 1 capital. Common Equity Tier 1 capital is the most loss-absorbing form of capital, which includes qualifying common stock and related surplus net of treasury stock; retained earnings; and qualifying common equity Tier 1 minority interests. Depending on how the institution elects to calculate regulatory capital, Tier 1 capital may also include certain accumulated other comprehensive income elements plus or minus regulatory deductions or adjustments as appropriate. The federal banking agencies expect the majority of common equity Tier 1 capital to be in the form of common voting shares Additional Tier 1 capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund and Troubled Asset Relief Program instruments that previously qualified for Tier 1 capital, and qualifying Tier 1 minority interests, less certain investments in other unconsolidated financial institutions' instruments that would otherwise qualify as additional Tier 1 capital.
Tier 1 Leverage Capital Ratio	Tier 1 capital (equity capital) divided by average total assets.
Tier 1 Risk-Based Capital Ratio	Tier 1 risk-based capital divided by risk-weighted assets.
Tier 2 Capital	Includes an institution's allowance for loan and lease losses up to 1.25 percent of its risk-weighted assets, qualifying preferred stock, subordinated debt, and qualifying tier 2 minority interests, less any deductions in tier 2 instruments of an unconsolidated financial institution.
Total Capital	Tier 1 and Tier 2 capital combined.
Total Risk-Based Capital Ratio	Total risk-based capital divided by risk-weighted assets.

Glossary of Terms

Term	Definition
Troubled Institution	Any insured state nonmember bank that: (1) Has a CAMELS composite rating, as determined in its most recent report of examination of 4 or 5, or in the case of an insured state branch of a foreign bank, an equivalent rating; or (2) Is subject to a proceeding initiated by the FDIC for termination or suspension of deposit insurance; or (3) Is subject to a cease-and-desist order or written agreement issued by either the FDIC or the appropriate state banking authority that requires action to improve the financial condition of the bank or is subject to a proceeding initiated by the FDIC or state authority which contemplates the issuance of an order that requires action to improve the financial condition of the bank, unless otherwise informed in writing by the FDIC; or (4) Is informed in writing by the FDIC that it is in troubled condition for purposes of the requirements of section 303.101(c) of the FDIC Rules and Regulations on the basis of the bank's most recent report of condition or report of examination, or other information available to the FDIC.
Troubled Debt Restructuring	A restructured or modified loan is considered as troubled debt restructuring 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.
Uniform Bank Performance Report (UBPR)	An individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the FFIEC for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the UFIRS to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Acronyms and Abbreviations

Acronym / Abbreviation	Explanation
ACI	Adversely Classified Items
ADC	Acquisition, Development, and Construction
AI	Assuming Institution
ALLL	Allowance for Loan and Lease Losses
AML	Anti-Money Laundering
ASC	Accounting Standards Codification
BSA	Bank Secrecy Act
Call Report	Consolidated Report of Condition and Income
CAMELS	**C**apital Adequacy, **A**sset Quality, **M**anagement Practices, **E**arnings Performance, **L**iquidity Position, and **S**ensitivity to Market Risk
CDFI	Community Development Financial Institution
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CO	Consent Order
COO	Chief Operating Officer
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
FASB	Financial Accounting Standards Board
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
GAAP	Generally Accepted Accounting Principles
IDFPR	Illinois Department of Financial and Professional Regulation
IG	Inspector General
MDI	Minority Depository Institution
MLR	Material Loss Review
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RADD	Regional Automated Document Distribution and Imaging System
RMS	Division of Risk Management Supervision
SBI	Seaway Bancshares, Incorporated
SLA	Shared-Loss Agreement
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
ViSION	Virtual Supervisory Information on the Net

Corporation Comments

FDIC

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

August 11, 2017

TO: E. Marshall Gentry
Assistant Inspector General for Program Audits and Evaluations

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

SUBJECT: Response to the Draft Audit Report Entitled, Material Loss Review of Seaway Bank and Trust Company, Chicago, IL (Assignment No. 2017-020)

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 Seaway Bank and Trust Company, Chicago, Illinois, which failed on February 27, 2017. This memorandum is the response of the Division of Risk Management Supervision (RMS) to the OIG's Draft Report (Report) received on July 31, 2017.

The underlying cause of Seaway's failure was poor corporate governance and risk management practices by the Board and management. Seaway acquired assets in 2010 and 2011 from the FDIC as receiver of two failed banks. Errors in calculating the value of the indemnification asset associated with the acquired assets began in the first quarter of 2013 when bank management brought the accounting in-house. As a result of poor oversight, the Board was not aware of the true financial condition of the bank for much of 2013. The problems facing the institution were compounded by the death of the bank's long-time Chairman in April 2013, at which point the Chairman's widow assumed a controlling interest in the bank's holding company. The Board attempted to address examination findings in 2014 by dismissing those individuals responsible for the bank's deterioration and accounting problems. The Board failed to find qualified candidates to fill those vacancies, and Seaway's asset quality deteriorated further. The Board filled those vacancies using consultants, which significantly increased overhead expenses. This, coupled with increasing loan losses, ultimately depleted Seaway's capital and led to the bank's failure.

The Report covers the period 2009 through failure. During that period, the FDIC and the Illinois Department of Financial and Professional Regulation (IDFPR) conducted seven onsite examinations, six onsite visitations, and several offsite monitoring analyses. During this period, the IDFPR conducted independent examinations in 2010 and 2012, which the FDIC accepted. The FDIC conducted visitations in 2010 and 2011, shortly after Seaway acquired failed bank assets from the FDIC as Receivers of First Suburban Bank and Legacy Bank. The Report finds that the FDIC conducted timely and regular examinations consistent with regulations and supervisory guidance. The Report concludes that while it was permissible under FDIC rules and

Corporation Comments

regulations to alternate the 2012 examination with the IDFPR, it would have been prudent for the FDIC to participate in the 2012 IDFPR examination or conduct a separate visitation. The FDIC agrees that it would have been permissible under FDIC rules and regulations for the FDIC to participate in the 2012 examination or conduct a separate visitation to ensure Seaway was properly accounting for the SLA assets, and in retrospect it may have been beneficial to do so.

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