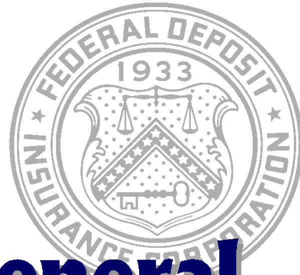
Office of Inspector General



June 7, 2000
Audit Report No. 00-022

Material Loss Review - The Failure of Pacific Thrift and Loan Company Woodland Hills, California

TABLE OF CONTENTS

OVERVIEW	1
HISTORY AND BACKGROUND	3
OBJECTIVES, SCOPE, AND METHODOLOGY	6
RESULTS OF AUDIT	8
CAUSES OF PTL'S FAILURE AND THE RESULTING MATERIAL LOSS TO THE BANK INSURANCE FUND	9
A General Overview of the Loan Securitization Process	10
The Mechanics Behind the PTL/PAMM IORRs	10
Concentration in Interest-Only Residual Receivables Led to PTL's Failure	12
Changes in Portfolio Composition Result in Asset Growth	13
Excessive Overhead Expenses Eliminate Earnings	14
The Asian Economic Crisis Further Exacerbates PTL's Earnings and Threatens PTL's Tenuous Liquidity Position	17
The Final Decline of Capital Signals the Demise of PTL	17
ASSESSMENT OF DOS'S SUPERVISION OF PTL	19
The Quality of PTL's Capital Base Was Negatively Impacted by the Implementation of FAS 125	20
Tier 1 Leverage Capital Ratio Fails to Reflect the Risks Associated with IORRs	23
The Risk-Based Capital Ratio Reflects the Risks Associated with IORRs	23
DOS Used Prompt Corrective Action Appropriately	24
Interagency Examination Guidance and Other Regulatory Actions	25
Recommendation	25
Concentration in High-Risk IORRs Contributed to PTL's Insolvency	25
Recommendation	28

Parent Companies of Industrial Loan Companies Escape Inclusion Under the Bank Holding Company Act and Are Unregulated Entities 28

Recommendations 30

Lack of Access to External Accounting Firm's Workpapers Further Delays DOS's Assessment of the Valuation of the IORRs 30

PTL Instructed to Obtain an Independent Valuation 30
DOS Attempts to Gain Access to E&Y's Model and Workpapers 32

Recommendation 33

DOS'S ACTIVITIES IN RESPONSE TO RECENT BANK FAILURES 33

CORPORATION COMMENTS AND OIG EVALUATION 36

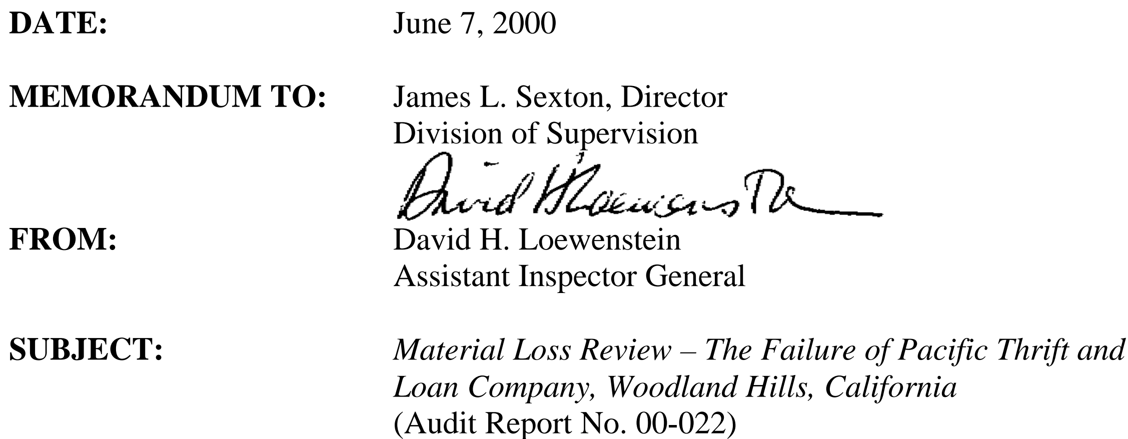
GLOSSARY 37

APPENDIXES
Appendix I - A DETAILED DISCUSSION OF THE SECURITIZATION PROCESS 42
The Securitization Process and the Parties Involved 42
Credit Enhancements Increase the Protection Against Losses to the Investor 42
Interest-Only Residuals: A By-Product of the Securitization Process 43
Appendix II - CORPORATION COMMENTS 45
Appendix III - MANAGEMENT DECISION TABLE 47

TABLES
Table 1: Examination Results and Regulatory Actions for PTL 6
Table 2: Compensation Paid to PTL's Executive Officers 16
Table 3: Capital Injections From PAMM to PTL 18
Table 4: PTL's Capital Ratios 1996 - 1999 24
Table 5: Quarterly Values for the IORRs, Total Assets, and Equity Capital 26
Table 6: E&Y Valuation Reports 31
Table 7: DOS Initiatives 35
Table 8: Calculation of Excess Residual Interest 43

FIGURES
Figure 1: The Securitization Process 11
Figure 2: Comparison of PTL's and Its Peer Group's Overhead Expenses Expressed as a Percentage of Average Assets 14
Figure 3: Gain on Sale of Loans 22
Figure 4: Total Equity Capital 23
Figure 5: Net Income 27

Federal Deposit Insurance Corporation — Office of Audits
Washington, D.C. 20434 — Office of Inspector General



DATE: June 7, 2000

MEMORANDUM TO: James L. Sexton, Director
Division of Supervision

FROM: David H. Loewenstein
Assistant Inspector General

SUBJECT: *Material Loss Review – The Failure of Pacific Thrift and Loan Company, Woodland Hills, California*
(Audit Report No. 00-022)

In accordance with section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Pacific Thrift and Loan Company (PTL), Woodland Hills, California, to determine the causes of the thrift's failure and to evaluate the FDIC's supervision of the thrift. PTL was closed on November 19, 1999 with total assets of $117.6 million. At the time of closure, the Federal Deposit Insurance Corporation (FDIC) estimated that the Bank Insurance Fund (BIF) would incur a loss of $49.9 million. The estimated loss was raised to $52 million as of December 31, 1999. The loss was exacerbated by PTL's sizeable investment in interest-only residual receivables (IORR) generated through their securitization program. The Division of Supervision's (DOS) regulatory efforts acknowledged the risks associated with the IORRs and attempted to quantify any potential losses in the IORRs.

OVERVIEW

PTL was an industrial loan company whose principal business activity was the securitization of subprime loans, which were either generated through one of its many loan production offices or purchased through other financial intermediaries or brokers. The State of California Department of Financial Institutions (State) closed PTL on November 19, 1999 after PTL was unable to meet the State's demand for a capital injection of $1.9 million. The capital deficiency stemmed from the thrift's earlier implementation of Statement of Financial Accounting Standards (FAS) 125, effective January 1, 1997, which permitted PTL to record the IORRs, a by-product of the securitization of subprime loans, as assets on their balance sheet. Prior to 1997, PTL's general practice was to sell loans for cash. Between the March 31, 1997 and the September 30, 1999 Call Reports,[1] PTL's IORRs increased from $10.8 million to $48.8

[1] See glossary for further explanation of this and other terms used throughout this report.

million, an increase of 352%. PTL's overly optimistic valuation assumptions resulted in inflated values that were unrealizable.

Because of the unique characteristics of industrial loan companies, such as not accepting demand deposits, their parent or holding companies are not under the jurisdiction of the Bank Holding Company Act and are therefore unregulated by federal regulatory authorities. Unrestrained borrowing through lines of credit and cash advances on the IORRs by PacificAmerica Money Center, Inc. (PAMM), the parent holding company, allowed PTL to generate loans without reliable and stable funding sources. The structuring of the loan sales and the receipt of the cash advances also resulted in PTL's incurring numerous apparent violations of law associated with transactions between affiliated entities.

PTL's management established extremely optimistic assumptions for the projection and recording of anticipated future income associated with their IORRs. As a result, capital increased dramatically during 1997 from recording the increasing gains achieved on the sale of the securitized loans. However, the growth in the IORRs, coupled with the lack of sustained cash flow from the IORRs, placed undue stress on PTL's capital base.

The FDIC examiners were alert to the risks during their first exposure to PTL's IORRs during their March 1997 examination. These complex derivative instruments were new to the examiners, a situation that eventually prompted assistance from FDIC Capital Markets Specialists in Washington. The initial problem faced by the regulators was trying to establish a fair market value for the IORRs. Because the retained interests were new in the financial markets, there was limited public information available. FAS 125 indicates that the best evidence of fair value is a quoted market price in an active market. In instances where a quoted market price is unavailable, the accounting rules allow for a fair value to be estimated.

To arrive at such an estimate, the FDIC required PTL to obtain a third-party independent valuation of PTL's IORRs. In early 1998, PTL contracted with Ernst & Young (E&Y) to conduct an independent valuation of the IORRs. The regulators believed that E&Y was conducting a fair market analysis of the IORRs. During the April 1998 examination, DOS attempted to get E&Y's valuation model so that they could determine how the process worked. In addition, DOS also requested access to Ernst and Young's workpapers so they could review exactly how E&Y derived its conclusions. E&Y refused to allow DOS access to its model and workpapers, stating that the model was proprietary and that its workpapers were not available for third-party review. DOS contacted the Legal Division to determine how DOS could gain access to E&Y's workpapers. A DOS representative wrote a letter to E&Y, and at the April 1999 examination, DOS gained access to E&Y's workpapers. E&Y later told DOS that the work it performed was not an independent fair market analysis, but only a computation based on agreed-upon procedures using assumptions provided by PTL's management.

The State closed PTL on November 19, 1999 after PTL was unable to meet the State's demand to increase their capital base. As a result of the losses associated with PTL and

the IORRs, the FDIC has estimated that the loss to the BIF will be at least $52 million as of December 31, 1999.

Our report on PTL is structured as follows:

- The **History and Background** section provides information on the principals of the thrift and the evolving corporate structure. It also recaps the examination history of the thrift from 1989 through 1999 with emphasis on the proposed and actual enforcement actions related to those examinations.

- A separate section discusses our **Objectives, Scope, and Methodology** in conducting this review.

- The **Results of Audit** section summarizes our findings and recommendations.

- Our main discussion of PTL is presented in **two major sections**. In the first section, we discuss **the causes of PTL's failure** and show how the IORRs were structured and how they contributed to the bank's eventual ruin. The second major section of our report addresses **the FDIC's supervision of PTL**. This part of our report focuses on the regulatory efforts demonstrated by the FDIC examiners as they tried to assess the risk and valuation of a new and complex securitized asset, including the FDIC's implementation of Prompt Corrective Action (PCA). It also shows how the Division of Supervision (DOS) has taken measures based upon PTL and other recent bank failures to address the risks involved with subprime lending and securitization activities.

- Our report contains five **recommendations** designed to provide support for current FDIC initiatives and to provide FDIC examiners guidance for improving the examination process.

- Due to the complexity of some of the issues presented, we have included a **glossary of terms** at the conclusion of the report.

HISTORY AND BACKGROUND

Tracing PTL's Heritage

Pacific Thrift and Loan Company began its operations as an industrial loan company (ILC) on July 22, 1988 in Woodland Hills, California. ILCs are the evolutionary counterparts of the Morris Plan Banks, which were started in 1900. Morris Plan Banks were essentially finance companies that directed their lending to individuals who owned no property. Their practice was to loan money to borrowers based on endorsements from two credit-worthy individuals who knew the borrower. Morris Plan Banks were an attempt to provide individuals with an opportunity to borrow funds without having to resort to loan sharks. Such institutions issued thrift investment certificates, similar to a bank's certificate of deposit. ILCs operate today in a manner similar to that of Morris

Plan Banks at the turn of the century. ILCs also issue thrift certificates; however, they have expanded their practices and are engaged primarily in lending to individuals and commercial businesses. ILCs also engage in collateral-based lending, which is generally related to loans secured by real estate and is another departure from the philosophy of the Morris Plan Banks. PTL was very niche-oriented and diverted its lending practices from conventional portfolio loans to loans made to subprime borrowers for securitization purposes.

In California, ILCs were previously insured by a state insurance system. However, the state fund went bankrupt after a significant ILC failure, and in the 1980s there were several uninsured ILCs operating in California. The State of California required the remaining ILCs to either obtain Federal Deposit Insurance Corporation (FDIC) insurance or cease operations. PTL received insurance from the FDIC on December 19, 1988.

PTL's Management Team

The founder/chairman of PTL was the thrift's leading policymaker. From its inception in 1988 until 1993, PTL operated primarily as a residential lender and limited its operations to the Southern California area. The California real estate recession in the early 1990s led to increased loan losses at PTL. To reduce the economic risks of concentration in a single geographic region, PTL diversified its lending operations to target regions throughout the country.

A new management team joined PTL in 1993, consisting of a President, Chief Financial Officer, and Executive Vice President. Each of these three executive officers had come from Topa Thrift and Loan (Topa), Los Angeles, California. On November 12, 1992, Topa received an FDIC Cease and Desist (C&D) Order relating to deficient management practices, significant asset quality weaknesses, unprofitable operations and other issues. Topa was subsequently sold and its charter was surrendered without a monetary loss to the FDIC.

Upon joining PTL, this management team immediately implemented an expansionary program of originating and selling subprime mortgage loans. This program provided monetary gains that helped resolve PTL's previous capital problems. However, management's expansionary activities without regard to adequate policies, programs, and controls resulted in serious shortcomings. This became apparent with PTL's reaction to the Financial Accounting Standards Board's issuance of FAS 125. Previously, PTL sold whole loans to purchasers at a premium and received all of the proceeds in cash at the time of the sale. After the issuance of FAS 125, although PTL continued to sell the loans at a premium, only the par value of the loans was received in cash. The premium on the loan sales was received in the form of a pro rata share of an IORR. The receipt, valuation, and recordation of the IORRs ultimately caused the collapse and downfall of the institution.

PTL's Holding Company

At PTL's inception, it was a wholly owned subsidiary of Presidential Mortgage Company (Presidential), which was part of a two-tiered holding company relationship. Presidential was a California limited partnership organized on June 15, 1981 and was wholly owned by Presidential Management, a California partnership. In 1994, PacificAmerica Mortgage Corporation (PMC) was formed and subsequently acquired by Presidential to serve as its ultimate replacement. At this time, Presidential was heavily burdened with debt, so Presidential began the process of restructuring and capital restoration through an initial public offering. It was anticipated that PTL could benefit from the offering by receiving capital contributions from the parent. This process was consummated in June 1996 when Presidential became PacificAmerica Money Center (PAMM), Inc., a Delaware Corporation. PMC was absorbed into the new corporate structure with PTL remaining as PAMM's principal subsidiary.

PTL's Struggle for Success

PTL was first designated as a problem institution by the bank regulatory agencies in 1991 and was subsequently subjected to numerous formal and informal supervisory actions. Table 1 details a historical perspective of regulatory actions pursued against PTL from 1989 until its closing in 1999.

Table 1: Examination Results and Regulatory Actions for PTL

	CAMEL(S) Ratings	Composite Ratings	Supervisory Action(s) Recommended By FDIC and State Examiners	Resulting Action
9/30/89 FDIC	2-2-2-2-2	2	None	No action taken.
10/29/90 State	4-3-3-3-3	3	None	No action taken.
9/23/91 FDIC	2-2-2-2-3	2	None	No action taken.
10/31/91 State	4-4-4-4-4	4	None	No action taken.
6/15/92 FDIC	3-4-4-4-4	4	Recommended an MOU.	RO favored a C&D; after a capital injection, an MOU was issued.
11/18/92 State	3-3-3-4-4	3	None	Continuation of MOU.
6/7/93 FDIC	3-3-3-4-4	3	Recommended termination of MOU and issuance of bullet C & D.	MOU terminated and bullet C & D issued.
1/10/94 State	3-4-4-4-3	4	Letter sent regarding issuance of CMPs for filing late Call Report.	Continuation of C & D; the Call Report was filed late due to an earthquake - no action on CMPs.
9/26/94 FDIC	5-4-4-5-3	5	Recommended additional bullet C & D.	C & D that was issued in 1993 continued; additional bullet C & D issued. PCA Directive issued.
1/27/95 State	5-4-4-5-3	5	CMPs recommended for late filing of Call Reports. FDIC recommends combining two C & D's into one Order. State issues Order to Cure Deficiency of Net Worth.	Thrift stipulated to pay CMPs. FDIC combines two C & D's into one Order. Board stipulated to new C & D. State issues a Notice of Compliance, Net Worth Deficiency.
10/31/95 State	3-3-3-3-2	3	None	Continuation of C & D.
11/27/95 FDIC	3-3-3-3-3	3	None	Continuation of C & D.
3/3/97 State	2-3-2-2-2-3	2	Recommended terminating C & D replacing with an MOU.	C & D terminated and replaced with an MOU.
3/3/97 FDIC	3-4-4-3-2-3	4	None	Continuation of MOU.
4/27/98 Joint	4-4-4-4-4-4	4	Recommended a more comprehensive MOU.	A more comprehensive MOU issued; Order issued by the State.
12/24/98				C&D issued by FDIC became effective.
4/26/99 FDIC	5-5-5-5-5-5	5	State issued a demand for capital.	Order and a demand for capital issued by the State. FDIC issued a PCA Directive, C & D, and a second C & D for Y2K concerns.

Sources: DOS and State Banking Department Examination Reports, Bank Information Tracking System, DOS Correspondence

On November 19, 1999, the California Department of Financial Institutions closed PTL and appointed the FDIC as receiver. One hour prior to the closing, PAMM filed for bankruptcy.

OBJECTIVES, SCOPE, AND METHODOLOGY

We performed this audit in accordance with section 38(k) of the Federal Deposit Insurance (FDI) Act, which provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. A loss is considered material if it is or becomes apparent that the loss will

exceed $25 million and 2 percent of the institution's total assets at the time the Corporation was appointed receiver. The FDI Act requires that the OIG report be completed within 6 months after "it becomes apparent" that a material loss has been incurred. However, the amount of the loss estimate can vary based on changing economic conditions and the FDIC's approach to resolving and liquidating the institution. The actual loss to the BIF will not be known until all receivership assets are liquidated. As a result, in determining whether to initiate a material loss review, the OIG generally relies on the loss estimates recorded by the FDIC's Division of Finance (DOF). PTL was closed on November 19, 1999 with total assets of $117.6 million; DOF provided its initial estimated loss of $49.9 million to the OIG on December 7, 1999, and we immediately initiated our material loss review.

The scope of this audit included an analysis of PTL's operations from December 1988 when the FDIC insured the thrift, until its failure on November 19, 1999. Our review also entailed an evaluation of the regulatory supervision of the bank over the same period. Our specific objectives were to: (1) determine the cause(s) of PTL's failure and resulting material loss to the BIF and (2) assess the FDIC's supervision of the thrift, including implementation of the Prompt Corrective Action requirements of section 38 of the FDI Act.

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

- Analyzed examination and visitation reports prepared by the FDIC and the State of California regulators from 1989 until 1999;
- Reviewed bank data and correspondence maintained at the Division of Supervision San Francisco Regional Office;
- Reviewed reports prepared by the Division of Resolutions and Receiverships (DRR) and DOS relating to the bank's closure;
- Interviewed DOS management in Washington, D.C., and San Francisco, California;
- Interviewed Legal Division officials at the San Francisco Regional Office;
- Interviewed DRR officials in Washington, D.C., and at the Dallas Regional Office;
- Interviewed FDIC examiners from the Los Angeles West and East field offices and the Atlanta Regional Office who participated in examinations or reviews of examinations of PTL;
- Interviewed Capital Markets Specialists in Washington, D.C.;
- Interviewed accounting specialists in Washington, D.C., and from the San Francisco Regional Office;
- Met with the officials from the California Department of Financial Institutions to discuss the historical perspective of the institution, its examinations, and other activities regarding the State's supervision of the bank;
- Researched and reviewed FAS 125;
- Researched and reviewed information on unregulated holding companies and industrial loan companies;

- Researched interest-only residual receivables;
- Reviewed bank records (board minutes, prospectuses, policies and procedures, responses to enforcement actions) obtained from DRR in Dallas, Texas, for information that would provide insight into the thrift's failure;
- Reviewed bank records obtained from DRR in Washington, D.C., relating to the asset securitizations and interest-only residual receivables;
- Reviewed regional office records obtained from DOS and DRR relating to the supervision and closing of PTL;
- Reviewed PTL's Uniform Bank Performance Reports from 1989 until 1999;
- Reviewed PTL's Call Reports from 1989 through 1999; and
- Reviewed pertinent DOS policies and procedures.

We performed the audit fieldwork at the DOS and Legal Division offices in San Francisco, California; the DOS field office in Los Angeles, California; the DRR office in Dallas, Texas; the State of California Department of Financial Institutions office in Los Angeles, California, and DOS and DRR offices in Washington, D.C.

We conducted the audit in accordance with generally accepted government auditing standards. Our opinions and conclusions are based on records obtained by FDIC at PTL's failure. We do note, however, that PAMM, PTL's holding company, filed for bankruptcy an hour before the institution was closed. Because of the bankruptcy proceedings, PAMM's records were removed from the premises, and DRR was unable to review the documents to determine if any of PTL's records were included. Certain records that we would expect to see in PTL's files such as the final agreement between PTL and Ernst and Young to obtain the asset valuation, Call Report workpapers, and general correspondence files were not included in the DRR files. The absence of these files served to limit the scope of our review. We conducted the audit fieldwork from December 1999 through April 2000.

RESULTS OF AUDIT

PTL's management did not operate the institution in a safe and sound manner, which led to losses in the thrift's IORRs generated in connection with the securitization of subprime loans. FAS 125 allowed entities to estimate the values of IORRs based on reasonable and supportable assumptions. PTL's losses were compounded by PTL's application of FAS 125, in which management established extremely optimistic assumptions for projecting and recording anticipated future income associated with the IORRs. The unrestrained borrowing, through lines of credit and cash advances on the IORRs by PAMM, the parent holding company, allowed PTL to generate loans without reliable and stable funding sources. This was clearly demonstrated when funding sources began to collapse with the Asian financial crisis in 1998, and PTL was unable to recover from its already strained liquidity position to continue to compete in the securitization arena.

The FDIC Division of Supervision's regulatory oversight of PTL was responsive to the risks associated with the thrift's IORRs. DOS's regulatory efforts demonstrated attempts

to address these risks and the problems associated with the IORRs, given the power, ability, and market information that were available to DOS at that time.

Since the failure of PTL, the FDIC's Division of Supervision has issued significant examination guidance regarding subprime lending and asset securitization. The guidance specifically addresses the risks posed by subprime lending and asset securitization as well as the examination methods and regulatory treatment that examiners are to use when they encounter financial institutions engaged in either or both types of activities. We recommend that DOS actively pursue amending the capital standards to exclude interest-only residuals from the calculation of Tier 1 Leverage Capital. DOS is currently working on an interagency rulemaking that is addressing this issue. In addition, we recommend that DOS develop an approach for limiting an institution's interest-only residuals to an amount that will not impair the capital protection of the institution. Regarding the unique structure of industrial loan companies, we recommend that DOS staff be reminded that they have access to examine the records of affiliated entities under section 10(b) of the FDI Act and that DOS examiners should routinely review institutions' material intercompany transactions with unregulated holding companies. Lastly, due to the delays and confusion surrounding the independent valuations performed by a public accounting firm conducting work for PTL at the request of the FDIC, we offer recommendations to improve this process going forward.

CAUSES OF PTL'S FAILURE AND THE RESULTING MATERIAL LOSS TO THE BANK INSURANCE FUND

PTL's demise was caused by bank management's failure to operate the institution in a safe and sound manner, which led to losses in the IORRs and the depletion of the institution's capital base. FAS 125 allowed entities to estimate the values of IORRs based on reasonable and supportable assumptions. PTL's losses were compounded by PTL's application of FAS 125, in which management established extremely optimistic and liberal assumptions for projecting and recording anticipated future income associated with the IORRs. Unrestrained borrowing through lines of credit and cash advances on the IORRs by PAMM, the parent holding company, allowed PTL to generate loans without reliable and stable funding sources. The structuring of the loan sales and the receipt of the cash advances also caused PTL to commit numerous apparent violations of law associated with transactions between affiliated entities.

Soon after the inception of the IORR program in 1997, PTL's capital and asset bases increased due to its proliferation in the securitization business. However, funding sources began to collapse with the Asian economic crisis in 1998, and PTL was unable to recover from its already strained liquidity position to continue to compete in the securitization arena. The FDIC and the State, as regulators, repeatedly warned PTL's management that PTL's policies, procedures, and modeling techniques were inadequate for valuing and recording the anticipated future income on the IORRs. Repeated requests by regulators for PTL to have an independent valuation conducted by an outside third party resulted in

a series of denials and arguments from PTL instead of an accurate and usable value for the IORRs.

Despite the liberal assumptions used by management in projecting future income, inordinate overhead expenses were rapidly eroding PTL's earnings. As a result, in 1998 the FDIC required that PTL cease its acceptance of IORRs in its securitizing operations and limit activities to cash-only sales for loans. Because of the diminished volume of sales and the nominal premium received for the loans, income could not keep pace with the overhead expenditures. Capital was depleted and PTL was unable to restore the capital base through outside sources. The State of California Department of Financial Institutions closed PTL on November 19, 1999.

The events and principal conditions that led to the failure of PTL and resulted in a material loss to the BIF include management's failure to adhere to safe and sound banking principles resulting in losses sustained in the IORRs and the depletion of the thrift's capital. PTL's failure has resulted in estimated losses of $52 million as of December 31, 1999 to the BIF sustained largely by the securitization operations and the IORRs.

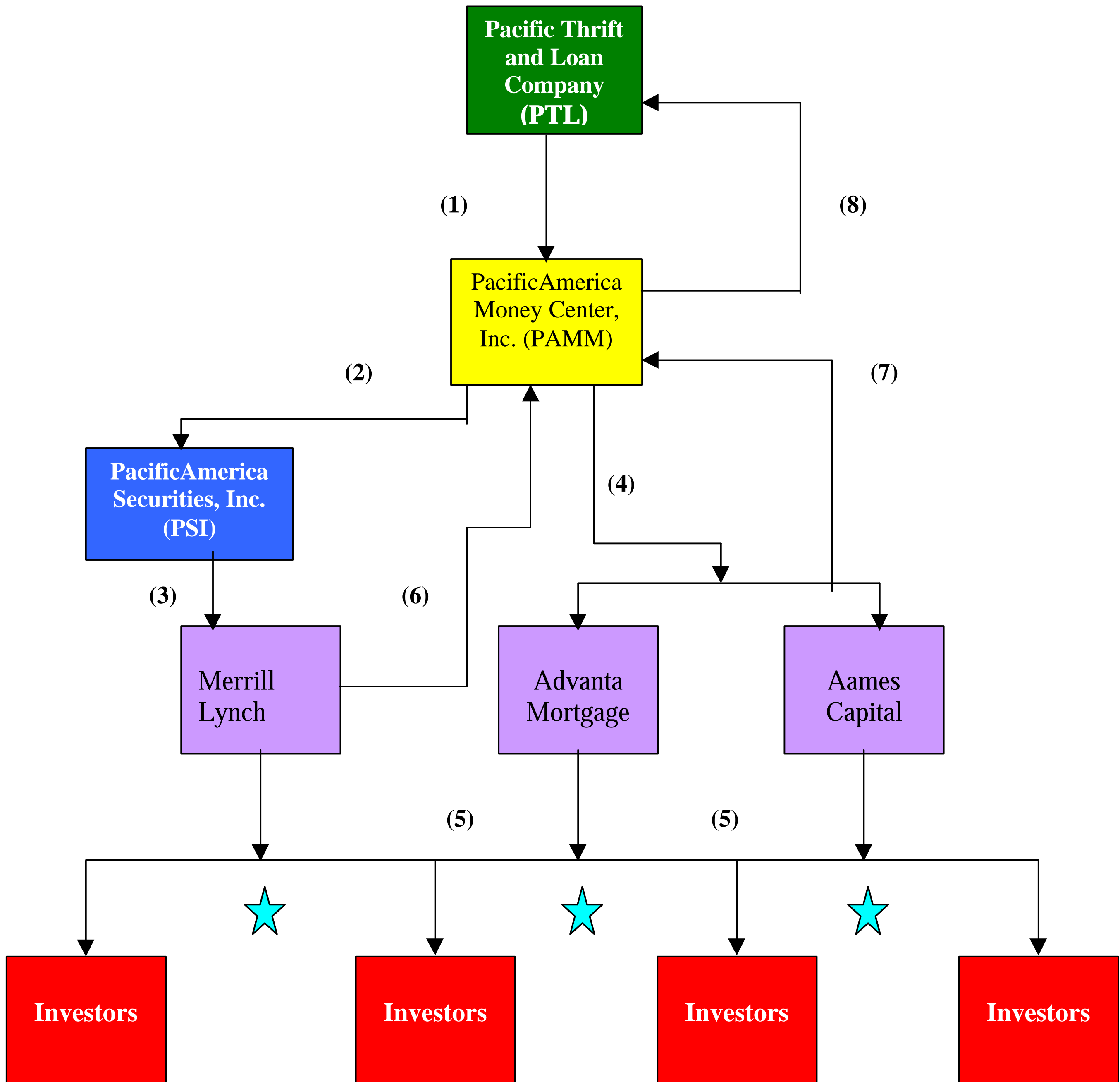
A General Overview of the Loan Securitization Process

Asset securitization is the process of transforming generally illiquid assets into securities that can be readily traded in the marketplace. Asset securitizations can be structured in a myriad of ways since there are no set requirements for structuring asset securitizations. Most securitized assets are mortgage-backed securities, such as first and second mortgages on residential real estate, or asset-backed securities, such as credit cards or automobile loans. Since PTL was involved in the loan securitization of residential mortgage loans, we will refer to these instruments collectively as mortgage-backed securities (MBS) for the purposes of this report. For a more comprehensive discussion of the securitization process, refer to appendix A.

The Mechanics Behind The PTL/PAMM IORRs

PTL and PAMM forged a unique structure for their IORR. Figure 1 illustrates and summarizes the mechanics behind how their securitizations were structured and the method employed to allow the loans to flow from the initial origination at PTL to the sale of securities to the ultimate investor.

Figure 1: The Securitization Process



★ For simplicity, the actual steps in the securitization process such as acquiring a trustee, servicer, guarantor, etc., have been omitted.

Sources: OIG Analysis based on data obtained from DOS and Division of Resolutions and Receiverships.

(1) PTL originated loans with individual borrowers and purchased loans from wholesalers for resale in the securitization market. PTL sold the loans to their parent, PAMM, for the par, or face, value of the loans.

(2) PAMM sold some of the loans to PacificAmerica Securities, Inc. (PSI). PSI was a special purpose entity created to facilitate the securitization process by acquiring loans from PAMM for resale to Merrill Lynch under a "warehousing" agreement.

(3) PSI sold the loans to Merrill Lynch. Merrill Lynch packaged the loans into a securitized MBS for sale in the secondary market to potential investors.

(4) PAMM also sold loans to other financial groups such as Advanta and Aames to securitize into an MBS for sale in the secondary market to potential investors.

(5) These firms (Advanta and Aames) conducted and completed the securitization activities relating to the mortgage loans. They then sold the MBS to investors in the marketplace.

(6) Merrill Lynch issued an actual interest-only (IO) strip certificate. PAMM held the actual certificate indicating its ownership rights in the residual interests. Even though Merrill Lynch acquired the loans at a premium, they paid PAMM the par, or face, value for the loans in cash. The premium was comprised of PAMM's percentage ownership in the IO strip. Merrill Lynch distributed part of the premium as a cash advance to PAMM on a specific percentage of the future anticipated income from the IO strip. The advance had to be repaid prior to any additional cash flow distributions of the IO strip to PAMM.

(7) PAMM had master agreements with Advanta and Aames pertaining to the ownership percentages and the division of the residual interests in the securitizations that were sold to investors. The Advanta and Aames securitizations did not have IO strips. Even though Advanta and Aames acquired the loans at a premium, they paid PAMM the par, or face, value for the loans in cash. The premium was comprised of the percentage ownership in the IORRs. The premium amount due to PAMM was in the form of an IORR. Advanta and Aames distributed part of the premium as a cash advance to PAMM on a specific amount of the future anticipated income from the IORRs. The advance had to be repaid prior to any additional cash flow distributions of the IORRs.

(8) PAMM and PTL had intercompany agreements that specified their pro rata shares of the IORR from each of the securitizations. PAMM downstreamed the funds from the cash advances from Advanta, Aames, and Merrill Lynch to PTL. This provided PTL with available liquidity in order to fund additional loans and continue the securitization process.

Concentration in Interest-Only Residual Receivables Led to PTL's Failure

The implementation of FAS 125 in 1997 permitted PTL to record IORRs, a by-product of the securitization of subprime mortgage loans, as assets on their balance sheet. It also

allowed the recording of the discounted projected future income associated with the IORRs. As a result, assets increased with a growth rate of 72 percent in 1997. The growth in the IORRs, coupled with the lack of sustained cash flow from the IORRs, placed undue stress on PTL's capital base. Management's failure to curb excessive overhead expenses and the inability to generate core profitability to augment capital finally led to the closure of PTL.

Changes in Portfolio Composition Result in Asset Growth

The overall business strategy changed course several times during PTL's history. The changes in the business plan first appeared to be following an orderly sequence of events in response to managerial initiatives to increase revenues and find a market niche in which the thrift could excel. At inception, PTL was primarily engaged in residential lending along with some real estate-secured commercial loans. Asset growth was rapidly expanding in response to its entrance in a new business environment. Asset growth rates were correspondingly high from 1989 until 1991 with ratios of 248 percent, 75 percent, and 121 percent respectively.

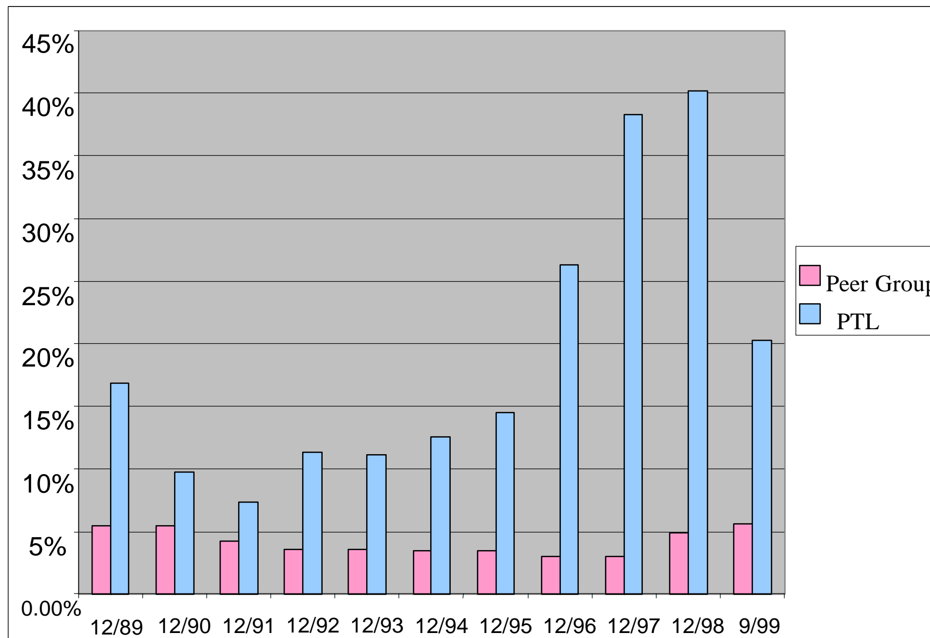
In late 1991, PTL became involved in Federal Home Administration Title 1 home improvement loans, which were extended to pay for construction costs of home improvements or for debt consolidation. This program was only offered in California, and the loans were secured by residential properties. The purpose was to originate the loans, sell the guaranteed portions, and retain the servicing rights to the sold portions. In 1993, PTL began to originate loans for sale as indicated by the master sale agreement with Aames. In 1994, PTL entered the securitization market by originating loans for sale to third-party securitizing entities. By 1995, PTL's revenue was dependent upon the sale of loans with more than 50 percent of the income being derived from this activity of selling loans to third-party securitizing entities. The asset growth rates tapered during the period between 1992 and 1996, with a low of negative 10 percent and a high of 33 percent.

In 1997, PTL began the sale of loans for securitization with the new feature of retaining IORRs. PTL's implementation of FAS 125 affected the intensity of the asset growth as well as altering the composition of the asset and income structures. The rapid expansion into the sale of loans for securitization with the retention of IORRs resulted in an asset growth rate of 71 percent in 1997. Capital increased 115 percent between December 31, 1996 and December 31, 1997, because of the income generated by the IORRs as a result of recording the increasing gains achieved on the sale of loans. This expansionary period ended abruptly in 1998 with the Asian economic crisis and the substantial decline in the demand for subprime loans in the secondary markets. Although the business strategy changed once more with the discontinuation of the wholesale loan division, PTL was unable to restore its capital to a level that would allow it to continue as a going concern. As of September 30, 1999, the IORRs represented approximately one-third of PTL's total assets.

Excessive Overhead Expenses Eliminate Earnings

PTL experienced only 4 years of positive earnings from December 1989 until September 1999. In the first 5 years of operations, overhead expenses in the form of salaries and reimbursements to its parent company outpaced PTL's ability to generate sufficient income sources to ensure profitability during 4 of those 5 years. The regulators constantly criticized PTL for the excessive payments made to the holding company. Also, several violations of the Federal Reserve Act's Sections 23A and 23B were cited in several Reports of Examination in connection with these payments. The payments were for services provided to PTL by PAMM. Because PTL and PAMM shared the same office space and essentially the same pool of employees, the overhead expenses were pro rated on the basis of loan volume generated by each entity, and PTL and PAMM had a master agreement governing the distribution of expenses and the reimbursements of fees. However, the regulators felt that PTL was absorbing a disproportionate share of the expenses and that in some cases, the expenses may have been duplicative. The excessive overhead expenses were a constant source of criticism by the regulators. PTL's overhead expenses were also disproportionate when compared to those of its peer group, which consists of similarly sized and geographically situated financial institutions. Figure 2 illustrates the disparity between PTL's overhead costs and those of its peer group.

Figure 2: Comparison of PTL's and Its Peer Group's Overhead Expenses Expressed as a Percent of Average Assets



Source: Uniform Bank Performance Report

With PTL's expansion into loan sales for securitization, its salary expenses continued to escalate. PTL began expanding its operations into different states by opening loan production offices (LPOs). These sites were staffed with individuals who solicited loans for PTL. At one point, PTL was operating from 61 different locations throughout the United States, several of which had not received approval from the State of California Department of Financial Institutions, as required by law.

In addition to the expenses associated with the LPOs, PAMM had employment agreements with several of the executive officers of the institution. Compensation included a specified salary and a provision for bonuses. The bonuses were tied to PAMM's consolidated pre-tax profits or the return-on-equity ratios. Since PTL was PAMM's principal subsidiary, the more profitable PTL was in any given year, the more the executive officers were entitled to receive in bonuses. This provision prompted PTL's management to increase the volume of loans that were originated and subsequently sold in the secondary market. It also provided incentives for PTL's management to use liberal assumptions in valuing the IORRs, thereby including higher dollar values as income. Detailed below in table 2 is a compilation of the salaries received by the executive officers of PTL from 1994 through 1999.

Table 2: Compensation Paid to PTL's Executive Officers

Title	Year	Salary ($)	Bonus ($)	Total ($)
Chairman of the Board/Former CEO	1999	*	*	*
	1998	*	*	*
	1997	235,000	1,633,728	1,868,728
	1996	450,704	222,750	673,454
	1995	400,466	-	400,466
	1994	214,200	-	214,200
Former President/COO	1999	**	**	**
	1998	216,000	-	216,000
	1997	235,000	1,478,050	1,713,050
	1996	247,583	354,750	602,333
	1995	214,273	-	214,273
	1994	161,600	-	161,600
Executive Vice-President Lending	1999	-	-	-
	1998	153,600	# 477,756	631,356
	1997	163,200	637,008	800,208
	1996	184,600	207,112	391,712
	1995	159,600	-	159,600
	1994	109,600	-	109,600
CFO	1999	##	##	##
	1998	84,389	-	84,389
	1997	201,798	-	201,798
	1996	163,577	51,667	215,244
	1995	144,400	-	144,400
	1994	125,967	-	125,967

Source: DOS and DRR

* The Chairman remained active with PTL as Chairman; however, he did not receive any compensation in 1998 and 1999. He relinquished his position as CEO in April 1999.
** The President terminated his employment effective 1/8/99.
# The bonus was paid prior to the issuance of the MOU. The EVP was not employed by PTL during the 4/99 examination. The date of his departure is not known.
The CFO resigned 6/27/99.

Even though PAMM paid the salaries and bonuses for the Chairman of the Board and the former President/COO, PTL was its principal source of revenue. In addition, PTL upstreamed dividends to PAMM in 1996 and 1997 totaling $1.1 million and $3.5 million, respectively. The compensation expense, coupled with the other salary expenses, the premises expenses, and other overhead costs, rendered PTL unable to generate sufficient profits to cover these expenses and maintain the capital base at an adequate level.

The Asian Economic Crisis Further Exacerbates PTL's Earnings and Threatens PTL's Tenuous Liquidity Position

In the fall of 1998, a series of events transpired creating a domino-like effect that ultimately affected PTL's subprime loan market and the value of the IORRs. The events began with the Asian economic crisis and the substantial losses incurred by several large hedge funds. This led to a general stock market decline, which resulted in an increased demand for U.S. Treasury securities. Since mortgage rates are based on comparably mature U.S. Treasury securities, the yields on mortgages plummeted to new lows not seen in decades. This, in turn, caused an increase in mortgage prepayments. As a result, Wall Street investment banks, one of the primary sources of funding to subprime lenders, made margin calls on loans to subprime lenders and reduced the availability for warehouse loan funding. This caused a number of mortgage-backed securitizing firms and subprime lenders to experience severe liquidity shortages due to their reduced ability to obtain financing on loans and IORRs.

To combat the liquidity shortfall, many subprime lenders announced that they would begin selling loans on a cash basis, which created a glut of mortgage loans being sold for cash in the marketplace. These events reduced the demand to purchase loans for securitization and created an oversupply of loans available for sale in the secondary market. These market forces had an impact on the secondary market for IORRs causing a decline in their value.

PTL's major loan purchasers were unwilling to buy the loans on a cash-only basis, which resulted in PTL's inability to sell loans for a profit. PAMM's warehouse line of credit was significantly reduced, which resulted in PAMM's inability to purchase additional loans from PTL. Despite these adverse conditions, PTL continued to commit to fund loans. The lack of available sources of funding and the lack of cash flows from the IORRs constricted PTL's liquidity even further.

PAMM was also experiencing liquidity problems. PAMM defaulted on the advances from Merrill Lynch in connection with three securitizations. In October 1998, Merrill Lynch announced a margin call on the collateral due to the decline in value of the securitizations and the IORRs. PAMM borrowed additional funds from another entity to remedy the defaulted payments. Because of the downturn in the securitization market and PAMM's strained cash position, PAMM was forced to get an extension on the borrowing. On December 14, 1998, the FDIC issued a Cease and Desist Order (C&D) against PTL. One of the provisions of the C&D required PTL to cease generating IORRs. PTL sold two additional packages of loans in 1998 before the effective date of the C&D. Both deals included the retention of IORRs.

The Final Decline of Capital Signals the Demise of PTL

Since 1991, PTL had been designated as a problem institution. One of the conditions that earmarked PTL as a regulatory concern was its tenuous capital position. PAMM had

injected capital into the institution for 7 of PTL's almost 11 years as a financial institution. As indicated by table 3, several injections were quite sizeable.

Table 3: Capital Injections From PAMM to PTL
($000's omitted)

Year	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1997*
Amount	$200	$630	$2,940	$2,816	$1,294	$424	$1,800

Source: Call Reports submitted to the FDIC by PTL.

During the early 1990s, the capital injections from PAMM precluded an excessive decline of capital; however, the ongoing ability of PAMM to continue injecting funds was not insured or guaranteed. PTL's capital problems were the product of its asset expansion and weakened earnings. PTL's continued growth by venturing into new product lines and geographically diverse areas was never restrained by management. Earnings were weakened through the excessive payments to PAMM for the continued exorbitant overhead costs, including the operating and the salary expenses.

In 1997, when PTL became ensconced in the securitization market, PTL's capital position began to deteriorate. Because the income on the IORRs consisted of projections of future income rather than actual cash receipts, PTL's capital base was augmented by intangible estimates of income rather than by tangible cash resources. Also, at the April 27, 1998 joint examination, examiners required the reversal of an accounting entry that did not comply with the Federal Financial Institutions Examination Council's *Instructions for the Preparation of Statements of Condition and Income*. Specifically, PAMM assumed PTL's deferred tax liability, totaling $6.4 million, and considered the amount a capital injection. Examiners required an adjustment or reversal to capital for the following reasons:

- PAMM's assumption of the liability did not relieve PTL of the tax liability in the views of the federal and state taxing authorities,
- The transaction did not have economic substance since no cash changed hands,
- Call Report instructions required PTL to report its taxes on a single entity basis, and
- The MOU did not recognize the conversion of a deferred tax liability as an acceptable source of capital.

Because of the reversal of the accounting adjustment, PTL was considered "Undercapitalized" for purposes of Prompt Corrective Action in August of 1998.

PTL submitted several capital restoration plans before the FDIC would approve an acceptable one. Components of the plan included discontinuing the wholesale loan division, which was the department that originated approximately 75 percent of PTL's loans for securitization purposes; reducing expenses; restructuring PAMM's debt to enable PAMM to divert a portion of the cash flow from its IORRs to PTL; and increasing capital through a public or private offering of debt or equity securities. PTL discontinued

the wholesale division; however, it was unable to generate sufficient income through its retail loan division to meet the overhead expenses. The attempt to raise capital failed and PTL was unable to restore the capital to an acceptable level. At the conclusion of the April 26, 1999 FDIC examination, PTL's Tier 1 Leverage Capital ratio was 1.54 percent with a Total Risk-Based Capital ratio of 1.01 percent. The State issued a demand for capital of approximately $1.9 million based on PTL's August 31, 1999 financial statements. PTL was unable to cure the deficiency, and the State closed the institution on November 19, 1999. One hour prior to the closure of the institution, PAMM declared bankruptcy.

ASSESSMENT OF DOS'S SUPERVISION OF PTL

PTL's designation as a problem institution did not begin with the subprime securitization process. When PTL was established, its business focus centered in residential lending. Over the years, various strategies were integrated into PTL's business plans, and PTL changed and expanded into other lending avenues in an attempt to achieve profitability. However, PTL did not become profitable, and problems emerged that required close attention by regulatory authorities. As illustrated by table 1, PTL was subject to regulatory actions beginning in 1992. The FDIC has been instrumental in recommending and taking supervisory actions in an effort to stem the various problems encountered by PTL.

We concluded that DOS was alert to the risks associated with PTL's IORRs. DOS's regulatory efforts demonstrated attempts to address these risks and the problems associated with the IORRs given the power, ability, and market information that were available to DOS at that time. In 1997, the IORRs were new to the market. There were no sources of readily available market information such as appropriate discount rates, historical default rates, or historical prepayment speeds. DOS examiners defined the risks; however, they were unable to locate accurate comparable data for these instruments in the public sector. Even though DOS adversely classified the IORRs beginning in 1997, they did not require a write-off of the IORRs until 1999 when historical data became available for comparative purposes.

On January 1, 1997, financial institutions implemented FAS 125, which permitted them to record the IORRs as assets on the institutions' books. FAS 125 also permitted the recording of the fair value of the anticipated future income to be derived from the IORRs as capital. This practice resulted in the rapid growth of Tier 1 Capital and a concentration in IORRs on PTL's books. Because of the IORRs' recent introduction into the financial markets, information on which to base a conclusive valuation was severely limited. DOS was thwarted in its efforts to ascertain a reliable valuation and supporting documentation from PTL's external CPA firm, which was assessing a value for the IORRs. Since PTL was an industrial loan company and did not meet the definition of a bank under the Bank Holding Company Act, PAMM was not considered a bank holding company. Therefore, PAMM was not regulated by any federal agency. The unregulated aspect of PTL's holding company permitted PAMM to continue borrowing funds in the

forms of lines of credit and cash advances on the IORRs to enable PTL to continue extending loans for securitization purposes. The risky venture into asset securitization and the debt leveraging from the parent assisted in further eroding PTL's capital base from which the institution was unable to recover.

DOS conducted timely safety and soundness examinations and visitations both independently and concurrently with the State banking authority. DOS appropriately applied the Prompt Corrective Action (PCA) provisions. Following the failure of PTL and in conjunction with the other regulatory authorities, DOS implemented examination guidance pertaining to IORRs and is in the process of recommending rulemaking amendments to the capital requirements outlined in Part 325 of the FDIC Rules and Regulations. The recommendations in this section of the report address these issues as well as methods to improve the examination process of industrial loan companies.

The Quality of PTL's Capital Base Was Negatively Impacted by the Implementation of FAS 125

The implementation of FAS 125 permitted entities that owned IORRs to record the IORRs as assets and the present value of the future anticipated, yet unrealized, income as part of their capital. Incorporating such income projections can result in an inflated capital base. The failure to realize these income projections can also have a devastating impact on an entity's capital position.

FAS 125 went into effect on January 1, 1997. FAS 125 established certain criteria regarding the control, accounting, and valuation of the transfer of financial assets. The cash flows associated with the retained interests in securitization activities were reclassified into servicing assets and interest only strips, securities, loans, other receivables, or retained interests in securitizations that could be contractually prepaid or settled in a manner such that the holder would not recover substantially all of its recorded investment. The retained interests represent the right to cash flows and other assets not used to extinguish bondholder obligations and pay credit losses, servicing fees, and other trust-related fees. FAS 125 specified that the retained interests should be reflected on the balance sheet as assets, and that the expected future cash flows should be included in income, which would be closed to the capital account at the end of the year. FAS 125 indicated that the best evidence of fair value is a quoted market price in an active market. In instances where a quoted market price is unavailable, the accounting rules allow for a fair value to be estimated. The estimate should be based on the best information available, and it must be supported by reasonable and current assumptions.

Because the retained interests were new in the financial markets, there was limited public information about them available. Information on default rates, discount rates, and prepayment rates of securitizations of subprime loans was not readily available for comparative purposes. Unexpected market events can dramatically affect the discount rates or the default rates, thereby affecting the value of the asset and impairing the collectability of the future income stream. The use of liberal and unsupported assumptions can result in material inaccuracies in financial statements and require

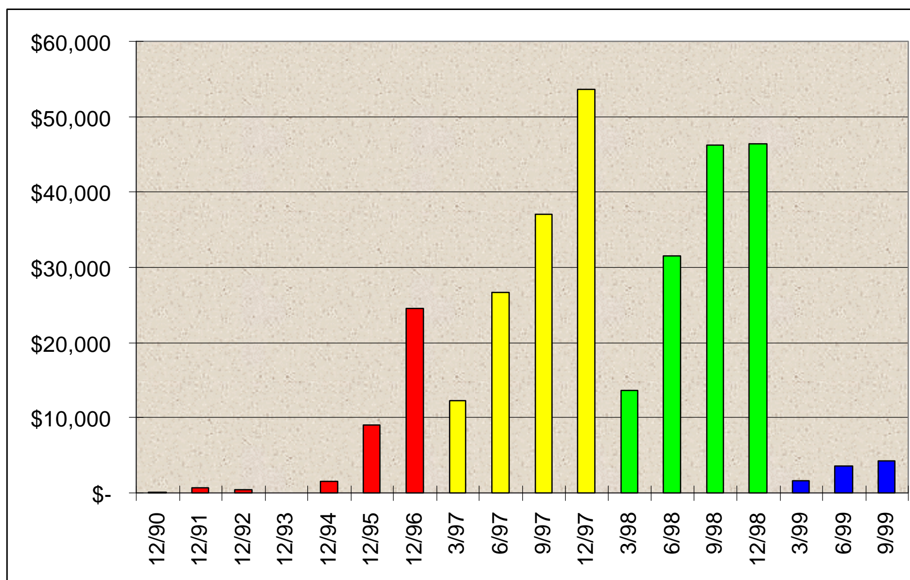
material write-downs of the retained interests. If the retained interests represent an excessive concentration of the institution's capital, material write-downs of the IORR asset can cause the demise of an institution.

PTL initially began selling subprime loans on a cash basis during the early 1990s. The only master agreement for the sale of loans that could be located for that time period was between PTL and Aames Capital (Aames), indicating that Aames was one of their primary purchasers during this period. Aames combined PTL's loans with loans purchased from other financial intermediaries and securitized them for sale to investors.

With the implementation of FAS 125 in 1997, PTL ceased selling subprime loans strictly for cash. PTL and PAMM, its holding company, developed an arrangement whereby PTL sold its loans to PAMM. PAMM, in turn, sold these loans to various securitizing entities including Aames, Advanta Mortgage (Advanta), and Merrill Lynch for a premium. Each sale to the three securitizing entities was governed by a master sales agreement. Although each agreement varied, each had a common thread. At the time of the sale, each entity would remit the equivalent of the principal value of the loans in cash. The IORRs represented the premium on the sale. Because of the immediate need for cash resources to continue the lending process, PAMM received cash advances on a portion of the IORRs. This cash represented part of the premium on the sale. The securitizing entities would take the cash flows from the IORRs to repay the cash advances before PAMM or PTL received any of its remaining shares of the IORRs.

PTL and PAMM had an agreement indicating each entity's pro rata share in its portion of the IORRs. PTL and PAMM recorded the values of the IORRs in accordance with FAS 125 using a discounted cash flow model. This cash flow model was based on assumptions, including discount rates, default rates, and prepayment rates, that PTL and PAMM made concerning the portfolio of subprime loans, which were composed of the securitized assets. The end result of the valuation process can be summarized simply as: the more liberal the assumptions, the higher the value of the IORRs.

Figure 3: Gain on Sale of Loans
($000's omitted)

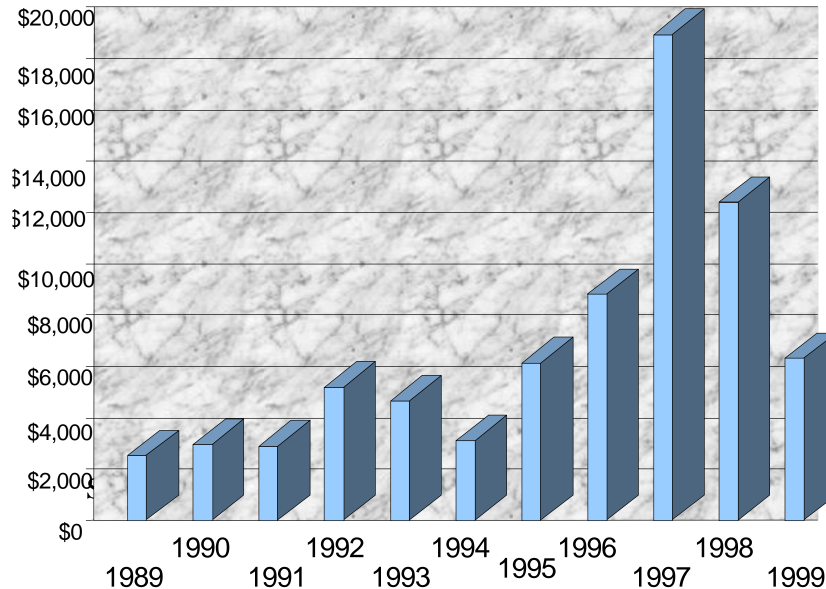


Source: Call Reports submitted to the FDIC by PTL. The values for the quarters for the years 1997, 1998, and 1999 are cumulative.

As indicated by figure 3, the gain recorded on the sale of the loans began to escalate in 1997 with the implementation of FAS 125. Although the trend tapered slightly in 1998 due to a decline in the demand for subprime loans caused in part by the Asian economic crisis, PTL was still actively engaged in the sale of subprime loans for securitization purposes.

Figure 4 reflects the increase in capital brought about by the increase in loan production and the gain on sale of loans associated with the IORRs. PTL's total equity capital increased 115 percent between December 31, 1996 and December 31, 1997. The increase is primarily attributable to the gains on the sale of loans which more than doubled from $24,489,000 in 1996 to $53,639,000 in 1997. Figure 4 reflects the marked increase in the equity capital account during 1997 and 1998 over prior periods. The principal risk associated with the income generated by the IORRs was the failure of the anticipated future income to materialize due to changing market conditions or through the use of flawed or liberal assumptions. One of the provisions in the FDIC's December 1998 Cease and Desist Order forced PTL to cease receiving IORRs as compensation for the sale of loans, which would require PTL to sell loans only for cash. Figure 4 indicates the substantial decline in equity once the income was arrested from its accelerated growth through the use of liberal assumptions associated with the IORRs in 1999.

Figure 4: Total Equity Capital ($000's omitted)



Tier 1 Leverage Capital Ratio Fails to Reflect the Risks Associated With IORRs

The Tier 1 Leverage Capital ratio is the benchmark used by regulatory agencies to begin determining the capital adequacy of a financial institution. Part 325 of the FDIC's Rules and Regulations details the specifics pertaining to the Tier 1 Leverage Capital ratio, including regulatory minimums. To arrive at the Tier 1 Leverage Capital ratio, total Tier 1 Capital is divided by Average Total Assets. Any income, whether realized or not, is included in the capital accounts and is therefore included in the calculation.

In the case of PTL, the projected future income on the IORRs, whether realizable or not, was recorded in accordance with FAS 125 and was included in the thrift's Tier 1 Capital. The average assets' value also increased; however, the value increased only by the amount of the IORRs that were recorded in the "Other Assets" category of the balance sheet. Only the numerical values of the IORRs were reflected in the ratio. The potential default and prepayment risks, which the IORRs may or may not have had to absorb, were not reflected in the Tier 1 Capital ratio. Therefore, the potential risks associated with these instruments were not accurately reflected in the Tier 1 Leverage Capital ratios.

The Risk-Based Capital Ratio Reflects the Risks Associated With IORRs

The Risk-Based Capital ratio is calculated by dividing its qualifying total capital base by its risk-weighted assets. In order to calculate the Risk-Based Capital ratio, risk-based assets are calculated by assigning assets and off-balance sheet items to broad risk categories. Even though PTL sold the loans to other entities, the IORRs provided a cushion against losses. Since the excess interest would absorb losses and protect the bond investors, the loans were considered "sold with recourse" and were used as off-

balance sheet items in the calculation of the Risk-Based Capital ratio. The inclusion of the converted loan balances caused an inordinate increase in the risk-based assets as opposed to the increase in capital, causing the Risk-Based Capital ratio to decline from the beginning of the securitization activities. Table 4 illustrates the relationship between the Risk-Based and the Tier 1 Leverage Capital ratios from the 1996 examination until the last examination of the institution.

Table 4: PTL's Capital Ratios 1996 - 1999

Capital Ratios	*12/31/96 State Exam*	*6/30/97 FDIC Exam*	*9/30/97 FDIC Visitation*	*3/31/98 Joint Exam*	*3/31/99 FDIC Exam*
Tier 1 Leverage Capital Ratio	8.31%	16.01%	14.30%	12.64%	1.54%
Tier 1 Risk Based Capital Ratio	10.05%	8.54%	8.01%	6.10%	0.62%
Total Risk Based Capital	11.30%	8.96%	8.43%	6.80%	1.01%

Source: FDIC Reports of Examination (1996 - 1999)

As indicated by the ratios in the table, the Tier 1 and Total Risk-Based Capital ratios never increased from the inception of the securitization process. These ratios reflected the risks inherent in the IORRs. The Tier 1 Leverage Capital Ratio, however, almost doubled with the onset of the securitization activities during 1997 before beginning its decline.

DOS Used Prompt Corrective Action Appropriately

The Congress enacted section 38 of the Federal Deposit Insurance Act, Prompt Corrective Action, to ensure regulatory intervention when an insured financial institution's capital declines below specified minimum levels. Following the September 26, 1994 examination, a Prompt Corrective Action letter notified PTL that it was critically undercapitalized pursuant to section 38 of the FDI Act. The letter noted that PTL was subject to the mandatory requirements of section 38 as of October 31, 1994. This meant PTL would have to submit a capital restoration plan; restrict asset growth, acquisitions, new activities, and branches; and limit the payment of dividends or other capital distributions, management fees, or senior executive compensation. The letter further stated that the FDIC would place the thrift in receivership as of March 19, 1995 unless it was determined that an alternate course of action would better serve the purposes of section 38. PAMM made a capital injection and PTL restructured its expenses, which generated $700,000 prior to December 31, 1994. PAMM injected additional capital in early 1995 and the thrift was adequately capitalized by March 31, 1995.

From 1995 through 1997, PTL maintained its capital levels in such a way as to preclude notification under PCA. However, the FDIC notified PTL of its non-conformance with

PCA capital requirements twice in 1998 and again in 1999. Proper notification procedures were used to apprise PTL of its capital condition.

Interagency Examination Guidance and Other Regulatory Actions

Following the failure of PTL, all of the federal regulators issued a Financial Institution Letter (FIL) entitled *Interagency Guidance on Asset Securitization Activities*, which was released on December 13, 1999. The FIL outlines the risks associated with asset securitizations, the fundamental management controls that should be operating in institutions engaged in asset securitizations, and the examination treatment afforded to IORRs whose valuations do not meet the regulatory guidelines. In addition, the federal regulatory authorities have instituted a rulemaking process and drafted amendments to the regulatory capital standards that would not permit the inclusion of IORRs based on subprime securitizations in assets or capital unless certain specified criteria are met.

Conclusion

Even though the Risk-Based Capital ratios indicated the potential exposure in the IORRs, the Tier 1 Leverage Capital Ratio did not reflect the speculative nature of these investments. Examiners use the Tier 1 Leverage Capital Ratio as the starting point for evaluating the adequacy of capital. If the ratio does not indicate the potential risks posed by IORRs, the capital adequacy of an institution may be overrated. If examiners are to assess the true safety and soundness of financial institutions, the earnings and capital cannot be inflated by potentially unattainable income.

Recommendation

We recommend that the Director of the Division of Supervision:

(1) Continue to pursue amending the capital standards to exclude IORRs based on subprime securitizations from the calculation of Tier 1 Leverage Capital.

Concentration in High-Risk IORRs Contributed to PTL's Insolvency

The implementation of FAS 125 acted as a catalyst for the growth of the IORRs, which soon became a concentration of PTL's capital. As a result of recording the values for the IORRs, PTL's asset and capital bases began to expand. Soon, the IORRs represented a large portion of total assets, several times larger than PTL's capital. This undue reliance on one asset that represented in excess of 100 percent of PTL's capital soon became a formidable force that PTL was unable to control.

FAS 125 lists the criteria for including IORRs as assets on an institution's records. It also specifies the criteria for projecting and including the potential future income stream as part of an entity's capital. However, FAS 125 is silent pertaining to maximum amounts that may be safely incorporated in an entity's balance sheet without jeopardizing the integrity of its financial structure. The implementation of FAS 125 permits institutions to

capture the present value of the future income stream in the current period. This practice can assist in fueling asset and capital growth and expansion even though this future income is not guaranteed to materialize.

During the period of 1997 until PTL's closure, regulatory guidelines did not address specifics pertaining to minimum or maximum amounts of IORRs that financial institutions could safely retain as part of their financial makeup. Regulatory examination reports can include a "Concentrations Page" that lists credits or items that exceed 25 percent of Tier 1 Capital as a means of identifying potential problem areas. Each of the FDIC's full scope regulatory examination reports from 1997 until PTL's closure listed the IORRs as a concentration.

Various formal and informal supervisory actions implemented from 1997 until 1999 addressed the concentration problem and required reductions in the outstanding IORR balance. In addition to the increasing net income, which effectively raised capital, PAMM also infused capital contributions in an attempt to reduce the IORR concentration. However, the rapid expansion of the IORRs due to management's focus on this avenue as its principal business endeavor rendered management either unable or unwilling to comply with the provisions of the enforcement actions.

Table 5 illustrates the various balances of the IORRs, total assets, and total capital since the implementation of FAS 125. As indicated by table 5, the balance of the IORRs habitually exceeded 25 percent of the institution's total capital, which would cause the IORRs to be considered a concentration and represented more than an inordinate percentage of PTL's asset base.

Table 5: Quarterly Values for the IORRs, Total Assets, and Equity Capital ($000's omitted)

Date	*IO Residual*	*Total Assets*	*% of IO Residual to Total Assets*	*Total Equity Capital*	*% of IO Residual to Total Equity Capital*
03/31/97	10,802	97,486	11.08	15,713	68.75
06/30/97	17,469	114,306	15.28	17,362	100.62
09/30/97	22,513	126,346	17.82	17,683	127.31
12/31/97	29,205	160,333	18.22	18,914	154.41
03/30/98	37,058	151,225	24.51	19,325	191.76
06/30/98	46,107	167,237	27.57	19,393	237.75
09/30/98	47,103	181,594	25.94	18,017	261.44
12/31/98	49,246	181,229	27.17	12,382	397.72
03/31/99	48,401	155,083	31.21	10,206	474.24
06/30/99	48,852	146,189	33.42	8,690	562.16
09/30/99	48,847	127,342	38.36	6,298	775.60

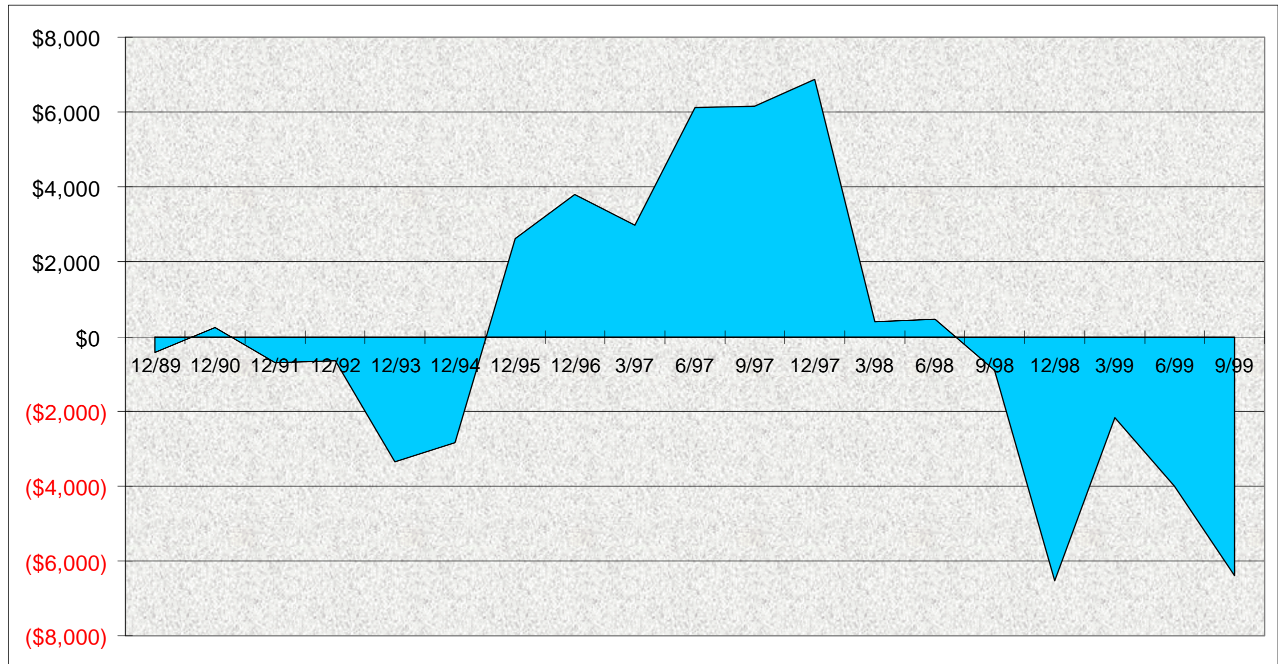
Source: Call Reports (1997 - 1999) submitted to the FDIC by PTL.

The IORRs aspect of the securitization process consumed PTL's business strategy. In the fall of 1998, the Asian economic crisis caused a downturn in the securitization markets. One of the hardest hit activities was the subprime lending area. The securitizing firms

could not sell the securities composed of subprime loans to investors. As a result, the market for purchasing subprime loans from financial intermediaries declined. Because of its heavy concentration in subprime loan holdings, PTL was faced not only with dwindling income and declining capital but with severe liquidity concerns as well. PTL could not sell the loans on its books; therefore, additional loans could not be extended because of PTL's limited cash resources. Since the subprime securitization business consumed the largest percentage of the thrift's business activities, income from other sources was insufficient to maintain the institution's capital at acceptable levels.

Figure 5 illustrates the surge in net income due to the recording of the income associated with the IORRs during 1997, its rapid decline during the Asian economic crisis in 1998, and its continued downward spiral after the practice of retaining IORRs ceased. Because of the intense concentration in this one business venture of IORRs, PTL was unable to derive income from other sources in sufficient quantities to maintain adequate capital levels, which ultimately led to the thrift's closure.

Figure 5: Net Income ($000's omitted)



Source: Call Reports submitted to the FDIC by PTL.

Conclusion

Despite banking regulators' attempts to curtail the concentration in the IORRs through criticisms in the Reports of Examination and by issuing various enforcement actions, PTL took limited actions to reduce the concentration in the IORRs. The FDIC did not have any policies or procedures in place governing the volume of IORRs in relation to total capital that an institution could hold. In order to protect financial institutions from the risks in IORRs, acceptable parameters of IORRs to capital need to be developed. In

the event that the proposed rulemaking for amending Part 325 takes an extended amount of time, DOS needs to devise a method to limit the amount of IORRs held by financial institutions as a percent of capital.

Recommendation

We recommend that the Director of the Division of Supervision:

(2) Develop an approach for limiting interest-only residuals to an amount that will not impair the capital protection of the institution.

Parent Companies of Industrial Loan Companies Escape Inclusion Under the Bank Holding Company Act and Are Unregulated Entities

Because of the unique characteristics of industrial loan companies, their parent or holding companies are not subject to the Bank Holding Company Act (BHCA) and are therefore unregulated by federal banking authorities. PTL was an industrial loan company organized under the California Industrial Loan Laws. As an industrial loan company, PTL issued "thrift certificates," which are similar to a bank's certificates of deposit. However, PTL did not accept demand deposits, including items such as checking accounts that permit the withdrawal of funds from an account by a third party. PAMM was the holding company that owned the stock of PTL. The BHCA lists a definition for "banks." Entities that do not accept demand deposits are not considered banks under the BHCA. Even though PAMM owned PTL, a financial institution, PTL was not considered a bank. Therefore, since PTL was not considered a bank for purposes of the BHCA, PAMM was excluded from the provisions of the BHCA. PAMM was not regulated as a bank holding company and was not examined by any bank regulatory agency.[2]

Because of PTL and PAMM's unique working relationship, operating from the same physical locations and using the same management team and loan personnel, it appeared that the entities were not separate and distinct companies. The lines became blurred and management viewed the two entities as one operating concern.

Even though PAMM was not subject to the BHCA provisions, its activities were restrained by the Federal Reserve Act since it was considered an "affiliate" of PTL. Since 1993, the FDIC cited PAMM for numerous violations of the Federal Reserve Act's Sections 23A and 23B, which pertain to transactions between financial institutions and their affiliated entities. PAMM was able to borrow money to advance the growth of PTL's loan underwriting of subprime loans in order to facilitate the securitization process to the third-party securitizers. These borrowings aided in increasing the asset size of PTL by providing the cash resources so PTL could extend credit, then subsequently sell the loans for securitization and retain portions of the IORRs for PTL and PAMM. The

---

[2] Bank holding companies under the purview of the Bank Holding Company Act of 1956 are examined and regulated by the Federal Reserve Board.

California Industrial Loan Laws precluded PTL from directly borrowing the substantial amount of funds that PAMM was able to access. PTL's management was able to circumvent the industrial loan laws by allowing PAMM to become the borrower. While PAMM was incurring monumental amounts of debt, no federal agency was present to regulate these activities. The major problem with the borrowing arrangement was whether or not PAMM had the financial wherewithal to repay the debt on a stand-alone basis without relying on PTL for financial support. Also, PAMM's portion of the IORRs may not have been sufficient to retire the debt. PTL was deferring the receipt of any cash flow until PAMM's debt was extinguished. If the cash flows were less than the forecasted amounts, both portions of the IORRs may have been required to service the debt. Therefore, neither PTL nor PAMM would receive any cash flow from the IORRs.

There were numerous financial transactions between PAMM and PTL. In addition to PAMM's borrowings, there were transactions pertaining to the purchase and sale of loans between the parent and its subsidiary. Also, the cash advances received from the securitizing firms were downstreamed from PAMM to PTL. PAMM also made numerous capital contributions to PTL, including one that required reversing by the regulators because of its failure to conform with generally accepted accounting principles. Finally, there were the intercompany agreements between PTL and PAMM regarding the percentage ownerships in the IORRs and the pledging of PTL's assets to secure PAMM's debt. All of these financial transactions occurred without the benefit of regulatory oversight prior to their occurrence.

In January 1998, the DOS San Francisco Regional Office (SFRO) contacted the FDIC's Legal Division to determine whether the FDIC could examine PAMM at the next safety and soundness examination of PTL. The most recent examination of PTL revealed serious concerns about its operations and transactions with PAMM. Specifically, PAMM was providing a number of services for PTL and was, in turn, entitled to a share of certain assets. The April 27, 1998 examination included a review of transactions between PTL and PAMM. The examination revealed a transaction whereby PAMM was accepting responsibility for PTL's income tax liability and considering that amount to be a capital contribution to PTL. This transaction was promptly disallowed by the regulators and reversed from PTL and PAMM's records. Also, apparent violations of Sections 23A and 23B of the FRB's regulations, transactions with affiliates, were also noted.

In 1998, the FDIC's Legal Division responded to an inquiry by DOS and informed DOS that it had access to PAMM through section 10(b) of the FDI Act. DOS did not need any special intervention from the Legal Division to obtain access to the records of the holding company. The Legal Division representative also stated that if such a situation should arise with DOS needing access to a holding company's records, examiners should contact the Legal Division and apprise them of the circumstances so that the Legal Division would be prepared if the situation between the examiners and the institution should escalate.

Conclusion

Because of the unregulated nature of holding companies associated with industrial loan companies (ILCs), the transactions between the two entities may not be routinely subject to review by regulatory agencies. Since access to the holding companies is available under section 10(b) of the FDI Act, it is imperative that material transactions between unregulated holding companies and their banking subsidiaries be reviewed by regulators during safety and soundness examinations.

Recommendations

We recommend that the Director of the Division of Supervision:

(3) Send a memo to DOS staff reminding them that they have access to examine the records of affiliated entities under section 10(b) of the FDI Act.

(4) Instruct DOS examiners that when they examine industrial loan companies, DOS should routinely review intercompany transactions with unregulated holding companies.

Lack of Access to External Accounting Firm's Workpapers Further Delays DOS's Assessment of the Valuation of the IORRs

DOS was unable to access the workpapers of the external accounting firm that was performing the external valuations of the IORRs. Since the IORRs had no active market, PTL relied on its own internal model and the external valuations to assess the values of the IORRs. Because DOS examiners could not initially review Ernst and Young's (E&Y) workpapers, they were unable to obtain a full understanding of the process used by E&Y, review the derivation of the variables used by E&Y, and fully comprehend E&Y's conclusions.

<u>PTL Instructed to Obtain an Independent Valuation</u>

As discussed earlier, PTL actively began their securitizing activities in 1997 with the advent of FAS 125. When the first examination, dated March 3, 1997, was conducted after the securitizing activities began, there was little information available to the examiners regarding a valuation of the IORRs. After the completion of the March 1997 examination, the exam report recommended that PTL obtain a valuation of the IORRs from an independent third party. PTL obtained an external valuation, which was reviewed at the September 30, 1997 FDIC visitation. The visitation indicated that the independent IORR model had several deficiencies, including flawed assumptions regarding the prepayment, discount, and historical loss rates. A proposed MOU was pending in early 1998 that would require PTL to obtain an independent third party valuation. The proposed MOU included a provision for PTL to obtain prior written consent from the FDIC before entering a contract for an annual independent valuation of the IORRs. PTL submitted a February 18, 1998 proposal from E&Y to the SFRO. After

reviewing the proposal, the DOS case manager believed that the proposal was inadequate to provide a valuation to satisfy the FDIC's requirements. PAMM was under time constraints to meet the deadline for filing its 10K the quarterly report with the Securities and Exchange Commission (SEC). Because of these extenuating circumstances relating to the timely submission of PAMM's 10K report, the FDIC agreed to remove from the proposed MOU the provision requiring FDIC consent prior to entering a contract for an independent valuation. A revised MOU was subsequently issued requiring an independent third-party valuation. PTL selected E&Y to conduct the valuation, even though E&Y's earlier proposal was considered unacceptable by the SFRO personnel because of its failure to address all of the pertinent issues surrounding the IORRs.

The FDIC did not receive a signed copy of the engagement letter/agreement between PAMM and E&Y and was not certain of the exact nature of the work contracted between the two parties or the type of work actually performed. In performing this material loss review, we were unable to locate a copy of the final agreement. A follow-up letter to PTL from E&Y dated May 11, 1999, stated, "We utilized the information provided to us as well as information gathered from public sources to objectively and independently prepare the prepayment, default and discount rate assumptions included in our report."

Table 6 indicates the dates of the various valuations received by PTL from E&Y and the terminology used in the reports to describe the type of work performed by E&Y.

Table 6: E&Y Valuation Reports

Valuation Date	*Date of Report*	*Terminology Describing the Work Performed*
12/31/97	3/9/98	"…an analysis of the fair market value…"
5/31/98	7/13/98	"…an analysis of the fair market value…"
8/31/98	10/29/98	"…an analysis of the fair market value…"
11/30/98	1/20/99	"…has calculated the present value…"
12/31/98	3/1/99	"…has calculated the present value…"
2/28/99	5/6/99	"…has performed certain agreed upon procedures relating to the calculation…"
6/30/99	10/25/99	"…has performed certain agreed upon procedures relating to the calculation…"

Source: E&Y's Valuation Reports (1997-1999)

The valuations received prior to April 1999 consisted of the total IORRs held by PTL and PAMM. Consideration for the repayment of the cash advances was not included in the valuation. In April 1999, DOS informed PTL that an independent valuation of PTL's net amount of the IORRs (PTL's total percentage portion less the repayment of the cash advance) must be obtained. The DOS case manager conducted a follow-up telephone conversation with an individual from E&Y who was responsible for the oversight of the valuation to ensure that E&Y fully understood exactly what the FDIC wanted in the valuation. The E&Y representative then informed the case manager that E&Y had not performed "valuations." Instead, E&Y's work consisted of providing "agreed upon procedures" calculations, which meant that E&Y performed the calculations based on

assumptions derived by PAMM and PTL. After several inquiries, the E&Y representative informed the case manager that E&Y would not be conducting a net calculation strictly for PTL's portion of the IORR. Even though the first three "valuations" (3/98, 7/98, 10/98) expressly stated that they represented a "fair market analysis" of the IORRs, E&Y stated that the values were calculations based on assumptions provided by PTL and PAMM's management. Agreed upon procedures would not meet the terms of the 1998 MOU or the subsequent 1998 Cease and Desist Order.

A letter dated June 8, 1999 from E&Y indicates how E&Y defined the term "agreed upon procedures." The letter stated that E&Y asked two of the "big five" accounting firms if they were issuing fair market value opinions on IORRs. The firms indicated that work on valuations of IORRs were based on "agreed upon procedures" which was the common form of analysis. This approach uses a discounted cash flow methodology, which according to E&Y is the accepted methodology for valuing cash flow interests.

FAS 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, details the specifics for recording the value of IORRs. Paragraph 42 describes the fair value of an asset as the amount for which the asset can be purchased or sold in an active market. Paragraph 43 states that in the absence of an active market, the estimate of fair value can be determined based on the best information available in the circumstances. FAS 125 states that an example of an acceptable valuation technique is the present value of estimated expected cash flows using a discount rate commensurate with the risks involved. Based on E&Y's description of their process, we believe the valuation techniques used by E&Y went beyond agreed upon procedures and complied with procedures for obtaining a "fair value" according to FAS 125. However, the assumptions E&Y used in their calculations were optimistic and unsupported.

DOS Attempts to Gain Access to E&Y's Model and Workpapers

During the April 27, 1998 examination, DOS examiners attempted to obtain acess to E&Y's model so that they could determine how the process worked if different variables or assumptions were used. DOS examiners also wanted to review E&Y's workpapers so they could determine exactly how E&Y derived several of the assumptions used in the valuation process and to garner a better understanding of E&Y's conclusions. E&Y refused to allow DOS access to its model, stating that the model was proprietary. Also, E&Y refused to allow DOS access to its workpapers, stating that they were not available for third-party review.

In January 1999, the SFRO sent an inquiry to the FDIC's Legal Division for assistance in gaining access to E&Y's workpapers and the model used to value the assets. On March 12, 1999, the DOS drafted a letter to E&Y requesting access to the workpapers. On March 22, 1999, E&Y responded that DOS could review the workpapers with a representative from E&Y present and that selected items could be copied. At the April 26, 1999 examination, the examiners were able to review the historical default rates and

the actual prepayment rates of the IORRs and compare the values with the assumptions used by PTL and E&Y. DOS discovered that the actual default and prepayment rates were much higher than the assumptions used by E&Y or PTL.

The DOS Examiner-in-Charge of the examination gave a detailed presentation to PTL's Board on July 26, 1999, demonstrating the effects on the value of the IORRs using actual performance versus using PTL and E&Y's assumptions. E&Y countered with a presentation indicating support for its assumptions in valuing the IORRs. Nevertheless, E&Y's presentation did not dissuade DOS examiners, and they classified a portion of the IORRs "Loss" and the balance "Doubtful."

Conclusion

When DOS agreed to modify the MOU by eliminating their approval of PTL's contract for calculation of the IORRs, DOS also eliminated its means of assuring that the work performed would fully address its supervisory concerns. Since DOS did not receive a signed formal copy of the engagement agreement/letter between PTL and E&Y, DOS was unable to distinguish exactly the type of services that were being performed for the institution. Because the verbiage in the earlier reports referred to "valuations," DOS believed that E&Y was providing services required by the MOU and the C&D even though E&Y later disputed this claim. Because of the disputes arising from this situation, we believe controls should be implemented to specify exactly what is required or expected from third parties to preclude future disagreements surrounding actions that the FDIC requests of an institution.

Recommendation

We recommend that the Director of the Division of Supervision:

(5) Issue instructions that when DOS directs a financial institution to contract with a third party to perform additional work to clarify an issue for the FDIC, DOS should implement procedures to ensure that the parameters of the work to be performed are responsive to the requirements established by the FDIC and that provisions will be included allowing the FDIC access to all pertinent workpapers.

DOS'S ACTIVITIES IN RESPONSE TO RECENT BANK FAILURES

The failures of BestBank in Boulder, Colorado; First National Bank of Keystone in Keystone, West Virginia; and Pacific Thrift and Loan Company in Woodland Hills, California were either related to subprime lending and securitization activities or both. DOS, in conjunction with the other federal regulators, has developed and implemented several examination policies and procedures addressing the risks associated with these activities. Also, DOS and the other regulatory agencies have initiated a rulemaking process to re-evaluate the inclusion of IORR income based on subprime securitizations in the capital accounts of financial institutions. DOS has instituted study aids for examiners

and case managers to familiarize them with IORRs. Table 7 sumnmarizes DOS's recent and planned initiatives in the area of subprime lending and asset securitization.

Table 7: DOS Initiatives

DATE	GUIDANCE
March 1, 1999	Interagency Guidance on Subprime Lending FIL-20-99
August 1, 1999	Revisions to Capital Markets Examination Handbook; Modifications to Chapters Covering: ❑ Mortgage Derivative Securities ❑ Asset-Backed Securities ❑ Structured Notes ❑ Securitization Chapter
October 12, 1999	Interagency Guidance on High Loan-to-Value Residential Real Estate Lending FIL-94-99
December 13, 1999	Interagency Guidance on Asset Securitization Activities FIL-109-99
January 24, 2000	Subprime Lending Examination Procedures DOS Memorandum
February 28, 2000	Securitization Examination Procedures DOS Memorandum
March 6, 2000	Retained Interests Self-Study Guide DOS Securities, Capital Markets, & Trust Branch
May 16-19, 2000	Regional Capital Markets and Securities Specialist Seminar will include 2 days of training with a particular emphasis on retained interests.
Draft Form	Action: Notice of Proposed Rulemaking Capital; Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Retained Interest

Source: DOS

DOS has implemented measures to combat potential abuses of emerging capital markets issues. It is developing methods to enhance the knowledge and skills of the DOS examination force. DOS is also seeking regulatory remedies to protect the integrity of financial institutions' capital structures through current rulemaking initiatives. The OIG is supportive of DOS's actions in achieving their immediate results and continues to support their ongoing efforts to protect the bank insurance fund.

CORPORATION COMMENTS AND OIG EVALUATION

On May 26, 2000, the Director, DOS, provided a written response to the draft material loss review. The Director, DOS, stated that he concurs with the report's recommendations. The Corporation, in conjunction with the other federal regulators, has initiated proposed rulemaking to limit and/or eliminate the inclusion of IORRs associated with subprime securitizations in the calculation of Tier 1 leverage capital and to place restrictions on the amount of IORRs that can be retained as a percentage of capital. The Director, DOS, has agreed to send a memorandum reminding examiners of their authority to examine affiliated entities under section 10(b) of the FDI Act. The Director, DOS, also stated that a short e-mail would be sent to the Regional Directors in the three regions (San Francisco, Dallas, and Kansas City) that currently have ILCs that show no bank holding company affiliation reminding them to review pertinent transactions between the holding companies and the ILCs. DOS agreed to draft procedures governing work contracted by financial institutions with third parties to ensure that the parameters of the work to be performed are responsive to the requirements established by the FDIC and that provisions will be incorporated allowing the FDIC access to all pertinent workpapers.

The Corporation's response to the draft report and subsequent conversations with management provided the elements necessary for management decisions on the report's recommendations. Therefore, no further response to this report is necessary. Appendix II presents management's response to the draft report and Appendix III presents management's proposed actions on our recommendations and shows that there is a management decision for each recommendation in this report.

GLOSSARY

Affiliate	Any individual or organization that can exercise "corporate control" over a bank through stock ownership or positions on the Board of Directors as defined by section 23A of the Federal Reserve Act.
Bankruptcy-remote Entity/ Special Purpose Corporation	In the asset securitization process, the loan originator sells and transfers the pools of assets to either a bankruptcy-remote entity, which is like a grantor trust or a special purpose corporation. They will issue the securities or ownership interests in the cash flows of the underlying collateral. These corporate structures pay the originator for those assets with the proceeds from the sale of the securities. They are typically protected from bankruptcy by various structural and legal arrangements. They are usually unrelated to the originator and its sole assets are those being securitized.
CAMEL(S) Rating	The FDIC and other financial institution regulators use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance. Areas of financial and operational concern are evaluated and given a numerical rating of "1" through "5," with "1" having the least concern and "5" having the greatest concern. The performance areas, identified by the CAMEL acronym are: Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity. A sixth component, Sensitivity to Market Risk, was added in December 1996 changing the acronym to CAMELS.
Call Report	An institution's quarterly Consolidated Report of Condition and Income which contains a balance sheet, income statement, and other detailed financial schedules containing information about the institution.
Cease and Desist Order (C&D)	A formal enforcement action issued by a financial institution's regulator's to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated by the regulator when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

<table>
<tr><td rowspan="6">Composite Rating</td><td colspan="2">An overall rating given to a bank based on the six components of the CAMELS rating. A rating of “1” through “5” is given, with “1” having the least regulatory concern and “5” having the greatest concern. A description of the ratings is as follows:</td></tr>
<tr><td>Rating “1”</td><td>Indicates strong performance, significantly higher than average.</td></tr>
<tr><td>Rating “2”</td><td>Reflects satisfactory performance, performance which is average or above: this includes performance that adequately provides for the safe and sound operation of the bank.</td></tr>
<tr><td>Rating “3”</td><td>Represents performance that is flawed to some degree and as such is considered fair. It is neither satisfactory nor unsatisfactory but is characterized by performance that is below-average quality.</td></tr>
<tr><td>Rating “4”</td><td>Refers to marginal performance, significantly below average. If left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.</td></tr>
<tr><td>Rating “5”</td><td>Considered unsatisfactory; performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, threatens the viability of the institution.</td></tr>
<tr><td>Concentration</td><td colspan="2">A concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the FDIC's Report of Examination. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital.</td></tr>
<tr><td>Credit Enhancements</td><td colspan="2">Credit enhancements may be either internal or external. Internal enhancements are created by redirecting internal cash flows. Examples include senior-subordinate structures and cash reserve accounts funded by the originator. External credit enhancements are not dependent on redirecting internal cash flows. Examples include letters of credit issued by banks, surety bonds issued by insurance companies, guarantees issued by financial assurance companies, and subordinated loans from third parties.</td></tr>
<tr><td>Division of Resolutions and Receiverships (DRR)</td><td colspan="2">The division of FDIC which exists to plan and efficiently handle the resolutions of failing FDIC-insured institutions and to provide prompt, responsive, and efficient administration of failing and failed financial institutions.</td></tr>
<tr><td>Leverage Capital</td><td colspan="2">Banks must maintain at least the minimum leverage requirement set forth in Part 325 of the FDIC Rules and Regulations. The minimum leverage requirement consists only of Tier 1 (Core) capital.</td></tr>
</table>

Memorandum of Understanding (MOU)	An informal administrative action between a bank's Board of Directors and the regulators to take certain corrective actions on specific regulatory concerns. The termination of an MOU should be considered when the bank's overall condition has significantly improved and the bank has substantially complied with its terms.
Par Value	The nominal or face value of a stock or bond certificate or loan. It is expressed as a specific amount marked on the face of the instrument. Par value is not related to market value, which is the amount a buyer is willing to pay for an item.
Prompt Corrective Action (PCA)	Section 38 of the FDI Act establishes a framework for taking prompt supervisory actions against insured banks that are not adequately capitalized. The following categories and minimum ratio requirements are used to describe capital adequacy: Well Capitalized: Total risk-based capital ratio of 10% or greater; and Tier 1 risk-based capital ratio of 6% or greater; and Leverage ratio of 5% or greater; and is not 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, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure. Adequately Capitalized: Total risk-based capital ratio of 8% or greater; and Tier 1 risk-based capital ratio of 4% or greater; and Leverage ratio of 4% or greater or 3% or greater if the bank is rated composite "1" under the CAMELS rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth. Undercapitalized: Total risk-based capital ratio that is less than 8%; or Tier 1 risk-based capital ratio that is less than 4%; or Leverage ratio that is less than 3% if the bank is rated Composite "1" under the CAMELS rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth. Significantly Undercapitalized: Total risk-based capital ratio that is less than 6%; or Tier 1 risk-based capital ratio that is less than 3%; or Leverage ratio that is less than 3%. Critically Undercapitalized: Tangible equity to total assets ratio that is equal to or less than 2%.

Risk-Based Capital	A "supplemental" capital standard under part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Risk-Weighted Assets	A system of calculating the risk-weighting of assets by assigning assets and off-balance sheet items to broad risk categories.
Section 10(b) of the FDI Act	Section 10(b) lists the power of the Board of Directors to appoint examiners to conduct regular and special examinations of financial institutions. Also, examiners shall have the power, on behalf of the Corporation, to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully the relationship between the institution and its affiliate and the effect of the relationship on the institution.
Section 10(c) of the FDI Act	Section 10(c) of the FDI Act authorizes the appropriate federal banking agency to administer oaths and affirmations, and to examine and take and preserve testimony under oath as to any matter with respect to the affairs or ownership of any such bank, institution or affiliate.
Section 23(A) of the Federal Reserve Act	Section 23(A) of the Federal Reserve Act establishes restrictions on transactions between financial institutions and their affiliates. They include restrictions on the amount of the transactions and collateral requirements for certain transactions with affiliates.
Section 23(B) of the Federal Reserve Act	Section 23(B) of the Federal Reserve Act also places restrictions on transactions with affiliates. It requires transactions to be on the same terms and standards or at least as favorable as those prevailing for comparable transactions with a nonaffiliate. In the absence of comparable transactions, they must be on terms and circumstances that in good faith would be offered to or apply to nonaffiliated companies.
Sold With Recourse	A general ledger term meaning that the purchaser of a financial asset from an original creditor has a claim on the original creditor in case the debtor defaults. Specific arrangements to provide recourse arise in a variety of innovative transactions, including various types of securitized assets. Such arrangements can take many forms, including an explicit guarantee that credit losses will be reimbursed or the assets will be replaced by assets of similar quality, or indemnification by a third-party guarantor for any losses.
Subprime borrower	A borrower whose credit is below good credit standards and whose loans are usually referred to as marginal, nonprime or below "A" quality loans. These borrowers pose a greater risk and are characterized by paying debts late, filing for personal bankruptcy and/or having an insufficient credit history.

Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations and is the sum of : • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus** • Intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g) of the FDIC Rules and Regulations.
Tier 2 (Supplemental) Capital	Tier 2 Capital is defined in Part 325 of the FDIC Rules and Regulations and is generally the sum of: • Allowances for loan and lease losses, up to a maximum of 1.25% of risk-weighted assets; • Cumulative perpetual preferred stock, long-termed preferred stock and related surplus; • Perpetual preferred stock (dividend is reset periodically); • Hybrid capital instruments; and • Term subordinated debt and intermediate-term preferred stock.
Tier 1 Leverage Capital Ratio	Tier 1 Capital divided by total assets.
Total Risk-Based Capital ratio	The total qualifying capital divided by risk-weighted assets.
Uniform Bank Performance Report (UBPR)	A report prepared by FDIC comparing an individual bank with its peer Group banks.
Warehousing	The borrowing of short-term funds by a mortgage banker, using permanent mortgage loans as collateral. This interim financing is used to carry mortgages in inventory until they are sold and delivered to a permanent investor.

APPENDIX I

A DETAILED DISCUSSION OF THE SECURITIZATION PROCESS

The Securitization Process and the Parties Involved

In its simplest form, the securitization process begins by segregating loans into homogeneous pools with respect to cash flow characteristics or risk profiles. These pools are then transferred to a bankruptcy-remote entity such as a special purpose corporation that issues securities in the underlying collateral. There are several intervening roles that are interspersed between these two steps. Some of the different roles included in the securitization process are those of servicers, trustees, and guarantors. Each security issue has a servicer who is responsible for collecting the principal and interest payments and for transmitting these funds to either a trust or to the investors. A trustee monitors the activities of the servicer to ensure that it properly fulfills its responsibilities. A guarantor may be involved in the process. The guarantor's responsibility is to ensure that investors receive their payments in a timely manner, even if the servicer has not collected the funds from the obligors.

Credit Enhancements Increase the Protection Against Losses to the Investor

The structure of a mortgage backed security (MBS) and the terms of investors' interests in the collateral can vary considerably. They will depend on factors such as the type of collateral, the wants and needs of investors, and the use of credit enhancements. Often the securities are structured to re-allocate the risks entailed in the underlying collateral into subparts or tranches that match the needs of the investors.

For example, two classes of tranches may be offered on an MBS. The first tranche is a senior class. The second tranche is a junior or subordinated class. The senior tranche has more protection against credit losses than the junior subordinated tranche since it will receive its payments first and the junior class will absorb any of the initial losses before the senior class absorbs any losses. Therefore, as the interest rate paid is in proportion to the level of risk accepted, the interest rate paid on the senior tranche will be less than the interest rate paid on the junior tranche. After the requirements of the senior class are fulfilled, the junior class will receive any remaining cash flow from the securities. The higher risk of loss to the junior class is rewarded with a potential higher return on investment. Generally, the higher the risk, the higher the potential return. Therefore, the structure of an MBS offers one form of protection against losses.

Other ways to enhance the senior classes are with credit enhancements. Privately issued MBSs generally rely on a form of credit enhancement provided by the originator or a third party to protect investors from credit losses. Recourse provisions are guarantees that require the originator to cover any losses up to a contractually agreed-upon amount. These provisions are usually in the form of a spread account. This is an account that is

established with the difference between the interest earned on the assets in the pool and the interest that is paid out to investors. These funds accumulate to an agreed-upon level to protect against losses in the securities. This interest spread is accumulated to repay investors in the event that unexpected losses occur. Overcollateralization is another form of credit enhancement. This occurs when the value of the underlying assets exceeds the face value of the security. Because the collateral is worth more than the amount owed to investors, there is a margin of protection against unanticipated losses.

Interest-Only Residuals: A By-Product of the Securitization Process

Other types of financial instruments may arise as a result of the securitization process. One of these is the residual interest. The residual interest represents claims on the cash flows that remain after all obligations to investors and any related expenses have been paid, which normally include funds to build reserves and pay loan losses, servicing fees, and liquidation expenses. When the loans for the pools originate, they bear a stated interest rate. The securities are issued to investors at a lower rate than the stated rate on the loans. The difference between the rate that the loans are paying versus what the pools are paying to investors is called the residual. Residuals may be retained by the sponsors of the securities or purchased by investors in the form of securities known as interest-only strips. Table 8 illustrates a simplified calculation for excess residual interest.

Table 8: Calculation of Excess Residual Interest

BEGIN WITH:	Gross Interest
LESS:	Pass Through Rate to Investors
	Delinquency Advances (Net of recoveries)
	Servicer's Fees
	Servicing Advances & Liquidation Expenses
	Reserve Deposits
	Realized Losses
PLUS:	Prepayment Penalties Collected
	Interest on Reserves
EQUALS:	Excess, or Residual Interest

Source: FDIC's DRR

Of the above-mentioned components, the one that can cause the most concern is that of the realized losses. When valuing the interest-only residual receivables (IORRs), assumptions have to be made regarding prepayment, discount, and default/loss rates. In PTL's case, when valuing the IORRs, the realized losses were estimated since there were no historical loss rates for these types of instruments. Therefore, there was no established foundation upon which to base a more informed assumption. If the actual losses are in excess of the projections, the excess interest will decline, and the value of the IORRs will be reduced.

FDIC
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, DC 20429 Division of Supervision

CORPORATION COMMENTS

MEMORANDUM TO: Gaston L. Gianni, Jr.
Inspector General

FROM: James L. Sexton
Director

SUBJECT: Audit Memorandum Regarding Results of OIG Material Loss Review of Pacific Thrift & Loan, Woodland Hills, California

We appreciate the opportunity to respond to the five suggestions set forth by the Office of Inspector General (OIG) in their Material Loss Review of the Failure of Pacific Thrift & Loan (PTL), Woodland Hills, California.

RECOMMENDATIONS

The OIG recommends that the Director of the Division of Supervision (DOS):

1. "Continue to pursue amending the capital standards to exclude IORRs *(defined in OIG's memorandum as interest-only residual receivables) on subprime securitizations from the calculation of Tier 1 Leverage Capital."*

AND

2. *"Develop an approach for limiting interest-only residuals to an amount that will not impair the capital protection of the institution."*

DOS concurs with these recommendations. As noted in the OIG's Memorandum, DOS has been working, on an interagency basis, to limit or eliminate the amount of IORRs, which can be included in the calculation of Tier 1 Leverage Capital. On April 18, 2000, the Supervision Task Force of the Federal Financial Institutions Examination Council (FFIEC) supported a consensus for a proposal that would require that "dollar-for-dollar" capital be held against the value of residual interests retained or assumed by an institution resulting from securitization activities. The proposal will also restrict undue concentrations in IORRs by placing retained interests within the 25% of Tier 1 capital sublimit already established for nonmortgage servicing assets and purchased credit card relationships for regulatory capital purposes. Any amount above this limit will be deducted from Tier 1 capital. By combining the two approaches, both the risk-based and the leverage ratios can be impacted, and the approaches will serve as a supervisory governor on the creation of residual interests. The proposal will continue to proceed along the normal route, including final approval by the FFIEC, and a public comment period, with the ultimate objective of amending the current capital adequacy standards. Given that much

coordination is necessary with other agencies, the ultimate timetable for completion is difficult to predict.

3. *"Send a memo to DOS staff reminding them that they have access to examine the records of affiliated entities under section 10 (b) of the FDI Act."*

DOS concurs with this recommendation. The DOS Manual of Examination Policies explains the authority to examine affiliated entities under Section 10 (b) of the FDI Act in the sections entitled "Basic Examination Concepts and Guidelines" and "Related Organizations". The Manual also emphasizes that no examination under the authority of Section 10 (b) is to be made without prior clearance from the Regional Office. We believe that DOS staff is aware of this authority, but in the PTL case, given the infrequent use of this authority, DOS contacted the Legal Division out of an abundance of caution. The OIG's Memorandum also states that "The Legal Division representative also stated that if such a situation should arise, DOS needing access to a holding company's records, examiners should contact the Legal Division and apprise them of the circumstances so that the Legal Division would be prepared if the situation between the examiners and the institution should escalate." We will send a reminder to examiners regarding 10 (b) authority by the third quarter of 2000.

4. *"Instruct DOS examiners that when they examine industrial loan companies, DOS should routinely review intercompany transactions with unregulated holding companies."*

DOS concurs with this recommendation. DOS has identified 44 nonmember industrial loan companies, that show no holding company affiliation, which means either there is no holding company involved or that the holding company is not regulated by a Federal bank regulatory agency. Of these 44 institutions, 38 are located in the San Francisco Region (where PTL was located), four are in the Dallas Region and two are in the Kansas City Region. It is felt that with such a small group of potentially affected institutions in only three regions, that a short e-mail directed to the Regional Directors of the affected regions will suffice. This will be accomplished by the third quarter of 2000.

5. *"Issue instructions that when DOS directs a financial institution to contract with a third party to perform additional work to clarify an issue for the FDIC, DOS should implement procedures to ensure that the parameters of the work to be performed are responsive to the requirements established by the FDIC and that provisions will be included allowing the FDIC access to all pertinent workpapers."*

DOS concurs with this recommendation. We will draft such procedures and issue them by the fourth quarter of 2000.

APPENDIX III

MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider FDIC's responses as management decisions in accordance with the act and related guidance, several conditions are necessary. First, the response must describe for each recommendation

- the specific corrective actions already taken, if applicable;
- corrective actions to be taken together with the expected completion dates for their implementation; and
- documentation that will confirm completion of corrective actions.

If any recommendation identifies specific monetary benefits, FDIC management must state the amount agreed or disagreed with and the reasons for any disagreement. In the case of questioned costs, the amount FDIC plans to disallow must be included in management's response.

If management does not agree that a recommendation should be implemented, it must describe why the recommendation is not considered valid. Second, the OIG must determine that management's descriptions of (1) the course of action already taken or proposed and (2) the documentation confirming completion of corrective actions are responsive to its recommendations.

This table presents the management responses that have been made on recommendations in our report and the status of management decisions. The information for management decisions is based on management's written response to our report and subsequent discussions with management.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	DOS is currently working with the other federal regulatory agencies to limit and/or eliminate the amount of IORRs based on subprime securitizations that can be included in Tier 1 Leverage Capital. On April 8, 2000, the Supervision Task Force supported a consensus for a proposal that would require dollar-for-dollar capital to be held against the value of the IORRs.	4th Quarter 2000	The revised capital standards if the proposed rulemaking is finalized in its current form.	NA	Yes
2	The proposal mentioned in #1 would also restrict undue concentrations in IORRs by placing them within the 25% of Tier 1 Capital sublimit established for nonmortgage servicing assets and purchased credit card relationships for regulatory capital purposes. The proposal will continue to proceed along the proper channels including approval by the FFIEC and a public comment period with the ultimate objective of amending the capital adequacy standards.	4th Quarter 2000	The revised capital standards if the proposed rulemaking is finalized in its current form.	NA	Yes
3	DOS will send a reminder to examiners regarding their 10(b) authority to examine affiliated entities.	3rd Quarter 2000	The reminder sent to DOS examiners.	NA	Yes
4	DOS will send a short e-mail to the Regional Directors of the three regions with ILCs that show no bank holding company affiliations to remind DOS examiners that they should review transactions between the holding companies and the ILCs.	3rd Quarter 2000	The e-mail sent to the Regional Directors of the affected regions.	NA	Yes
5	DOS will draft procedures governing work contracted by a financial institution with third parties to ensure that the parameters of the work to be performed are responsive to the requirements established by the FDIC and that provisions will be incorporated allowing the FDIC access to all pertinent workpapers.	4th Quarter 2000	The procedures drafted by DOS.	NA	Yes