Office of Inspector General

August 14, 2003
Audit Report No. 03-036

Material Loss Review of the Failure of Southern Pacific Bank, Torrance, California

OFFICE OF INSPECTOR GENERAL
DELIVERING QUALITY TIMELINESS VALUE
OFFICE OF AUDITS

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FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20434

Office of Audits
Office of Inspector General

DATE: August 14, 2003

MEMORANDUM TO: Michael J. Zamorski, Director
Division of Supervision and Consumer Protection

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of the Failure of Southern Pacific Bank, Torrance, California* (Audit Report No. 03-036)

In accordance with section 38(k) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o, the Office of Inspector General (OIG) conducted a review of the failure of Southern Pacific Bank (SPB), Torrance, California. On February 7, 2003, the California Commissioner of Financial Institutions closed the institution and named FDIC as receiver. At the time of failure, SPB reported total assets of approximately $1.1 billion. On February 14, 2003, FDIC's Division of Finance notified the OIG that the estimated cost of the failure to the Bank Insurance Fund (BIF) would be $134.5 million. As of June 30, 2003, this estimated loss had declined to $100 million due to higher than expected proceeds from asset sales.

As mandated by the FDI Act, the audit objectives were to: (1) ascertain why the bank's problems resulted in a material loss[1] to the insurance fund and (2) assess the FDIC's supervision of the bank, including implementation of the Prompt Corrective Action (PCA)[2] requirements of Section 38 of the FDI Act. In this report, we address each of these objectives and discuss our findings as part of our analysis of the bank's failure and the regulators' efforts to require SPB's management to operate the bank in a safe and sound manner. Appendix I contains additional information on our objectives, scope, and methodology.

[1] A material loss is defined by section 38 of the FDI Act, in general, as a loss that exceeds the greater of $25 million or 2 percent of the institution's total assets at the time the FDIC was appointed receiver.

[2] See the glossary (Appendix X) at the end of this report for an explanation of this and other terms and acronyms used throughout this report.

BACKGROUND

SPB was chartered as an industrial loan company[3] (ILC) by the State of California on March 1, 1982, under the name of Southern Pacific Thrift & Loan.[4] The institution received federal deposit insurance on November 5, 1987. Initially, the institution originated residential mortgage loans and sold the loans and servicing rights to its parent, Imperial Bank. SPB remained a direct subsidiary of Imperial Bank until January 1992 when Imperial Bank formed Imperial Credit Industries, Inc. (ICII), and contributed all of the outstanding stock of SPB to ICII.[5] Appendix II contains an ICII organizational chart. SPB and Imperial Bank were subject to regulation, supervision, and examination under both California and federal law, by the California Department of Financial Institutions (DFI)[6] and by the FDIC, respectively. But by law, ICII was not subject to Bank Holding Company Act (BHCA) regulations. ICII annually filed a *Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, with the Securities and Exchange Commission. Each year ICII's 10-K stated that it was not regulated or supervised by the DFI, FDIC, Federal Reserve Board or any other bank regulatory authority, except with respect to:

- the general regulatory and enforcement authority of the DFI and the FDIC over transactions and dealings between ICII or any of its affiliates and SPB; and,
- the specific limitations regarding ownership of the capital stock of a parent company of any industrial bank and the payment of dividends.

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[3] An industrial loan company, industrial bank, or other similar institution, which is an institution organized under the laws of a state which, on March 5, 1987, had in effect or had under consideration in such state's legislature a statute that required or would require such institution to obtain insurance under the FDI Act (12 U.S.C. 1811 et seq.) - (I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties; (II) which has total assets of less than $100,000,000; or (III) the control of which is not acquired by any company after August 10, 1987. The current California Financial Code (CA FC), section 1400, pertains to the licensing and regulation of industrial banks and states that any reference to the term industrial loan company means industrial bank. CA FC section 105.5 defines an industrial bank to mean a corporation organized for the purpose of engaging in the industrial banking business, and section 105.7 defines industrial banking business to include the making of loans and acceptance of deposits, including deposits evidenced by investment or thrift certificates, but excluding demand deposits.

[4] The 1996 California legislation that created the California Division of Financial Institutions also authorized the use of the word bank by thrift and loan companies, such as SPB, in their names. Effective October 8, 1997, Southern Pacific Thrift & Loan changed its name to Southern Pacific Bank.

[5] ICII was SPB's holding company. By March 31, 2002, ICII had a capital deficit of approximately $97 million. ICII was publicly traded on the NASDAQ until it was delisted on May 15, 2002. In July 2003, ICII filed for protection from creditors under Chapter 11 of the federal bankruptcy law. ICII listed $190 million in liabilities and $20 million in assets in its filing in U.S. Bankruptcy Court in Los Angeles.

[6] The DFI was created on July 1, 1997. DFI was formed by consolidating the divisions of Credit Unions and Industrial Loan Companies from the Department of Corporations into the former State Banking and Savings and Loan Departments. Prior to July 1, 1997, SPB was supervised by the California Department of Corporations (DOC).

In the early 1990s, SPB grew rapidly from aggressive marketing for deposits and from bulk mortgage loan purchases, mostly from affiliates.[7] SPB warehoused[8] mortgage loans, but also held a small portfolio for investment purposes. The bank nearly tripled in asset size from $452 million at the February FDIC 1993 examination to nearly $1.4 billion by year-end 1994. However, $1.1 billion of total assets were mortgage loans held for sale (also known as pre-sold loans),[9] which were generally on the books for less than 90 days.

At the beginning of 1994, SPB's total assets were greater than $500 million for the first time, crossing the asset threshold of Section 36 of the FDI Act[10] and thus requiring SPB management to prepare, annually, reports that included the following:

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP).
- A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting.
- A written assertion about the institution's compliance during the year with federal laws and regulations relative to (a) insider loans and (b) dividend restrictions and state laws and regulations relative to dividend restrictions.

In addition, Section 36 required SPB management to engage an independent accountant to provide the following reports annually:

- An audit report on the GAAP-basis financial statements.
- An examination-level attestation report on management's assertion about financial reporting controls.

The financial statement audit, performed in accordance with generally accepted auditing standards (GAAS), and the examination of management's assertion about financial reporting controls, performed in accordance with the American Institute of Certified Public Accountants' (AICPA) Statement on Standards for Attestation Engagements (SSAE), were required to be filed with the FDIC and other regulatory agencies within the 90 days following SPB's fiscal year-end. SPB management was also

[7] Section 2(k) of the Bank Holding Company Act, 12 USC 1841et seq., defines the term "affiliate" to mean any company that controls, is controlled by, or is under common control with another company.

[8] Loans originated through a line of credit are essentially warehoused until sold into the secondary market. Warehousing allows a mortgage banker to leverage capital, thus permitting increased loan production.

[9] Held for sale, or pre-sold loans are loans purchased for subsequent sale in the market. These loans were generally not permanent in nature and were typically on the bank's books for less than 90 days.

[10] The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 added Section 36 to the Federal Deposit Insurance Act (FDI Act), codified to 12 U.S.C. 1831m, and Part 363 of the FDIC Rules and Regulations, codified to 12 C.F.R. Part 363 implements Section 36 of the FDI Act. FDICIA contained accounting, corporate governance, and regulatory reforms designed to correct weaknesses in the deposit insurance system. Among other measures, FDICIA's early warning reforms provide for timely disclosure of internal control weaknesses. FDICIA also established audit and reporting requirements for insured depository institutions with total assets of $500 million or more and their independent public accountants.

required to file with the regulators any management letter, qualification, or other report within 15 days following receipt from SPB's independent accountant.

SPB's parent, ICII, conducted its core business segments primarily through SPB where ICII originated loans and leases. SPB historically obtained the liquidity necessary to fund its parent ICII's former residential mortgage banking operations and its own investing activities through deposits and, if necessary, through borrowings under lines of credit and from the Federal Home Loan Bank (FHLB).

In 1995, ICII began to reposition, transform and diversify its core business activities from the traditional mortgage banking operations of originating and selling conforming residential mortgage loans to offering higher margin loan, lease, investment, and financial services products. ICII diversified its loan and lease products by focusing on the creation and acquisition of additional finance businesses as described below:

- Non-Conforming Residential Lending – Non-conforming residential lending was conducted through ICII's subsidiary, Southern Pacific Funding Corporation (SPFC)[11], a mortgage banking company that originated, purchased, and sold high-yielding, single family non-conforming mortgage loans. SPFC commenced operations in January 1993 as a division of SPB and after April 1995, operated as a subsidiary of ICII before completing an initial public offering of its common stock in June 1996.

- Business Finance Lending – Business finance lending was conducted through Imperial Business Credit, Inc. (IBC), an ICII wholly-owned commercial leasing company specializing in lending to small businesses and three divisions of SPB: Coast Business Credit (CBC), the Loan Participation and Investment Group (LPIG) and the Auto Lend Group (Auto Lend).

- Commercial Mortgage Lending – ICII conducted its commercial mortgage lending operations through the Income Property Lending Division (IPLD) of SPB. IPLD was formed in February 1994 to expand ICII's apartment and commercial property lending business and focused on the small loan market for apartments and commercial loans consisting of loans less than $2.5 million.

- Consumer Lending – ICII conducted consumer lending operations through the Auto Lending Division (ALD) and Consumer Credit Division (CCD) of SPB. ICII eventually closed ALD operations in February 1999 because of the significant losses incurred from this business. ICII also closed its CCD operations in December 1998 because they did not generate returns that met profitability expectations.

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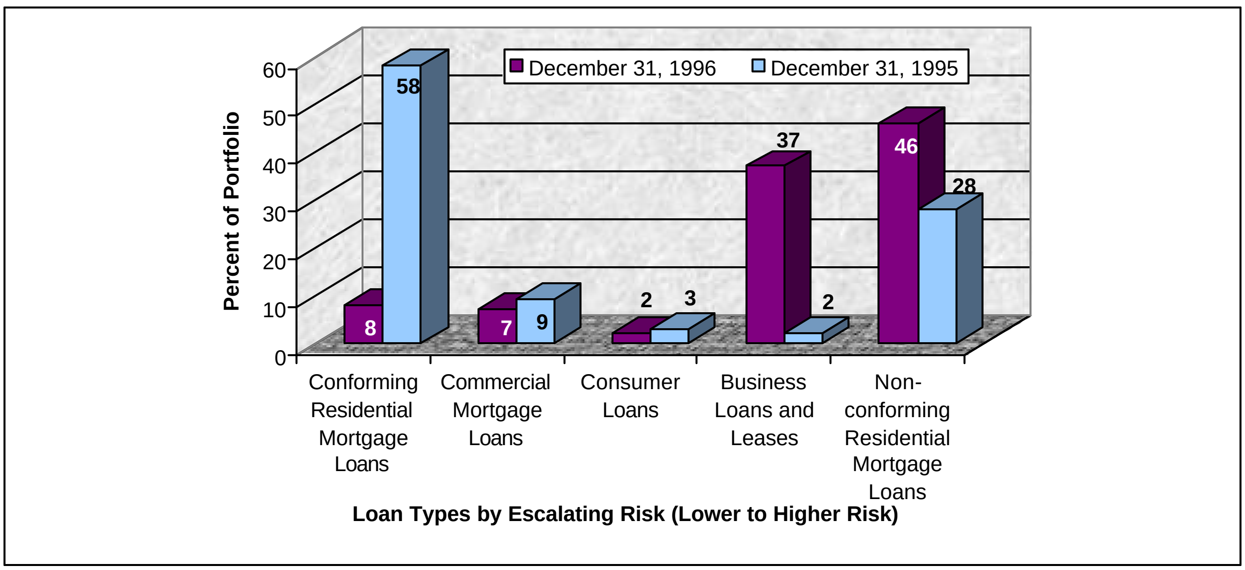
[11] SPFC was a specialty finance company engaged in the business of originating, purchasing, and selling non-conforming mortgage loans secured primarily by one-to-four family residences. The majority of the Company's loans were made to owners of single family residences who used the loan proceeds for purposes such as mortgage refinancing, home purchase, debt consolidation, home improvements, and educational expenditures. SPFC focused primarily on lending to individuals who had significant equity in the value of their homes but had impaired or limited credit histories. As a result, SPFC's customers were less likely to qualify for loans from conventional mortgage lenders and generally paid higher interest rates than interest rates charged by conventional mortgage lenders.

- Franchise Lending – Franchise lending was conducted through ICII's subsidiary, Franchise Mortgage Acceptance Corporation, LLC (FMAC), a full-service franchise finance company engaged in the business of originating loans and equipment leases to top-tier established franchisees of national and regional franchise concepts. ICII eventually divested itself of FMAC.

SPB historically obtained the liquidity necessary to fund ICII's former residential mortgage banking operations and SPB's investing activities through deposits and, if necessary, through borrowings under lines of credit and from the Federal Home Loan Bank (FHLB). By 1996, the bank's business lines were expanded to include commercial lending, franchise financing, and asset-based lending through the bank's acquisition of CBC from Coast Federal Savings and Loan. Business operations conducted through divisions of SPB were primarily financed through deposits, capital contributions from ICII to SPB, a warehouse line of credit and FHLB borrowings. CBC specialized in higher yield and higher risk commercial loans to several major industries including airlines, telecommunications, technology, and entertainment.

As part of the repositioning and diversification process, ICII's loan portfolio composition as a percentage of total loans and leases outstanding at December 31, 1996, changed as shown in Figure 1 below.

Figure 1: Change in Composition of ICII's Loan Portfolio

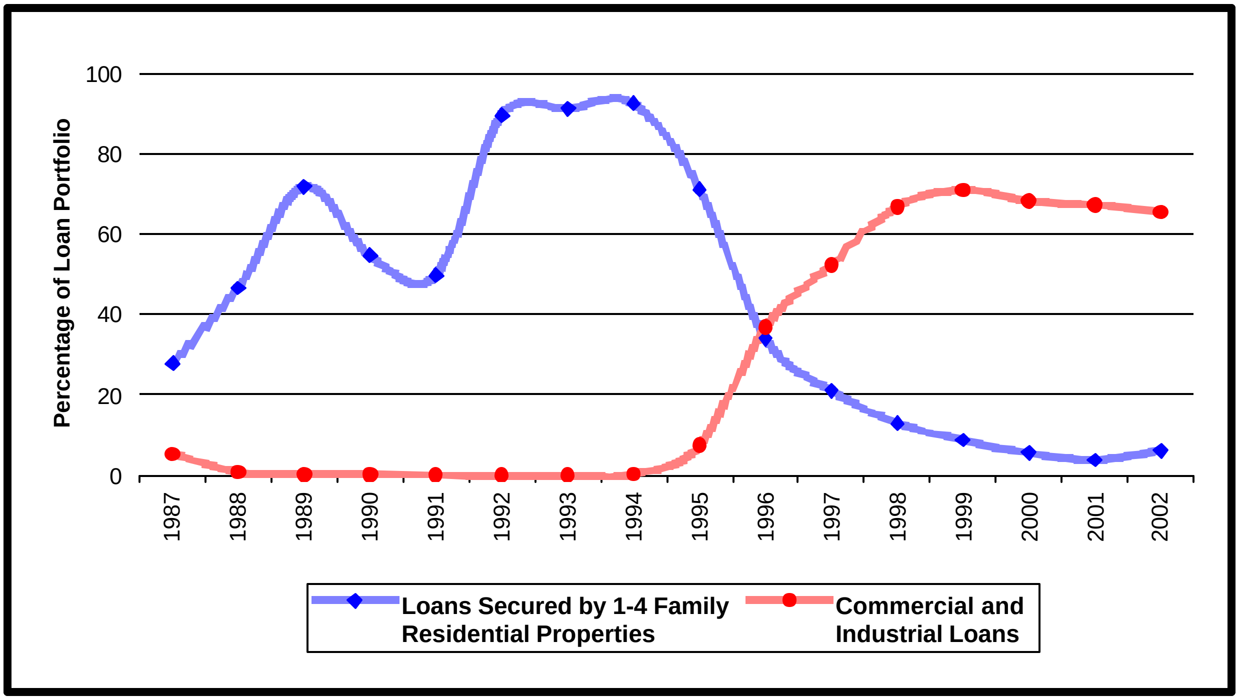


Source: ICII's 1996 Securities and Exchange Commission Form 10-K.

As noted above, ICII's conforming residential mortgage loans, commercial mortgage loans, and consumer loans decreased, while higher risk non-conforming residential mortgage loans and business loans and leases increased as a percentage of total outstanding loans and leases.

SPB's parent, ICII, repositioned, transformed, and diversified its core business activities from the traditional mortgage banking operations to offering higher-margin loan, lease, investment and financial services products. The effect of this major change was reflected in SPB's loan portfolios, most notably in its lower-risk loans secured by one-to-four family residential properties and higher-risk commercial and industrial loan portfolio as shown in Figure 2.

Figure 2: Change in SPB's Loan Portfolio Mix from 1987 to 2002



Source: SPB Call Reports.

From 1987 through 1999, SPB's composite CAMELS[12] rating fluctuated between a 2 and a 3. However, during the 1996 examination by FDIC and DFI, examiners had several concerns that required SPB's Board of Directors to oversee improvements in the bank's compliance with laws, regulations, and statutes; adherence to lending policies; quality of assets; and, internal controls, practices, and policies over operations. Overall, for the first time, examiners concluded that the Board and management had not been effective in managing, supervising, or administrating the growth of SPB. These concerns persisted until the failure of SPB in 2003. Following the 1996 examination SPB entered into a joint memorandum of understanding (MOU) with the FDIC and DFI on September 30, 1996. This was the first informal action against SPB. Table 1 summarizes SPB's examination history and supervisory actions from 1992 through 2003.

[12] Financial institution regulators use the Uniform Financial Institutions Rating System to evaluate a bank's performance. Six areas of performance are evaluated and given a numerical rating of 1 through 5, with 1 representing the least degree of concern and 5 the greatest degree of concern. The six performance areas are: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. A composite CAMELS rating is an overall rating given to a bank based on the six performance areas. A rating of 1 through 5 is given. A rating of 1 indicates strong performance; 2 reflects satisfactory performance; 3 represents below-average performance; 4 refers to marginal performance that could threaten the viability of the institution; and, 5 is considered critical, unsatisfactory performance that threatens the viability of the institution.

Table 1: FDIC and California DFI Supervisory Actions for SPB from 1992 to 2003

Examination Date and Issuer	CAMEL(S) / Composite Ratings	Supervisory Actions Recommended by FDIC and California DFI Examiners	Resulting Actions
10/31/1992, DFI	2-2-2-1-2 / **2**	None	None
02/04/1993, FDIC	1-2-2-2-2 / **2**	None	None
01/10/1994, FDIC	2-2-3-2-2 / **2**	None	None
12/15/1994, DFI	2-3-3-2-3 / **3**	None	None
01/16/1996, DFI Concurrent w/FDIC	2-3-3-2-2 / **3**	None	Concurred / Signed-on to FDIC's MOU Effective 9/26/96.
01/16/1996, FDIC Concurrent w/DFI	2-3-3-2-2 / **3**	Recommended MOU	MOU Effective 9/26/96.
04/14/1997, DFI Concurrent w/FDIC	2-3-3-2-2-2 / **3**	None	Of the 6 provisions in FDIC's 9/26/96 MOU, 5 satisfied. Board Resolution adopted on 10/29/97 to address 4/14/97 exam deficiencies.
04/14/1997, FDIC Concurrent w/DFI	2-2-3-2-2-2 **/ 2**	None	Same as above.
05/11/1998, Joint DFI and FDIC	3-3-4-2-2-2 / **3**	Recommended MOU.	MOU Effective 01/27/99
06/21/1999, Joint DFI and FDIC	3-3-3-3-2-3 / **3**	MOU considered but not recommended.	Significant progress on 1/27/99 MOU but it but remains in effect. Board Resolution adopted on 1/26/00 to address 1999 examination deficiencies.
06/26/2000, Joint DFI and FDIC	3-4-4-4-2-2 / **4**	Recommended C&D Order.	Progress on 1/27/1999 MOU, but 2 important provisions--maintenance of capital and reserves--not fully satisfied. - FDIC C&D Order issued 12/15/00. - DFI Final Order issued 01/03/01.
01/21/2001, DFI Concurrent w/FDIC	4-5-4-5-4-4 / **4**	None	DFI Final Order in effect 01/03/01.
01/22/2001, FDIC Concurrent w/DFI	4-5-4-5-4-4 / **4**	None	C&D Order in effect since 12/15/00.
11/26/2001, Joint DFI and FDIC Visit	5-5-4-5-4-4 / **5**	PCA to be pursued after year-end 2001 capital determined.	FDIC C&D and DFI Final Orders remain in effect. FDIC PCA Notification of Capital Category issued 02/01/02
02/03/2002, DFI Concurrent w/FDIC	5-5-5-5-5-5 / **5**	SPB undercapitalized for PCA purposes as of December 31, 2001.	FDIC C&D and DFI Final Orders remain in effect. PCA notification demanded capital plan and included other restrictions.
02/04/2002, FDIC Concurrent w/DFI	5-5-5-5-5-5 / **5**	Same as above.	SPB in substantial non-compliance with Orders and remains under PCA.
11/18/2002 FDIC	5-5-4-5-4-5 / **5**	FDIC & DFI recommend capital infusion of $55 and $54 million, respectively.	FDIC C&D Order, DFI Final Order, and PCA Demand for Capital remain in effect.
02/07/2003, DFI	Bank Closed	DFI closes bank and FDIC is named receiver.	Loss estimated by FDIC at $134.5 million as of 02/14/03.

Source: FDIC and California DFI reports of examination and related correspondence.

SPB's board of directors stipulated to an FDIC Cease and Desist Order (C&D) that became effective on December 15, 2000. This was the first formal action against SPB by the FDIC. The Order required SPB to retain qualified management, increase capital, reduce classified assets, restrict dividends and bonuses, and improve other operations. On December 31, 2000, the bank was considered significantly undercapitalized for PCA purposes, because the bank's Total Risk-Based Capital ratio decreased to 5.57 percent, Tier 1 Risk-Based Capital ratio decreased to 2.86 percent, and Tier 1 Leverage Capital ratio decrease to 2.82 percent. On December 31, 2001, the bank was considered undercapitalized for PCA purposes because its Total Risk-Based Capital ratio increased only to 6.34 percent, Tier 1 Risk-Based Capital ratio increased only to 3.51 percent, and Tier 1 Leverage Capital ratio increased only to 3.03 percent. Although SPB's capital improved, on February 1, 2002, FDIC required SPB's Board to prepare and submit a capital restoration plan by March 1, 2002, and inform the board of the restrictions under Section 38 of the FDI Act. SPB remained in substantial noncompliance with FDIC's order as of December 2002. The DFI issued a similar enforcement action, a Final Order, that became effective on January 3, 2001.

After several revisions, SPB's capital plan was accepted on May 24, 2002. The plan required that SPB increase Tier 1 capital by a minimum of $55 million by July 22, 2002, through capital injections and/or through the sale of certain assets. SPB failed to meet the capital plan, and on July 25, 2002, FDIC notified SPB that it was significantly undercapitalized for PCA purposes. A revised capital plan was submitted on November 26, 2002, that called for one of ICII's senior debt holders to acquire approximately 80-percent ownership of SPB by directly purchasing $30 million in common stock. On November 18, 2002, the senior debt holder filed a Notice of Change of Control with the FDIC, and it was accepted for processing on December 11, 2002. Subsequently, in January 2003 and while FDIC was reviewing the senior debt holder's pending Notice, the senior debt holder decided to withdraw the pending Notice and notified the FDIC and other interested parties of the decision on January 23, 2003. Without another source of capital, the SPB was determined to be critically undercapitalized as of December 31, 2002, and closed on February 7, 2003. Appendix III contains a chronology of significant events in SPB's history.

RESULTS OF AUDIT

SPB failed because of ineffective corporate governance, leading to a material loss to the Bank Insurance Fund. Specifically, the individual who served both as the Chairman and President of the bank's holding company, ICII, and as the Chairman and interim President of SPB dominated the operations of the bank, and the Board failed in its responsibilities. Under these circumstances, bank management:

- pursued a strategy of high-growth, high-risk commercial lending without proper risk management processes;
- concentrated the bank's lending in the telecommunications, technology, entertainment, and airline industries, without adequate underwriting;
- operated the bank and its largest commercial lending division under an incentive bonus program that rewarded key executives based on reported profits, without balancing performance measures related to the safety and soundness of the institution;
- frequently ignored examiner recommendations; and
- did not correct significant problems identified in internal reviews, allowing internal control and other problems at the bank to persist.

Additionally, SPB's external auditor did not assure adequate disclosure of SPB's financial condition, results of operations, and internal control weaknesses. As a result, the bank experienced significant losses in its commercial loan portfolio. Furthermore, the downturn in the telecommunications and technology sectors in the early 2000s and the impact of the September 11th terrorist attacks on the airline industry exacerbated the deterioration in the bank's portfolio.

In addition to the estimated loss to the Bank Insurance Fund, SPB suffered losses of over $325 million in the bank's commercial and industrial portfolio from 1997 to 2002. In the mid- to late 1990s, SPB dramatically shifted its business strategy from mortgage lending to high-risk commercial lending. The bank changed its focus to higher-risk loans, with potentially higher yields, concentrating in the telecommunications, technology, entertainment, and airline industries. Many of these new business lines were pursued without an adequate loan review program and internal loan grading system. Inferior underwriting and credit administration, combined with the rapid growth in these product lines without an adequate provision for loan losses, led to increasing asset problems and adverse classifications. SPB's attempts to resolve these problems through loan workout strategies increased the bank's exposure and delayed the full recognition of losses. Although SPB's holding company provided capital infusions of $125 million and purchased SPB assets of $31 million from 1997 to 2002, the bank's continuing losses led to a depletion of the capital needed to sustain operations.

With respect to the supervision of SPB, the FDIC and state examiners conducted annual examinations, consistently identifying and reporting deficiencies and taking various informal and formal enforcement actions, but these actions were of limited effect in reducing the risk of a material loss to the insurance fund. Examiner guidance is needed for assessing the capital requirements and provision for losses associated with high-risk commercial loans. FDIC and state examiners conducted annual examinations of SPB from 1993 until its closure. The examiners repeatedly identified and reported on significant, yet uncorrected problems at the bank. The regulators also required the bank to operate under two MOUs, in 1996-1997 and 1999-2000, and one C&D Order from 2000 until SPB failed. However, we identified two areas where supervision could be improved:

- examination guidance and assistance is needed for determining the appropriate amount of equity capital needed for high-risk commercial loans; and
- examination guidance is needed for assessing the provision for loan losses associated with high-risk commercial loans, including the use of peer group average ratios, historical loan loss averages, and adjustments for qualitative risk factors such as new areas of lending, new management, and high loan growth.

The FDIC implemented PCA in accordance with the requirements of Section 38 of the FDI Act. However, PCA was not fully effective due to the inadequate provision for loan losses that overstated SPB's income and capital for several years and to the bank's failure to execute its approved capital plan.

Other Issue: Federal Oversight of ILC Parent Holding Companies

Of the 10 material loss reviews we have conducted, this is the second involving industrial loan companies – the 1999 failure of Pacific Thrift and Loan was the other. In the case of SPB, its parent holding company, ICII, was not subject to the regulatory oversight provided under the BHCA. However, the FDIC was authorized by law to examine any affiliate of SPB, including its parent company, to determine the relationship between SPB and its parent/affiliate and the effect of such a relationship on the bank. Our report contrasts the oversight and authority provided under the BHCA with that which is available by statute to FDIC for parent holding companies of industrial loan companies such as ICII. We also intend to conduct an audit specifically focusing on non-bank bank holding companies and the potential risks, if any, which may result from the reduced level of federal oversight for holding companies not covered by the BHCA.

This report contains six recommendations designed to improve the bank supervision process and promote the safety and soundness of FDIC-supervised institutions.

FINDINGS AND RECOMMENDATIONS

WHY THE BANK'S PROBLEMS RESULTED IN A MATERIAL LOSS

Corporate Governance

SPB's Board of Directors (Board) and senior management[13] exhibited a pattern of mismanagement and failed to provide an adequate system of corporate governance.[14] The Board's failure to provide adequate oversight was a principal cause of the bank's failure, which happened in large part because the Chairman dominated the Board. The bank engaged in high-growth, high-risk strategies in the mid-late 1990s with liberal underwriting, but without proper risk management processes. The Board and senior management disregarded various laws and banking regulations and frequently ignored examiner recommendations and enforcement actions, which resulted in a large number of non-performing loans at the bank's asset-based lending division, Coast Business Credit (CBC); Auto Financing Division; PrinCap Mortgage Warehouse Inc. (SPBs wholly-owned subsidiary); and its leveraged syndicated credit division, Loan Participation Investment Group (LPIG). Adding to these problems was: the lack of adequate internal control, such as segregation of duties; inadequate preparation of workpapers for Call Reports; miscalculation of discounts on loans to facilitate the sale of other real estate; lost held-for-sale loan files; poor accounting for specific reserves; lack of conformity with SPB's policies and procedures; and questionable opinions by the external auditor, who also performed internal review services. To achieve an effective corporate governance environment, the Board (including the audit committee), senior management, internal review, and external audit must all be in place and working cohesively. As discussed below, this did not occur at SPB.

Board of Directors

The Chairman of the Board (COB) of SPB also held the positions of President and COB at SPB's parent holding company, ICII. This individual was the one constant management figure through most of the bank's history. SPB's Board meetings were held simultaneously with ICII's Board meetings. Many of the internal routine exceptions noted by examiners involved loan servicing performed by affiliated and unaffiliated third parties without adequate oversight. Weak internal operations existed and continued from examination to examination because the bank was so integrated with its parent holding company, ICII. According to the April 14, 1997 examination, the "distinction was blurred between the bank and its [parent] as a stand alone entity." Examiners had stressed the importance of maintaining a separation between the bank, ICII and its affiliates, and other third parties, but these concerns were repeatedly ignored. The continued lack of adherence to Sections 23A and 23B of the Federal Reserve Act, codified to 12 U.S.C. §§ 371c and 371c-1, and various California Financial Code regulations suggests

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[13] Senior management refers to executive officers and excludes directors.

[14] For financial institutions, corporate governance is the manner in which their Board of Directors and senior management govern their business and affairs. Corporate governance affects the way corporate objectives are set and aligns corporate activities and behaviors to ensure safe and sound business operations and compliance with laws and regulations. Effective corporate governance considers the interests of stakeholders and, ultimately, protects depositors' interests.

that the bank lacked the ability or willingness to comply with applicable requirements. Transactions with affiliates were not monitored for compliance with federal regulations which subsequently led to continued violations (see Appendix IV).

In an April 14, 1997 Report of Examination (ROE), FDIC examiners stated that the "Board and management had not been effective in managing, supervising, or administering the growth of the bank." This difficulty was the result of the Board and management's failure to properly manage and adapt to the growth experienced in the early 1990s. During that time, the bank's assets grew from less than $100 million to over $1 billion. The significant growth was the result of increased transactions with its parent company and affiliates. The Board and management lacked the knowledge of regulatory requirements, effective management skills, and the ability to properly account for these transactions.

In a joint June 21, 1999 examination conducted by the FDIC and California Department of Financial Institutions (DFI), the examiners determined that ICII had become more involved with the bank and had expanded SPB's Board to include five ICII directors. Significant losses in the CBC, Auto Lending Division, and LPIG portfolios, as well as SPB's wholly–owned subsidiary, PrinCap Mortgage Warehouse, Inc., were due to a lack of adequate Board supervision. These losses are discussed below.

- Auto Lending Division – Significant losses were attributable to a lack of SPB's management oversight in the administration of the division. The thrift discontinued funding auto paper through this division in June 1999. The portfolio was reduced by sales, losses on sales and valuation write-downs.

- CBC – Adverse loan classifications dramatically increased. However, SPB's management believed that the classifications were low and appropriate for an asset-based loan portfolio and typical for that industry. Credit managers were extending funds to very weak borrowers with the belief that the borrowers would recover financially. This practice had gone unsupervised by senior bank management.

- PrinCap Mortgage Warehouse, Inc. (PrinCap) – Significant losses were the result of fluctuations in the loan securitization market and ineffective servicing practices, which resulted in significant increases in classifications.

- LPIG – Significant losses occurred in the LPIG division as the result of concentration of syndicated credits in the airline, telecommunication, technology, and entertainment industries.

In the FDIC's January 22, 2001 examination, examiners noted that, "… the Board of Directors had failed to properly supervise the bank or to implement sound policies and objectives." Some examples of inadequate supervision by the Board and SPB management identified by examiners follow:

- Excessive management turnover – From 1997 through 2001 SPB had three presidents, two chief executive officers, and three chief financial officers.

- SPB experienced growth by sacrificing the quality of its activities – The bank operated with a decentralized entrepreneurial management structure in which business development dominated the corporate cultural at the expense of sound loan administration and prudent credit judgment.

- Numerous occurrences of alleged borrower frauds – Senior managers sacrificed prudent credit judgment because bonuses were paid based on corporate growth and profitability.

- Repeat transactions with affiliates – Board and management were consistently cited for apparent violations of Sections 23A and 23B of the Federal Reserve Act.

According to FDIC's Manual of Examination Policies, the quality of management is probably the single most important element in the successful operation of a bank. Management includes both the Board of Directors, which is elected by the shareholders, and the executive officers, who are appointed to their positions by the Board. Examiner guidance in DSC Examination Modules addresses various control and performance standards in evaluating bank management. These standards include whether a bank's board has established policies to maintain a system that effectively measures and monitors risk and to implement corrective actions recommended by auditors and supervisory authorities. To determine whether a bank's risks are adequately identified, measured, monitored, and controlled, the examiners evaluate whether the Board has:

- identified and assessed major risks that influence the success or failure of the bank,
- established adequate policies and procedures given the size and complexity of the bank,
- implemented adequate controls to ensure adherence to bank policies and legal and regulatory requirements, and
- implemented appropriate systems to monitor the bank's activities.

The Board's failure to provide adequate oversight of SPB resulted in concentrations of affiliate transactions, concentrations of credit risk, high-risk lending, and a disregard for banking laws, regulations, and examiner recommendations. FDIC and State of California ROEs from 1992 through 2002 identified numerous matters requiring Board attention pertaining to the lending function. These areas included basic tenets of banking, such as affiliate transactions, risk management, asset quality, loan policies, and loan administration.

Senior Management

SPB senior management did not fulfill its responsibilities to operate the bank in a safe and sound manner. Specifically, senior management allowed the agressive growth of concentrated high-risk assets. Management did not ensure appropriate loan administration procedures or provide a sufficient Allowance for Loan and Lease Losses (ALLL) which contributed to the collapse of SPB.

The bank's poor condition had occurred, according to FDIC examiners, largely during the COB's stewardship. The Board had abdicated its management oversight role to the bank's COB who also served as the bank's interim President from December 2000 to July 2001. The examiners stated that: "The bank is characterized by a decentralized, entrepreneurial management structure in which individual managers are given bonus incentives related to growth and profitability." Examiners also stated: "The entrepreneurial management philosophy has created a climate where business development has dominated the bank's corporate culture at the expense of sound loan administration and prudent credit judgment."

Bonus Incentives Drive Poor Loan Underwriting

Management focused on the quantity of loans as opposed to the quality of loans due to the lucrative bonuses tied to performance incentives (see Table 2). This bonus structure encouraged the following practices:

- initiating high-risk loans without commensurately higher reserves, and
- restructuring such loans to mask their non-current status or lack of payment.

Senior management allowed the aggressive growth of high-risk assets that eventually led to the bank's demise. During the joint June 26, 2000, examination, FDIC and DFI examiners reported that CBC managers were continuing the risky practice of advancing additional funds to weak borrowers in the hope they would recover financially. Such workout loans whose repayment was not predicated on identifiable or historical sources of cash, or that may have had intangible collateral of questionable value, tended to be highly speculative and exposed the bank to increased risk. The effect of keeping some of these loans current, as opposed to charging them off, helped maintain higher profit margins for SPB's CBC division and increased bonuses based on performance.

Several executives had employment agreements that included bonus incentives based on overall pre-tax profits, and in the case of CBC, the asset-based lending division of SPB, bonuses were based only on the division's profits even though the overall organization was losing money. During October 2000, a former SPB president, who served from 1998 until 2000, met with FDIC management and stated that while he was president of SPB, CBC had been allowed to operate independently from his oversight. During that time, CBC's portfolio represented from 32 to 42 percent of the bank's total assets. He indicated that CBC's senior executive staff did not report to him, but reported directly to the President/CEO of the bank's parent holding company, ICII. He further stated that CBC's executive officers were under contract with ICII and received annual bonuses based solely on pre-tax profitability at CBC as calculated from internally generated figures at CBC. These incentives appeared to have resulted in the failure to report problem loans and a propensity to liberally restore credits. Internal risk ratings of loans in the CBC portfolio failed to accurately reflect the high degree of risk inherent in the loan portfolio, and management did not properly account for problem loans that should have been placed on a nonaccrual status.[15]

The FDIC examiners identified two executive officers at CBC who received annual bonuses paid in an amount equal to 1.5 percent of CBC's annual pre-tax profit prior to the payment of bonuses provided for in their employment contracts. The OIG examined SPB's parent holding company records during this review and obtained a list of bonuses paid to 58 CBC employees during 1998. Although the OIG does not have the corresponding employment agreements, many of the bonuses paid to these executives and non-executives were significant (see Table 2). CBC's loan portfolio grew from $289 million in 1996 to $765 million in 2000. In addition, the individual who served as the ICII President/CEO and SPB COB, and the individual who served as SPB's president from 1994 -1998 and as vice-chairman of SPB's Board in 1999, received bonuses tied to a percentage of overall company pre-tax profits. Table 2 shows examples of employee salaries and bonuses.

Table 2: Examples of SPB and ICII Employee Salaries and Bonuses from 1994 to 2001

Name / Position	Fiscal Year	Salary	Bonus
ICII President and CEO and SPB Chairman	1994	$ 256,398	$ 125,621
	1995	300,000	252,603
	1996	300,000	700,000
	1997	450,000	700,000
	1998	502,114	0
	1999	500,000	500,000
	2000	500,000	500,000
	2001	339,006	0
SPB President (resigned as SPB President in December 1998 and as Vice-Chairman of SPB in September 1999)	1994	166,500	81,531
	1995	200,000	166,027
	1996	200,000	400,000
	1997	250,000	501,000
	1998	304,224	0
	1999	334,615	0
President, CBC Division	1998	300,000	471,404
	1999	300,000	391,000
CBC Chairman and CEO	1998	300,000	471,404
	1999	300,000	391,000
CBC Employee #1	1998	90,000	45,000
CBC Employee #2	1998	110,000	75,000
CBC Employee #3	1998	120,00	70,000
CBC Employee #4	1998	85,000	43,000
CBC Employee #5	1998	105,000	55,000
CBC Employee #6	1998	95,000	47,000

Source: SPB and ICII records.

During the June 26, 2000 examination, FDIC examiners suggested that management review the calculations and compensation agreements for the two CBC executive officers and upon renewal or extension of their contracts, consider adding other incentive criteria, such as asset quality and accuracy

[15] A nonaccrual loan is not earning the contractual rate of interest in the loan agreement as a result of financial difficulties experienced by the borrower.

of loan grades. In the December 15, 2000 C&D Order issued by the FDIC, the bank was restricted from paying bonuses to executive officers without the prior written consent of the FDIC Regional Director. In addition, the bank was required to adopt a comprehensive employee compensation plan.

Lack of Response to Examination Recommendations

The FDIC and DFI cited SPB's Board and management for noncompliance with existing policies and continuous violations of laws and regulations. Appendix IV shows accounting problems, internal control weaknesses, and apparent violations of law cited by the regulators. Senior management's failure to address these concerns led to an increase in the volume of adversely classified loans. Examiners identified several problems:

- poor underwriting and overreliance on enterprise values,
- inadequate risk diversification,
- aggressive marketing of deposits and bulk mortgage loan purchases, mostly from affiliates,
- higher-yield and higher-risk commercial lending to major industries, including airlines, telecommunications, technology, and entertainment,
- participations in Shared National Credits (SNCs), several of which involved the same industries in which CBC had concentrated,
- subprime lending in commercial and multi-family real estate,
- asset-based lending to businesses showing signs of credit unworthiness,
- overadvances to businesses with anticipation of possible turnaround profits (CBC relied on borrower turnaround projections), and
- large provisions to allowances were needed to cover loan losses experienced by SPB and as a result of these large provisions, SPB experienced excessive operating losses.

Section 4.1 of FDIC’s Manual of Examination Policies provides the following:

> The primary responsibility of executive management is implementation of the Board's policies and objectives in the bank's day-to-day operations. A bank's performance with respect to asset quality and diversification, capital adequacy, earnings capacity and trends, and liquidity and funds management is, to a very significant extent, a result of decisions made by the bank's directors and officers. When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. At a minimum, assessment of management by bank examiners should include the following considerations:
>
> - Existing management's past record of performance in guiding the bank;
> - Whether loan losses and other weaknesses are recognized in a timely manner;
> - Past compliance with supervisory agreements, commitments, orders, etc.; and
> - Capability of management to develop and implement acceptable plans for problem resolution.

In reports of examinations from 1995 until the bank's failure in 2003, examiners identified violations of Sections 23A and 23B of the Federal Reserve Act, Part 362 of the FDIC Rules and Regulations, and various other California Financial Code regulations as shown in Appendix IV. The examinations also contained references to the Board and management regarding the increase in classified assets; deficiencies in accounting and control systems and risk management systems; and a lack of centralized control in the volume of acquisitions made by the parent or the bank. Each affiliate and/or subsidiary operated autonomously, without direct guidance or controls in place to properly govern the unit. Inadequate due diligence or disregard of due diligence was evident with almost every business acquisition. The May 11, 1998 joint examination by FDIC and DFI identified severe accounting and internal control weaknesses that subsequently led management to overstate its year-end cash position by $11 million. Significant unreconciled differences in general ledger accounts totaled approximately $2.5 billion. With the subsequent change in management (new SPB president as of December 1998), and with the help of a contractor, the unreconciled differences were corrected. However, the ongoing accounting and control deficiencies created concerns regarding the institution's overall condition, its management, capital levels, and asset quality. SPB's earnings during this time were strong but were adversely affected by the accounting and control deficiencies.

The FDIC examiners reported in 2002 that the bank had been operating with:

- inadequate capital,
- large operating losses,
- high management turnover over during the last four examinations,
- net loan losses in excess of $330 million for the last 3 years, and
- an excessive amount of adversely classified loans.

The deterioration in asset quality required large provisions to the ALLL and depleted capital excessively, whereby SPB had reached the point of imminent failure without a substantial infusion of capital. Loan classifications were further increased by 45 percent as the result of examination findings. The volume of nonaccrual loans were determined to be at high levels, which represented 200 percent of the ALLL. Although SPB made a $55.3 million provision for losses in the first 9 months of 2002, the ALLL was still underfunded by $15.9 million as of December 31, 2002.

Inadequate Board and management supervision is evidenced by SPB's poor loan administration practices, lax collection policies and procedures, and an underfunded ALLL. The bank's risk profile increased, yet the Board failed to take significant actions to address this high risk-profile.

Internal Review

SPB management and the Board did not correct all problems identified in internal reviews and, therefore, did not fulfill their responsibility to ensure that the system of internal controls at SPB operated effectively. SPB's internal review contractor reported numerous accounting problems, internal control weaknesses, and apparent violations of law and regulations to SPB's management and the Board. However, they failed to take all necessary corrective actions to address these problems. As a result, material deficiencies identified by regulators in subsequent examinations and internal control problems were allowed to continue at SPB, increasing the risk of loss of assets. A list of accounting problems, internal control weaknesses, and apparent violations cited by the regulators in their reports of examination is in Appendix IV.

According to Financial Institution Letter (FIL) 133-1997, *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*, issued December 22, 1997,[16] by the four federal banking agencies,[17] effective internal control[18] is a foundation for the safe and sound operation of a banking institution or savings association. The Board and senior managers of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility *cannot* be delegated to others within the institution or to outside parties. An important element of an effective internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control so that management can take prompt, remedial action. The FIL also states that to properly discharge their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues so that they will have knowledge of the internal auditor's findings and operating management's solutions to identified internal control weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the Board (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether internal control weaknesses or other exceptions are being resolved expeditiously by management.

Before November 1996, bank personnel performed internal reviews at SPB. However, the regulators criticized SPB's internal review function in several ROEs. For example, in 1993 no internal reviews were conducted. In 1994, an SPB manager was designated internal auditor while retaining his managerial responsibilities, resulting in a lack of segregation of duties. Finally, in 1995, the regulators pointed out that SPB's internal review function reported deficiencies, but the deficiencies remained uncorrected.

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[16] FIL 133-1997 was replaced by FIL 133-2003, *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*, on March 17, 2003. The new policy statement updated the agencies' internal audit guidance as a result of the Sarbanes-Oxley Act of 2002, reflected the agencies' experience with the 1997 policy, and incorporated recent developments in internal auditing. The sections cited above were not changed.

[17] There are four federal regulators of banks and savings and loan institutions: the Board of Governors of the Federal Reserve System (Federal Reserve Board or FRB), the FDIC, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). For more information, see Primary Federal Regulator in the Glossary.

[18] Internal control is a process, brought about by an institution's Board, management, and other personnel, designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and, compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components is essential to achieving the internal control objectives.

In November 1996, ICII's Board and audit committee outsourced the internal review function for ICII and its affiliates, including SPB, to KPMG Internal Audit Services, a division of KPMG LLP. This arrangement continued until 2002. After KPMG took over internal review responsibilities, regulators noted that SPB's internal control practices and procedures improved. Regulators also noted that the frequency and extent of internal reviews were appropriate for the nature and complexity of the institution. However, subsequent examinations continued to identify material deficiencies.

Our review of internal review reports, audit committee minutes, and other correspondence determined that KPMG's internal review services for SPB were adequate. The frequency and extent of review and testing by KPMG were consistent with the nature, complexity, and risk found in SPB's on- and off-balance sheet activities. In addition, KPMG reported numerous accounting problems, internal control weaknesses, and apparent violations of law and regulations to SPB's Board. However, SPB management and the Board failed to take all necessary corrective actions, resulting in repeat internal review findings and the continuation of internal control problems at SPB.

External Audit

In reports on SPB's financial statements, KPMG LLP rendered unqualified opinions and unqualified attestations on internal controls despite SPB's numerous and repeated accounting problems, internal control weaknesses, and apparent violations of laws and regulations (see Appendix IV). At a minimum, KPMG should have added explanatory language to its reports. As a publicly traded company, ICII's financial statements and KPMG's opinions on the statements were publicly available. However, by not publicly disclosing SPB's problems, KPMG defeated the purpose of accounting rules and public disclosure, i.e., to fairly, accurately, and promptly inform the public of the actual financial performance of SPB. At the same time, KPMG did not issue management letters to the bank and holding company's Boards after the 2000 and 2001[19] audits to inform the Boards of the bank's internal control problems in writing. These management letters would have, in turn, been forwarded by the bank to the regulators and could have been used to aid in supervising the bank. Furthermore, in addition to being SPB's independent auditor for the purpose of expressing an opinion on the financial statements, KPMG also provided non-audit services such as internal review, due diligence, and consulting to SPB and ICII. Therefore, KPMG had an apparent conflict of interest that would now be prohibited by the Sarbanes-Oxley Act of 2002, Public Law 107-204.

<u>KPMG Did Not Assure Adequate Disclosure of SPB's Condition</u>

ICII's Board engaged the accounting firm of KPMG LLP to audit the financial statements of both ICII and its subsidiaries, including SPB. Altogether, KPMG was SPB's external auditor from 1986 until it was closed. During that period, KPMG issued unqualified opinions on SPB's financial statements for

[19] SPB was closed before its 2002 audit was completed.

each of the years we reviewed – 1990 through 2001 – and did not add any explanatory language to its opinions until 2001, when KPMG rendered a going concern opinion.[20]

The AICPA's Statement on Auditing Standards (SAS) 58, *Reports on Audited Financial Statements*, as amended, provides guidance on financial statement audit reports. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, an adverse opinion, or a disclaimer of opinion. SAS 58, paragraph 11, states that certain circumstances, while not affecting the auditor's unqualified opinion, may require the auditor to add an explanatory paragraph or other explanatory language to the standard report. SAS 58, paragraph 11, provides several examples in which explanatory language would be required, including: "The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report," and: "There has been a material change between periods in accounting principles or in the method of their application." In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements as prescribed in SAS 58, paragraph 37: "In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, he may wish to emphasize that the entity is a component of a larger business enterprise or that it has had significant transactions with related parties, or he may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period."

Our review of KPMG's work papers and communications with SPB's Board disclosed that KPMG knew about SPB's apparent violations of laws and regulations and internal control and accounting problems through regulatory reports as well as its own audits and internal reviews. Appendix IV contains a list of the problems identified by examiners. Nevertheless, KPMG issued unqualified opinions without adding explanatory language about these problems. KPMG did not issue an opinion with explanatory language regarding SPB's ability to continue as a going concern until after the regulators' November 2001 report – when regulators rated SPB a composite 5 and issued a Prompt Corrective Action Directive because the bank was undercapitalized.

To comply with paragraph 11 of SAS 58, KPMG should have added explanatory language to several of its reports. KPMG should have disclosed that SPB's financial statements could have been affected by the uncertainty of the future resolution of large reconciling items, that there had been a material change between periods in application of accounting principles resulting in the reconciliation problems, and that there could be other recurring accounting problems. For example, the 1998 ROE states that, as a result of a systems conversion that began in August 1997 and other accounting problems, SPB had nearly $2.5 billion in unreconciled items in its loan control account and $900 million in unreconciled items in its cash accounts. From 1993 through 1998, KPMG reported account reconciliations as a problem in its management letters to SPB. Total assets at the bank were about $1.5 billion at the end of 1997 and $1.9 billion at the end of 1998. Therefore, therefore the financial statements could have been materially misstated, and KPMG should have acknowledged that the bank had an amount about twice

[20] There was substantial doubt that the bank had the resources needed to continue to operate. For more information, see Going Concern Determination in the Glossary.

its total assets in suspense accounts waiting to be properly classified. If even a small percentage of the unreconciled items were written off, the amount could have been material. Furthermore, the 1998 ROE also contained numerous references to accounting problems at SPB and stated several times that SPB management's failure to properly control accounts made the integrity and validity of financial statements questionable and caused the filing of incorrect Call Reports.[21]

Further, in accordance with paragraph 37 of SAS 58, KPMG should have added explanatory language to some of its reports regarding the comparability of financial statements. Because of the unreconciled cash and loan accounts, large unreconciled balances would have existed at the end of 1997 and 1998, making it impossible to accurately determine the balance of the cash and loan accounts at SPB. Thus, the financial statements may not have reflected the true financial condition of the bank and could not have been comparable with those of the preceding period.

KPMG Did Not Provide a Written Report of SPB's Internal Control Weaknesses to SPB's Audit Committee and Regulators

KPMG did not issue management letters after its 2000 and 2001 audits. Although not required by auditing standards, it would have been prudent for KPMG to have issued management letters for those audits in view of internal control problems at the bank.

SAS 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended, provides guidance on identifying and reporting conditions that relate to an institution's internal control over financial reporting observed during an audit of financial statements in accordance with generally accepted auditing standards. Letters issued in accordance with SAS 60 are generally referred to as management letters. SAS 60 requires that reportable conditions observed during an audit be communicated to the audit committee, preferably in writing, or to individuals with a level of authority and responsibility equivalent to that of an audit committee in organizations that do not have one. Reportable conditions are matters coming to an auditor's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control that could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve the internal control components of (a) the control environment, (b) risk assessment, (c) control activities, (d) information and communication, and (e) monitoring.

Also, banks are required by FDIC Rules and Regulations codified to 12 C.F.R. § 363.4(c), of the FDIC Rules and Regulations, to file a copy of any management letter, qualification, or other report issued by its independent public accountant with the FDIC, the appropriate federal banking agency, and

[21] Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income from banks and Office of Thrift Supervision (OTS) Thrift Financial Reports from savings associations – collectively referred to as Call Reports – are sworn statements of financial condition that are submitted to FDIC quarterly in accordance with federal regulatory requirements in Title 12 of the Code of Federal Regulations. Call reports consist of a balance sheet, income statement, and other supplemental information and provide detailed analyses of balances and related activity.

any appropriate state bank supervisor within 15 days after receipt. In addition, Section 36 of the FDI Act gives FDIC, in consultation with the other federal banking agencies, authority to set accounting and auditing standards for institutions subject to Section 36. Corresponding guidance in SAS 60 states: "When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made."

Under SAS 60, management letters are not required if the Board has previously been made aware of the problem and acknowledged its consideration of the problem. Indeed, the regulators' reports of examination covering the same periods as KPMG's 2000 and 2001 audits identified significant internal control weaknesses and other problems at the bank. These weaknesses included an inadequate ALLL and apparent violations of laws and regulations, including the filing of inaccurate Call Reports, violation of lending limits, impermissible investments, and unlawful related-party transactions. Furthermore, our analysis of the adequacy of the ALLL (see Finding B, later in this report) indicates that the allowance was significantly understated during this time and that appropriate adjustments may have been sufficient to downgrade SPB's capital category designation for purposes of PCA. Also, properly stating the ALLL would have reduced SPB's operating results, which were already at a net loss for 2000 and 2001. Since KPMG did not issue management letters for its 2000 and 2001 audits, the audit firm did not formally disclose whether there were reportable conditions found during the audit. To ensure full disclosure to regulatory authorities, independent public accountants should disclose reportable conditions in a management letter or other correspondence. This would ensure that regulators are made aware of any significant internal control issues noted by the independent auditors.

Recommendation

We recommend that the Director, DSC:

(1) Evaluate and pursue opportunities to emphasize and obtain written reports from independent auditors performing bank audits to bank boards of directors disclosing all reportable conditions found during audits.

Some Services Provided by KPMG Would Now Be Prohibited

KPMG had an apparent conflict of interest because its auditors performed annual financial statement audits at the same time other KPMG staff provided internal review, tax, and consulting services to SPB and ICII. Although not a violation of law at the time, this practice is now prohibited under the Sarbanes-Oxley Act and U.S. Securities and Exchange Commission (SEC) rules.

On July 30, 2002, the Sarbanes-Oxley Act of 2002 was enacted. It contains new requirements for public companies and established a new regulatory body for public accounting firms. In addition to including earlier SEC rules on auditor independence, it prescribes new requirements for registered public accounting firms and prohibits them from providing any professional services other than those provided in connection with the audit or review of the financial statements of their public clients. Subsequently, the SEC issued rules implementing the congressional mandate and strengthening requirements regarding auditor independence. Overall, the rules are intended to provide greater assurance to investors that independent auditors are performing their public responsibilities.

Requirements for external auditors under the Sarbanes-Oxley Act, most of which became effective May 6, 2003, are shown in Table 3. The table has also been annotated to show which issues affected by the Act would have been relevant to KPMG's work at SPB.

Table 3: Sarbanes-Oxley Act Requirements for External Auditors

Section and Topic	Requirement of the Section	KPMG Services at SPB
102(a) – Registered Accounting Firms	No unregistered accounting firm may prepare or issue an audit report for a public company.	
201 – Restrictions on Non-Audit Services	The following categories of non-audit services cannot be provided by external auditors:	
	(1) bookkeeping,	✓
	(2) financial information system design and implementation,	
	(3) appraisal or valuation services, fairness opinions or contributions in kind reports,	✓
	(4) actuarial services,	
	(5) internal review outsourcing services,	✓
	(6) management functions,	
	(7) human resource services,	
	(8) broker-dealer, investment adviser, or investment banking services,	
	(9) legal services,	✓
	(10) expert services unrelated to the audit, and	✓
	(11) any other service that the Public Company Accounting Oversight Board deems impermissible.	
	Tax services are allowed if pre-approved by the client's audit committee.	✓
203 – Rotation of Audit Partners	Lead and concurring partners must rotate after 5 years, with a time out period of 5 years. Other engagement team partners must rotate after 7 years, with a time out period of 2 years.	
204 – Specific Reports and Responsibilities	Before issuing a report, auditors must report to Audit Committees: (a) critical accounting policies and practices, (b) alternative GAAP treatments discussed with management, and (c) all other material written communications between the auditor and management.	✓
206 – Prohibition of Conflicts of Interest	An accounting firm is prohibited from providing any audit service if the Company's Chief Executive Officer, Chief Financial Officer, controller, chief accounting officer or any person in an equivalent position was employed by that firm and participated in the audit during the one-year period immediately preceding the initiation of the audit.	✓
303 – Prohibition of Improper Influence on Audits	It is unlawful to fraudulently influence, coerce, manipulate or mislead the independent auditor for the purpose of rendering the financial statements materially misleading.	
404(b) – External Auditor Attestation Related to Internal Control	The registered accounting firm must attest to, and report on, management's assertions regarding their assessment of the effectiveness of the company's internal controls.	✓

Source: Sarbanes-Oxley Act of 2002.

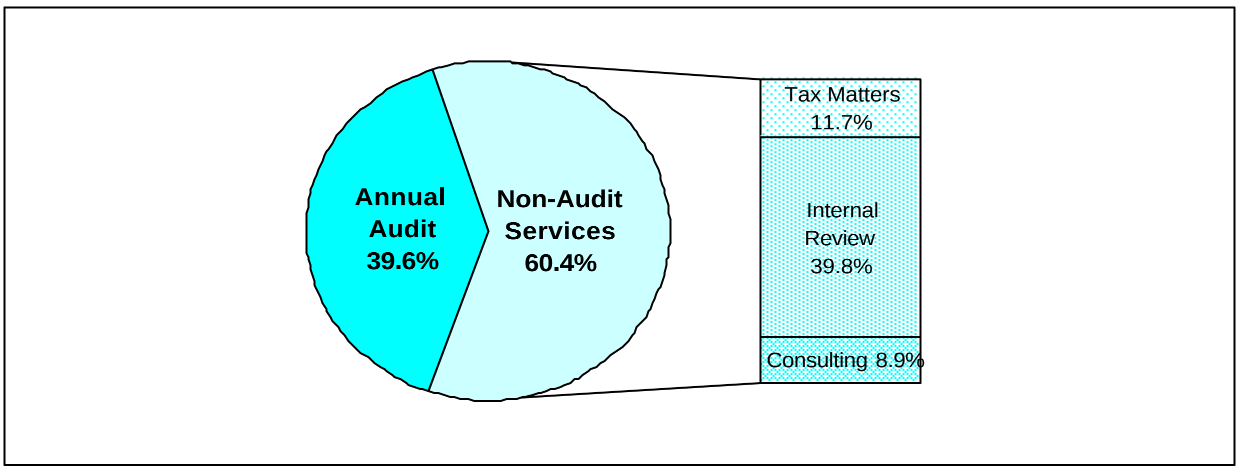
KPMG was SPB's external auditor from 1986 until SPB was closed in 2003. SPB's parent company, ICII, also contracted with KPMG for annual financial statement audits for itself and its subsidiaries, including SPB. As an example of a practice that is now prohibited, KPMG provided internal review services to ICII and SPB from 1996 through 2002 and performed other non-audit work such as tax, due diligence, and consulting services. In fact, KPMG was paid more for non-audit services than for its annual audits for the years 1999 through 2001.[22] Fees paid to KMPG for audit and other services provided in 1999 through 2001 are summarized in Table 4 and Figure 3.

Table 4: Fees Paid to KPMG for Services Provided from 1999 to 2001

Service Provided by KPMG	2001	2000	1999	Total 2001-1999
Annual Financial Statement Audit	$ 437,700	$ 459,450	$ 518,950	$ 1,416,100
Tax Matters	$ 46,905	$ 129,763	$ 242,082	$ 418,750
Internal Review	433,151	333,947	654,043	1,421,141
Non-Financial Systems Consulting	213,932	104,040	--	317,972
Total Non-Audit Fees	$ 693,988	$ 567,750	$ 896,125	$ 2,157,863
Total Audit and Non-Audit Fees	**$ 1,131,688**	**$ 1,027,200**	**$ 1,415,075**	**$ 3,573,963**

Source: KPMG letters to SPB required under SAS 61, *Communication with Audit Committees*.

Figure 3: Breakdown of Fees Paid to KPMG from 1999 to 2001



Source: KPMG letters to SPB required under SAS 61, *Communication with Audit Committees*.

[22] Total audit and non-audit costs were not available for 2002 because SPB was closed before its 2002 audit was completed. Further, before 1999, KPMG did not provide a breakdown of audit and non-audit fees in its SAS 61 letters to ICII's and SPB's boards of directors.

Failure To Diversify the Risk in the Bank's Loan Portfolio

The primary cause of SPB becoming critically undercapitalized was bank management's failure to diversify the risk in the bank's risky loan portfolio. Specifically, management pursued a business strategy that focused on high loan growth through potentially high-risk, high-yield financing. In addition, the bank had concentrations in higher-yield and high-risk commercial loans involving the telecommunications, technology, entertainment, and airline industries. In the early 1990s, SPB grew rapidly from $56.5 million as of December 31, 1990, to $1.4 billion as of December 31, 1993. In 1995, SPB began to reposition, transform, and diversify its core business activities. That is, SPB switched from its mortgage banking operations of originating and selling conforming residential mortgage loans to commercial lending, funding mortgage banking operations, and asset-based lending through the bank's acquisition of CBC. CBC specialized in higher-yield and higher-risk commercial loans in several major industries including airlines, telecommunications, technology, and entertainment. In addition, the bank held a portfolio of participations in SNCs, several of which included the same industries listed above in which CBC had concentrated its investments. For the most part, SPB's problems began to appear in the late 1990s when the bank's loans in these sectors grew significantly, from $600 million in 1999 to $850 million in 2000. Asset quality had dramatically deteriorated due to weak management processes, poor loan administration practices, and high-risk workout strategies for problem credits that resulted in increased classifications. By the end of 2001, the economy was deteriorating and the compounded effects of September 11, 2001, were being felt. In particular, these events caused the airline and telecommunications credits to deteriorate at a rapid rate.

High-Risk Asset Portfolio

From 1997 through 2002, SPB suffered losses of over $325 million in the bank's commercial and industrial loan portfolios. These incurred losses caused the bank to fail and a material loss to the BIF.

SPB specialized in higher-yield and higher-risk commercial loans to the major industries previously noted, had concentrations of credit in commercial and multi-family real estate and extended mortgage warehouse lines to mortgage loan originators. The bank's underwriting standards were generally liberal as the bank targeted borrowers generally categorized as having weakened credit histories and charged interest rates commensurate with the increased risk. In the absence of an industry-wide definition of subprime commercial loans and for the purposes of this report, we use the term subprime to describe SPB's commercial loan portfolios. During the April 1997 FDIC examination, examiners first described SPB's loan portfolio as being centered in subprime lending, making it more sensitive to economic downturns than competing institutions with more strict underwriting requirements. From 1997 through 2002, ROEs continually noted that SPB's borrowing base was generally subprime and warned that this type of borrowing base was riskier than the standard borrower base because subprime borrowers were normally more susceptible to economic downturns.

From 1994 and 1999 (see Figure 2) the bank changed its business strategy from engaging in mortgage lending to high-risk commercial lending. By the end of 2002, an excessive amount of problem assets in the commercial and industrial loan portfolio resulted in credit losses of $325 million that dramatically depleted the bank's equity capital.

The major losses were centered in the bank's largest loan division, CBC, which specialized in asset-based lending. Table 5 below provides a description of CBC's portfolio size and losses compared to the bank's total assets and losses.

Table 5: Comparison of CBC's Asset Size and Losses to Those of SPB from 1996 to 2002

Exam Date	Rating: Composite / Asset Quality	Total Assets ($ in Thousands)		Adversely Classified Assets ($ in Thousands)		Amount Classified As Loss ($ in Thousands)	
		SPB	% CBC	SPB	% CBC	SPB	% CBC
Jan. 1996	**3** / 3	$1,446,189	9.33	$ 33,948	7.66	$ 1,948	0
Apr 1997	**2** / 2	1,384,008	22.40	57,803	8.65	3,963	14.48
May 1998	**3** / 3	1,669,281	31.63	54,916	18.21	7,070	0
June 1999	**3** / 3	1,837,267	35.86	116,728	53.11	19,076	68.95
June 2000	**4** / 4	1,902,148	47.31	184,054	49.99	50,452	53.52
Jan. 2001	**4** / 5	1,865,185	32.17	226,535	54.21	9,870	86.87
Feb. 2002	**5** / 5	1,401,350	38.11	255,506	72.56	16,973	73.65
Nov. 2002	**5** / 5	1,095,022	46.67	213,426	73.47	28,816	37.54

Source: FDIC reports of examination.

At December 31, 1993, SPB had assets of $1.4 billion and was offering FDIC-insured investment certificates, which are functionally equivalent to bank certificates of deposit. SPB also engaged in the origination of residential and income-producing real estate secured mortgage loans for its own portfolio. As a subsidiary of ICII, SPB's primary assets consisted of mortgage loans held for sale that were originated or acquired by the ICII Mortgage Banking Business. At December 1994, the bank's loan portfolio was divided into two major groups:

- mortgage loans originated and serviced by the bank, approximating $200 million; and
- mortgage loans originated and serviced by the parent company ICII, approximating $1,100 million. These loans were usually held on the bank's books for less than 90 days, and were considered held for sale.

<u>Expansion into High-Risk Assets</u>

From 1993 through 1999, SPB management engaged in a high-risk lending strategy and expanded into commercial lending, the funding of mortgage banking operations, and asset-based lending to companies and borrowers with weakened credit histories. During that period, the bank created or acquired 10 new commercial-based lending divisions or loan portfolios and 1 consumer lending division (see Appendix V). According to FDIC examiners, many of these new business lines were pursued without an adequate loan review program and internal loan grading system. In addition, inferior underwriting and credit administration practices during a high-growth period in 1998 and 1999 exacerbated the credit problems. From 1992 through 2002, the bank suffered losses of over $373 million, of which about $325 million were in the bank's commercial and industrial loan portfolio in 1997 through 2002.

As early as 1993, FDIC examiners voiced concern with growing asset problems. At the FDIC February 2, 1993 examination, the examiners described the overall condition of the bank as satisfactory. The bank's primary business activity was the funding of mortgage loans to be held for sale. The bank's asset base had grown dramatically over the previous year, from $439 million to $777 million in average assets, during which time it became involved with the funding of mortgage loans, to be held for sale, for its parent, ICII. Essentially, the SPB was being used as a conduit to generate deposits to fund ICII's mortgage banking operations. ICII, which wholly-owned the bank at that time, originated the majority of the loans that were funded by the bank. As the asset base increased, ICII injected capital to protect against potential losses. Although total assets increased significantly, the risk involved was partially mitigated due to the short time the loans are actually held by the bank.

By the January 10, 1994 examination, examiner concerns arose over growing asset problems relative to the bank's permanent assets, and the level of adverse classifications represented an increase of 80 percent over the previous examination level. Adversely classified items totaled $14.7 million, of which $12.9 million, 87 percent, represented adversely classified loans. In addition, examiners noted that if ICII's mortgage banking operations experienced significant deterioration in pre-sold loan quality and a corresponding loan origination volume decline, SPB would have a relatively riskier portfolio.

During the period of 1998–1999, adversely classified loans increased 113 percent, from $54.9 million to $116.7 million. See Table 5 for a breakdown of asset classifications and losses by examination date.

Overall, the bank's assets were non-traditional and comprised of higher-yield and higher-risk credits. Such an asset composition was considered more susceptible to general economic conditions and cycles in industry sectors. From May 1998 through February 2001, ROEs warned that SPB would be vulnerable to national economic fluctuations due to the subprime nature of the loan portfolios. The vulnerability was primarily due to two characteristics of the thrift's asset base: first, the borrowing base was generally subprime, which made the borrowers sensitive to economic fluctuations; second, some portfolios were sensitive to particular economic trends. For the 12 months ended December 31, 2000, the bank suffered a large loss of about $117 million, resulting in a negative 6 percent return on average assets. The principal cause of the loss was large loan loss provisions. According to examiners, however, the loan losses could be attributed to weak underwriting practices and lack of management oversight rather than economic conditions.

Coast Business Credit Division

The January 16, 1996, FDIC examination of SPB disclosed that in September 1995, the bank had acquired CoastFed Business Credit Corporation (CBBC) from Coast Federal Bank, FSB (Coast). At the time of the transaction, CBBC was a wholly-owned asset-based lending subsidiary of Coast. Immediately following the acquisition, SPB liquidated CBBC as a separate corporate entity, merged it into SPB, and renamed the division Coast Business Credit (CBC). The FDIC San Francisco Regional Office never received a merger or consolidation application regarding the acquisition and requested that SPB explain the transaction and review the application requirements of Part 303.3 of the FDIC Rules and Regulations, 12 C.F.R. §303.3, and section 18(c) of the FDI Act.

In a letter dated July 31, 1996, outside counsel for SPB responded that no regulatory application was necessary. Section 18(c) (1) of the FDI Act, codified to 12 U.S.C. §1828, provides that:

> Except with the prior written approval of the responsible agency, which shall in every case referred to in this paragraph be the Corporation, no insured depository institution shall (A) merge or consolidate with any noninsured bank or institution.

Attorneys for the bank argued that the term noninsured institution was narrowly defined and included only depository institutions in which the deposits were not insured by the FDIC. According to FDIC legal counsel, SPB's argument was contrary to the long-standing interpretation espoused by FDIC. The term noninsured institution included any noninsured entity, which would include any corporation or partnership. As a result, the definition would clearly include an entity such as CBCC, and SPB would have had to file a merger application with the FDIC before dissolving and merging CBBC into a division of the bank. On December 10, 1996, the Executive Vice President of the bank responded to the FDIC's application request, stating that SPB had agreed to cooperate with the FDIC and provide available information; however, the bank's response should not be construed as an admission that a merger application was required. The San Francisco Regional Director notified SPB in a March 10, 1997, letter that its regular merger application involving CBCC had been approved after the fact.

CBC focused on asset-based lending, through underwriting criteria based on cash flow and collateral rather than on earnings and net worth. Borrowers tended to be at the marginal end of the credit spectrum and generally did not qualify for credit on more conventional terms. Although the CBC was a division of the bank, CBC operated as an independent company. CBC historically concentrated its lending efforts in the technology industry. CBC loans were categorized based on the type of collateral securing the loan:

- Accounts Receivable Loans – Accounts receivable loans were revolving lines of credit that were secured principally by accounts receivable. Each borrower's customers normally made their payments directly to CBC, usually on a daily basis. CBC deposited the payments daily and applied the funds to the borrowers' loan balances.

- Inventory Loans. – Inventory loans were typically revolving lines of credit secured by eligible inventory that was restricted to raw materials and finished goods. Inventory loans were generally made in conjunction with accounts receivable loans to qualifying borrowers.

- Participation Loans – Participation loans consisted of term loans or revolving lines of credit in which CBC and other lenders (banks or other asset-based lenders) jointly lent to borrowers when the loan amount exceeded the lending limits of an individual lender.

- Other Loans – CBC also made term loans secured by real property, equipment, or other fixed assets. These were typically term loans with 3- to 5-year amortization periods, but were due and payable upon termination of the master loan and security agreement.

CBC Portfolio Deterioration

One of the causes of the weaknesses in the CBC loan portfolio was the poor restructuring of problem credits. The management of problem credits at CBC was ineffective and had significantly contributed to the volume and severity of adverse classifications. Two practices that exacerbated asset quality problems at CBC were the transfer of ownership[23] and funding of over-advances.[24] CBC disregarded the tenets of proper asset-based lending and caused an increase in loss exposure and substandard classifications and the deferral of loss recognition. Furthermore, SPB's internal risk ratings did not accurately reflect the high degree of risk inherent in the loan portfolio of CBC. FDIC examiners found that the internal loan review team and the bank's Problem Asset Committee had not accurately rated the CBC portfolio, despite an accurate portrayal of the 15 other SPB portfolios. SPB's credit review process was not allowed to operate with a sufficient degree of independence in evaluating the CBC portfolio, resulting in inaccurate risk ratings, the deferral of loss recognition, and an under-funded loan loss reserve.

During the January 1996 examination, examiners found that the credit administration of the purchased portfolio was inadequate. CBC had already experienced loan losses of about $2.1 million since it was acquired in 1995. The examiners noted several weaknesses, which included the lack of lockbox arrangements and the lack of quarterly bank inspections of accounts receivables. Most of the loans were serviced by the institutions that sold them to the bank, and the bank appeared to be placing an undue level of responsibility on the servicers to monitor CBC's loan portfolio. In addition, the servicers also monitored delinquencies in the serviced portfolios with little actual review performed by SPB management.

CBC continued to grow dramatically through 1998 and established aircraft-related sector concentrations. The 1998 ROE stated that because SPB's loan portfolio was centered in subprime lending, the bank was more sensitive to economic downturns than competing institutions with stricter underwriting requirements. A large percentage of the loans were secured with real estate and, because many of these loans were backed with junior liens, collateral values could be reduced or eliminated when property values declined. Examiners advised that a recessionary environment could also impact

[23] Often when a commercial borrower's financial condition declines to a level at or near insolvency, bank management pursues "peaceful possession" of the borrower's company. A peaceful possession entails a release of the guarantors from their obligations as long as they agree to release the company to the bank without legal interference. Management then transfers ownership to a third-party workout specialist in belief that he or she will be able to either turn the company's financial condition around and/or find investors to put money into the company.

[24] In instances involving workout credits, bank management may advance funds to struggling companies over the amount supported by collateral (over-advance). This is done with the expectation that the third-party workout specialists/investors will be able to eventually turn the company around.

the bank's auto lending portfolio because subprime borrowers are normally more susceptible to economic downturns and could be among the first employees to lose their jobs.

The June 1999 FDIC examination found that classifications in the CBC portfolio rose from $10 million, with no loss classifications at the last examination, to $62 million, of which $13 million was classified as loss. According to the ROE, although credit administration within CBC was capable, CBC management had a propensity to extend over-advances to very weak borrowers on the belief that the borrowers would turn their businesses around. This practice, which previously went unchecked by senior bank management, caused an expansion in the bank's loss exposure. As a result, examiners suggested closer supervision over CBC by senior management and the Board. At the June 26, 2000 FDIC examination, examiners found that the bank had taken steps to institute requirements for approval of over-advances at higher management levels outside of CBC. Nevertheless, the oversight provided by the Senior Loan Committee proved ineffective, and the same type of risky workout strategies continued unabated.

By January 2001 credit losses had overwhelmed operating income and dramatically depleted the bank's equity capital. Risk was exacerbated by the higher-risk nature of the bank's liberal underwriting guidelines. About 79 percent of the bank's outstanding loans were concentrated in CBC, the Income Property Lending Division (IPLD),[25] and the Loan Participation Investment Group (LPIG)[26] portfolios: CBC represented 48 percent, the IPLD portfolio represented 23 percent, and the LPIG represented 8 percent. Although SPB received a capital infusion from ICII, the viability of the bank remained uncertain. Net loan losses realized in 2000 were centered on CBC and LPIG, with net loan charge-offs of over $73 million and $32 million, respectively. The amount of charge-offs represented an aggressive attempt to rid the CBC and LPIG portfolios of problem assets. Over-advances on loans at CBC significantly contributed to the $122 million in operating losses suffered in the previous 2 years. The practice of over-advancing funds to weak borrowers had ceased. However, the previous liberal lending practices had resulted in a weakened portfolio that would likely continue to be plagued with high levels of problem loans and losses.

By the February 2002 FDIC examination, approximately 76 percent of the bank's credit losses ($72 million) in 2001 and 74 percent of the adversely classified loans ($185 million) were originated at

[25] The IPLD made property rehabilitation loans to higher-risk customers based on the "as completed" collateral value of multi-family income-producing properties. As of October 2002, the IPLD had $242 million in total assets. Approximately 70 percent of the portfolio was secured by apartment buildings and 30 percent was secured by commercial property. Prior to 2001, all of the loans in the portfolio were classified as held for sale. During 2001, management changed its strategy and decided to retain the loans that were risk weighted at 50 percent and to sell the loans that were risk rated at 100 percent. The quality of the portfolio was generally viewed as adequate. According to examiners, although collateral properties could be categorized as class B or class C, management had priced the loans accordingly.

[26] In 1995, the bank formed the LPIG to invest in and purchase senior secured debt of other companies (participations) offered by commercial banks in the secondary market. The principal types of loans in the LPIG's portfolio were revolving lines of credit and long-term loans or letters of credit, the majority of which were reviewed under the Shared National Credit Program. Bank management stopped originating new commitments in 1998 and anticipated continued reductions in the outstanding balances as the portfolio matured.

CBC. These problem loans were attributed to deterioration in enterprise-value type loans, [27] as well as the economic downturn and specific weaknesses in the telecommunications and technology sectors. According to the ROE, significant losses at CBC beginning in 1998 could be traced to management's departure from lending based upon "hard" collateral. Management changed its collateral requirements and began approving "cash stream" loans.[28] This lending change proved to be problematic and its repercussions were still being experienced over 3 years later.

CBC Problem Loan Workout Strategies

During the June 1999 FDIC examination, examiners identified weaknesses in how CBC managed problem loan workout strategies and warned that credit administration at CBC needed improvement. CBC had been allowed to operate autonomously from the bank. CBC's managers were under employment contracts with ICII, and had been paid substantial salaries. In addition, they received annual bonuses based solely on pre-tax profitability at CBC as calculated from internally generated reports. These incentives appeared to have resulted in the failure to report problem loans and a propensity to liberally restructure credits.

At the June 2000 examination, examiners found that CBC management had continued to capitalize interest and over-advance large sums on an unsecured basis to problem borrowers in the hope that the debtors could turn their companies around and repay the debts. These companies generally had negative cash flows, negative equity, and insufficient sales to support operations. In some cases, these companies had new ownership who contributed minimal or no equity. In addition, there was a shortfall of collateral coverage for many of the classified CBC loans.

According to the FDIC case manager, while over-advances at SPB occurred due to bank management's conscious decision to extend monies beyond collateral values, in many cases, the over-advances were caused when collateral dissipated. In other cases, the over-advances occurred because borrowers misrepresented collateral values. All three of these scenarios were experienced at SPB and caused large loan losses.

[27] Enterprise value can be defined as the imputed value of a business. This valuation is often based on the anticipated or imputed sale value, market capitalization, or net worth of the borrower. The sale value is normally some multiple of sales or cash flow based on recent mergers or acquisitions of other firms in the borrower's industry. This enterprise value is often relied upon in the underwriting of leveraged loans to evaluate the feasibility of a loan request, determine the debt reduction potential of planned asset sales, assess a borrower's ability to access the capital markets, and to provide a secondary source of repayment. Consideration of enterprise value is appropriate in the credit underwriting process. However, enterprise value and other intangible values, which can be difficult to determine, are frequently based on projections and may be subject to considerable change. Consequently, reliance upon them as a secondary source of repayment can be problematic.

[28] Cash stream loans are loans for which debt service is derived from consumer cash collections or consumer monthly payments. Collateral for such loans includes enterprise value; multiples of earnings before interest, taxes, depreciation, and amortization; and subscriber-based collections.

Effective December 26, 2000, the bank was placed under a Cease and Desist Order (C&D Order) by the FDIC. The C&D Order included the following provision related to over-advancing funds to troubled borrowers:

> Provision 4: Extension of Credit
>
> a. Beginning with the effective date of this Order, the bank shall not extend, directly, or indirectly, any additional credit to, or for the benefit of, any borrower who has a loan or other extension of credit from the bank that has been charged off or classified, in whole or in part, Loss or Doubtful and uncollected. The requirements of this Paragraph shall not prohibit the bank from renewing (after collection in cash of interest due from the borrower) any credit already extended to any borrower.
>
> b. Additionally, during the life of this Order, the bank shall not extend, directly or indirectly, any additional credit to, or for the benefit of, any borrower who has a loan or other extension of credit from the bank that has been classified, in whole or part, Substandard and is uncollected.
>
> c. Paragraph 4(b) shall not apply if the bank's failure to extend further credit to a particular borrower would be detrimental to the best interests of the bank. Prior to the extending of any additional credit pursuant to this Paragraph, either in the form of a renewal, extension, or further advance of funds, such additional credit shall be approved by a majority of the Board of Directors, or a designated committee thereof, who shall certify, in writing:
>
> - why the failure of the bank to extend such credit would be detrimental to the best interest of the bank;
> - that the bank's position would be improved thereby; and
> - how the bank's position would be improved. The signed certification shall be made a part of the minutes of the Board of Directors or designated committee, and a copy of the signed certification shall be retained in the borrower's credit file.

At the January 2001 FDIC examination, examiners found that the bank was in compliance with Provision 4 of the C&D Order, as outlined above.

In previous discussions with examiners, CBC management indicated that it did not make decisions to use these practices loosely, but only in certain warranted circumstances when management believed that the borrower's difficulties could be resolved favorably in a relatively short time. However, examiners stated that some of these tactics resulted in delayed charge-offs and exposed the bank to more risk. As a result, examiners recommended that CBC management formalize a policy that addressed the large, unsecured term loans to be included as part of the loan policy. Specifically, the policy was to include:

- policies, procedures, and approval process for over-advances;
- guidelines and processes for the authorization, utilization, and limits for over-advances; and
- provisions for line officers to conduct analyses on the borrower's ability to service over-advances.

Bank management's use of problem loan workout strategies exacerbated asset quality problems at CBC and led to excessive increases in loss exposure and improper deferral of loss recognition. Examiners found, in fact, that there were unsatisfactory levels of adversely classified assets. Furthermore, the use of these practices basically disregarded the principles of sound asset-based lending and resulted in an adverse effect on the bank's financial position.

At least three harmful results of these practices occurred:

- SPB had an increased loss exposure. The bank was most often in a loss position at the time of the peaceful possession, that is, it had over-advanced funds to the original owners and had an unsecured position. In an effort to improve its position, SPB often supported the borrower through over-advances which, in many cases, simply increased the bank's risk exposure. For three CBC credits, over-advances exceeded $2.2 million in just 3 months from April 30, 2000, to July 31, 2000. The entire $2.2 million was classified as a contingent liabilities loss in the June 2000 ROE.

- The use of the workout practices resulted in the deferral of loss recognition. At the time of peaceful possession, the troubled companies were generally insolvent; yet the bank did not charge off the unsecured portion of the credits. Credits with such defined weaknesses should be written down to collateral value at the time of transfer. Management further deferred losses by supporting companies' operations through over-advances. In many cases, this practice supported a company that would otherwise fail and thus deferred the time when loss on the unsecured portion of the credit should have been recognized. Based on our review of CBC's over-advance reports, we determined that from May 1999 through January 2000, CBC's over-advances increased from $3.3 million to $12.6 million. At the conclusion of the January 22, 2001 examination, examiners estimated that $62.7 million of $73.3 million in loans charged off at CBC in 2000 were attributed to borrowers benefiting from liberal over-advance practices.

- Workout practices employed by CBC management increased in substandard classifications. They increased because management tended to transfer ownership of problem companies to new individuals rather than foreclose on the assets. The collateralized portions of the credits generally remained on the bank's books as substandard classifications. Had management liquidated the assets on many of the problem companies, which is generally the collection practice of asset-based lenders, the level of substandard classifications would have been greatly reduced.

In addition to these practices, CBC management did not properly report and account for nonaccrual loans and continued to accrue interest on these loans even though over-advances exceeded interest payments.[29] As a result, management was, in effect, funding interest payments through unsecured over-advances. Further, management did not place companies that were in liquidation in a nonaccrual status. The reason for the improper reporting stemmed from management's optimistic view of collecting full principal and interest on problem loans.

By the January 2001 FDIC examination, administration of CBC had improved and CBC discontinued unsecured term lending to distressed borrowers and liberal over-advance practices.

CBC Asset Concentrations

In November 2001, the FDIC reviewed concentrations at SPB.[30] The examiners focused on the bank's loans and leases to the airline industry, and their review revealed substantial deterioration of the portfolio. The bank had approximately $92 million in loans directly or indirectly supported by aircraft leases, $14 million in loans advanced directly to the airline carriers, and $11 million in loans secured by airline parts. The events of September 11, 2001, had a severe impact on CBC's $55 million aircraft leasing portfolio, with direct loan losses of approximately $16 million in the fourth quarter attributed to that event. Management attempted to negotiate with the airline companies; however, SPB was a minor loan participant. Examiners estimated that an additional provision of $20 million was needed to cover the loan risk associated with the portfolio. At the November 2002 FDIC examination, the bank's loan classifications were still centered in the CBC division, with large concentration exposures in both the telecommunications and airline industries, as shown in Table 6.

[29] According to FDIC's Manual of Examination Policies, continuing to accrue income on assets that are in default as to principal and interest overstates a bank's assets, earnings, and capital. Instructions for the Preparation of Reports of Condition and Income indicate, in summary, that where the period of default of principal or interest equals or exceeds 90 days, the accruing of income should be discontinued unless the asset is well-secured and in process of collection. Banks are strongly recommended to follow this guideline not only for reporting purposes but also for bookkeeping purposes.

[30] According to the FDIC's Manual of Examination Policies, generally 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. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. Concentrations generally are not inherently bad, but do add a dimension of risk that management of the institution should consider when formulating plans and policies. The manual also provides the following guidelines for identifying direct and indirect concentrations of obligations: (1) concentrations of 25 percent or more of Tier 1 Capital by individual borrower, small interrelated group of individuals, single repayment source or individual project; and (2) concentrations of 100 percent or more of Tier 1 Capital by industry, product line, type of collateral, or short-term obligations of one financial institution or affiliated group. Any other concentrations may be listed in the 25-percent category if desired.

Table 6: SPB Industry Concentrations from 2000 to 2002 ($ in Thousands)

Industry	December 2000	December 2001	September 2002
Telecommunications			
- Amounts Extended	$176,041	$149,469	$92,854
- Percent of Tier 1 Capital	335%	329%	418%
Airline			
- Amounts Extended	$122,485	$93,986	$60,844
- Percent of Tier 1 Capital	233%	207%	274%
Entertainment			
- Amounts Extended	$116,927	$135,683	--
- Percent of Tier 1 Capital	223%	299%	--
Technology			
- Amounts Extended	--	$52,389	--
- Percent of Tier 1 Capital	--	115%	--
Total Amount Extended	$415,453	$379,137	$153,698
Total Assets	$1,865,185	$1,401,350	$1,095,022
Percent Total Assets	22.27%	27.06%	14.04%

Source: FDIC January 2001, February 2002, and November 2002 reports of examination.

The November 2002 examination found that adversely classified items totaled $213 million, of which 98 percent were loans and leases. Approximately 45 percent of the classifications were not adversely classified at the previous examination, indicating that credit quality was deteriorating. Most of these loans were originally made in 1999 and 2000. At the time of the examination, historical loss percentages were estimated as shown in Table 7.

Table 7: SPB's Historical Losses in Industry Concentrations ($ in Thousands)

	2001		2002		Remaining Balance
	Losses	Loss %	Losses	Loss %	
Telecommunications	$ 31,191	22%	$ 40,937	27%	$ 92,854
Airline	16,660	14%	17,357	18%	60,844
Technology	16,840	21%	4,870	11%	27,081
Entertainment	Data not provided in reports of examination.				

Source: FDIC November 2002 report of examination.

Losses from the three concentrations approximated 70 percent of gross credit losses in 2001 and 60 percent in 2002. Nine of the bank's ten largest loan losses were in concentrated industries as illustrated in Table 8. Approximately 37 percent of the telecommunications concentrations and 100 percent of the airline concentrations were adversely classified. Table 9 provides a breakdown of the major loan losses at CBC for 2002 and shows that although the bank's concentrations affected more than one of its lending divisions, the major losses related to loan concentrations were in CBC. These adversely classified items included SNCs that examiners had classified as substandard or doubtful.

Table 8: SPB's Ten Largest Losses in 2001 ($ in Thousands)

Industry	Gross Amount	Division	SNC
Aircraft	$ 15,700	CBC	
Paging	12,200	CBC	
Paging	11,700	CBC	SNC
Entertainment	7,400	CBC	
Telecommunications	7,300	CBC	SNC
Technology	6,200	CBC	
Technology	4,200	CBC	
Telecommunications (DSL)	3,800	CBC	SNC
Steel Manufacturing	2,700	CBC	SNC
Telecommunications (DSL)	2,500	CBC	
Total	**$73,700**		

Source: FDIC February 2002 report of examination.

During the 2002 FDIC examination, examiners also found that 4 of the 10 largest loan classifications were CBC credits in concentrated industries (see Table 9).

Table 9: SPB's Ten Largest Asset Classifications in 2002 ($ in Thousands)

Industry	Amount	Division	SNC
Aircraft	$ 18,400	CBC*	
Advertising	15,000	CBC	
Clay Tile Mfg.	14,600	CBC	
Paging	14,400	CBC*	
Car Rentals	11,700	LPIG	SNC
Telecommunications	9,900	CBC*	
Hazardous Waste Mgt.	9,800	CBC	
Telecommunications	9,700	CBC*	SNC
Telecommunications	9,600	LPIG	SNC
Railroad	9,300	LPIG	SNC
Total	**$ 122,400**		

Source: FDIC February 2002 report of examination.
* CBC credits in concentrated industries.

The loans of most concern to examiners were those directly tied to the telecommunications sector. Credit exposures to borrowers in the telecommunications industry comprised the largest and most problematic concentration of credit. At December 31, 2001, telecommunications exposure totaled $149 million or 329 percent of Tier 1 Capital. Approximately $60 million or 40 percent of the exposure was adversely classified or deemed to have Substandard characteristics.

High Loan Growth

A study prepared by the FDIC's former Division of Research and Statistics (recently combined with the Division of Insurance to form the Division of Insurance and Research) entitled *History of the Eighties–Lessons for the Future* was published in December 1997. Volume I, *An Examination of the Banking Crises of the 1980s and Early 1990s*, detailed the life cycle of a bank failure. The study recognized that rapid loan growth was identified repeatedly as a precursor to failure. In addition, institutions that failed typically moved through three stages of deterioration. In the first stage, loan growth is rapid, loan concentrations emerge, and lending is aggressive (internal controls in the growth areas tend to be weak, and underwriting standards are generally more lenient). In the second stage, the institution's loan-quality problems increase, profits decline, and inadequate reserve levels become apparent. In the final stage, deteriorating asset quality leads to losses and a depletion of bank capital. The study also notes that only over time do the effects of growth or risk-taking – whether these effects are good or bad – become apparent.

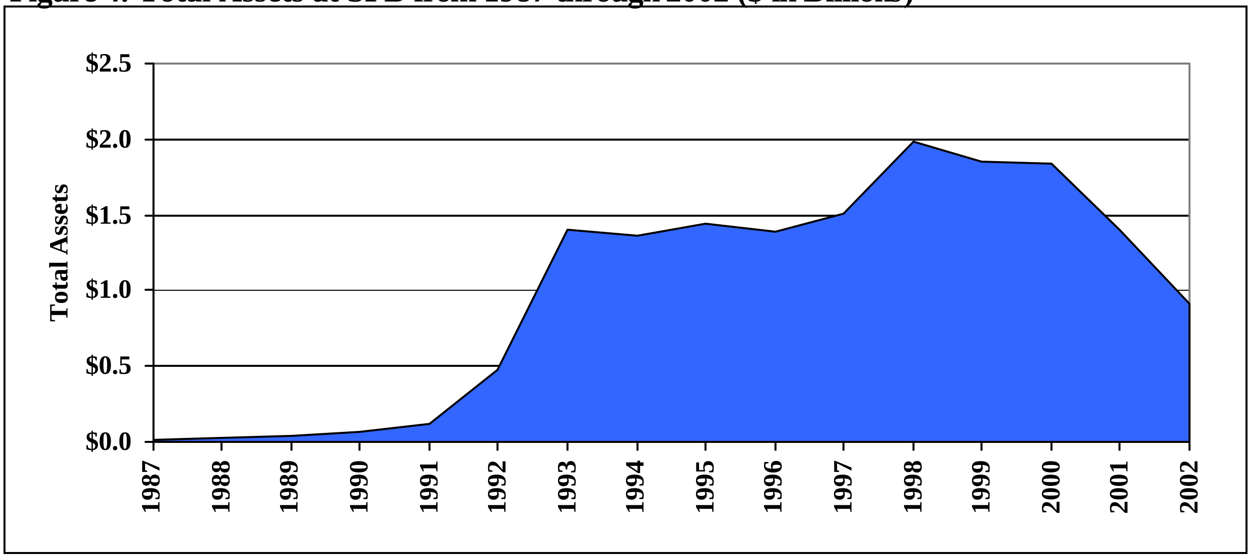
The study also recognized that growth-related risk can come in at least two areas, loans and bank management. There may be increased loan concentrations in risky areas, and there may be management lapses such as lowered underwriting standards, increased reliance on volatile funding, or a general weakening of internal controls in order to facilitate rapid growth. Both areas at SPB experienced increased growth-related risk. In particular, the bank was subject to concentrations in risky areas, liberal underwriting standards, significant reliance on volatile funding, and weak internal controls.

To mitigate the increased growth-related risk, a bank should employ strategies that consider loan quality, capital adequacy, and ALLL sufficiency. The study noted the following:

> … neither growth itself nor most other risk taking is necessarily bad for a financial institution. Banks earn their income by assuming risk; to increase risk through growth can therefore be a sound strategy. Such a strategy would ideally be accompanied by increases in capital as a buffer against higher losses, maintenance of high underwriting standards, and attention to proper risk management–in other words, by prudent management of the institution's growth. Moreover, regardless of whether the increased lending is prudent, ill timed, or very risky, the growth will generate added revenue from increased loan fees and interest income. In addition, because these are all new loans, initially there are no delinquencies and no loss charge-offs, so that the growth is almost always accompanied by growth in income and capital (assuming retained earnings). Only over time do the effects of growth or other risk taking–whether these effects are good or bad–become apparent. This long lead time before problems appear makes it difficult to identify future problem banks accurately.

One of the contributing factors to SPB's failure was the aggressive growth pursued by bank management. From 1991 through 2000, the bank was in a constant state of growth. From 1991 to 1994, the bank was engaged in lending, originating, and selling subprime residential and consumer loans. During this period, the bank grew from an institution with total assets of $56.5 million as of December 31, 1990 to $1.4 billion as of December 31, 1994. In particular, a total growth rate of 2,318 percent was achieved. From 1994 through 1999, the bank changed its loan strategies and product focus to low-quality and high-risk commercial and industrial loans with the prospect of greater profits. As the bank's investment in subprime residential loans declined, the focus in commercial and industrial loans increased. As of December 31, 1993, the bank had no commercial loans in a total loan portfolio of $1.2 billion. As of December 31, 1999, total commercial loans equaled $1.1 billion in a total loan portfolio of $1.5 billion. Figure 4 shows the level of growth achieved.

Figure 4: Total Assets at SPB from 1987 through 2002 ($ in Billions)



Source: OIG analysis of Uniform Bank Performance Reports.

SPB's ROEs since December 1994, typically noted that rapid and significant levels of growth were occurring. In addition, a few of the reports identified managerial weaknesses, loan underwriting and administrative concerns, and the lack of strategic plans in relationship to the bank's growth. The January 1996 and April 1997 reports also identified the initial shift away from single-family residential lending into commercial and industrial loans. In these reports, the commercial and industrial lending was described as being riskier and subject to greater losses. Subsequently, the June 1999, June 2000, January 2001, February 2002, and November 2002 ROEs noted the level and growth of adverse classifications that were attributable directly to CBC and the corresponding rapid growth and liberal underwriting of the portfolio.

ASSESSMENT OF THE FDIC'S SUPERVISION OF THE INSTITUTION

The FDIC and DFI examiners conducted annual examinations of SPB from 1993 until its closure in 2003 (see Table 1). The scope of examinations was generally comprehensive, and examiners repeatedly identified and reported on significant areas of concern and risk at the institution. As shown on Table 1, from 1998 until the bank failed, SPB operated under various supervisory actions by FDIC and DFI. Of these actions, specific provisions were made for capital and the ALLL. While detail reviews were performed and recommendations were made on capital adequacy and the ALLL, further analysis and study were needed to establish the appropriate level of capital and of the loan loss reserve. As discussed in the following sections, OIG analysis indicates that both capital and the ALLL were underfunded for an extended period based on the level of risk assumed by bank management. Furthermore, additional funds, above those initially requested by examiners, should have been sought to strengthen the bank's financial position. If these additional funds were sought and obtained, management may have been encouraged to take further steps by limiting asset growth or enacting a more conservative loan underwriting program. Ultimately, once loan losses began to be recognized, the level and severity of losses exceeded the available funds of the bank, resulting in its failure. As a result, the supervisory effectiveness of reducing the risk of a material loss to the insurance fund was limited. These issues are presented in detail in the following sections, which address the FDIC's supervision of the institution, including implementation of the PCA provisions of the FDI Act.

Finding A: Examiners Need More Guidance on How to Evaluate High-Risk Commercial Loan Programs that Target Subprime Borrowers

SPB's high-risk commercial loan programs were not evaluated by examiners in a manner that ensured that capital requirements and ALLL adequately addressed the risks inherent in these types of the credits. Although current examination procedures provide guidance for reviews of commercial and industrial loans (to include asset-based loans), they do not provide guidance for the evaluations of commercial lending programs that target borrowers with subprime characteristics.[31] In addition, examiners have not received guidance related to quantifying the amount of ALLL or capital needed to offset the additional risk in subprime commercial lending programs. As a result, institutions with lending programs that target subprime commercial credits may not be required to maintain capital and ALLL at levels that adequately address the risks inherent in these types of lending programs.

FDIC's Manual of Examination Polices contains policies and procedures related to examinations of loan portfolios composed of commercial and industrial loans, accounts receivable financing, leveraged financing, commercial real estate loans, and real estate construction loans, all of which were present in SPB's asset portfolio (see Appendix V). Although the manual addresses problem loans, impaired loans, and subprime consumer loans, the procedures do not address the risk inherent in loan programs that target, either through origination or purchase, subprime commercial loans to be held in the institution's portfolio or accumulated and packaged for sale.

[31] In the absence of an industry-wide definition of subprime commercial loans and for the purposes of this report, we use the term subprime to describe SPB's commercial loan portfolios.

DSC and the Federal Financial Institutions Examination Council (FFIEC) have issued specific guidelines (see Appendix VI) for examiners to follow when reviewing subprime mortgage and consumer loans and subprime credit card programs at FDIC-insured institutions. These guidelines assist examiners and bank management in effectively managing risks associated with subprime lending programs, establishing adequate allowance levels to cover losses, and maintaining capital levels that reflect the additional inherent risks associated with subprime lending. However, the procedures (with the exception of those related to subprime consumer loans) are geared towards loans that were underwritten for borrowers that, at the time of origination, did not have questionable or weakened credit histories.

Specifically, the FFIEC January 2001, *Expanded Guidance for Evaluating Subprime Lending Programs* (Expanded Guidance) addresses subprime lending and provides the following definition:

> The term subprime refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.

The Expanded Guidance states that generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- bankruptcy in the last 5 years;
- relatively high-default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

The guidance also provides the following definition of subprime lenders: "…institutions that systematically target the subprime market through programs that employ tailored marketing, underwriting standards, and risk selection."

In addition, the guidance states that the term subprime lending "program" refers to the process of acquiring on a regular or targeted basis, either through origination or purchase, subprime loans to be held in the institution's own portfolio or accumulated and packaged for sale.

During the April 1997 FDIC examination, examiners first described SPB's loan portfolio as being centered in subprime lending, making SPB more sensitive to economic downturns than competing institutions with more strict underwriting requirements. From 1997 through 2002, ROEs continually noted that SPB's borrowing base was generally subprime and warned about susceptibility to economic downturns. Examiners also noted that the entire CBC portfolio had subprime characteristics that required more than normal management attention in the identification, monitoring, and control of risk. Despite some variance, the underwriting standards were generally liberal as SPB targeted borrowers with weaknesses and charged interest rates commensurate with those weaknesses. The borrowers were generally categorized as B and C borrowers who tended to be at the marginal end of the credit spectrum and generally did not qualify for credit on more conventional terms. Examiners warned bank management that a large percentage of loans were secured with real estate and that because many of these loans were backed with junior liens, collateral values could be reduced or eliminated when property values declined.

According to the Expanded Guidance, each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities. The analysis should be tailored to reflect the size, concentration level, and relative risk of the institution's subprime lending activities and should consider the following elements:

- portfolio growth rates;
- trends in the level and volatility of expected losses;
- the level of subprime loan losses incurred over one or more economic downturns, if such data/analyses are available;
- the impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets;
- any deterioration in the average credit quality over time due to adverse selection or retention;
- the amount, quality, and liquidity of collateral securing the individual loans;
- any asset, income, or funding source concentrations;
- the degree of concentration of subprime credits;
- the extent to which current capitalization consists of residual assets or other potentially volatile components;
- the degree of legal and/or reputation risk associated with the subprime business line(s) pursued; and
- the amount of capital necessary to support the institution's other risks and activities.

The Expanded Guidance states that because subprime lending poses more risk than standard lending, it is expected that the starting point for determining capital levels would be at a minimum, one and a half to three times greater than what is appropriate for non-subprime assets of a similar type. The guidance also states that refinements to capital levels should be made based on the particular circumstances of each bank. As a result, the capital ratios should be set well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

From 1994 through 1999, SPB management engaged in a high-risk lending strategy and expanded into commercial lending, wholesale equipment lease financing, and asset-based lending to companies and borrowers with impaired credit histories. During that time, the bank created 10 new commercial-based lending divisions within the bank:

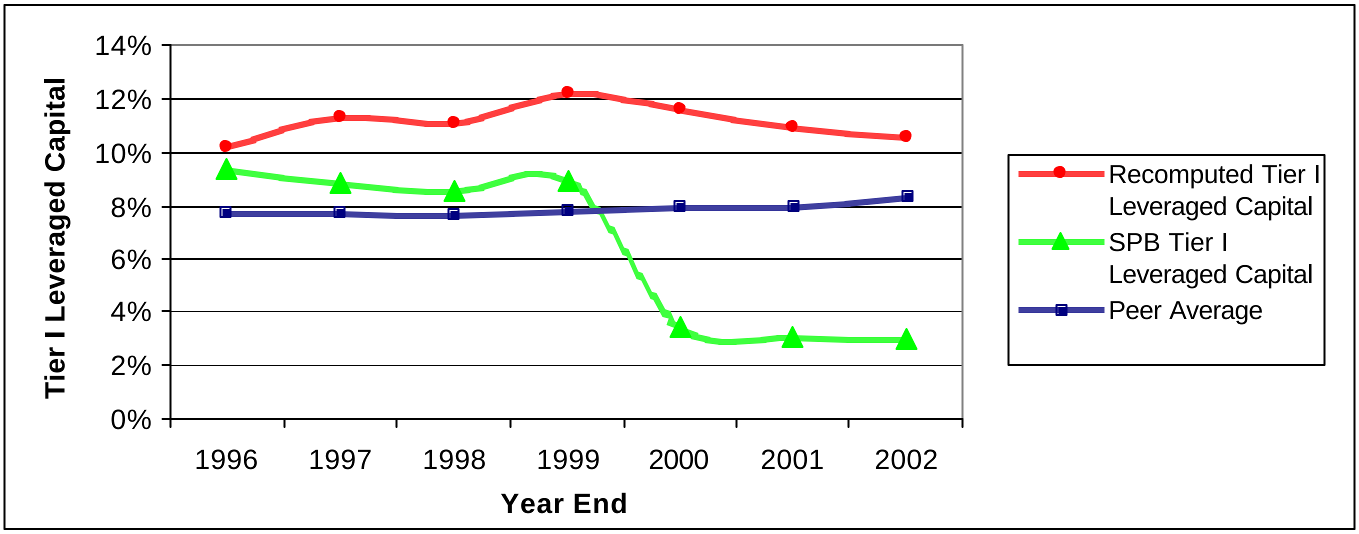
- 6 divisions focused on providing high-risk loans to subprime borrowers in the areas of asset-based commercial lending, new and used automobile paper, commercial real estate rehabilitation loans, bulk sales of nonconforming real estate loans, and automobile dealership inventory loans;
- 2 divisions provided loans on a wholesale basis to mortgage companies and leasing companies;
- 1 division specialized in Shared National Credits; and
- 1 division specialized in motion picture financing.

FDIC examiners stated that many of these new business lines were pursued without an adequate loan review program and internal loan grading system. By April 1997, SPB had discontinued single-family residence lending and was concentrating on commercial and multifamily income properties and commercial finance lending. Moreover, by this time, examiners noted that the bank's loans, regardless of type, were generally subprime. From 1997 through 2002, the bank suffered losses of over $324 million in its commercial and industrial loan portfolios.

We found that examiners conducted reviews of SPB’s management of commercial loan portfolios. The reviews were in compliance with the DSC policy manual and covered SPB policies, internal rating systems, problem loan work-out strategies, ALLL calculations, management incentives, and Board oversight. Although we found that the examiners conducted reviews of individual credits to determine the loss classifications and required ALLL, we noted only one case in which examiners took additional steps to identify the industry risk posed by the types of subprime commercial loans specific to SPB. Although current examination procedures for asset-based commercial lenders do not require specific studies of industry standards, during the 2002 examination, the examiner-in-charge (EIC) and the case manager attempted to research the industry standards for capital allotments to determine the amounts of equity capital allotted to asset-based commercial loan credits by the private sector. They found that the private sector was carrying 20 percent of capital for these types of credits. According to the EIC, this ratio was in line with the examiners’ idea of a capital allocation of 15 to 20 percent for SPB's largest lending division, CBC. The examiners used this analysis as a basis for getting SPB management to agree to allocating higher capital levels.

As a part of our analysis, we recomputed SPB‘s Tier 1 Leverage Capital based on the 20 percent equity capitalization rate for asset-based commercial loans as described in the case above. We compared our recomputed percentages to the percentages allotted by SPB, as well as to those of the bank’s peers. As demonstrated in Figure 5, SPB’s capital allocations were above the peer average through 1999; however, the bank’s averages dropped significantly below that of peer banks thereafter.

Figure 5: Recomputation of Tier 1 Leverage Capital



Source: SPB Call Reports from 1996 through 2002.

From 1996 through 1999, the difference in the amounts of the capital allotted to asset-based credits by SPB and its peer banks ranged from 0.90 percent to 1.11 percent, with SPB allotting more capital than its peer banks. From 2000 through 2002, the trend changed, and the differences ranged from 4.94 to 5.58 percent, with SPB maintaining less capital than its peer banks.

We also recomputed SPB's Tier 1 Leverage Capital for 1996–2002 based on the 20-percent equity capital assumption to determine how much, if any, additional capital would have been required to cover the risks associated with the bank's asset-based commercial loans. We found that the amounts of additional capital that would have been required for CBC alone ranged from $30 million to $126 million annually (see Table 10). As a result of our recompilation of SPB's equity capital , we found that SPB's capital was underfunded from 1996 through 2002.

Table 10: Additional Tier 1 Capital Based on a 20-Percent Equity Capital Allotment

Year-end	Capital Increase ($ in Thousands)	
	CBC	SPB Total
1996	$ 30,728	$ 13,310
1997	54,058	342,735
1998	71,708	59,566
1999	79,024	67,106
2000	126,517	174,868
2001	90,542	133,381
2002	55,674	86,737

Source: SPB Call Reports from 1996 through 2002.

DSC management informed us that in addition to policies for on-site examinations of commercial loans, DSC has policies for pre-scoping examinations that address commercial loans, and DSC has identified red flags to alert examiners to potential problems. According to the DSC case manager, when examiners conduct reviews of commercial loans, examiners take a sample of the loans and review them on a credit-by-credit basis rather than applying a formula approach to quantifying the risks. The sample would include the largest and most problematic credits in the portfolio. After conducting a review of individual loans, the examiners make conclusions about the entire portfolio. According to DSC, this is the best way to assess commercial loans. During our review of examination data for four of the largest lending divisions at SPB, we found that examination coverage of the loan portfolios ranged from 12 percent to 100 percent of the dollar value of each of the four divisional loan portfolios (see Table 11).

Table 11: Examination Coverage of High-Risk Assets at SPB

Exam Date	Ratings: Composite / Asset Quality	Total Assets ($ in Billions)	Percentage of Total Portfolio Reviewed			
			CBC	IPLD	LPIG	LHO
June 2000	**4** / 4	$ 1.902	24	21	38	44
Jan. 2001	**4** / 5	$ 1.865	68	18	15	31
Feb. 2002	**5** / 5	$ 1.401	85	46	47	36
Nov. 2002	**5** / 5	$ 1.095	54	12	78	100

Source: FDIC reports of examination from 2000 to 2002.

DSC management informed us that it would be very difficult to develop a formula approach similar to the FFIEC guidelines for subprime consumer loan programs because there are too many variables to consider related to commercial loans. The factors used to determine capital requirements for these credits must be evaluated separately and then weighted to arrive at a final amount. Because each set of circumstances will differ, the weights will vary based on the individual bank. Further, the development of additional examination guidance may require an interagency (FFIEC) effort, and the guidance would need to be sufficiently flexible to be used by each agency involved.

During discussions with FDIC management, we were told that many commercial loans recently underwritten in banks tends to be non-rated or subinvestment grade in relation to bond ratings as published by Standard and Poors and Moody's, due to the fact that prime companies have direct access to the capital markets; however, the quality of commercial lending varies from institution to institution, and capital adequacy at each institution must be subjectively determined. Also, San Francisco Regional Office management and examiners stated that very few institutions engage in commercial subprime lending and that development of a policy to address these types of credits might not be feasible.

Examiners did not evaluate SPB's lending programs that targeted subprime commercial credits in a manner that addressed the inherent risks in the programs. As a result, SPB was not required to maintain capital and ALLL at levels that adequately addressed the risks inherent in these types of lending programs. In addition, there is a potential for a lack of consistency in on-site examinations of banks with subprime commercial lending programs, particularly with regard to setting capital and ALLL at levels that address the risk inherent in these programs. Further, obtaining bank management's agreement on the examiners' method for calculating the required capital levels may be difficult without some form of agency guidance.

Recommendations

We recommend that the Director, DSC;

(2) Enhance or reinforce existing examination guidance to, at a minimum, identify techniques examiners may use to evaluate capital and loan loss allowance information available from bank and non-bank sectors, for comparing and contrasting variances in capital allocation for these types of commercial loan programs; and

(3) Reinforce examiner awareness of DSC subject-matter experts in high-risk commercial lending, and encourage examiners and case managers to avail themselves of these experts, when appropriate.

Finding B: SPB's Allowance for Loan and Lease Losses was Underfunded

The ALLL was underfunded for the level of risk assumed by bank management and present in the loan portfolio. The methodology employed by examiners to validate the bank's ALLL did not adequately consider the following:

- the use of peer group average ratios;
- the use of historical loan loss averages; and
- the assignment of qualitative adjustments for existing risk factors such as new areas of lending, new management, and high loan growth.

Properly stating the ALLL would have reduced SPB's operating results, which already showed a net loss beginning in 1999, and may have been sufficient to downgrade SPB's capital category designation for purposes of PCA.

FDIC's Manual of Examination Policies for safety and soundness examinations assigns examiners the responsibility for assessing the quality of the loan and lease portfolio, the loan review system, and the adequacy of the ALLL. Loan portfolio analysis and the determination of loan quality are used to establish and determine the adequacy of the ALLL. In general, the greater the risk in the loan portfolio, the greater the allowance should be to reserve for potential losses and to mitigate the increased risk. The Loan Portfolio Management and Review: General Examination Documentation module, Core Analysis, instructs examiners to assign classifications to loans reviewed, evaluate the internal loan classifications for accuracy, and evaluate the level and trend of classified loans. If the internal grading system is reliable, examiners are to use the bank's data for preparing the appropriate ROE pages, determining the overall level of classifications, and providing supporting comments regarding the quality of the loan portfolio. The Loan Portfolio Management and Review: General Examination Documentation module, Expanded Analysis, instructs examiners to determine an appropriate ALLL level and provides examiners seven areas of consideration.[32]

The OIG recognizes, as do DSC's various policies and procedures, that reviewing and assessing an institution's ALLL is a complex and detailed process. In addition, the OIG recognizes that the seven areas of consideration in the expanded analysis procedures are subject to a substantial degree of judgment, are not all weighted or viewed equally, and are not conclusive in that the results in one particular method do not necessarily imply adequacy or inadequacy of the ALLL. In particular, while the use of peer group averages can be useful in identifying divergent trends and can be helpful as a supplemental check of the reasonableness of management's assumptions and analysis, peer group averages are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. The historical loss averages are also subject to a certain degree of subjectivity and adjustment, and calculations can range from a simple average of net charge-offs over a relevant period to more complex techniques, such as migration analysis. The use and assignment of qualitative adjustments are also subjective and can entail complex computations. Furthermore, examination guidance in the

[32] Appendix VII contains a detailed listing of the seven methodologies used in determining an appropriate ALLL level.

quantification of qualitative adjustments is limited, and some discretion is available in how these risk factors (once quantified) could be applied through either a greater ALLL or a higher capital level.

Use of Peer Group Data Comparisons

Based on a review of the reports of examination and on a review of the workpapers for the June 2000, January 2001, and February 2002 examinations, examiners conducted a limited analysis of SPB's financial structure against that of a peer group average. In general, examiners stated that the bank's financial structure was so unique (the institution was an industrial loan company, assets were centered in low quality commercial and industrial loans, and deposits were centered in high-rate Certificates of Deposits) that making comparisons against peer group averages would not have been meaningful. In addition, although a few examiners favored the idea of formulating a customized peer average that would have been specifically tailored to the financial structure of this bank, the examiners did not formulate an analysis in this area to specifically address the adequacy of the ALLL. Other examiners noted that designating a specific pool of banks as a peer group would have been difficult due to the bank's unique financial structure. Regardless, the analysis of peer group averages (based on a review of the Uniform Bank Performance Report[33]) would have provided greater insight into the adequacy of the ALLL. Based on our analysis of SPB's financial position to their peer group average for the ratio Loan and Lease Allowance to Non-Accrual Loans and Leases, as of December 31, 2002, the ALLL would have been underfunded by $368 million and an adjusted Tier 1 Leverage Capital ratio would have equaled a negative 51.7 percent.

FDIC's Statement of Policy entitled, *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)*, dated December 21, 1993, states:

> Institutions are … encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the ALLL to classified and nonclassified loans and leases, to past due and nonaccrual loans and leases, to total loans and binding commitments, and to historical gross and net charge-offs.

The policy statement also recognizes that "… while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analysis, they are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility." The policy statement assigns examiners the responsibility to "Perform a quantitative

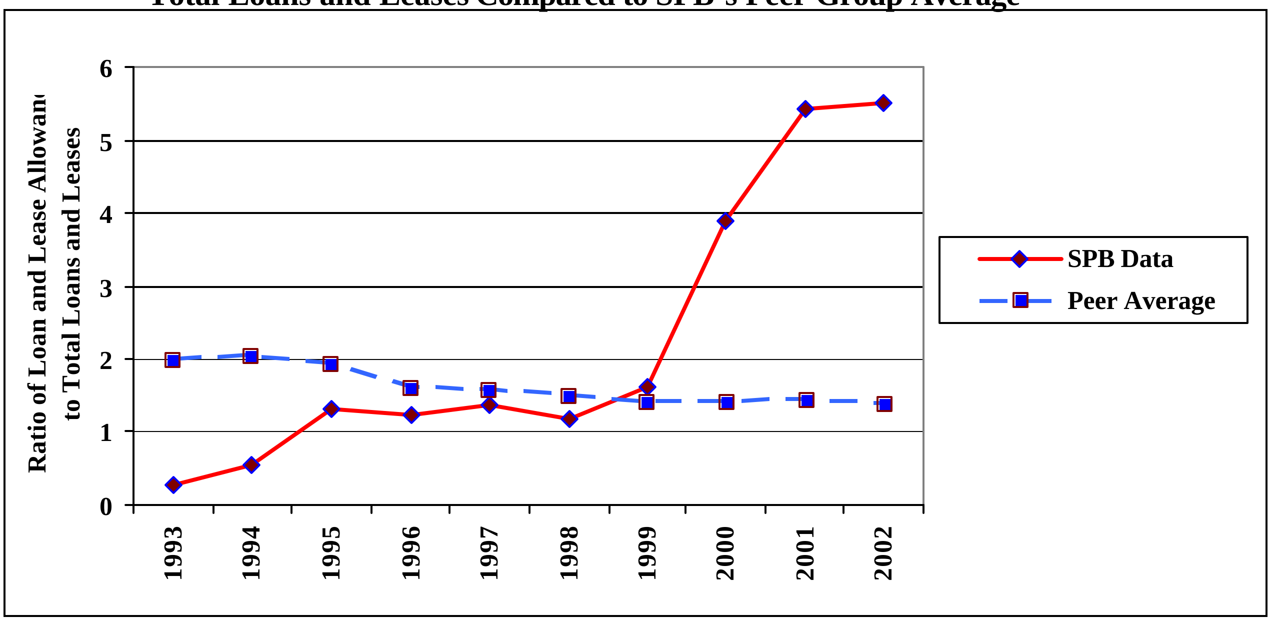
[33] The Uniform Bank Performance Report (UBPR) is an analytical tool created for bank supervisory, examination, and management purposes. In a concise format, it shows the impact of management decisions and economic conditions on a bank's performance and balance-sheet composition. The performance and composition data contained in the report can be used as an aid in evaluating the adequacy of earnings, liquidity, capital, asset and liability management, and growth management. Bankers and examiners alike can use this report to further their understanding of a bank's financial condition, and through such understanding, perform their duties more effectively. The UBPR is available online at WWW.FFIEC.GOV.

analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL."

The Core Analysis procedures instruct examiners to determine the overall adequacy of the ALLL. Examiners should, "Evaluate the overall level of the ALLL for reasonableness…Consider reviewing applicable UBPR ratios as a check for reasonableness." The Expanded Analysis procedures also instruct examiners to determine an appropriate ALLL level. In determining this level, the examiners should consider seven areas. Two of the seven areas require examiners to perform a comparison of the bank's allowance against various peer averages. One of the procedures requires examiners to, "Consider the average reserve coverage of non-performing loans by state, rating, and charter." The other procedure requires examiners to, "Consider the historical average of loan loss reserves to non-performing loans for all banks in the region and nation."

Our comparison of SPB's ALLL position to the peer group average showed that the allowance was deficient. As illustrated in Figure 6, the bank's ALLL was below the peer group average from 1993 to 1998 and then significantly rose in subsequent years.

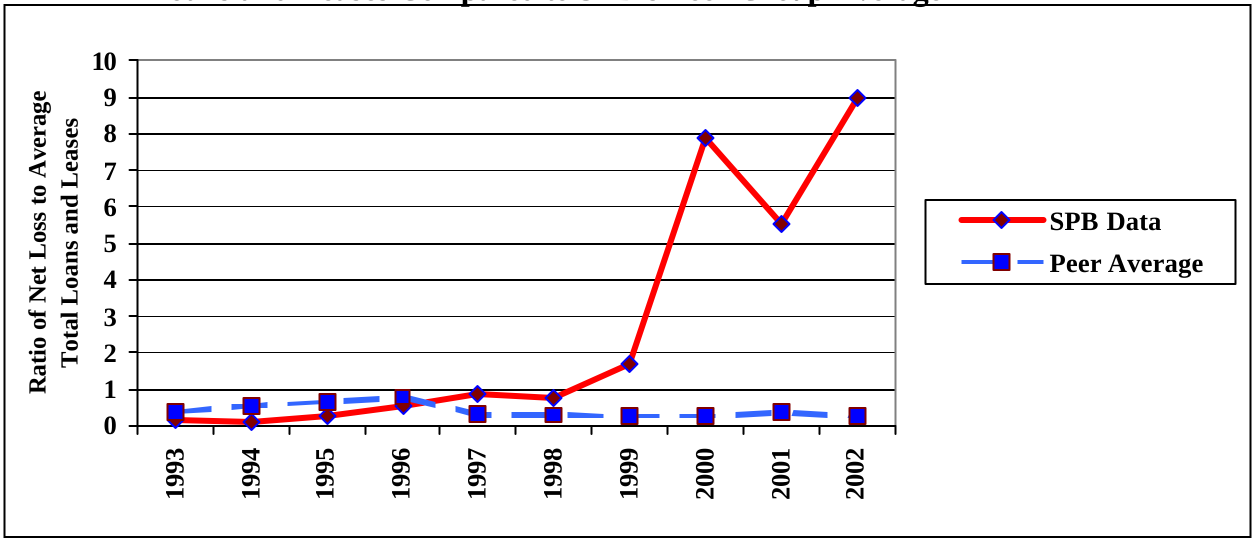
Figure 6: SPB's Ratio of Loan and Lease Allowances to Total Loans and Leases Compared to SPB's Peer Group Average



Source: OIG analysis of Uniform Bank Performance Reports.

Despite this growth, the ALLL level was still not sufficient to adequately cover the potential loss exposure in the loan portfolio. As illustrated in Figure 7, the losses that were recognized grew slowly at first, due in part to the high level of loan growth that was experienced within the CBC portfolio and the deferment of loan loss recognition practices. After 1998, loan losses grew rapidly and significantly exceeded the loan losses experienced by the peer group average.

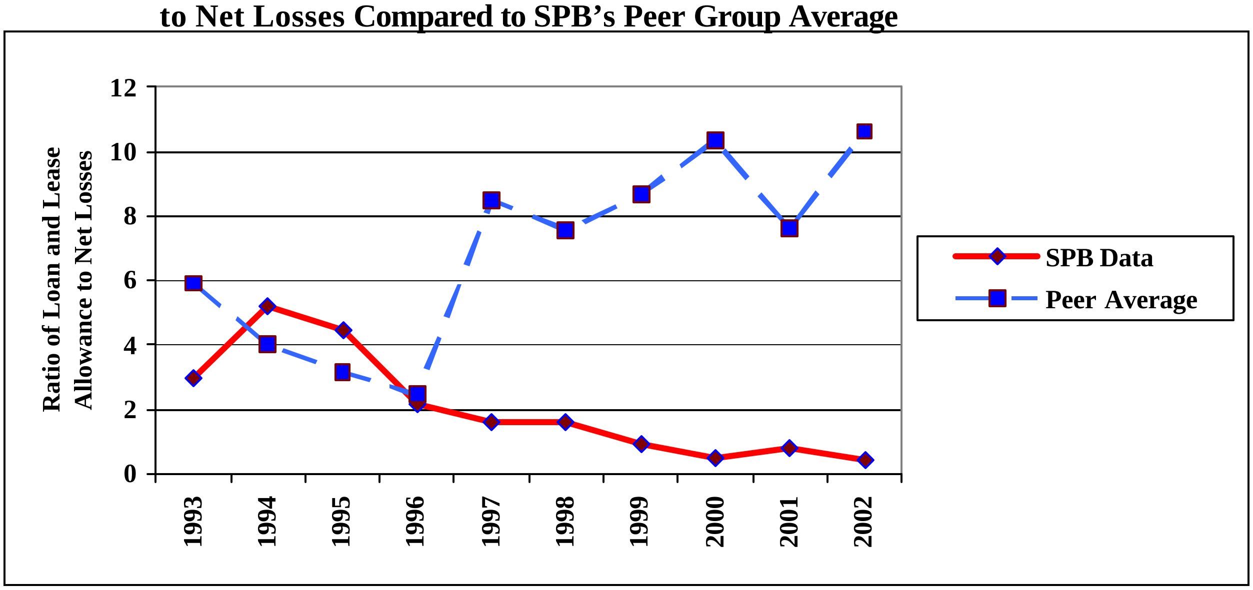
Figure 7: SPB's Ratio of Net Loss to Average Total Loans and Leases Compared to SPB's Peer Group Average



Source: OIG analysis of Uniform Bank Performance Reports.

As illustrated in Figure 8, the bank's ALLL as a percentage of net losses had been declining since 1994 and was significantly below the peer group average since 1997. This significant disparity continued to exist despite the higher allowance levels maintained by the bank from 2000 to 2002, as shown in Figure 6.

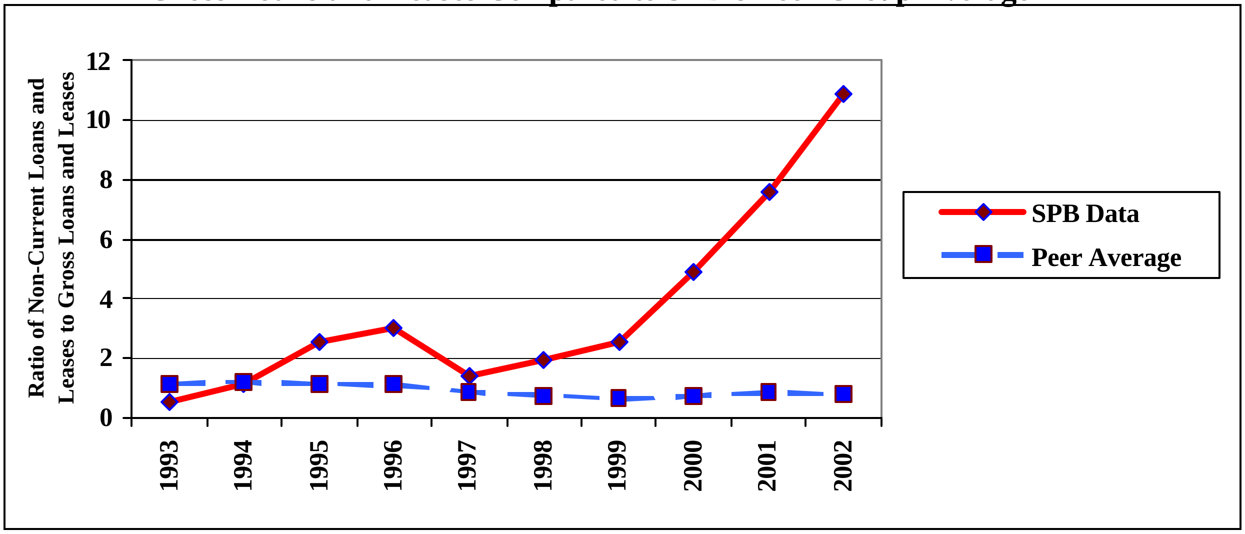
Figure 8: SPB's Ratio of Loan and Lease Allowance to Net Losses Compared to SPB's Peer Group Average



Source: OIG analysis of Uniform Bank Performance Reports.

In addition, analysis of the bank's noncurrent and nonaccrual loan portfolios provides a further indication of the direction of loan quality. As illustrated in Figure 9, noncurrent loans and leases rapidly grew from 1997, despite the artificial treatment of bringing certain delinquent loans current by capitalizing interest.

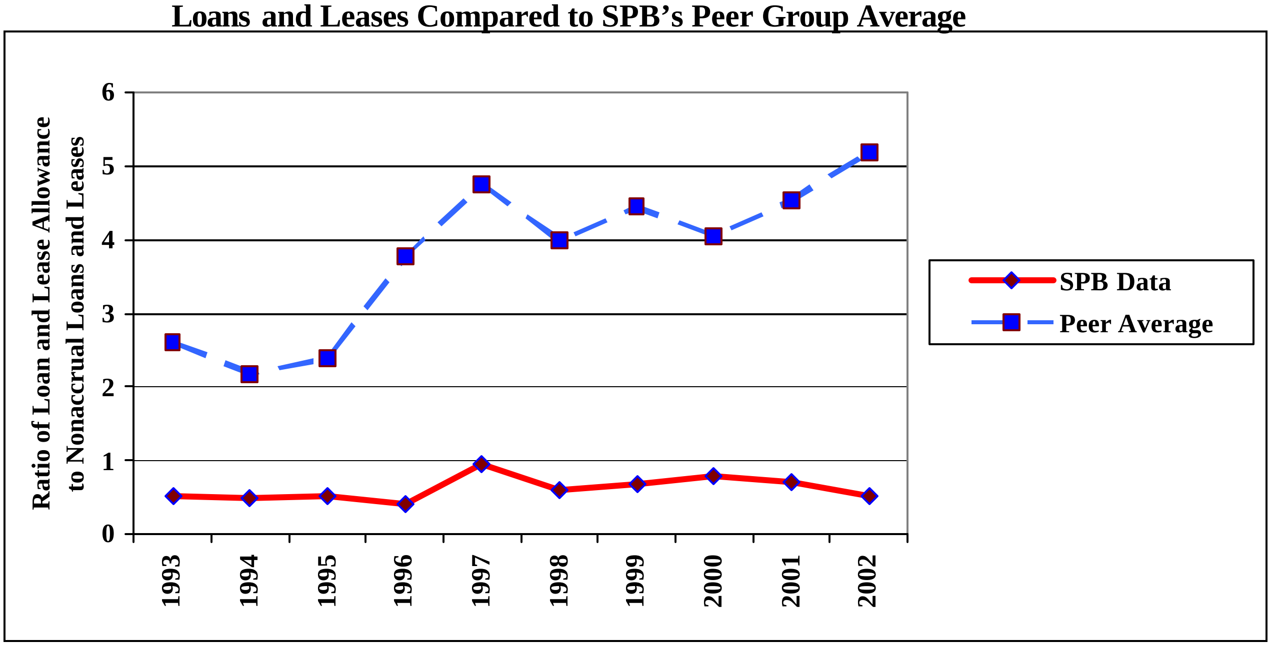
Figure 9: SPB's Ratio of Non-Current Loans and Leases to Gross Loans and Leases Compared to SPB's Peer Group Average



Source: OIG analysis of Uniform Bank Performance Reports.

As illustrated in Figure 10, the ALLL as a percentage of nonaccrual loans is significantly below the peer group average for the periods shown. Logically, however, an individual should expect that the bank's position would be higher than the peer group average because of the bank's higher than average risk profile.

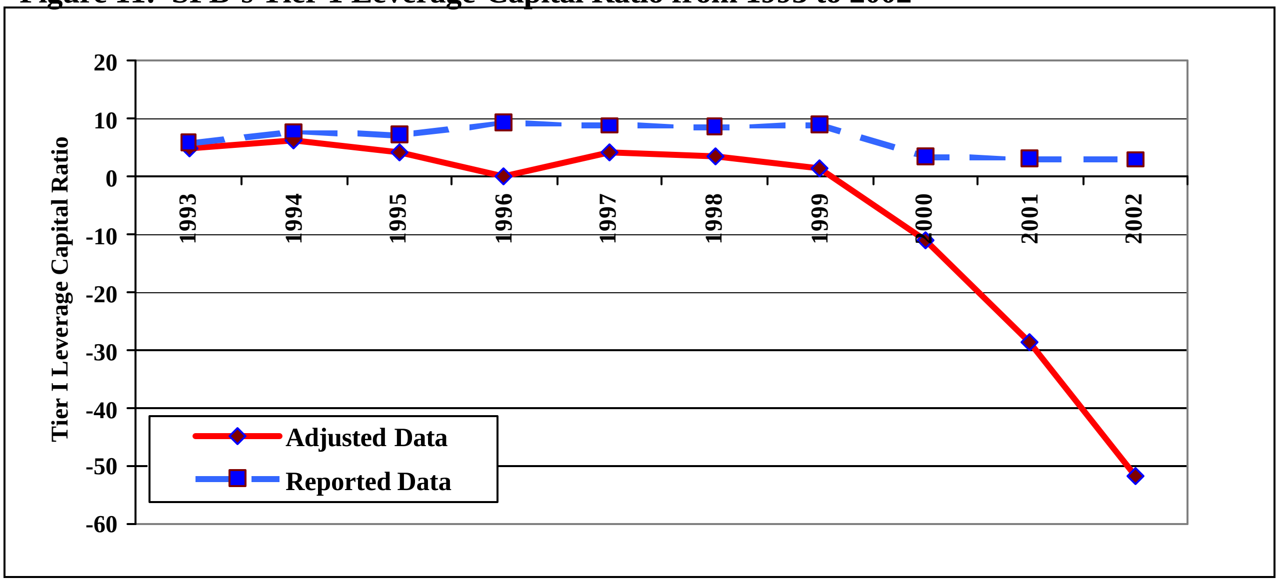
Figure 10: SPB's Ratio of Loan and Lease Allowance to Nonaccrual Loans and Leases Compared to SPB's Peer Group Average



Source: OIG analysis of Uniform Bank Performance Reports.

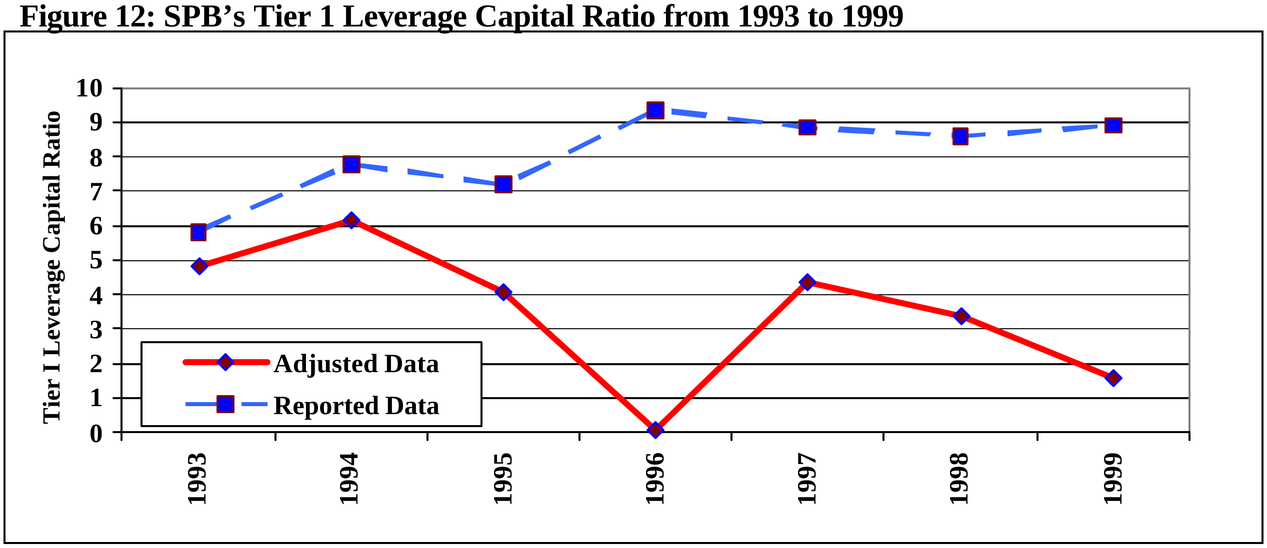
Figures 11 and 12 show what the impact would have been to the bank's Tier 1 Leverage Capital ratio if the allowance was maintained as a percentage of nonaccrual loans that was equal to the bank's peer group average. As can be seen, from 1994 to 1999, the capital position would have declined significantly from the reported levels, becoming critically undercapitalized for Prompt Corrective Action purposes in 1996 and then again in 1999.[34] From 1999 to 2002, the Tier 1 Leverage Capital ratio would have declined to a negative 51.7 percent, with additional provisions to the ALLL during that period totaling $368 million. The OIG does not suggest that this level of provision to the reserve was necessary for the period of 1999 to 2002, only that such a divergence indicates that a comprehensive review of the bank's ALLL would be necessary. The analysis also indicates that the bank possesses a higher risk profile than peer average and that a more conservative reserve factor should be considered.

Figure 11: SPB's Tier 1 Leverage Capital Ratio from 1993 to 2002



Source: OIG computations and analysis of Uniform Bank Performance Reports.

Figure 12: SPB's Tier 1 Leverage Capital Ratio from 1993 to 1999



Source: OIG computations and analysis of Uniform Bank Performance Reports.

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[34] In accordance with 12 C.F.R. Part 325 of FDIC's Rules and Regulations, critically undercapitalized institutions are defined, for Prompt Corrective Action purposes, as insured depository institution with a ratio of Tangible Equity Capital to Total Assets that is equal to or less than 2 percent. The computation of this ratio is equivalent to the computation of the ratio Tier 1 Leverage Capital to Average Total Assets.

Based on our review of the reports of examination, we found that FDIC examiners did not provide a written analysis of the bank's reserve ratios in comparison to the peer group averages. In addition, examiner discussions of delinquent and nonaccrual loans, on an aggregate basis, were limited to notations on the level and trend of these portfolios. No analysis was provided to supplement the determination of the ALLL's adequacy. Furthermore, although examiners also noted that management's ALLL methodology did consider trends of delinquent and nonaccrual loans, the reports of examination did not discuss how this data was used. However, of note, in the January 1996 ROE, examiners stated that, "The company's methodology for establishing loan loss reserves … may not be able to adequately project future losses considering that the company has moved into several new areas of lending … historic losses may not be an appropriate basis for calculating reserves for a large part of the portfolio… It is recommended that the company review industry information to re-evaluate the adequacy of its reserves …" This recommendation was not repeated in subsequent reports.

Based on a review of DSC's workpapers for the June 2000, January 2001, and February 2002 examinations, at only one of the examination was a documented analysis of the bank's reserve level in relationship to peer averages conducted. However, the analysis was flawed. The stipulated procedure requires examiners to, "Consider the average reserve coverage of non-performing loans by state, rating, and charter." The other procedure requires examiners to, "Consider the historical average of loan loss reserves to non-performing loans for all banks in the region and nation." The examiner performed an analysis by comparing what the required reserve level would be based on the use of the peer average reserve coverage of nonperforming loans.

The examiner used the following peer group averages and reserve percentages in performing the analysis:

- All California institutions – 175 percent (Population of 301 banks),
- All California banks with total assets less than $3 billion – 200 percent (Population of 288 banks),
- All California banks with total assets greater than $3 billion – 166 percent (Population of 12 banks),
- San Francisco Region, all banks with the same charter – 187 percent (Population of 130 banks – Charter used was 'State Member,' the Charter of SPB was 'State Non-Member,' with a reserve coverage of 173 percent),
- San Francisco Region, all banks with a composite rating of 4 – 88 percent (Population of 8 banks), and
- San Francisco Region, all banks with a composite rating of 5 – 214 percent (Population of 1 bank).

The examiner also performed a verification of the percentages by utilizing the following peer group averages:

- Kansas City Region, by CAMEL Rating – 77 percent,
- Kansas City Region, by Class – 206 percent,
- Kansas City Region, by Asset Size – 223 percent,
- Dallas Region, by Class – 122 percent,

- Dallas Region, all banks with a composite rating of 4 – 70 percent, and
- Dallas Region, all banks with a composite rating of 5 – 194 percent,

However, the examiner discounted the above data. The examiner's workpapers noted:

> The results of this peer comparison ranged from $67 million to $215 million. The range was too wide to be useful and research indicated a lack of institutions with the subject's characteristics. For example, San Francisco Region (Dallas Region) peer data showed 4 rated banks retained an ALLL equivalent to 69.50 percent of nonperforming loans, however, 5 rated banks in the Region retained ALLL coverage of 194.24 percent. This appears contradictory. Applied to the level of nonperforming loans at the subject on the examination date of $97 million, this would indicate an ALLL range of $67 million to $188 million.

As a result, the examiners noted that their "… preference in measuring ALLL adequacy under this technique is to assure a minimum of 100 percent coverage of nonperforming loans. This is a 'rule of thumb' used by market analysis." The examiner's analysis was flawed due to the limited population of composite 4 and 5 rated banks. As noted above, the San Francisco Region had only eight banks with a composite 4 rating and 1 bank with a composite 5 rating. By eliminating those two comparisons, the variance note by the examiner (an ALLL range of $67 million to $188 million, or a difference of $121 million) is significantly reduced (an ALLL range of $161 million to $194 million, or a difference of $33 million) and the analysis would have shown that the allowance was underfunded by a minimum of about $92 million (nonperforming loans of $97 million multiplied by 166 percent, equals a reserve coverage of $161 million, less the outstanding reserve balance of $69 million, equals a shortfall of $92 million). Also of note, for the year ended 2002, SPB's actual net loan losses equaled $94 million.

Of the remaining two sets of workpapers, one set contained peer average statistical data beyond the Uniform Bank Performance Report. However, no analysis of this data was evident. The second set of workpapers stipulated the examiners' acceptance of management's methodology, and the examiners limited their analysis to applying their loan classifications to the bank's methodology. Examiners stated that generally this particular bank did not have any meaningful peer group from which to formulate useful comparisons.

Based on our review of the bank's Quarterly Allowance Analysis reports, the bank did not perform a ratio comparison of the bank's allowance position against peer group averages. In addition, the analysis performed on nonaccrual loans was limited to a discussion of the level and trend of these assets. The bank did not perform an analysis on these loans, as a portfolio, that supplemented the determination of the ALLL's adequacy.

The examiners' limited use and analysis of peer group averages resulted from a misunderstanding of the value that the data can provide in assessing the adequacy of the ALLL. Also to a limited extent, based on the one set of workpapers that indicated a preference of ensuring a minimum coverage of 100 percent of nonperforming loans, the examiners may have lacked a contextual understanding of the purpose and use of these ratios. In particular, the purpose of performing this analysis appears to be directed at ensuring the adequacy of the whole loan portfolio (by using a multiplier) rather than just ensuring the ALLL coverage of those individual loans that are on nonaccrual status, as was done by the examiner.

As illustrated in Figures 10, 11, and 12, a significant disparity existed between the bank's position and that of the peer group average. As a result, the ALLL had been understated for an extended period. This, in turn, indicates that both net income and capital were overstated, potentially delaying regulatory corrective action.

Use of Historical Loan Loss Averages

The reports of examination and the workpapers for the June 2000, January 2001, and February 2002 examinations, showed that examiners performed limited analysis on the verification or determination of the bank's historical loan loss averages in assessing the bank's ALLL and in assigning a reserve percentage for non-adversely classified loans. Although the reports of examination noted that the bank applied historical loss percentages to classified and non-classified segments of the loan portfolio, limited analysis was performed on the appropriateness of how these percentages were applied in the ALLL. In general, examiners stated that they did not recall how or how closely the loss percentages and averages were reviewed. One examiner stated that, at any bank, in general, examiners would "eye ball" the ratios for reasonableness. Regional Office management expressed concern about the potential for "double counting" and the need to discount the ratio, if a straight/unadjusted historical loss average was used in conjunction with assigning loss exposure estimates to adversely classified loans. While this would be a potentially valid concern in an institution with a static or improving loan portfolio, it would not be valid in an institution with a deteriorating asset quality position. Furthermore, while bank management asserted, based on the ROEs, that the initial losses experienced in CBCs were temporary, one-time events, no analysis was presented to demonstrate how this would have discounted or adjusted the historical net loss average, or even whether it should be considered.

FDIC's Statement of Policy entitled, *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)*, dated December 21, 1993, and the Loan Portfolio Management and Review: General Examination Documentation module, Expanded Analysis, require that examiners determine an appropriate ALLL level by comparing the reported ALLL (after deduction of all loans, or portions thereof, classified Loss) against the sum of the following amounts:

- Fifty percent of the portfolio that is classified Doubtful.
- Fifteen percent of the portfolio that is classified Substandard.
- For the portions of the portfolio that have not been adversely classified (including those loans designated Special Mention), estimated credit losses over the upcoming 12 months (based on the institution's average annual rate of net charge-offs experienced over the previous 2 or 3 years on similar loans, adjusted for current conditions and trends).

The Expanded Analysis procedures also require examiners to determine an appropriate reserve level by determining whether the ALLL is sufficient to cover all the following risks:[35]

- Any losses on loans accorded Loss classifications (in whole or in part) that have not yet been charged off.
- Estimated probable losses for all loans accorded Doubtful classifications (without partial Loss classification).
- Estimated probable losses for all remaining adversely classified loans (without partial Loss or Doubtful classification).
- Other problem loans (either individually or in pools).
- Estimated probable losses for the remaining categories of loans in the portfolio.
- Supplemental amount for unidentified loan portfolio losses.

For safety and soundness examinations, FDIC's Manual of Examination Policies defines the term estimated credit losses as:

> … an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan, or pool of loans. The estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principals (GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged off against the ALLL … Estimated credit losses should reflect consideration of all significant factors that affect repayment as of the evaluation date. Estimated losses on loan pools should reflect historical net charge-off levels for similar loans, adjusted for changes in current conditions or other relevant factors. Calculation of historical charge-off rates can range from a simple average of net charge-offs over a relevant period, to more complex techniques, such as migration analysis.

Based on the opinion of FDIC's Accounting Section, the terms estimated credit losses and estimated probable losses as used in the two Expanded Analysis methodologies noted previously have the same meaning. FDIC's Accounting Section also noted the following, which is also discussed in the Interagency Policy Statement:

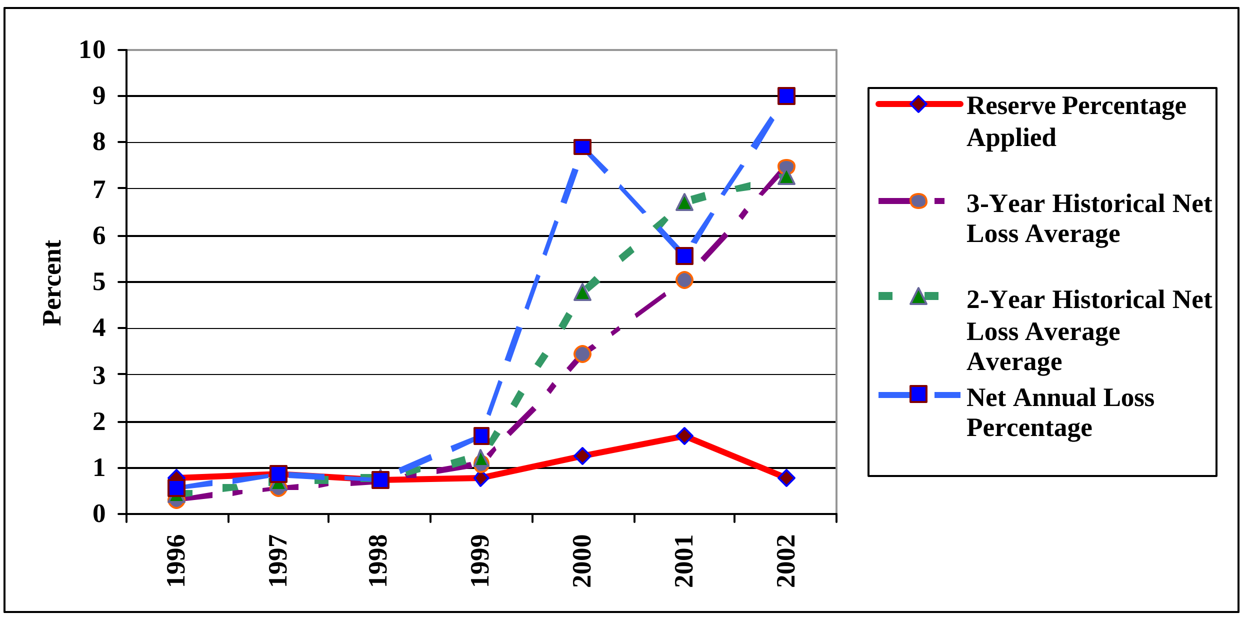
> … this calculation should only be considered a starting point for an examiner's analysis of ALLL adequacy. The Interagency Policy Statement indicates that the calculation is a test of 'reasonableness' and that the amount calculated is 'neither a "floor" nor a "safe harbor" level for an institution's ALLL. Therefore, a shortfall relative to this amount does not necessarily indicate that an ALLL is inadequate. Rather, a shortfall indicates that the examiner must review management's methodology more closely before making a determination about ALLL adequacy. At the same time, an ALLL in excess of the amount derived from this calculation does not necessarily indicate that the ALLL is adequate and does not relieve the examiner of the

[35] Based on discussions with FDIC regional office managers and examiners, more weight is assigned to this particular methodology than to the others in determining the adequacy of the ALLL.

responsibility to ensure that an institution's methodology is appropriate given the specific risk characteristics of the institution.

Based on our review of the reserve percentages used to provide for an allowance for non-adversely classified loans and leases, the allowance was deficient. Figures 13 and 14 show the disparity in the bank's reserve allocation to those loans classified as Pass in comparison to the total loan portfolio's historical net loss averages. Figure 13 provides a comparison based on the total loan portfolio, and Figure 14 provides a comparison based only on the CBC loan portfolio. The figures show that the reserve percentage applied by the bank had only a nominal correlation to the actual and historical average loss rates that SPB was experiencing. The reserve percentage applied to the total loan portfolio (for non-adversely classified loans, excluding watch list/special mention loans) rose above 1 percent only in 2000 and 2001. In 2001, the reserve percentage equaled 1.7 percent, an increase of 42 basis points[36] over the previous year's percentage. This level, however, was 335 basis points below the 3-year historical net loss average. For the same period, CBC's reserve percentage rose to 3.7 percent, an increase of 235 basis points over the previous year's percentage. This level was 358 basis points below the 3-year historical net loss average.

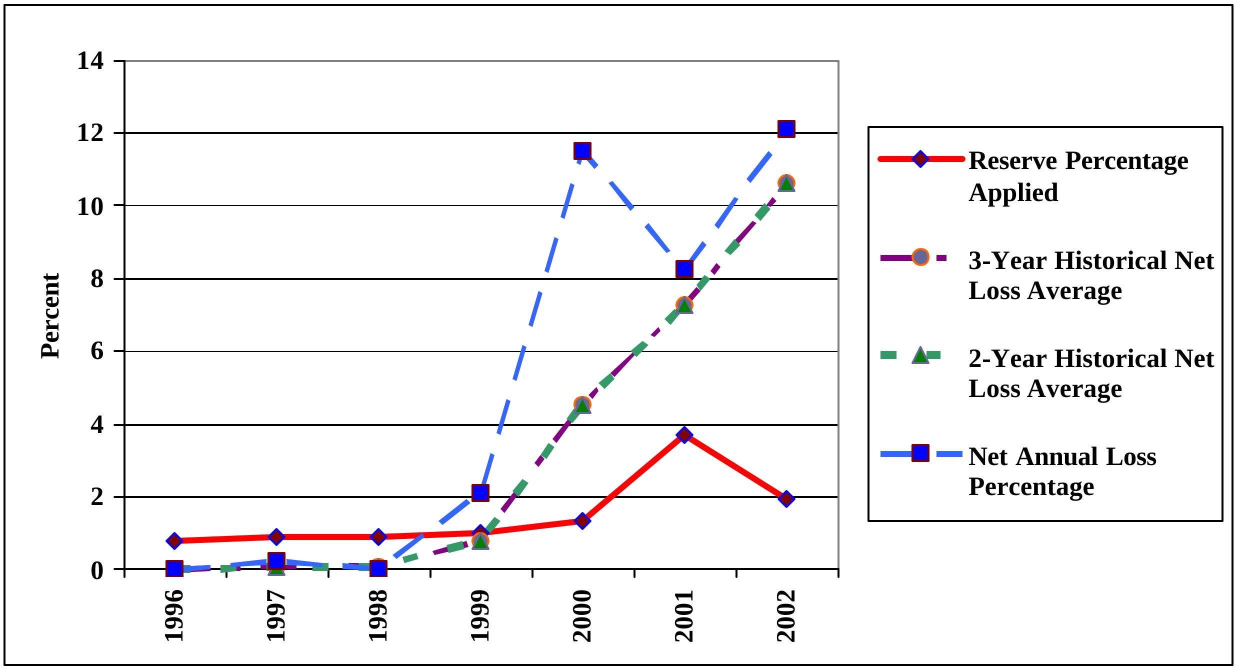
Figure 13: Historical Loss Averages in Comparison to Reserve Percentages for Non-Adversely Classified Loans



Source: OIG analysis of Uniform Bank Performance Reports and Southern Pacific Bank's Quarterly Allowance Analysis. All data was provided as of year-end, except for the Quarterly Allowance Analysis reports for 1999 and 2002. The corresponding dates used were September 30, 1999 and November 30, 2002, respectively. Only loans designated as a Pass were considered; watch/special mention loans were excluded.

[36] Barron's Business Guides *Dictionary of Banking Terms* describes a basis point as the smallest measure in quoting yields, equal to one one-hundredth of one percentage point, or .01 percent. A bond whose yield to maturity changes from 8.50 percent to 9.25 percent is said to move 75 basis points in yield.

Figure 14: CBC's Historical Loss Averages in Comparison to Reserve Percentages for Non-Adversely Classified Loans*

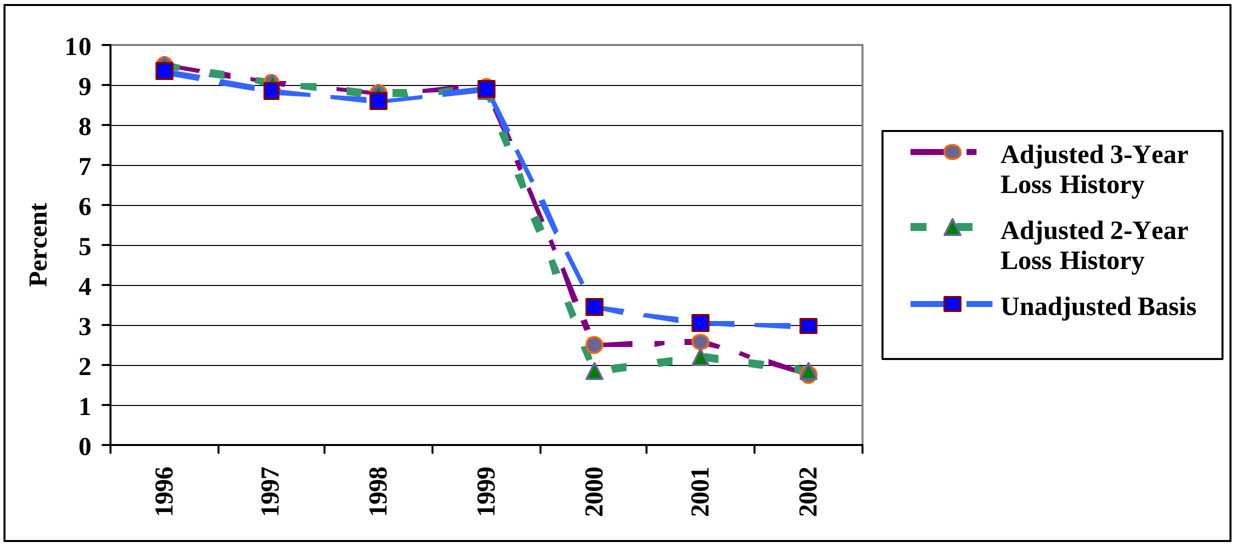


Source: OIG analysis of Uniform Bank Performance Reports and Southern Pacific Bank's Quarterly Allowance Analysis. All data was provided as of year-end, except for the Quarterly Allowance Analysis reports for 1999 and 2002. The corresponding dates used were September 30, 1999 and November 30, 2002, respectively. Only loans designated as a Pass were considered; watch list/special mention loans were excluded.

*Coast Business Credit's Net Annual Loss Percentage was based on the Uniform Bank Performance Report line item "Net Losses by Type of LN&LS – Commercial and Industrial Loans."

Figure 15 shows the effect that the use of historical net loss averages would have had on the bank's Tier 1 Leverage Capital ratio based on CBC's reserve differentials. The percentages in Figure 15 do not include any qualitative adjustments that may have been deemed necessary by the OIG. Additionally, the percentages do not incorporate examination specific adjustments, unless the bank's Call Reports and Uniform Bank Performance Reports were revised. For Prompt Corrective Action purposes, as of December 31, 2000, the bank would have been designated as either critically undercapitalized based on the use of the 2-year historical net loss average or significantly undercapitalized based on the use of the 3-year historical net loss average. As of December 31, 2001, the bank would have been designated as significantly undercapitalized based on either average. As of December 31, 2002, the bank would then have been designated as critically undercapitalized based on either average. The unadjusted basis would indicate that capital was undercapitalized for year-end 2000 and 2001, and that capital was significantly undercapitalized for the year-end 2002. The January 2001, February 2002, and November 2002 Reports of Examination designated the bank's capital as significantly undercapitalized, undercapitalized, and significantly undercapitalized, respectively. If watch list/special mention loans were included in the analysis, Tier 1 Leverage Capital ratios would decline an additional 6 to 52 basis points for the years ended 2000 to 2002.

Figure 15: Impact to the Tier 1 Leverage Capital Ratio



Source: OIG analysis of Uniform Bank Performance Reports and Southern Pacific Bank's Quarterly Allowance Analysis.

Based on our review of the reports of examination, the FDIC examiners did not provide a detailed description or analysis of the historical loan loss averages. Generally the reports of examination did note that the bank applied historical loss percentages to classified and non-classified segments of the loan portfolio. However, as shown in the figures above, from 1999 to 2002, the percentages applied to non-classified loans appear deficient. From 1996 to 1999, CBC's annual loan losses were minimal due to the limited maturity and significant growth of the portfolio. In addition, starting with the May 1998 ROE, the reports typically noted that management used three methods to calculate the adequacy of the ALLL. Those methods were identified as the Exposure Method, the Formula Method, and the Historical Charge-Off Analysis Method. The examiners also noted that different loan types were analyzed separately to properly reserve for their respective risks. The later ROEs noted that the bank's quarterly review relied more heavily on the loss exposure method for individual credits but also considered historical loss experience, trends in delinquent and nonaccrual loans, concentrations, and prospective economic conditions. In addition, the following observations were noted:

- In the January 1996 ROE, examiners noted that the historical loss percentages appeared reasonable and supportable and that the historical loan losses were very low. The examiners also recognized that the bank was moving into several new areas of lending and that the previous method of relying on historical loss averages should be amended to consider the new lending activities.
- In the June 1999 ROE, the examiners noted that the reserve allocations for Pass loans and Other Assets Especially Mentioned were raised by management during the examination to 1.0 percent and 3.0 percent, respectively, from a 0.9 percent allocation. However, no accompanying analysis was provided to support this change or to justify its sufficiency.
- In the January 2001 ROE, the examiners noted that management believed that the previous year's losses were an aberration and that considering the apparent improvement in credit and problem asset administration, the losses were not considered to have predictive value. Regardless, examiners attributed to the allowance an allocation of 2 percent against those loans

classified as Pass in contrast to the bank's allocation of 1.5 percent. The examiners justified the higher allocation factors based on examiner analysis and an attempt to recognize loss experience without over-weighting calendar year 2000 losses.

- The February 2002 and November 2002 ROEs, noted that the bank's historical loss analysis was considered somewhat flawed due to the lack of documentation supporting the internal allocations. However, both reports also noted that this did not detract from the overall methodology. The February 2002 report also detailed that management applied a 3-percent reserve factor to all non-classified technology and telecommunication loans and a reserve factor of 1.5 percent to the remaining Pass loans at Coast Business Credit. The examiners also noted that the total reserve for all technology loans was 7.5 percent and that this factor was well below the bank's historical average annual loss rate of 24 percent.

Based on our review of DSC's workpapers for the June 2000, January 2001, and February 2002 examinations, examiners did not appropriately compute and/or apply the historical loan loss average to loans that were not adversely classified. Based on a review of the February 2002 examination workpapers, examiners accurately calculated the 3-year historical net loss average and correctly applied that percentage to the Regulatory Test methodology. The Regulatory Test method applies a formulaic approach to establishing reserves based on the classification category. However, when performing the Exposure Analysis, the examiners utilized the bank's reserve factors. Based on our analysis, as of the February 2002 examination date, the ALLL was underfunded by an additional $25 million. Of the remaining two sets of workpapers, no analysis of this data was evident. However, as noted above, the January 2001 ROE noted and the examination workpapers showed that the examiners did apply a slightly higher reserve percentage to those Coast Business Credit loans that were not adversely classified. The examiners applied a 2-percent reserve factor, while the actual 3-year historical net loss average equaled 4.54 percent .

Based on our review of the bank's Quarterly Allowance Analysis reports, the bank did prepare a trend analysis of aggregate loan losses. However, a direct correlation to the reserve ratios applied to non-adversely classified loans was not provided. In addition, no analysis was performed on these loss factors that supplemented the determination of the ALLL's adequacy. Also of note, the Quarterly Allowance Analysis reports reference a KPMG survey and historical trends report as support for the reserve percentages used. Most of the examiners did not recall reviewing or obtaining that particular report. A few examiners noted that no reliance would have been placed on that data if it had been obtained. One examiner stated that the information was considered and that the KPMG loss rate information was based on early data relative to the decline in technology, telecommunications, and aircraft sectors; however, the survey and workpapers were not retained to document this review.

The limited determination and analysis of historical loss averages can be attributed to the lack of clarity in outstanding policies and procedures on the appropriate use of these reserve factors in assessing and establishing an allowance for non-adversely classified loans.
As illustrated in Figures 13 and 14, a significant disparity existed between the bank's reserve percentages and that of the historical loss averages. As a result, based on the OIG's analysis, the ALLL has been understated since December 31, 2000. This, in turn, indicates that both net income and capital were overstated.

Use and Quantification of Qualitative Risk Factors

Several qualitative risk factors were present that were not fully considered or quantified in the determination of the ALLL adequacy. In particular, risk factors existed such as new areas of lending, new management, high loan growth, and concentrations of credit. Due to the presence of these risk factors, additional reserves were needed to mitigate the corresponding risk. The lack of consideration and quantification of these factors resulted in the ALLL being underfunded.

FDIC's Manual of Examination Policies for safety and soundness examinations states that

> Estimated credit losses should reflect consideration of all significant factors that affect repayment as of the evaluation date. Estimated losses on loan pools should reflect historical net charge-off levels for similar loans, adjusted for changes in current conditions or other relevant factors." The manual further states that, "Estimated credit losses should reflect consideration of all significant factors that affect collectibility of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses, are not by themselves, a sufficient basis to determine an adequate level. Management should also consider any factors that are likely to cause estimated losses to differ from historical loss experience, including but not limited to:
>
> - Changes in lending policies and procedures, including underwriting, collection, charge-off, and recovery practices.
> - Changes in local and national economic and business conditions.
> - Changes in the volume or type of credit extended.
> - Changes in the experience, ability, and depth of lending management.
> - Changes in the volume and severity of past due, nonaccrual, restructured, or classified loans.
> - Changes in the quality of an institution's loan review system or the degree of oversight by the Board of Directors.
> - The existence of, or changes in the level of, any concentrations of credit.

The Core Analysis procedures of the Loan Portfolio Management and Review: General Examination Documentation module instruct examiners, in part, to determine whether management considers any factors that are likely to cause estimated credit losses to differ from historical loss experience including, but not limited to, changes in the nature and volume of the portfolio and the existence and effect of any concentrations of credit and changes in the level of such concentrations.

The Expanded Analysis procedures of the Loan Portfolio Management and Review: General Examination Documentation module instruct examiners, in part, to determine an appropriate ALLL level and to consider the following factors to determine an appropriate percentage for non-classified loans (a partial listing of items is provided):

- Expertise, training, and adequacy of loan staff.
- Adequacy of charge-off policies.
- Capitalization of interest.
- Level and trend of overdue and nonaccrual loans.
- General economic considerations (local, state, regional, national).
- Growth trends.
- Entry into new areas of lending.

FDIC's Statement of Policy entitled, *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)*, dated December 21, 1993 states, in reference to the use of historical net loss averages, that, "In cases where the institution has an insufficient basis for determining this amount, the examiner may apply the industry-average net charge-off rate to non-classified loans and leases."

While examiners recognized and reported on the presence of several qualitative risk factors such as new areas of lending, new management, high loan growth, and concentrations of credit, examiners took limited action in considering and quantifying these risks in the assessment of the ALLL. However, based on examiner testimony, a qualitative adjustment was made for the existence of loan concentrations, as a noted risk factor during the February 2002 examination. However, this adjustment was embedded in the examiners' assigned loan loss reserve percentages that were applied to adversely classified credits on an individual basis. No workpaper documentation was produced to show the effect of this adjustment or how this reserve factor adjustment was determined.

Based on our review of the bank's Quarterly Reserve Analysis reports, the qualitative factors noted above were not used by SPB in the determination of the ALLL. As of December 2000, the reserve analysis performed by the bank did consider present and prospective economic conditions and loan concentrations; however, these risk factors were not used to formulate or support quantifiable adjustments to the reserve balance. In particular, the most complete discussion was the bank's analysis of loan concentrations. As of December 2001, this analysis included a discussion of each particular industry; a break-down of loans adversely and non-adversely classified; the assignment of individual reserve allocations to each loan; and on a limited basis, the aggregate amount of reserves assigned to each concentration in comparison to historical losses. The concentration listing showed that Pass loans were assigned a reserve allocation of 3 percent, watch list loans were assigned a reserve allocation of 3 to 5 percent, Substandard loans were assigned a reserve allocation of 15 to 25 percent, and Doubtful loans were assigned a reserve allocation of 50 percent. The bank's analysis also stated that, "The total reserve for all technology loans now stands at $3.9 million, or 7.5 percent of outstandings. The 7.5 percent factor is below the bank's historical average yearly loss rate of 24 percent for technology loans; however, much of the loss exposure has been either charged-off or provided for…" However, no support was presented and no discussion detailed how the percentages were formulated or how they were adjusted for the increased risk factor of the loans being a part of a concentration.

The February 2002 ROE noted under the bank's Exposure Method for the Coast Business Credit loan portfolio that:

> Management does not have documented support for reserve allocations for loans at CBC. Management applies a 3 percent reserve factor to all non-classified technology and telecom loans and a reserve factor of 1.5 percent to the remaining pass loans at Coast. In general, all pass and watch-graded telecommunications and technology loans receive a 3 percent to 5 percent reserve factor, respectively…When asked whether there was documented support for using the 3 percent to 5 percent reserve factors and the 1.5 percent reserve factor for the remaining pass credits, (management) indicated that there was not.

Based on these comments, the analysis of allocating reserve percentages appears to have been determined based only on the assessment of credit quality and not from the existence of the concentration as a qualitative risk.

Due to the lack of analysis and consideration of several qualitative risk factors, the ALLL was underfunded for an extended time. As a result, both net income and capital were overstated. In addition, the failure to encourage proper risk management and risk mitigation through the identification and quantification of risk allowed management to pursue a significant level of aggressive growth within certain business lines. In general, if DSC pursued a more conservative approach in assessing the adequacy of the bank's ALLL by quantifying and reserving for the qualitative risk present, then management may have slowed its growth strategies and limited the potential risk and loss to the BIF.

DSC has provided guidance to examiners on assessing the adequacy of a bank's ALLL through various sources, including, but not limited to, the FDIC's Examination Documentation modules, Manual of Examination Policies, Regional Directors Memoranda, and Statements of Policy. However, DSC's policies and procedures do not specifically detail how examiners should make the determination that estimated loan losses might differ from the bank's historical loss experience and from the bank's assumptions utilized within its methodology of determining the ALLL. In addition, the OIG has also recently issued an audit report entitled *Examiner Assessment of High Loan-Growth Institutions,* dated December 23, 2002. In that report, the OIG presented six recommendations for enhancing DSC's assessment of high loan-growth institutions. The findings and recommendations in that report may assist in developing further guidance for examiners in measuring and quantifying qualitative risk.

Recommendations

We recommend that the Director, DSC:

(4) Emphasize the importance of following existing procedures on the use and analysis of peer average data in review of the ALLL.

(5) Reinforce and/or clarify existing guidance on the use of historical loss reserve factors for non-adversely classified loans.

(6) Reinforce and/or clarify existing guidance on the application and quantification of qualitative adjustments to the loan loss reserve factors or to the determination of capital adequacy.

Implementation of Prompt Corrective Action

DSC implemented Prompt Corrective Action (PCA) in accordance with regulatory guidelines. As SPB's capital deteriorated, the bank was notified of its designated capital category, and DSC promptly took discretionary actions available under PCA. However, PCA's effectiveness at minimizing losses to the insurance fund was limited because of the bank's delay in and failure to make provision for an adequate allowance for loan losses, to enforce programs for repayment of loans, and to promptly recognize loan losses. Due to these activities, both net income and capital were overstated.

PCA was incorporated into the FDI Act under Section 38, effective December 19, 1992. PCA aims to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. For those institutions that do not meet minimal capital standards, regulators may impose restrictions on dividend payments, limit management fees, curtail asset growth, and restrict activities that pose excessive risk to the institution. Section 38 of the FDI Act, codified to 12 U.S.C. 1831o, defines five capital categories for insured financial institutions as follows: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The section requires specific supervisory actions to occur when the financial institutions fall into any one of the lower three capital categories. PCA supplements the use of other available enforcement tools, such as Cease and Desist Orders, removal of an institution-affiliated party, and civil money penalties that may address unsafe and unsound banking practices before capital becomes impaired.

Section 38(f)(2) of the FDI Act requires the appropriate federal banking agency to take one or more of the actions listed in that section against institutions which are significantly undercapitalized or undercapitalized institutions which have failed to file or implement a capital restoration plan. The mandatory restrictions may be embodied in an action taken pursuant to section 8 of the FDI Act, codified to 12 U.S.C. §1818, or in a PCA directive. Regardless of the enforcement tool used to achieve the desired result, every critically undercapitalized, significantly undercapitalized, or undercapitalized institution that has failed to file or implement an acceptable capital restoration plan must have a formal action in place or in process that covers the mandatory restrictions. Such formal action can be avoided only if the FDIC Board is able to make a determination that the action would not further the purpose of section 38. (See Prompt Corrective Action (PCA) in the glossary for an explanation of the various PCA capital categories and corresponding ratio measurements.)

Table 12 shows the examiner's assigned capital component ratings and the corresponding informal and formal enforcement action taken by DSC based on the ROEs from May 1998 to November 2002. Capital and ALLL provisions are also listed in part.

Table 12: Informal and Formal Enforcement Actions – Capital and ALLL Provisions

Exam Date	PCA Capital Category	Capital Component Rating	Informal / Formal Action and Effective Date	Capital and ALLL Provisions
May 1998	Well Capitalized	3	Memorandum of Understanding (MOU) January 7, 1999	- Maintain the minimum risk-based capital requirements for a Well Capitalized institution. - Maintain an adequate ALLL.
June 1999	Adequately Capitalized	3	Bank Board Resolution (BBR) January 26, 2000 and MOU continued	MOU provisions continued. No capital or ALLL provisions in BBR.
June 2000	Adequately Capitalized	3	Cease and Desist Order December 15, 2000	- Tier 1 Leverage Capital ratio of 9%. - Total Risk Based Capital ratio of 12%. - Maintain an adequate ALLL
Jan. 2001	Significantly Under-capitalized	4	Cease and Desist Order continued	C&D Order provisions continued.
Feb. 2002	Under-capitalized	5	Cease and Desist Order continued	C&D Order provisions continued.
Nov. 2002	Significantly Under-capitalized	5	Cease and Desist Order continued	C&D Order provisions continued.

Source: FDIC reports of examination.

Based on the reports of examination, SPB was first identified by examiners as having less than satisfactory (rated 3) capital at the May 1998 examination. During this examination, concern was noted due to the severity of accounting deficiencies and to the unrestrained asset growth. In the June 1999 and June 2000 examinations, capital continued to be considered less than satisfactory due to the relative risk in the bank's asset base and the subsequent deterioration in asset quality and earnings, respectively. In the January 2001 examination, capital deteriorated and was considered to be inadequate (rated 4) as a result of the bank's poor asset quality and poor earnings performance. In the February 2002 and November 2002 examinations, capital was downgraded further to a 5 rating due to the noted depletion of capital levels caused by excessive operating and loan losses.

From 1998 to 2002, the FDIC issued one Memorandum of Understanding and one Cease and Desist Order. The state also issued a Final Order that was similar to FDIC's Cease and Desist Order. In addition, the bank's Board of Directors adopted a Board Resolution to address concerns in the June 1999 ROE. The issuance of the Memorandum of Understanding and Cease and Desist Order implemented PCA actions and imposed restrictions before it was applicable.

In February 2002, management was notified that the bank was undercapitalized for PCA purposes, was subject to certain restrictions, and was required to submit a capital plan to the FDIC within 30 days. PCA notifications are also considered formal enforcement actions. The recapitalization plan was required by March 2002, and FDIC subsequently approved the submitted plan in May 2002. However, in July 2002, FDIC notified the bank that it had failed to implement the capital plan requirements and that the bank was deemed to be significantly undercapitalized for PCA purposes. A revised capital plan was requested and subsequently submitted in November 2002. The revised capital plan was not approved by FDIC. Also in November 2002, the state issued a capital demand requesting the bank to increase capital levels to an 8.5 percent tangible equity capital ratio, a minimum of $54 million. In February 2003, the bank was closed by the state.

Since January 1998, $110.8 million in capital infusions and $14 million in non-cumulative preferred stock were received by SPB, while $7.7 million in dividends were paid out. The majority of these capital infusions was received in 2001 and 2002 and totaled $86.3 million. Despite these capital infusions from the holding company, capital continued to deteriorate and the bank failed to meet the capital provisions contained in the outstanding Cease and Desist Order and approved capital plan.

PCA's effectiveness at minimizing losses to the insurance fund was limited because of the bank's failure to make provision for an adequate ALLL, enforce programs for repayment of loans, and promptly recognize loan losses. As a result, both net income and capital were overstated for an extended period. Furthermore, more capital was needed than the regulatory minimums established for the capital category of well capitalized. As discussed elsewhere in this report, a Tier 1 Leverage Capital ratio in the range of 11 to 12 percent was needed based on the results of applying a 20-percent capitalization rate to the bank's loan portfolio of commercial and industrial loans. Had this study been conducted and applied to the bank earlier, and in conjunction with establishing a more conservative ALLL, bank management may have slowed the growth of the commercial and industrial loan portfolio, thus limiting losses to the bank and ultimately to the deposit insurance fund. Also of note, had these standards been applied earlier, additional funds may have been provided by the holding company to bolster operations that were not available in the later years. Had additional funds been made available to SPB in the form of higher reserves and capital coverage, then the failure of the institution could have been prevented and/or the losses to the insurance fund reduced.

Regardless, the effectiveness of implementing PCA was delayed, and when PCA was implemented, the financial condition of the institution had deteriorated so significantly that a sizable capital contribution would have been necessary to save the institution, thus limiting potential corrective action.

Other Issue: Federal Oversight of ILC Parent Holding Companies

Of the 10 material loss reviews we have conducted, this is the second involving industrial loan companies – the 1999 failure of Pacific Thrift and Loan was the other. In the case of SPB, its parent holding company, ICII, was not subject to the regulatory oversight provided under the BHCA. However, the FDIC was authorized by law to examine any affiliate of SPB, including its parent company, to determine the relationship between SPB and its parent/affiliate and the effect of such a relationship on the bank. Our report contrasts the oversight and authority provided under the BHCA with that which is available by statute to FDIC for parent holding companies of industrial loan companies such as ICII. We also intend to conduct an audit specifically focusing on non-bank bank holding companies and the potential risks, if any, which may result from the reduced level of federal oversight for holding companies not covered by the BHCA.

ILC History

ILCs have existed since the early 1900s. Initially, ILCs operated as consumer finance companies using their own capital or borrowings to fund their loans and investments. The ILCs usually made lower quality, higher-interest-rate consumer loans, which the commercial banks avoided. The ILCs offered "thrift instruments" which performed much as modern certificates of deposits, but with a high rate of interest that attracted investors. Even after the establishment of the FDIC in 1934, investors continued to seek the ILCs above market rates on their investments. Over time, the ILCs became more like banks, while commercial banks eventually grew to recognize the value of the consumer loan market. In 1982, the Garn-St. Germain Depository Act permitted ILCs to apply for FDIC insurance.

In the mid-1980s, a major business conglomerate, Gulf and Western Resources, Inc., observed that the BHCA defined a bank as an entity that made commercial loans and accepted demand deposits. This conglomerate opined that if it created a corporation that did only one of these things, that entity would not be a "bank" and, furthermore, its parent company would not be a bank holding company and, therefore, would not be subject to the activity limitations contained in the BHCA. National or state chartered banks that accepted demand deposits or made commercial loans, but not both, became known as "nonbank banks." ILCs were included in this category, making them an appealing option for commercial companies that could not otherwise get into the banking business due to federal restrictions.

Subsequently, the Competitive Equality Banking Act of 1987 (CEBA), Public Law 100-86, changed the definition of bank to an institution that has FDIC insurance or accepts deposits and engages in the business of making commercial loans. CEBA redefined the term bank for the purposes of BHCA to include any bank insured by the FDIC, but at the same time expressly excluded certain institutions from the definition of bank. Excluded are ILCs, industrial banks, and other similar institutions that meet certain criteria. The Gramm-Leach-Bliley Act of 1999 (GLBA), Public Law 106-102, did not repeal the ILC exception contained in the BHCA. Generally, in order to maintain the exemption to the BHCA, an ILC had to meet at least one of the following conditions: (1) the institution could not accept demand deposits, (2) the institution's total assets had to be less than $100 million, or (3) control of the institution had not been acquired after August 10, 1987. SPB and its parent holding company, ICII, were grandfathered and exempted from the BHCA.

One of the values in the ILC charter lay in its exemption from the BHCA. Today, the ILC has become an attractive charter for nonbank companies that want to own a financial institution without requiring the parent company to divest all nonbank-related activities as required by the BHCA and face regulation by the Federal Reserve. The authority of the ILC to engage in activities is determined by the laws of the chartering state. There is no federal charter for an ILC. ILCs can offer most of the services of traditional banks including consumer and business loans, credit cards and auto financing without having to face regulation by the Federal Reserve. There are a minority of states that offer ILC charters including California, Colorado, Hawaii, Indiana, Minnesota, Nevada and Utah. About 50 insured ILCs operate nationwide, with the majority operating in Utah and California. The parent companies of the ILCs include a diverse group of financial and commercial firms; however, a number of institutions continue to operate a community-based business model on a stand-alone basis.

FDIC's Regulatory Authority

Beginning in 1983, FDIC-insured ILCs increased as a number of existing ILCs obtained FDIC insurance coverage and several de novo applications were approved. ILCs became subject to the FDIC's safety and soundness regulations and other supervisory programs with exception to limitations in its cross-guarantee authority and Golden Parachute authority.[37] The FDIC and the state banking regulator conduct the safety and soundness examination for FDIC-insured, state chartered institutions, including ILCs, which are not members of the Federal Reserve System. FDIC regulates ILCs in the same manner as other state nonmember institutions, and ILCs receive regular examinations.

The insured institution's transactions with affiliates are reviewed during each safety and soundness examination when deemed necessary. Sections 23A and 23B of the Federal Reserve Act, which are applicable to state nonmember banks through section 18(j) of the FDI Act, are the primary statutes governing transactions between a financial institution and its affiliates and are designed to prevent the misuse of a bank's resources stemming from these transactions. Section 23A regulates loans or extensions of credit to affiliated organizations and investments in affiliates by restricting the amount of loans, extensions of credit, and investments,[38] and requiring that the loans or extensions of credit meet certain collateral standards. Section 23B generally prohibits any transaction with an affiliate on terms or conditions less favorable to the bank than a transaction with an unrelated third party.

Affiliate transactions are specifically addressed within the FDIC's Manual of Examination Policies and on-site examination tools. The FDIC's Manual of Examination Policies provides the following cautionary introduction to a discussion regarding relationships and transactions with affiliated entities:

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[37] Legislative corrections are being pursued in the proposed Financial Services Relief Act of 2003.

[38] Section 23A of the Federal Reserve Act limits the aggregate of all covered transactions between a bank and (1) a particular affiliate to 10 percent of the bank's capital stock and surplus, and (2) all of its affiliates to 20 percent of the bank's capital stock and surplus.

> The relationship of a bank with its affiliated organizations is important to an analysis of the condition of the bank itself. Because of the commonality of ownership or management which exists, transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties. Also, affiliates offer an opportunity to engage in types of business endeavors which are prohibited to the bank itself yet those endeavors may affect the condition of the bank. In recognition of the importance of relationships with affiliated organizations the FDIC has been granted authority, under certain conditions, to examine affiliates in connection with its examination of a bank.

At the initiation of each on-site examination, the FDIC submits a Request Package to the subject institution. Among the items requested are the following:

- List of officers and directors of affiliates, including organizational chart, if available.
- List of affiliated organizations and their financial statements as of the financial statement date, or most recent date available.
- Most recent annual report, 10-K, and /or 10-Q.
- Tax allocation agreement with the holding company.
- Fee structure of transactions with the holding company and/or affiliates.

The above items serve as the starting points for reviews of an institution's relationships with affiliated entities. The Examination Documentation modules, which serve as an examination tool during on-site bank examinations, includes a Related Organizations module containing 28 review points addressing policies and procedures; internal controls; audit or independent reviews; information and communication systems; affiliate operations; compliance with Sections 23A and 23B of the Federal Reserve Act, Part 362 of FDIC's Rules and Regulations and other applicable regulations; and affiliate capitalization. The expanded analysis, which supports additional or more in-depth review as appropriate, includes eight additional steps.

Violations of Sections 23A or 23B of the Federal Reserve Act, or other applicable regulations by state nonmember banks may be the subject of a variety of informal or formal enforcement actions, including Memoranda of Understanding, Cease and Desist Orders, or Civil Money Penalties. The FDIC MOU, dated September 16, 1996, imposed on SPB specifically requested the bank to adopt and implement a program to ensure that affiliate transactions comply with applicable laws and regulations. The January 27, 1999 MOU also contained provisions for the bank to eliminate and correct all violations of applicable laws and regulations.

Although the FDIC does not have statutory authority to directly supervise the parent companies of ILCs, the FDIC does have the authority under Section 10(b)(4) of the FDI Act, codified to 12 U.S.C. § 1820, in examining any insured depository institution, to make examinations of the affairs of any affiliate, including the parent holding company, as may be necessary to disclose fully the relationship between the institution and the affiliate, and to determine the effect of such relationship on the depository institution.

Examinations of affiliates that are considered necessary by the examiner must be supported by compelling reasons. No affiliate examination may be undertaken without prior clearance from the FDIC regional office. Section 10(c) of the FDI Act empowers the FDIC to issue, in the course of an examination, subpoenas and to take and preserve testimony under oath so long as the documentation or information sought relates to the affairs or ownership of the institution being examined. Accordingly, individuals, corporations, partnerships, or other entities that in any way affect the institution's affairs or ownership may be subpoenaed and required to produce documents under the Section 10(c) powers.

Under Section 8(b) of the FDI Act,[39] the FDIC has the enforcement authority to issue Cease and Desist Orders, either by consent of the parties, or through an administrative hearing process, against insured state nonmember banks and/or their institution-affiliate parties.[40] Cease and Desist Orders may be issued to prevent or stop insured ILCs and or their institution-affiliated parties from engaging in unsafe or unsound banking practices and/or violations of the law. The Cease and Desist Orders may also contain provisions requiring the institution and or party to take affirmative corrective action to correct or remedy any conditions resulting from a violation or practice addressed in the subject order. The following types of affirmative corrective actions are expressly addressed in the statute:

- Restitution or reimbursement, indemnification, or guarantee against loss if the institution or party was unjustly enriched or the violation or practice involved a reckless disregard for the law.
- Restriction of the institution's growth.
- Disposal of loans or assets.
- Rescission of agreements or contracts.
- Employment of qualified officers or employees.
- Such other action as is deemed appropriate by the agency.

In December 2000, the FDIC issued a Cease and Desist Order that included a restriction on the flow of dividends from SPB to ICII. This restriction remained in place until SPB failed.

BHCA Inspections

The Federal Reserve's (FED) *Bank Holding Company Supervision Manual* provides a perspective on the positive and negative benefits of the holding company structure in the regulated industry environment. The holding company structure allows entities to avoid some of the constraints of regulation, such as limitations of geographic areas a firm can serve. Second, a holding company structure allows the regulated firm to expand into other product markets that often are not subject to regulation. Thirdly, the use of a holding company structure increases the organization's financial flexibility, thereby avoiding financial constraints imposed by regulation, including limitations on leverage, types of assets acquired, and types of liabilities that can be issued. Finally, the holding company may receive a financial advantage by obtaining tax benefits.

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[39] Codified to 12 U.S.C. 1818(b).

[40] Section 3(u)(1) of the FDI Act, codified to 12 U.S.C. §1813, defines institution-affiliate parties as "any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution … ."

While these positive effects may exist, there are also two primary ways a holding company structure can have an adverse effect on the financial condition of a regulated subsidiary. First, the holding company and/or its unregulated and regulated subsidiaries can take excessive risks and fail. This failure then has a "ripple effect" on the regulated bank, impairing its access to financial markets. The second way that a holding company can have a harmful effect on the financial condition of a regulated bank is through adverse intercompany transactions and excessive dividends. The FED Board has formally stated that a bank holding company should act as a source of financial and managerial strength to its subsidiary banks. Congress has expressly endorsed the Board's long-standing view that holding companies must serve as a "source of strength to subsidiary financial institutions." This policy was formalized into Regulation Y in 1983, which states:

> A bank holding company shall serve as a source of strength to its subsidiary banks and shall not conduct its operations in an unsafe and unsound manner.

As part of this policy, a bank holding company should stand ready to use its available resources to provide adequate capital funds to its subsidiary bank during periods of financial stress or adversity and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary bank. A bank holding company should not withhold financial support from a subsidiary bank in a weakened or failing position when the holding company is in a position to provide the support. A bank holding company's failure to assist a troubled or failing subsidiary bank would generally be considered an unsafe and unsound banking practice and/or a violation of Regulation Y. Consequently, such a failure would generally result in the issuance of a cease-and-desist order or other enforcement action as authorized under banking law.

Although parent holding companies of ILCs are not subject to the FED's "source of strength" policy statement, section 4.3 of FDIC's Manual of Examination Policies used to examine ILCs states:

> A sound, well-managed holding company can be a source of strength for unit banks; however, if the condition of the holding company or its nonbank subsidiaries is unsound, the operation of the subsidiary banks can be adversely affected.

The FED's *Bank Holding Company Supervision Manual* states that the overall supervisory program under a holding company structure commences with a preliminary risk assessment of the strengths and weaknesses of the holding company and provides a basis for determining the inspection procedures to be performed. The risk assessment identifies the organization's principal business activities and the types and quantities of risks associated with the activities. The quality of management and the control of risks are also considered when formalizing and structuring the supervisory strategy to be followed in conducting the inspection of the holding company. The inspection focuses on evaluating the organization's risk-management processes to determine the extent to which these management processes can be relied on. The inspection also measures the financial strength of the bank holding company and focuses on the financial indices of both the consolidated entity and its component parts. The principal indices appraised are quality of assets, earnings, capital adequacy, cash flow and liquidity, and the competency and effectiveness of management. In addition, the FED's inspection program assesses the transactions between insured subsidiaries and affiliates to determine the impact or consequences of transactions between the parent holding company or its nonbanking subsidiaries and the insured subsidiaries. The FED's inspection process is intended to encourage sound banking practices and to take appropriate supervisory action when warranted. The full-scope FED inspection may be conducted at a point in time or through a series of targeted or limited-scope reviews conducted on an ongoing or continuous basis for the largest and most complex organizations.

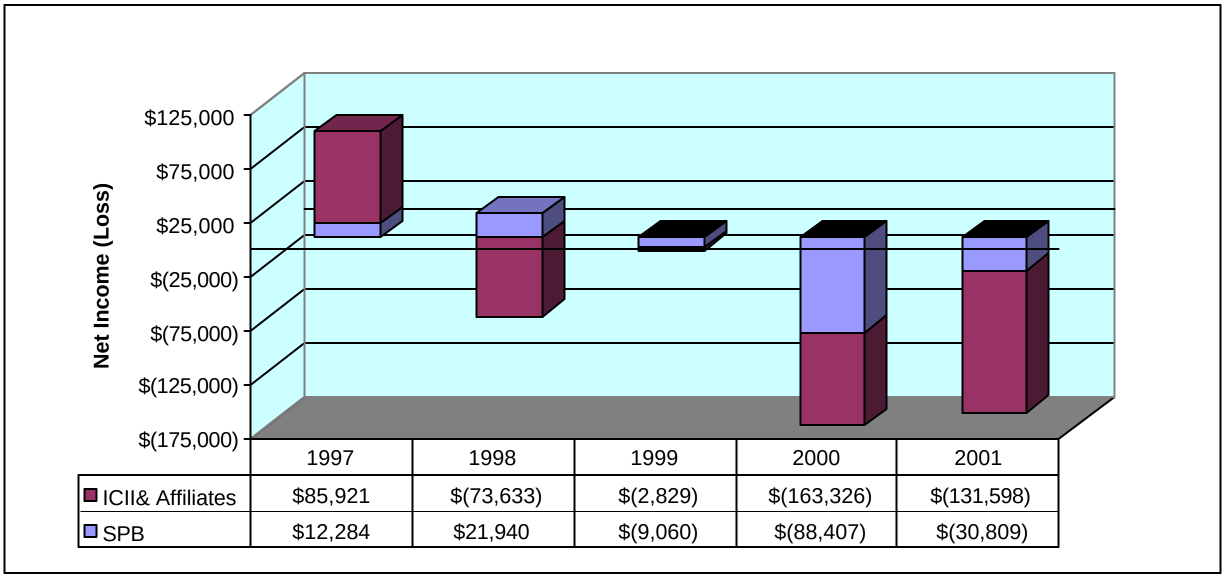
FDIC's Visitations of Parent Holding Company

The FDIC performed its first on on-site visitation of ICII in February 2001. A second on-site visitation of the holding company was conducted in February 2002. The purpose of these holding company visitations was to determine the overall condition of the holding company and its ability to support SPB. The FDIC examiner performed a review of the parent holding company and all its nonbank affiliate activities. At both visitations, the examiner concluded that ICII was not a source of strength for the bank.

Prior to the on-site visitations, reviews of ICII were conducted through the traditional bank examination process and were limited to affiliate transactions identified on SPB's records and in discussions with SPB's management, ICII's 10-K reports submitted to the Securities and Exchange Commission, and independent audit reports. The FDIC determined that the available information precluded the need for an onsite presence until its visitation in April 2001.

Based on our review, ICII's financial troubles began as early as 1998. In 1998, ICII incurred a $74 million loss in the holding company and its non-bank subsidiary operations compared to an $86 million profit in 1997, reflecting a $160 million change in earnings over the 2-year period. This significant change in revenues was primarily attributed to ICII recording large nonrecurring gains in 1997 on sales of stock in its equity investments of affiliate entities, along with a large gain on a termination agreement with another affiliate. In 1998, ICII's subsidiary, Southern Pacific Funding Corporation (SPFC), filed for Chapter 11 bankruptcy protection which led to a resultant decline in SPFC's common stock to below $1 dollar a share. ICII recorded a write-off of $82.6 million in its SPFC equity investment. In addition, ICII recorded equity impairments of $24.5 million and $13 million relating to its affiliates, Impac Mortgage Holdings, Inc. and Imperial Credit Commercial Mortgage Investment Corporation, respectively. Negative revenues in these and other affiliate investments also resulted in large losses. ICII's price on its common stock dropped from a high of about $27 a share in March 1998 to about $8 a share at year-end. As noted in Figure 16 below, ICII continued to experience losses after 1998.

Figure 16: SPB and ICII Net Operating Income From 1997 to 2001 ($ in Thousands)



	1997	1998	1999	2000	2001
ICII& Affiliates	$85,921	$(73,633)	$(2,829)	$(163,326)	$(131,598)
SPB	$12,284	$21,940	$(9,060)	$(88,407)	$(30,809)

Source: ICII's 1997 through 2001 Annual Reports to its stockholders. The 2002 Annual Report was not completed by ICII

Our analysis of ICII's capital injections and other actions since its spin off from Imperial Bank in 1992 indicates that ICII had historically, in the early years, provided SPB with capital injections before FDIC and DFI issued the 2000 Cease and Desist Orders. Table 13 on the following page provides the history of ICII's capital injections to SPB.

Table 13: Capital Infusions to SPB by Year ($ in Thousands)

Year	Capital Contributed	Assets Purchased	Dividends Paid	Description
1992	$ 10,000			Imperial Bank provided funds to SPB as part of the spin-off of ICII and SPB.
1992	16,000			ICII provided cash through Initial Public Offering (IPO) of stock proceeds.
1993	51,000			ICII provided cash through issuance of debt.
1994	0			
1995	0			
1996	0		$ 6,200	SPB paid ICII a dividend.
1997	0		18,540	Sixty percent of net income paid out in dividends to ICII. Bank policy limited dividends to 35 percent of net income, an excess of $7.752 million in dividends.
1997	0	$18,400		ICII purchased low quality asset.
1998	9,547			Residential mortgage loans and interest-only (IO) mortgage-backed securities. $2 million of IO's were classified as substandard at the 1999 exam.
1998	0		4,000	SPB paid ICII a dividend.
1999		10,000		ICII purchased low quality asset.
1999	0		3,700	SPB paid ICII a dividend.
2000	15,000			ICII provided cash to SPB.
2000	14,000			ICII exchanged $9 million of SPB's subordinated debt and contributed $5 million in cash for 50,000 shares of preferred stock.
2001	18,100			ICII provided cash to SPB.
2001	22,000			ICII forgave $22 million of $42 million in subordinated debt.
2001	16,200			Outside Investors provided infusion.
2002	30,000			ICII provided $10 million cash, exchanged $20 million in subordinated debt for preferred stock.
2002		2,900		ICII purchased low quality asset.

Source: ICII Annual Reports and FDIC ROEs

ICII provided capital infusions to SPB before 1994, when SPB and ICII earnings were strong and the indebtedness was low. Also prior to 1994, ICII had no subsidiaries other than SPB. After 1994, ICII did not have a history of significant capital infusions to SPB until November 2000. From 1994 through 1999, SPB paid ICII $32.4 million in dividends, while ICII purchased $28.4 million of SPB's low-quality assets and contributed $9.5 million in assets to SPB, of which $2 million was classified as Substandard at the 1999 examination. ICII provided a cash contribution to SPB in November 2000, 1 month before FDIC and DFI issued Cease and Desist Orders to SPB. From 2000 through 2002, ICII provided a total of $118.2 million in capital infusions, of which only $48.1 million was cash contributions and $51 million was an exchange of subordinated debt for preferred stock. This had no financial impact on the overall financial condition.

**CORPORATION AND STATE OF CALIFORNIA
COMMENTS AND OIG EVALUATION**

On August 8, 2003, the DSC Director provided a written response to the draft report. The response is presented in its entirety as Appendix VIII to this report. DSC concurred with all six recommendations. DSC's comments were responsive, and we consider all the recommendations to be resolved. The recommendations will remain undispositioned and open until we have determined that corrective action has been taken and is effective. A summary chart showing management's responses to our recommendations is presented in Appendix IX.

In its response to the draft, DSC commented on specific sections of the report. We have clarified our position on those topics, which are bulleted below, followed by the OIG's evaluation (in italics) of DSC's comments. We did not take issue with DSC's assessment of SPB's management as a factor in SPB's failure, the Supervisory History of the bank, and the Change in Control Proposal.

- <u>Cause of Failure and Material Loss</u>

  In addressing the Cause of Failure and Material Loss, DSC commented on the Impact of Economic Factors on Credit Quality. Specifically, DSC states:

  > The factors ultimately bearing on the Bank's failure included a higher-risk lending model that was not fully supported with a commensurate risk management program, and the impact of the economic downturn, particularly on commercial credit portfolios. The Bank's business strategy developed during the mid- to late-1990s and focused on large syndicated credits and asset-based lending, which developed into moderately high concentrations in the telecommunications, air transportation, technology, and entertainment sectors. Collectively, these factors placed the Bank in a vulnerable position. Financial protection in the form of capital, allowance for loan losses, and earnings was eroded by rapid and unforeseen economic deterioration (exacerbated by the 9/11 event) in the various industry sectors in which the bank concentrated its lending.

  Economic factors in the early 2000s may have exacerbated the deterioration in the bank's portfolio;, however, SPB is one of only a very few banks that have failed after being subject to the same factors. Furthermore, SPB began to experience losses in 1999, prior to the economic downturn. The losses continued until its failure. We therefore agree with the statement in DSC's response that "Overall, management's poor decisions and practices played the decisive role in the Bank's failure."

- <u>Other Matters – Holding Company Structure</u>

  In its discussion of the Holding Company Structure, DSC states:

  > We believe that the FDIC has the necessary authority to determine the extent and effect of relationships between insured institutions and their affiliated entities. Furthermore, the FDIC

can exercise its authority to pursue formal or informal enforcement actions against an institution or institution-affiliated party, which includes the controlling shareholder.

Our report points out that there are differences between the authority exercised by the FDIC in reviewing transactions with affiliates and the authority provided to the FRB for supervising companies covered by the BHCA. We intend to conduct a subsequent audit focusing on non-bank bank holding companies and the potential risks, if any, which may result from the reduced level of federal oversight for holding companies not covered by the BHCA.

- Other Matters – "Subprime" Terminology

DSC pointed out that the interagency guidance and definitions of subprime lending are generally applicable to consumer lending, not commercial lending. Specifically:

> … the guidelines would not apply to traditional asset-based commercial lending… . When dealing with higher-risk commercial loans to weak borrowers, examiners continue to classify these loans where warranted.

Our report explains that the interagency guidance on subprime lending applies principally to consumer loans. We specifically state that "In the absence of an industry-wide definition of subprime commercial loans and for the purposes of this report, we use the term subprime to describe SPB's commercial loan portfolios." During our audit, FDIC examiners typically referred to SPB's portfolios as subprime and, therefore, we elected to use the same terminology employed by the examiners.

DSC Responses to OIG Recommendations

Each recommendation is summarized below along with DSC's responses to the recommendations.

1. Evaluate and pursue opportunities to emphasize and obtain written reports from independent auditors performing bank audits to bank boards of directors disclosing all reportable conditions found during audits or confirming that there were no reportable conditions.

   DSC concurs with the recommendation and will refer the issue to its Chief Accountant for study by September 30, 2003. In addition to possibly developing examiner guidance, actions may also include referring certain matters to the appropriate authoritative bodies that establish or maintain applicable accounting or auditing standards. DSC actions will be concluded no later than June 30, 2004.

2. Enhance or reinforce existing examination guidance to, at a minimum, identify techniques examiners may use to evaluate capital and loan loss allowance information available from bank and non-bank sectors, for comparing and contrasting variances in capital allocation for these types of commercial loan programs.

3. Reinforce examiner awareness of DSC subject matter experts in high-risk commercial lending, and encourage examiners and case managers to avail themselves of these experts, when appropriate.

4. Emphasize the importance of following existing procedures on the use and analysis of peer average data in review of the ALLL.

5. Reinforce and/or clarify existing guidance on the use of historical loss reserve factors for non-adversely classified loans.

6. Reinforce and/or clarify existing guidance on the application and quantification of qualitative adjustments to the loan loss reserve factors, or to the determination of capital adequacy.

   For recommendations 2 through 6, DSC will develop and utilize material, possibly a case study, to present a history of events and "lessons learned." Included will be discussions of unique issues presented in this case, various financial analyses deserving of examiner attention, and supervisory strategies and techniques that may be applied under similar circumstances. At a minimum, issues covered will include higher-risk commercial lending, analyses of capital and reserves, and supervisory strategies. DSC will complete necessary materials by June 30, 2004.

State of California Response

We provided a copy of our draft report to the California Department of Financial Institutions for review and comment. The Commissioner elected not to provide an official response, but his staff did provide informal comments, which we have addressed in the preparation of this final report.

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 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). Southern Pacific Bank was closed on February 7, 2003 with total assets of about $1.1 billion. On February 14, 2003, DOF provided the OIG with its initial estimated loss of $134.5 million to the Bank Insurance Fund, and we immediately initiated our material loss review. As of May 31, 2003, the revised estimated loss is $100 million.

As mandated by the FDI Act, the audit objectives were to: (1) ascertain why the bank’s problems resulted in a material loss to the insurance fund and (2) assess the FDIC’s supervision of the bank, including implementation of the Prompt Corrective Action (PCA) requirements of section 38 of the FDI Act. The scope of this audit included an analysis of Southern Pacific Bank’s operations from 1992 until its failure on February 7, 2003. Our review also entailed an evaluation of the regulatory supervision of the bank over the same period. To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the FDIC and the State of California examiners from 1992 until 2002.
- Reviewed bank data and correspondence maintained at the Division of Supervision and Consumer Protection’s (DSC) San Francisco Regional Office.
- Reviewed reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.
- Reviewed KPMG records at the offices of KPMG’s counsel in Los Angeles, California.
- Reviewed Imperial Credit Industries, Inc. records at its offices in Torrance, California.
- Interviewed DSC management in Washington, D.C., and the San Francisco Regional Office.
- Interviewed DRR officials at the Dallas Regional Office.
- Interviewed FDIC examiners from the Los Angeles West Field Office who participated in examinations or reviews of examinations of Southern Pacific Bank.
- Met with officials from the State of California Department of Financial Institutions in Los Angeles, California to discuss the historical perspective of the institution, its examinations, state banking laws, and other activities regarding the state's supervision of the bank.

- Reviewed bank records maintained by DRR in Dallas, Texas, for information that would provide insight into the bank's failure.
- Reviewed various annual reports and accompanying financial statements.
- Reviewed pertinent DSC policies and procedures.
- Researched various banking laws and regulations, including California Industrial Loan Company laws.

We performed the audit field work at the DSC San Francisco Regional Office in San Francisco, California; the DSC Los Angeles West field office in Los Angeles, California; DRR offices in Dallas, Texas; the State of California Department of Financial Institutions in Los Angeles, California; and DSC offices in Washington, D.C. We conducted the audit from February 14, 2003 through August 14, 2003 in accordance with generally accepted government auditing standards.

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We did not test for irregularities or illegal acts, except as noted in this report. Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act.

We performed a limited review of Southern Pacific Bank’s management controls pertaining to its operations, to determine whether:

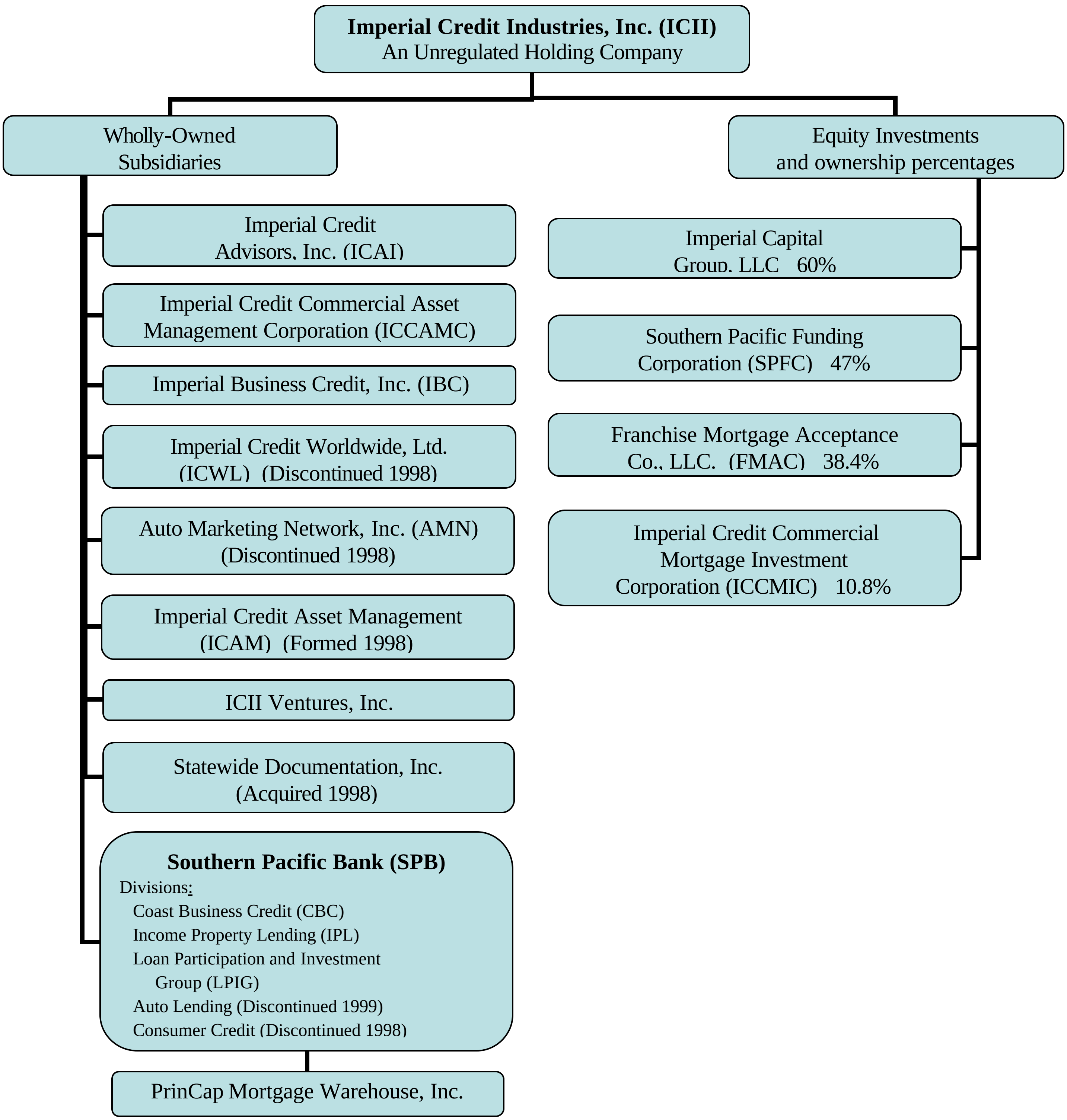
- programs (lending, risk management, etc.) met objectives;
- reliability of data was maintained and fairly disclosed in reports;
- compliance with laws and regulations occurred; and
- resources were safeguarded against waste, loss, and misuse.

We reviewed documentation and conducted inquiries regarding Southern Pacific Bank’s illegal acts or abuses that were identified by FDIC.

We did not assess the validity and reliability of computer-based and processed data from Southern Pacific Bank or the FDIC because this was not an objective of the audit. We relied on interviews and individually prepared reports and correspondence and other evidence to support our audit. Therefore, the audit results were not impacted.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, manage and measure results to justify appropriations and authorizations, and design budgets that reflect strategic missions. In this audit, we did not assess the strengths and weaknesses of DSC’s annual performance plan in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives.

IMPERIAL CREDIT INDUSTRIES, INC. 1998 ORGANIZATIONAL CHART



CHRONOLOGY OF SIGNIFICANT EVENTS

The following chronology describes significant events in Southern Pacific Bank's history, including examinations conducted, major problems identified, and enforcement actions taken by the FDIC and the Department of Financial Institutions, State of California.

03/01/82	Southern Pacific Thrift & Loan (SPTL) receives charter from state of California.
11/05/87	SPTL receives federal deposit insurance.
01/01/92	Imperial Bancorp forms Imperial Credit Industries, Inc.(ICII) and contributes all outstanding stock of SPTL to ICII.
12/93	SPTL's assets tripled from $452 million at the Feb. exam to $1.4 billion by year-end.
01/10/94	FDIC examination resulted in a composite 2 rating.
12/15/94	California Department of Financial Institutions (DFI) examination resulted in composite 3 rating. SPTL had experienced significant growth and lacked adequate controls. Due diligence on loans was considered inadequate. SPTL's Board of Directors consisted of only three members, who were also directors.
04/19/95	FDIC visitation confirms issues highlighted by state examination. Asset quality considered satisfactory.
09/30/95	Coast Business Credit (CBC) is purchased from Coast Federal Bank. CBC begins its aggressive expansion to include the solicitation of business outside the state of California.
01/16/96	Concurrent examination with the state, composite rating 3 was received. Deficiencies in SPTL's operational controls and risk management were considered. Two outside directors were added and a memorandum of understanding (MOU) was arranged on September 21, 1996.
04/14/97	Concurrent examination with the state. FDIC issued composite rating 2, and DFI issued composite rating 3 to SPB. MOU compliance was noted. Significant accounting control problems were noted and addressed by the Board. Bank Board Resolution was implemented on October 29, 1997.
09/16/97	Southern Pacific Thrift & Loan named changed to SPB.
05/11/98	FDIC joint examination with DFI resulted in composite rating of 3. Unreconciled general ledger accounts totaled $2.4 billion which resulted from inadequate staffing, high employee turnover, and poor planning for the August 1997 system conversion. SPB hires a contractor to reconcile accounts. Examination also noted that the total assets at the bank had increased to 25 percent in only the first half of 1998 which exceeded the bank's budget projection of 18 percent. Examination identified SPB new operations of funding mortgage bankers through a newly acquired subsidiary, PrinCap Mortgage Warehouse, Inc. (PrinCap), its mortgage warehouse division.
05/18/98	Information Systems (IS) examination commences; a composite 3 rating is issued.
11/02/98	MOU issued as the result of IS examination. MOU required the bank to correct account reconciliation's, improve data, improve security procedures, and increase the scope of IS audits, correct Y2K assessment deficiencies, and submit progress reports.
12/07/98	SPB President resigns, and new one is appointed by Board with regulatory approval.

01/27/99 MOU issued to correct weaknesses noted at the May 11, 1998, examination. This MOU required the bank to establish adequate accounting controls, eliminate all violations of law, achieve and maintain well-capitalized risk-based capital levels, maintain an adequate loan loss reserve, restrict cash dividends to 35 percent of net income, and submit periodic progress reports.

06/21/99 Joint examination with DFI resulted in SPB receiving a composite rating of 3. Despite full compliance with IS MOU, SPB remained in less than satisfactory condition. Management resolved accounting reconciliations and satisfied provisions of MOU, yet SPB's adversely classified items and reserves had more than doubled in size since the last examination to 77 percent. The deterioration was noted in the Auto Finance Division, CBC Division, and PrinCap – SPB's wholly-owned subsidiary. Deterioration in the portfolio was the result of poor underwriting, servicing, and accounting issues, as well as a decline in the used car market. ALLL was determined to be underfunded by $19 million, and management provided a $21.6 million provision to the ALLL during the exam. SPB was considered adequately capitalized for PCA purposes as of March 31, 1999, and met the well-capitalized status as of June 30, 1999. During the examination, management had sold a significant portion of the auto lending division, established policies and procedures for CBC, and hired new management at PrinCap. Examiners recommended that a revised MOU be pursued in order to restore SPB to a satisfactory level. The bank was informed that the institution is considered to be a troubled institution for Section 32 purposes.

10/20/99 SPB President and CFO meet with FDIC to discuss current developments since the June 1999 exam. FDIC was advised that the Auto Lending Division had been dissolved due to the large amount of loss that it had incurred; CBC was attempting to pursue and maintain better borrowers. After the termination of many of ICII's subsidiary operations, SPB now represented 95 percent of ICII's operations. The previous MOU remained in effect.

11/17/99 FDIC issues after-the-fact nonobjection letter for Change of Control filed by a management investment fund. On May 17, 1999, ICII purchased from it parent, Imperial Bank 3,682,537 shares of stock. This repurchase caused the aggregate holdings of several investment funds to increase from 24.1 to 36.8 percent. It was the contention of the fund owner that he did not have the power to direct the management or policies of ICII and thus did not control ICII or SPB.

01/26/00 SPB's Board adopts a Bank Board Resolution, in which immediate actions were taken to address concerns of FDIC and DFI from the June 1999 exam. SPB needed to address its credit quality, sufficiency of reserves, strategic planning, and operations and accounting, The MOU remains in effect.

06/26/00 FDIC joint examination with DFI. SPB's condition considered unsatisfactory. Large credit losses apparent in CBC as the result of weak management processes and over-advances on an unsecured basis to distressed business in the hope of turning the business around financially. The deterioration in asset quality necessitated large provisions to ALLL. SPB made a $49 million provision as of June 30, 2000. Capital level declined to adequately capitalized despite parents' capital infusion of $14 million in subordinate debt in Tier 2 Capital. SPB receives a composite rating of 4.

09/00 President and Director of SPB resign. Chairman of the Board of SPB and ICII is appointed interim President and Chief Executive Officer pending regulatory approval.

10/26/00 Former President and Director of SPB meet with DSC Assistant Regional Director and Case Manager in San Francisco Regional Office to discuss the independent operations at CBC.

12/13/00 SPB Board stipulated to a Cease and Desist Order issued December 15, 2000 by FDIC.

12/28/00 DFI issues Final Order to SPB Board.

01/22/01 FDIC and DFI concurrent exam commenced. Asset quality continues to deteriorate due to CBC's previous underwriting practices. Adversely classified assets increased from $184.1 million at prior exam to $226.5 million at present exam. SPB had a $117 million loss for the year 2000. The losses are the result of the large provisions to the ALLL of $169 million for this period.

03/07/01 FDIC gives nondisapproval notice for interim president to serve as bank President and Chief Executive Officer.

03/28/01 FDIC approves bank's request to retire $42 million in subordinated debt in exchange for $42 million in noncumulative perpetual preferred stock.

03/31/01 During the first quarter of 2001, the bank became undercapitalized for PCA purposes; however, SPB received from ICII $21.1 million in cash and converted $22 million in subordinated debt to non-cumulative perpetual preferred stock. Approximately $16.1 million came from outside investors, and the remaining $5 million came from the liquidation of assets at ICII, which determined that the bank was considered adequately capitalized for PCA purposes with a total risk-based capital ratio and Tier 1 leverage capital ratio of 8.28 percent and 6.06 percent, respectively.

07/01 Interim President and CEO resign from bank.

08/01/01 New President and CEO is appointed at SPB and receives regulatory approval.

11/15/01 Newly appointed Chairman, President, and Chief Executive of SPB resigns.

11/26/01 Concurrent visitation by FDIC and DFI. Loan quality had further deteriorated since Sept 11, and examiners feared that SPB will likely fail in the near future. Examiners noted approximately $92 million in loans directly or indirectly supported by aircraft leases, $14 million in loans advanced directly to the airline carriers, and $11 million in loans secured by aircraft parts. Since Sept 11, the portfolio had deteriorated rapidly. Allowance was estimated to be underfunded by $20 million, and Tier 1 Capital was less than 4 percent. Examiners also determined that ICII was experiencing financial distress. As a result of SPB's deteriorating condition and ICII's financial status, a composite 5 rating was given. SPB was then added to the Project Failure Report with a projected failure in the fourth quarter of 2002.

01/07/02 FDIC issued nonobjection to the appointment of new President and Chief Executive Officer of SPB.

02/01/02 FDIC notified bank that it was considered undercapitalized for PCA purposes and was subject to certain restriction that requires the submittal/filing of SPB's capital plan with the FDIC within 30 days.

02/04/02 Commencement of concurrent examination by FDIC and DFI. In the previous 3 years, the bank had charged off in excess of $240 million in loans, and classified assets continue to increase. Shared National Credits with substandard characteristics, when added to classified assets, results in $298 million in total classified assets which represented 408 percent of Tier 1 Capital and ALLL.

05/09/02 Again, newly appointed and approved President and CEO resigns due to differences with the Board.

05/24/02 ICII's stock was delisted from NASDAQ due to the devaluation of ICII's stock below $3.00. Again, newly appointed and approved individual takes office at SPB as President and CEO.

FDIC accepts SPB's revised capital plan. Plan calls for increase in capital of $55 million by July 22, 2002, from outside investors or from profits realized from the sale of certain assets. The plan calls for the reduction of non-performing assets currently from $117.2 million to $49.1 million by December 31, 2002. In addition, ICII is to sign a performance guarantee for ensuring the capital plan is pursued and realized.

07/15/02 A subordinated debt holder of ICII filed a Change of Bank Control Notice with DFI, and a nonobjection notice was issued by DFI on July 30, 2002.

07/25/02	SPB fails to implement approved Capital Plan and was deemed significantly undercapitalized for PCA purposes. A new capital plan was requested.
08/07/02	FDIC receives SPB's revised Capital Plan and indicated that SPB was negotiating an agreement with investor to infuse $30 million.
08/31/02	Visitation commenced concurrently by FDIC and DFI. Loan quality was targeted, and an additional $29 million provision was determined to be necessary to cover the loan exposure. In addition, the bank was directed to charge off an additional $38 million in loans classified as loss as of September 30, 2002. After the adjustment of findings, Tier 1 Leverage Capital ratio declined to approximately 2.5 percent.
09/12/02	FDIC learned that investor had filed a notice of default on the senior secured debt at ICII and was proceeding with foreclosure on SPB's stock.
11/04/02	DFI issues a demand for capital to SPB to increase capital levels to 8.5 percent tangible equity capital ratio. This would increase the capital to a minimum of $54 million by November 18, 2002. Due to negotiations with investor who had filed a Notice for Change of Control to recapitalize the bank, DFI extended the capital demand to December 10, 2002 and then again to January 31, 2003.
11/18/02	A subordinated debtholder files Notice of Change of Control to acquire SPB and a wavier of the cross guaranty provisions due to his ownership of Affinity Bank.
	FDIC extends the August visitation into full scope examination to expand the review of SPB's loan portfolio in order to better determine the extent of losses and to assess the viability of investor's recapitalization plan. Examiners found that SPB had further deteriorated and that its Tier 1 Leverage Capital ratio and total Risk-based Capital ratio had declined to 2.04 and 3.58 percent, respectively. The bank's PCA category is considered significantly undercapitalized. The adversely classified assets had increased 45 percent since the previous examination 10 months earlier. In the last 3 years, SPB had charged off in excess of $330 million in loans. Bank's composite rating is 5.
11/26/02	SPB files a revised capital plan which indicates a $30 million capital injection by an investor, with the intent to return SPB's capital level to a well-capitalized position.
01/08/03	FDIC disapproves of the investor's Notice of Change of Control due to the high likelihood of further loan deterioration in aircraft and telecommunication industry concentrations.
01/22/03	Investor withdraws the Notice of Change of Control due to the excessive volume of problem assets posing too much risk to make any further investments into SPB and ICII.
	SPB enters into a repurchase agreement with a hedge fund in an effort to maintain average assets at levels commensurate with the previous month's average. However, due to PCA limitations, the Bank was restricted from increasing average assets above the previous month's levels.
06/24/03	FDIC issues a PCA directive requiring SPB to obtain FDIC approval on all transactions.
02/03/03	FDIC approves an investigation of the repurchase agreement.
02/04/03	Revised November 26, 2002, Capital Plan is rejected by FDIC due to the withdrawal of Notice of Change of Control
02/07/03	DFI closes the institution because SPB failed to meet capital demands, and the FDIC is named receiver.

ACCOUNTING PROBLEMS, INTERNAL CONTROL WEAKNESSES, AND APPARENT VIOLATIONS OF LAW CITED BY REGULATORS IN SOUTHERN PACIFIC BANK'S REPORTS OF EXAMINATION

Area	Subject	Deficiency Cited by the Regulators	Year of Examination Report										
			92	93	94	95	96	97	98	99	00	01	02
Accounting	Financial Accounting Standard (FAS) 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities	The value of Collateralized Mortgage Obligation (CMO) residuals overstated.			6								
Accounting	FAS 5, Accounting for Contingencies	Charge-off or write down of receivables.	9		6								
Accounting	FAS 5, Accounting for Contingencies, FAS 114, Accounting by Creditors for Impairment of Loan (as amended by FAS 118 and FAS 5)	Allowance for loan and lease losses - maintenance of reasonable reserves and allowance deficient.			5					4	4	4	
Accounting	FAS 65, Accounting for Certain Mortgage Banking Activities	Available-for-Sale (AFS) vs. Held-to-Maturity (HTM) - Accounting rules (FAS 65) requires that the transfer of loans from AFS to HTM be done at the lower of cost or market (LOCOM). SPB transferred the Long Beach portfolio to the HTM account at book value.						4					
Accounting	FAS 65, Accounting for Certain Mortgage Banking Activities	No verification of the calculation of gains on sale of loans or securities, and reconciliation of loans serviced by the parent (ICII).			1								
Accounting	FAS 91, Accounting and Reporting for Loan Origination Fees and Cost	Either SPB not in compliance or examiners were unable to verify whether SPB was in compliance with FAS 91.			0		0						
Internal Control	Design: Absence of appropriate segregation of duties consistent with appropriate control objectives	Segregation of duties – the thrift's account certifications were not being approved by someone other than the person reconciling the accounts to the general ledger. FDIC recommended that management implement a policy requiring a second party to regularly approve the certifications.		0									
Internal Control	Design: Internal auditor retained management duties	SPB's approved internal audit policy designated the Vice President/Bank Operations, as the internal auditor. This designation created a conflict of interest, because the individual would be auditing the same department he managed.			0								

See Legend at the end of this appendix.

Area	Subject	Deficiency Cited by the Regulators	Year of Examination Report										
			92	93	94	95	96	97	98	99	00	01	02
Internal Control	Design: Accounting department lacked sufficient resources	The company's accounting department had only one employee who had accounting background. The Senior Vice President - Accounting, assisted by two clerical staff, was responsible for journal entries, posting to general ledger, bank reconciliations, etc. and various regulatory reports preparations. With the existing resources, it would be expected that books and records could not be reconciled in a timely manner and that there would be no financial and analytical reports available for the Board of Directors to review.			**0**								
Internal Control	Operational: Cash Reconciliations not performed or not performed in a timely manner	Cash accounts not reconciled.			**4**			**0**	**1**				
Internal Control	Operational: Failure of identified controls in preventing or detecting misstatements of accounting information in Call Reports	Bank had inadequate workpapers to support Call Reports, which had math, preparation, and other errors.		**0**	**0**		**0**					**0**	
Internal Control	Operational: General Ledger -Subsidiary Ledger Reconciliations not performed or not performed in a timely manner	Differences between general and subsidiary ledger balances; GL/SL accounts do not reconcile.			**3**		**5**	**5**	**1**				
Internal Control	Operational: Competency, knowledge skills of risk management personnel	Accounting personnel, most notably employees in the loan accounting department, are relatively unfamiliar with many of the thrift's accounts. Recently, key employees familiar with the accounting practices left the thrift without passing vital information on to their replacements.							**0**				
Apparent Violation	State of California) Financial Code 1221	Section 1221 (a) states in part "The obligations … of any one person owing to a commercial bank at any one time shall not exceed the following limitations: (a) Obligations which are unsecured shall not exceed 15% of the sum of the shareholders' equity, allowance for loan losses, capital notes, and debentures of the bank."										**5**	

Area	Subject	Deficiency Cited by the Regulators	Year of Examination Report										
			92	93	94	95	96	97	98	99	00	01	02
Apparent Violation	CA Financial Code 18407.	Code states: "An industrial loan company shall . . . submit its unaudited financial statements, prepared in accordance with Generally Accepted Accounting Principles (GAAP) and consisting of at least a balance sheet and a statement of income as of the date and for the period specified by the commissioner." As a result of significant Call Report errors discovered during the examination, amended Call Reports of Condition and Income are required for December 31, 1997 and March 31, 1998.							**0**				
Apparent Violation	CA Financial Code 18021 (a), (b), and (c).	These sections of California code set forth a requirement to have out-of-state deposits in FDIC insured institutions.									**5**		
Apparent Violation	CA Financial Code 18029 (previously 1133). Books and records. Each industrial loan company shall keep and use in its business, books, accounts, and records which will enable the commissioner to determine if the company is complying with the provisions of this division and with the rules and regulations made by the commissioner.	Because **reconciliations** were either not completed or not completed in a timely manner, it is very difficult to determine whether the general ledger account balances accurately reflect the thrift's true financial position. In April 1998, the thrift hired a contractor to perform a review of the thrift's accounting practices for resolution of the cash reconciliation and other general ledger account problems and to provide a long-term strategy on the thrift's accounting system and practices.			**4**				**1**				
Apparent Violation	CA Financial Code 18029 (previously 1133). Books and records. Each industrial loan company shall keep and use in its business, books, accounts, and records that will enable the commissioner to determine if the company is complying with the provisions of this division and with the rules and regulations made by the commissioner.	- Reported delinquencies understated \$1.6 million at September 30, 1992. - Pre-sold mortgage loans cannot be held in company's books longer than 90 days from dates of funding. Examination disclosed that \$145.9 million of pre-sold mortgage loans portfolio, as of October 31, 1992, exceeded this limitation.	**2**										

Area	Subject	Deficiency Cited by the Regulators	Year of Examination Report										
			92	93	94	95	96	97	98	99	00	01	02
Apparent Violation	CA Financial Code 18271. An industrial loan company that has investment certificates outstanding shall not make loans to, or hold the obligations of, any one person as primary obligor in an aggregate principal amount in excess of 20% of the unimpaired capital stock and surplus of the company not available for dividends as provided in Section 18319.	The thrift held an obligation of General Electric Capital for $40 million in commercial papers. The 5 percent unsecured limit amounts to $7.5 million, with $32.5 million extended as an apparent violation.								**4**	**3**		
Apparent Violation	FDIC Rules and Regs., Part 304.4, Reports of Condition and Income	Management did not properly report Tier 1 capital in either the December 31, 1997 or the March 31, 1998 Call Reports.							**0**				
Apparent Violation	FDIC Rules and Regs. Part 306.6(a), Disclosure of Exempt Records	ICII, the bank's parent company, disclosed partial findings and opinions from FDIC examiners at the January 22, 2001 examination in a debt offering memorandum released to potential third-party investors.											**0**
Apparent Violation	FDIC Rules and Regs. 325.3(b)(2)	Part 325.3(b)(2) states that "the minimum leverage capital requirement for a bank shall consist of a Tier 1 Capital to total assets of not less than four percent." After adjusting for examination findings, the bank's Tier 1 Capital to total assets ratio was 2.82% as of December 31, 2000.										**0**	**0**
Apparent Violation	FDIC Rules and Regs. Part 337.2, Standby Letters of Credit	The thrift's 1997 Annual Report does not disclose standby letters of credit, and inadequate control and subsidiary records exist for issued standby letters of credit.							**0**				

Area	Subject	Deficiency Cited by the Regulators	Year of Examination Report										
			92	93	94	95	96	97	98	99	00	01	02
Apparent Violation	FDIC Rules and Regs. Part 362, Activities of Insured State Banks and Insured Savings Associations	Apparent violation of Part 362.3(a) of the FDIC Rules and Regulations: "No insured state bank may directly or indirectly acquire or retain as principal any equity investment of a type that is not permissible for a national bank." The thrift's asset-based lending division, Coast Business Credit, frequently obtains stock warrants from borrowers in addition to loan origination fees. On December 15, 1998, CBC management exercised the warrants related to one of its borrowers.								**0**		**5**	
Apparent Violation	FDIC Rules and Regs. Part 364, Standards for Safety and Soundness	Management does not adequately control its general ledger accounts, in apparent violation of Part 364.101 and Section 18029 of the CA Financial Code.							**0**				
Apparent Violation	FDIC Rules and Regs. Part 364.II.C, Standards for Safety and Soundness	Section 364.II.C requires financial institutions to establish and maintain loan documentation. The thrift did not review a full set of documentation for loans. Most of the documentation was held by the servicer or a trustee acting on behalf of the servicer.					**0**						
Apparent Violation	Regulation O, Insider Transactions	Apparent violation of Part 215.8 of the Federal Reserve Board's rules and regulations pertaining to annual records the thrift is required to maintain on insiders.		**0**									
Apparent Violation	Federal Reserve Act ¶ 23A and 23B, Related Party Transactions	Related Party Transactions, apparent violations of ¶ 23A and 23B of Federal Reserve Act.			**3**		**5**	**5**	**5**			**5**	**5**

LEGEND:
1 = Deficiency where the dollar amount involved was greater than or equal to $1 billion.
2 = Deficiency where the dollar amount involved was greater than or equal to $100's of millions.
3 = Deficiency where the dollar amount involved was greater than or equal to $50 million.
4 = Deficiency where the dollar amount involved was greater than or equal to $10 million.
5 = Deficiency where the dollar amount involved was greater than or equal to $1 million.
6 = Deficiency where the dollar amount involved was greater than or equal to $500,000.
7 = Deficiency where the dollar amount involved was greater than or equal to $100,000.
8 = Deficiency where the dollar amount involved was greater than or equal to $50,000.
9 = Deficiency where the dollar amount involved was less than $50,000.
0 = Deficiency where the dollar amount involved was not estimated or stated by the regulators.

SPB's PORTFOLIO COMPOSITION

As discussed in the report, from 1993 through 1999, SPB management engaged in a high-risk lending strategy and expanded into commercial lending, franchise financing, and asset-based lending to companies and borrowers with impaired credit histories. During that time, the bank created 1 new consumer lending division, and 10 new commercial-based lending divisions within the bank. The table below provides a description for each of these lending divisions.

1993	Date Formed	Type of Lending
Southern Pacific Leasing Division was established to diversify SPB's lending activities from traditional real estate lending. Southern Pacific Leasing Division offered equipment lease financing on a wholesale basis and offered warehouse lines of credit to other leasing companies.	Formed by SPB in 1994.	Equipment lease financing and warehouse lines of credits
1994		
Auto Lending Division was formed to fund new and used automobile purchase contracts for subprime lenders. The division also purchased automobile loans from other independent loan originators. The portfolio was made up of "B" and "C" rated auto paper with borrowers located throughout the United States. Much of the deterioration could have been avoided had management effectively supervised the portfolio and eliminated the deficiencies prior to the growth in the portfolio. From the middle of 1998 through June 1999, SPB recognized approximately $45 million in losses and market valuation write-downs.	Formed in October 1994, and discontinued operations in February 1999.	Subprime auto loans
Income Property Lending Division (IPLD) was formed to expand the existing apartment and commercial property lending business. IPLD made property rehabilitation loans to higher-risk customers based on the "as completed" collateral value of multifamily income-producing properties. IPLD's maximum loan amount is approximately $2.5 *million*.	Formed by SPB in February 1994.	Commercial real estate rehabilitation loans to high-risk customers
Consumer Credit Division offered installment loans and Second Lien Mortgages for the purpose of home improvement, loan consolidation, manufactured housing, and other consumer goods.	Formed in early 1994.	Consumer credit
Bulk Acquisitions Division was formed to acquire for investment and for sale existing portfolios of non-conforming residential mortgage loans. The Division targeted established institutions and governmental entities such as the former Resolution Trust Corporation and the FDIC for the purchase of mortgage loan portfolios. In 1995, the Division worked in concert with Southern Pacific Funding Corporation (SPFC) and acquired $550 million in loans, reselling $160 million in September in a securitization.	Formed in August 1994.	Bulk sales of subprime residential mortgage loans

1995	Date Formed	Type of Lending
Coast Business Credit (CBC) provided asset-based commercial business loans to small and mid-sized businesses with annual revenues ranging from approximately $10 to $100 million. CBC focused on asset-based lending, through underwriting criteria based upon cash flow and collateral rather than on earnings and net worth. The CBC portfolio had subprime characteristics in that the borrowers were typically B and C rated companies and had typically pledged all of the companies' assets to the bank as collateral. CBC focused its lending activities on high-technology businesses engaged in the computer industry. At December 31, 1995, CBC had loans totaling $48.3 million to technology companies, representing 31.3% of its total portfolio, and loans totaling $105.9 million to non-technology companies.	Formed October 1995.	Subprime asset-based lending, and airline and technology syndicated credits
Loan Participation and Investment Group (LPIG) invested in and purchased nationally syndicated commercial loan participations originated by commercial banks and insurance companies, primarily in the secondary market. The majority of the loans were reviewed under the Shared National Credit (SNC) Program.	Formed by SPB in September 1995. Bank management stopped originating new commitments in 1998 and allowed the portfolio to run off.	Shared National Credits
Long Beach Mortgage was a purchased portfolio of subprime 1-4 family residential loans. The borrowers were self-employed with less than satisfactory credit histories. According to the bank president, the loans were part of a program which emphasized collateral rather than repayment ability.	Purchased late 1995.	Loans to subprime borrowers for 1-4 family residential mortgage loans
1996		
Auto Lend Group was formed to finance automobile dealership inventories. SPB believed that the Auto Lend Group's products offered synergistic opportunities when offered in connection with the bank's sub-prime auto lending activity (under the bank's Auto Lending Division) to provide car dealerships a complete financing package.	Formed September 1996.	Loans to Subprime auto dealerships to finance inventories
1997		
Imperial Warehouse Finance (formerly PrinCap Mortgage Warehouse) provided warehouse lending to residential mortgage bankers. PrinCap, a mortgage warehousing lender located in New Jersey, extended loans to individual mortgage brokers who, in turn, used the funds to originate and sell mortgages. The mortgages were both standard residential and residential construction loans.	Purchased in October 1997 and established as a wholly-owned subsidiary of the bank.	Warehouse lending to residential mortgage brokers
1999		
The Lewis Horwitz Organization (LHO) operated as a division of SPB providing lines of credit for independent motion picture and television production. The loans were collateralized with domestic and foreign film distribution contracts. LHO was considered the leader in the financing of smaller-budget independent films and had been operating approximately 40 years prior to the bank's acquisition of the organization.	Acquired October 1999 and sold October 2002.	Lines of credit for motion picture and television production

Source: FDIC reports of examination, and ICII Annual Reports from 1993 through 1999.

SUBPRIME LENDING POLICIES AND PROCEDURES

In response to industry and consumer queries, the federal bank regulators have defined characteristics that are attributable to subprime borrowers and lenders and have identified the concerns that center on subprime credit card banks.

"Subprime lenders" are institutions that systematically target the subprime market through lending programs that employ tailored marketing, underwriting standards, and risk selection.

The term “subprime program” refers to the process of acquiring, on a regular or targeted basis either through origination or purchase, subprime loans to be held in the institution’s portfolio or accumulated and packaged for sale. Subprime lending programs may also target borrowers with questionable repayment capacity evidenced by low credit scores or high-debt-burden ratios. Subprime lending does not refer to individual subprime loans originated and managed in the ordinary course of business as exceptions to prime risk selection standards.

The federal banking agencies have defined "subprime borrowers" using the characteristics that are most often associated with these borrowers. The term “subprime” refers to borrowers that typically have weakened credit histories that include payment delinquencies, previous charge-off judgments, bankruptcies, foreclosures, repossessions, high-default probability, and poor debt-to-income ratios. While some of these attributes are not always indicative of a subprime borrower, taken as a whole, they generally represent potential troubled or problem borrowers.

The federal banking agencies have also taken measures to ensure that financial institutions address the increased risks associated with subprime lending through the issuance of guidance and policy statements. The following procedures and guidelines have been issued.

<u>Interagency Guidelines on Subprime Lending</u>

In March 1999, the Federal Financial Institutions Examination Council (FFIEC) issued *Interagency Guidelines on Subprime Lending* that defined subprime lending as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Regulators were required to review and evaluate the capital levels at examinations and through offsite monitoring techniques. In addition, the guidance states that measures can be implemented and enforced if the capital levels are deemed to be inadequate. Specifically, the guidance stresses the need for bank risk management programs to address loan pricing and requires the following for risk management programs:

- planning and strategy should be consistent with overall business strategy of the bank;
- staff expertise requires specialized skills and knowledge;
- lending policy should establish the framework for pricing decisions and profitability analysis; and
- management should conduct reviews of credit scoring, pricing, and the adequacy of the allowance for loan and lease losses models.

Expanded Guidance for Evaluating Subprime Lending Programs

In January 2001, the FFIEC issued *Expanded Guidance for Evaluating Subprime Lending Programs.* This Expanded Guidance supplements the guidelines issued in March 1999 and is specifically tailored to institutions that have subprime lending programs with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 Capital. In addition, the Expanded Guidance refines the definition of subprime lending, clarifies the agencies' expectations regarding an institution's risk management processes, and provides a more detailed discussion of the supervisory expectations for examinations of subprime lending programs. The guidance also provides additional risk factors and examination procedures to consider in the following areas:

- Allowance for Loan and Lease Losses (ALLL);
- Capital Adequacy;
- Portfolio Review and Analysis;
- Classification Guidelines;
- Cure Programs; and
- Predatory or Abusive Lending Practices.

To address risk management expectations, the guidance states that management's ability should be judged by the quality of the risk management and control processes in place and the extent to which management is adhering to those processes. When a primary supervisor determines that an institution's risk management practices are materially deficient, the supervisor may instruct the institution to discontinue its subprime lending programs.

For ALLL, the guidance states that classified loans are considered loans that are not adequately protected by the sound worth and repayment capacity of the borrower or the pledged collateral. Full liquidation of the debt may be in jeopardy. The ALLL covering subprime loans that are not classified should be sufficient to absorb estimated losses on outstanding balances over the current operating cycle, which is typically 12 months. The Board and management are responsible for determining the adequacy of the ALLL and documenting the methodology that determines the balance of the ALLL.

For capital, the policy states that each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities. Such lenders are also responsible for documenting the methodology and analysis supporting the specified level of capital. The methodology should be tailored to reflect the size, concentration, and risk posed to the institution by the subprime lending activities. The guidance lists several potential factors to be considered when determining the appropriate amount of capital and states that since subprime lending possesses more risk than standard lending, it is expected that the capital levels would be at a minimum, one and a half to three times greater than what is appropriate for non-prime assets of a similar type. The capital adequacy analysis should also include stress testing as a tool for estimating unexpected losses in subprime lending pools. Shock tests of basic assumptions will assist in determining a portfolio's susceptibility to changes in market and business conditions.

FDIC Examination Documentation (ED) Module for Subprime Lending

FDIC developed an ED module to be used at examinations of institutions that conduct subprime lending activities. Topics in the ED module include the following items:

- preliminary review, policy considerations, internal controls, audit or independent reviews, information and communication systems;
- portfolio analysis, allowance for loan and lease losses, servicing and collections, scoring models, profitability, and capitalization; and
- third parties, securitizations, managerial effectiveness, transaction-level testing, portfolio quality, and stress testing of capital adequacy.

Under each section, detail is provided as to the type of work that should be performed in order to achieve a level of confidence on whether the bank is administering the program effectively.

Credit Card Specialty Bank Examination Guidelines

FDIC issued this guide in May 1997 to aid examiners in the proper evaluation techniques for institutions with credit card portfolios. Credit card specialty banks have unique characteristics. According to DSC, this guide is to be used in conjunction with the guidance pertaining to subprime lending.

FFIEC Credit Card Account Management and Loss Allowance Guidance

On January 8, 2003, the FFIEC issued interagency guidance for account management and loss allowances for credit card lending. According to the guidelines, recent examinations of institutions engaging in credit card lending have disclosed a wide variety of account management, risk management, and loss allowance practices, a number of which were deemed inappropriate. As of March 31, 2002, five FDIC-supervised institutions were heavily involved in subprime credit card receivables.

Federal regulators issued the guidelines to more tightly monitor specialty credit card lenders, especially those that have increased their subprime lending business. The rules require companies to more carefully monitor how much credit to extend to customers with too much debt, be more consistent in the way they declare loans worthless, and maintain stronger reserves against bad loans and customer fees. The guidelines are aimed at the large specialty credit card companies whose business is issuing credit and who can incur significant losses when customers default.

The guidance applies to all institutions under the member agencies' supervision that offer credit card programs. It describes the expectations for prudent risk management practices for credit card activities, particularly with regard to credit line management, over-limit practices, and workout and forbearance practices. The guidance also specifically addresses income recognition and loss allowance practices for credit card lending and states that recent examinations of credit card lenders have revealed a variety of income recognition and loss allowance practices. Such practices have resulted in inconsistent estimates of incurred losses and, accordingly, the inconsistent reporting of loss allowances. To address the account management, risk management, and loss allowance practices for credit card lending, the guidance provides procedures for:

- Credit Line Management,
- Over-limit Practices,
- Minimum Payment and Negative Amortization,
- Workout and Forbearance Practices,
- Income Recognition and Loss Allowance Practices, and
- Policy Expectations.

ED Modules for Credit Card Lending

Two of FDIC's ED modules address credit card activities. The first module addresses merchant credit card lending. It provides the core and expanded analysis procedures to be conducted in the course of an examination. The impact analysis is also included in the module. The second module addresses consumer credit card activities and is to be applied to institutions that specialize in credit cards and to those institutions whose primary business focus is not credit card receivables. Both modules focus on the examination procedures outlined in the credit card specialty examination guidelines.

The analyses prescribed in the ED modules apply to merchant credit card activities and credit card activities in general. Specific details concerning all aspects of credit card lending are contained in the supplemental guidelines for credit card specialty examinations.

ALLOWANCE FOR LOAN AND LEASE LOSS REVIEW GUIDELINES

As prescribed by FDIC examination documentation (ED) modules, examiners should consider seven areas in determining appropriate allowances for loan and lease losses (ALLL) in addition to reviewing the bank's allowance methodology and applicable Uniform Bank Performance Report (UBPR) ratios as a check for reasonableness.

To determine an appropriate ALLL level, examiners should:

1. Consider comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified loss) against the sum of the following amounts:

    - 50 percent of the portfolio that is classified Doubtful,
    - 15 percent of the portfolio that is classified Substandard, and
    - for the portions of the portfolio that have not been adversely classified (including those loans designated Special Mention), estimated credit losses over the upcoming 12 months (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends).

2. Determine if the ALLL is sufficient to cover all of the following risks:

    - Any losses on loans accorded Loss classifications (in whole or in part) that have not yet been charged-off.
    - Estimated probable losses for all loans accorded Doubtful classifications (without partial Loss classification).
    - Estimated probable losses for all remaining adversely classified loans (without partial Loss or Doubtful classification).
    - Other problem loans (either individually or in pools).
    - Estimated probable losses for the remaining categories of loans in the portfolio.
    - Supplemental amount for unidentified loan portfolio losses.

3. Consider the bank's loan loss history in aggregate and by loan type.

    - Calculate the average loan loss history for the past five years using gross loan losses to average total loans. (Data available from latest year-end UBPR).
    - Evaluate any aberrations in a specific year, and make adjustments needed for current conditions to arrive at a realistic average.
    - Consider migration analysis.

4. Consider the average reserve coverage of non-performing loans by state, rating, and charter.

5. Consider the historical average of loan loss reserves to nonperforming loans for all banks in the region and nation. (Reserve coverage of nonperforming loans is typically higher for sound loan portfolios than those where problems exist.

6. Estimate the potential loss exposure in classified and Special Mention loans.

7. Consider the following factors to determine an appropriate percentage for nonclassified loans:

   - Degree of Board or committee involvement, oversight, and control.
   - Expertise, training, and adequacy of loan staff.
   - Adequacy of loan policy and adherence to policy requirements.
   - Effectiveness of collection procedures.
   - Adequacy of renewal and extension policies.
   - Adequacy of charge-off policies.
   - Effectiveness of internal loan review function.
   - Adequacy of appraisal procedures.
   - Maintenance and analysis of financial information.
   - Adequacy of documentation (other than financial information).
   - Capitalization of interest.
   - Overreliance on collateral values.
   - Composition of the loan portfolio. (It may be appropriate to use different percentages for consumer, residential, and commercial real estate and commercial loans.)
   - Existence of self-dealing and insider transactions.
   - Level of classified loans and trend over past few examinations.
   - Level and trend of internally identified loan problems.
   - Level and trend of overdue and nonaccrual loans.
   - General economic considerations (local, state, regional, national).
   - Growth trends.
   - Entry into new areas of lending.
   - Extent of out-of-territory lending.
   - Adequacy of follow-up systems, etc.
   - Existence of off-balance sheet items (loan commitments, letters of credit).

CORPORATION COMMENTS

FDIC

Federal Deposit Insurance Corporation
550 17th St. NW Washington DC, 20429

Division of Supervision and Consumer Protection

August 8, 2003

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Michael J. Zamorski *Michael J. Zamorski*
Director, Division of Supervision and Consumer Protection

SUBJECT: Draft Report Entitled *Material Loss Review of the Failure of Southern Pacific Bank, Torrance, California*

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Southern Pacific Bank (SPB or Bank), Torrance, California, which failed on February 7, 2003. This memorandum represents the Division of Supervision and Consumer Protection's (DSC) response to the OIG's draft report entitled *Material Loss Review of the Failure of Southern Pacific Bank, Torrance, California.*

DSC appreciates the opportunity to respond to the OIG's draft report. Recommendations in the draft report suggest that DSC reinforce existing examiner guidance and pursue opportunities to address certain matters involving external audit activities. Overall, we concur with the recommendations.

Cause of Failure and Material Loss

The factors ultimately bearing on the Bank's failure included a higher-risk lending model that was not fully supported with a commensurate risk management program, and the impact of the economic downturn, particularly on commercial credit portfolios. The Bank's business strategy developed during the mid- to late-1990s and focused on large syndicated credits and asset-based lending, which developed into moderately high concentrations in the telecommunications, air transportation, technology, and entertainment sectors. Collectively, these factors placed the Bank in a vulnerable position. Financial protection in the form of capital, allowance for loan losses, and earnings was eroded by rapid and unforeseen economic deterioration (exacerbated by the 9/11 event) in the various industry sectors in which the bank concentrated its lending.

Management

Balance sheet growth from 1989 to 2000 indicates that the Bank's numerous shifts in lending strategies were aggressively pursued. As the 1990s progressed, the Bank moved through a number of strategic changes, culminating in the decision to pursue commercial lending activities in the form of asset-based lending (acquiring Coast Business Credit in late-1995), as well as

Shared National Credits (SNC)[1] and other loan participation programs.[2] The risk of generally focusing on higher-risk borrowers was heightened by the Bank's historically high level of loans relative to its total assets.

With its focus on loan production, the management team was ill-prepared to identify and respond to significant deterioration in the loan portfolio. Further, the Bank's allowance for loan losses was repeatedly found to be deficient. As conditions worsened, capital was also found to be deficient.

In pursuing its various strategies, management did not implement appropriate risk management programs. This was notable in the Bank's lack of attention to many of the principles of asset-based lending. In particular, management failed to adequately:

- identify the higher-risk characteristics of the borrower base,
- monitor collateral values as loans and additional extensions were approved,
- develop and maintain the necessary expertise and support to administer the lending activities, which included broad-based collateral and geographically dispersed borrowers, and
- diversify risks, including risks within and across industry sectors, resulting in moderately high concentrations in the telecommunications, technology, entertainment, and air transportation industries.

Overall, management's poor decisions and practices played the decisive role in the Bank's failure. The board was involved in significant decision-making that was ultimately carried out through an entrepreneurial culture that emphasized short-term results with inadequate attention to appropriate risk management practices. This culture was reinforced through incentive programs that emphasized short-term results without safeguards that would adequately protect the Bank's long-term interests.

Numerous management changes during the period of 2000 through 2002 hindered efforts to implement a successful strategy to address the Bank's significant weaknesses. However, it is important to note that some of management's actions were prompted by supervisory initiatives to remedy identified weaknesses. These actions positively affected the Bank's condition, and resulted in efforts to market bank assets, reduce insured deposits and borrowings, and strengthen the Bank's Tier 1 Capital position.

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[1] The Shared National Credit (SNC) Program was established in 1977 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency to provide an efficient and consistent review and classification of large syndicated loans. The annual program covers loans or loan commitments of at least $20 million that are shared by three or more financial institutions.

[2] A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants.

Impact of Economic Factors on Credit Quality

The Bank's higher-risk lending strategy resulted in concentrations within industry sectors that were negatively impacted by rapid, unforeseen economic events. The degree and rapidity of such deterioration was not anticipated even by objective economic experts. For instance, although cautionary language tempered its assessment, the Federal Reserve Board's *Monetary Policy Report* of July 2000 presented the following assessment:

> "The impressive performance of the U.S. economy persisted in the first half of 2000 with economic activity expanding at a rapid pace. Overall rates of inflation were noticeably higher, largely as a result of steep increases in energy prices. The remarkable wave of new technologies and the associated surge in capital investment have continued to boost potential supply and to help contain price pressures at high levels of labor resource use. At the same time, rising productivity growth--working through its effects on wealth and consumption, as well as on investment spending--has been one of the important factors contributing to rapid increases in aggregate demand that have exceeded even the stepped-up increases in potential supply...."

To highlight the degree to which the economy impacted the Bank, an analysis of the gross loan losses suffered during the period of 2000 through 2002 indicates that more than 64 percent of losses were on loans that were originated during 1999 or prior years - a period of relatively stronger economic activity. Several industry sectors in which the Bank held interests showed deterioration in median Estimated Default Frequency (EDF; as tracked by *Moody's KMV*)[3] scores of 900 percent or more during the period of June 1999 through 2002. At the extreme, the telephone sector, which was one of the more significant industry concentrations held by the Bank, declined 1,216 percent from the base score of year-end 1999. Approximately 71 percent of the deterioration occurred during 2001.

The rapidly changing economic circumstances are also illustrated by the Bank's SNC experience. Of the SNCs against which the Bank suffered charge-offs, fourteen had been rated Pass at the time of the investment; one was extended as Special Mention. Further, estimated default frequencies for six companies included in the SNC portfolio deteriorated significantly after origination.

Nationally, after reaching a decade low in 1998, the volume of adversely classified SNCs more than quadrupled to 8.4 percent of total commitments in 2002; adding the volume of Special Mention balances increased the level of criticized credits to 12.6 percent of total commitments.[4]

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[3] Default risk is measured by the EDF on a scale of 0-20, which estimates the probability of default within one year. KMV's calculation is based on (1) the current market value of the firm, (2) the structure of the firm's current obligations, and (3) the vulnerability of the firm to large changes in market value measured in terms of asset volatility. KMV uses forward-looking information, market equity values, current debt structure, and market volatility. Companies can be grouped according to industry or other indicators.

[4] Of the $1.9 trillion in total SNC commitments, U.S. banking organizations and foreign banking organizations each held 45 percent of the exposures, and nonbank firms held the remaining 10 percent.

It is noteworthy that, of the gross loan losses during the period of 2000 to 2002, approximately 36 percent ($116 million) was attributable to the Bank's interests in SNCs and other participated or syndicated loans. A significant amount of these losses were attributable to loans in which the Bank was a participating institution, as opposed to the lead lender. As a participating institution, the Bank's ability to influence or control administration and collection of the outstanding loan balance was limited.

In addition, the rapidity and degree of deterioration in the Bank's financial condition was due in part to Bank management inappropriately basing credit decisions on enterprise value, which represents an imputed value of a business as a going concern. Because of the volatility in enterprise or similar valuations, perceived repayment capacity can dissipate quickly and significantly.[5] Thus, during periods of uncertainty and rapid economic reversals, judgments become increasingly difficult. With the marked change in economic conditions, Bank management's judgments regarding portfolio quality, workout strategies, and adequacy of the allowance for loan losses were proved flawed, resulting in the rapid and significant erosion of capital.

Supervisory History

Matters giving rise to supervisory concern during the 1990s were distinct and generally resolved through informal enforcement actions. Although the various supervisory responses, in retrospect, could arguably have been stronger during the 1990s, the actions taken were consistent with the assigned ratings. Nevertheless, we agree that these matters did not bear directly on the Bank's failure.

Supervisory concern grew significantly as the Bank's condition began deteriorating. As a result of the June 2000 examination, the FDIC and California Department of Financial Institutions (DFI) increased their attention on the Bank through on- and off-site activities. The FDIC pursued formal enforcement action in the form of a Cease and Desist Order, while the DFI initiated a similar Order on its own behalf (collectively, Orders). In addition, progress reports, capital plans, and other submissions received heightened scrutiny. In response, management changes were implemented and internal practices and conditions received greater management attention.

Overall, our supervision reduced risk to the insurance fund; notably insured deposits declined by more than 55 percent from the peak reached in mid-2000. The related asset shrinkage included a combination of charge-offs, asset sales, payments, collections, and other resolutions. The conditions imposed by the Orders and Prompt Corrective Action constricted lending activities

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[5] On April 9, 2001, following a sharp increase in classified and other problem assets, the regulatory agencies issued guidance to bankers and examiners to describe more fully supervisory expectations regarding sound practices for leveraged financing activities, including bank reliance on enterprise values. The guidance noted that, in many cases, the associated problems were largely unanticipated by institution management, and that the lessons learned needed to be fully incorporated into institution risk management processes and examiner guidance.

and caused the parent and others to provide significant resources to strengthen the Bank's capital position. The holding company contributed cash and assets approximating $62 million and converted approximately $56 million of subordinated debt and preferred stock into a common equity position.

With conditions deteriorating and the Bank's losses mounting, a capital plan was required under Prompt Corrective Action. A plan was approved in May 2002 that required a $55 million increase in Tier 1 Capital.

Change in Control Proposal

The most viable opportunity for new capital came in the form of a change in bank control notice, filed by an existing investor in the parent company's debt. The individual's submission was based on a comprehensive awareness of the Bank's portfolio and overall condition, and envisioned an initial capital injection of $30 million. The plan indicated that an additional $10 million would be provided within the twelve months following consummation, if required by the DFI or FDIC. The notice remained active until January 23, 2003, when the proponent withdrew the notice from consideration, apparently due in part to an inability to raise the amount of funds necessary to meet the requirements of the Bank's approved PCA capital plan.

Responses to Formal Recommendations

1. Evaluate and pursue opportunities to emphasize and obtain written reports from independent auditors performing bank audits to bank boards of directors disclosing all reportable conditions found during audits or confirming that there were no reportable conditions.

   DSC concurs with the recommendation and will refer the issue to its Chief Accountant for study by September 30, 2003. In addition to possibly developing examiner guidance, actions may also include referring certain matters to the appropriate authoritative bodies that establish or maintain applicable accounting or auditing standards. DSC actions will be concluded no later than June 30, 2004.

2. Enhance or reinforce existing examination guidance to, at a minimum, identify techniques examiners may use to evaluate capital and loan loss allowance information available from bank and non-bank sectors, for comparing and contrasting variances in capital allocation for these types of commercial loan programs; and

3. Reinforce examiner awareness of DSC subject matter experts in high-risk commercial lending, and encourage examiners and case managers to avail themselves of these experts, when appropriate.

4. Emphasize the importance of following existing procedures on the use and analysis of peer average data.

5. Reinforce and/or clarify existing guidance on the use of historical loss reserve factors for non-adversely classified loans.

6. Reinforce and/or clarify existing guidance on the application and quantification of qualitative adjustments to the loan loss reserve factors, or to the determination of capital adequacy.

    DSC will develop and utilize material, possibly a case study, to present a history of events and "lessons learned." Included will be discussions of unique issues presented in this case, various financial analyses deserving of examiner attention, and supervisory strategies and techniques that may be applied under similar circumstances. At a minimum, issues covered will include higher-risk commercial lending, analyses of capital and reserves, and supervisory strategies. DSC will complete necessary materials by June 30, 2004.

Other Matters

We would like to comment on two other items in the draft report; one item is included under the caption of "Other Issue" and the other relates to a definitional distinction.

Holding Company Structure

Overall, we do not believe that the organizational structure or charter type played a role in the Bank's failure. While the Bank's activities supported the company's overall business strategy, such models are not unusual. Further, the company's activities were financial in nature. In our opinion, the Bank ultimately failed because of management weaknesses that led to poorly developed and implemented strategies. The impact of these deficiencies was magnified by the lack of adequate risk management programs and rapidly changing economic circumstances.

From the Bank's inception through the 2000 examination, the FDIC assessed the organization through reviewing the company's reports filed with the Securities and Exchange Commission and other available information, requesting supplemental information, and discussing various matters with company officials. Examiners also reviewed transactions and relationships between the insured institution and its affiliated entities during each on-site examination. When deemed appropriate in 2001 and 2002, the FDIC exercised its authority under the FDI Act to conduct on-site reviews at the parent company.

The parent company provided significant financial support, particularly in more recent periods of difficulty, during which the parent augmented the Bank's core capital position by $118 million. Ultimately, parent company shareholders, who included sophisticated institutional investors, would not commit additional resources to the company. Attention then turned toward external sources of capital. At least three parties – including a money management firm and two parties with controlling interests in existing institutions – expressed an interest in the Bank. None chose to invest the funds necessary to recapitalize the Bank; however, in the FDIC's experience, this progression is not unusual as failure becomes a more distinct possibility and the economic feasibility of additional investment becomes a determining factor.

We believe that the supervisory activities relative to the parent organization provided the necessary awareness and perspective of the company's circumstances and the potential financial impact on the Bank. As a result, the FDIC moved to preserve and improve the Bank's operational and financial condition through the various formal and informal enforcement actions. In this regard, not only did the actions serve to restrict dividend payments to the parent company, the actions also improved the Bank's overall condition through the parent company's acquisition of problem assets and injection of capital. Further, the actions addressed affiliate transactions, which were better controlled and documented by 1998.

We believe that the FDIC has the necessary authority to determine the extent and effect of relationships between insured institutions and their affiliated entities. Furthermore, the FDIC can exercise its authority to pursue formal or informal enforcement actions against an institution or institution-affiliated party, which includes the controlling shareholder. As such, the FDIC can pursue actions under section 8 of the FDI Act, including cease and desist orders, to impose restrictive or affirmative conditions, as circumstances warrant. For example, a cease and desist order may be imposed to prevent unsafe and unsound practices or to rescind agreements entered into by the parent that are found to be unsafe or unsound with respect to the insured institution.

"Subprime" Terminology

While the interagency "Expanded Guidance on Subprime Lending Programs" (FIL-9-2001) does not expressly limit the definition of subprime lending to only consumer debt, previous guidance on the subject, "Risks Associated with Subprime Lending" (FIL-44-97), stated that "[s]ubprime lending is defined as extending consumer credit..."

In the more recent guidance, the regulatory agencies did not limit the definition of subprime loans to include only consumer loans in order to allow for some flexibility to address industry innovation. For instance, it is conceivable that we might apply the guidelines to a credit card program for commercial borrowers or possibly a subprime small business loan program that has many of the same **homogeneous** loan characteristics as the consumer program. However, the guidelines would not apply to traditional asset-based commercial lending such as borrowing base or factoring arrangements. Unlike subprime loans, these credit arrangements are not readily grouped into homogenous pools for analytical purposes, and they require a great deal of individualized underwriting and custom review.

Examiners continue to evaluate traditional commercial lending as they have done in the past, with a focus on risk management practices. This includes an evaluation of management planning and strategy, lending policies, loan administration procedures, loan review and monitoring, staff expertise, and reserves. When dealing with higher-risk commercial loans to weak borrowers, examiners continue to classify these loans where warranted.

MANAGEMENT RESPONSES TO RECOMMENDATIONS

This table presents the management responses that have been made on recommendations in our report and the status of recommendations as of the date of report issuance. The information in this table is based on management's written response to our report.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved[a]: Yes or No	Dispositioned[b]: Yes or No	Open or Closed[c]
1	DSC concurred with the recommendation and will refer the issue to its Chief Accountant for study by September 30, 2003. In addition to possibly developing examiner guidance, actions may also include referring certain matters to the appropriate authoritative bodies that establish or maintain applicable accounting or auditing standards.	June 30, 2004	N/A	Yes	No	Open
2 - 6	DSC generally concurred with the recommendations and will develop and utilize material, possibly a case study, to present a history of events and lessons learned. Included will be discussions of unique issues presented in this case, various financial analyses deserving of examiner attention, and supervisory strategies and techniques that may be applied under similar circumstances. At a minimum, issues covered will include higher risk commercial lending, analyses of capital and reserves, and supervisory strategies.	June 30, 2004	N/A	Yes	No	Open

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

[b] Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

[c] Once the OIG dispositions the recommendation, it can then be closed.

GLOSSARY

Term	Definition
Accounts Receivable Financing	Accounts receivable financing is a specialized area of commercial bank lending in which borrowers assign their interests in accounts receivable to the lender as collateral. Typical characteristics of accounts receivable borrowers are those businesses that are growing rapidly and need year-round financing in amounts too large to justify unsecured credit, those that are non-seasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups, those whose working capital is inadequate for the volume of sales and type of operation, and those whose previous unsecured borrowings are no longer warranted because of various credit factors.
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) to three categories: Substandard, Doubtful, and Loss.
Allowance For Loan And Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL at a level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.
Auditor's Opinion	**Auditor's Standard Report or Unqualified Opinion:** The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his report. **Qualified Opinion:** A qualified opinion states that, except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP).

Auditor's Opinion (continued)	**Adverse Opinion:** An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. **Disclaimer of Opinion:** A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. It is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statements. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from GAAP.
Call Reports (Thrift Financial Reports and Consolidated Reports of Condition and Income)	Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income from banks and Office of Thrift Supervision (OTS) Thrift Financial Reports from savings associations – collectively referred to as Call Reports – are sworn statements of financial condition that are submitted to the FDIC quarterly in accordance with federal regulatory requirements in Title 12 of the Code of Federal Regulations (12 CFR). Call Reports consist of a balance sheet, income statement, and other supplemental information and provide detailed analyses of balances and related activity.
CAMELS Rating, Composite Rating, and UFIRS Rating	Financial institution regulators use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance. Six areas of performance are evaluated and given a numerical rating of 1 through 5, with 1 representing the least degree of concern and 5 the greatest degree of concern. The six performance areas identified by the CAMELS acronym are C Capital adequacy, A Asset quality, M Management practices, E Earnings performance, L Liquidity position, and S Sensitivity to market risk. A composite CAMELS rating is an overall rating given to a bank based on the six components of the CAMELS rating. A rating of 1 through 5 is given. A rating of 1 indicates strong performance; 2 reflects satisfactory performance; 3 represents below average performance; 4 refers to marginal performance that could threaten the viability of the institution; and, 5 is considered critical, unsatisfactory performance that threatens the viability of the institution.

Capital Adequacy	A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. Capital adequacy, as it relates to quarterly Call Reports, can be evaluated to a limited extent based on certain financial information that includes amounts used in calculations of an institution's various regulatory capital amounts. Part 325 of the FDIC Rules and Regulations, 12 CFR §325.101, et. seq, implements section 38 of the FDI Act, 12 USC §1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are not adequately capitalized.
Cease and Desist Order (C&D Order)	A formal enforcement action issued by the regulator's Board of Directors to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	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 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.
Commercial Loans	Loans for commercial or industrial purposes to business enterprises, whether proprietorships, partnerships, or corporations, are commonly described by the term "commercial loans." Commercial or business loans frequently comprise one of the most important assets of a bank. They may be secured or unsecured and for short- or long-term maturities. Such loans include working capital advances, term loans, and loans to individuals for business purposes

Direct Lease Financing	Leasing is a recognized form of term debt financing for fixed assets. While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management, and projections of future operations. Additional considerations for a lease transaction are the type of property and its marketability in the event of default or termination of the lease. Those latter considerations do not radically alter the manner in which an examiner evaluates collateral for a loan. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Sale of leased property/collateral remains a secondary source of repayment and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance.
Division of Resolutions and Receiverships (DRR)	The division of the FDIC which plans and handles the resolution of failing and failed FDIC-insured institutions.
DFI – State of California's Department of Financial Institutions	DFI is responsible for regulating the safety and soundness of state-chartered financial institutions to maintain public confidence and facilitate a strong financial services system. DFI also licenses financial institutions in the State of California.
Division of Supervision and Consumer Protection (DSC)	Effective July 1, 2002, the FDIC's Division of Supervision and the Division of Compliance and Consumer Affairs were merged to form the new Division of Supervision and Consumer Protection (DSC). The DSC promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. The mission of DSC is to promote stability and public confidence in the nation's financial system by: • examining and supervising insured financial institutions to ensure they operate in a safe and sound manner, that consumers' rights are protected, and that FDIC-supervised institutions invest in their communities, and • providing timely and accurate deposit insurance information to financial institutions and the public.

Enterprise Value	Enterprise value can be defined as the imputed value of a business. This valuation is often based on the anticipated or imputed sale value, market capitalization, or net worth of the borrower. The sale value is normally some multiple of sales or cash flow based on recent mergers or acquisitions of other firms in the borrower's industry. This enterprise value is often relied upon in the underwriting of leveraged loans to evaluate the feasibility of a loan request, determine the debt reduction potential of planned asset sales, assess a borrower's ability to access the capital markets, and to provide a secondary source of repayment. Consideration of enterprise value is appropriate in the credit underwriting process. However, enterprise value and other intangible values, which can be difficult to determine, are frequently based on projections and may be subject to considerable change. Consequently, reliance upon them as a secondary source of repayment can be problematic. Because enterprise value is commonly derived from the cash flows of a business, it is closely correlated with the primary source of repayment. This interdependent relationship between primary and secondary repayment sources increases the risk in leveraged financing, especially when credit weaknesses develop.
Examination Function	The FDIC, in conjunction with other federal and state regulatory agencies, examines financial institutions to ensure they are conducting business in compliance with consumer protection rules and in a way that minimizes risk to their customers and to the deposit insurance funds. There are five categories of examinations: Community Reinvestment Act, Compliance, Information Systems & E-banking, Safety & Soundness, and Trust.
Executive Officer	The executive officer of a company or bank is a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not: the officer has an official title, the title designates the officer an assistant, or the officer is serving without salary or other compensation. The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless the officer is excluded, by resolution of the Board of Directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein.

FDIC Supervision Program	The FDIC's Supervision Program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised insured depository institutions. As supervisor, the FDIC performs safety and soundness examinations of FDIC-supervised institutions to assess their overall financial condition, management practices and policies, and compliance with applicable laws and regulations. Through the examination process, the FDIC also assesses the adequacy of management and internal control systems to identify and control risks. Procedures normally performed in completing this assessment may disclose the presence of fraud or insider abuse. The FDIC supervises FDIC-insured state-chartered banks that are not members of the Federal Reserve System and are described as state non-member banks. This includes state-licensed insured branches of foreign banks and state-chartered mutual savings banks. The FDIC also has examination authority and special insurance activity authority for state member banks that are supervised by the Board of Governors of the Federal Reserve System (FRB), national banks that are supervised by the Office of the Comptroller of the Currency (OCC), and savings associations that are supervised by the Office of Thrift Supervision (OTS). This authority is exercised in the FDIC's role as insurer of those institutions.
Federal Deposit Insurance Corporation (FDIC)	The Federal Deposit Insurance Corporation's mission is to maintain the stability of and public confidence in the nation's financial system. To achieve this goal, the FDIC was created in 1933 to insure deposits and promote safe and sound banking practices.
Federal Financial Institutions Examination Council (FFIEC)	The Federal Financial Institutions Examination Council (FFIEC) is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) and to make recommendations to promote uniformity in the supervision of financial institutions.

Floor Plan Lending	Floor plan (wholesale) lending is a form of retail goods inventory financing in which each loan advance is made against a specific piece of collateral. As each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid. Items commonly subject to floor plan debt are automobiles, home appliances, furniture, television and stereophonic equipment, boats, mobile homes and other types of merchandise usually sold under a sales finance contract. Floor plan loans involve all the basic risks inherent in any form of inventory financing. However, because of the banker's inability to exercise full control over the floored items, the exposure to loss may be greater than in other similar types of financing.
Generally Accepted Accounting Principles (GAAP)	Generally Accepted Accounting Principles (GAAP) is the body of principles governing the accounting for financial transactions and preparation of financial statements. GAAP is derived from guidance issued by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) in the form of Accounting Research Bulletins (ARB), Accounting Principles Board (APB) Opinions, FASB Statements of Financial Accounting Standards (SFAS), and FASB Statements of Financial Accounting Concepts (SFAC).
Generally Accepted Auditing Standards (GAAS)	Generally Accepted Auditing Standards (GAAS) are policies, guidelines, and procedures set forth by the AICPA that an auditor is required to follow in performing an audit in order to render an opinion on an organization's financial statements.
Going Concern Determination	Statement on Auditing Standards (SAS) 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended, requires independent accountants to evaluate – as part of every financial statement audit – whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period, not to exceed 1 year beyond the date of the financial statements being audited.
Insider	A person who is or is proposed to be a director, officer, organizer, or incorporator of an applicant; a shareholder who directly or indirectly controls 10 percent or more of any class of the applicant's outstanding voting stock; or the associates or interests of any such person. An Institution-affiliated party shall have the same meaning as provided in section 3(u) of the Bank Holding Company Act of 1956.

Insured Depository Institution	The term insured depository institution means any bank or savings association the deposits of which are insured by the FDIC.
Internal Control	Internal control is an integral component of an organization's management that provides reasonable assurance of achieving effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.
Leverage Capital	Banks must maintain at least the minimum leverage requirements set forth in Part *325* of the FDIC Rules and Regulations 12 CFR §325.3. The minimum leverage requirement is a ratio of Tier 1 (Core) capital to total assets of not less than 3 percent or greater, depending upon the condition of the institution.
Leveraged Financing	Leveraged financing is an important financing vehicle for mergers and acquisitions, business re-capitalizations and refinancings, equity buyouts, and business or product line build-outs and expansions. It is also used to increase shareholder returns and to monetize perceived "enterprise value" or other intangibles. A transaction is considered leveraged when the obligor's post-financing leverage as measured by debt-to-assets, debt-to-equity, cash flow-to-total debt, or other such standard unique to particular industries significantly exceeds industry norms for leverage. Leveraged borrowers typically have a diminished ability to adjust to unexpected events and changes in business conditions because of their higher ratio of total liabilities to capital. Consequently, leveraged financing can have significant implications for a banking organization's overall credit risk and presents unique challenges for its risk management systems.
Management Letters	Auditors are required to inform the audit committee (or its equivalent) about significant deficiencies in the design or operation of the internal control structure that come to their attention in the course of an audit. This is generally done in a letter to management, commonly referred to as a management letter.
Memorandum of Understanding (MOU)	An informal corrective administrative action from institutions considered to be of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, an MOU is to be considered for all institutions rated a composite 3.

Non-Audit Services	Non-audit services, according to the Sarbanes-Oxley Act of 2002, are any professional services provided to a securities issuer by a registered public accounting firm, other than those provided to an issuer in connection with an audit or a review of the financial statements of an issuer.
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.
Primary Federal Regulator	The institution's charter determines which federal banking agency is the primary federal supervisor of the particular institution. There are four Federal regulators of banks and savings and loan institutions: • Board of Governors of the Federal Reserve System (Federal Reserve Board or FRB) - Primary Federal regulator responsible for state-chartered commercial bank members of the Federal Reserve System. • Federal Deposit Insurance Corporation (FDIC) - Primary Federal regulator responsible for state-chartered banks not members of the Federal Reserve System and state chartered savings banks. • Office of the Comptroller of the Currency (OCC) - Primary Federal regulator responsible for nationally chartered commercial banks. • Office of Thrift Supervision (OTS) - Primary Federal regulator responsible for federally chartered savings and loan associations, federal savings banks and state-chartered savings and loan associations.
Principal Shareholder	A person that directly or indirectly, or acting through or in concert with one or more person, owns, controls or has the power to vote more than 10 percent of any class of voting securities of a member bank or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual.

<table>
<tr>
<td>Prompt Corrective Action (PCA)</td>
<td>
Part 325 of the FDIC Rules and Regulations, 12 CFR §325.101, et. seq; implements section 38 of the FDI Act, 12 USC §1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are not adequately capitalized. The following codes and categories are used to describe capital adequacy:
<table>
<tr><th colspan="2">Code - Category</th><th>Total Risk-Based Capital</th><th>Tier 1 Risk-Based Capital</th><th>Leverage Capital</th></tr>
<tr><td>W</td><td>Well Capitalized</td><td>10 percent or more, and</td><td>6 percent or more, and</td><td>5 percent or more.</td></tr>
<tr><td>A</td><td>Adequately Capitalized</td><td>8 percent or more, and</td><td>4 percent or more, and</td><td>4* percent or more.</td></tr>
<tr><td>U</td><td>Under-capitalized</td><td>Less than 8 percent, or</td><td>Less than 4 percent, or</td><td>Less than 4* percent.</td></tr>
<tr><td>S</td><td>Significantly Undercapitalized</td><td>Less than 6 percent, or</td><td>Less than 3 percent, or</td><td>Less than 3 percent.</td></tr>
<tr><td>C</td><td>Critically Undercapitalized</td><td colspan="3">The institution’s tangible equity is 2 percent or less regardless of its other capital ratios.</td></tr>
<tr><td colspan="5">* 3 percent if the bank is rated composite 1 under the CAMELS rating system, is not experiencing or anticipating significant growth, and has well-diversified risk.</td></tr>
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<tr>
<td>Real Estate Construction Loans</td>
<td>A construction loan is used to construct a particular project within a specified period and should be controlled by supervised disbursement of a predetermined sum of money. It is generally secured by a first mortgage or deed of trust and backed by a purchase or takeout agreement from a financially responsible permanent lender. Construction loans are vulnerable to a wide variety of risks. The major risk arises from the necessity to complete projects within specified cost and time limits. The risk inherent in construction lending can be limited by establishing policies that specify that type and extent of bank involvement. Such policies should define procedures for controlling disbursements and collateral margins and assuring timely completion of the projects and timely repayment of the bank's loans.</td>
</tr>
<tr>
<td>Red Flags</td>
<td>A warning sign that something may not be right. In this report it refers to irregular or unusual activity at the bank.</td>
</tr>
</table>

Registered Public Accounting Firm	A public accounting firm registered with the Public Company Accounting Oversight Board in accordance with the Sarbanes-Oxley Act of 2002. A public accounting firm is a proprietorship, partnership, incorporated association, corporation, limited liability company, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports; and to the extent so designated by the rules of the Board, any associated person of any such entity. Enactment of the Sarbanes-Oxley Act of 2002, changed the term used to describe accountants in the SEC Act of 1934. Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1) was amended by the Sarbanes-Oxley Act of 2002 by replacing "an independent public accountant" with "a registered public accounting firm."
Regulation O	The Federal Reserve regulation that restricts the amount of credit banks may extend to their own executive officers, directors, and principal shareholders.
Risk-Based Rules and Capital Regulations	A supplemental capital standard under 12 CFR §325, Appendix A. II. 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) less certain deductions.
Risk-Focused Examination Process	The risk-focused examination process attempts to assess an institution's risk by evaluating its processes to identify, measure, monitor, and control risk. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain time and evaluating the soundness of the institution's processes for managing risk.
Risk-Weighting	A system of calculating the risk-weighting of assets based on assigning assets and off-balance assets into broad risk categories, 12 CFR §325, Appendix A.II.
Safety and Soundness Examinations	These periodic, on-premise examinations help assess an institution's financial condition, policies and procedures, and adherence to laws and regulations. These examinations are a vital tool in protecting the financial integrity of the deposit insurance funds and promoting the public confidence in the banking system and individual banks.

SAS (Statement on Auditing Standards)	Rules and guidance issued by the Auditing Standards Board (ASB). The ASB is the senior technical committee of the AICPA designated to develop and issue auditing, attestation, and quality control standards and guidance. Rule 202 of the AICPA Code of Professional Conduct requires AICPA members who perform professional audit and attest services to comply with standards promulgated by the ASB.
SAS 58	Statement on Auditing Standards (SAS) 58, Reports on Audited Financial Statements, prescribes the form of the auditor's standard report issued in connection with audits of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. SAS 58 distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.
SAS 60	Statement on Auditing Standards (SAS) 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, requires independent auditors of all companies to report to the audit committee or its equivalent all reportable conditions noted in the audit.
SAS 61	Statement on Auditing Standards (SAS) 61, *Communication with Audit Committees*, requires independent auditors of public companies to directly inform the group with management oversight responsibility of certain audit-related matters other than internal control matters.
Section 10(b) of the Federal Deposit Insurance Act	Section 10(b) of the FDI Act, 12 USC §1820 (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 Federal Deposit Insurance Act	Section 10(c) of the FDI Act, 12 USC §1820(c), authorizes the representative of an appropriate Federal banking agency to administer oaths and affirmations and to examine and take and preserve testimony under oath as to any matter in respect to the affairs or ownership of any such bank, institution, or affiliate.

Section 23A of the Federal Reserve Act	Section 23A of the Federal Reserve Act, 12 USC §371(c), establishes restrictions on transactions between financial institutions and their affiliates. These include restrictions on the dollar amount involved in the transactions and establishes collateral requirements for certain transactions with affiliates.
Section 23B of the Federal Reserve Act	Section 23B of the Federal Reserve Act, 12 USC §371(c)-I, 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 non-affiliate. 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.
Shared National Credit (SNC)	Any loan and or formal commitment, including any asset such as other real estate, stocks, notes, bonds, and debentures taken for debts previously contracted, extended to a borrower by a supervised institution, its subsidiaries, and affiliates which in original amount aggregates $20 million or more and, (1) which is shared by three or more unaffiliated institutions under a formal lending agreement; or (2) a portion of which is sold to two or more unaffiliated institutions, with the purchasing institution(s) assuming its prorated share of the credit risk.
Sold With Recourse	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 bereplaced 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. These borrowers pose a greater risk and are characterized by paying debts late, filing for personal bankruptcy, and/or having an insufficient credit history.

Syndicated Lending	Syndicated loans represent a substantial portion of commercial and industrial loan portfolios. Many large bank portfolios are comprised exclusively of syndicated loans. A syndicated loan involves two or more banks contracting with a borrower, typically a large or middle market corporation, to provide funds at specified terms under the same credit facility. The average commercial syndicated credit is in excess of $100 million. Syndicated credits differ from participation loans in that lenders in syndication participate jointly in the origination process, as opposed to one originator selling undivided participation interests to third parties. The syndicated market formed to meet basic needs of lenders and borrowers, specifically: raising large amounts of money, enabling geographic diversification, satisfying relationship banking, obtaining working capital quickly and efficiently, spreading risk for large credits among banks, and gaining attractive pricing advantages.
Thrift Institution	12 USC § 1841(I) defines a thrift institution as: (a) a domestic building and loan or savings and loan association (b) non-profit cooperative bank without capital stock (c) a federal savings bank, or (d) a registered state-charted savings bank and holding company.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 CFR §325.2 (A), as: **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:** • Certain intangible assets; • identified losses; • investments in securities subsidiaries subject to section 337.4; and • deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 1 Leverage Capital Ratio	Tier 1 Capital divided by total assets as defined in 12 CFR §225, Appendix D.,II.a.

Tier 2 (Supplemental) Capital	Tier 2 Capital is defined in Part 325 of the FDIC Rules and Regulations, 12 CFR §325, Appendix A., I.A.2, and generally consists of: • Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets, • Cumulative perpetual preferred stock, long-term preferred stock and related surplus, • Perpetual preferred stock (dividend is reset periodically), • Hybrid capital instruments, • Term subordinated debt and intermediate-term preferred stock, and • Eligible net unrealized holding gains on equity securities.
Total Risk-Based Capital Ratio	The total qualifying capital divided by risk-weighted assets defined by 12 CFR § 325.2(w).
Uniform Bank Performance Report (UBPR)	A report comparing an individual bank or thrift to its peer group.
Unsafe or Unsound Practice	Generally, an unsafe or unsound practice is any action or lack of action that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the agencies administrating the insurance funds.

PREVIOUSLY ISSUED MATERIAL LOSS REVIEW REPORTS

- **The Failure of the Connecticut Bank of Commerce, Stamford, Connecticut**
  (Issue date: March 10, 2003)
- **The Failure of Pacific Thrift and Loan Company, Woodland Hills, California**
  (Issue date: June 7, 2000)
- **The Failure of BestBank, Boulder, Colorado**
  (Issue date: January 22, 1999)
- **The Failure of First Trust Bank, Ontario, California**
  (Issue date: May 16, 1997)
- **The Failure of the Bank of Newport, Newport Beach, California**
  (Issue date: October 8, 1996)
- **The Failure of Pacific Heritage Bank, Torrance, California**
  (Issue date: January 26, 1996)
- **The Failure of The Bank of Hartford, Hartford, Connecticut**
  (Issue date: December 1, 1995)
- **The Failure of The Bank of San Pedro, San Pedro, California**
  (Issue date: December 21, 1994)
- **The Failure of The Bank of San Diego, San Diego, California**
  (Issue date: April 29, 1994)