Office of Inspector General

September 2009
Report No. AUD-09-022

Material Loss Review of Alliance Bank, Culver City, California

AUDIT REPORT

oig

Federal Deposit Insurance Corporation

Report No. AUD-09-022 **September 2009**

Material Loss Review of Alliance Bank, Culver City, California

Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Alliance Bank, Culver City, California (Alliance). On February 6, 2009, the State of California, Department of Financial Institutions (DFI), closed Alliance and named the FDIC as receiver. On March 4, 2009, the FDIC notified the OIG that Alliance's total assets at closing were $1.2 billion, with a material loss to the Deposit Insurance Fund (DIF) estimated at $205.9 million.

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

Background

Alliance was insured on May 18, 1980 and was headquartered in Culver City, California. At closing, the bank had four branches located in the greater Los Angeles area of Southern California. Alliance provided traditional banking activities within its Southern California marketplace and focused primarily on commercial real estate (CRE), commercial and industrial, and other lending and specialized in acquisition, development, and construction (ADC) loans.

The FDIC and DFI alternated safety and soundness examinations of Alliance, conducting a total of four examinations from March 2004 to May 2007. The FDIC's off-site review of Alliance as of December 31, 2007, identified deteriorating conditions in the bank's loan portfolio. Based upon the results of the off-site review, the FDIC joined the DFI at the June 2008 examination, which originally had been scheduled as an independent DFI examination.

Audit Results

Causes of Failure and Material Loss - The failure of Alliance and resulting material loss to the DIF were due to bank management's aggressive pursuit of asset growth concentrated in ADC lending without adequate risk management controls and sound credit administration practices. As of December 31, 2007, over 70 percent of the bank's $903 million loan portfolio was secured by real estate. The bank's ADC portfolio deteriorated quickly when the California residential real estate market began to decline in 2007. Total adverse loan classifications increased from $23 million to $176 million between the May 2007 and June 2008 examinations, with resulting losses causing examiners to conclude, at the latter examination, that capital was deficient. Further, the bank's liquidity became strained, and funding options were limited as the bank had fallen to the Adequately Capitalized category for PCA purposes as of June 30, 2008. Bank management had not implemented timely corrective actions in response to examiner recommendations from 2004 to 2008 related to the diversification of the bank's loan portfolio, credit administration weaknesses, and liquidity management. As a result of the large operating losses the bank incurred during 2008, the bank's capital levels steadily declined until the bank was deemed Critically Undercapitalized and closed on February 6, 2009.

Assessment of FDIC Supervision - The FDIC and DFI conducted timely examinations of Alliance and advised management of the need to adequately monitor the higher-risk lending profile of the institution. Also, examiners identified the problems, such as high growth and concentrations that ultimately led to Alliance's failure. Examiners made recommendations, in some cases, in multiple ROEs, to strengthen the bank's risk management controls and credit administration practices and limit its uses of wholesale funding. Further, the FDIC's off-site monitoring efforts and coordination with DFI in 2008 resulted in the FDIC joining the DFI's examination. In addition, the FDIC and DFI worked together in an effective manner during 2008 to downgrade Alliance's ratings based on its deteriorating financial condition, notify the bank of its declining capital, and implement a Cease & Desist Order in October 2008 to address the bank's critical asset quality, liquidity, and capital deficiencies and stem the bank's unsafe and unsound practices. The FDIC appropriately implemented PCA in reclassifying Alliance's capital levels and restricting Alliance's access to brokered deposits. Although the estimated loss to the DIF represented 17 percent of the bank's assets, the actions of regulators during 2008 helped avoid greater losses resulting from the bank's lending practices in the deteriorating Southern California economy.

In retrospect, the May 2007 FDIC examination could have resulted in additional supervisory action to address the significant risks posed by Alliance's aggressive growth concentrated in ADC lending, reliance on wholesale funding, and weak risk management practices. Although Alliance's reported financial condition was satisfactory at the time of the 2007 examination, the economic decline in its marketplace was becoming evident, including an increase in the bank's adverse loan classifications. The FDIC participated in the issuance of interagency guidance in December 2006, highlighting that institutions with CRE concentrations should focus additional attention on risk management practices and capital levels and establishing supervisory criteria for elevated supervisory oversight. Alliance's concentrations exceeded these supervisory criteria and left the bank unprepared to effectively address the risks associated with the economic decline in its market.

This report presents the FDIC OIG's analysis of Alliance's failure and the FDIC's efforts to ensure Alliance's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations, as warranted.

Management Response

On August 27, 2009, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to the draft report. In its response, DSC summarized the OIG's conclusions regarding the causes of Alliance's failure and the resulting material loss to the DIF and DSC's supervisory activities related to Alliance. DSC also acknowledged the OIG position that the risk factors identified in 2007 could have led to earlier action.

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Federal Deposit Insurance Corporation
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Office of Audits
Office of Inspector General

DATE: September 1, 2009

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

FROM: /Signed/
Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Alliance Bank, Culver City, California*
(Report No. AUD-09-022)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Alliance Bank (Alliance). On February 6, 2009, the California Department of Financial Institutions (DFI) closed the institution and named the FDIC as receiver. On March 4, 2009, the FDIC notified the OIG that Alliance's total assets at closing were $1.2 billion with an estimated loss to the Deposit Insurance Fund (DIF) estimated at $205.9 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency which reviews the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); ascertains why the institution's problems resulted in a material loss to the DIF; and makes recommendations to prevent future losses.

The audit objectives were to: (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of the institution, including implementation of the PCA provisions of section 38. Appendix 1 contains details on our objectives, scope, and methodology, and Appendix 2 contains a glossary of terms. Acronyms used in the report are listed in Appendix 4.

[1] As defined by section 38(k)(2)(B) of the FDI Act, a loss is material if it exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.
[2]The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by the institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition; management policies and practices, including internal control systems; and compliance with applicable laws and regulations; and (2) issues related guidance to institutions and examiners.

This report presents the FDIC OIG's analysis of Alliance's failure and the FDIC's efforts to ensure Alliance's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the FDIC's supervision program and make recommendations, as warranted.

BACKGROUND

Alliance was a state-chartered nonmember institution that became insured on May 18, 1980. Alliance, which was headquartered in Culver City, California:

- had one branch in Irvine, one branch in Woodland Hills, one branch in Burbank, and one branch in West Los Angeles;
- provided traditional banking activities within its Southern California marketplace and focused primarily on commercial real estate (CRE), commercial and industrial, and other lending; and
- specialized in acquisition, development, and construction (ADC) loans.

Alliance was a wholly-owned subsidiary of Alliance Bancshares California, a one-bank holding company created in 2000. Alliance's main market area were the Los Angeles and Orange counties of California, with more than 82 percent of the bank's deposits concentrated in Los Angeles County. The Chairman of the Board (Chairman), along with his father and the family trust, collectively controlled 18 percent of the holding company stock.

In the late 1990s, Alliance embarked on an aggressive growth strategy centered in ADC lending in its Southern California market. Management slowed asset growth briefly after the FDIC's 2000 examination; however, Alliance's asset growth increased by an average of 40 percent annually from 2003 to 2008. At the June 2008 examination, Alliance's CAMELS composite rating was downgraded to 5,[3] indicating extremely unsafe and unsound practices or conditions; critically deficient performance, often with inadequate risk management practices; and great supervisory concern. Institutions in this category pose a significant risk to the DIF and have a high probability of failure. Details on Alliance's financial condition, as of December 2008, and for the 5 preceding calendar years follow in Table 1.

[3] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Table 1: Financial Condition of Alliance

Uniform Bank Performance Report	**Dec-08**	**Dec-07**	**Dec-06**	**Dec-05**	**Dec-04**	**Dec-03**
Total Assets ($000s)	$1,113,361	$1,065,009	$874,621	$674,286	$409,443	$281,940
Total Deposits ($000s)	$951,106	$860,500	$717,038	$561,454	$305,089	$225,027
Total Loans ($000s)	$895,889	$902,936	$709,690	$551,477	$305,345	$203,575
Net Loan Growth Rate	*-2.19%*	*26.72%*	*28.43%*	*80.68%*	*50.53%*	*35.00%*
Net Income (Loss) ($000s)	($65,367)	$5,364	$9,363	$6,834	$4,168	$2,421
Loan Mix (% of Avg. Gross Loans):						
Total Real Estate Secured Loans	**69.17%**	**71.42%**	**69.01%**	**69.24%**	**67.81%**	**67.10%**
Construction and Development	23.93%	34.37%	36.75%	31.91%	28.10%	26.24%
CRE – Nonfarm/nonresidential	35.46%	29.00%	24.85%	28.05%	29.83%	31.18%
1-4 Family Residential – excluding Home Equity Lines of Credit	3.81%	2.52%	3.00%	2.57%	2.06%	1.79%
Funding						
Net Loans/Deposits	91.29%	103.16%	97.70%	102.63%	98.95%	89.12%
Core Deposits/Avg. Assets	63.75%	66.05%	52.52%	60.75%	66.46%	58.12%
Brokered/Avg. Assets	23.48%	17.65%	18.28%	12.91%	7.76%	11.36%
Large Time/Avg. Assets	17.04%	15.91%	28.10%	19.56%	12.34%	19.77%
Borrowings/Avg. Assets	7.70%	6.33%	5.07%	8.26%	11.39%	12.32%
Net Non-Core Funding Dependency Ratio	71.54%	23.96%	34.98%	37.29%	28.36%	19.79%
Examination Information	**06/30/2008**	**05/07/2007**	**03/27/2006**	**04/11/2005**	**03/29/2004**	**04/07/2003**
Component/Composite Ratings	455554/5	222222/2	222232/2	222232/2	222223/2	222222/2
Adverse Classifications Coverage Ratio	202.60%	25.95%	24.78%	3.44%	9.68%	22.16%

Source: Uniform Bank Performance Reports (UBPR) and Reports of Examination (ROE) for Alliance.

DSC's Los Angeles West Field Office and DFI alternated safety and soundness examinations of Alliance, conducting a total of four examinations from March 2004 through May 2007. The FDIC's off-site review of Alliance as of December 31, 2007, identified deteriorating conditions in the bank's loan portfolio. Based upon the results of the off-site review, the FDIC joined DFI at the June 2008 examination, which had been scheduled as an independent DFI examination.

California Economic Conditions

The FDIC's Division of Insurance and Research (DIR) publishes local economic data for the FDIC's Regional Offices. In the Winter 2006 issue of *FDIC Outlook*, regional analysts identified trends that were expected to affect banking across the FDIC's regions during 2007. According to these analysts, the construction sector drove much of the San Francisco Region's[4] economic expansion and contributed to high and increasing concentrations of CRE and construction loans. ADC loans, a component of CRE lending, was the most rapidly growing portfolio sector reported by banks in the San Francisco Region. The region's median ADC Loans to Tier 1 Capital Ratio was more than twice the average for the rest of the country as of

[4] The FDIC's San Francisco Region covers all of California and 10 other states.

mid-year 2006. Analysts indicated that a slowdown in the critical construction sector could jeopardize the sustainability of a bank's strong performance.

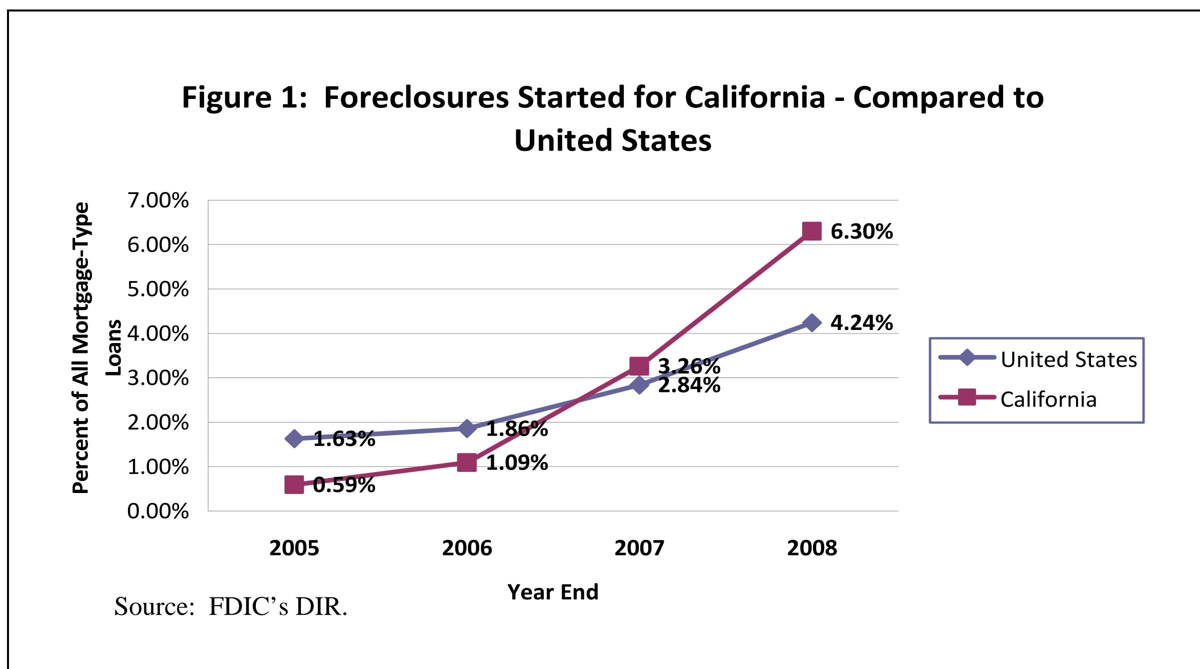
Data indicated that California was one of the states with the most acute downturn in housing. As home prices slumped, foreclosure activity rose at a startling pace. As noted in Table 2 below, certain indicators showed that the economic conditions in California were slowing considerably during 2006 through 2008.

Table 2: Indicators of Economic Downturn in California

	2006	2007	2008
Residential Real Estate Activity			
Total Housing Permits	155,419	104,788	61,222
Percent of Change from 1 Year Earlier	*-23.1%*	*-32.6%*	*-41.6%*
Mortgage Delinquencies			
Total Past Due (for all loan types)	3.3%	5.4%	9.1%
Foreclosures Started (for all loan types)	1.1%	3.3%	6.3%

Source: FDIC's Division of Insurance and Research (DIR).

Further, as indicated in Figure 1, below, California's rapid increase in foreclosure activity was higher and grew faster than the national average from 2007 to 2008.



Source: FDIC's DIR.

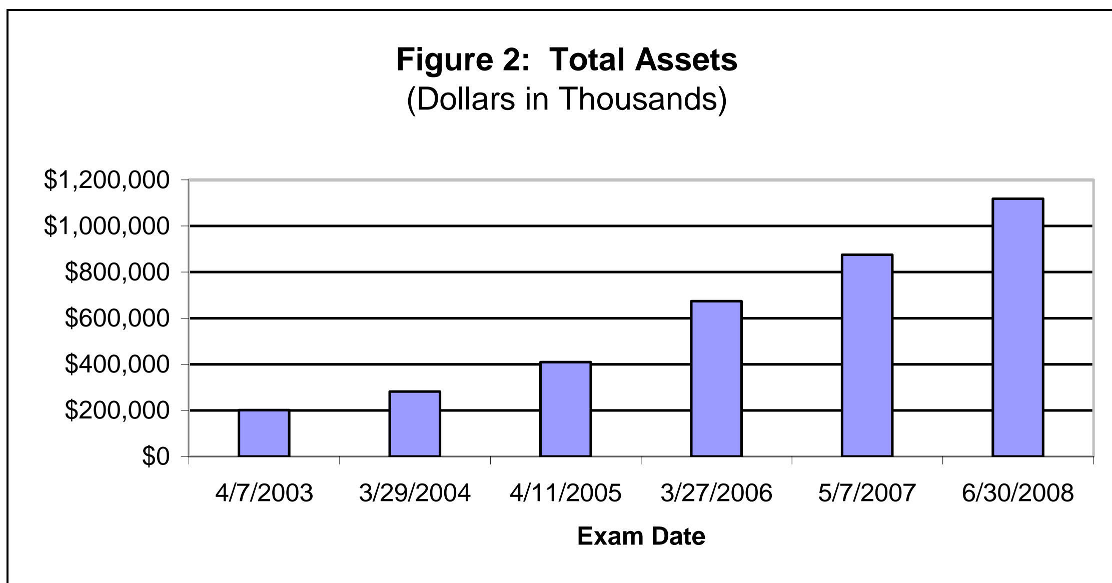
Examiners concluded in the 2008 ROE that Alliance's unsatisfactory financial condition was the result of significant exposure to distressed Southern California real estate markets. Specifically, Alliance had significant risk exposure from ADC lending activities in six Southern California counties.

CAUSES OF FAILURE AND MATERIAL LOSS

The failure of Alliance and resulting material loss to the DIF were due to bank management's aggressive pursuit of asset growth concentrated in ADC lending without adequate risk management controls and sound credit administration practices. As of December 31, 2007, over 70 percent of the bank's $903 million loan portfolio was secured by real estate. The bank's ADC portfolio deteriorated quickly when the California residential real estate market began to decline in 2007. Total adverse loan classifications increased from $23 million to $176 million between the May 2007 and June 2008 examinations, with resulting losses causing examiners to conclude, at the latter examination, that capital was deficient. Further, the bank's liquidity became strained, and funding options were limited as the bank had fallen to the Adequately Capitalized category for PCA purposes as of June 30, 2008. Bank management had not implemented timely corrective actions in response to examiner recommendations from 2004 to 2008 related to the diversification of the bank's loan portfolio, credit administration weaknesses, and liquidity management. As a result of the large operating losses the bank incurred during 2008, the bank's capital levels steadily declined until the bank was deemed Critically Undercapitalized and closed on February 6, 2009.

Aggressive Growth in ADC Lending

From the bank's inception in 1980 until 1996, total assets averaged $44 million. Beginning in 1997, Alliance management embarked on a strategy of aggressive growth, comprised primarily of ADC loans. Asset growth was initially funded through core deposits; however, in 2002, the bank began to rely more heavily on wholesale funding sources. From December 31, 2003 to December 31, 2007, the bank's total assets grew from about $282 million to nearly $1.1 billion. Management achieved this asset growth primarily through originations of CRE loans, and particularly ADC loans. The bank's growth was heavily funded with wholesale funding sources, which equaled 45 percent of total deposits as March 31, 2007. After the 2000 examination and due to regulators' concerns about the bank's high concentrations in ADC loans (totaling 644 percent of Tier 1 Capital), a Memorandum of Understanding (MOU) was put in place from June 2000 until August 2001. The MOU, among other things, required a reduction in the ADC concentration. During the time the MOU was in force, management slowed asset growth and lowered the concentration in ADC loans to 344 percent of Tier 1 Capital. However, asset growth accelerated to over 28 percent between the 2001 and the April 2002 examination after the MOU had terminated. Total assets increased by 40 percent between the 2003 and 2004 examinations and again by 45 percent between the 2004 and 2005 examinations. Total assets increased by 65 percent between the 2005 and 2006 examinations and again by 29 percent between the 2006 and 2007 examinations. The increase in total assets is shown in Figure 2, which follows.



Source: ROEs for Alliance.

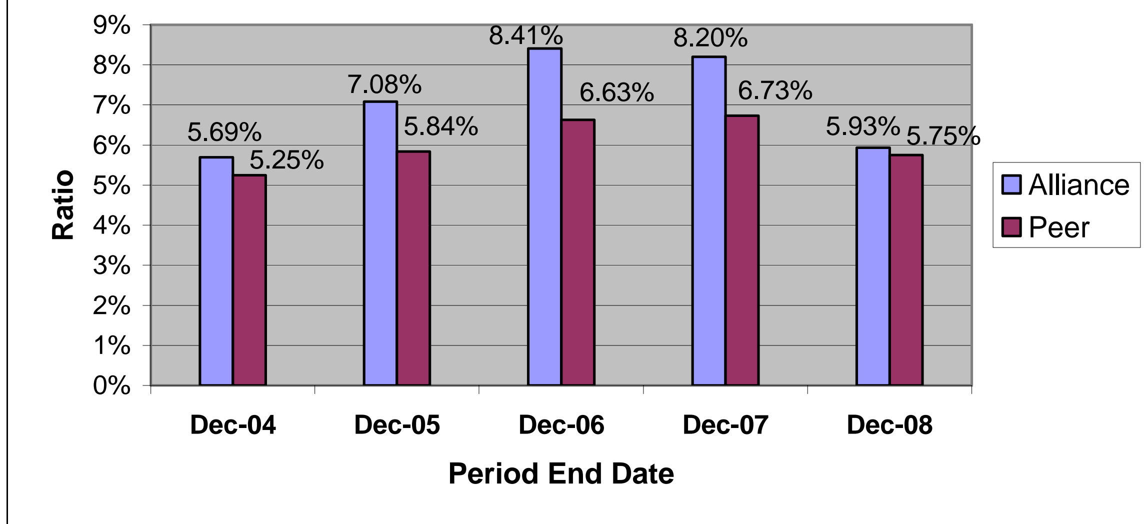
Concentrations in CRE and ADC Loans

Alliance's increased origination of ADC loans led to its rapid growth in assets. Examiners reported that these loans included speculative real estate development lending, including lending on an unsecured basis in amounts that appeared to exceed the bank's lending limits to individual borrowers. Interagency guidance on CRE lending entitled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 12, 2006 (CRE Guidance), states that CRE lending, in general, and construction lending, in particular, may require a greater level of supervisory oversight. Specifically, the guidance states that an institution may be identified for further supervisory analysis of the level and nature of risk if it has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or

- total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

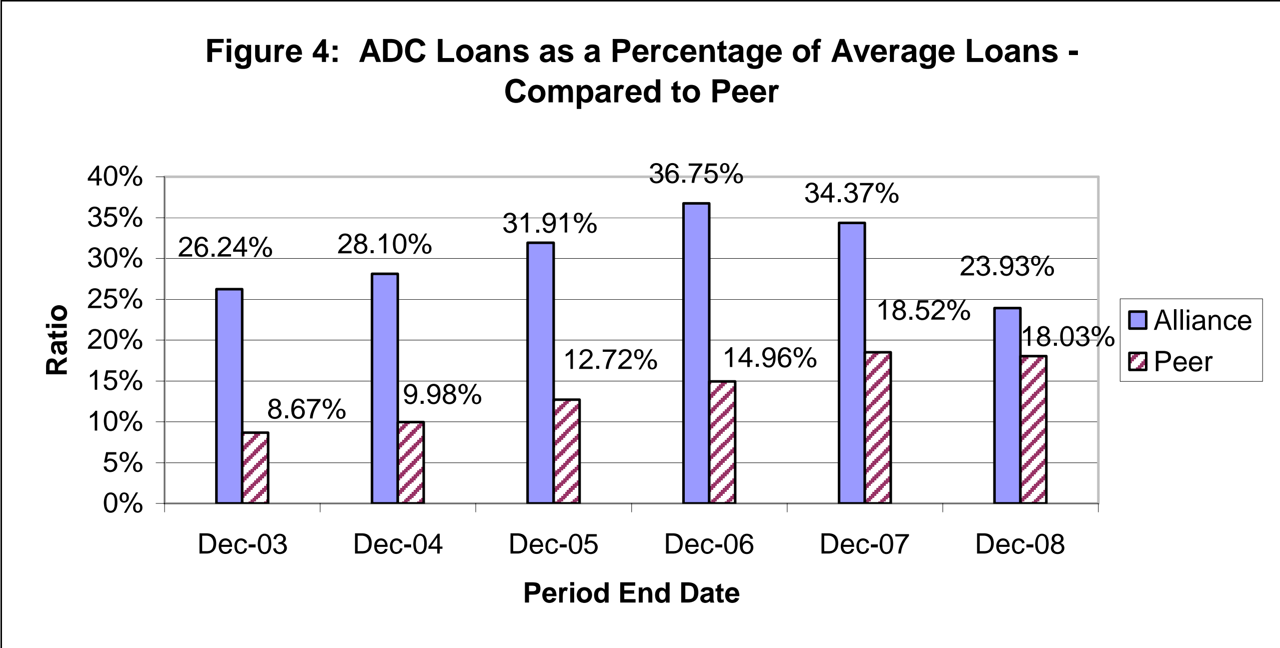
As of the May 2007 examination, CRE and ADC loans totaled about 571 percent and 311 percent of Total Risk-Based Capital, respectively, which exceeded the supervisory criteria and warranted elevated oversight. Furthermore, from December 2003 to December 2007, Alliance's loan portfolio was concentrated in ADC loans at levels significantly above its peer banks. This strategy appeared to work well prior to 2007 when the Southern California real estate market was accelerating. As shown in Figure 3, which follows, Alliance's interest income as a percentage of average assets exceeded its peer group; however, the significant concentrations in ADC loans made the bank vulnerable to changes in the real estate market.



Source: UBPRs for Alliance.

Examiners concluded that Alliance's asset quality was critically deficient during the joint FDIC/ DFI June 2008 examination, primarily due to the high level of loan losses and volume of classifications. The deterioration in the Southern California residential real estate market, coupled with the bank's high concentrations of ADC lending in this market, produced a significant increase in classifications. Total classifications had risen from $23 million at the May 2007 examination to $175.8 million at the June 2008 examination. Further, another $24.6 million in loan losses was posted with the bank's June 30, 2008 Report of Condition and Income (Call Report). Examiners determined that the problem loans were generally large dollar, speculative[5] residential construction and land loans. Examiners found that although these loans were secured by real estate, in nearly all cases, the principals or guarantors lacked the capacity to carry the notes. A significant volume of land or lot development loans were on hold because it was not feasible to build out due to the decreased demand from buyers. Examiners determined that the excessive size of the residential real estate portfolio was the primary cause of the critically deficient asset quality as over 70 percent of the residential construction and land loans outstanding at the June 2008 examination had been adversely classified. Alliance's ADC loans, as a percentage of average loans, as compared to its peer banks is shown in Figure 4, which follows.

[5] Construction is to be completed, and the project is not pre-sold or pre-leased.



Source: UBPRs for Alliance.

According to the CRE Guidance, financial institutions with high concentrations of CRE loans require strong concentration risk management practices. Although Alliance's board of directors (BOD) and management established limits for concentrations, management did not always identify, measure, monitor, and report risk exposures. As discussed below, examiners expressed their concerns to Alliance's BOD and management regarding the bank's risk management, weak credit administration practices, and concentrations in ADC loans that contributed to the bank's rapid decline.

Risk Management/Credit Administration Weaknesses Noted in ADC Loans

Examiner concerns with Alliance's high concentration in ADC lending were reported in the 2004 through 2008 ROEs. In addition, although Alliance was rated a 2 in both management and asset quality until 2008, each of these examinations reported weaknesses and made recommendations regarding the bank's risk management and/or credit administration practices. After the bank's loan portfolio began suffering significant losses in 2008, examiners downgraded both management and asset quality to 5 and implemented a Cease and Desist Order (C&D) requiring the bank to diversify its loan portfolio.

The 2004 DFI examination noted that concentrations persisted in the real estate loan portfolio, and management was advised to implement more stringent credit administration and underwriting processes. Specifically, credit administration and underwriting weaknesses were noted in one loan relationship where modifications of the loan terms had not been approved by the Loan Committee for over a month after the loan advancement, and the purpose of the advance was inconsistent with the purpose contained in the loan agreement. Also, quarterly status reports, current rent rolls, and operating statements were not being obtained and analyzed

on a timely basis as required by the loan agreement. Further, there was no documentation indicating that current financial statements of the borrower and guarantor had been analyzed. Examiners also noted that although the external loan review appeared adequate, expansion of the loan review comments to include a more detailed analysis of the borrower's current financial information was needed.

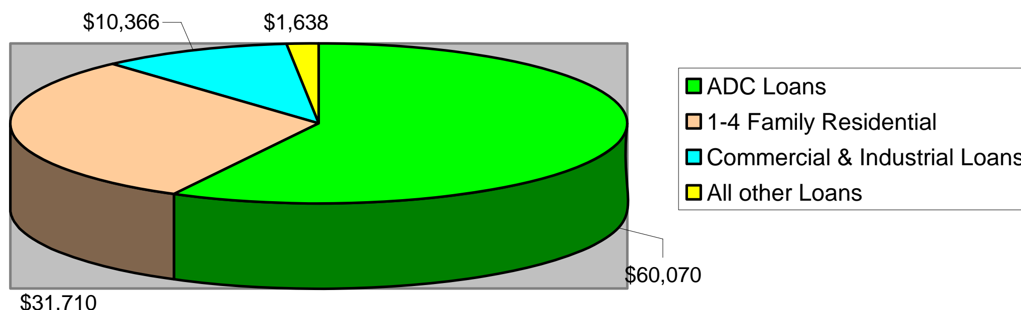
The 2005 FDIC examination made recommendations for improvements in the reporting and monitoring of concentrations of credit in CRE and speculative residential construction loans. For example, examiners recommended that more comprehensive credit presentations to the loan committee were needed and that policies, procedures, and methodologies regarding concentrations of credit oversight needed to be strengthened, particularly in consideration of the large volume of higher-risk CRE and construction-related credits in the loan portfolio. Furthermore, examiners cited an apparent contravention of Appendix A to Part 365 of the FDIC Rules and Regulations – *Interagency Guidelines for Real Estate Lending Policies*, due to inadequate market analysis. Specifically, management's market analysis did not include several factors related to how market shifts and changes in concentrations may impact the quality of the loan portfolio and adequacy of the allowance for loan and lease losses (ALLL).

The 2006 DFI examination continued to report concerns regarding Alliance's loan concentrations. Although management had enhanced reporting and monitoring by providing extensive reports to the BOD on a monthly basis, management was not accurately reporting loan concentrations or the total debt of the bank's largest customer. Also, several loans were identified during the examination that did not have current financial statements or tax returns, standby letters of credit had not been certified, and the appraisal review function was conducted by the individual loan officers rather than an independent reviewer.

The 2007 FDIC examination more favorably reported on the bank's concentrations, stating that the loan policy adequately covered recommended underwriting and administrative standards, which examiners concluded were sound; however, examiners recommended that the policy include a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions. The examiners further stated that these industry concentrations added risk and were actively monitored by management.

By the 2008 examination, the Southern California real estate market had severely deteriorated, and Alliance's concentrations in CRE and ADC lending had severely eroded the bank's financial condition. Examiners concluded that shortcomings in loan collection and asset disposition practices had caused the protracted sell-out and repayment expected on many of the problem construction loans. Examiners found multiple loan renewals or extensions without principal reduction, extended length of delinquency on some past-due loans, delayed foreclosure proceedings, and no other real estate owned as of June 30, 2008. Weaknesses were also reported in the loan review and grading program. Examiners found that management had only recently downgraded many classified loans prior to the examination. Furthermore, examiners concluded that the bank had employed inadequate risk management practices and that loan concentrations had been increasingly funded by brokered deposits and other non-core funding sources. Alliance's net loan charge-offs on loans and leases are shown, by loan type, as follows in Figure 5.

Figure 5: Net Charge-offs on Loans and Leases



Source: UBPRs at year-end 2004 through 2008 for Alliance.

Heavy Reliance on Wholesale Funding to Fuel Growth

Alliance increased its reliance on brokered deposits and Federal Home Loan Bank (FHLB) borrowings to meet loan portfolio growth demands. Brokered deposits and FHLB borrowings comprised 29 percent and 21 percent of the bank's total liabilities at year-end 2004 and 2003, respectively. Examiners downgraded liquidity to less than satisfactory in 2005 and 2006 due to the bank's continued reliance on volatile funding sources, which consistently exceeded its peer group average for such funding sources and exceeded the bank's policy limit of 20 percent. Net non-core funding continued to rise. Specifically, the non-core dependency ratio as of December 31, 2005 and March 31, 2007 was 36.9 percent and 40 percent, respectively. During the 2007 examination, examiners (1) concluded that although wholesale funding sources were used extensively, the satisfactory condition and earnings performance levels lent support for the heavy reliance on wholesale funding and (2) therefore raised the liquidity rating to 2. Alliance's cost of funds was progressively above its peer banks as shown in Table 3, below.

Table 3: Alliance's Cost of Funds

Year-End	Interest Expense as a Percentage of Average Assets	Bank's Peer Group (%)	Peer (State of California) (%)
12-31-2002	2.43	2.16	1.50
12-31-2003	1.76	1.63	1.04
12-31-2004	1.36	1.38	0.94
12-31-2005	2.16	1.89	1.47
12-31-2006	3.23	2.70	2.26
12-31-2007	3.56	3.07	2.64
12-31-2008	3.17	2.31	1.99

Source: UBPRs for Alliance.

However, examiners recommended that a formal contingency plan be established to identify specific steps to be taken in the event of a liquidity crisis, including scenarios such as legal limits triggered by PCA standards. As of June 30, 2008, the bank's non-core funding dependence escalated to 50.2 percent, and by July 31, 2008, Alliance's brokered deposits made up 36 percent of total deposits. However, the bank was subsequently prohibited, under section 29 of the FDI Act, from accepting, renewing, or rolling over brokered deposits without an FDIC waiver, because the bank was deemed Adequately Capitalized under PCA provisions of the FDI Act.

Using brokered deposits may have been a reasonable strategy had Alliance maintained satisfactory asset quality; however, the non-core funding dependence resulted in a liquidity crisis during 2008 when the bank's loan portfolio deteriorated, which ultimately led to Alliance's failure.

Underwriting Weaknesses

Although examiners generally concluded that Alliance's loan underwriting practices were sound, weaknesses were noted during examinations conducted from 2004 to 2008. The 2004 examination reported underwriting weaknesses in one loan relationship as follows.

- Modification of the terms of the loan for $300,000 advanced on March 3, 2004 for the purchase of a single-family residence was not approved by the bank's Loan Committee until April 14, 2004. The purpose of the advance was inconsistent with the original purpose contained in the loan agreement. The Chief Credit Officer approved the advance prior to recording the second Deed of Trust, which remained unrecorded as of April 22, 2004. The advance was made to a personal checking account.

- Quarterly status reports, current rent rolls, and operating statements were not obtained and analyzed on a timely basis as required by the loan agreement.

- Financial statements contained various errors, and there was no documentation indicating that the current financial statements of the borrowers and guarantor were analyzed.

During the 2005 examination, examiners made recommendations for more comprehensive credit presentations to the Loan Committee. Furthermore, examiners cited an apparent contravention of Appendix A to Part 365 of the FDIC Rules and Regulations – *Interagency Guidelines for Real Estate Lending Policies*, due to inadequate market analysis. During the 2006 examination, the largest substandard loan classifications were downgraded primarily due to weak underwriting practices. The 2007 examination found Alliance's underwriting policies to be sound and did not report any underwriting weaknesses, and the 2008 examination reported weaknesses in underwriting practices related to one insider loan that had not been found in other loans.

In addition to examiner reviews of Alliance's underwriting practices, Alliance's Audit Committee engaged outside firms to conduct loan reviews in August 2006 and April 2008. The 2006 loan review recommended that the bank needed to place more emphasis on quality and timely financial data in assessing the credit quality of borrowers. Also, the reports indicated that

the bank was relying on the sale of real estate collateral as the primary source of repayment for real estate loans.

DSC's *Risk Management Manual of Examination Policies* (Examination Manual) stresses that prudent lending practices should include, among other things, that effective management of risk is dependent on the quality of analysis at origination as well as after the loan is advanced. Changes in the condition or the advancement of additional funds should be documented in credit memorandums, and credit memorandums should be updated at least annually. Loan reviews conducted from 2004 to 2008 indicated that these practices were not always followed by Alliance.

ASSESSMENT OF FDIC SUPERVISION

The FDIC and DFI conducted timely examinations of Alliance and advised management of the need to adequately monitor the higher-risk lending profile of the institution. Also, examiners identified the problems, such as high growth and concentrations that ultimately led to Alliance's failure. Examiners made recommendations, in some cases, in multiple ROEs, to strengthen the bank's risk management controls and credit administration practices and limit its use of wholesale funding. Further, the FDIC's off-site monitoring efforts and coordination with DFI in 2008 resulted in the FDIC joining the DFI examination. In addition, the FDIC and DFI worked together in an effective manner during 2008 to downgrade Alliance's ratings based on its deteriorating financial condition, notify the bank of its declining capital, and implement a C&D in October 2008 to address the bank's critical asset quality, liquidity, and capital deficiencies and stem the bank's unsafe and unsound practices. The FDIC appropriately implemented PCA in reclassifying Alliance's capital levels and restricting Alliance's access to brokered deposits. Although the estimated loss to the DIF represented 17 percent of the bank's assets, the actions of regulators during 2008 helped avoid greater losses resulting from the bank's lending practices in the deteriorating Southern California economy.

In retrospect, the May 2007 FDIC examination could have resulted in additional supervisory action to address the significant risks posed by Alliance's aggressive growth concentrated in ADC lending, reliance on wholesale funding, and weak risk management practices. Although Alliance's reported financial condition was satisfactory at the time of the 2007 examination, the economic decline in its marketplace was becoming evident, including an increase in the bank's adverse loan classifications. Also, the 2007 ROE noted that Alliance's Tier 1 Leverage Capital ratio decreased slightly from the prior year, but remained satisfactory at 9.35 percent, with the Total Risk-Based Capital at 11.67 percent. Alliance went from a well-rated institution at the May 2007 examination to a 5-rated institution at the June 2008 examination. The FDIC participated in the issuance of interagency guidance in December 2006, highlighting that institutions with CRE concentrations should focus additional attention on risk management practices and capital levels and establishing supervisory criteria for elevated supervisory oversight. Alliance's concentrations exceeded these supervisory criteria and left the bank unprepared to effectively address the risks associated with the economic decline in its market.

Examination History

Since it was chartered in 1980, Alliance was examined on an annual basis by the FDIC and DFI, either independently or jointly. The FDIC's Los Angeles West Field Office and the DFI conducted safety and soundness examinations of Alliance from 2000 to 2008 as shown in Table 4.

Table 4: Examination History of Alliance

Examination Date	Agency	Supervisory Ratings
06/30/2008	**Joint**	455554/5
05/07/2007	**FDIC**	222222/2
03/27/2006	**DFI**	222232/2
04/11/2005	**FDIC**	222132/2
03/29/2004	**DFI**	222223/2
04/07/2003	**FDIC**	222222/2
04/29/2002	**Joint**	223332/2
01/08/2001	**Joint**	222232/2
02/07/2000	**FDIC**	333222/3

Source: ROEs for Alliance.

As discussed previously, Alliance began to rapidly grow during 1999 by originating a large volume of construction loans. During the 2000 FDIC examination, examiners found that Alliance's overall risk profile had increased significantly since the previous FDIC examination. According to the ROE, substantial growth in construction lending resulted in a concentration in such loans representing approximately 644 percent of Tier 1 Capital, which increased the inherent risk within the loan portfolio to an imprudent level and caused the bank to be highly sensitive to market risks. Management was considered less than satisfactory because of its willingness to increase the risk profile of the institution to an unacceptable level. Although earnings were above average, they reflected the high-risk practice of over-concentrating lending in ADC projects, which could be detrimentally affected with the onset of adverse economic conditions. Liquidity had become marginal because management had solicited higher-cost deposits from potentially volatile funding sources to fund loan growth. As a result, the FDIC downgraded several of the bank's component ratings and the composite rating to 3 from the prior examination in 1999 when Alliance was 2-rated. In addition, an MOU was put in place with management in June 2000 to correct the less-than-satisfactory conditions. Among other things, the MOU required the bank to systematically reduce the amount of loans or other extensions of credit in real estate development and construction. As of the January 2001 examination, examiners reported that the bank had made significant progress in reducing the excessive concentration of construction/land development loans after the 2000 examination.

However, examinations beginning in 2004 began reporting concerns again regarding the bank's concentration levels in construction and land development loans and credit administration weaknesses. The 2005 examination noted the bank's dependence on net non-core funding to

meet loan portfolio growth demands. Table 5, which follows, summarizes examiners' comments and recommendations related to these areas from 2004 to 2008.

Table 5: Examiner Comments and Recommendations Regarding Alliance's Loan Concentrations, Credit Administration Weaknesses, and Uses of Wholesale Funding

Examiner Comments	Examination Dates				
	Mar 2004	April 2005	Mar 2006	May 2007	June 2008
ADC Loan Concentrations					
• Concentrations persist in the real estate loan portfolio	✓	✓	✓	✓	✓
Credit Administration Weaknesses					
• Credit administration practices and risk identification or underwriting need improvement	✓	✓	✓		✓
• Underwriting weaknesses noted in sampled loans	✓		✓		✓
• Insufficient factors used in analysis of speculative residential construction loans		✓			
• The market analysis does not include several factors identified in Appendix A to Part 365 (apparent contravention of policy)		✓			
• Weak documentation of discussions regarding market analyses and concentration of credit in BOD minutes		✓			
• Various recommendations for management to improve its analysis of speculative residential construction loans		✓			
• Various recommendations regarding enhancements to the bank's loan policy		✓			
• Various recommendations to improve the concentration analysis, and reporting and monitoring of loan concentrations and presentations to the Loan Committee		✓	✓		
• Recommendation that management should identify all relationships outstanding to a borrower to prevent the bank from exceeding its lending limits			✓		
• Recommendation that the loan policy should be revised to include a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions				✓	
• Management needs to adequately document the reason(s) a particular loan will be considered "impaired"					✓
• Shortcomings in loan collection and asset disposition practices					✓
• Controls over the CRE and construction loan concentration risks proved to be clearly inadequate					✓
• Weakness was noted in the loan review and grading program					✓
• The BOD must ensure that sufficient resources are available to accurately identify problem assets and to do so in a timely manner					✓
• Management needs to ensure there is timely identification and grading of problem loans					✓

Examiner Comments	Examination Dates				
	Mar 2004	April 2005	Mar 2006	May 2007	June 2008
Uses of Wholesale Funding					
• Increased reliance on costlier funding sources such as brokered deposits and FHLB borrowings to meet loan portfolio growth demands		✓	✓	✓	✓
• Non-core funding dependence ratio is much higher when recalculated to include the inherently volatile funds from the large deposit relationships including Internet deposits		✓		✓	✓
• Several customers control a large volume of deposits			✓	✓	
• Certain liquidity ratios are not being correctly calculated or reported				✓	
• Lack of adequate liquidity contingency plan				✓	✓
• Funding sources are rapidly diminishing					✓
• Recommendation to reassess targeted liquidity ratios			✓		
• Recommendation to review and revise liquidity policy guidelines to ensure consistency			✓		
• Recommendation to establish a detailed formal liquidity contingency plan				✓	
• Recommendation to develop and implement forward looking measures to comprehensively understand the liquidity risk profile					✓

Source: ROEs for Alliance.

Concentrations and Credit Administration Weaknesses

Concentrations. As shown in Table 5, beginning in 2004, and at each subsequent examination, examiners identified that Alliance's loan portfolio was (1) concentrated in ADC lending and reported to management that ADC concentrations made the bank vulnerable to a downturn in the real estate market and (2) warranted management's continued monitoring. However, examiners did not downgrade the institution's asset quality or management ratings or initiate other formal or corrective enforcement action until after the June 2008 examination, such as the MOU implemented after the 2000 examination. Based on our review of examinations from 2004 to 2008 and discussions with examiners, action was not taken because of the apparent strong protection of collateral; positive real estate market conditions; management involvement; capital levels; and an effective program in place to measure, monitor, and control the inherent risks. Examiners also noted that the level of the construction loan portfolio was not as severe from 2004 to 2008 as it was during the 2000 examination when total construction loans outstanding represented 644 percent of Tier 1 Capital. The 2007 ROE reported that Alliance's BOD had voted to reduce the bank's ADC concentrations to 250 percent of Tier 1 Capital. However, during the 2007 examination, CRE and ADC loans represented 571 percent and 311 percent of Total Risk-Based Capital, respectively, exceeding supervisory criteria in interagency guidance and warranting additional institution and supervisory attention. The 2007 examination noted that the volume of adversely classified loans had increased from $16.8 million at the 2006 examination to $22.9 million as of March 31, 2007.

However, the 2008 examination report that downgraded Alliance's asset quality to critically deficient stated that: "While the identification, measurement, and monitoring of CRE and

construction loan concentrations is comprehensive, controls over these concentration risks, as evidenced in high board established policy limits, proved to be clearly inadequate." Examiners told us that although management was slow to react to the declining real estate market and take actions necessary to limit the bank's loan losses, examiners found the bank's management, over the years, to be receptive to examiners' recommendations, properly classifying problem loans and monitoring the loan concentrations. Examiners also noted that the bank generally maintained an adequate ALLL, although during the 2008 examination, examiners found that the ALLL was underfunded by $3.8 million. The C&D, stipulated to by Alliance in October 2008, contained three requirements for the bank related to asset quality: (1) develop, revise, adopt, and implement a comprehensive policy for determining the adequacy of the ALLL; (2) adopt and implement a plan for reduction and collection of classified assets and delinquent loans; and (3) develop, revise, adopt, and implement a written plan requiring the prudent diversification of the loan portfolios.

Credit Administration Weaknesses. Examiners also consistently reported credit administration weaknesses during each examination. As shown in Table 5, these were most pronounced during the 2005, 2006, and 2008 examinations and related to insufficient market analysis for speculative loans, risk identification, reporting concentrations, loan policies, loan collection, and asset disposition practices. From 2005 to 2007, reported weaknesses declined with each examination. The only credit administration weakness reported in the 2007 ROE was that the bank's loan policy did not contain a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions. Examiners recommended that the loan policy should contain a contingency plan to include selling or securitizing CRE loans and that management should periodically assess the marketability of the portfolio. Otherwise, the 2007 ROE reported that the loan policy adequately covered recommended underwriting and administration standards, which examiners concluded were sound. In response to the 2007 ROE, Alliance sold a group of CRE loans, opened a new branch to increase core deposits, and updated loan and liquidity funds management policies.

Liquidity and Use of Wholesale Funding

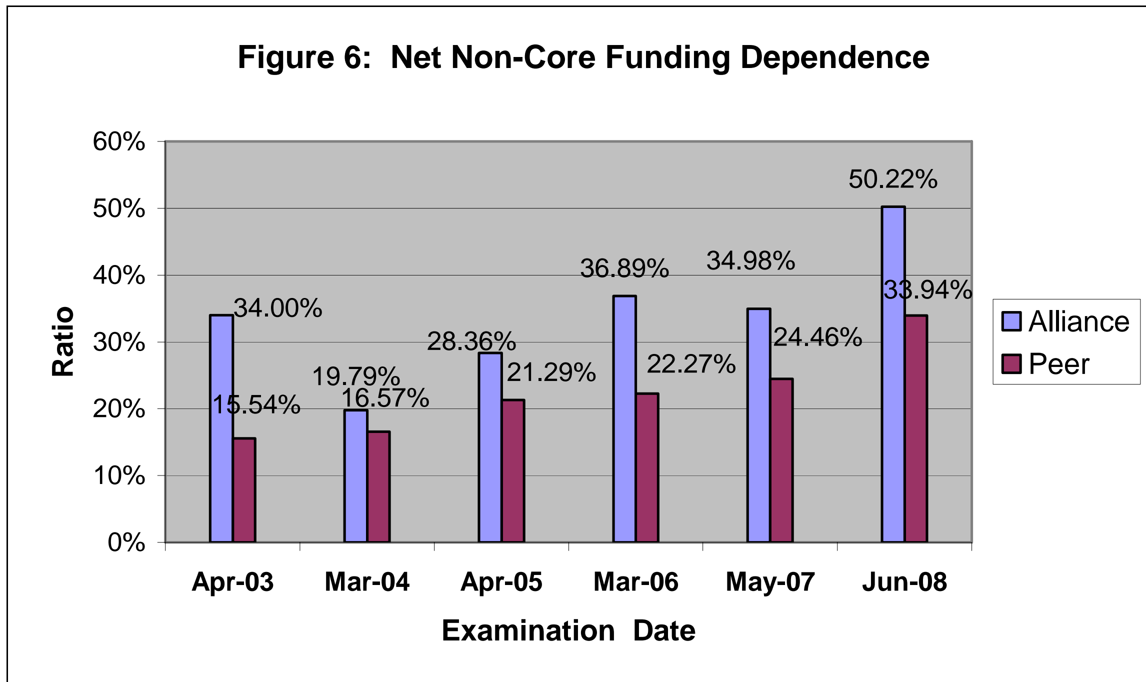
Examiners found that Alliance relied on brokered deposits and FHLB borrowings and had a high-risk wholesale funding strategy as shown in Table 6, which follows. This resulted in the bank's liquidity rating being downgraded during the 2005 and 2006 examinations. Examiners also identified inadequate controls over the bank's high-risk wholesale funding strategy that included inadequate monitoring and reporting and the lack of an adequate contingency liquidity plan (CLP). The resulting dependence on brokered deposits and FHLB borrowings negatively affected and further deteriorated the bank's financial condition.

Table 6: Alliance's Funding Sources, by Examination Date

Non-Core Funding Sources	Year-End Date (Dollars in $000)				
	Dec-04	**Dec-05**	**Dec-06**	**Dec-07**	**Dec-08**
Brokered deposits	$40,592	$125,847	$162,449	$197,159	$312,426
FHLB Borrowings less than 1 year	$52,000	$15,000	$0	$40,000	$100,000
FHLB Borrowings greater than 1 year	$15,000	$20,000	$50,000	$40,000	$10,000
Certificates of Deposits over $100,000	$53,518	$185,098	$253,420	$157,183	$280,352
Total	**$161,110**	**$345,945**	**$465,869**	**$434,342**	**$702,778**

Source: UBPRs for Alliance.

A key metric of the risks related to a bank's liquidity management is the net non-core funding dependence ratio. This ratio is an indication of the degree to which the bank relies on non-core volatile liabilities, such as brokered deposits, FHLB borrowings, and certificates of deposit over $100,000 to fund long-term earning assets. Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. As noted in Figure 6, which follows, Alliance's reliance on non-core/volatile liabilities dropped after the April 2003 examination and was closer to its peer group average but then grew significantly above its peer group average from March 2006 to June 2008. This pattern reflects the bank's increasing reliance on the use of brokered deposits and FHLB borrowings to provide liquidity.



Source: OIG review of ROEs for Alliance.

The April 2005 ROE reported that while the bank was capable of meeting its typical asset funding needs, liquidity had become strained by a very large and potentially volatile deposit relationship. Further, the bank had increased reliance on costlier funding sources, such as

brokered deposits and FHLB borrowings. As a result, the bank's liquidity rating was downgraded from 2 at the prior examination to 3 in 2005.

The 2006 examination also resulted in a 3 liquidity rating as the bank's reliance on volatile liabilities had continued to increase and exceeded its policy limit of 20 percent. Net non-core funding dependence as of December 31, 2005 was 36.9 percent, representing a 30-percent increase since the April 2005 examination. Brokered deposits had increased 210 percent, and the BOD had approved further increases. Examiners recommended that the BOD and management reassess the bank's targeted liquidity ratios.

In 2007, examiners continued to report that wholesale funding was used extensively; however, the bank's overall satisfactory condition and earnings performance lent some support for the heavy use of wholesale funding, and the liquidity rating was raised to 2. Examiners recommended that a formal liquidity contingency plan be established to identify specific steps to be taken in the event of a liquidity crisis and that Alliance identify specific scenarios such as legal limits triggered by PCA standards and reputation risk.

By the June 2008 examination, Alliance's liquidity levels were rated critically deficient. Examiners reported that management did not have a contingency plan in place and, because the bank's PCA category had fallen to Adequately Capitalized as of its June 30, 2008 Call Report, the bank was prohibited from accepting, renewing, or rolling over brokered deposits without a waiver from the FDIC.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and mandatory supervisory actions that are to be triggered by an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are not adequately capitalized.

The FDIC evaluated Alliance's capital position and assigned a capital component rating of 2 from the 2001 to the 2007 examinations, indicating a satisfactory capital level relative to the bank's risk profile. The bank's Call Report as of June 30, 2008, indicated that the bank's capital ratios had significantly declined and, based on these ratios, Alliance's capital category became Adequately Capitalized.

PCA's focus is on capital, and capital can be a lagging indicator of an institution's financial health. In addition, the use of PCA Directives can depend on the accuracy of capital ratios in a financial institution's Call Reports. Alliance's reported capital ratios remained in the Well Capitalized to Adequately Capitalized range after its operations had begun to deteriorate. During the June 2008 examination, examiners considered the ALLL to be underfunded by $3.8 million, which overstated capital and earnings and underreported the deterioration of the loan portfolio.

Subsequently, the 2008 examination downgraded the bank's capital rating to a 4, indicating a deficient level of capital that could threaten the viability of the institution and require the bank to obtain financial support from shareholders or other external sources. Further, the joint FDIC/DFI October 2008 C&D contained several capital-related provisions. These provisions required the bank to:

- Formulate and implement a capital plan
- Raise $30 million in capital within 60 days
- Bring Tier 1 Capital to 10 percent of total assets
- Submit a status report on requirement to raise capital

However, Alliance was unable to raise additional capital, and the bank's capital position continued to decline. The FDIC issued a PCA Directive to Alliance, dated December 1, 2008, notifying the bank that based on amended ratios filed on November 25, 2008, it fell within the Undercapitalized Capitalized category for PCA, and the FDIC asked Alliance to submit a capital plan. Subsequently, based on its December 31, 2008 Call Report submitted on February 4, 2009, Alliance became Critically Undercapitalized and was closed on February 6, 2009.

Conclusion

Based on our conclusion that Alliance's failure and material loss were due to the bank's rapid growth in ADC lending without adequate risk management controls and sound credit administration practices, the FDIC should have taken additional supervisory actions, particularly during the 2007 examination, before which Interagency Guidance had highlighted the risks of CRE concentrations. When similar circumstances occurred in 2000, the FDIC downgraded the bank and signed an MOU to address these concerns. Although the concentrations in ADC lending after 2004, as a percentage of Total Risk-Based Capital, did not become as severe as those reported in 2000, they were significantly higher in dollar terms, above peer, and along with the bank's reliance on brokered deposits, warranted greater attention.

As mentioned previously, Interagency Guidance on CRE, issued in December 2006, states in general, that an institution may be identified for further supervisory analysis of the level and nature of risk if it has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds total reported loans for CRE of 300 percent or ADC loans of 100 percent or more of the institution's total capital. During the 2007 examination, Alliance's CRE and ADC concentrations exceeded the criteria established by the guidance. In addition, the 2007 ROE reported that Alliance's loan classifications had increased by 37 percent from the prior examination. While examiners appropriately recommended that the bank's loan policy be revised to include a contingency plan to reduce or mitigate concentrations in the event of adverse market conditions, examiners did not downgrade the institution or pursue an MOU.

However, we found that examinations of Alliance from 2004 to 2008 were conducted in a timely and complete manner and that examiners clearly notified Alliance management of the risks the bank's high concentrations in ADC lending posed to the institution. Furthermore, examiners

made recommendations to strengthen the bank's credit administration practices and limit its uses of wholesale funding during each of these examinations. As a result of off-site monitoring and communication between the FDIC and DFI, the agencies worked together in an effective manner during 2008 to aggressively downgrade Alliance; notify the bank of its declining PCA categories; and implement a C&D to address the bank's critical asset quality, liquidity, and capital deficiencies. Although the loss to the DIF represented 17 percent of the bank's assets, the actions of regulators during 2008 were effectively conducted to prevent further losses resulting from the bank's lending practices and accelerated by the decline in the Southern California economy.

CORPORATION COMMENTS

On August 27, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 3 of this report. In its response, DSC summarized the OIG's conclusions regarding the causes of Alliance's failure and the resulting material loss to the DIF and DSC's supervisory activities related to Alliance. DSC also acknowledged the OIG position that the risk factors identified in 2007 could have led to earlier action.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted the audit from March 2009 to July 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it may not have been feasible to address certain aspects of the standards, as discussed on the next page.

Scope and Methodology

The scope of this audit included an analysis of Alliance's operations from January 1, 2004 until its failure on February 6, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period. In addition, we reviewed ROEs issued from 2000 to 2008 to obtain a perspective on Alliance's examination history.

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

- Analyzed examination reports and available supporting work papers prepared by the FDIC and DFI examiners from 2004 to 2008.

- Reviewed the following:

  - Bank data and correspondence maintained at DSC's San Francisco Regional Office (SFRO) and Los Angeles West Field Office.

  - Reports prepared by Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

  - Alliance's financial audit work papers from the offices of McGladrey & Pullen, LLP, Irvine, California.

  - Bank records maintained by DRR in Dallas for information that would provide insight into the bank's failure.

  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in the FDIC's SFRO.

  - DSC examiners from the Los Angeles West Field Office who participated in examinations or reviews of examinations of Alliance.

  - DRR contractors at the Alliance Receivership Office in Pasadena, California.

  - DRR and Legal Division personnel at the Dallas Regional Office.

- Discussed with officials from the California DFI, Los Angeles, California, their coordination with the FDIC on joint examinations.

- Researched various federal banking laws and regulations.

We performed the audit fieldwork at the FDIC's Headquarters in Washington, D.C., SFRO, and the DSC Los Angeles West Field Office.

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

Due to the limited nature of the audit objectives, we did not assess DSC's overall internal control or management control structure. We performed a limited review of Alliance's management controls pertaining to its operations as discussed in the finding section of this report.

For purposes of the audit, we did not rely on computer-processed data to support our significant findings and conclusions. Our review centered on interviews, ROEs, correspondence, and other evidence to support our audit.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain other aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

GLOSSARY OF TERMS

Term	Definition
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 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.
Cease and Desist Order (C&D)	A formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A 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 ROE. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital. Concentrations representing 100 percent or more of Tier 1 Capital should include concentrations by: industry, product line, type of collateral and short-term obligations of one financial institution or affiliate group.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C. section 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

August 27, 2009

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Alliance Bank, Culver City, California (Assignment No. 2009-024)

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 Alliance Bank (Alliance), which failed on February 6, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Audit Report (Report) received on August 6, 2009.

Alliance failed due to management's aggressive pursuit of asset growth concentrated in acquisition, development, and construction (ADC) lending without the implementation of adequate risk management controls and sound credit administration practices. The Report concludes that the FDIC and the State of California Department of Financial Institutions conducted timely examinations of Alliance and advised management of the risks posed by these high concentrations. The Report further specifies that examiners made recommendations to strengthen Alliance's risk management controls and credit administration practices and limit the institution's use of wholesale funding.

The Report notes that DSC appropriately implemented Prompt Corrective Action regulations restricting Alliance from brokered deposits, and that DSC took effective actions in 2008 to downgrade Alliance and implement a Cease and Desist Order. The OIG concludes these actions proved to be a significant factor in limiting further losses to the Deposit Insurance Fund from the failure of Alliance. The OIG's note that the risk factors identified in 2007 could have led to earlier action is acknowledged.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
C&D	Cease & Desist Order
CAMELS	**C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
DFI	Department of Financial Institutions
DIF	Deposit Insurance Fund
DIR	Division of Insurance and Research
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SFRO	San Francisco Regional Office
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System
U.S.C.	United States Code