

Office of Inspector General



Office of Material Loss Reviews
Report No. MLR-10-004

**Material Loss Review of First Bank of
Beverly Hills, Calabasas, California**

November 2009



Why We Did The Audit

On April 24, 2009, the California Department of Financial Institutions (DFI) closed First Bank of Beverly Hills (First Bank), Calabasas, California, and named the FDIC as receiver. On May 7, 2009, the FDIC notified the Office of Inspector General (OIG) that First Bank's total assets at closing were \$1.3 billion and the estimated loss to the Deposit Insurance Fund (DIF) was \$394 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of First Bank.

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

Background

First Bank opened in December 1980 as a federally chartered savings and loan institution regulated by the Office of Thrift Supervision. In November 2004, First Bank submitted an application to DFI to convert from a federally chartered institution to a state-chartered, commercial institution. At that time, First Bank was considered well managed and in satisfactory financial condition. The FDIC became the institution's primary federal regulator effective September 1, 2005.

Prior to 2006, First Bank's lending focused primarily on commercial real estate (CRE) in southern California and other western states. In 2006, the institution expanded its lending to include acquisition, development, and construction (ADC), primarily in California and Nevada. At the time of its failure, First Bank operated a single office in Calabasas, California. The institution was wholly owned by the Beverly Hills Bancorp, Inc., a publicly-traded one-bank holding company.

Audit Results

Causes of Failure and Material Loss

First Bank failed because its Board and management did not adequately manage the risks associated with the institution's heavy concentrations in CRE and ADC loans and investments in mortgage backed securities (MBS). In the fall of 2006, First Bank initiated an aggressive ADC lending program that focused on rapidly growing real estate markets in California and Nevada. As part of its ADC lending program, First Bank purchased approximately \$117 million in loan participations without performing proper due diligence and originated over \$70 million in loans without adequate underwriting and administration. In addition, First Bank maintained a high liquidity risk profile in the years leading to its failure because it relied almost exclusively on costly and potentially volatile wholesale funding sources consisting primarily of brokered deposits and Federal Home Loan Bank borrowings to support its real estate lending and investing activities.

First Bank's concentrations in CRE and ADC loans, coupled with its heavy reliance on wholesale funding sources, made the institution particularly vulnerable when its primary lending markets began to deteriorate in early 2007. Further, First Bank's Board paid dividends in 2007 that resulted in negative retained earnings and a reduction of capital at a time when the institution had an elevated risk profile. By 2008, weaknesses in First Bank's risk management practices had translated into a significant decline in the quality of the institution's loan portfolio and MBS. The losses and provisions associated with this

decline depleted the institution's earnings and capital, and significantly impaired its liquidity position. DFI closed First Bank because it was unable to raise sufficient capital to support its operations or find a suitable acquirer.

FDIC's Supervision of First Bank

From September 2005 until the institution failed in April 2009, the FDIC, in conjunction with DFI, provided ongoing supervision of First Bank through four on-site risk management examinations. Through its supervisory efforts, the FDIC identified risks in First Bank's operations and brought these risks to the attention of the institution's Board and management in reports of examination. Such risks included the institution's heavy concentration in CRE and ADC loans, weak loan underwriting and credit administration practices, and excessive reliance on wholesale funding sources. The FDIC also coordinated with DFI to issue a formal enforcement action in February 2009 to address risks at the institution.

In retrospect, more proactive supervisory action at earlier examinations may have been prudent given the risks associated with First Bank's ADC lending program, concentrations in MBS, and heavy reliance on wholesale funding sources. Such actions could have included requiring the institution to establish and implement:

- strong policies and procedures (including appropriate personnel) to manage and control the risks associated with its ADC lending program.
- effective risk management practices to manage its MBS portfolio.
- a plan to reduce its dependence on wholesale funding sources.

Earlier and more proactive supervisory action may have influenced First Bank's Board and management to constrain its excessive risk-taking in these three areas, thereby mitigating, to some extent, the losses incurred by the DIF.

With respect to PCA, we concluded that the FDIC had properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for First Bank. However, PCA's effectiveness in mitigating losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure. Specifically, First Bank was considered well capitalized for PCA purposes until December 8, 2008. However, by December 2008, examiners had already determined that First Bank's overall financial condition was critically deficient and that the probability of its failure was high.

Management Response

The Director, Division of Supervision (DSC), provided a written response to a draft of this report on November 3, 2009. In the response, DSC reiterated the OIG's conclusions regarding the causes of First Bank's failure. Regarding our assessment of the FDIC's supervision of First Bank, DSC cited several supervisory activities, discussed in our report, that were undertaken to address key risks at the institution prior to its failure. DSC also noted that it has issued updated guidance reminding examiners to take appropriate action when concentration and volatile funding risks and payment of dividends are imprudently managed.

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DATE: November 5, 2009

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

FROM: */Signed/*
Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of First Bank of Beverly Hills,
Calabasas, California (Report No. MLR-10-004)*

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss¹ review of the failure of First Bank of Beverly Hills (First Bank), Calabasas, California. The California Department of Financial Institutions (DFI) closed the institution on April 24, 2009, and named the FDIC as receiver. On May 7, 2009, the FDIC notified the OIG that First Bank's total assets at closing were \$1.3 billion and the estimated loss to the Deposit Insurance Fund (DIF) was \$394 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. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action (PCA)*; a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review were to: (1) determine the causes of First Bank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision² of First Bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of First Bank's failure and the FDIC's efforts to ensure that First Bank's Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not

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 FDIC-supervised insured depository 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.

contain formal recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our material loss 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 DSC’s supervision program and make recommendations as warranted. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of terms and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation’s comments on this report.

Background

First Bank opened in December 1980 as a federally chartered savings and loan institution regulated by the Office of Thrift Supervision (OTS). In November 2004, First Bank submitted an application to DFI to convert from a federally chartered institution to a state-chartered, commercial institution. At that time, First Bank was considered well managed and in satisfactory financial condition. DFI approved First Bank’s application, subject to certain conditions,³ and the FDIC became the institution’s primary federal regulator effective September 1, 2005. Prior to 2006, First Bank’s lending focused primarily on commercial real estate (CRE) in southern California and other western states. In 2006, the institution expanded its lending to include acquisition, development, and construction (ADC), primarily in California and Nevada.

At the time of its failure, First Bank operated a single office in Calabasas, California. The institution did not have any other branches, subsidiaries, or affiliates. First Bank was wholly-owned by the Beverly Hills Bancorp, Inc. (Bancorp), a publicly-traded one-bank holding company. Collectively, the institution’s directors controlled approximately 24 percent of Bancorp’s outstanding stock. However, no individual shareholder controlled more than 8 percent of Bancorp, and the company’s shares were widely held. Table 1 summarizes selected financial information for First Bank for the year ending December 31, 2008, and for the 4 preceding calendar years ending December 31.

Table 1: Selected Financial Information for First Bank

Financial Measure	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Total Assets (\$000s)	\$1,491,148	\$1,452,783	\$1,565,940	\$1,368,078	\$1,299,306
Total Loans (\$000s)	\$842,311	\$985,074	\$1,021,166	\$955,473	\$915,775
Total Deposits (\$000s)	\$1,016,459	\$652,503	\$863,574	\$625,738	\$580,538
Return on Assets (%)	(6.46)	.23	1.29	1.2	1.12
Federal Home Loan Bank (FHLB) Borrowings (\$000s)	\$400,000	\$611,000	\$496,337	\$530,837	\$474,837
Tier 1 Leverage Capital Ratio (%)	3.37	8.62	9.75	9.59	8.31

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

³ Such conditions included obtaining \$10 million in additional capital, notifying DFI of any material deviations in the institution’s business plan and projections for 3 years following its conversion to a state-chartered institution, and maintaining a minimum ratio of tangible shareholder’s equity to total tangible assets of at least 8 percent for 3 years following the conversion.

Causes of Failure and Material Loss

First Bank failed because its Board and management did not adequately manage the risks associated with the institution's heavy concentrations in CRE and ADC loans, and investments in mortgage backed securities (MBS). In the fall of 2006, First Bank initiated an aggressive ADC lending program that focused on rapidly growing real estate markets in California and Nevada even though its 2006 strategic plan did not address ADC lending. As part of its ADC lending program, First Bank purchased approximately \$117 million in loan participations without performing proper due diligence and originated over \$70 million in loans without adequate underwriting and administration. In addition, First Bank maintained a high liquidity risk profile in the years leading to its failure because it relied almost exclusively on costly and potentially volatile wholesale funding sources consisting primarily of brokered deposits and FHLB borrowings to support its real estate lending and investing activities.

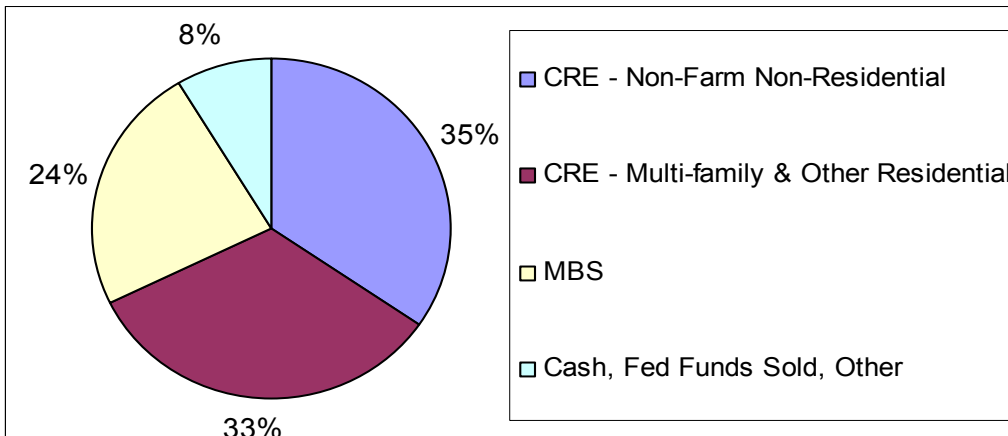
First Bank's concentrations in CRE and ADC loans, coupled with its heavy reliance on wholesale funding sources, made the institution particularly vulnerable when its primary lending markets began to deteriorate in early 2007. Further, First Bank's Board paid dividends in 2007 that resulted in negative retained earnings and a reduction of capital at a time when the institution had an elevated risk profile. By 2008, weaknesses in First Bank's risk management practices had translated into a significant decline in the quality of the institution's loan portfolio and MBS. The losses and provisions associated with this decline depleted the institution's earnings and capital, and significantly impaired its liquidity position. DFI closed First Bank because it was unable to raise sufficient capital to support its operations or find a suitable acquirer.

Lending and Investments Primarily Associated with Real Estate

From the time it converted to an FDIC-regulated institution in September 2005, until its failure in April 2009, almost all of First Bank's assets were associated with real estate. At the close of 2005, approximately 97 percent of First Bank's \$955 million loan portfolio consisted of CRE loans, placing the institution in the 99th percentile of its peers for CRE concentrations. First Bank also maintained a significant concentration in government-sponsored enterprise (agency) and non-agency⁴ sponsored MBS. Figure 1 illustrates the composition of First Bank's assets as of December 31, 2005.

⁴ Non-agency (or private label) securities are securities issued by an entity other than the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

Figure 1: Composition of First Bank's Assets as of December 31, 2005



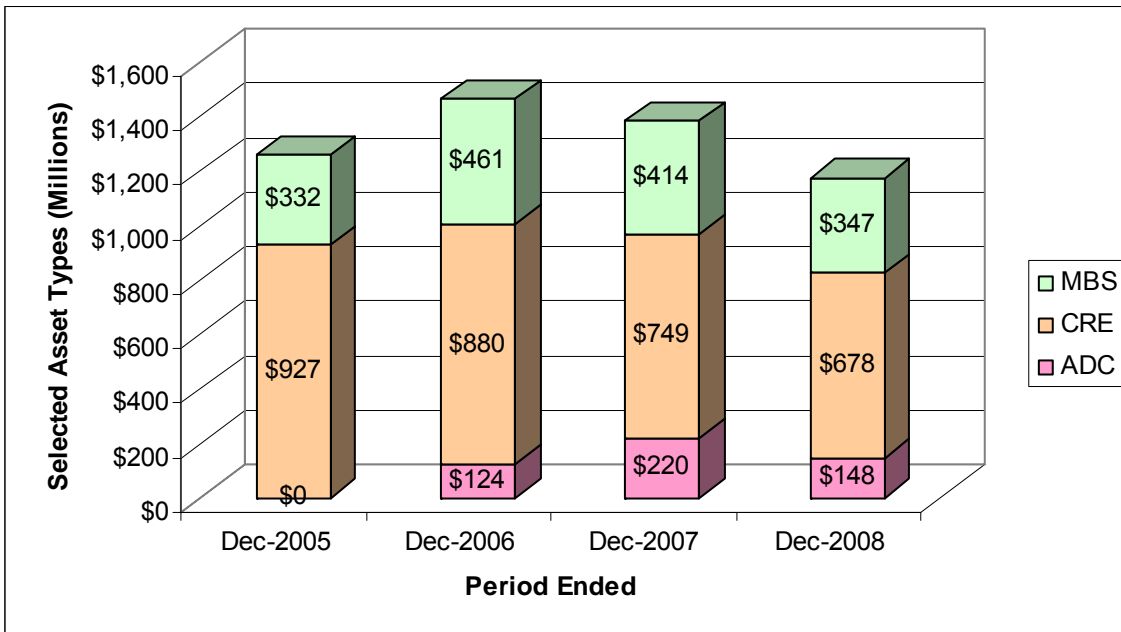
Source: OIG analysis of UBPR data for First Bank.

Concentrations in CRE and ADC Loans

First Bank's lending during 2005 and through September 2006 was generally conservative and focused primarily on multi-family and commercial income-producing loans that were collateralized by stable and performing properties. According to an analysis conducted during the September 2005 examination, the weighted average loan-to-value (LTV) of First Bank's loan portfolio was less than 70 percent, well below the 80 percent limit defined in Part 365, *Real Estate Lending Standards*, of the FDIC Rules and Regulations. First Bank's CRE loans were also diversified among a wide range of property types and geographic locations, and the volume of classified loans was low. The institution's conservative lending practices, coupled with its heavy reliance on high-cost wholesale funding, were contributing factors that limited the institution's earnings.

In an effort to improve its asset yields, First Bank initiated an aggressive ADC lending program in the fall of 2006, by purchasing a participation interest in eight ADC loans totaling approximately \$117 million from another institution. The participation loans were secured by single-family and condominium construction projects, and residential development projects in California and Nevada. First Bank also began originating ADC loans in late 2006, and by June 30, 2007, the institution had nearly \$190 million in ADC loans, representing approximately 18 percent of the loan portfolio. First Bank implemented its ADC lending program when its target real estate lending markets had either peaked or were beginning to decline. Figure 2 illustrates the change in the composition of First Bank's ADC, CRE, and MBS assets that resulted in increased risk.

Figure 2: Changes in Composition of First Bank's ADC, CRE, and MBS Assets



Source: OIG analysis of the UBPR Data and Consolidated Reports of Condition and Income (Call Report) for First Bank.

The FDIC's December 2006 guidance, entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, recognizes that there are substantial risks posed by CRE concentrations, and in particular ADC concentrations. Such risks include unanticipated earnings and capital volatility during a sustained downturn in the real estate market. The December 2006 guidance defines institutions with significant CRE concentrations as those institutions reporting loans for construction, land development, and other land (i.e., ADC) representing 100 percent or more of total capital; or institutions reporting total CRE loans representing 300 percent or more of total capital where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months. Due to the risks associated with CRE and ADC lending, regulators consider institutions with significant CRE and ADC concentrations to be of greater supervisory concern.

As of June 30, 2007, First Bank's CRE loans represented 680 percent of total capital, and ADC concentrations represented 126 percent of total capital, exceeding the levels defined in the 2006 guidance as warranting greater supervisory concern. During the August 2007 examination, examiners noted that classified assets had increased from approximately \$10.6 million to approximately \$28.2 million, with much of the increase attributed to the ADC loan participations that the institution had purchased in October 2006. By the November 2008 examination, adversely classified assets had jumped to over \$202 million, or approximately 125 percent of Tier 1 capital and reserves, and the institution was at serious risk of failure. Of the \$202 million in classified assets, approximately \$176 million pertained to loans, \$15 million to MBS, and the remainder to other assets. The majority of the \$176 million in loan classifications related to ADC loans.

Investments in Mortgage Backed Securities

At the time of the November 2008 examination, First Bank's \$322 million securities portfolio consisted almost entirely of MBS. Approximately one-half of these securities were government agency sponsored securities, and the remainder were AAA-rated,⁵ non-agency sponsored securities. First Bank did not adequately identify, measure, or control the post-purchase market risk of its MBS. For example, the institution did not effectively manage concentrations in its MBS portfolio or implement procedures requiring the sale of MBS during deteriorating market conditions (sometimes referred to as "stop-loss price limits") to mitigate losses to the institution.

When the real estate market began to deteriorate in 2007, the underlying collateral of First Bank's MBS was adversely affected, severely limiting the marketability of the securities. Based on our interviews with FDIC capital markets specialists, we learned that some of First Bank's AAA-rated MBS were collateralized with Alt-A type mortgages. Alt-A type mortgages are inherently riskier than traditional mortgages because they are typically larger than traditional mortgages and the borrower's income and assets are not always fully verified. In its December 31, 2008 Call Report, First Bank recognized a loss related to its non-agency sponsored MBS of approximately \$48 million.

Risk Management Practices Associated with ADC Loans

Weaknesses in First Bank's ADC due diligence, loan underwriting, and credit administration practices were contributing factors in the asset quality problems that developed when the institution's real estate lending markets deteriorated in 2007 and 2008. In general, First Bank did not have the appropriate policies, procedures, and personnel to ensure adequate risk management of its ADC lending program.

Due Diligence for Loan Participations

First Bank did not perform proper due diligence before it purchased approximately \$117 million in ADC loan participations in October 2006. For example, although First Bank purchased a 90-percent participation interest in a loan valued at approximately \$18.5 million, control over the administration of the loan remained with the selling institution and did not transfer to First Bank. In addition, First Bank relied on the selling institution's underwriting when it purchased the participation interest. According to the November 2008 ROE, the underlying property was located on the San Andreas Fault and required extensive geological and seismic studies before development could begin. Division of Resolutions and Receiverships (DRR) officials advised us that there was no evidence in the loan files that engineering reviews had been performed before the loan was funded. The required studies delayed the project, and by 2008, the borrower had abandoned the property. Approximately \$15 million of the \$18.5 million loan was subsequently classified as loss.

⁵ Organizations such as Standard & Poor's and Moody's Investors Service assign credit ratings for debt obligations of public and private corporations. Generally, these ratings are on a scale from AAA to D, with AAA reflecting the highest rating (i.e., the best credit worthiness and the least risk of default).

According to the DSC *Risk Management Manual of Examination Policies*, institutions purchasing participations must make a thorough, independent evaluation of the transactions and the risks involved before committing any funds. Institutions should also apply the same standards of prudence, credit assessment, approval criteria, and “in-house” limits that would be employed if the purchasing organization were originating the loan. The ADC loan participations purchased by First Bank accounted for almost \$58 million of the \$202 million (or 29 percent) in classified assets and almost \$23 million of the \$63.6 million (or 36 percent) in assets classified as loss during the November 2008 examination.

Loan Underwriting

Several of the larger ADC loans originated by First Bank were not properly underwritten and were subsequently classified by examiners. For example, in January 2007, First Bank approved an ADC loan valued at approximately \$26.6 million for a development project in Las Vegas, Nevada. The institution sold approximately 41 percent of the loan to two other institutions and retained the \$16 million balance on its own books. First Bank relied on hypothetical appraised values that were based on certain assumptions (such as the site being ready for development and properly zoned) rather than on “as is” or projected values when approving the loan. First Bank did not obtain appropriate assurance that the necessary zoning approvals could be secured before funding the loan, and the zoning approvals were never obtained. Over \$10 million of the loan was subsequently classified as loss.

In addition, the November 2006 ROE stated that First Bank used improper market values as defined in the *Interagency Appraisal and Evaluation Guidelines* when underwriting four ADC loans. This contravention resulted in one of the four loans exceeding the supervisory LTV limit of 80 percent as defined in Part 365. Two of these four ADC loans accounted for 14 percent of the total asset classifications in the November 2008 examination.

Credit Administration

First Bank exhibited a number of weak credit administration practices that impaired the quality of the institution’s ADC loans. Such weaknesses included:

- Not recognizing the severity of loan problems and losses in a timely manner.
- Not obtaining current financial statements, tax returns, appraisals, cash flow data, and other financial information on loans.
- Using an allowance for loan and lease losses (ALLL) methodology that did not comply with interagency guidelines.
- Improperly using interest reserves, resulting in a delayed recognition of performance problems on certain loans and higher earnings.

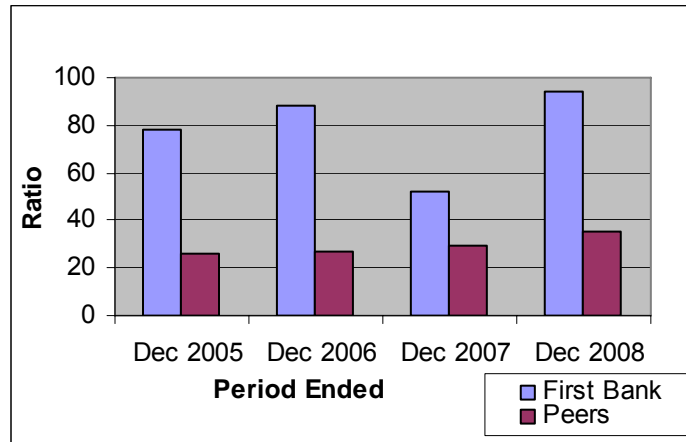
- Not performing market analysis and feasibility studies before making loan commitments.

Reliance on Wholesale Funding Sources

From its conversion to a state-chartered institution until its failure, First Bank maintained a high liquidity risk profile due to its heavy reliance on wholesale funding sources.

Figure 3 illustrates the trend in First Bank’s net non-core funding dependence ratio⁶ for the years ended 2005 through 2008.⁷ During this period, First Bank’s net non-core funding dependence ratio was typically two to three times greater than its peer group. Such rankings indicate that the institution’s potential volatile funding dependence was higher than almost all of the other institutions in First Bank’s peer group.

Figure 3: First Bank’s Net Non-Core Funding Dependence Ratio Relative to Peers



Source: OIG analysis of UBPR Data for First Bank.

First Bank’s wholesale funding sources consisted almost exclusively of brokered deposits and FHLB borrowings. At the time of the November 2008 examination, brokered deposits totaled \$540 million (or 79 percent of total deposits) and FHLB borrowings totaled approximately \$430 million (or about 39 percent of assets). Both of these figures were significantly higher than First Bank’s peer group averages.

When properly managed, wholesale funding sources offer important benefits, such as ready access to funding in national markets when core deposit growth in local markets lags planned asset growth. However, wholesale funding sources also present potential risks, such as higher costs and increased volatility. According to the *Risk Management Manual of Examination Policies*, placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited during distressed financial or economic conditions. Under such circumstances, institutions could be required to sell assets at a loss in order to fund deposit withdrawals and other liquidity needs.

⁶ The net non-core funding dependence ratio is a measure of the degree to which an institution relies on non-core funding to support longer-term assets (e.g., loans that mature in more than 1 year). An elevated ratio reflects heavy reliance on potentially volatile funding sources that may not be available in times of financial stress. For purposes of this report, the terms non-core funding and wholesale funding have substantially the same meaning.

⁷ The decline in First Bank’s net non-core funding dependence ratio in 2007 was caused by a change in how the institution reported brokered deposits in its Call Report rather than a decline in brokered deposits.

First Bank's access to wholesale funding sources was contingent upon the institution maintaining a sound credit risk profile. When examiners advised First Bank officials in December 2008 that the institution had fallen to *adequately capitalized* for PCA purposes (as discussed more fully later in this report), the institution's access to brokered deposits became restricted. In addition, the decline in First Bank's asset quality reduced the institution's borrowing capacity with the FHLB, placing an additional strain on liquidity. Further, earnings were not sufficient to augment capital, and the institution's weakened credit risk profile limited its access to other contingency funding sources.

Dividend Payments

During the November 2006 examination, First Bank management advised examiners that a recommendation would be made to Bancorp to discontinue its quarterly cash dividend for 2007 based on (1) a projected decline in the institution's return on assets, (2) planned asset growth, and (3) a requirement to maintain a tangible shareholder's equity ratio of at least 8 percent. Examiners commented that, given these concerns and the institution's concentration levels, such actions would be prudent. However, the institution paid quarterly cash dividends totaling \$9.6 million during 2007, and made a one-time dividend payment of \$10 million in the fourth quarter of 2007 to redeem a trust-preferred security held by Bancorp that paid an above market interest rate. The combined total of these dividends resulted in negative retained earnings in 2007 of approximately \$16 million and a reduction in First Bank's capital at a time when the institution had an elevated risk profile. First Bank's cash dividends to net income ratio for 2007 was 563 percent, compared to the institution's peer group average of 47 percent.

FDIC's Supervision of First Bank

Through its supervisory efforts, the FDIC identified risks in First Bank's operations and brought these risks to the attention of the institution's Board and management in ROEs. Of particular note, examiners reported that First Bank's liquidity risk profile was less than satisfactory in every examination conducted from 2005 until the institution's failure. Examiners also commented in the November 2006 examination that First Bank's ADC lending program presented increased risk for the institution. In addition, examiners made recommendations in the August 2007 ROE to improve First Bank's risk management practices with respect to CRE concentrations and non-agency sponsored MBS. Further, examiners identified a number of serious concerns in the November 2008 examination. Such concerns included poor management, excessive reliance on wholesale funding sources, heavy concentrations in CRE and ADC loans, an underfunded ALLL, and inadequate ADC loan underwriting and credit administration.

As discussed more fully below, more proactive supervisory action at earlier examinations may have been prudent given the risks associated with First Bank's ADC lending program, concentrations in MBS, and heavy reliance on wholesale funding sources. Such supervisory action may have influenced First Bank's Board and management to constrain

excessive risk-taking in these three areas, thereby mitigating, to some extent, the losses incurred by the DIF.

Supervisory History

The OTS supervised First Bank prior to its conversion to a state-chartered institution in September 2005. During its final examination of First Bank in April 2004, OTS examiners concluded that the institution was fundamentally sound, well capitalized, and effectively managed. From September 2005 until the institution failed in April 2009, the FDIC, in conjunction with DFI, provided ongoing supervision of First Bank through four on-site risk management examinations. Table 2 summarizes key information pertaining to the on-site risk management examinations that were conducted of First Bank from 2004 until the institution failed.

Table 2: On-site Examinations of First Bank

Examination Date	Regulators	Supervisory Ratings (UFIRS)*	Informal or Formal Action Taken**
11/03/08	FDIC and DFI	555555/5	C&D
08/27/07	DFI	222232/2	None
11/20/06	FDIC	222232/2	None
09/26/05	FDIC/DFI	212232/2	None
04/26/04	OTS	222232/2	None

Source: OIG analysis of ROEs and information in the FDIC's Virtual Supervisory Information on the Net system for First Bank.

*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.

** Informal corrective actions often take the form of Bank Board Resolutions or Memorandums of Understanding. Formal corrective actions often take the form of cease and desist orders (C&D), but under severe circumstances can also take the form of insurance termination proceedings.

Consistent with its practices for other insured financial institutions, the FDIC monitored information in First Bank's quarterly Call Reports for potential concerns using various offsite monitoring tools.⁸ The FDIC's offsite monitoring process did not identify any supervisory concerns related to First Bank until June 2008, when an analysis of the institution's March 31, 2008 Call Report was completed. At that time, First Bank's loan problems had become evident, earnings had declined, and SCOR was indicating a possible downgrade of the institution's supervisory composite rating from a "2" to a "3." DSC officials advised us that they decided not to accelerate First Bank's examination scheduled for November 2008 because other problem institutions in the San Francisco

⁸ The two primary offsite monitoring tools used by the FDIC are the Statistical CAMELS Offsite Rating (SCOR) system and the Growth Monitoring System (GMS). SCOR uses statistical techniques to measure the likelihood that an institution will receive a supervisory rating downgrade at the next examination. GMS is designed to identify institutions experiencing rapid growth and/or a funding structure highly dependent on non-core funding sources.

region were showing greater signs of stress and examination resources needed to be prioritized.

During the November 2008 examination, examiners concluded that the institution's financial condition was critically deficient and that the probability of its failure was high. Examiners assigned First Bank a supervisory composite rating of "5" and prepared a C&D to address the institution's problems. The institution stipulated to the C&D on February 10, 2009. Among other things, the order required First Bank to:

- Increase its Tier 1 capital by not less than \$70 million, and thereafter maintain Tier 1 capital in an amount not less than 8 percent of total assets.
- Enter into a definitive agreement to merge the institution with and into an insured depository institution or sell the institution.
- Not make any distribution to the shareholders without the prior written approval of the FDIC and DFI.

DFI closed First Bank on April 24, 2009 because the institution was unable to raise sufficient capital to support its operations or find an acceptable acquirer.

ADC Lending Program

As discussed previously, in the fall of 2006, First Bank initiated an aggressive ADC lending program that focused on rapidly growing real estate markets in California and Nevada. As part of the program, First Bank purchased approximately \$117 million in ADC loan participations in October 2006. As described earlier in this report, First Bank did not perform adequate due diligence when it purchased these loan participations. The lack of due diligence was a contributing factor in the ADC administration and asset quality problems that developed in the years that followed. By the November 2006 examination, ADC loans represented over 140 percent of First Bank's Tier 1 capital and reserves.

Examiners noted in the November 2006 examination that First Bank's ADC lending presented increased risk for the institution and focused their loan sample on this new lending area. Although examiners concluded that First Bank's ADC lending activities were generally satisfactory, examiners did identify some underwriting and administration issues that resulted in contraventions to Part 365 regarding LTV computations and loan concentrations. As a result of the increased risk associated with First Bank's ADC lending program and the issues identified during the examination, examiners lowered First Bank's asset quality component rating from a "1" to a "2."

In addition to the weak ADC lending practices described in the November 2006 ROE, our review of FDIC and institution records and discussions with DSC and DRR officials

found that the institution was not fully adhering to other standards defined in Part 365 at that time. Such standards included:

- Monitoring conditions in the institution's lending areas so that it can react quickly to changes in market conditions that are relevant to lending decisions;
- Considering both internal and external factors in the formulation of the institution's loan policies and strategic plan, including the expertise and size of its lending staff;
- Establishing loan administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review; and
- Having requirements for feasibility studies and sensitivity and risk analyses for construction and development loans.

While examiners noted contraventions to Part 365 regarding LTV computations and loan concentrations in the November 2006 examination, examiners could have expanded their criticisms to include the aforementioned bulleted items and made recommendations requiring management to take appropriate remedial action.

Investments in Mortgage Backed Securities

First Bank had purchased almost all of its MBS by the end of 2006 and its MBS risk management practices did not change materially between 2006 and 2008. Although examiners noted that First Bank needed to improve its pre-purchase analysis of non-agency sponsored MBS during the August 2007 examination, examiners were not critical of the institution's MBS risk management practices prior to the November 2008 examination. During the November 2008 examination, examiners noted that First Bank's concentration in MBS was both aggressive and risky and that the institution had not adequately identified, measured, or controlled the post-purchase market risk of its MBS. Earlier criticism of First Bank's MBS risk management practices may have resulted in the institution implementing more effective risk mitigation measures, such as post-purchase analyses, potentially reducing the losses associated with these assets.

Reliance on Wholesale Funding

According to the *Risk Management Manual of Examination Policies*, an institution's funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. As previously mentioned, examiners consistently reported that First Bank's liquidity risk profile was less than satisfactory in the years leading to its failure. In the September 2005 and November 2006 ROEs, examiners commented that deterioration in First Bank's credit profile or capital position could restrict its access to wholesale funding sources. In retrospect, the FDIC could have required First Bank to commit to a plan as early as 2005 to reduce the

institution's dependence on wholesale funding sources. Such action may have influenced First Bank's Board to take more action to acquire core deposits, thereby reducing the institution's liquidity risk profile.

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. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations implements the requirements of PCA by establishing a framework of restrictions and mandatory supervisory actions that are triggered by an institution's capital levels. Based on the supervisory actions taken with respect to First Bank, the FDIC properly implemented applicable PCA provisions of FDI Act section 38. However, PCA's effectiveness in mitigating losses to the DIF was limited because PCA did not require action until the institution was at serious risk of failure.

In the case of First Bank, capital was a lagging indicator of the institution's financial health. Specifically, First Bank was considered *well capitalized* for PCA purposes until December 8, 2008, when examiners advised institution officials that, based on information in the Call Report for the period ending September 30, 2008 and the results of the November 2008 examination, the institution had fallen to *adequately capitalized*. However, examiners had determined during the November 2008 examination that First Bank's overall financial condition was critically deficient and that the probability of the institution's failure was high. On January 27, 2009, the FDIC formally notified First Bank that it had fallen to *adequately capitalized* for PCA purposes. The notification included a reminder that First Bank was subject to certain restrictions defined in PCA, including a prohibition on the acceptance, renewal, or roll-over of brokered deposits without a waiver from the FDIC.

Based on information contained in First Bank's Call Report for the period ending December 31, 2008, the FDIC determined that First Bank's capital position for PCA purposes had further deteriorated to *undercapitalized*. Accordingly, the FDIC notified First Bank on February 4, 2009 that it was *undercapitalized* for PCA purposes and again reminded the institution of its obligations under PCA. Such obligations included submitting a capital restoration plan to the FDIC and not soliciting, accepting, or rolling over any brokered deposits. Table 3 illustrates First Bank's capital levels relative to the PCA thresholds for *well capitalized* institutions as of the November 2008 examination and the institution's Call Report for the period ending December 31, 2008.

Table 3: First Bank’s Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions

Capital Ratio	Well-Capitalized Threshold	November 2008 Examination	December 31, 2008 Call Report
Tier 1 Leverage Capital	5% or more	5.55%	3.38%
Tier 1 Risk-Based Capital	6% or more	7.92%	5.20%
Total Risk-Based Capital	10% or more	9.20%	6.48%

Source: UBPR, November 2008 ROE, and Part 325 of the FDIC Rules and Regulations.

When First Bank’s efforts to raise needed capital and find an acceptable acquirer were not successful, the institution was closed.

Corporation Comments

We issued a draft of this report on October 19, 2009. We subsequently met with representatives of DSC to discuss the results of our review. Based on our discussion, we made certain changes to the report that we deemed appropriate. On November 3, 2009, the Director, DSC, provided a written response to the draft report. The response is provided in its entirety as Appendix 4 of this report.

In its response, DSC reiterated the OIG’s conclusions regarding the causes of First Bank’s failure. Regarding our assessment of the FDIC’s supervision of First Bank, DSC cited several supervisory activities, discussed in our report, that were undertaken to address key risks at the institution prior to its failure. DSC also noted that it has issued updated guidance reminding examiners to take appropriate action when concentration and volatile funding risks and payment of dividends are imprudently managed.

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 First Bank's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of First Bank, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act.

We conducted this performance audit from May 2009 to October 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of First Bank's operations from 2004 until its failure on April 24, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed ROEs prepared by the OTS, FDIC, and DFI from 2004 through 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 DRR and DSC relating to the bank's closure. We also reviewed records maintained by DRR at the Irvine, California, office for information that would provide insight into the bank's failure.
 - Pertinent FDIC policies and procedures.

Objectives, Scope, and Methodology

- Interviewed the following FDIC officials:
 - DSC management in Washington, D.C. and the SFRO.
 - DRR personnel at the Irvine, California, Office and at the former bank's offices in Calabasas, California.
- Met with DFI officials to discuss the historical perspective of the institution, DFI examinations, and other activities related to the state's supervision of the institution.
- Performed audit field work at DRR offices in Irvine, California, and DSC offices in San Francisco and Los Angeles.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, ROEs, and interviews of examiners to understand First Bank's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including ROEs, correspondence files, and testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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 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) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan 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 loan losses associated with off-balance sheet loan instruments such as standby letters of loan.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Federal Home Loan Bank (FHLB)	One of 12 Federal Home Loan Banks from which financial institutions in America borrow funds to finance housing, economic development, infrastructure and jobs.
Loan-to-Value	The ratio between the amount of a loan and the appraised value of the collateral for that loan.
Mortgage Backed Security	Securities representing an undivided interest in a pool of mortgages with similar characteristics. Payments on the underlying mortgages are used to make payments to the security holders.
Prompt Corrective Action (PCA)	<p>The purpose of PCA is to resolve the 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, <i>Prompt Corrective Action</i>, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than <i>adequately capitalized</i>. The following terms are used to describe capital adequacy: (1) <i>Well Capitalized</i>, (2) <i>Adequately Capitalized</i>, (3) <i>Undercapitalized</i>, (4) <i>Significantly Undercapitalized</i>, and (5) <i>Critically Undercapitalized</i>.</p> <p>A PCA Directive is a formal enforcement action seeking corrective action of compliance with the PCA statute with respect to an institution that falls within any of the three categories of <i>undercapitalized</i> institutions.</p>

Glossary of Terms

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 data reported in Reports of Condition and Income submitted by banks.
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Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CRE	Commercial Real Estate
DFI	California Department of Financial Institutions
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GMS	Growth Monitoring System
LTV	Loan-to-Value
MBS	Mortgage Backed Securities
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
ROE	Report of Examination
SCOR	Statistical CAMELS Offsite Rating
SFRO	San Francisco Regional Office
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments



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

Division of Supervision and Consumer Protection

November 3, 2009

MEMORANDUM TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of First Bank of Beverly Hills, Calabasas, CA
(Assignment No. 2009-043)

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 First Bank of Beverly Hills (FBBH) which failed on April 24, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on October 19, 2009.

The Report concludes FBBH failed due to the Board and senior management's ineffective risk management practices related to concentrations in commercial real estate (CRE) loans; acquisition, development, and construction (ADC) loans; and investments in mortgage backed securities (MBS), coupled with a heavy reliance on wholesale funding.

The Report further states that FBBH was particularly vulnerable when primary lending markets began to deteriorate in early 2007, and that FBBH's weak risk management practices quickly translated into a significant decline in loan and MBS portfolio quality. The associated provisions and losses depleted FBBH's capital and earnings and impaired liquidity. The Board's decision to pay dividends in 2007, to satisfy trust preferred stock and pay shareholders, also contributed to the reduced capital position.

As part of DSC's supervisory program, examiners conducted on-site risk management examinations in November 2006 and November 2008, which included recommendations regarding concentrations, non-core funding, and payment of dividends. Certain offsite tools, including personal contacts with bank management in February and June 2007, and off-site reviews conducted in March, June, and September 2008, were also utilized to monitor FBBH's condition. Additionally in February 2009, DSC issued a formal enforcement action against FBBH to address its weak risk management practices. DSC has issued updated guidance reminding examiners to take appropriate action when concentration and volatile funding risks, and payment of dividends are imprudently managed.

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