Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-040

Material Loss Review of Imperial Capital Bank, La Jolla, California

July 2010

Office of
Inspector General

Executive Summary

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Why We Did The Audit

On December 18, 2009, the California Department of Financial Institution (CDFI) closed Imperial Capital Bank (Imperial) and named the FDIC as receiver. On January 20, 2010, the FDIC notified the Office of Inspector General (OIG) that Imperial's total assets at closing were $4.1 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $618.9 million. As of June 16, 2010, the estimated loss to the DIF had decreased to $487.9 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review.

The audit objectives were to (1) determine the causes of Imperial's failure and the 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

Imperial was a state-chartered nonmember bank headquartered in La Jolla, California that converted from an industrial loan company charter in December 2002 and was wholly-owned by Imperial Capital Bancorp, Inc. Imperial specialized in commercial real estate (CRE) loans, primarily involving multi-family housing, and to a lesser extent, residential acquisition, development, and construction (ADC) loans. Beginning in 2002, Imperial expanded its offering of multi-family loan products nationwide and operated 11 branches and 14 loan production offices.

Audit Results

Causes of Failure and Material Loss

Imperial's failure can be attributed to the Board and management pursuing an aggressive growth strategy concentrated in CRE and ADC lending without establishing sound risk management practices to manage the concentrations during the economic downturn. Ineffective monitoring of the speculative real estate construction market and inadequate oversight of the highly concentrated CRE loan portfolio led to critically deficient asset quality. Furthermore, during 2008, the Board and management increased the risk profile of the bank by purchasing high-risk investment securities when markets for those securities were collapsing. This decision created an additional asset concentration and burden on capital. Specifically, earnings became critically deficient and eroded the bank's capital as a result of operating losses associated with the decline in the bank's ADC and CRE loan portfolios as well as market depreciation in the investment portfolio. As the bank's financial condition deteriorated, its ability to rely on Federal Home Loan Bank (FHLB) borrowings and brokered deposits became limited and strained its liquidity. Despite actions taken by the Board and management to address its deteriorating condition, the CDFI ultimately closed Imperial due to its deteriorating asset quality, poor earnings, and inadequate capital.

The FDIC's Supervision of Imperial

Between 2006 and 2009, the FDIC and the CDFI conducted timely examinations of Imperial and made recommendations to strengthen the bank's risk management controls and credit administration practices and limit its use of wholesale funding. Further, beginning in 2008, the FDIC and the CDFI acted aggressively to downgrade the bank's composite and component ratings, address weaknesses in

Imperial's management through implementation of enforcement actions, and curtail unsafe and unsound practices in 2008 and 2009. However, despite the Board's and management's responses to enforcement actions taken in 2008 and 2009, the bank's financial condition became critically deficient and Imperial was unable to develop adequate plans for restoring capital.

Although examiners found Imperial's risk management practices and capital levels to be satisfactory and commensurate with the bank's risk profile prior to 2007, ultimately Imperial was not adequately prepared to handle the rapid and severe economic downturn. In retrospect, greater supervisory emphasis and a more forward-looking assessment of Imperial's risk profile during its growth period may have been prudent given that Imperial's concentrations were significant and CRE concentrations can expose institutions to unanticipated earnings and capital volatility when adverse changes in market conditions occur. Specifically, the FDIC and the CDFI could have recommended that Imperial focus greater attention on analyzing the potential impact a downturn in the economy would have on its operations, including the need for a viable plan to mitigate the bank's concentration risk before economic conditions deteriorated.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008, the FDIC reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. In 2008 and 2009, the FDIC also issued guidance related to liquidity management and the use of volatile or special funding sources by financial institutions that are in a weakened condition, respectively. Further, the FDIC recently completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner. Imperial was unsuccessful in raising needed capital and the bank was subsequently closed on December 18, 2009.

Management Response

On July 12, 2010, the Director, DSC, provided a written response to the draft report. DSC reiterated the OIG's conclusions regarding the causes of Imperial's failure. With regard to our assessment of the FDIC's supervision of Imperial, DSC summarized the supervisory history, including offsite monitoring activities described in our report. In addition, DSC described the composite and component rating downgrades made as a result of the March 2008 examination and the emphasis noted by examiners for Imperial to reassess the level of its loan concentrations in light of national economic conditions. Formal enforcement action was taken when examiners found Imperial's financial condition had become critically deficient at the February 2009 visitation. However, consistent with information presented in our report, DSC's response states that Imperial was unable to comply with the majority of the enforcement action provisions or raise necessary capital to remain viable. Further, DSC recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as Imperial, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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3501 Fairfax Drive, Arlington, VA 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: July 19, 2010

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

/Signed/

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

SUBJECT: *Material Loss Review of Imperial Capital Bank, La Jolla, California* (Report No. MLR-10-040)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the FDIC Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Imperial Capital Bank (Imperial), La Jolla, California. The California Department of Financial Institutions (CDFI) closed Imperial on December 18, 2009 and named the FDIC as receiver. On January 20, 2010, the FDIC notified the OIG that Imperial's total assets at closing were $4.1 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $618.9 million. As of June 16, 2010, the estimated loss to the DIF had decreased to $487.9 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. 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 Imperial's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision[2] of Imperial, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Imperial's failure and the FDIC's efforts to ensure that Imperial's Board of Directors (Board) and management operated the institution in a safe and sound manner.

[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.

The report does not 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.[3] Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of key terms and Appendix 3 contains a list of acronyms. Appendix 4 contains the Corporation's comments on this report.

Background

Imperial was a state-chartered nonmember bank headquartered in La Jolla, California that converted from an industrial loan company charter in December 2002 and was wholly-owned by Imperial Capital Bancorp, Inc. Imperial engaged in commercial real estate (CRE) loans, primarily involving multi-family housing, and to a lesser extent residential acquisition, development, and construction (ADC) loans. Beginning in 2002, Imperial expanded its offering of multi-family loan products nationwide and operated 11 branches and 14 loan production offices. Table 1 provides details on Imperial's financial condition as of September 30, 2009 and for the 4 preceding calendar years.

Table 1: Financial Information for Imperial, 2005 to 2009

Financial Measure ($000s)	Sept-2009	Dec-2008	Dec-2007	Dec-2006	Dec-2005
Total Assets	4,046,888	4,433,431	3,537,299	3,405,901	3,038,087
Total Loans	2,556,663	2,798,976	3,174,448	3,020,752	2,566,319
Total Investments	1,352,937	1,480,680	281,799	318,676	411,193
Total Deposits	2,822,300	2,953,016	2,207,998	2,084,533	1,762,863
Brokered Deposits	659,253	739,879	379,434	332,797	152,746
Federal Home Loan Bank (FHLB) Borrowings	1,053,437	1,175,633	991,235	980,000	931,957
Net Income (Loss)	(100,083)	(24,131)	21,267	32,726	27,781

Source: Uniform Bank Performance Reports (UBPR) for Imperial.

Causes of Failure and Material Loss

Imperial's failure can be attributed to the Board and management pursuing an aggressive growth strategy concentrated in CRE and ADC lending without establishing sound risk management practices to manage the concentrations during the economic downturn. Ineffective monitoring of the speculative real estate construction market and inadequate oversight of the highly concentrated CRE loan portfolio led to critically deficient asset quality. Furthermore, during 2008, the Board and management increased the risk profile

[3] For example, in May 2010, the FDIC OIG's Office of Evaluations initiated a review of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

of the bank through the acquisition of Collateralized Mortgage Obligations (CMOs)[4] when the CMO market was collapsing. This decision created an additional asset concentration and burden on capital. Specifically, earnings became critically deficient and eroded the bank's capital as a result of operating losses associated with the decline in the bank's ADC and CRE loan portfolios as well as market depreciation in the CMO portfolio. As the bank's financial condition deteriorated, its ability to rely on FHLB borrowings and brokered deposits became limited and strained its liquidity. Despite actions taken by the Board and management to address its deteriorating condition, the CDFI ultimately closed Imperial due to its deteriorating asset quality, poor earnings, and inadequate capital.

Aggressive Growth Strategy

Imperial's management pursued an aggressive growth strategy primarily through loan originations at its branch and loan production offices located in California, Nevada, Maryland, New Jersey, and Texas. From December 31, 2003 to December 31, 2008, the bank's total assets grew 175 percent—from about $1.6 billion to $4.4 billion. Asset growth during 2004 and 2005 was 30 percent and 34 percent, respectively, and loan growth, the largest contributor, increased 43 percent in 2005. Management achieved this asset growth primarily through originations of multi-family CRE loans because it believed a nationwide focus on loan growth would decrease portfolio risk through geographic diversification. However, as discussed later, Imperial also significantly increased ADC lending, and, in 2008, further increased the bank's risk profile with the purchase of approximately $826 million in CMOs. The bank relied heavily on wholesale funding sources, which equaled 65.13 percent of total deposits as of December 31, 2008, to support its growth strategy.

CRE and ADC Loans

After obtaining its charter as a state nonmember bank, and particularly during the years prior to its failure, Imperial's loan portfolio was highly concentrated in CRE. As shown in Table 2, CRE loans as a percentage of Total Capital and as a percentage of average gross loans exceeded 800 percent and 92 percent, respectively, from 2005 to 2009 and substantially exceeded Imperial's peer group[5] in these categories.

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[4] CMOs (also referred to as mortgage-backed securities) are created when individual mortgage loans are packaged or pooled by issuers and offered for sale to investors. There are two types of issuers – agency and private label. Agency-issued mortgage-backed securities meet specific underwriting criteria whereas private label issues generally comprise nonconforming loans.

[5] Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area. Since 2006, Imperial's peer group included all insured institutions with assets in excess of $3 billion. Prior to 2006, Imperial's peer group included all insured institutions with assets between $1 billion and $3 billion.

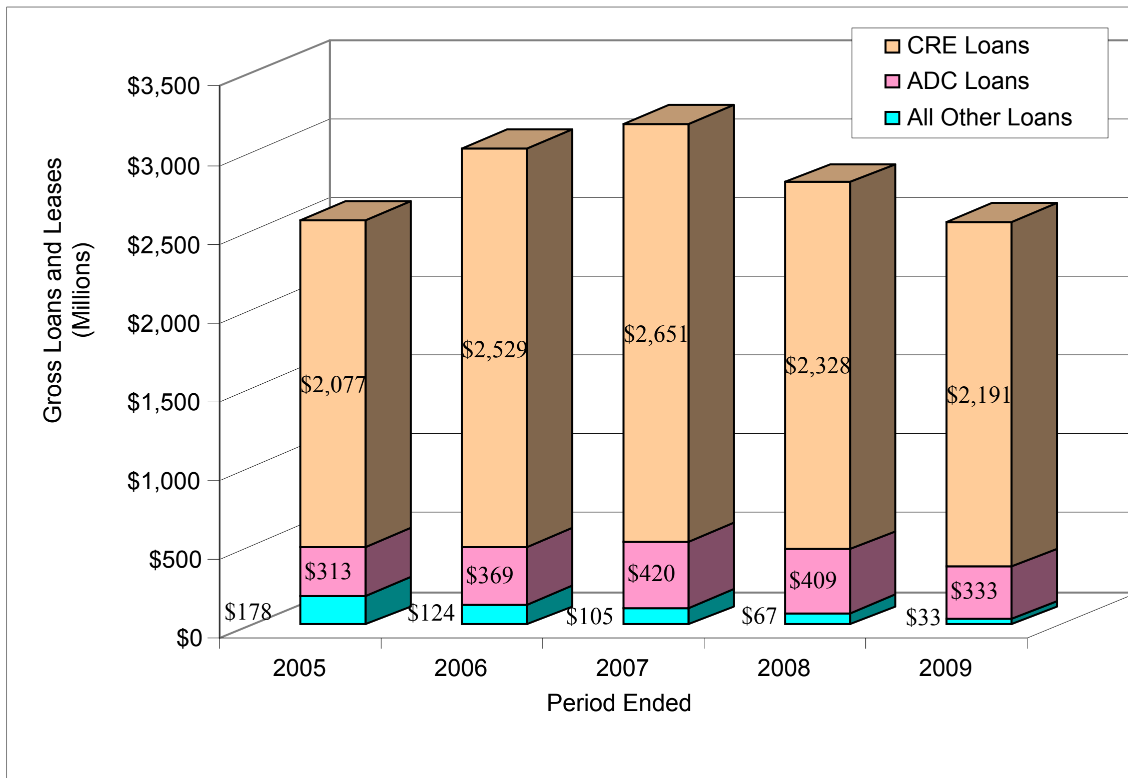
Table 2: Imperial's CRE Concentrations Compared to Peer Group

Period Ending	CRE Loans as a Percentage of Total Capital		CRE Loans as a Percentage of Average Gross Loans	
	Imperial	Peer Group	Imperial	Peer Group
December 31, 2005	806.59	359.00	92.82	41.29
December 31, 2006	890.14	249.46	94.79	30.20
December 31, 2007	926.98	279.14	96.44	33.96
December 31, 2008	930.83	273.48	97.21	34.20
September 30, 2009	1,259.73	271.32	97.89	34.99

Source: UBPRs for Imperial.

The majority of the bank's CRE concentration was centered in loans secured by multi-family residential property, which increased from 596 percent of Tier 1 Capital as of December 31, 2005 to 720 percent of Tier 1 Capital as of March 31, 2007. In addition, from 2004 to 2008, Imperial nearly doubled its ADC concentration from 75 percent to 139 percent of Total-Risk Based Capital. Figure 1 shows Imperial's loan composition from 2005 to 2009.

Figure 1: Composition of Imperial's Loan Portfolio, 2005 to 2009



Source: UPBRs for Imperial.

Imperial's lending strategy was initially profitable; the bank's net income ranged from $21.2 million to $32.7 million annually from 2005 to 2007, and examiners indicated that management was adequately measuring, monitoring, and reporting the loan concentrations. However, during 2007, real estate markets in the bank's lending areas

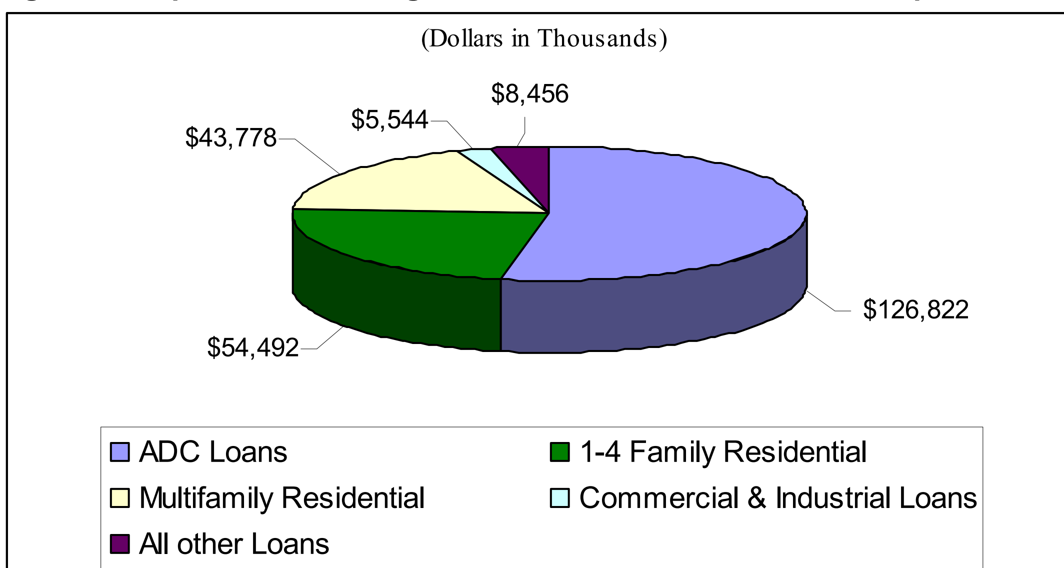
began to decline, which led to substantial asset quality deterioration and net losses in 2008 and 2009.

On December 12, 2006, federal banking regulatory agencies issued *Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance), to reinforce existing regulations and guidelines for real estate lending and safety and soundness.[6] The Joint Guidance focuses on those CRE loans for which cash flow from real estate is the primary source of repayment (i.e., ADC lending). The Joint Guidance states that the agencies had observed an increasing trend in the number of institutions with concentrations in CRE loans and noted that rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Indeed, as noted in Imperial's March 2008 examination report, the softening of the multi-family real estate market in 2007 began to result in an upward trend in classified credits. Specifically, Imperial's highly concentrated CRE and ADC lending strategy led to a dramatic increase in the bank's Adversely Classified Items Coverage Ratio,[7] from 29.05 percent as of March 31, 2007 to 70.93 percent as of December 31, 2007.

Although ADC loans represented less than 15 percent of the total loan portfolio, these loans accounted for a disproportionate volume of loan losses. As shown in Figure 2, from December 31, 2005 to September 30, 2009, the majority of loan charge-offs totaling over $125 million involved ADC loans.

[6] The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as the agencies in the guidance).
[7] The Adversely Classified Items Coverage Ratio is a measure of the level of asset risk and the ability of capital to protect against that risk. A lower ratio is desirable because a higher ratio indicates exposure to poor quality assets and may also indicate less ability to absorb the consequences of bad loans.

Figure 2: Imperial's Net Charge-off on Loans and Leases as of September 30, 2009



Source: Call Reports for Imperial.

Collateralized Mortgage Obligations

In an attempt to achieve higher yields and enhance earnings and risk-based capital ratios, Imperial's Board and management acquired $826 million in CMOs from March to September 2008. Imperial purchased these securities mainly with FHLB borrowings and brokered deposits. The CMOs were primarily backed by Alt-A loans[8] issued by financial institutions, including IndyMac Bank, Countrywide Bank, and Washington Mutual Bank. The majority of the loans supporting the CMOs were underwritten in 2006, based on stated income or limited documentation, and were concentrated in California, Arizona, and Florida—states with high home-value depreciation. Imperial purchased these CMOs at a discount, allowing for a cushion to absorb potential principal write-downs.

Management focused on yield analysis and failed to consider the impact of the CMO program on liquidity and market risks. An internal analysis, prepared soon after Imperial's program was implemented, showed the bank's net present value of equity from the CMO purchases significantly outside of the bank's policy guidelines. Also, management had failed to consider the risk of potential downgrades on regulatory capital requirements.

Management's decision to purchase the CMOs created an additional asset concentration and increased the risk profile of the bank. Although the CMOs were AAA-rated when purchased, nearly 90 percent of the portfolio migrated to sub-investment grade and became adversely classified by December 31, 2008. Bank management re-securitized the

[8] An Alt-A loan is a mortgage made to a borrower that typically does not involve verification or documentation of income, assets, or employment. Instead, the approval of the loan is based primarily on the applicant's Fair Isaac Corporation (FICO) credit score.

CMO investment portfolio into a Real Estate Mortgage Investment Conduit (REMIC)[9] trust on December 23, 2008 in an effort to improve the securities' value by capturing the discount on those securities remaining at sub-investment quality. Nonetheless, by March 31, 2009, approximately $9 million had been identified as a credit loss from the CMO purchase.

In Financial Institution Letter (FIL) 20-2009, entitled, *Risk Management of Investments in Structured Credit Products*, dated April 2009, the FDIC re-emphasized existing supervisory guidance[10] to banks on the purchase and holding of complex structured credit products, such as Other Mortgage-Backed Securities. Specifically, FIL 20-2009 states:

> Risk management of investments in structured credit products should include adequate due diligence, reasonable exposure limits, accurate risk measurement, an understanding of the tranche structure, knowledge of the collateral performance, and a determination of investment suitability. Institutions should strive to limit concentrations in any one investment category, especially complex, illiquid, and high-risk investments such as structured credit products. Institutions must understand not only an investment's structural characteristics, but also the composition and credit characteristics of the underlying collateral. Management should conduct analysis at both the deal and pool level using information that sufficiently captures collateral characteristics. Such analysis should be conducted prior to acquisition and on an ongoing basis to monitor and limit risk exposures.

Further, according to FIL 20-2009, amid the credit turmoil, some institutions that were attracted to higher yields purchased illiquid and, in some instances, distressed structured securities at a discount. This strategy assumed the discount would provide a margin of safety against principal losses even given continued market stress, including ongoing deteriorating collateral performance and credit rating downgrades. However, in many cases, the discounts signaled the market's well-founded concerns and risk perception. Further, the FDIC has found that generally the discounts were not sufficient to cover the losses that followed.

FIL 20-2009 also reiterates that despite their initial credit ratings, these securities retained predominately speculative or high-risk characteristics. As a result, the purchase of higher-risk structured financial securities at a discount did not preclude the securities from adverse classification or analysis required by accounting rules to determine whether a decline in fair value was temporary or an other than temporary impairment.

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[9] A REMIC mortgage derivative is a type of mortgage-backed security that is secured by pass-through mortgage-backed securities or pools of individual loans whose collateral cash flows (principal and interest payments) are divided among multiple tranches/classes to create securities with distinctive risk/return characteristics. A REMIC is a security collateralized by previously-issued mortgage derivative tranches rather than by the pass-through mortgage-backed securities.

[10] The existing supervisory guidance was primarily contained in FIL-45-98, *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, and FIL-70-2004, *Uniform Agreement on the Classification of Assets and Appraisal of Securities*.

Risk Management Practices

An institution's Board is responsible for establishing appropriate risk limits, monitoring exposure, and evaluating the effectiveness of the institution's efforts to manage and control risk. The Joint Guidance reiterates that concentrations in CRE lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the past. Earlier guidance on ADC lending[11] emphasized that management's ability to identify, measure, monitor, and control portfolio risk through effective underwriting policies, systems, and internal controls was crucial to a sound ADC lending program. Imperial's Board did not consistently ensure that management established effective risk management practices sufficient to limit the bank's exposure to CRE and ADC concentrations, allowing the bank to grow significantly without appropriate limits and monitoring practices commensurate with the increased risk associated with those concentrations.

Credit Administration

According to the FDIC's *Risk Management Manual of Examination Policies* (Examination Manual), the degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. According to the Examination Manual, placing undue reliance upon a property's appraised value in lieu of an adequate initial assessment of a debtor's repayment ability is a potentially dangerous mistake. Although examiners reported that Imperial's loans were prudently underwritten, examiners noted that credit administration practices began to weaken, which impaired the bank's ability to adequately monitor the impact of the economic downturn on its loan portfolio. Such credit administration weaknesses were noted in the March 2008 and April 2009 examinations, which recommended that Imperial:

- Perform aggregate stress testing on the debt coverage ratios for the CRE portfolio, as well as property type concentrations such as multi-family loans, to quantify the impact of increasing interest rates.

- Improve the internal loan grading system. Management was not recognizing the severity of individual credit weaknesses and assigning appropriate internal grades. As a result, examiners downgraded loans totaling approximately $92 million.

- Be more vigilant in obtaining current financial information on borrowers. Examiners noted that $669 million of the multi-family loans were supported by stale or inadequate financial information.

- Consistently ensure that loan workout strategy decisions were based on a comprehensive feasibility analysis and thoroughly documented.

[11] FIL-110-98, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending,* dated October 8, 1998.

- Prohibit the practice of increasing loan commitments to replenish interest reserves when construction or stabilization activities have ceased or are materially behind schedule.

- Reevaluate loan-to-value limits in various categories. Single-family residential tract construction loans, condominium construction and conversions, and retail and mixed-use building construction and bridge loans were classified in an amount disproportionate to their representation in the loan portfolio.

Allowance for Loan and Lease Losses

Although Imperial's Allowance for Loan and Lease Losses (ALLL) methodology was generally found to be satisfactory, the 2007 examination report recommended that the ALLL policy and methodology be updated to incorporate provisions of the *Interagency Policy Statement on the ALLL*, dated December 13, 2006. In addition, each subsequent examination or visitation recommended that, due to the volume of loan downgrades, the ALLL be increased to provide for a range of at least 1.70 percent of total loans. Further, as previously mentioned, the bank's loan grading system needed enhancements. The deficiencies in the loan grading system resulted in a consistent underreporting of adversely classified loans and underfunding of the ALLL. During the April 2009 examination, the ALLL was determined to be underfunded by $23.6 million.

Reliance on Wholesale Funding Sources

To fund its asset growth, Imperial relied heavily on wholesale funding sources, including FHLB borrowings and brokered deposits, which required the bank to maintain a sound credit risk profile. According to the Examination Manual, financial institutions may use wholesale funding sources as an alternative to core deposits. Table 3 shows Imperial's total deposits, including time deposits greater than $100,000 and wholesale funding sources from 2006 to 2009.

Table 3: Imperial's Total Deposits and Wholesale Funding Sources, 2006 to 2009

Period Ending	Total Deposits ($000s)	Time Deposits of $100,000 or More ($000s)	Brokered Deposits ($000s)	Federal Home Loan Bank Borrowings ($000s)	Federal Funds Purchase and Resale ($000s)
September 2009	2,822,300	876,999	659,253	1,053,437	0
December 2008	2,953,016	846,883	739,879	1,175,633	30,000
December 2007	2,207,998	725,143	379,434	991,235	30,000
December 2006	2,084,533	1,017,329	332,797	980,000	30,000

Source: UBPRs for Imperial.

Imperial's net non-core funding dependence ratio[12] also consistently exceeded its peer group average for such funding sources. Further, when the bank exceeded the 45-percent

[12] The net non-core funding dependence ratio is defined as non-core liabilities less short-term investments divided by long-term assets. Non-core liabilities include time deposits of $100,000 or more, brokered deposits, federal funds purchased, and other borrowed money.

policy limit for this ratio in 2005, Imperial's management increased the limit to 60 percent in 2006. The bank exceeded this new policy limit in 2006, 2008, and the quarter ending September 30, 2009. 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.

In addition, as shown in Table 4, Imperial's cost of funds consistently surpassed its peer group due to its high net non-core funding dependence. The higher cost of funds negatively impacted the bank's net interest margin as deposits and FHLB borrowings re-priced to higher market interest rates in 2007. According to the 2008 examination report, net income decreased from $32.7 million in 2006 to $21.3 million in 2007, and the report attributed the primary reason for the decline in earnings to the compression of net interest rate margin.

Table 4: Imperial's Cost of Funds, 2005 to 2008

Period Ending	Interest Expense as a Percentage of Average Assets	Bank's Peer Group (%)	Peer (State of California) (%)
December 31, 2005	3.01	2.00	1.46
December 31, 2006	4.01	2.99	2.26
December 31, 2007	4.52	3.26	2.63
December 31, 2008	3.92	2.24	1.99

Source: UBPRs for Imperial.

In response to an August 2008 enforcement action, Imperial's Board agreed to develop a plan to reduce the bank's reliance on volatile funding sources. At the October 29, 2008 joint visitation, examiners noted that Imperial anticipated reducing its net non-core funding dependence ratio to approximately 50 percent by 2010. When Imperial's capital levels fell to *Adequately Capitalized* in January 2009, the bank became subject to interest rate limitations on deposits and restrictions on the acceptance or renewal of brokered deposits per section 337.6, *Brokered Deposits,* of the FDIC Rules and Regulations. During the April 20, 2009 joint examination, the examiners noted that Imperial was in apparent violation of section 337.6 due to offering rates on deposits that were higher than the rate restrictions in the regulation. The bank's deterioration also resulted in the termination of its secondary sources of funding.

The FDIC's Supervision of Imperial

Between 2006 and 2009, the FDIC and the CDFI conducted timely examinations of Imperial and made recommendations to strengthen the bank's risk management controls and credit administration practices and limit its use of wholesale funding. Further, beginning in 2008, the FDIC and the CDFI acted aggressively to downgrade the bank's composite and component ratings, address weaknesses in Imperial's management through implementation of enforcement actions, and curtail unsafe and unsound practices in 2008 and 2009. However, despite the Board's and management's responses to enforcement

actions taken in 2008 and 2009, the bank's financial condition became critically deficient and Imperial was unable to develop adequate plans for restoring capital.

Although examiners found Imperial's risk management practices and capital levels to be satisfactory and commensurate with the bank's risk profile prior to 2007, ultimately Imperial was not adequately prepared to handle the rapid and severe economic downturn. In retrospect, greater supervisory emphasis and a more forward-looking assessment of Imperial's risk profile during its growth period may have been prudent given Imperial's concentrations were significant and CRE concentrations can expose institutions to unanticipated earnings and capital volatility when adverse changes in market conditions occur. Specifically, the FDIC and the CDFI could have recommended that Imperial focus greater attention on analyzing the potential impact a downturn in the economy would have on its operations, including the need for a viable plan to mitigate the bank's concentration risk before economic conditions deteriorated.

The FDIC has taken a number of actions to address issues discussed in this report based on lessons it has learned from failures during the financial crisis. Of note, in 2008 the FDIC reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. In 2008 and 2009, the FDIC also issued guidance related to liquidity management and the use of volatile or special funding sources by financial institutions that are in a weakened condition, respectively. Further, the FDIC recently completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

Supervisory History

Between 2006 and 2009, the FDIC and the CDFI conducted four onsite examinations of Imperial, as required,[13] and two onsite visitations, and monitored Imperial's financial condition using various offsite monitoring tools. The 2008 visitation and the 2009 examination were conducted jointly by the FDIC and the CDFI. From 1995 through 2007, Imperial was considered a well-performing institution and consistently received composite "2" CAMELS ratings.[14] Our work focused on the FDIC's supervisory actions from 2006 until the bank was closed in December 2009. Table 5 summarizes Imperial's supervisory history during this period, including the supervisory actions taken.

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[13] Section 337.12 of the FDIC Rules and Regulations, which implements section 10(d) of the FDI Act, requires annual full-scope, onsite examinations of every state nonmember bank at least once every 12-month period and allows for 18-month intervals for certain small institutions (total assets of less than $500 million) if certain conditions are satisfied.

[14] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System 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 5: Examinations and Visitations of Imperial, 2006 to 2009

Start Date	As of Date	Agency	Supervisory Rating	Supervisory Action
04/10/2006	12/31/2005	FDIC	222232/2	None Applicable
05/14/2007	03/31/2007	CDFI	222232/2	None Applicable
03/24/2008	12/31/2007	FDIC	333333/3	Memorandum of Understanding (MOU)
10/29/2008 (V)*	09/30/2008	Joint	444444/4	Cease & Desist Order (C&D)
02/10/2009 (V)	12/31/2008	FDIC	444444/4	C&D
04/20/2009	03/31/2009	Joint	555555/5	C&D

Source: Reports of Examination (ROE), Visitation Reports, and enforcement actions for Imperial.
*V - Visitation

In addition to onsite examinations, the FDIC conducted offsite monitoring, which generally consists of periodic contact with bank management to discuss current or emerging issues and the use of various offsite monitoring tools, including the offsite review list, to monitor institutions between examinations. In this case, FDIC officials contacted bank officials as part of the pre-examination planning process and to follow up on emerging issues or concerns. Imperial was flagged in June 2008 for offsite review based on Call Report data; however, by this time, the bank was already under closer supervisory scrutiny due to the declining financial condition noted during the March 2008 examination.

Supervisory Response Related to Key Risks

Examiners consistently identified Imperial's concentrations and, as the deterioration in the bank's financial condition became evident, regulators worked in a timely manner to limit the institution's losses, address management weaknesses, and improve the bank's operations. However, in retrospect, a more forward-looking assessment of Imperial's risk profile, especially the bank's exposure to an economic downturn, may have been prudent in 2006 and 2007.

2006 Supervisory Activities

In the April 2006 examination, examiners assigned Imperial a composite "2" CAMELS rating, concluding that the overall condition of the bank was sound. Examiners did note, however, that Imperial's liquidity position was less than satisfactory. As a result, examiners rated the liquidity component a "3" because of the bank's over-reliance on FHLB advances to fund loan growth and maintain liquid assets, which resulted in a higher cost of funds compared to its peer group, as discussed earlier in this report. Although examiners found that Board reports related to funds management were comprehensive and depicted compliance with established policy limits, they noted that certain policy limits for liquidity measures were too liberal and merited reconsideration. In that regard, examiners made a number of recommendations to reduce the bank's reliance on non-core funding sources and strengthen funds management practices.

Examiners also found asset quality and management to be satisfactory and assigned both components a "2" rating. The volume of adversely classified items had increased by 53 percent, from $66 million at the prior examination to $101.7 million, but only resulted in a moderate increase in the adversely classified items coverage ratio. The bank continued to have a significant concentration of loans secured by CRE. Specifically, total CRE loans had grown to $2.4 billion and represented 899 percent of Tier 1 Capital as of December 31, 2005, an increase from 749 percent as of December 31, 2004. However, examiners concluded that although the CRE concentration was excessive, Imperial's portfolio had a relatively lower risk profile because the majority of these loans involved multi-family housing geographically dispersed throughout California and the rest of the United States.

Further, examiners concluded that management adequately monitored the CRE exposure but made recommendations to improve the qualitative and quantitative analyses of the loans through the implementation of additional risk identification measures. Notably, the recommendations aligned with the Joint Guidance, which was not issued in final until December 2006. In response to the examination finding, management indicated it was developing a more comprehensive reporting process to better assess the portfolio risk profile and manage its credit concentration exposures. Further, management stated it was aware of the proposed regulatory guidance on concentrations of credit (the Joint Guidance) and expressed its intent to comply with the provisions once the final guidance was issued.

2007 Supervisory Activities

The CDFI's May 2007 examination found the bank's overall condition had remained satisfactory and assigned a composite "2" CAMELS rating. Liquidity was still considered less than satisfactory as the bank continued to be heavily dependent upon FHLB advances and other non-core deposits to meet funding needs.

The 2007 examination report stated that asset quality remained satisfactory, noting that the Adversely Classified Items Coverage Ratio had declined from 32.94 percent at the 2006 examination to 29.05 percent. Imperial continued to have a significant concentration in CRE loans and specifically in multi-family residential real estate and construction loans. CRE loans represented 1,103 percent of Tier 1 Capital as of March 31, 2007. The Joint Guidance issued in December 2006 provided supervisory criteria for identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny, as follows:

- total reported loans for construction, land development, and other land that represent 100 percent or more of the institution's total capital; or
- total commercial real estate loans that represent 300 percent or more of the institution's total capital, and the outstanding balance of an institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Examiners concluded that the risk in the CRE concentration was mitigated by prudent underwriting and geographic diversification. Examiners reported that Imperial's loan

policy and underwriting procedures were comprehensive and consistently applied throughout the portfolio. Additionally, Imperial's Total Risk-Based Capital Ratio had declined from 12.20 percent to 11.24 percent since the 2006 examination because asset growth outpaced capital growth. However, the examination report stated that capital ratios remained satisfactory and adequately supported Imperial's operations, growth, and the overall risk profile of the institution.

Further, although examiners found management's methodology for calculating and evaluating the ALLL to be adequate, examiners made recommendations to revise the ALLL policy and methodology to incorporate provisions of the December 13, 2006 *Interagency Policy Statement on the ALLL.*

2008 Supervisory Activities

The FDIC's 2008 onsite examination found that the overall condition of the bank had begun to deteriorate as a result of economic events and Imperial's implementation of an aggressive growth strategy without access to lower-cost core deposits. The FDIC and the CDFI conducted a joint visitation in October 2008 to follow up on management's efforts to address concerns identified during the examination and its response to an MOU that became effective in August 2008.

March 2008 Examination. Examiners found that Imperial's overall condition was less than satisfactory and downgraded the bank's CAMELS composite rating to a "3". The examination report concluded that management's aggressive growth strategy during the 2004 to 2006 period, which included opening multiple loan production offices and funding growth with higher cost non-core deposits, combined with the decline in the real estate market, had led to elevated risks levels in the institution.

Specifically, examiners found asset quality to be less than satisfactory. Adversely classified loans had significantly increased, and primarily involved construction projects or bridge loans to finance acquisition, rehabilitation, and repositioning of various property types. Construction delays, cost overruns, and extended marketing periods for finished units were symptoms of those projects that did not proceed as expected.

Imperial's management was criticized for not recognizing the severity of individual credit weaknesses and assigning appropriate internal loan grades. The examination report stated that internal asset review memoranda and accompanying loan file documentation effectively identified loan problems but that management often seemed unwilling to use the information to assign a proper loan grade. Examiners noted that this condition represented a notable change from prior examinations and made several recommendations to improve the bank's loan underwriting and credit administration practices, including re-evaluating permissible loan-to-value limits; improving internal loan grading and external loan review practices; and limiting practices involving replenishing interest reserves on construction loans. Further, examiners noted that management should reassess the level of loan concentrations given national economic conditions.

Earnings performance had declined during 2007 with a return on average assets of 0.61 percent, down from 1.06 percent during 2006. Examiners attributed the decline primarily to a significant volume of higher-yielding loans that were paid off and replaced by loans with lower yields. Furthermore, an increase in the cost of funds occurred as deposits and FHLB borrowings re-priced to higher market interest rates.

Imperial's liquidity position remained less than satisfactory due to its continued heavy reliance on volatile deposits and FHLB advances. Management was again encouraged to reduce its reliance on non-core deposits. In addition, examiners recommended that management regularly review and update the contingency liquidity plan to ensure that it remained appropriate for changing business conditions and economic climates. Examiners also noted that Imperial's capital position was less than satisfactory and that management should be proactive in assessing capital needs and ensure that capital considerations remained at the forefront of Imperial's strategic planning because failure to maintain a *Well Capitalized* position could reduce the bank's FHLB borrowing capacity and its access to brokered deposit sources.

August 2008 MOU. The FDIC and the CDFI jointly proposed an MOU to address the weaknesses noted during the March 2008 examination. The MOU effective August 8, 2008, included provisions for reducing adversely classified assets, improving the internal and external loan grading process, addressing credit administration and underwriting weaknesses, reducing loan concentration risk, improving the methodology for determining the appropriateness of the ALLL, implementing a written strategic plan that included capital and profitability targets, and improving asset and liability management policies and practices.

October 2008 Joint Visitation. The scope of this visitation included a limited assessment of each CAMELS component, a study of management's responses to the MOU, and a review of the bank's strategy to purchase $826 million in privately-issued CMOs made subsequent to the March 2008 examination. Examiners found that the bank's overall condition had deteriorated to unsatisfactory and made an interim downgrade of all CAMELS ratings to "4". The visitation report noted that bank management's response to the MOU appeared to adequately address each provision but would require additional time for examiners to assess the implementation and ultimate effectiveness of the bank's actions.

The visitation report stated that management had initiated potentially positive changes to manage lending risks; however, they concluded that asset quality continued to decline. Further, examiners were also critical of the Board's and management's decision to purchase privately-issued CMOs, which examiners noted was done without appropriate policies, systems, or personnel. The visitation report stated that these investments resulted in an additional asset concentration counter to the MOU provision that required Imperial to institute plans to reduce existing asset concentrations in CRE loans.

Imperial's liquidity position remained unsatisfactory due to the continued volatile liabilities dependence, with approximately 51 percent of funding coming from FHLB

borrowings and brokered deposits. Tier 1 Leverage Capital of 7.19 percent and Total Risk-Based Capital of 10.43 percent were considered to be unsatisfactory levels due to the volume of problem assets, inadequate earnings, and unfavorable near-term capital augmentation prospects.

The visitation report noted that management had initiated several corrective actions to address issues, including development of a capital enhancement plan, completion of the re-securitization transaction involving the CMOs, and an independent assessment to support management's accounting for such transactions. According to the visitation report, management requested regulatory officials to defer any actions until it could provide further information. However, as a result of the October 2008 visitation findings, examiners proposed a C&D requiring improvements in all CAMELS rating components, which are discussed below.

2009 Supervisory Activities

In 2009, the C&D resulting from the October 2008 joint visitation became effective, and the FDIC conducted a limited scope visitation in February to focus on Imperial's asset quality, capital adequacy, and liquidity. In April 2009, the FDIC and the CDFI conducted the last onsite examination of the bank.

February 2009 C&D. The C&D, effective February 17, 2009, required the bank to:

- retain qualified management,
- increase Board participation in the affairs of the bank,
- develop a capital plan within 60 days to achieve and maintain its Tier 1 Leverage Capital ratio above 9 percent and Total Risk-Based Capital ratio above 13 percent,
- implement a comprehensive policy for determining the appropriateness of the ALLL,
- reduce CRE concentrations,
- develop and implement a written liquidity and funds management policy, and
- not pay cash dividends without the prior written consent of the FDIC and the CDFI.

February 2009 Visitation. In addition to the issuance of the C&D, the FDIC conducted a limited scope visitation on February 10, 2009, to assess the bank's performance since the October 2008 visitation, focusing on the evaluation of asset quality, capital adequacy, and liquidity. The visitation report stated that:

- Asset quality remained unsatisfactory and significant concerns continued to exist regarding Imperial's $826 million CMO investment portfolio, which was resecuritized into a REMIC trust on December 23, 2008.
- Imperial's capital position continued to be unsatisfactory and the bank was considered to be *Adequately Capitalized* for PCA purposes. Management planned to raise capital ratios by reducing assets, but acknowledged that achieving capital requirements would be difficult given limited earnings prospects and daunting economic challenges.

- The liquidity position surrounding the bank's financial condition remained unsatisfactory.

April 2009 Joint Examination. Despite efforts by the bank to address the issues reported by examiners, its condition continued to deteriorate so that its ongoing viability was threatened, and Imperial received a composite "5" rating as a result of this examination. Specifically, examiners concluded that ineffective Board and management oversight of significant concentrations in CRE and excessive exposures in speculative residential construction and land development loans, funded with an excessive reliance on volatile funding sources, resulted in unacceptably high levels of risk tolerance that had led to the bank's critically deficient condition. Further, the examination report noted that the lack of a comprehensive analysis of the potential effect of a downturn in the economy and the current stress in the residential real estate market had magnified the risks to the bank.

Examiners were also highly critical of management's decision regarding the CMO purchase and reported that Imperial had not conducted a comprehensive analysis and modeling prior to purchase to determine the impact on credit, capital, liquidity, and market risks. Examiners cited the bank for a contravention of the *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* (Investment Statement) and also a contravention of the *Joint Agency Policy Statement on Interest Rate Risk* (IRR Statement). Imperial was in violation of the Investment Statement for not properly assessing the risk of the non-agency CMO purchase program to the institution prior to implementation. Instead, the Board relied on an assessment by a third-party trust investment firm, which promoted the program and acted as financial advisor for selecting the securities as well as broker in the vast majority of the purchases. Examiners concluded that Imperial's management had focused on yield analysis and failed to consider the impact of the program on liquidity and market risks. With respect to the IRR Statement, examiners stated that the Board and management did not identify the risks arising from the acquisition of the CMO.

Additionally, the examination report cited Imperial for an apparent violation of section 337.6, *Brokered Deposits*, because the bank offered rates on deposits that were higher than the rate restrictions set forth in the regulation. According to the examination report, as discussed below, the bank was considered *Adequately Capitalized* as of December 31, 2008 and, as such, was required to comply with section 337.6 rate restrictions as of January 31, 2009, which corresponds to the date the December 31, 2008 Call Report was filed. Examiners found that the bank was not using the appropriate geographical area to compare rates as defined in the regulation. During the examination, the bank fell to *Undercapitalized*, which required tighter restrictions on rates.

Supervisory Lessons Learned

In hindsight, it would have been prudent for examiners to emphasize Imperial's vulnerability to an economic downturn, especially given the bank's significant concentrations and the fact that past regulatory history has demonstrated that CRE markets can experience fairly rapid changes. We recognize that (1) the supervisory thresholds in the Joint Guidance do not constitute limits on an institution's lending activity but are intended to serve as high-level indicators to identify institutions potentially exposed to CRE concentration risk and (2) examiners found that Imperial's underwriting procedures were comprehensive and credit administration practices were adequate. Nonetheless, such emphasis may have helped focus management's attention on developing a contingency plan to reduce concentrations before the economy began to deteriorate.

The FDIC has taken a number of actions to address issues discussed in this report. Of note, in 2008 the FDIC issued FIL-22-2008, *Managing CRE Concentrations in a Challenging Environment*, which reiterated broad supervisory expectations with regard to managing risk associated with CRE and ADC concentrations. Specifically, the guidance re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management practices. It also articulated the FDIC's concern about interest reserves for ADC loans, stating that examiners have noted an inappropriate use of interest reserves when the underlying real estate project is not performing as expected.

The FDIC also issued guidance related to liquidity management and the use of volatile or special funding sources by financial institutions that are in a weakened condition in 2008 and 2009, respectively. Specifically, in August 2008, the FDIC issued guidance, FIL-84-2008 entitled *Liquidity Risk Management*, to highlight the importance of contingency funding plans to address relevant stress events and the requirements governing the acceptance, renewal, or rolling over of brokered deposits. FIL-13-2009, *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*, states that institutions rated "3", "4", or "5" that engage in material growth strategies, especially those that are funded with volatile liabilities or temporarily expanded FDIC insurance or liability guarantees, pose a significant risk to the DIF and will be subject to heightened supervisory review and enforcement.

Further, the FDIC recently completed a training initiative for its entire supervisory workforce that emphasizes the need to assess a bank's risk profile using forward-looking supervision. The training addressed the need for examiners to consider management practices as well as current financial performance or trends in assigning ratings, as allowable under existing examination guidance.

Implementation of PCA

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

to the DIF. Part 325, *Capital Maintenance*, of the FDIC Rules and Regulations defines the capital measures used in determining the supervisory actions that will be taken pursuant to section 38 for FDIC-supervised institutions. Part 325 also establishes procedures for the submission and review of Capital Restoration Plans (CRP) and for the issuance of directives and orders pursuant to section 38.

Based on the supervisory actions taken with respect to Imperial, the FDIC properly implemented applicable PCA provisions of section 38. Imperial was considered *Well Capitalized* for PCA purposes until December 31, 2008. Table 6 illustrates the significant decline in Imperial's capital levels from 2008 to 2009.

Table 6: Imperial's Capital Levels Relative to PCA Thresholds for *Well Capitalized* Institutions

Exam/Visit Date	Tier 1 Leverage	Tier 1 Risk-Based	Total Risk-Based	Capital Classification
Well-Capitalized Threshold	≥ 5%	≥ 6%	≥ 10%	
Joint Visitation 10/29/08	7.19	9.52	10.43	*Well Capitalized*
FDIC Visitation 2/10/09	6.03	8.02	9.28	*Adequately Capitalized*
Joint Examination 4/20/09	4.44	5.57	6.83	*Undercapitalized*

Source: Visitation Reports, and ROEs for Imperial and Part 325 of the FDIC Rules and Regulations.

Imperial was considered *Adequately Capitalized* based on its December 31, 2008 Call Report. Further, as previously mentioned in this report, the C&D signed on February 17, 2009 included a capital provision that specifically directed Imperial to increase and maintain a Tier 1 Leverage Capital ratio above 9 percent and a Total Risk-Based Capital ratio above 13 percent – amounts that are greater than required by PCA for *Well Capitalized* institutions. The C&D also required the institution to develop a plan to eliminate its reliance on brokered deposits.

The FDIC's efforts to monitor Imperial's capital position and the bank's response to supervisory actions after February 2009 included the following:

- **April 8, 2009**. The FDIC issued a letter to Imperial based on the results of the FDIC's limited scope visitation conducted on February 10, 2009. The visitation found that the bank's capital position remained unsatisfactory and reiterated that it was considered *Adequately Capitalized* for purposes of PCA as of December 31, 2008.

- **May 14, 2009.** The FDIC again notified Imperial that the bank was *Adequately Capitalized* for PCA purposes based on capital-related ratios reported in the institution's December 31, 2009 Call Report. The notification included a reminder that Imperial was subject to brokered deposit and deposit interest rate restrictions, as defined in PCA.

- **June 25, 2009.** As a result of the joint April 2009 examination, the FDIC required Imperial to amend the institution's March 31, 2009 Call Report. Based on the revised Call Report, the FDIC determined that Imperial's capital position for PCA

purposes had further deteriorated to *Undercapitalized* and, accordingly, the FDIC sent a PCA notification letter to Imperial and again reminded the institution of its obligations under PCA.

- **August 7, 2009.** Imperial submitted a CRP to the FDIC and the CDFI. The regulators rejected the CRP on September 18, 2009 because (1) none of the proposed capital restoration transactions had been consummated, (2) the plan did not return capital to adequate levels until well beyond 2011, and (3) the plan failed to meet the capital levels required by the February 17, 2009 C&D. Imperial submitted a revised CRP on November 13, 2009 that the FDIC and the CDFI also determined to be inadequate.

- **October 13, 2009.** Due to the lack of a viable CRP and the continued deterioration of the bank's capital, the FDIC issued a Supervisory PCA Directive. Among other things, the Directive included provisions that required the bank to:

    - Recapitalize the bank within 30 days.
    - Restrict the interest rates paid on deposits to comply with section 337.6 of the FDIC Rules and Regulations.
    - Refrain from accepting, renewing or rolling over any brokered deposits to comply with section 337.6.
    - Ensure that the bank's average total assets during any calendar quarter did not exceed its average total assets during the preceding calendar quarter.
    - Refrain from making any capital distributions or dividend payments to its parent or any affiliate of the bank or paying any bonuses or increased compensation to any director or officer of the bank without prior written approval from the FDIC.

Ultimately, regulators concluded that Imperial would be unable to raise the level of capital required and, as a result, the bank was closed by the CDFI on December 18, 2009. Imperial had submitted an application for the Troubled Asset Relief Program on October 28, 2008 for funding of $93.5 million; however, the bank subsequently withdrew its application on April 20, 2009.

Corporation Comments

On July 12, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety as Appendix 4 of this report. DSC reiterated the OIG's conclusions regarding the causes of Imperial's failure. With regard to our assessment of the FDIC's supervision of Imperial, DSC summarized the supervisory history, including offsite monitoring activities described in our report. In addition, DSC described the composite and component rating downgrades made as a result of the March 2008 examination and the emphasis noted by examiners for Imperial to reassess the level of its loan concentrations in light of national economic conditions. Formal enforcement action was taken when examiners found Imperial's financial condition had become critically deficient at the February 2009 visitation. However, consistent with information presented

in our report, DSC's response states that Imperial was unable to comply with the majority of the enforcement action provisions or raise necessary capital to remain viable. Further, DSC recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as Imperial, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

Objectives, Scope, and Methodology

Objectives

We performed this performance audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if the 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.

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

We conducted the audit from March 2010 to June 2010 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 material loss review included an analysis of Imperial's operations from 2005 until its failure on December 18, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed examination and visitation reports prepared by the FDIC and the CDFI from 2006 to 2009.
- Reviewed the following:
    - Selected examination work papers prepared by the FDIC from 2006 to 2009.
    - Bank data contained in UBPRs and Call Reports.
    - Correspondence received from DSC's San Francisco Regional Office, San Francisco, California and Orange County Field Office, Mission Viejo, California.

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed records provided by DRR that would provide insight into the bank's failure.

  - DSC's ViSION Modules, including Supervisory Tracking & Reporting.

  - Financial Statements for Imperial for 2006 through 2009.

  - Federal Reserve Bank Inspection Reports for 2008 and 2009.

  - Pertinent DSC policies and procedures.

  - Correspondence received from Imperial Bancorp regarding actions taken by Imperial in response to examination findings.

- Interviewed the following FDIC officials:

  - DSC regional management from the San Francisco Regional Office.

  - DSC examiners from the Orange County Field Office.

  - CDFI examiners and officials from the CDFI Office in San Diego, California.

We performed our audit field work at the OIG offices in Arlington, Virginia and DSC's San Francisco Regional Office.

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

Consistent with our audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC's systems, reports, ROEs, and interviews of DSC and CDFI examiners to obtain an understanding of Imperial's management controls pertaining to the causes of failure and material loss as discussed in the body of this report. Although we obtained information from various FDIC systems, we determined that the controls pertaining to these systems were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on 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

Objectives, Scope, and Methodology

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 was not part of the audit objectives. DSC's compliance with the Results Act is reviewed in OIG program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with the provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act and the FDIC Rules and Regulations. 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)	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is 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.
Collateralized Mortgage Obligations (CMOs)	A type of mortgage-backed security, CMOs are bonds that represent claims to specific cash flows from large pools of home mortgages. The streams of principal and interest payments on the mortgages are distributed to the different classes of CMO interests, known as tranches, according to a complicated deal structure. Each tranche may have different principal balances, coupon rates, prepayment risks, and maturity dates (ranging from a few months to 20 years).
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.

Glossary of Terms

Federal Home Loan Bank (FHLB)	FHLBs provide long- and short-term advances (loans) to their members. Advances are primarily collateralized by residential mortgage loans, and government and agency securities. Community financial institutions may pledge small business, small farm, and small agri-business loans as collateral for advances. Advances are priced at a small spread over comparable U.S. Department of the Treasury obligations.
Loan-to-Value	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral.
Prompt Corrective Action (PCA)	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, *Prompt Corrective Action*, of the FDI Act, 12 U.S.C. section 1831(o), 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 undercapitalized categories.

Glossary of Terms

Tier 1 (Core) Capital	In general, this term is defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Troubled Asset Relief Program (TARP)	TARP is a program of the United States Treasury Department to purchase assets and equity from financial institutions to strengthen the financial sector.
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.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk
CDFI	California Department of Financial Institutions
CMO	Collateralized Mortgage Obligations
CRE	Commercial Real Estate
CRP	Capital Restoration Plan
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
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
UBPR	Uniform Bank Performance Report

Corporation Comments

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

July 12, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/**Signed**/
FROM: Sandra L. Thompson
Director

SUBJECT: Draft FDIC Response to the Draft Audit Report Entitled, Material Loss Review of Imperial Capital Bank (Assignment No. 2010-022)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Imperial Capital Bank, La Jolla, California (Imperial) which failed on December 18, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on June 14, 2010.

The Report concludes Imperial failed because the Board of Directors and management did not develop and implement adequate risk management practices pertaining to Imperial's significant concentration in nationwide multifamily commercial real estate (CRE) loans; acquisition, development, and construction (ADC) loans; and investments in higher-risk, mortgage-backed securities. The aggressive loan growth of Imperial was fueled by reliance on wholesale funding sources such as FHLB borrowings and brokered deposits.

From 2006 through December 2009, the FDIC and the State of California Department of Financial Institutions (CDFI) jointly and separately conducted four full scope examinations and two visitations. The FDIC also conducted offsite reviews and other offsite monitoring activities. At the March 2008 examination, FDIC examiners downgraded composite and component ratings, and noted that management should reassess the level of loan concentrations given national economic conditions. At the February 2009 FDIC visitation, examiners found that Imperial's financial condition had become critically deficient and formal enforcement action was taken. Imperial was unable to comply with the majority of the provisions and was unable to raise necessary capital to remain viable.

DSC recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as Imperial, and has issued updated guidance reminding examiners to take appropriate action when those risks are imprudently managed.

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