Office of Inspector General

May 2009
Report No. AUD-09-012

Material Loss Review of Security Pacific Bank, Los Angeles, California

AUDIT REPORT

Office of Audits

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Federal Deposit Insurance Corporation

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Why We Did The Audit

As required by section 38(k) of the Federal Deposit Insurance Act, the Office of Inspector General (OIG) conducted a material loss review of the failure of Security Pacific Bank, Los Angeles, California (SPB). On November 7, 2008, the California Department of Financial Institutions (DFI), closed SPB and named the FDIC as receiver. On November 19, 2008, the FDIC notified the OIG that SPB's assets at closing totaled $540.3 million, with a material loss to the Deposit Insurance Fund (DIF) estimated at $208.4 million. As of December 31, 2008, the estimated loss to the DIF decreased to $175.5 million.

The audit objectives were to (1) determine the causes of the financial institution's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) provisions of section 38. Our ability to evaluate supervisory efforts prior to 2007 was limited because the retention of work papers beyond one examination is generally discouraged in accordance with FDIC policies.

Background

The FDIC has been the bank's primary federal regulator since it was chartered in 1981. SPB's loan portfolio primarily consisted of commercial real estate loans (CRE), with a significant concentration in land acquisition, development, and construction loans (ADC).

FDIC guidance issued to financial institutions describes a risk management framework to effectively identify, measure, monitor, and control CRE concentration risk. That framework includes effective oversight by bank management, including the board of directors (BOD) and senior executives, and sound loan underwriting, credit administration, and portfolio management practices.

Audit Results

SPB failed primarily due to bank management's pursuit of a high-risk business strategy focused on rapid asset growth concentrated in CRE/ADC loans, which were financed primarily with wholesale funding sources, including volatile non-core deposits and borrowings. As the California residential real estate market began to decline in 2007, the bank's loan portfolio deteriorated quickly and impaired the financial condition of the institution. Ultimately, as a result of substantial loan losses, the bank was unable to maintain adequate capital or satisfy liquidity requirements, leading to its failure. Specifically:

Management. SPB's BOD did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities or implemented timely corrective actions in response to examiner recommendations related to diversification of the bank's loan portfolio, inadequate monitoring of real estate lending, and liquidity management. Further, examiners criticized management's market analysis and monitoring processes, especially considering that the institution did not take sufficient action to address the problems related to the residential real estate market in 2007.

Asset Quality. SPB's ADC loans, as a percent of its loan portfolio, were significantly above peer group averages from 2004 through 2008. Additionally, SPB's CRE/ADC and commercial loans were primarily concentrated in one area of Southern California. SPB did not follow sound credit administration practices, including those related to (1) loan risk ratings, (2) nonaccrual loans, and (3) monitoring of real estate lending and unsecured loans. As asset quality declined, SPB did not maintain a sufficient allowance for loan and lease losses, and significant losses reduced earnings and depleted capital.

Liquidity. SPB was dependent on higher-cost and more volatile wholesale funding sources, such as Internet certificates of deposit, Federal Home Loan Bank advances, and the solicitation of high-interest-rate deposits by in-house salaried employees (money desk deposits) to fund asset growth. Liquidity levels declined because management did not adequately monitor and control liquidity ratios, implement an adequate contingency liquidity plan, and reduce its dependence on non-core deposits in a timely manner.

Supervision. The FDIC and DFI conducted timely examinations of SPB from 1985 until its closing in 2008. In 2006, the FDIC reported concerns about SPB's rapid CRE/ADC loan growth through a heavy reliance on wholesale funding sources but did not make recommendations regarding the risks of the bank's high CRE/ADC concentrations that ultimately led to SPB's failure. By September 2007, the overall condition of the bank had deteriorated to unsatisfactory, and the bank's component and composite ratings were downgraded to 4. However, timely supervisory action was not taken commensurate with the risks that the CRE/ADC concentrations and other loan underwriting and credit administration weaknesses posed to the institution. In particular, the 2007 examination results were submitted to the San Francisco Regional Office in November 2007, but enforcement action to address the bank's significant weaknesses was not implemented until about 5 months later. Greater supervisory concern and more timely supervisory action were warranted in light of such weaknesses. In April 2008, the FDIC and DFI jointly issued a Cease and Desist Order, which, among other things, addressed the need for more prudent diversification in the bank's loan portfolio and implementation of a capital maintenance plan. A joint FDIC/DFI examination began in August 2008, but the Report of Examination had not yet been issued in final form when SPB was closed on November 7, 2008.

The FDIC OIG plans to issue a series of summary reports on the material loss reviews it is conducting and will make appropriate recommendations related to the failure of SPB and other FDIC-supervised banks at that time, including with regard to implementation of PCA provisions.

Management Response

The Division of Supervision and Consumer Protection (DSC) provided a written response to the draft report, noting that SPB's primary growth phase occurred between 2003 and 2005, when the Southern California real estate market also was expanding rapidly, and the subsequent material decline in real estate values in SPB's market area contributed to the severe deterioration in SPB's asset quality, excessive operating losses, and severe erosion of capital. DSC agreed with the OIG's assessment that SPB failed due to management's pursuit of a high-risk business strategy focused on rapid asset growth concentrated in CRE loans, including ADC loans, financed primarily with wholesale funding. Further, DSC acknowledged that implementation of the formal enforcement action was delayed. DSC has since adopted strategies aimed at improving the timeliness of enforcement actions in problem bank situations.

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Office of Audits
Office of Inspector General

DATE: May 18, 2009

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

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Material Loss Review of Security Pacific Bank, Los Angeles, California* (Report No. AUD-09-012)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Security Pacific Bank (SPB). On November 7, 2008, the California Department of Financial Institutions (DFI) closed the institution and named the FDIC as receiver. On November 19, 2008, the FDIC notified the OIG that SPB's total assets at closing were $540.3 million with a loss to the Deposit Insurance Fund (DIF) estimated at $208.4 million. As of December 31, 2008, the estimated loss had decreased to $175.5 million.

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

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

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

[2] The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by the institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition; management policies and practices, including internal control systems; and compliance with applicable laws and regulations; and (2) issues related guidance to institutions and examiners.

This report presents the FDIC OIG's analysis of SPB's failure and the FDIC's efforts to ensure SPB's management operated the bank in a safe and sound manner. The FDIC OIG plans to issue a series of summary reports on our observations on the major causes, trends, and common characteristics of financial institution failures resulting in a material loss to the DIF. Recommendations in the summary reports will address the FDIC's supervision of the institutions, including implementation of the PCA provisions of section 38.

BACKGROUND

SPB, initially called Golden Pacific Bank, was insured by the FDIC and established on December 7, 1981. The institution was renamed Network Bank USA on August 18, 1999 and became SPB on November 4, 2004. SPB, which was headquartered in Los Angeles, California:

- had two branches in Los Angeles; one branch in Ontario, California; and one branch in Orange County, California;

- provided traditional banking activities within its marketplace and focused primarily on commercial real estate (CRE), commercial and industrial, construction, and other lending; and

- specialized in residential acquisition, development, and construction (ADC) loans, many of which were significantly concentrated in the Inland Empire and Greater Los Angeles areas of Southern California.

SPB was primarily owned by Security Pacific Bancorp, a bank holding company. SPB's main market area was Southern California with nearly 93 percent of the bank's deposits concentrated in Los Angeles County. The Chairman of the Board (Chairman) personally controlled 60 percent of the holding company's stock, and his family collectively owned or controlled 98 percent of the stock. Additionally, the holding company owned Security Pacific Credit Corporation (SPCC), a finance company that was incorporated in February 2002. SPCC's loan clientele consisted of small- to middle-market businesses and included some affiliated companies controlled by the Chairman.

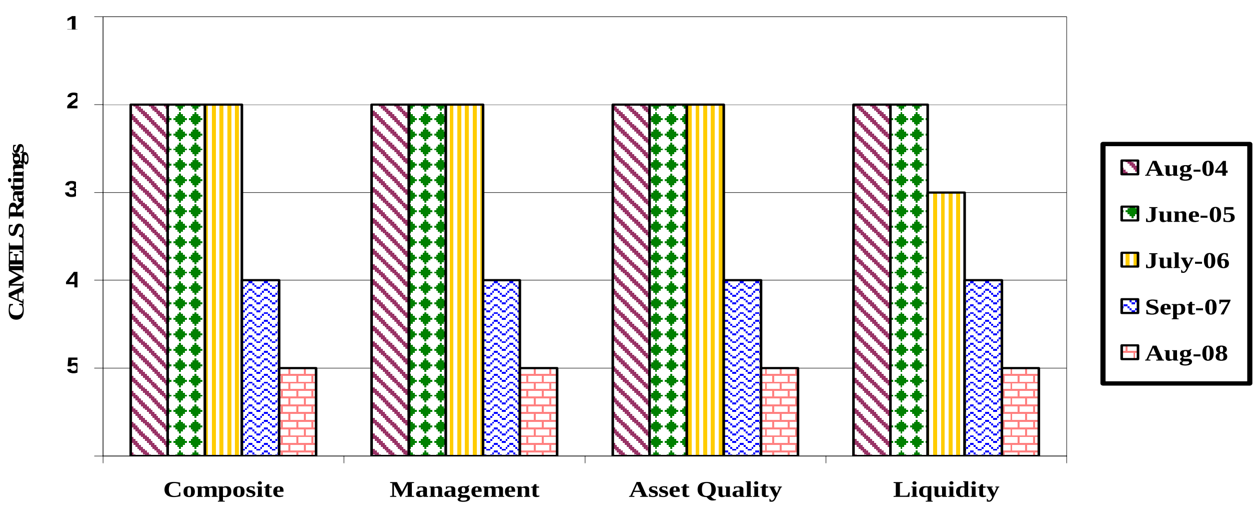
DSC's Los Angeles West Field Office and DFI performed regular safety and soundness examinations of SPB, conducting a total of five examinations from August 2004 through August 2008. Each examination was conducted jointly by the FDIC and DFI, with the exception of the 2006 examination which was an FDIC examination conducted under the FDIC's *Maximum Efficiency, Risk Focused, Institution Targeted (MERIT) Guidelines.*[3]

[3] The FDIC followed MERIT guidelines, dated January 27, 2004, in performing examinations for well capitalized banks with a 1 or 2 composite rating for the two most recent examinations and that met other criteria in the guidelines.

In 2003, SPB's management decided to concentrate its loan portfolio in real estate construction to obtain higher yields and offset its high cost of funds. At the September 2007 examination, SPB's CAMELS composite rating was downgraded to 4,[4] indicating unsafe and unsound practices or conditions and a distinct possibility of failure if such conditions and practices were not satisfactorily addressed and resolved. In 2008, SPB's composite rating was downgraded to a 5, indicating extremely unsafe and unsound practices or conditions; critically deficient performance, often with inadequate risk management practices; and great supervisory concern. Institutions in this category pose a significant risk to the DIF and have a high probability of failure.

Further, with respect to selected component ratings, as indicated in Figure 1 below, SPB's liquidity rating was downgraded to 3 at the July 2006 examination. At the following September 2007 examination, SPB's management, asset quality, and liquidity ratings were downgraded to 4. As a result of the August 2008 joint examination, the FDIC and DFI issued a problem bank memorandum in October 2008 and downgraded SPB's management, asset quality, and liquidity ratings to 5.

Figure 1: SPB's Key CAMELS Ratings



Source: OIG review of Reports of Examination (ROE) and the October 2008 Problem Bank Memorandum.

In January 2008, based on off-site monitoring of SPB's financial condition, the FDIC considered SPB to be in "troubled condition" and identified the institution as a "problem bank." To address examination concerns, inadequate risk management controls, and other safety and soundness

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[4] 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.

issues, the FDIC and DFI subsequently issued a Cease and Desist Order (C&D) effective April 22, 2008 (discussed later in the report).

Details on SPB's financial condition, as of September 2008, and for the 5 preceding calendar years follow in Table 1.

Table 1: Financial Condition of SPB

	30-Sept-08	31-Dec-07	31-Dec-06	31-Dec-05	31-Dec-04	31-Dec-03
Total Assets ($000s)	$527,959	$594,725	$544,951	$536,335	$307,005	$214,823
Total Deposits ($000s)	$456,472	$501,563	$441,604	$436,556	$272,358	$181,558
Total Loans ($000s)	$467,588	$525,294	$489,459	$444,505	$257,097	$165,715
Net Loan Growth Rate	(14.88)%	6.46%	9.67%	72.90%	55.12%	115.35%
Net Income (Loss) ($000s)	(73,585)	(1,236)	17,720	10,360	4,986	1,793
Loan Mix (% of Avg. Gross Loans):						
All Loans Secured by Real Estate	65.24%	68.34%	84.66%	92.75%	92.42%	87.68%
Construction and Development (ADC)	31.64%	39.13%	39.38%	34.90%	33.12%	11.32%
CRE - Nonfarm/nonresidential	26.89%	24.93%	36.07%	41.18%	42.10%	54.04%
Multifamily Residential Real Estate	6.7%	4.28%	8.87%	16.09%	16.71%	20.82%
1-4 Family Residential – excluding Home Equity Lines of Credit	0.0%	0.0%	0.35%	0.59%	0.49%	1.50%
Home Equity Loans	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Commercial and Industrial Loans	34.74%	30.92%	14.71%	7.20%	7.45%	11.85%
Adverse Classifications Ratio	199%	98%	0%	0%	0%	0%

Source: Uniform Bank Performance Reports (UBPR) and ROEs for SPB.

RESULTS IN BRIEF

SPB failed primarily due to bank management's pursuit of a high-risk business strategy focused on rapid asset growth concentrated in CRE/ADC loans, financed primarily with wholesale funding sources, including volatile non-core deposits and borrowings. As the California residential real estate market began to decline in 2007, the bank's loan portfolio deteriorated quickly and impaired the financial condition of the institution. Ultimately, as a result of substantial loan losses, the bank was unable to maintain adequate capital or satisfy liquidity requirements, leading to its failure. Specifically:

Management. SPB's BOD did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities or implemented timely corrective actions in response to examiner recommendations. In particular, the BOD did not ensure that proper controls were in place, including those related to concentrations, loan underwriting, and credit administration, to properly manage the rapid increase in the loan portfolio. Additionally, SPB did not adequately address recommendations in FDIC and DFI ROEs related to diversification of the bank's loan portfolio, inadequate monitoring of real estate lending, and liquidity management. Further, examiners criticized management's market analysis and monitoring processes, especially considering that the institution did not take sufficient action to address the problems related to the residential real estate market in 2007.

Asset Quality. SPB's ADC loans, as a percent of its loan portfolio, were significantly above peer group averages from 2004 through 2008. Additionally, these and other CRE and commercial loans were primarily concentrated in one area of Southern California. SPB had weak loan portfolio management and underwriting controls and did not follow sound credit administration practices, including those related to loan risk ratings and nonaccrual loans and monitoring of real estate lending and unsecured loans. As asset quality declined, SPB did not maintain a sufficient allowance for loan and lease losses (ALLL), and significant losses reduced earnings and depleted capital.

Liquidity. SPB became dependent on higher-cost and more volatile wholesale funding sources, such as Internet certificates of deposit (CD), Federal Home Loan Bank (FHLB) advances, and money desk deposits to fund asset growth. Liquidity levels declined because management did not adequately monitor and control liquidity ratios or implement an adequate contingency liquidity plan. Specifically, management failed to reduce its dependence on non-core deposits in a timely manner.

Supervision. The FDIC and DFI conducted regularly scheduled examinations of SPB from 1985 until its closing in 2008. In 2006, the FDIC reported concerns about SPB's rapid CRE/ADC loan growth through a heavy reliance on wholesale funding sources. By September 2007, the overall condition of the bank had deteriorated to unsatisfactory, and the bank's component and composite ratings were downgraded to 4. At that time, the FDIC did not issue a PCA Directive to SPB because the bank was still considered well capitalized. However, in April 2008, the FDIC and DFI jointly issued a C&D which, among other things, addressed the need for more prudent diversification in the bank's loan portfolio and implementation of a capital maintenance plan. A joint FDIC/DFI examination began in August 2008, but the ROE had not yet been issued in final form when SPB was closed on November 7, 2008.

The 2006 ROE downgraded liquidity due to the level of non-core deposits but did not make recommendations regarding the risks of the bank's high CRE/ADC concentrations that ultimately led to SPB's failure. The 2006 ROE highlighted SPB's rapid asset growth and high-risk CRE/ADC concentrations, but the asset quality rating was not downgraded due to the bank's proactive monitoring of its CRE/ADC portfolio and lack of non-performing loans. Once the bank's financial condition had deteriorated in 2007, timely supervisory action was not taken commensurate with the risks these concentrations and loan underwriting and credit administration weaknesses posed to the institution. In particular, the 2007 examination results were submitted to DSC's San Francisco Regional Office (SFRO) in November 2007; however, enforcement action to address the bank's significant weaknesses was not implemented until about 5 months later. Greater supervisory concern and more timely supervisory action were warranted in light of such weaknesses.

MANAGEMENT

SPB's Board of Directors (BOD) did not ensure that bank management identified, measured, monitored, and controlled the risk of the institution's activities or implemented timely corrective actions in response to examiner recommendations. Examinations from 2004 to 2006 resulted in a 2 (satisfactory) rating for SPB's management. The 2007 examination significantly downgraded SPB's management to a 4 (unsatisfactory) rating, indicating deficient BOD and management performance, inadequate risk management practices, and excessive risk exposure. SPB's concentration in real estate construction resulted in significant losses and risks to the bank that depleted earnings and negatively impacted capital. The 2007 ROE made a number of recommendations to improve loan quality and to address the increased risks inherent in the loan portfolio. Although bank management started decreasing the bank's concentrations in construction lending at the end of 2006, the loan portfolio had significantly deteriorated by the September 2007 examination, and by the 2008 examination, the bank's problems resulted in a 5 rating, requiring immediate action by the BOD and management to preserve the safety and soundness of the institution, and immediate financial assistance was needed to recapitalize the institution in order for the institution to survive. However, SPB management was unable to raise additional capital to meet liquidity requirements, resulting in the bank's failure prior to issuance of the 2008 ROE.

Examiner Concerns and Recommendations Regarding Management

Examiner concerns with the SPB's high concentration in ADC lending were noted in each ROE for the 2004 through 2008 examinations. Until the September 2007 ROE, the ROEs indicated that although the bank had a significant CRE concentration, BOD oversight and management monitoring of the concentrations were adequate. Beginning with the July 2006 examination, examiners also expressed concern regarding the use of a money desk to fund rapid growth, particularly growth in high-yield ADC loans.

SPB's annual net loan growth rate was 115 percent, 55 percent, and 73 percent in 2003, 2004, and 2005, respectively. During that period, however, SPB had no adversely classified assets. SPB's BOD and management began an effort to diversify the loan portfolio by emphasizing commercial and industrial loan growth in 2006 and 2007. As the residential real estate market began to decline rapidly in 2007, SPB's concentration in ADC loans quickly deteriorated and impaired the financial condition of the institution. Although examiners expressed concerns regarding SPB's loan concentrations, examiners did not report credit administration practices as weak until the 2007 ROE. A summary of examiner comments and recommendations regarding SPB's management follows in Table 2.

Table 2: Examiner Comments Regarding SPB's BOD and Management Performance

Examiner Comments	Examination Dates				
	Aug 2004	June 2005	July 2006	Sept 2007	Aug 2008
Overall conclusion on BOD and management performance					
• Satisfactory	✓	✓	✓		
• Ineffective supervision of bank operations				✓	✓
Compliance with laws and regulations					
• Apparent violations related to affiliate, Bank Secrecy Act, or other activities		✓			✓
• Apparent violations related to loan underwriting and/or credit administration			✓	✓	✓
Bank organization					
• One or more key management positions inadequately staffed		✓		✓	
• Inadequate management succession plan				✓	✓
• Apparent inadequate staffing of accounting and lending functions				✓	
Growth of operations					
• Loan growth was aggressive, significant, or faster than anticipated	✓	✓	✓		
• Loan growth supported by wholesale liquidity sources	✓		✓		
• Loan portfolio was focused on CRE/ADC high-risk lending	✓	✓	✓	✓	✓
Policy and procedures					
• Interest rate risk program is not independently reviewed				✓	✓
• Report of Condition and Income (Call Report) was inaccurate		✓		✓	✓
• External loan review program needs improvement				✓	✓
• Loan portfolio administration procedures require improvement related to watch list criteria and portfolio stress testing			✓	✓	✓
Risk management					
• Credit administration and risk identification practices were weak				✓	✓
• Internal audit practices and/or related risk assessment process need improvement	✓			✓	✓
• Inadequate attention to, and implementation of, examiner recommendations					✓
• Inadequate strategic plan				✓	
• BOD reports for interest rate risk need improvement				✓	✓
• BOD reports for liquidity are inadequate and inaccurate				✓	
Examiner recommendations					
• Review and/or improve policies and procedures to ensure compliance with laws and regulations	✓	✓	✓	✓	✓
• Perform a review of staffing levels				✓	
• Improve credit administration procedures			✓	✓	✓
• Develop written management succession plan				✓	
• Obtain an independent review of the interest rate risk program				✓	✓
• File an amended Call Report		✓		✓	✓
• Improve the external loan review program				✓	✓
• Improve audit practices and/or related risk management activities	✓			✓	✓
• Develop and accept a revised strategic plan				✓	
• Establish reasonable policy guidelines and limits for interest rate risk				✓	

Source: FDIC and DFI ROEs for SPB.

Risk Management

SPB's management did not ensure that adequate risk management controls were implemented and followed and did not act in a timely manner to address the high-risk lending practices identified by examiners related to the bank's highly concentrated ADC lending. SPB management fostered a culture of high-risk tolerance and rapid growth financed with wholesale funding which affected the overall safety and soundness of the institution.

Financial institutions with high CRE loan concentrations require strong risk management practices. Beginning in 2003, SPB began rapidly acquiring and originating CRE/ADC loans concentrated in the Inland Empire and Greater Los Angeles areas of Southern California. However, as noted below, SPB did not follow sound risk management practices, including those related to monitoring, diversification, and portfolio stress testing:

- the 2005 ROE advised management that to be more effective in monitoring concentrations, the bank should further stratify the portfolio by geographic area; and

- the 2006 ROE noted that there were no real estate construction loans on SPB's watch list and that the procedure for portfolio stress testing appeared inaccurate and misleading.

By the June 2007 examination, SPB had approximately $67.7 million in adversely classified assets due to the decline in the real estate market in the bank's concentrated lending area. In September 2008, examiners determined that management and the BOD had not demonstrated the ability to correct problems and implement appropriate risk management practices and that problems and significant risks were inadequately identified, measured, monitored, or controlled, threatening the continued viability of the institution. We consider inadequate risk management controls and the lack of management action to address control deficiencies to be significant concerns, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Management

According to DSC's *Risk Management Manual of Examination Policies* (Examination Manual), the quality of management is probably the single most important element in the successful operation of a bank. The BOD is responsible for formulating sound policies and objectives for the bank, effective supervision of its affairs, and promotion of its welfare, while the primary responsibility of senior management is implementing the BOD's policies and objectives in the bank's day-to-day operations. Also according to the manual, the capability and performance of management and the BOD is rated based upon, but not limited to, an assessment of compliance with laws and regulations.

Prior to the 2007 examination report, SPB's management had been favorably rated since 2004. The 2004 through 2006 ROEs included examiner concerns related to the high level of CRE concentrations; however, management was found to be proactive in monitoring the construction and real estate markets, and other credit administration practices were found to be generally satisfactory. In addition to the concerns expressed about the use of volatile funding sources and high CRE concentrations, the 2006 ROE brought three other issues to management's attention. First, the ROE criticized SPB's loan-to-value calculation in underwriting one loan. Examiners recommended that management review the loan-to-value calculations for SPB's entire portfolio to determine if there were other exceptions, and if so, report them to the BOD; management agreed to do such a review. Second, the ROE noted that no real estate construction loans were on the bank's internal watch list and identified one loan relationship that deserved management's attention because of a number of concerns related to the loan. Third, the ROE advised management that the procedure for portfolio stress testing related to residential real estate appeared to be inaccurate and misleading. Because of the concern over the high CRE/ADC concentrations, FDIC examiners told us that they heightened their off-site monitoring of SPB after the 2006 examination. During its off-site monitoring, DSC observed a decline in SPB's financial condition in early 2007; therefore, DSC participated in the DFI examination scheduled for September 2007.

The September 2007 FDIC/DFI joint examination of SPB showed that the ADC loan portfolio was concentrated in the Inland Empire and Greater Los Angeles areas of Southern California, which had been negatively impacted by a weak housing market and rising foreclosure levels. Adversely classified assets increased to 93 percent of SPB's capital and reserves. The examiners downgraded each of SPB's component ratings and the risk management composite rating to 4. In addition, the FDIC and DFI jointly issued a C&D on April 22, 2008, requiring the bank, among other things, to reduce adversely classified assets and delinquent loans, implement more effective lending and collection policies, and develop a strategic plan. Most notably, the C&D contained a provision that addressed the need for more prudent diversification in the bank's loan portfolio.

A joint FDIC/DFI examination commenced on August 18, 2008; however, the bank was closed prior to issuance of the ROE. During this examination, examiners found that the performance of SPB's BOD and management was critically deficient and that risk management practices were unacceptable. Problems and significant risks were inadequately identified, measured, monitored, and controlled, and management had not made progress in complying with the C&D. Consequently, the examiners concluded that the bank's composite and all component ratings should be downgraded to 5 (critically deficient).

In examinations prior to 2007, examiners expressed concern regarding SPB's adoption of higher-risk lending policies, loan portfolio administration weaknesses, and high non-core funding but did not make recommendations for management to reduce its high level of CRE/ADC concentrations or dependence on volatile funding sources to fund SPB's rapid growth in CRE/ADC lending. Greater supervisory concern was needed prior to the decline in the Southern California real estate market to encourage SPB to diversify its loan portfolio in order to reduce the effect the significant market decline had on SPB's asset quality. Once the economic downturn affected SPB's financial condition, examiners significantly downgraded the institution at the September 2007 examination. The exit meeting with SPB senior management was held on October 29, 2007, and the examination report was submitted to the SFRO on November 14, 2007; however, FDIC and DFI officials did not meet with SPB's BOD until January 23, 2008 to present the ROE. Furthermore, the FDIC and DFI did not issue the C&D until April 22, 2008.

SFRO officials explained that this delay occurred because of scheduling conflicts in arranging the BOD meeting between FDIC, DFI, and SPB management. Nevertheless, SFRO officials were communicating with SPB management on a consistent basis during that period to work on the elements of a corrective action plan based on the 2007 examination. SFRO officials further stated that due to their concern about the timeliness of enforcement actions, the SFRO had established an operational goal for 2009 that enforcement actions would be presented to the BOD within 30 days of examination completion.

ASSET QUALITY

SPB's asset quality received a 2 (satisfactory) rating from the 2004 through 2006 examinations. The 2007 examination downgraded asset quality to 4, indicating that the bank's level of risk and problem assets were significant and inadequately controlled, subjecting the bank to potential losses that threatened the viability of the institution. At the August 2008 examination, examiners gave asset quality a 5 rating, indicating that SPB's asset quality was critically deficient and presented an imminent threat to the institution's viability.

Corresponding increases in SPB's adversely classified assets and ALLL were also significant (see Table 3). In particular, SPB's asset quality deteriorated as asset classifications significantly increased from $11,000 in 2004 to over $132.5 million (about 27 percent of the total loan portfolio) as of August 31, 2008. At the August 2004 examination, the adversely classified items were 0.04 percent of Tier 1 Capital plus the ALLL. By the August 2008 examination, this amount rose to 198.72 percent of Tier 1 Capital plus the ALLL.

Table 3: SPB's Asset Classifications and ALLL

	Asset Quality (Dollars in Thousands)					
	Asset Classifications				**Analysis of ALLL**	
Examination Date	**Substandard**	**Doubtful**	**Loss**	**Total Adversely Classified Items**	**ALLL Computed by SPB**	**Increase in ALLL Required by Examiners**
Aug 04	$0	$0	$11	$11	$2,367	$0
June 05	$0	$0	$0	$0	$3,224	$0
July 06	$0	$0	$0	$0	$4,928	$0
Sept 07	$48,660	$17,256	$1,829	$67,745	$6,670	$13,409
Aug 08	$113,865	$0	$18,640	$132,505	$29,019	$23,325

Source: FDIC and DFI ROEs for SPB.

Examiner Concerns and Recommendations Regarding Asset Quality

Examiner concerns regarding SPB's asset quality related to its concentration in high-risk CRE/ADC loans (see Table 4). As stated earlier in this report, a significant portion of the CRE/ADC loan portfolio was concentrated in Southern California, which had a weak housing market and rising foreclosure levels. Examiner concerns and recommendations in the 2007 examination addressed credit monitoring, ongoing market analysis, the ALLL methodology, and internal risk rating processes. A summary of such comments and recommendations regarding SPB's asset quality follows in Table 4.

Table 4: Examiner Comments and Recommendations Regarding SPB's Asset Quality

Examiner Comments	Examination Dates				
	Aug 2004	June 2005	July 2006	Sept 2007	Aug 2008
Overall conclusion on asset quality					
• Satisfactory	✓	✓	✓		
• Less than satisfactory				✓	✓
CRE and ADC loan concentrations					
• Concentration developing or already developed	✓	✓	✓	✓	✓
• Management is adequately monitoring concentrations	✓	✓	✓		
• Monitoring of concentrations, including ongoing market analysis, is inadequate				✓	✓
• Risk and/or impact of a declining economic environment noted	✓	✓	✓	✓	✓
Adverse classifications					
• Noticeable loan quality deterioration/increase in adverse classifications				✓	✓
Assessment of asset management practices					
• ALLL not adequately funded				✓	✓
• ALLL methodology needs improvement		✓		✓	
• Credit administration procedures need improvement		✓	✓	✓	✓
• Loan underwriting weaknesses noted			✓	✓	✓
• Internal loan risk rating needs improvement			✓	✓	✓
Examiner recommendations					
• Monitor risk in the CRE and ADC loan concentrations, including stratification by geographic market		✓		✓	✓
• Adequately fund the ALLL				✓	✓
• Improve the ALLL methodology		✓		✓	
• Improve loan underwriting and/or credit administration procedures		✓	✓	✓	✓
• Improve the internal loan risk rating system			✓	✓	✓

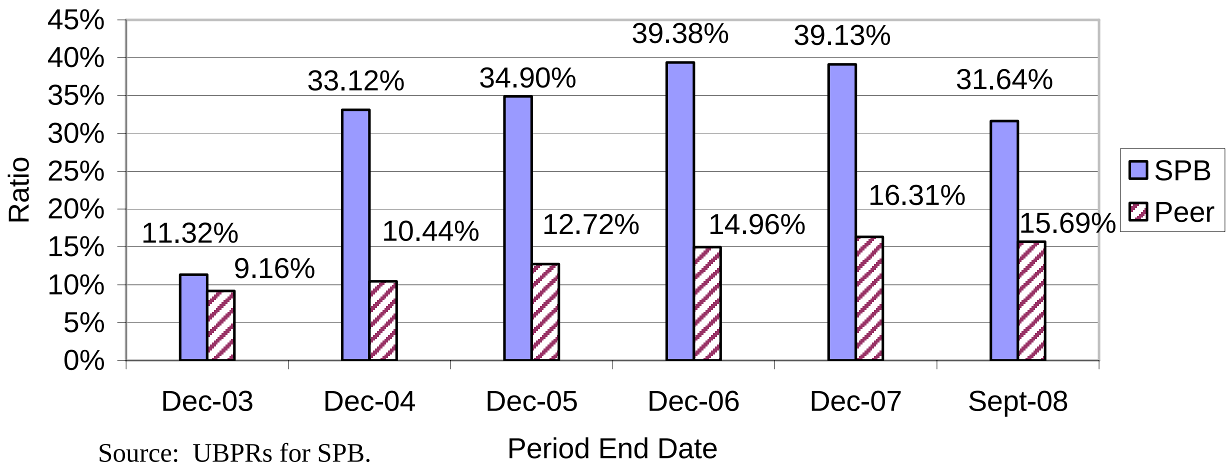
Source: FDIC and DFI ROEs for SPB.

Concentrations in CRE and ADC Loans

Beginning in 2003, SPB's BOD made a strategic decision to pursue aggressive loan growth focused primarily on residential ADC loans. For 2003, 2004, and 2005, SPB reported loan growth of 115 percent, 55 percent, and 73 percent, respectively. ADC loans reached 303 percent of total capital at year end 2005. Figure 2, which follows, shows that by year-end 2004, SPB's

ADC loan portfolio, as a percentage of average loans, was significantly above the bank's peer group average.

Figure 2: ADC Loans as a Percentage of Average Loans-Compared to Peer



Source: UBPRs for SPB.

In late 2006, SPB's asset quality began to decline as its loan portfolio, which was highly concentrated in ADC loans, began to deteriorate. SPB then made efforts to diversify the loan portfolio in 2006 and 2007. However, the decline in the California real estate market was worsening, and the bank's ADC loan portfolio rapidly deteriorated as reflected by the increasing level of the ALLL.

Interagency guidance on CRE lending entitled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 12, 2006, acknowledges that a concentration in CRE loans, coupled with weak loan underwriting and depressed CRE markets, had contributed to significant loan losses.[5]

Examiners did not express concern about SPB's loan underwriting practices until the 2006 examination but had expressed concern regarding aggressive growth and high concentrations in CRE lending since the 2004 ROE. SPB did not follow sound risk management practices to properly risk rate the loan portfolio in a timely manner. Once asset quality began to decline, SPB's ability to adequately monitor its declining loan portfolio was impaired due to the rapid deterioration of the real estate market. The 2007 examination found that several loans had well-defined weaknesses yet were internally rated as "pass." Further, examiners considered the external loan review conducted twice a year at the bank as only marginally adequate. Examiners recommended several actions to mitigate the bank's CRE risk, but bank management failed to

[5] The FDIC also issued Financial Institution Letter (FIL) 22-2008 on March 17, 2008, entitled, *Managing Commercial Real Estate Concentrations In a Challenging Environment*, which re-emphasized the importance of strong capital and ALLL and loan risk management practices for state nonmember institutions with significant CRE and construction and development loan concentrations.

implement actions to adequately address the recommendations, and asset quality continued to decline. As shown previously in Table 3, examiners identified an increasing level of adverse classifications at the September 2007 and August 2008 examinations. During the 2008 examination, examiners determined that SPB had failed to take action to implement adequate monitoring and a control infrastructure regarding CRE concentrations. As asset quality declined and losses were recognized, SPB's liquidity position became critical, and earnings and capital were eroded. We consider loan concentrations without adequate risk management controls to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Allowance for Loan and Lease Losses

In both the 2005 and 2007 examinations, examiners noted problems with the ALLL methodology. For example, the 2005 examination stated that the methodology was overly complex and recommended that it be simplified. The 2006 examination found that the ALLL methodology had been revised and was satisfactory. In 2007, examiners reported that the ALLL methodology was unacceptable because management used inaccurate information in its June 30, 2007 analysis and noted that the bank did not comply with interagency policy, in part, because the process needed to be based on a comprehensive, well-documented analysis of the portfolio. According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (FIL-105-2006), dated December 13, 2006, each institution must analyze the collectibility of its loans and maintain an ALLL at a level that is appropriate and determined to be in accordance with Generally Accepted Accounting Principles (GAAP).[6] An appropriate ALLL covers estimated loan losses on individually evaluated loans that are determined to be impaired as well as estimated loan losses inherent in the remainder of the loan and lease portfolio.

The 2007 ROE reported that SPB's ALLL was deficient by approximately $13 million. Further, during the 2008 examination, examiners determined that the ALLL was underfunded by $23 million, primarily due to significant downgrades in credit quality during the 2008 examination, and that there were deficiencies in the bank's calculation of the ALLL.

As SPB's assets deteriorated and the need to substantially increase the ALLL became apparent, earnings were significantly impacted (see Table 5, which follows). SPB's earnings were overstated based on the ALLL being underfunded. The need to increase the ALLL ultimately led to the erosion of earnings.

[6] The FIL reiterates key concepts and requirements, pertaining to the ALLL, included in GAAP and existing supervisory guidance. In addition, the policy describes the nature and purpose of the ALLL; the responsibilities of BODs, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound loan grading system.

Table 5: SPB Net Income (Loss) and ALLL (Dollars in Thousands)

	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Sept 2008
Net Income	$4,986	$10,360	$17,720	$(1,236)	$(73,585)
ALLL	$2,476	$4,254	$6,644	$11,296	$21,492

Source: UBPRs for SPB.

Regulatory Supervision Related to Asset Quality

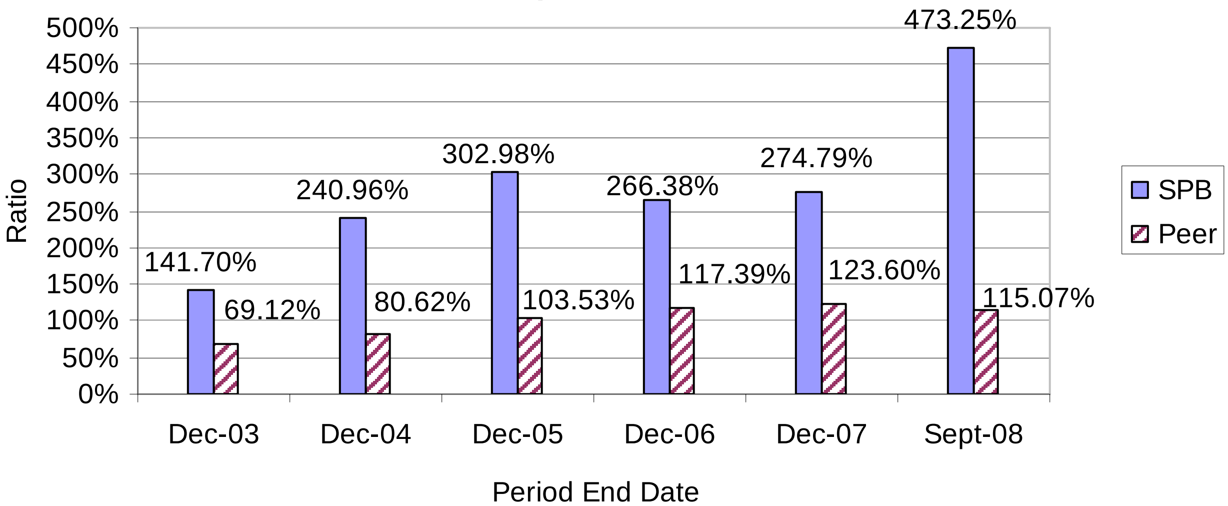
According to the December 2006 interagency guidance, CRE lending, in general, and construction lending, in particular, may require a greater level of supervisory oversight. Specifically, the guidance states that an institution may be identified for further supervisory analysis of the level and nature of risk if it has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria:

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

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

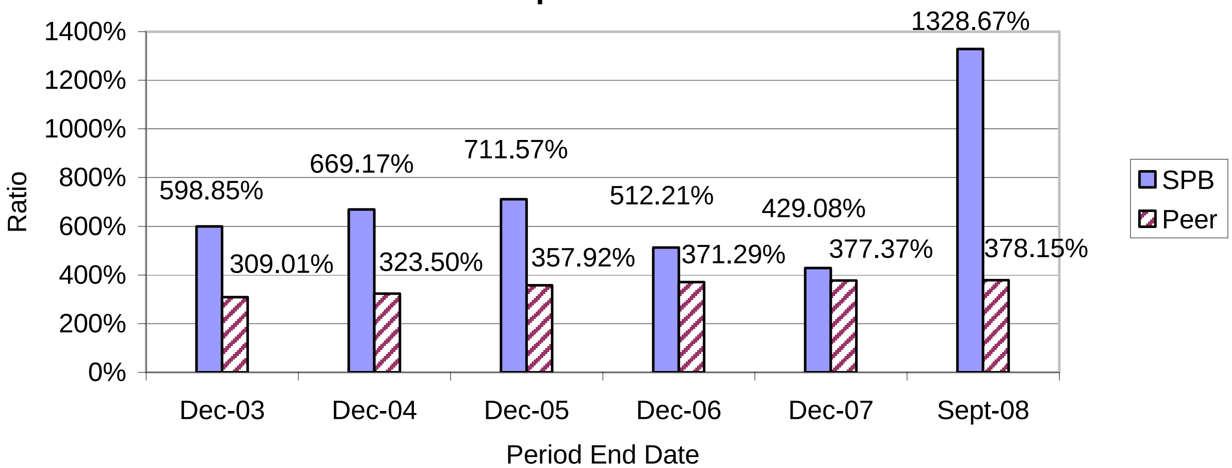
As noted in Figures 3 and 4, which follow, from 2003 to 2008, SPB's CRE and ADC loans, as a percentage of total capital, far exceeded the capital criteria thresholds for additional supervisory oversight.

Figure 3: ADC Loans as a Percentage of Total Capital - Compared to Peer



Source: UPBRs for SPB.

Figure 4: CRE Loans as a Percentage of Total Capital - Compared to Peer



Source: UBPRs for SPB.

In addition, SPB's ADC and CRE loans, as a percentage of total risk-based capital, were historically higher than the bank's peer group average. The ROE for SPB's 2004 examination assigned a 2 rating to asset quality, yet highlighted the bank's rapid growth and concentration in residential ADC lending and the additional risk that this type of lending entailed. The ROE recommended that management closely monitor the residential real estate market. The 2005 ROE also assigned a 2 rating to asset quality, noting a continued significant growth in CRE lending but no loan classifications. The 2006 ROE stated that there were no criticisms in the way management deals with the bank's concentrations in CRE loans but that concentrations in CRE loans and the increased risks these loans present warranted attention. Examiners downgraded SPB's asset quality in the 2007 examination after noting significant loan classifications.

Examiners told us that they initially planned to downgrade SPB's asset quality rating during the 2006 examination due to the high concentrations in CRE/ADC loans and that they had advised SPB's senior management that a preliminary 3 asset quality rating was being assigned. Examiners stated that SPB management strongly disagreed that a downgrade was appropriate because the bank had no loan classifications and management was adequately monitoring SPB's loan concentrations. According to DSC officials, examiners ultimately determined that the UFIRS component rating definitions did not support a downgrade in SPB's asset quality rating based solely on the high CRE/ADC loan concentrations because (1) management was proactive in monitoring the concentrations and (2) the bank had no adversely classified assets. After the 2006 examination, DSC expanded its off-site monitoring of SPB and planned a joint examination of SPB with DFI for September 2007.

The 2007 joint examination downgraded SPB's asset quality to 4; however, after the exit conference with SPB management on October 29, 2007, the FDIC and DFI did not present the ROE to SPB's BOD until January 2008. The ROE indicated that asset quality as of July 31, 2007 had deteriorated and was unsatisfactory due to the significant level and severity of classifications, the increasing high level of risk in the loan portfolio, and credit administration concerns. These credit administration concerns related to (1) the bank's inability to adequately rate the risk of its portfolio in a timely manner, (2) inadequate monitoring of real estate and unsecured loans, and (3) failure to obtain current financial statements from borrowers. After the BOD received examination results on January 23, 2008, SPB stipulated to a joint FDIC/DFI C&D on April 22, 2008.

Concentrations of Credit. At the 2004 through 2006 examinations, examiners indicated that management practices related to asset concentrations were satisfactory but expressed concern regarding the rapid growth in CRE/ADC loan concentrations. In particular, the 2006 ROE referred to FIL-4-2006, *Proposed Interagency Guidance on Commercial Real Estate*, and observed that SPB's concentrations far exceeded those levels requiring heightened risk management practices as prescribed by the FIL. Although the concentration in CRE loans was high and warranted attention, examiners indicated that management was proactive in monitoring the concentration and the real estate market. Yet 1 year later at the 2007 examination, examiners criticized concentration-related procedures, stating, "loans are not adequately being managed, the risk identification process needs improvement, and loans are not being placed on nonaccrual in accordance with policy." The 2008 examination determined that management and the BOD had failed to institute adequate risk management practices and policies relative to the size, nature, and scope of concentrations in CRE/ADC loans. Specifically, management and the BOD had allowed concentrations in these areas to persist at significant levels without implementing appropriate information systems and compensating controls. As a result, SPB's vulnerabilities had been exposed with the deterioration in the real estate market.

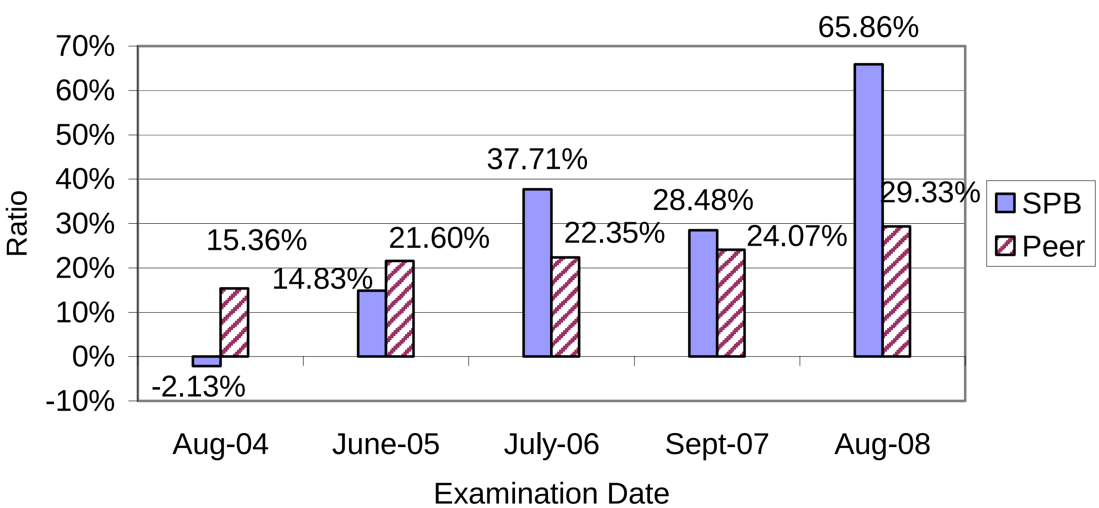
The 2006 examination report cautioned SPB's management regarding the bank's rapid asset growth and high concentrations that ultimately led to SPB's failure; however, the asset quality rating was not downgraded because management was viewed as being pro-active in monitoring its high concentrations, and the bank had no adversely classified assets at that time. However, once the bank's financial condition had deteriorated in 2007, the examiners significantly downgraded SPB's asset quality rating. Examiners needed to be more aggressive in their recommendations and ratings regarding asset quality based on the risks they identified prior to the 2007 examination rather than delay these actions until an economic decline became evident. More timely supervisory action related to SPB's high level of concentrations, which far exceeded those of peer institutions, was needed prior to the economic downturn to limit the high-risk lending practices that the bank was employing.

LIQUIDITY

Examiners for the 2004 and 2005 risk management examinations assigned a 2 rating to liquidity. SPB's liquidity rating was downgraded to a 3 with the 2006 examination due to the bank's heavy reliance on volatile non-core funding sources to fund asset growth. Liquidity was further downgraded to a 4 at the 2007 FDIC examination because bank management did not adequately monitor and control liquidity. By the 2008 examination, liquidity had been downgraded to a 5, indicating that SPB's liquidity levels or funds management practices were so critically deficient that the bank's continued viability was threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

A key metric of the risks related to a bank's liquidity management is the net non-core funding dependence ratio. This ratio indicates the degree to which the bank relies on non-core volatile liabilities, such as CDs of more than $100,000; brokered deposits; and FHLB advances to fund long-term earning assets. Generally, the lower the ratio, the less risk exposure there is for the bank, whereas higher ratios reflect a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. As noted in Figure 5 below, SPB's reliance on non-core/volatile liabilities exceeded its peer group average during the bank's last three examinations, with the variance soaring as of the 2008 examination. This pattern was attributable to the bank's heavy reliance on the use of volatile Internet CDs, brokered deposits, and money desk deposits to provide liquidity.

Figure 5: Net Non-Core Funding Dependence Ratio - Compared to Peer



Source: OIG review of ROEs for SPB.

The 2004 ROE indicated that Internet CD growth during 2004 was used to fund growth in the bank's construction loan portfolio. At the time, liquid assets, which were primarily federal funds sold, exceeded deposits over $100,000, and the net non-core funding dependence ratio at the time of the 2004 examination was negative. The 2005 ROE noted that the reported net non-core dependence ratio of 15 percent (rounded) did not reflect the risk of volatile Internet-based deposits under $100,000. The 2006 ROE emphasized the bank's use of a money desk and brokered deposits to fund rapid growth in real estate construction loans and discussed the risks of these higher-cost deposit products. In 2007, although the reported net non-core dependence ratio was lower than the 2006 ratio, reflecting a decrease in balances of $100,000 or more, the ROE noted that if money desk and brokered deposits under $100,000 were considered, volatile liability dependence would be "an extremely high 48 percent." During the August 2008 examination, examiners noted that the bank continued to use wholesale funding extensively, with volatile non-core deposits comprising $367 million, or 71 percent of total deposits.

Examiner Concerns and Recommendations Regarding Liquidity

Both the 2004 and 2005 ROEs emphasized that management relied heavily on time deposits obtained through the Internet, representing 51 percent of total deposits by the 2005 examination. Liquidity levels at the time were considered adequate; therefore, the 2004 and 2005 ROEs rated SPB's liquidity as satisfactory.

The 2006 examination was the first examination to reflect that the bank's funds management practices had become inadequate. The 2006 ROE noted that the heavy use of volatile deposits to fund rapid growth in real estate construction loans was "a business model that entails higher risk" and that this funding strategy was dependent on continued favorable economic conditions. The results of the 2007 examination showed that management and the BOD did not effectively respond to examiner criticism of liquidity in the 2006 ROE.

The 2007 ROE noted that it was unclear how management was monitoring and controlling liquidity and that since the departure of the Chief Financial Officer in 2007, money desk deposit and construction loan activity no longer appeared to be correlated. In addition, the ROE raised concerns that six large depositors accounted for 15 percent of deposits, yet management had not performed an analysis to determine the stability of these deposits. The ROE noted that negative earnings might erode large depositor confidence, leaving the bank potentially exposed to deposit fluctuations. The ROE recommended that management reduce reliance on high-cost money desk and brokered deposits and evaluate the stability of other high-rate savings deposits. Finally, the ROE criticized bank management for not adequately monitoring liquidity ratios and reflecting those ratios in reports to the BOD, resulting in the bank operating outside of approved liquidity policy guidelines. FDIC examiners recommended that management and the BOD develop a contingency liquidity plan (CLP) and incorporate it into the bank's liquidity policy to define reasonable policy limits and the steps to be taken when those limits were exceeded.

The results of the 2008 examination indicated that SPB remained ineffective at addressing liquidity concerns. Examiners noted that the bank continued to operate outside of liquidity policy guidelines. In addition, the bank had added some general statements about liquidity contingency planning to its liquidity policy, but examiners concluded that more specific guidance was still needed.

A summary of examiner comments and recommendations related to liquidity follows in Table 6.

Table 6: Examiner Comments and Recommendations Regarding SPB's Liquidity

Examiner Comments	Examination Dates				
	Aug 2004	**June 2005**	**July 2006**	**Sept 2007**	**Aug 2008**
Overall conclusion on liquidity					
• Satisfactory	✓	✓			
• Less than satisfactory			✓	✓	✓
Assessment of liquidity management practices					
• Funds management practices are adequate	✓	✓			
• Funds management practices are inadequate			✓	✓	✓
• Contingency liquidity plan guidance is inadequate				✓	✓
• Increased oversight needed for volatile funding sources				✓	
• No analysis of large deposit stability				✓	
• Operating outside the parameters established in liquidity policy and/or no guidelines established				✓	✓
Funding source risks					
• Reliance on potentially volatile non-core funding sources, such as Internet CDs, brokered deposits, and money desk deposits	✓	✓	✓	✓	✓
• Funding strategy is high cost, high risk			✓	✓	✓
• Several customers control a large volume of deposits	✓			✓	✓
• Declining economic and/or financial condition could impair access to liquidity			✓	✓	✓
Examiner recommendations					
• Evaluate reasonable policy guidelines and limits for liquidity				✓	✓
• Develop plans to reduce reliance on high-cost money desk and brokered deposits				✓	✓
• Closely monitor and maintain liquidity levels				✓	✓
• Develop a detailed contingency liquidity plan and incorporate it into the liquidity policy				✓	✓
• Analyze the stability of the bank's largest depositors				✓	

Source: FDIC and DFI ROEs for SPB.

Lack of an Adequate CLP. SPB did not implement sound liquidity management controls that included a comprehensive CLP. As a result, when SPB's liquidity position became severely critical in 2008, bank management was ineffective in obtaining sufficient liquidity for the institution.

According to the Examination Manual, CLPs should be in force and include strategies for handling liquidity crises and procedures for addressing cash-flow shortfalls in emergency situations. The manual also states that financial institutions should have an adequate CLP in place to manage and monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources.

By the 2007 examination, SPB demonstrated an increasing reliance on volatile funding sources, a decline in earnings performance and projections, and a significant decline in asset quality—three early warning indicators that should have prompted SPB of the need for a comprehensive CLP. In response to a recommendation in the 2007 ROE, bank management updated the bank's liquidity policy to include a general discussion of contingency planning. However, examiners concluded that the guidance was not specific enough to be effective, considering the bank's drastically diminishing liquidity.

Shortly before SPB's failure, DSC issued additional guidance related to liquidity risk and CLPs. The FDIC's *Liquidity Risk Management* guidance, dated August 26, 2008, urged financial institutions to establish a formal CLP that establishes quantitative liquidity risk guidelines. The guidance also states that CLPs should identify the institution's liquidity risk profile and the types of stress events that may be faced including, but not limited to, a deterioration in asset quality, becoming less than well capitalized, the need to fund unplanned asset growth, loss of access to market funding sources, and the impact of negative press coverage. We consider the lack of an adequate CLP be a significant concern, which we will address in our summary reports covering multiple bank failures.

Brokered Deposit Restrictions. The 2006 ROE identified examiner concern with SPB's reliance on money desk and brokered deposits as a primary source of liquidity to fund the rapid growth of the bank's real estate construction portfolio. The ROE noted that this strategy caused the bank's cost of funds to exceed its peer group average and that it could create liquidity risks for the bank under adverse economic conditions. The 2007 ROE advised management that the bank's declining financial condition might result in limitations on the availability of brokered and other high-rate deposits.

The FDIC's Rules and Regulations, section 337.6, *Brokered Deposits*, restricts access to brokered deposits for banks that are less than well capitalized, stating that an adequately capitalized institution may not accept, renew, or roll over any brokered deposit unless the bank had applied for and had been granted a waiver of this restriction by the FDIC. The PCA-related provisions in Part 325[7] of the FDIC's Rules and Regulations indicate that a bank may be categorized as less than well capitalized if it is subject to a C&D issued by the FDIC. As a result of the jointly issued C&D, SPB was categorized as adequately capitalized, and its access to new or rollover brokered deposits was restricted on April 22, 2008, the effective date of the C&D.

Bank management initially submitted a brokered deposit waiver application on May 2, 2008, but it was returned by the FDIC as inadequate on July 9, 2008. On July 15, 2008, the bank submitted a new application, and on July 31, 2008, the FDIC approved a waiver for $25 million in brokered deposits through August 31, 2008. The bank subsequently obtained $18.4 million in brokered deposits with maturities of 6 and 9 months. On August 4, 2008, the bank attempted to expand the scope of the waiver, but the FDIC rejected the request because the bank had not been effective in resolving its capital and liquidity problems or in reducing its dependence on brokered deposits. From the end of June 2008 until the bank failed on November 7, 2008, the bank experienced a steady decline of $89 million in total deposits, primarily as a result of maturing CDs that the bank only partially replaced by using brokered deposits. On August 28, 2008, the bank requested an extension of its brokered deposit waiver beyond August 31, but the FDIC did

[7] Subpart B, *Prompt Corrective Action*, section 325.103(b) - *Capital categories* - notes that a bank shall be deemed to be well capitalized if it maintains certain minimum capital ratios and is not subject to any written agreement, order, capital directive, or PCA Directive issued by the FDIC pursuant to section 8 of the FDI Act, the International Lending Supervision Act of 1983, or section 38 of the FDI Act, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

not approve this request. Once the bank's brokered deposit waiver expired, additional sources of funding available to the bank were inadequate to address the bank's liquidity needs. We consider the overreliance on brokered deposits to be a significant concern, which we will address in our summary reports covering multiple bank failures.

Regulatory Supervision Related to Liquidity

Although the 2006 ROE rated SPB's liquidity less than satisfactory and identified the risks inherent in the bank's reliance on a money desk to generate deposits, the ROE did not contain specific recommendations for improvement of the bank's liquidity position. At a minimum, the ROE could have recommended that the bank evaluate the adequacy of liquidity-related policy guidelines, with a goal of reducing reliance on volatile deposits. In addition, FDIC guidance notes that informal enforcement actions, such as a Bank Board Resolution, could be targeted to address concerns noted in an area where a liquidity rating of 3 has been assigned. However, we found no evidence that the FDIC had proposed an informal enforcement action as a result of the 2006 examination to encourage management to improve liquidity management practices.

By the 2007 examination, SPB exhibited early warning signs of the need for liquidity contingency planning, and examiners criticized the bank for not having developed an appropriate CLP as part of its liquidity policy. Although the bank had somewhat reduced its reliance on wholesale funding, the ROE noted that dependence on potentially volatile liabilities remained extremely high. In addition, the 2007 ROE indicated that the bank had not established policy guidelines for the loans-to-deposits ratio, which examiners considered to be very high; the 2006 ROE did not identify this policy weakness. The assigned 2007 liquidity rating of 4 merited formal enforcement action by DSC; however, as noted previously, the issuance of the C&D was not timely.

As part of the April 2008 C&D, the FDIC required that the bank take these actions to improve its liquidity management:

- Develop and submit a written 3-year strategic plan that addresses ways to ensure that the bank maintains adequate liquidity, specifically addresses the composition of the deposit portfolio, and includes provisions for increasing the bank's core deposits.
- Develop or revise, adopt, and implement a written liquidity and funds management policy.
- Restrict increases in money desk and brokered deposits.
- Submit a written plan for eliminating its reliance on money desk and brokered deposits.

Subsequent to the C&D, management stopped seeking deposits through an Internet listing service, and liquidity began to shrink as money desk deposits matured. During the 2008 examination, examiners evaluated the bank's progress in addressing recommendations from the 2007 examination and the provisions of the 2008 C&D. Examiners noted that the bank had experienced a 33-percent decrease in brokered and money desk deposits subsequent to the issuance of the C&D; however, as of the 2008 examination date, management continued to depend on wholesale funding, with 59 percent of the deposit base remaining in volatile money desk and brokered deposits.

IMPLEMENTATION OF PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. PCA establishes a system of restrictions and supervisory actions that are triggered by an institution's capital levels. Part 325 of the FDIC's Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured nonmember banks that are less than adequately capitalized.

The FDIC evaluated SPB's capital position and assigned a capital component rating of 2 in the 2006 examination, indicating a satisfactory capital level relative to the bank's risk profile. Subsequently, the 2007 examination downgraded the bank's capital rating to a 4, indicating a deficient level of capital that could threaten the viability of the institution and require the bank to obtain financial support from shareholders or other external sources. As a result, the April 2008 C&D contained several capital-related provisions even though the bank's reported PCA capital ratios had been in the well capitalized range. These provisions included:

- maintaining Tier 1 Capital at, or in excess of, 10 percent of the bank's total assets;
- implementing a capital maintenance and augmentation plan;
- submitting to the FDIC and DFI a written 3-year strategic plan addressing ways to ensure the bank maintains adequate capital; and
- restricting the payment of dividends without prior written consent of the FDIC and DFI.

As noted previously, the issuance of the C&D was not timely, which may have limited its effectiveness. The bank was subsequently categorized as adequately capitalized on April 22, 2008, the effective date of the C&D. On May 6, 2008, the bank filed a Call Report containing capital ratios that further supported the adequately capitalized category.

During the 2008 examination, which started in August and was completed in October 2008, examiners reviewed the bank's compliance with the provisions of the C&D. Examiners determined that although the bank had prepared a revised capital plan, certain planned actions had not materialized, and others were questionable. The bank did not pay any dividends during 2008 and obtained additional capital from the holding company and a stock sale; however, these attempts to increase Tier 1 Capital to the required percentage were not successful. In addition, the bank did not submit a strategic plan as required by the C&D.

Examiners concluded that the bank's capital was critically deficient, downgraded the capital rating to a 5, and categorized the bank as significantly undercapitalized. The FDIC formally notified the bank of this categorization in a PCA Notification letter, dated October 16, 2008. The letter stated that the bank was subject to the mandatory requirements of section 38 of the FDI Act including, but not limited to, submission of a written capital restoration plan and restrictions on asset growth and payments of dividends. Some of these requirements reiterated provisions included in the C&D. On October 17, 2008, DFI informed SPB that DFI may take "extreme action against the bank" unless the bank either merges or sells its business to another depository institution or increases tangible shareholders equity to the greater of $36.8 million, or 10 percent of total bank assets. The bank was unsuccessful and was subsequently closed November 7, 2008.

PCA's focus is on capital, and capital can be a lagging indicator of an institution's financial health. In addition, the use of PCA can depend on the accuracy of capital ratios in a financial institution's Call Reports. SPB's reported capital ratios remained in the well capitalized to adequately capitalized range long after its operations had begun to deteriorate. During the 2007 and 2008 examinations, examiners considered the ALLL to be underfunded by $13,409,000 and $23,325,000, respectively, which overstated capital and earnings and underreported the deterioration of the loan portfolio. In addition, the 2008 examination determined that bank management had incorrectly reported $2.7 million in stock warrants of an unrelated bank holding company as capital in its June 30, 2008 Call Report, overstating SPB's capital position and capital ratios as of that date.

CORPORATION COMMENTS

On May 12, 2009, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 3 of this report. In its response, DSC noted that SPB's primary growth phase occurred between 2003 and 2005, when the Southern California real estate market was expanding rapidly, and the subsequent material decline in real estate values in SPB's market area contributed to the severe deterioration in SPB's asset quality, excessive operating losses, and severe erosion of capital. DSC agreed with the OIG's assessment that SPB failed due to management's pursuit of a high-risk business strategy focused on rapid asset growth concentrated in CRE loans, including ADC loans, which were financed primarily with wholesale funding. Further, DSC acknowledged that implementation of the formal enforcement action in 2008 was delayed, but noted that SPB's BOD and management were provided detailed information regarding supervisory concerns following the 2007 examination. DSC has since adopted strategies aimed at improving the timeliness of enforcement actions in problem bank situations. DSC stated that it continues to proactively adjust its supervisory programs in response to changing and emerging risks to the economy, insured financial institutions, and the DIF.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

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

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

We conducted the audit from November 2008 to April 2009 in accordance with generally accepted government auditing standards. However, due to the limited scope and objectives established for material loss reviews, which are generally applied to just one financial institution, it may not have been feasible to address certain aspects of the standards, as discussed on the next page.

Scope and Methodology

The scope of this audit included an analysis of SPB's operations from January 1, 2004 until its failure on November 7, 2008. 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 reports and available supporting work papers prepared by FDIC and DFI examiners from 2004 to 2008.

- Reviewed the following:

  - Bank data and correspondence maintained at DSC's SFRO and Los Angeles West Field Office.

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

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

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

  - Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in the FDIC's SFRO.

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

  - DRR and contractor personnel at the SPB Receivership Office in Los Angeles, California.

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

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

- Researched various federal banking laws and regulations.

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

Our ability to evaluate the adequacy of DSC's supervisory efforts was limited by the lack of FDIC examination work papers for the 2006 FDIC examination. We were informed that the 2006 examination work papers had been destroyed prior to the commencement of our review, in accordance with FDIC guidelines, and thus were no longer available. Regional Directors Memorandum 01-039, *Guidelines for Examination Workpapers and Discretionary Use of Examination Documentation Modules*, dated September 25, 2001, and the Examination Manual note that, with some exceptions, the retention of work papers beyond one examination for well-rated banks is generally discouraged. We have issued an audit memorandum to the Director, DSC, communicating matters related to workpaper retention.

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

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

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

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

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

GLOSSARY OF TERMS

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) to three categories: • Substandard, • Doubtful, and • Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.
Cease and Desist Order (C&D)	A formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the ROE. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital. Concentrations representing 100 percent or more of Tier 1 Capital should include concentrations by: industry, product line, type of collateral, and short-term obligations of one financial institution or affiliate group.
Money Desk Deposits	Bank activities that involve the solicitation of high-interest-rate deposits by in-house salaried employees. Money desk deposits are considered to be a form of wholesale funding.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three catagories of undercapitalized institutions.
Stock Warrants	A stock warrant is a financial instrument issued by a company that gives the holder the right, but not the obligation, to buy an underlying security of the company at a certain price, quantity, and future time.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.

CORPORATION COMMENTS

FDIC

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

Division of Supervision and Consumer Protection

May 12, 2009

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, *Material Loss Review of Security Pacific Bank, Los Angeles, California* (Assignment No. 2009-008)

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 Security Pacific Bank (SPB), which failed on November 7, 2008. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received April 23, 2009.

We agree with the OIG's assessment that SPB failed due to bank management's pursuit of a high-risk business strategy. This strategy focused on rapid asset growth concentrated in commercial real estate (CRE), including acquisition, development and construction (ADC) loans, which were funded primarily with wholesale funding, including potentially volatile non-core deposits and borrowings. We note that SPB's primary growth phase occurred between 2003 and 2005 when the southern California real estate market also was expanding rapidly. In addition, we note that the subsequent material decline in real estate values in SPB's market area was a key contributing factor to the severe deterioration in SPB's asset quality, excessive operating losses, and severe erosion of capital.

The Draft Report states the OIG found that the FDIC and the California Department of Financial Institutions (CDFI) conducted timely and regular examinations of SPB. The Draft Report notes that examiners provided SPB's Board of Directors and management with early identification of concerns regarding SPB's CRE concentration levels, use of money desk funding, and misleading portfolio stress testing before SPB's financial condition began to deteriorate. We note that examiners heightened off-site monitoring of SPB following the 2006 examination and participated in the 2007 CDFI examination after observing a decline in SPB's condition in early 2007.

The Draft Report details several concerns that examiners identified in the areas of management, asset quality, liquidity, and the allowance for loan and lease losses with which we concur. The OIG concludes that greater supervisory concern and more timely supervisory action were warranted. DSC acknowledges that implementation of the formal enforcement action was delayed, although we note that SPB's Board and management were provided detailed information regarding supervisory concerns following the 2007 examination. Since that time, DSC has adopted strategies aimed at improving the timeliness of enforcement actions in problem bank situations. DSC continues to proactively adjust its supervisory programs in response to changing and emerging risks to the economy, insured financial institutions, and the Deposit Insurance Fund.

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

ACRONYMS IN THE REPORT

Acronym	Definition
ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BOD	Board of Directors
C&D	Cease & Desist Order
CAMELS	**C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk
CD	Certificate of Deposit
CLP	Contingency Liquidity Plan
CRE	Commercial Real Estate
DFI	Department of Financial Institutions
DIF	Deposit Insurance Fund
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
GAAP	Generally Accepted Accounting Principles
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SFRO	San Francisco Regional Office
SPB	Security Pacific Bank
SPCC	Security Pacific Credit Corporation
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System