Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-018

Material Loss Review of Temecula Valley Bank, Temecula, California

February 2010

Office of Inspector General

Executive Summary

Material Loss Review of Temecula Valley Bank, Temecula, California

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Why We Did The Audit

On July 17, 2009, the California Department of Financial Institutions (CDFI) closed the Temecula Valley Bank (TVB) and named the FDIC as receiver. On August 12, 2009, the FDIC notified the Office of Inspector General (OIG) that TVB's total assets at closing were $1.4 billion and the material loss to the Deposit Insurance Fund (DIF) was $384.5 million. As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the OIG conducted a material loss review of the failure of TVB.

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

Background

TVB opened for business on December 16, 1996, as a nationally-chartered bank regulated by the Office of the Comptroller of the Currency. On June 29, 2005, TVB converted from a national to a state charter. At that time, supervision of the bank transferred to the Federal Reserve Bank of San Francisco (FRBSF). On August 23, 2006, TVB withdrew from the Federal Reserve Bank System, to become a state-chartered, nonmember bank regulated by the FDIC. TVB was headquartered in Temecula, California, and had 11 full-service banking offices in Riverside, San Diego, and San Bernardino counties in California, as well as several loan production offices throughout California.

TVB engaged in community banking and commercial real estate (CRE) lending activities, including a significant amount of residential and commercial acquisition, development and construction (ADC) lending. The majority of the bank's lending was within California; however, the bank's lending programs also included loans originated under TVB's nationwide Small Business Administration (SBA) lending program. Under the SBA program, TVB became a "preferred lender", originating and funding loans primarily secured by CRE property and guaranteed up to 85 percent by the SBA.

Audit Results

Causes of Failure and Material Loss

TVB failed because its Board of Directors (Board) and management did not implement adequate controls to identify, measure, monitor, and control the risks associated with the bank's significant growth and concentrations in CRE loans and, in particular, ADC loans. In addition, TVB failed to implement adequate credit risk management controls and ensure that the bank maintained an adequate allowance for loan and lease losses (ALLL). TVB funded its CRE and ADC loans through potentially volatile sources, such as time deposits greater than $100,000 and brokered deposits. As TVB's financial condition deteriorated, the bank's access to funding became strained and subject to regulatory restrictions, leading to an unsatisfactory liquidity position. By mid-2009, cumulative net losses associated with deterioration in TVB's CRE and ADC loans far exceeded the bank's earnings and severely eroded capital. The CDFI closed TVB because the bank's Board and management were unable to find a suitable acquirer or raise sufficient capital to support the bank's operations and improve its capital position.

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The FDIC's Supervision of TVB

From August 2006 until the bank failed in July 2009, the FDIC, in conjunction with the CDFI, provided ongoing supervision of TVB through three on-site risk management examinations and three visitations. The FDIC also conducted offsite reviews and other offsite monitoring activities through it Relationship Manager Program. Through its supervisory efforts, the FDIC identified risks in TVB's operations and brought these risks to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's significant concentration in CRE loans, including ADC loans; weaknesses in credit risk management practices related to credit administration and the ALLL; and excessive reliance on potentially volatile funding sources. Examiners also reported apparent violations of regulations and contraventions of interagency policy associated with the institution's lending practices. In addition, examiners performed procedures to determine whether the bank had taken appropriate corrective action to address examiner recommendations, including those made by the FRBSF examiners prior to the bank's conversion to a state nonmember bank, and developed additional recommendations when the bank's corrective actions were not adequate.

The FDIC also pursued enforcement actions to correct problems identified in the April 2008 examination and December 2008 visitation. The FDIC's supervisory approach to TVB was consistent with prevailing guidance and practices at the time for a bank with TVB's risk profile. However, a lesson learned would be that earlier and greater supervisory attention to an institution like TVB is warranted, in light of the significant risk associated with high CRE and ADC concentrations in a declining real estate market, as identified by examiners in connection with the April 2007 examination and offsite monitoring conducted shortly thereafter.

With respect to PCA, we concluded that the FDIC had properly implemented applicable PCA provisions of section 38 based on the supervisory actions taken for TVB.

Management Response

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On February 12, 2010, the Director, Division of Supervision and Consumer Protection (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 TVB's failure. In addition, DSC stated that the rapid deterioration of local California real estate markets resulted in increased delinquencies and non-performing assets. Regarding our assessment of the FDIC's supervision, DSC stated that the FDIC and CDFI jointly conducted three full-scope examinations and three visitations from 2006 to 2009. DSC also conducted offsite reviews and other offsite monitoring activities during this period. Further, DSC stated that it recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as TVB, and has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

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Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: February 12, 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 Temecula Valley Bank, Temecula, California* (Report No. MLR-10-018)

As required by section 38(k) of the Federal Deposit Insurance (FDI) Act, the Office of Inspector General (OIG) conducted a material loss[1] review of the failure of Temecula Valley Bank (TVB), Temecula, California. On July 17, 2009, the California Department of Financial Institutions (CDFI) closed the institution and named the FDIC as receiver. On August 12, 2009, the FDIC notified the OIG that TVB's total assets at closing were $1.4 billion and the material loss to the Deposit Insurance Fund (DIF) was $384.5 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 FDI Act section 38. This report presents the FDIC OIG's analysis of TVB's failure and the FDIC's efforts to ensure TVB's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics

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[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.

of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of DSC's supervision program and make recommendations, as warranted. Appendix 1 contains details on our objectives, scope, and methodology. Appendix 2 contains a glossary of terms and Appendix 3 contains a list of acronyms used in the report. Appendix 4 contains the Corporation's comments on this report.

Background

TVB opened for business on December 16, 1996, as a nationally-chartered bank regulated by the Office of the Comptroller of the Currency (OCC). On June 29, 2005, TVB converted from a national to a state charter to take advantage of higher legal lending limits and reduced examination fees.[3] At that time, supervision of the bank transferred to the Federal Reserve Bank of San Francisco (FRBSF). On August 23, 2006, TVB withdrew from the Federal Reserve Bank System to become a state-chartered, nonmember bank regulated by the FDIC.

TVB was headquartered in Temecula, California, and had 11 full-service banking offices in Riverside, San Diego, and San Bernardino counties in California, as well as several loan production offices throughout California. In addition, until early 2009, TVB had Small Business Administration (SBA) loan production offices in Arizona, California, Florida, Nevada, Oregon, and Texas. TVB was wholly-owned by Temecula Valley Bancorp, Inc. (Bancorp), a one-bank holding company established in June 2002. Bancorp's stock was widely held, with the former Chairman, President and Chief Executive Officer representing the largest shareholder, as of December 31, 2008, owning approximately 6.6 percent of the outstanding stock.

TVB engaged in community banking and commercial real estate (CRE) lending activities, including a significant amount of residential and commercial acquisition, development and construction (ADC) lending. The majority of the bank's lending was within California; however, the bank's lending programs also included loans originated under TVB's nationwide SBA lending program. Under the SBA program, TVB became a "preferred lender", originating and funding SBA 504 and 7(a)[4] loans, primarily secured by CRE property and guaranteed up to 85 percent by the SBA. In 2008, the bank was one of the largest SBA 7(a) lenders in the nation based on dollar volume of loans.

Table 1 presents a summary of TVB's financial condition as of June 2009 and for the 5 preceding calendar years.

[3] TVB Bancorp, Inc., Securities and Exchange Commission, Form 10-K, for the fiscal year ended December 31, 2006.
[4] These SBA loan products are further defined in Appendix 2 of this report.

Table 1: Financial Condition of TVB

Financial Measure	Jun-09	Dec-08	Dec-07	Dec-06	Dec 05	Dec 04
(Dollars in Millions)						
Total Assets	$1,397	$1,510	$1,317	$1,237	$868	$606
Total Loans	$1,192	$1,380	$1,238	$1,144	$753	$530
Total Deposits	$1,276	$1,297	$1,164	$1,091	$744	$536
Loan Loss Allowance	$51	$52	$16	$13	$9	$6
Net Income (Loss)	($72.9)	($56.6)	$17.0	$18.4	$15.1	$11.2
Net Interest Margin	1.98%	3.80%	5.55%	6.51%	6.76%	5.86%
Return on Assets	(9.73%)	(3.91%)	1.31%	1.80%	2.07%	2.14%

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

Causes of Failure and Material Loss

TVB failed because its Board of Directors (Board) and management did not implement adequate controls to identify, measure, monitor, and control the risks associated with the bank's significant growth and concentrations in CRE loans and, in particular, ADC loans. In addition, TVB failed to implement adequate credit risk management controls and ensure that the bank maintained an adequate allowance for loan and lease losses (ALLL). TVB funded its CRE and ADC loans through potentially volatile sources, such as time deposits greater than $100,000 and brokered deposits. As TVB's financial condition deteriorated, the bank's access to funding became strained and subject to regulatory restrictions, leading to an unsatisfactory liquidity position. By mid-2009, cumulative net losses associated with deterioration in TVB's CRE and ADC loans far exceeded the bank's earnings and severely eroded capital. The CDFI closed TVB because the bank's Board and management were unable to find a suitable acquirer or raise sufficient capital to support the bank's operations and improve its capital position.

Board and Management Planning and Oversight

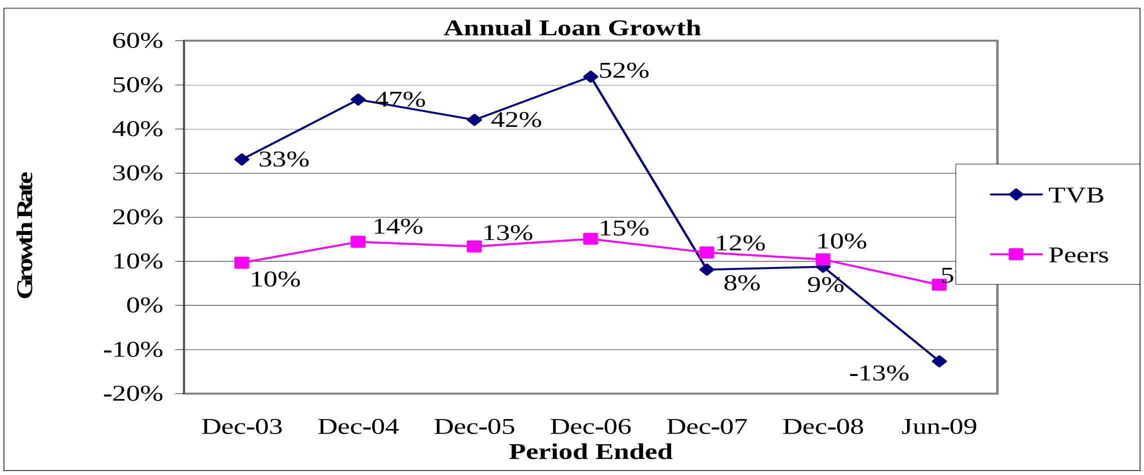
TVB's Board and management failed to effectively supervise the operations and promote the overall welfare of the institution. TVB's Board and management implemented a high-risk business strategy that included rapid growth, with a focus on earnings, by investing the majority of the bank's assets in higher-risk CRE and ADC loans while maintaining limited liquid assets. The bank relied on potentially volatile funding sources to support and sustain this loan growth strategy. Although this strategy allowed TVB to generally be *Well Capitalized*, as defined by section 38 of the FDI Act, and profitable through 2006, the bank's earnings and capital deteriorated once the economy started to decline in 2007. Also, as discussed later in this section, the influence exerted by a senior official and director over TVB's Board and management contributed to the bank's inability to effectively manage the risks associated with the bank's loan concentrations and potentially volatile funding.

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 Board formulates sound policies and objectives for the bank, and provides for the effective supervision of its affairs and promotion of its welfare. The primary responsibility of senior management is to implement the Board's policies and objectives into the bank's day-to-day operations. However, by TVB's March 2009 examination,[5] examiners concluded that TVB's management was critically deficient and had not been sufficiently proactive in identifying the extent of problem assets. Further, management had failed to (1) reduce the size of the bank to improve liquidity and capital; (2) develop realistic budget, strategic and capital plans; and (3) maintain effective internal controls.

High-Risk Business Strategy

TVB's Board and management did not sufficiently curtail the bank's lending until substantial deterioration in the bank's financial condition had occurred, in spite of regulatory concerns and a significant decline in the economic environment. As shown in Figure 1, TVB pursued a strategy of rapid loan growth from 2003 to 2006 that significantly exceeded the average for its peer group,[6] with annual loan growth ranging from 33 percent to 52 percent during that period.[7]

Figure 1: TVB's Annual Loan Growth Compared to Peers



Source: UBPRs for TVB.

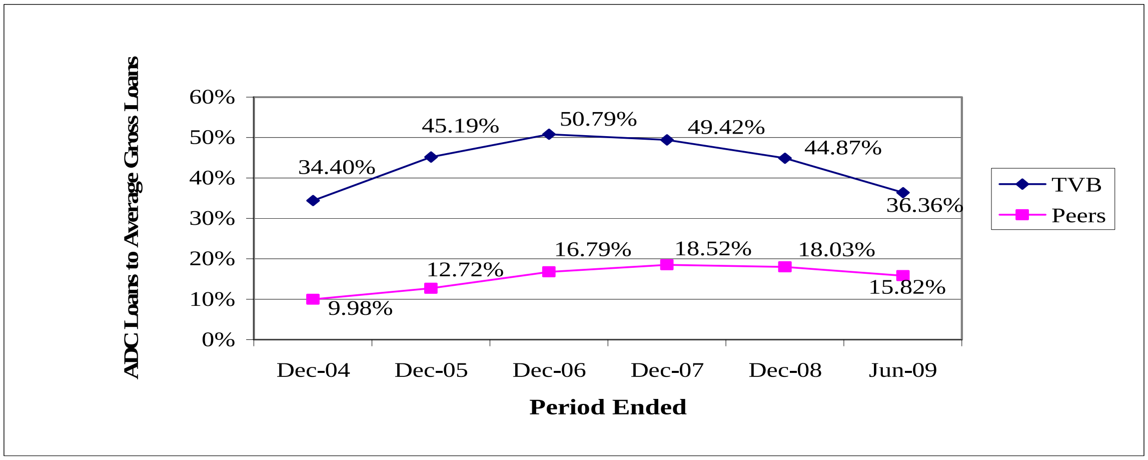
While TVB's loan growth through 2006 was more aggressive and, therefore, riskier than its peers, TVB's Board and management maintained the bank's capital at levels that were below those levels of its peers, as discussed in more detail in the *Implementation of PCA* section of this report. At the February 2006 examination, although the bank was *Well*

[5] Unless otherwise noted in this report, references to examination and visitation dates will refer to the month and year of the examination or visitation start dates.
[6] Commercial banks are assigned to one of 25 peer groups based on asset size and other criteria. From September 30, 2006 through 2009, TVB's peer group was all insured commercial banks having assets between $1 billion and $3 billion. Prior to that, TVB's peer group was all insured commercial banks with assets between $300 million and $1 billion.
[7] The majority of the bank's rapid asset growth occurred before TVB converted to a state nonmember bank and the FDIC became the bank's primary regulator in August 2006.

Capitalized, by definition, examiners concluded that the bank's capital levels were not commensurate with the risk associated with its loan strategy.

Much of the bank's loan growth focused on CRE lending, in general, and higher-risk ADC loans, in particular. As shown in Figure 2, the percent of TVB's ADC loans to average gross loans was consistently and significantly above the average for its peers.

Figure 2: TVB's ADC Loans as a Percent of Average Gross Loans Compared to Peers



Source: UBPRs for TVB.

Although the bank's overall loan growth slowed significantly beginning in 2007, as shown in Figure 1, TVB's Board and management failed to heed local and national economic signals and continued to originate speculative construction loans through mid-2008. Ultimately, ADC loans represented a majority of the loans subsequently charged-off or adversely classified, resulting in significant losses for the bank. Between December 2007 and December 2008, TVB's net income had decreased from $17 million to a negative $57 million. During the first half of 2009, earnings declined to a negative $73 million.

<u>Dominant Official</u>

Examiners and external auditors reported concerns regarding the influence that a former bank director and senior management official (Senior Official) had on the actions of the Board and bank operations. Specifically, the examiners and auditors concluded that the Senior Official's influence was a contributory factor in TVB's pursuit of high-risk business strategies and inadequate risk management practices. The December 2008 visitation and March 2009 examination reports noted various imprudent business practices that Board members and executive officers attributed to the Senior Official. Those practices included, but were not limited to:

- hindering communication between the Board and other executive officers;

- pressuring TVB's Board and management to make lending and compensation-related decisions that may not have been in the best interest of the bank;

- inadequately supervising lending units, prompting a "silo" organization structure where most units and the Appraisal Department reported to the Senior Official instead of the Chief Credit Officer; and

- refusing to charge off confirmed losses on collateral-dependent loans and other real estate and failing to implement an adequate ALLL methodology and adequately fund the ALLL.

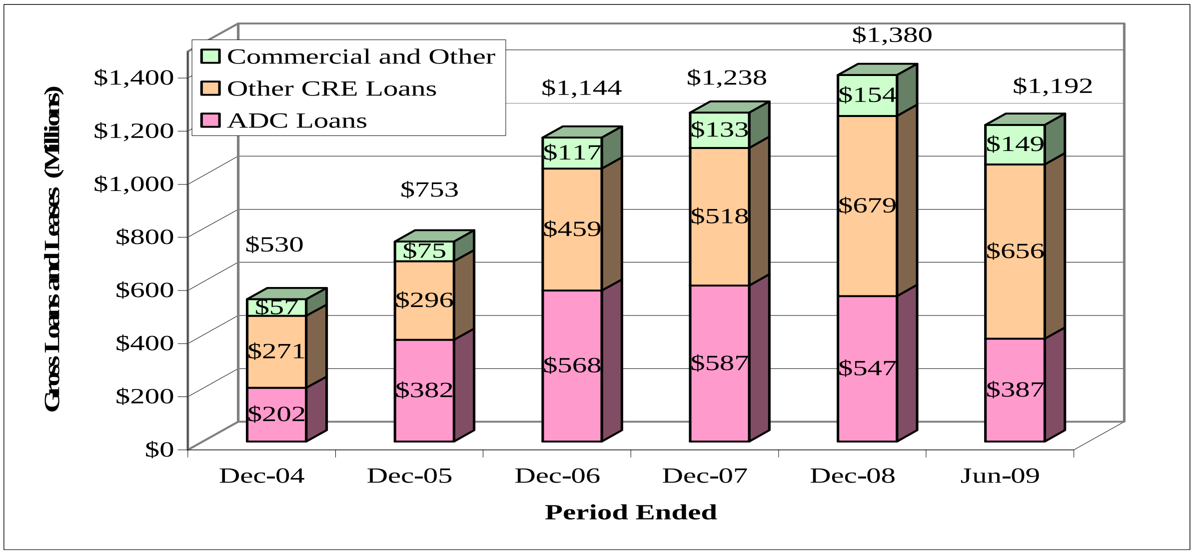
The December 2008 visitation report also noted the Senior Official's aggressive expansion of the SBA loan portfolio, funded with potentially volatile sources, in direct contrast to concerns expressed by members of bank management related to the economic slowdown and their uneasiness with having to rely on brokered deposits to fund this expansion.

In addition, TVB's external auditor concluded that the Senior Official suppressed important Board discussions. As noted in Bancorp's December 31, 2008 *Annual Report*, the external auditor identified inadequate Board and management oversight as a material internal control weakness due to inadequate documentation of strategic decision–making in Board minutes. Further, the March 2009 examination report concluded that the lack of independent Board supervision during the Senior Official's tenure contributed to the bank's unsatisfactory condition. Notwithstanding, examiners also concluded that other Board members and management (1) were not entirely absolved of their responsibilities for the resulting condition of the bank and (2) had accepted the Senior Officer's business plan and strategy for uncontrolled asset growth in higher-risk construction and SBA lending, funded by potentially volatile liabilities.

CRE and ADC Loan Concentrations

As noted in Figure 3, TVB pursued a lending strategy that was predominately focused on CRE and ADC loans, with a significant portion of the ADC portfolio concentrated in 1-4 family residential construction. Between December 2005 and December 2006, TVB substantially increased total CRE and ADC loans, with ADC loans accounting for more than 50 percent of the bank's total CRE loans during that period. TVB's overall growth in CRE lending continued through 2008, although management reduced the ADC portfolio by almost $40 million by December 31, 2008. By June 30, 2009, the ADC loans, which were mostly speculative in nature, had continued to decrease, but those loans still comprised approximately 32 percent of the bank's loan portfolio.

Figure 3: TVB's Loan Portfolio Composition and Growth



Source: OIG analysis of Consolidated Reports of Condition and Income (Call Reports) for TVB.

TVB's CRE lending strategy was initially profitable. Prior to 2008, high interest rates on the bank's CRE and ADC loans (generally based on the Wall Street Journal Prime Rate)[8] fueled a lucrative net interest margin and return on assets well above its peers. However, as discussed in Financial Institution Letter (FIL)-104-2006, entitled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, dated December 12, 2006, rising CRE concentrations can expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Despite evidence of weakening in the California housing market in 2007, the bank continued to originate speculative construction loans through mid-2008. By the March 2009 examination, which was based on December 31, 2008 financial data, the bank's non-owner occupied CRE totaled 1,153 percent of Total Capital, a significant increase from the already high rate of 603 percent 1 year earlier. Examiners concluded that this increase was primarily due to a significant decline in capital due to loan losses.

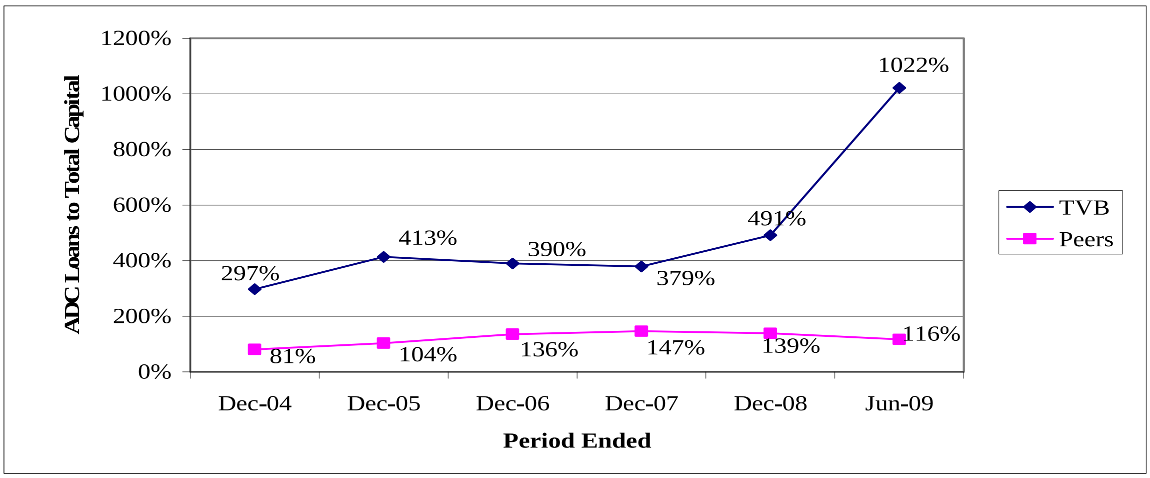
According to FIL-110-98, dated October 8, 1998, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that the activity remains profitable. In addition, according to the *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, CRE loan concentrations can pose substantial potential risks and inflict large losses on institutions. Therefore, risk management practices and capital levels should be commensurate with the level and nature of the CRE loan concentration risk. Although the guidance does not specifically limit a bank's CRE and ADC lending, it states that financial institutions with (1) ADC loans representing 100 percent or more of Total Capital, or (2) total CRE loans representing 300 percent or more of the institution's Total Capital, where the outstanding

[8] The Wall Street Journal Prime Rate is the base rate on corporate loans posted by at least 70 percent of the 10 largest U.S. banks.

balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months, may warrant greater supervisory scrutiny.

On October 12, 2006, during the FDIC's initial visitation of TVB, bank management informed the FDIC that TVB (1) was aware of the proposed guidance on CRE loan concentrations and (2) had "modeled" the bank's requirements in order to be prepared when the guidance became final. However, TVB's CRE and ADC loan concentrations at the April 2007 and all subsequent examinations remained significantly higher than the 300 percent and 100 percent supervisory criteria, respectively, as well as the bank's peer group averages. Figure 4 highlights TVB's ADC loan concentrations in relation to the bank's peer group.

Figure 4: TVB's ADC Loan Concentration to Total Capital Compared to Peers



Source: UBPRs for TVB.
Note: The sharp increase in the ADC loan concentration ratio in 2009 resulted from a decline in TVB's capital as a result of loan loss provisions, rather than growth in ADC lending.

Credit Risk Management Practices

TVB failed to develop, implement, and sustain an adequate credit risk management framework commensurate with the inherent risks associated with its CRE and ADC concentrations. According to the *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, strong risk management practices are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans. The guidance also states that financial institutions with CRE concentrations should ensure that risk management practices appropriate to the size of the portfolio, as well as the level and nature of concentrations, and the associated risk to the institution are implemented. Further, financial institutions should establish a risk management framework that effectively identifies, monitors, and controls CRE concentration risk.

The February 2006, April 2007, and April 2008 examinations generally found credit risk management practices, including loan underwriting and credit administration, to be adequate. However, weak credit risk management practices in 2008 and 2009 led to difficulties in resolving problem credits and monitoring and managing rapidly increasing troubled loan and other real estate assets. For example:

- The December 2008 visitation noted that TVB's overall management of the credit function needed improvement. Weaknesses in loan grading persisted, and examiners found additional weaknesses related to the external loan review program, the maintenance of current collateral values on problem assets, and the problem loan management function.

- The March 2009 examination noted that TVB needed to (1) devote additional resources to problem loan management, including improvements to the problem loan reporting system; (2) identify loan downgrades in a timely manner; and (3) ensure that updated appraisals were obtained on a consistent basis.

Allowance for Loan and Lease Losses

The February 2006 and April 2007 examinations concluded that TVB's ALLL methodology and balance were sufficient. By 2008, additional provisions to the ALLL were required as TVB's loan portfolio deteriorated and adverse classifications increased. Beginning with, and continuing after, the April 2008 examination, examiners and external auditors identified deficiencies with TVB's ALLL methodology and funding and made recommendations for the bank to substantially increase the ALLL. Table 2 provides information on TVB's adversely classified items and ALLL funding.

Table 2: TVB's Adversely Classified Items and ALLL

	Examination and Visitation Start Dates				
	Feb 27-06	Apr 09-07	Apr 21-08	Dec 01-08	Mar 02-09
	(Dollars in Thousands)				
Total Adversely Classified Items	$4,942	$30,666	$103,476	$175,942	$328,135
Adversely Classified Items as a Percent of Tier 1 Capital plus ALLL	5.30%	21.05%	60.86%	104.09%	244.16%
TVB's ALLL Funding	$9,039	$12,522	$16,969	$20,069	$51,537
Increase in ALLL Computed by Examiners	-0-	-0-	$2,480	-0-	$23,000

Source: Examination and visitation reports.

In addition, at both the April 2008 examination and December 2008 visitation, examiners cited TVB for an apparent contravention of the interagency 2006 *Policy Statement on*

Allowance for Loan and Lease Losses[9] because the bank's ALLL methodology did not meet policy requirements. The March 2009 examination noted that the bank's ALLL methodology and balance were generally appropriate as of December 31, 2008, due to the $33.8 million increase to the ALLL that TVB made based on concerns expressed by the bank's external auditors. However, as indicated in Table 2, examiners estimated that an additional provision of $23 million was needed as of March 2009 to replenish the ALLL, due to high loan losses incurred in the first quarter of 2009. TVB subsequently recorded a provision of $22.5 million, which increased the ALLL to $55.9 million. As of June 30, 2009, just prior to failure, TVB's ALLL totaled $50.8 million and represented 4.26 percent of total loans, compared to a 1.8 percent ratio for the bank's peer group.

Liquidity Management and Contingency Planning

TVB primarily financed the CRE and ADC concentrations with potentially volatile funding sources, including large time deposits of $100,000 or greater and brokered deposits. In addition, TVB was overly reliant on SBA loan sales for liquidity, and failed to develop and implement a comprehensive contingency liquidity plan (CLP) to assist the bank in planning for alternative sources of funding.

Reliance on Potentially Volatile Funding Sources

Although TVB's reliance on potentially volatile funding sources was not a primary cause of the bank's failure, as indicated in Table 3, TVB's reliance on large time deposits was significant from December 2004 through June 2009, nearly doubling from $240 million in December 2005 to $410 million in December 2006. TVB's reliance on brokered deposits, which began in 2006, almost doubled between December 2006 to December 2007, from $47 million to $88 million, respectively. According to the Examination Manual, such funding sources present potential risks, such as higher costs and increased volatility.

Table 3: TVB's Level of Large Time Deposits and Brokered Deposits

Potentially Volatile Funding	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Jun-09
	(Dollars in Millions)					
Time Deposits of $100,000 or More	$145	$240	$410	$400	$313	$317
Brokered Deposits	$0	$0	$47	$88	$361	$277

Source: UBPRs for TVB.

At the March 2009 examination, examiners noted that brokered deposits were instrumental in fueling TVB's asset growth in 2008. The brokered deposits had increased from $88 million in December 2007 to $361 million in December 2008, a 310 percent

[9] This policy statement reiterates key concepts and requirements included in Generally Accepted Accounting Principles and existing supervisory guidance for maintaining the ALLL at an appropriate level. The policy statement requires an institution to maintain an appropriate ALLL level, discusses items that need to be addressed in written policies and procedures, and describes methodologies that institutions need to use to determine an appropriate level.

increase, which placed the bank in the 90th percentile relative to peers. During that period, SBA and construction loans increased by $142 million.

The Examination Manual states that the net non-core funding dependence ratio is a key measure of the degree to which the bank relies on potentially volatile liabilities, such as, but not limited to, certificates of deposit over $100,000 and brokered deposits to fund long-term earning assets. Placing heavy reliance on potentially volatile funding sources to support asset growth is risky because access to these funds may become limited in times of financial stress or adverse changes in market conditions. Generally, the lower the dependence ratio, the less risk exposure there is for the bank. As noted in Table 4, TVB's net non-core funding dependence ratio consistently exceeded that of its peers from December 2004 to June 2009.

Table 4: TVB's Net Non-Core Funding Dependence Ratio Compared to Peers

	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Jun-09
	(Percentages)					
TVB	24	32	35	39	56	48
Peers	21	22	27	29	35	31

Source: UBPRs for TVB.

Significant loan-related losses deteriorated TVB's financial condition and capital position, and ultimately limited the bank's access to certain potentially volatile funding sources. Specifically, the March 2009 examination noted that restrictions on TVB's Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) Discount Window borrowings, in conjunction with a freeze in the market for SBA loan sales in late 2008 and subsequent limits on brokered deposits, created significant liquidity concerns for the bank. In addition, as TVB's capital position deteriorated, its access to brokered deposits was restricted based on section 29 of the FDI Act and Part 337 of the FDIC Rules and Regulations, as discussed later in this report.

SBA Loan Growth

During 2008, TVB's Board and management continued to emphasize growth in SBA lending in spite of: a need to preserve capital, unsatisfactory liquidity, and a notable reduction in sales activity in the secondary market for SBA 504 loans. Bank management justified this growth to (1) diversify the loan portfolio, (2) generate consistent interest income, and (3) provide liquidity through SBA loan sales. TVB officials also stated that the growth in SBA loans should not require additional funding, but instead be supported by reductions in construction and other loan originations. However, much of the growth was ultimately funded through brokered deposits, upon which restrictions were subsequently placed due to TVB's declining capital position and related loan losses. These restrictions, in conjunction with a substantial decline in the market for SBA loan sales in late 2008, led to significant liquidity concerns for TVB in early 2009.

Contingency Liquidity Planning

Examiners continually expressed concerns regarding TVB's CLP; however, bank management failed to develop one that was adequate. A comprehensive CLP can assist in projecting liquidity needs and planning for viable sources of liquidity as the bank's financial condition begins to deteriorate and applicable restrictions to funding sources become imminent. Institutions that use non-core funding, brokered deposits, and other high-rate funding strategies should ensure that their CLPs address relevant stress events. Examiners during the April 2008 examination criticized TVB's CLP for its lack of:

- a strategy for maintaining adequate liquidity if the secondary market for SBA 504 loans ceases to provide a reliable or timely source of liquidity;

- an exit strategy from the business line of originating and selling SBA 504 loans, or ability to identify permanent funding to maintain the loans on the balance sheet without impacting liquidity, should the secondary market for the loans diminish; and

- a plan for the use of brokered deposits and alternative sources should brokered deposits become restricted.

The need for a comprehensive CLP became further pronounced by December 2008, when brokered deposits alone comprised almost 28 percent of total deposits, nearly 3 times the level of the bank's peer group and remained at almost 3 times that of its peers in June 2009. This represented a substantial increase in TVB's level of brokered deposits at a time when the bank's financial condition was declining due to increases in adversely classified assets, which led to decreases in capital and subsequent restrictions on liquidity sources. By the March 2009 examination, TVB had revised its CLP to address examiners' concerns. However, the bank's actions were not timely or effective, as examiners concluded that TVB's liquidity position was tenuous, and contingency liquidity sources were inadequate.

The FDIC's Supervision of TVB

From August 2006 until the bank failed in July 2009, the FDIC, in conjunction with the CDFI, provided ongoing supervision of TVB through three on-site risk management examinations and three visitations. The FDIC also conducted offsite reviews and other offsite monitoring activities through it Relationship Manager[10] (RM) Program. Through its supervisory efforts, the FDIC identified risks in TVB's operations and brought these

[10] An RM serves as the designated local point-of-contact for the respective institutions in their assigned portfolio. The RM also monitors and participates in supervisory activities, develops supervisory plans, and ensures that information on the financial institution is updated as appropriate. The supervisory plan identifies anticipated monitoring needs and examination plans for the risk management examination cycle, based on risk or staffing considerations. RM contacts enable the FDIC regional offices to identify current and prospective issues that impact the risk profile or overall condition of financial institutions.

risks to the attention of the bank's Board and management through examination reports and other correspondence. Such risks included the bank's significant concentration in CRE loans, including ADC loans; weaknesses in credit risk management practices related to credit administration and the ALLL; and excessive reliance on potentially volatile funding sources. Examiners also reported apparent violations of regulations and contraventions of interagency policy associated with the institution's lending practices. In addition, examiners performed procedures to determine whether the bank had taken appropriate corrective action to address examiner recommendations, including those made by the FRBSF examiners prior to the bank's conversion to a state nonmember bank, and developed additional recommendations when the bank's corrective actions were not adequate. The FDIC also pursued enforcement actions to correct problems identified in the April 2008 examination and December 2008 visitation. The FDIC's supervisory approach to TVB was consistent with prevailing guidance and practices at the time for a bank with TVB's risk profile. However, a lesson learned would be that earlier and greater supervisory attention to an institution like TVB is warranted, in light of the significant risk associated with high CRE and ADC concentrations in a declining real estate market, as identified by examiners in connection with the April 2007 examination and offsite monitoring conducted shortly thereafter.

Supervisory History

The FRBSF and the CDFI conducted an examination of TVB in February 2006, before the bank converted to a state nonmember bank in August 2006. The FDIC and the CDFI conducted joint examinations and visitations of TVB from October 2006 to March 2009. Table 5 provides the supervisory history for TVB from 2006 to 2009, including CAMELS[11] component and composite ratings and enforcement actions taken.

Table 5: TVB's Examination and Visitation History, 2006 to 2009

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Enforcement Action
02/27/2006	12/31/2005	FRBSF/CDFI	222123/2 (3)[a]	None
10/12/2006 (Visitation)	Not applicable	FDIC/CDFI	Not applicable	None
04/09/2007	12/31/2006	FDIC/CDFI	222133/2	None
04/21/2008	03/31/2008	FDIC/CDFI	333343/3	Memorandum of Understanding (MOU), (Effective September 9, 2008) Problem Bank Designation[b]

[11] 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.

Examination Start Date	Examination as of Date	Agency	Supervisory Ratings (UFIRS)	Enforcement Action
12/01/2008 (Visitation)	09/30/2008	FDIC/CDFI	444444/4	Cease and Desist Order (C&D) (Effective February 12, 2009) Problem Bank Designation
01/15/2009 (Visitation)	01/13/2009	FDIC/CDFI	444454/5	C&D continued Problem Bank Designation
03/02/2009	12/31/2008	FDIC/CDFI	555555/5	C&D continued Problem Bank Designation

Source: Examination and visitation reports for TVB.
[a] The FRBSF also issued a risk management rating of “3” or “fair” that was supplemental to the UFIRS ratings.
[b] This designation required TVB to notify the FDIC in writing at least 30 days prior to certain management changes, including the addition or replacement of a Board member, or the employment or change in responsibilities of anyone who was, would become, or who performed the duties of a senior executive officer.

Examinations prior to 2006 were performed by the CDFI and the OCC. TVB generally received UFIRS component and composite ratings of “2”or better for every examination from inception through 2005, indicating that the bank gave no cause for supervisory concern, and weaknesses identified were considered minor and correctable in the normal course of business. The FRBSF and CDFI February 2006 examination rated management and board supervision as “satisfactory” based on the overall sound financial condition of the bank, but also concluded that the bank’s risk management practices were “fair” because they had not kept pace with the bank’s rapid growth and therefore reflected adversely on overall board and management oversight.

Visitations

In addition to three risk management examinations, the FDIC and the CDFI conducted three visitations at TVB, summarized below.

October 2006. The FDIC and the CDFI conducted an initial visitation after TVB converted from a Federal Reserve member bank to a state nonmember bank to assess the primary areas of risk. Examiners and TVB management also discussed the bank’s CRE and ADC concentrations, examiner expectations for a CLP, the bank’s SBA lending, and the proposed *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. The meeting also served to facilitate planning for the joint FDIC and CDFI examination scheduled for the second quarter of 2007, and to assess the bank’s progress in implementing recommendations made as a result of the FRBSF and the CDFI’s February 2006 examination.

December 2008. The purpose of the visitation was to follow up on the April 2008 examination results, validate TVB’s financial condition as part of its Troubled Asset Relief Program (TARP) application, determine possible effects of negative publicity about the bank, and assess corrective actions that TVB had implemented or planned to take in response to the September 2008 MOU. The FDIC and the CDFI determined that the bank’s condition had continued to deteriorate and was considered to be unsatisfactory, due to distressed asset quality and an increased volume of problem loans, weaknesses in the ALLL, and deficient earnings and capital. Accordingly, all of the bank's component ratings and the composite rating were rated as "4," indicating serious financial or managerial deficiencies and unsatisfactory performance.

January 2009. The visitation focused on the bank's liquidity position and determined that the bank's (1) financial condition had continued to deteriorate and (2) liquidity levels were critically deficient and threatened the near-term viability of the institution. Examiners also reminded TVB that once an FDIC- and CDFI-proposed C&D was in effect, TVB's capital category would be reclassified to *Adequately Capitalized* and the appropriate restrictions according to section 38 of the FDI Act would become applicable. In addition, TVB's access to other non-core funding sources, including FHLB and FRB borrowings, had been reduced. Examiners concluded that TVB was operating in an unsafe and unsound condition and needed to quickly improve the bank's deteriorating financial condition. The FDIC and the CDFI adjusted the bank's liquidity and composite ratings each to a "5," resulting in a CAMELS rating of 444454/5.

Offsite Reviews

FDIC examiners also conducted two offsite reviews of TVB during July 2008 and October 2008. Those reviews indicated that there was a probability of downgrades in TVB's component ratings—capital, asset quality, management, and earnings—and/or the overall composite rating. FDIC concerns were based on the bank's deteriorating capital levels, weakened asset quality, poor liquidity, deteriorating earnings and/or the downturn in the California real estate markets. Subsequently, TVB's component and composite ratings were downgraded at the December 2008 visitation, with additional downgrades occurring at the January 2009 visitation and March 2009 full-scope examination.

Supervisory Actions

The FDIC and the CDFI took various supervisory actions, including making recommendations and taking informal and formal enforcement actions, to address risk management concerns pertaining to the bank's operations, as noted below.

April 2007 Examination. The FDIC and the CDFI examiners followed up on the recommendations made by the FRBSF and the CDFI in 2006 and concluded that although TVB had made efforts to address prior recommendations, repeat recommendations related to liquidity were needed. Specifically, TVB needed to establish appropriate risk limits for managing potentially volatile funding sources and develop an adequate CLP. Examiners also noted that TVB had established significantly high tolerance levels for CRE and ADC lending, and recommended that the bank develop a contingency plan for the ADC concentration and a prudent limit for the aggregate CRE concentration that did not include owner-occupied properties.

April 2008 Examination. Examiners considered management less than satisfactory, citing the Board and management's strategy of focusing on construction lending while maintaining minimal liquid assets and the decision to increase speculative residential construction lending at a time when the residential real estate markets were weakening. Examiners concluded that TVB's capital was less than satisfactory due, in part, to significant increases in adverse classifications, declining earnings, and the declining ability of the holding company to inject capital. Examiners also warned TVB about the risks inherent in its continued reliance on potentially volatile funding sources, as well as SBA 504 loan sales, for liquidity. Examiners recommended that TVB thoroughly evaluate the risks related to the size of the bank's ADC loan portfolio, and update its CLP to address contingencies related to the market for SBA loan sales and the use of brokered deposits.

September 2008 MOU. DSC collaborated with the CDFI to determine the appropriate ratings for TVB as a result of the April 2008 examination and to enter into an MOU with TVB in September 2008. Discussions between DSC and the CDFI regarding downgrades in TVB's ratings and conclusions about the ALLL impacted the timeliness of the examination report and the MOU. When issued, the MOU included 10 provisions related to asset quality and concentrations of credit; strategic and capital planning; the ALLL; liquidity management, reliance on non-core funding, and the bank's CLP; and sensitivity to market risk.

In December 2008, examiners followed up on compliance with the MOU. The examiners concluded that the bank's condition was unsatisfactory and that actions taken by TVB in response to the MOU did not appear to have adequately addressed the provisions related to classified assets, concentrations of credit, ALLL provisions, and liquidity. Examiners informed TVB's Board that, as a result, a C&D would be forwarded to the institution.

February 2009 C&D. The FDIC and the CDFI jointly issued a C&D to TVB that contained provisions related to:

- Board participation and qualified management;
- asset quality, CRE concentrations, and the ALLL;
- strategic, profit, and capital planning and cash dividends; and
- liquidity and funds management, including brokered deposits.

March 2009 Examination. Examiners determined that TVB was operating in an unsafe and unsound condition and that the bank's performance was deemed to be critically deficient due to continued deterioration in the bank's asset quality, liquidity levels, earnings, and capital position. Examiners recommended that TVB take aggressive action to reduce CRE and ADC loan concentrations and improve management of problem loans. Regarding liquidity, management was asked to establish an action plan, clarify policy limits, and improve the brokered deposits reduction plan.

Supervisory Response to Risks Identified at TVB

During its 3-year supervision of TVB, the FDIC, in conjunction with the CDFI, implemented a supervisory strategy that included annual examinations, visitations, examiner recommendations, rating downgrades, and formal and informal actions. Examination and visitation reports for TVB indicated that the FDIC and CDFI examiners identified concerns and made recommendations related to the risks associated with TVB's (1) Board and management planning and oversight, (2) CRE and ADC loan concentrations, (3) credit risk management practices, (4) the ALLL, and (5) liquidity management and contingency planning. In addition, an MOU and C&D were issued with provisions that also addressed those risks. With regard to Board and management oversight, concerns regarding the bank's dominant official, whose influence played a role in the bank's failure, were not evident to examiners until the December 2008 visitation. We did determine, however, that earlier and greater supervisory attention to TVB may have been warranted, in light of the significant risk associated with the bank's high CRE and ADC concentrations in a declining real estate market, as identified by examiners in connection with the April 2007 examination and offsite monitoring conducted shortly thereafter.

Examination Coverage of the Dominant Official

The December 2008 visitation report concluded that TVB Board and management oversight was deficient, in part because of the Board's acceptance of the dominant influence and imprudent business decisions of the Senior Official, which contributed to the deterioration of the bank. None of the examinations conducted between 2006 and December 2008 concluded that TVB had a dominant or highly influential official.

The February 2006 examination, which was conducted by the FRBSF and the CDFI, did not report any concerns regarding whether the bank was susceptible to dominant influence or concentration of authority and concluded that management and board supervision was satisfactory. In addition, the April 2007 and April 2008 examination reports specifically indicated that TVB did not have a dominant officer or policy maker.

Examination procedures that may identify a dominant official include review of Board and committee minutes and Board packages. Although we found evidence that examiners performed these procedures during the April 2007 and April 2008 examinations, such review did not identify any recorded concerns from other Board members or bank management regarding a dominant official. In addition, examiners stated that Board members and senior bank management did not express any disagreement with the Senior Official over strategic decisions and/or the direction of the bank during those examinations. In December 2008, the Chairman of TVB's Board told examiners that there were heated discussions and disagreements with the Senior Official during Board meetings, but these issues were not captured in the Board minutes.

Examiners subsequently noted that it was difficult to identify the negative impact of the Senior Official's influence until after the official had left TVB during December 2008. Prior to that point, it appears that TVB's Board and management supported the Senior Official and did not express any concerns to examiners about the decisions made and actions taken by the Senior Official. Both the April 2007 and April 2008 examination reports state that examiners extended an invitation through the Senior Official for TVB's directors to attend examination meetings or meet with examiners; however, these reports indicate that none of the outside directors met with examiners during those examinations.

Supervisory Strategy – CRE and ADC Loan Concentrations

TVB's rapid growth resulted in a higher-risk profile for the institution and resulted in CRE and ADC loan concentrations that consistently and significantly exceeded supervisory guidelines and the bank's peer group averages.

April 2007 Pre-Examination Planning Memorandum. The memorandum noted the risks identified by the FRBSF and CDFI 2006 examination of TVB, including a CRE concentration that was 733 percent of Total Capital, largely comprised of ADC loans representing 413 percent of Total Capital. By year-end 2006, the CRE concentration remained high, with ADC loans comprising 50 percent of the total loan portfolio. The memorandum indicated that special emphasis would be placed on the review of speculative construction loans in view of the real estate market slowdown and on the management of the CRE concentration. An additional indicator that TVB had a high-risk profile was the bank's Real Estate Stress Test (REST)[12] score, which was "5" due to the bank's high volume of CRE and ADC loans—indicating the highest level of exposure to potential market deterioration. Accordingly, examiners concluded that TVB's monitoring of concentrations of credit was considered to be a high-risk area and would be targeted during the April 2007 examination.

April 2007 Examination. Examiners performed a targeted review of the bank's CRE and ADC concentrations. Although TVB's CRE and ADC concentrations substantially exceeded the parameters included in the 2006 guidance and presented substantial risk to the institution, examiners' decisions regarding the supervisory approach for TVB may have been influenced, in part, by examiner conclusions that TVB's (1) underwriting was conservative and concentration monitoring reports were extensive, (2) asset quality was satisfactory based on the level of adverse classifications, (3) 2006 earnings were satisfactory, and (4) capital levels had increased in 2006.

The April 2007 examination noted CRE loans comprised 94 percent of the bank's loan portfolio and CRE and ADC loan concentrations substantially exceeded the supervisory criteria in the *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. Specifically,

- non-owner occupied CRE totaled 541 percent of Total Capital; and since 2003, TVB's level of CRE loans had increased by approximately 230 percent, which was well in excess of the supervisory criteria of 50 percent over a 36-month period; and

[12] REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that of New England in the early 1990s. Risk factors include the ratio of construction and development loans to total assets, high non-core funding, and rapid asset growth. Other risk factors are based on the bank's percentage of CRE loans, multifamily loans, and commercial and industrial loans. A bank with a high concentration in ADC loans, coupled with rapid asset growth, would appear to be riskier than a bank with similar concentrations but low asset growth. REST uses statistical techniques and Call Report data to forecast an institution's condition over a 3- to 5-year period and provides a single rating from 1 to 5, with a rating of 5 indicating the highest risk.

- the ADC concentration totaled 445 percent of Total Capital.

Examiners also concluded that the risk in the construction portfolio was elevated due to the (1) size of the portfolio in relation to Total Capital, (2) emphasis on residential construction at a time when the residential market was slowing and included a significant volume of speculative lending, and (3) exposure to the Southern California market, which had experienced a rapid escalation in prices. Further, the possibility of TVB increasing its level of CRE loan concentration was evident as the bank's concentration-related guidelines allowed for a high volume of construction, non-construction CRE, and speculative lending, with a combined limit for all CRE at 1,000 percent of Tier 1 Capital.

Examiners made recommendations for TVB to develop a contingency plan to reduce the ADC concentration in the event of adverse market conditions and to proactively reduce ADC loan concentration limits as market conditions deteriorated. In addition, examiners indicated that the advisory nature of the *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* made it difficult for them to impose a supervisory action requiring TVB to reduce the high levels of CRE and ADC concentrations, prior to evidence of financial deterioration at the bank. According to the 2007 examination report:

- TVB's ADC loan portfolio risk was mitigated by the bank's reasonably conservative underwriting, an average loan-to-value ratio in the construction portfolio of 66 percent, and many projects being phased and detailed construction status reports being prepared to monitor the construction projects.

- Bank management continued to satisfactorily administer the bank's affairs, as evidenced by satisfactory asset quality, with an adversely classified items ratio of only 21 percent, strong earnings performance, and capital levels.

- TVB's capital levels, which had increased from the December 31, 2005 levels due to capital injections from the bank's holding company, were satisfactory relative to the bank's overall risk profile and elevated concentration risk.

Bank Contacts. Although TVB's composite rating was a "2" at the April 2007 examination, examiners contacted TVB three times between the April 2007 and April 2008 examinations. According to DSC officials, (1) it is unusual for examiners to contact "2"-rated institutions on such a frequent basis and (2) the contacts were an indication that examiners were aware of TVB's high-risk profile and closely monitoring the institution. In our view, the information and perspective gained from these contacts could have resulted in additional supervisory action and, possibly, further revision to the supervisory strategy.

- **June 2007.** About 2 months after the start of the April 2007 examination, the RM contacted TVB to discuss concerns related to the bank's ADC concentration. The RM:

- identified indications of increased risk to TVB and concluded that due to a high volume of ADC loans, increasing asset classifications, and the softening real estate market, ongoing reviews of the bank's ADC concentrations were warranted; and

- concluded that the bank's risk level was "high"[13] and recommended that DSC conduct a 6-month contact with TVB, focusing on various indicators for potentially deteriorating trends in the ADC portfolio to assist in determining whether a formal on-site visitation was needed.

Further, in August 2007, the RM developed the 2008 supervisory plan which noted that the prior examination report included concerns about TVB's monitoring of CRE concentrations; however, the plan did not specifically address TVB's ADC lending. Additional bank contacts included the following.

- **September 2007.** The CDFI contacted TVB to discuss an increase in the bank's delinquency ratio as of June 2007. The discussion, which was summarized by the RM in DSC correspondence, briefly noted the bank's ADC lending. TVB indicated that in spite of some signs of weakness, the bank was comfortable with its ADC exposure and the portfolio was performing well. DSC officials stated that, although not captured in the documentation for the September 2007 contact, the FDIC and the CDFI decided against conducting an on-site visitation or acceleration of the next examination based on the bank's financial trends and information provided by TVB.

- **January 2008.** The FDIC and the CDFI also met with TVB officials to obtain an overview of the bank and the actions taken to address the April 2007 examination concerns; however, DSC correspondence is not clear on what was discussed regarding the bank's ADC lending.

Examiners subsequently evaluated the risks related to TVB's CRE and ADC concentrations during the April 2008 examination. However, by that time, significant financial deterioration had occurred, and the bank's high level of CRE and ADC loans and continued growth in residential construction loans was of significant concern, given the weakening residential real estate markets and rising level of adverse classifications, loan losses, and other real estate owned.[14] The April 2008 examination report highlighted that:

- the overall CRE portfolio had declined as a percent of Total Capital since the prior examination; however, the level of non-owner occupied CRE and ADC loans to Total Capital still remained high, at 479 percent and 437 percent, respectively;

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[13] The "high" risk level indicated that until corrected, TVB's current or prospective exposures posed a risk of loss to the bank's earnings or capital that could materially impact TVB's financial condition.
[14] Other real estate owned is real estate property acquired by a bank through, or in lieu of, loan foreclosure.

- the level of speculative residential construction loans had increased substantially, by $70 million (or 24 percent), from the last examination and represented 224 percent of Total Capital; and

- the adversely classified items ratio had also increased significantly since the prior examination, from 21 percent to 61 percent. The majority of the classified loans were ADC loans, and most of those were speculative residential projects.

In addition, during the period between the April 2007 and April 2008 examinations, TVB increased its brokered deposits, which were used to support asset growth, by more than $40 million.[15] As discussed earlier, the FDIC worked with TVB to enter into an MOU in September 2008 to address the bank's asset quality, CRE and ADC concentrations, reliance on volatile funding sources, and other risks, based on the April 2008 examination results discussed above. During its follow-up activities, DSC examiners determined that TVB, ultimately, did not comply with many examiner recommendations and MOU provisions. Although TVB subsequently curtailed its ADC lending in July 2008, by 2009, the majority of TVB's adversely classified assets and charge-offs were related to ADC loans.

As indicated previously, the RM considered TVB's risk level to be "high," and until corrected, could impact the bank's financial condition. However, DSC officials stated that at that time, high concentrations in CRE and ADC were not reasons alone to change their supervisory approach, including accelerating an examination or downgrading a component rating. As a result, although the FDIC's intervening offsite contacts with TVB identified risks the bank was facing, those activities did not result in substantial adjustments to the FDIC's supervisory strategy for TVB.

In hindsight, earlier and greater supervisory attention to the higher-risk profile presented by TVB's CRE and ADC concentrations may have (1) been warranted before significant deterioration in the bank's financial condition had occurred and (2) better mitigated the elevated risks at TVB.

Implementation of PCA

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

[15] The April 2007 examination's as of financial date was December 31, 2006, at which time TVB's brokered deposits totaled $47.2 million. The April 2008 examination's as of financial date was March 31, 2008, at which TVB's brokered deposits totaled $87.8 million, an increase of more than $40 million from the bank's December 31, 2006 amount.

Based on the supervisory actions taken for TVB, the FDIC implemented applicable PCA provisions of section 38 of the FDI Act in the manner and timeframe required. However, by the time the FDIC was required to implement the PCA provisions, the bank had already been subject to an MOU and a C&D that required TVB to develop a plan to significantly improve its capital position. TVB was categorized as *Well Capitalized* from December 2006 through September 2008, as indicated in Table 6.

Table 6: TVB's Capital Ratios Relative to PCA Thresholds for Well Capitalized Banks

Capital Category	PCA Thresholds	Dec 06	Dec 07	Sept 08	Dec 08[a]	Mar 09	Jun 09
		TVB's Capital Ratios (Percentages)					
Tier 1 Leverage Capital	5% or more	11.16	10.48	10.04	6.03	4.00	1.42
Tier 1 Risk-Based Capital	6% or more	10.23	9.51	9.73	6.25	4.14	1.59
Total Risk-Based Capital	10% or more	11.20	10.66	10.98	7.52	5.43	2.87
PCA Category[b]	W	W	W	W	U	SU	CU

Source: Call Reports for TVB.
[a] The December 2008 ratios are based on TVB's December 31, 2008 Call Report revised March 19, 2009.
[b] W–Well Capitalized, U–Undercapitalized, SU–Significantly Undercapitalized, CU–Critically Undercapitalized.

At the February 2006 examination, FRBSF examiners highlighted the bank's low level of Total Risk-Based Capital in relation to its peers and rapid growth strategy, and recommended that TVB increase its capital. FRBSF examiners emphasized that a bank with substantial growth is expected to maintain a strong capital position substantially above minimum supervisory levels. Although TVB received capital contributions from its holding company in 2006 and 2008, TVB's Board and management continued to maintain the bank's Total Risk-Based Capital below that of its peers as shown in Table 7. As indicated previously in Figure 4, TVB's ADC loan concentration ratios far exceeded its peers.

Table 7: TVB's Total Risk-Based Capital Ratio Compared to Peers

	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Jun-09
	(Percentages)					
TVB	11.72	10.82	11.20	10.66	7.52*	2.87
Peers	13.06	12.95	11.99	11.83	11.70	12.11

Source: UBPRs for TVB.
* The December 2008 ratio is based on TVB's December 31, 2008 Call Report revised March 19, 2009.

TVB's capital category was reduced from *Well Capitalized* to *Adequately Capitalized* on February 12, 2009, the effective date of the C&D, which included capital-related provisions that required TVB to (1) develop and adopt a plan to maintain Tier 1 Leverage Capital above 10 percent and meet the minimum risk-based capital requirements identified in FDIC Rules and Regulations Part 325, Appendix A and (2) obtain written consent from the FDIC and the CDFI before paying any cash dividends.

TVB's efforts to raise capital were impacted by the severe deterioration in the CRE and ADC concentrations and the economic downturn. Although TVB submitted an application for TARP funding on October 28, 2008, the application was subsequently withdrawn. TVB's access to brokered deposits was restricted in February 2009 as a result of the C&D.[16] A subsequent downgrade of TVB's PCA category prohibited the bank from obtaining additional brokered deposits when, on April 8, 2009, the FDIC notified TVB that based on the bank's December 31, 2008 Call Report, its PCA capital category had fallen to *Undercapitalized*. Accordingly, TVB became subject to the mandatory requirements of section 29 of the FDI Act, and was no longer eligible to accept, renew, or roll over brokered deposits or receive a waiver to do so.[17] In addition, TVB became subject to the mandatory requirements of section 38 of the FDI Act, and was (1) required to submit a capital restoration plan (CRP) and (2) subject to other restrictions related to asset growth, acquisitions, new activities, new branches, payment of dividends or management fees, or any other capital distributions. Other significant events regarding TVB's actions to address the bank's capital were taken during 2009 that included, but were not limited to, the following:

May 12, 2009. TVB submitted a CRP to raise $75 million. However, on June 12, 2009, the FDIC informed TVB that the timeframe for raising the additional capital was not acceptable and the assumptions and projections supporting the CRP were not reasonable.

May 28, 2009. The FDIC notified TVB that the bank's capital category had fallen to S*ignificantly Undercapitalized* based on the March 31, 2009 Call Report and required TVB to provide information on actions planned or already taken to comply with the mandatory restrictions required under section 38 of the FDI Act.

June 15, 2009. The FDIC issued a PCA Directive that required TVB to, among other things, recapitalize through the sale of either bank stock or the bank.

June 26, 2009. TVB submitted a revised plan to obtain $76 million in new capital for the bank and $54 million for the bank's holding company. The FDIC subsequently informed TVB that the revised CRP was inadequate because the bank's proposal for obtaining the capital was not realistic and the capital projections failed to achieve the level of capital required under the C&D or other regulatory directives.

Subsequently, on July 17, 2009, the CDFI closed TVB due to the bank's severely deteriorated financial condition and the bank's inability to raise capital at the required level, and named the FDIC as receiver.

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[16] Under FDIC Rules and Regulations, Part 337, *Unsafe and Unsound Banking Practices,* an institution subject to an enforcement order may not accept, renew, or roll over any brokered deposits. However, if the institution is not *Undercapitalized*, as defined in Part 325 of the FDIC Rules and Regulations, it may request a waiver of these restrictions from the FDIC.

[17] Examiners for the March 2009 examination concluded that TVB had an inadvertent apparent violation of Part 337.6 of the FDIC Rules and Regulations because it was operating under the belief that the bank's capital category was *Adequately Capitalized.*

Corporation Comments

After we issued our draft report, we met with management officials to further discuss our results. Management provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On February 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 TVB's failure. In addition, DSC stated that the rapid deterioration of local California real estate markets resulted in increased delinquencies and non-performing assets. Regarding our assessment of the FDIC's supervision, DSC stated that the FDIC and the CDFI jointly conducted three full-scope examinations and three visitations from 2006 to 2009. DSC also conducted offsite reviews and other offsite monitoring activities during this period. Further, DSC stated that it recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as TVB, and has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

Objectives, Scope, and Methodology

Objectives

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

Our audit objectives were to (1) determine the causes of 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 this performance audit from September 2009 to February 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 audit included an analysis of TVB's operations from December 31, 2003 until its failure on July 17, 2009. Our review also entailed an evaluation of the regulatory supervision of the bank from August 23, 2006, the date that FDIC effectively became the primary regulator of TVB, until the bank failed.

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

- Analyzed examination and visitation reports issued by the FDIC and the CDFI from 2006 to 2009.

- Reviewed the following:

  - Available work papers for FDIC examinations and correspondence maintained at DSC's San Francisco Regional Office and Orange County Field Office in California.

  - The February 2006 FRBSF examination report and correspondence related to TVB's withdrawal from the Federal Reserve System to become a nonmember bank regulated by the FDIC in August 2006.

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure. We also reviewed selected failed bank records maintained by DRR in Irvine, California, for information that would provide insight into the bank's failure.

- o Audit Reports prepared by the bank’s external auditor, Crowe Horwath LLP, (formerly Crowe Chizek).

- o Pertinent DSC policies and procedures and various banking laws and regulations.

- o Actions that DSC implemented to comply with (1) provisions of section 29 and the FDIC Rules and Regulations, Part 337, *Unsafe and Unsound Banking Practices* restricting TVB’s use of brokered deposits and (2) section 38 of the FDI Act, including, but not limited to, issuing PCA notification letters and a PCA Directive, and restricting the bank’s growth and payment of dividends, when applicable, based on the bank’s capital category.

- Interviewed the following FDIC officials:

  - o DSC officials in Washington, D.C. and the San Francisco Regional Office.

  - o FDIC examiners from the DSC Orange County Field Office, who participated in examinations, visitations, or reviews of examinations of TVB.

  - o DRR officials at the FDIC Irvine office.

- Met with an official from the CDFI to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

We performed the audit field work at the OIG offices in Dallas, Texas and Arlington, Virginia and the DSC regional office in San Francisco.

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

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

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

Objectives, Scope, and Methodology

testimonial evidence to corroborate data obtained from systems that were used to support our audit conclusions.

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

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Call Report	Consolidated Reports of Condition and Income (also known as the Call Report) are reports that are required to be filed by every national bank, state member bank, and insured state nonmember bank pursuant to the FDI Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
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 unsafe or unsound practices 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 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.
Memorandum of Understanding (MOU)	An informal corrective administrative action for institutions considered to be of supervisory concern but which have not deteriorated to the point where they warrant formal administrative action. As a general rule, this action is to be considered for all institutions rated a composite "3".
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 United States Code 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

Term	Definition
SBA 504 Loans	The SBA 504 loan program is a co-lending product for long-term assets that involves a collaboration between a private sector lender, such as a bank, and a certified development company (CDC). Each party makes a separate loan to a qualifying small business. Typically, the bank portion consists of a loan secured by a first lien on the project, covering 50 percent of the project cost. The CDC portion consists of a loan secured by a second lien on the project, which covers 40 per cent of the project cost. The borrower is expected to cover the remaining 10 percent of the project cost. A secondary market for SBA 504 first lien loans exists, facilitating liquidity management at the lending bank.
SBA 7(a) Loans	The SBA 7(a) program's mission is to help small businesses receive credit. The program provides loan originators a guarantee that if a loan defaults, the SBA will pay off a portion of the remaining balance. Standard 7(a) loans between $150,001 and $2 million receive a 75 percent guarantee; those $150,000 and under receive an 85 percent guarantee. The guaranteed, and, to a lesser extent, the unguaranteed, portion of an SBA 7(a) loan can be sold into the secondary market.
Troubled Asset Relief Program (TARP)	The TARP was established under the Emergency Economic Stabilization Act of 2008. The Act established the Office of Financial Stability within the Department of the Treasury. Under the TARP, Treasury will purchase up to $250 billion of preferred shares from qualifying institutions as part of the Capital Purchase Program.
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.

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
CLP	Contingency Liquidity Plan
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
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FIL	Financial Institution Letter
FRB	Federal Reserve Bank
FRBSF	Federal Reserve Bank of San Francisco
MOU	Memorandum of Understanding
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RM	Relationship Manager
SBA	Small Business Administration
TARP	Troubled Asset Relief Program
TVB	Temecula Valley Bank
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

FDIC

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

TO: Stephen Beard

FROM: Sandra L. Thompson

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Temecula Valley Bank, Temecula, California (Assignment No. 2009-060)

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 Temecula Valley Bank (TVB) which failed on July 17, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on January 25, 2010.

The Report concludes that TVB management's decision to concentrate the loan portfolio in commercial real estate (CRE) and acquisition, construction, and development (ADC) loans and its reliance on non-core funding sources were the principal factors leading to TVB's deteriorating financial condition and ultimate failure. TVB's risk management practices were not sufficient for its business strategies of out-of-area SBA loans and participations and concentrations in CRE/ADC lending. The rapid deterioration of local California real estate markets resulted in increased delinquencies and non-performing assets. TVB did not possess adequate liquidity to continue its lending strategies and was unable to raise additional capital to absorb the loan losses and support operations.

From 2006 to 2009, the FDIC and the California Department of Financial Institutions (CDFI) jointly conducted three full-scope examinations and three visitations. DSC also conducted offsite reviews and other offsite monitoring activities during this period. Examiners expressed concern about TVB's CRE and ADC concentrations at the initial visitation in October 2006 after TVB converted from a Federal Reserve member bank to a state nonmember bank. At the first examination conducted jointly by the FDIC and CDFI in April 2007, TVB's Board of Directors was advised that credit risk and liquidity management practices needed substantial improvement. At the April 2008 exam, asset quality was poor, overall liquidity was unsatisfactory, and an informal enforcement program was implemented.

At the December 2008 joint visitation, examiners found that TVB had deteriorated to a level that raised significant regulatory concern and posed considerable risk, and DSC and CDFI implemented a formal enforcement program. DSC recognizes that strong supervisory attention is necessary for institutions with high CRE/ADC concentrations and volatile funding sources, such as TVB, and has issued updated guidance reminding examiners to take appropriate action when these risks are imprudently managed.

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