Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-10-011

Material Loss Review of MetroPacific Bank, Irvine, California

January 2010

Office of Inspector General

Executive Summary

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Why We Did The Audit

On June 26, 2009, the California Department of Financial Institutions (CDFI) closed MetroPacific Bank, (MetroPacific) Irvine, California, and named the FDIC as receiver. On July 6, 2009, the FDIC notified the Office of Inspector General (OIG) that MetroPacific's total assets at closing were $75.2 million and the material loss to the Deposit Insurance Fund (DIF) was $29 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 MetroPacific.

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

Background

MetroPacific was a state-chartered nonmember bank, established by the CDFI and insured by the FDIC effective February 7, 2005. MetroPacific, which was headquartered in Irvine, California, was a full-service community bank specializing in residential and commercial real estate loans (CRE), including residential acquisition, development, and construction (ADC) loans. MetroPacific provided traditional banking services within its marketplace and had no holding company, subsidiaries, or other affiliates.

Audit Results

Causes of Failure and Material Loss

MetroPacific, a de novo bank, failed primarily because it lacked stable and consistent management and oversight as a result of significant turnover in key management positions. The bank's Board of Directors and management were particularly ineffective in implementing risk management practices pertaining to adherence to the bank's business plan and rapid growth and concentrations in CRE and ADC loans. MetroPacific's operations suffered from inadequate loan underwriting and credit administration, loan policies, and allowance for loan and lease losses practices. The CRE and ADC concentrations and inadequate risk management controls, coupled with weak economic and real estate market conditions, (1) resulted in poor asset quality, a lack of earnings, and eroded capital and (2) left MetroPacific unprepared and unable to effectively manage the risks associated with its loan portfolio. An inadequate capital position finally led the CDFI to close the bank on June 26, 2009.

The FDIC's Supervision of MetroPacific

The FDIC and CDFI provided oversight of MetroPacific by performing four on-site examinations and two visitations from 2005 to 2009. Throughout that period, the examinations and visitations included examiner concerns and recommendations related to the performance of MetroPacific's management, the bank's loan portfolio, loan underwriting and credit administration deficiencies, and weak risk management practices.

The FDIC pursued enforcement actions to correct problems as a result of the January 2006 and February 2008 examinations. However, timelier supervisory action could have been taken to address deviations from the business plan. In addition, as the institution developed a higher-risk profile due to CRE and

ADC concentrations, supervisory action more directly addressing loan policy deficiencies would have been prudent—particularly at the time of the February 2007 examination.

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 MetroPacific. The effectiveness of PCA may have been impacted, however, by the fact that MetroPacific paid rates on certificates of deposit that exceeded the maximum permissible yield for *Adequately Capitalized* banks.

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 December 22, 2009, 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 MetroPacific's failure. In addition, DSC stated that, as a result of significant operational deficiencies noted at the first full-scope examination, MetroPacific agreed to a corrective program with an informal enforcement action in June 2006. Due to significant turnover in key management positions, MetroPacific lacked management stability and was unable to establish a sustainable core business model. DSC officials also stated that the February 2008 joint FDIC/CDFI examination identified a sharp increase in adversely classified assets, an inadequate ALLL, loan underwriting and administration weaknesses, and a significant deviation from MetroPacific's business plan, resulting in a formal enforcement action by the FDIC and CDFI.

With regard to our assessment of the FDIC's supervision, DSC stated that the supervisory program for de novo institutions was recently extended so that these institutions receive a full-scope examination every year for 7 years, as opposed to 3 years. Further, DSC stated that it is closely monitoring de novo business plans against actual performance throughout the 7-year period. DSC's August 2009 Financial Institution Letter, entitled, *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*, describes the program changes for de novo institutions and warns that changes to business plans undertaken without required prior notice may subject institutions or their insiders to civil money penalties.

Contents

DATE: January 6, 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 MetroPacific Bank, Irvine, California* (Report No. MLR-10-011)

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 MetroPacific Bank, Irvine, California. On June 26, 2009, the California Department of Financial Institutions (CDFI) closed the bank and named the FDIC as receiver. On July 6, 2009, the FDIC notified the OIG that MetroPacific's total assets at closing were $75.2 million and the material loss to the Deposit Insurance Fund (DIF) was $29 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 of the FDI Act. This report presents the FDIC OIG's analysis of MetroPacific's failure and the FDIC's efforts to ensure MetroPacific's management operated the bank in a safe and sound manner. We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we

[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.

may also conduct more in-depth reviews of specific aspects of the FDIC'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

MetroPacific was a state-chartered nonmember bank, established by the CDFI and insured by the FDIC effective February 7, 2005. MetroPacific, which was headquartered in Irvine, California, was a full-service community bank specializing in residential and commercial real estate (CRE) loans, including residential acquisition, development, and construction (ADC) loans. MetroPacific provided traditional banking services within its marketplace and had no holding company, subsidiaries, or other affiliates.

Table 1 provides a summary of selected financial information for MetroPacific as of March 2009, and for the 4 preceding calendar years.

Table 1: Financial Condition of MetroPacific

Financial Measure	Mar-09	Dec-08	Dec-07	Dec-06	Dec-05
Total Assets ($000s)	$75,316	$77,393	$63,402	$47,816	$40,026
Total Deposits ($000s)	$70,078	$69,690	$49,031	$35,435	$27,469
Total Loans ($000s)	$56,552	$59,551	$53,499	$34,650	$20,993
Net Income (Loss) ($000s)	($2,474)	($5,744)	($1,424)	($974)	($1,644)

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

Causes of Failure and Material Loss

MetroPacific, a de novo bank,[3] failed primarily because it lacked stable and consistent management and oversight as a result of significant turnover in key management positions. The bank's Board of Directors (Board) and management were particularly ineffective in implementing risk management practices pertaining to adherence to the bank's business plan and rapid growth and concentrations in CRE and ADC loans. MetroPacific's operations suffered from inadequate loan underwriting and credit administration, loan policies, and allowance for loan and lease losses (ALLL) practices. The CRE and ADC concentrations and inadequate risk management controls, coupled with weak economic and real estate market conditions, (1) resulted in poor asset quality, a lack of earnings, and eroded capital and (2) left MetroPacific unprepared and unable to effectively manage the risks associated with its loan portfolio. An inadequate capital position finally led the CDFI to close the bank on June 26, 2009.

[3] De novo institutions are subject to additional supervisory oversight and regulatory controls, including the development and maintenance of a current business plan and increased examination frequency.

Bank Management Turnover

MetroPacific experienced significant turnover rates in key management positions that resulted in unstable and inconsistent management oversight, which contributed to the bank's overall poor financial condition. From 2005 through the bank's failure in June 2009, the bank employed two Chief Executive Officers (CEOs), five Chief Credit Officers (CCOs), and three Chief Financial Officers (CFOs). This instability and inexperience in senior management and the bank's lack of consistent supervision over lending operations contributed to the development of the bank's concentrations, an excessive level of problem loans, and significant deficiencies in underwriting, loan policies, and ALLL practices.

In its business plan, MetroPacific acknowledged the significance of, and responsibilities associated with, these positions, which were critical to the safety and soundness and profitability of the bank. Those responsibilities are outlined below.

- **CEO—**In conjunction with the Board, the CEO was to (1) provide leadership, direction and guidance of the bank's activities to assure short and long-range profitability and planned growth of the bank in a safe and sound manner; and (2) keep the Board informed of financial results of operations, the status of loans, banking competition, and new business developments.

- **CCO—**The CCO was responsible for:

    - the safety and soundness of the bank's loan portfolio, management of the ALLL and insuring that all loan personnel were adhering to the general loan policy, rules, and regulations;

    - executing and administering day-to-day lending functions necessary through supervision of lending staff;

    - reviewing problematic loans with loan officers and taking necessary action to address those issues;

    - maintaining credit files, loan quality assurance and loan reports; and

    - ensuring that the bank's loan mix complied with the lending activities outlined in the bank's business plan.

- **CFO—**The CFO was responsible for the bank's system of internal controls, including developing basic objectives, policies, and operating plans.

Further, according to the DSC *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 Examination Manual also states that it is important for bank management to be aware of and to discharge those responsibilities in a manner that will ensure the stability and soundness of the institution. While it is not necessary for the Board to be actively involved in day-to-day operations of the bank, it must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices are established.

According to the FDIC's February 2008 examination report, MetroPacific exhibited a pattern of hiring or promoting individuals for the CEO and CCO positions who did not have prior lending background and/or experience critical for those positions. During that examination, examiners also concluded that the CCO was not considered qualified to manage the bank's loan portfolio and excessive level of problem assets. Examiners concluded that bank management was unsatisfactory due to significant turnover, an excessive level of problem assets and operating losses, inadequate risk management practices, and the absence of a qualified CCO.

Concerns regarding MetroPacific's inability to effectively manage the bank's operations were reported in the FDIC's April 2008 problem bank memorandum,[4] which noted that:

- the bank's weaknesses appeared to have resulted from poor oversight of the lending function, the lack of a CCO who had the necessary experience to manage the loan portfolio, and excessive turnover of the bank's lending staff; and

- bank management was considered unsatisfactory due to significant senior management turnover, the excessive level of problem assets and operating losses, inadequate risk management practices, and the absence of a qualified CCO.

The March 2009 examination determined that continuing weaknesses in management oversight were evident in all key areas, corrective action to address identified deficiencies continued to be hindered by turnover in key management positions, and major provisions of a June 2008 Cease & Desist Order (C&D)[5] had not been met. Examiners reported that the lack of consistent supervision over the bank's lending activities resulted in an excessive level of problem loans and substantial deficiencies in loan underwriting, loan policies, and ALLL practices. After about 4 years of operation, the bank's condition, including management, was deemed to be critically deficient.

Adherence to the Business Plan

Soon after MetroPacific opened for operations, the bank deviated from its business plan by quickly exceeding financial projections in several areas and failing to follow certain basic risk management controls. Such a deviation was contrary to the FDIC's *Final*

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[4] A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented and is also used to effect interim rating changes on the FDIC's systems. According to Section 32 of the FDI Act, financial institutions that are deemed to be in a troubled condition are required 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.

[5] As a result of weaknesses identified at the February 2008 examination, the FDIC and CDFI issued a joint C&D, which the Board stipulated to on June 17, 2008. Refer to the *Supervisory History* section of this report for additional information on the C&D.

Order for Deposit Insurance approving MetroPacific's deposit insurance.[6] In addition, although MetroPacific's business plan (1) indicated that the bank's loan mix would include a substantial segment of Small Business Administration (SBA) loans and (2) stated that the bank would avoid concentrations of credit, both the lending practices that the bank's Board and management implemented and MetroPacific's significant management turnover in key positions ultimately resulted in (1) the bank's inability to adequately develop the SBA lending as planned and (2) concentrations in CRE and ADC loans. More specifically:

- Although MetroPacific's business plan stated that the bank's proposed CCO and proposed President/CEO had considerable experience in establishing and administering SBA lending programs, problems associated with the bank's ability to achieve its intended level of SBA loans were noted at the bank's first full-scope examination conducted in January 2006.

- At the January 2006 examination, examiners (1) identified underperformance and the lack of expertise to effectively develop and manage the SBA loan portfolio and (2) noted that CRE and construction loans (i.e. ADC loans), which at that time represented 85 percent and 66 percent of Tier 1 Capital, respectively, were the largest categories of loans in the bank's portfolio.

As shown in Table 2, MetroPacific's higher-risk ADC lending was substantially greater than the projected levels during the bank's first 3 years of operation.

Table 2: MetroPacific's Projected and Actual Levels for ADC Loans

Period Ended	ADC Loans	
	Projected	Actual
December 2005	12.3%	32.5%
December 2006	9.3%	34.7%
December 2007	8.4%	38.1%

Source: OIG analysis of MetroPacific's business plan and UBPRs.

According to the *FDIC Statement of Policy on Applications for Deposit Insurance*, and in compliance with sections 5 and 6 of the FDI Act, the FDIC must be assured that the proposed institution does not present an undue risk to the DIF. The FDIC expects proposed institutions to submit a business plan commensurate with the capabilities of the bank's management and the financial commitment of the incorporators. According to guidance in effect at the time the FDIC approved MetroPacific's application for deposit

[6] The *Final Order for Deposit Insurance* included 11 conditions that the FDIC imposed on MetroPacific, and required the bank to comply with during its first 3 years of operation. The conditions were related, but not limited to: (1) operating within the parameters of the bank's business plan, with notification to the FDIC of major deviations from the plan within 60 days; (2) maintaining Tier 1 Capital at not less than 8 percent and an adequate ALLL; and (3) obtaining annual audits of the bank's financial statements by an independent auditor for at least the first 3 years of operation. On February 3, 2005, MetroPacific informed the FDIC that the bank had complied with or agreed to ensure future compliance with all 11 conditions included in the Order.

insurance, any significant deviation from the business plan within the first 3 years of operation—the de novo phase—was to be reported by the insured depository institution to the primary federal regulator 60 days before consummation of the change. Further, business plans that rely on high-risk lending or a special-purpose market, or that otherwise diverge from conventional bank-related financial services, require specific documentation as to the suitability of the proposed activities for an insured institution.

According to DSC officials, in both the January 2006 and February 2007 examination reports, examiners concluded that (1) MetroPacific's inability to develop the SBA loan portfolio as the bank had intended and the resultant concentrations in CRE and ADC loans were temporary situations, (2) the bank's level of CRE and ADC loans was near that of its peer group, and (3) the total number of loans included in the bank's portfolio was minimal. Therefore, according to DSC officials, examiners concluded that the bank was operating within the parameters of its business plan. However, as indicated in Table 2, although the number of loans in the bank's loan portfolio may have been considered to be minimal, MetroPacific significantly exceeded the bank's projected level of growth in high-risk ADC loans outlined in the bank's business plan for each year of its de novo period based on year-end financial data.

Examiners first concluded and reported that MetroPacific was not complying with the bank's business plan at the February 2008 examination. In addition to reporting noncompliance at that examination, an April 18, 2008 FDIC problem bank memorandum stated that MetroPacific's:

- lack of adherence to the originally submitted business plan and provisions in the *Final Order for Deposit Insurance* was troubling,

- concentrations of speculative construction and land development loans were well beyond original projections, and

- concentrations comprised the majority of the $28 million in adversely classified assets.

As indicated in Table 3, MetroPacific's noncompliance with its business plan was not limited to the type and extent of loans included in its portfolio, but also involved other controls included in the FDIC's basis for its decision to approve deposit insurance for MetroPacific.

Table 3: MetroPacific's Business Plan Compared to Actual Actions

Bank Business Plan	Actual Bank Actions
The Board would monitor adherence to the business plan quarterly and revise the plan accordingly.	The Board made no revisions to the original business plan during its de novo period.
Sound underwriting would be developed to keep the bank's loan loss exposure to a minimum.	MetroPacific's Board and management failed to ensure that appropriate loan underwriting and administration risk management controls were implemented and followed, failed to maintain an adequate ALLL, and allowed adversely classified assets totaling more than $28 million to exceed 282 percent of Tier 1 Capital prior to failure.
The Board and executive management would pursue a carefully managed growth strategy.	MetroPacific concentrated its loan portfolio in high-risk CRE and ADC loans, significantly increasing risk to the bank, while experiencing significant turnover rates in key management positions that resulted in unstable and inconsistent management oversight.
The intended geographical market was the bank's surrounding area/county.	MetroPacific originated numerous out-of-area loans that totaled over $10 million as of May 2008.
The bank would not pay fees to brokers for any deposits.*	MetroPacific purchased brokered deposits totaling $2.5 million during 2005 and more than $6.87 million during 2007.

Source: OIG's analysis of MetroPacific's business plan, ROEs, and examination workpapers.
* At the suggestion of an FDIC examiner, MetroPacific informed the FDIC in March 2007 of the Board's decision to use brokered deposits, in addition to other sources of wholesale funding. As noted by examiners during the February 2008 examination, the bank's use of brokered deposits was contrary to the business plan, and the notification provided to the FDIC was not in compliance with the provisions of the *FDIC's Final Order for Deposit Insurance*, which required the bank to provide a 60-day notification before materially deviating from the business plan.

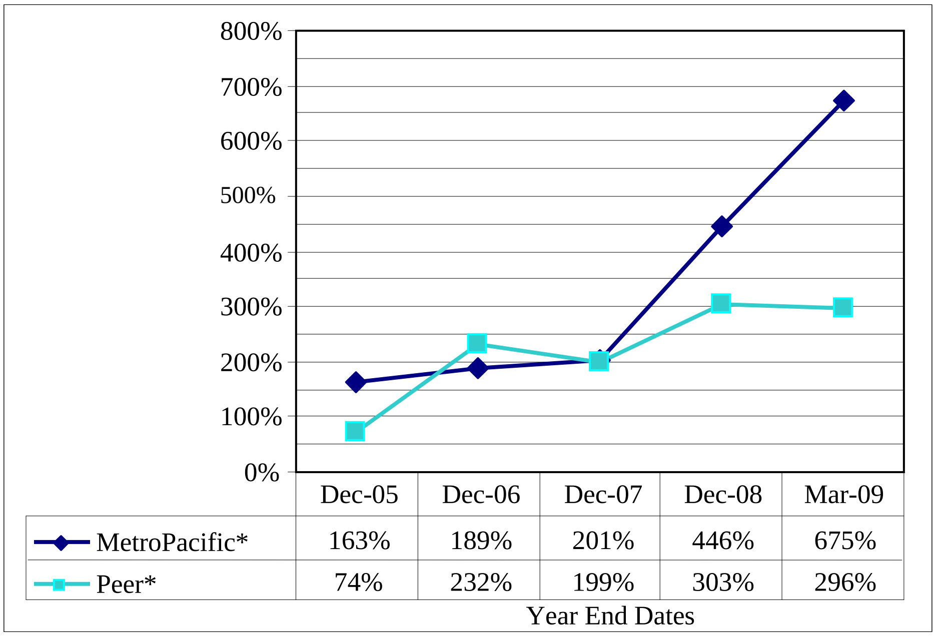
CRE and ADC Loan Concentrations

MetroPacific's business practices resulted in the bank concentrating its loan portfolio in CRE and ADC loans. However, MetroPacific did not ensure that sound loan underwriting and credit administration practices were developed, the loan policy was adequate, and an adequate ALLL was maintained, all of which significantly increased the bank's risk profile.

At the January 2006 examination, examiners noted that CRE loans, at 97 percent of total loans, represented MetroPacific's largest category of loans. ADC loans represented 32.5 percent of total loans. The examiners noted in the February 2008 examination report that MetroPacific's business plan had projected that SBA loans would comprise 37 percent of total loans, versus the actual ratio of 16 percent at that time. According to DSC officials, MetroPacific's inability to develop the bank's SBA loan portfolio resulted in the bank continuing to generate CRE and ADC loans, ultimately developing a concentration in those higher-risk loans.

As indicated in Figure 1, the bank's concentration in CRE as a percent of Total Capital grew at a rate which more than doubled that of its peers by 2009.

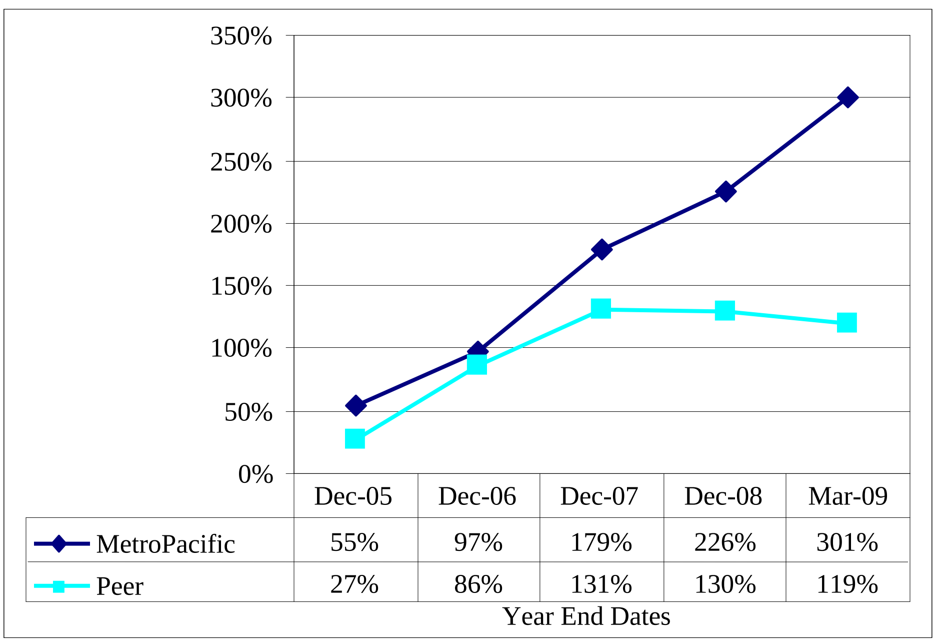
Figure 1: MetroPacific's CRE Loans to Total Capital Compared to Peers



Source: UBPRs for MetroPacific.
* Percentages for December 2007 through March 2009 do not include owner-occupied CRE.

Similarly, Figure 2 shows that the bank's concentrations in ADC loans, as a percent of the bank's Total Capital, consistently exceeded that of its peer group from 2005 through 2009, almost 200 percent more than that of its peer group in 2009.

Figure 2: MetroPacific's ADC Loans to Total Capital Compared to Peers



Source: UBPRs for MetroPacific.

Financial Institution Letter (FIL) 110-98, dated October 8, 1998, entitled, *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending*, defines ADC lending as a highly specialized field with inherent risks that must be managed and controlled to ensure that the activity remains profitable. In addition, the FDIC issued FIL-104-2006, entitled, *Concentrations in Commercial Real Estate, Sound Risk Management Practices*, dated December 12, 2006, which states that such concentrations can pose substantial potential risks and inflict large losses on institutions. Although the guidance does not specifically limit a bank's CRE lending, the guidance provides the following supervisory criteria for identifying financial institutions that may have potentially significant CRE loan concentrations warranting greater supervisory scrutiny.

- Total CRE loans that 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.

- Total reported loans for construction, land development, and other land represent 100 percent or more of the institution's Total Capital.

As shown in Figures 1 and 2, MetroPacific's levels of CRE and ADC concentrations began to exceed the 2006 supervisory criteria in 2008 and 2007, respectively. These concentration levels warranted strategies by MetroPacific to mitigate risk in the event of adverse market conditions. As discussed in subsequent sections of this report, the Board and management failed to effectively establish and implement such strategies.

Loan Policy

Throughout MetroPacific's de novo period, the Board and bank management failed to implement examiners' recommendations regarding deficiencies identified in the bank's loan policy. Those deficiencies related to issues such as, but not limited to, adequate controls to measure, monitor, and report CRE and ADC concentrations.

- **September 2004 Application Process, August 2005 FDIC Visitation Report, and January 2006 Examination Report.** Deficiencies in MetroPacific's loan policy were noted during the 2004 application process, the 2005 visitation, and again in the 2006 examination report. The FDIC made the following specific recommendations to strengthen the bank's proposed loan policy:

    - establish specific portfolio mix targets related to concentrations of credit,

    - define concentrations of credit and aggregate reporting of loans exceeding Part 365 loan-to-value limits, and

    - expand the loan policies to include the requirement for concentration reporting and acceptable risk tolerance parameters.

- **February 2007 Examination Report.** This examination report noted that bank management had implemented the prior examination recommendations for the bank to expand the concentration analysis and establish loan policy requirements for concentration reporting and acceptable risk tolerance parameters. However, examiners made additional recommendations for MetroPacific to:

    - expand the construction loan report to track the number of sold and leased units,

    - enhance the construction policy to include a marketing plan on speculative real estate loans,

    - measure concentrations as a percentage of risk-based capital, and

    - perform stress testing on variable rate commercial and real estate loans.

- **February 2008 and March 2009 Examination Reports.** Examiners continued to identify deficiencies in the bank's loan policy related to reporting and monitoring of concentrations as described above. Further, the February 2008 examination determined that, in some instances, management had failed to follow critical controls that were included in the loan policy, such as performing stress testing and/or sensitivity analysis on borrowers at loan origination. Accordingly, the FDIC addressed these deficiencies in a June 2008 C&D. However, at the following March 2009 examination, examiners also noted numerous deficiencies in the bank's loan policy, including deficiencies related to inadequate guidelines in the CRE concentration loan portfolio mix and monitoring of out-of-territory loans.

DSC's Examination Manual states that there are certain broad areas of consideration and concern that should be addressed in the lending policies of all banks regardless of size or location. According to the manual, a bank's lending policy should include guidelines, which, at a minimum, address the goals for portfolio mix and risk diversification and cover the bank's plan for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist. However, from its inception in 2005 until its failure in 2009, MetroPacific's Board and bank management failed to take timely and effective action to address deficiencies in the bank's loan policy related to CRE and ADC concentrations.

Loan Underwriting and Credit Administration Practices

Weaknesses in MetroPacific's loan underwriting and credit administration contributed to the bank's inability to effectively measure, monitor, and control the risks associated with the bank's loan portfolio. At the February 2008 examination, examiners noted inadequate loan underwriting and credit administration practices related to the following:

- Failure to obtain current appraisals or perform adequate appraisal reviews, which significantly impacted the accuracy of the ALLL.

- Overstated analyses of borrowers' ability to repay.

- Weak underwriting and credit approval process, including inadequate descriptions of borrowers' backgrounds, experiences, and credit histories.

- Failure to perform global financial analyses on borrowers and/or guarantors.

- Inappropriate use of interest reserves in which the bank shifted funds from a contingency reserve to replenish the interest reserve in an attempt to extend the carry period on construction projects.

- Ineffective loan grading and risk monitoring system that resulted in examiners downgrading over $14 million in loans to substandard or worse.

MetroPacific's management did not take timely and effective action to correct its weak loan underwriting and credit administration practices, as evidenced by the results of the subsequent March 2009 examination. At that examination, DSC reviewed approximately 57 percent of MetroPacific's loan portfolio and identified numerous repeat loan underwriting and credit administration weaknesses, in addition to adverse classifications totaling about $28 million. In addition, examiners concluded that there were substantial deficiencies in key risk management controls including, but not limited to, credit underwriting, appraisal review, loan impairment analysis,[7] and verification of a borrower's financial status that resulted in uncontrolled deterioration in the bank's asset quality.

Allowance for Loan and Lease Losses

The February 2008 examination concluded that MetroPacific's Board and management had failed to comply with the FDIC's *Final Order for Deposit Insurance,* which required the bank to maintain an adequately funded ALLL for the first 3 years of operation. In addition, MetroPacific's management did not consistently employ an ALLL methodology in compliance with the guidance entitled, *Interagency Policy Statement on Allowance for Loan and Lease Losses,* dated December 13, 2006. According to this policy, each financial institution must analyze the collectibility of its loans and maintain an ALLL at an appropriate level. 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.

[7] According to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses,* dated December 13, 2006, under Financial Accounting Standards (FAS) 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.

Examiners concluded at the February 2008 and March 2009 examinations that MetroPacific's ALLL was insufficient to protect against the level of potential loss in the bank's loan portfolio. In 2008, adverse classifications totaled more than $9 million, requiring additional provisions for the ALLL. By the March 2009 examination, adverse classifications had increased to $28 million, as shown in Table 4.

Table 4: MetroPacific's Adverse Classifications and ALLL

		ALLL Funding Level		ALLL to Total Loans and Leases	
Examination Dates	Adverse Classifications	MetroPacific's Funded Level	Examiner Recommended Increase	MetroPacific	Peers
	(Dollars in Thousands)			(Percentages)	
01/17/2006	$0	$155	$0	1.20	1.20
02/05/2007	$0	$463	$0	1.34	1.23
02/25/2008	$9,100	$650	$660	2.34	1.28
03/09/2009	$28,000	$3,282	$3,200	7.36	1.57

Source: ROEs and UBPRs for MetroPacific.

Examiners noted in the February 2008 examination report that the bank's ALLL was significantly underfunded, and the methodology was flawed due to weaknesses in loan grading, inadequate support for estimated credit losses, and the absence of an independent ALLL review. Consequently, by March 2009, examiners concluded that deficiencies in MetroPacific's ALLL resulted primarily from the bank's failure to identify problem assets in a timely manner and the subsequent misapplication of FAS 114 impairment principles. As a result, examiners recommended that MetroPacific increase the ALLL by $3.2 million.

The FDIC's Supervision of MetroPacific

The FDIC and CDFI provided oversight of MetroPacific by performing four on-site examinations and two visitations from 2005 to 2009. Throughout that period, the examinations and visitations included examiner concerns and recommendations related to the performance of MetroPacific's management, the bank's loan portfolio, loan underwriting and credit administration deficiencies, and weak risk management practices. The FDIC pursued enforcement actions to correct problems as a result of the January 2006 and February 2008 examinations. However, timelier supervisory action could have been taken to address deviations from the business plan. In addition, as the institution developed a higher-risk profile due to CRE and ADC concentrations, supervisory action more directly addressing loan policy deficiencies would have been prudent—particularly at the time of the February 2007 examination.

Supervisory History

Table 5 summarizes key information pertaining to the on-site risk management that the FDIC and CDFI conducted of MetroPacific, including the institution's (1) supervisory ratings,[8] examinations, and visitations and (2) supervisory and enforcement actions taken, including the MOU issued in 2006 and the C&D issued in 2008.

Table 5: MetroPacific's Examination and Visitation History

Examination Start Date	Agency	Supervisory Ratings (UFIRS)	Supervisory Action
08/08/2005 (Visitation)	FDIC	Not applicable	None
01/17/2006	FDIC/CDFI	223322/3	MOU (Effective June 9, 2006)*
09/12/2006 (Visitation)	FDIC	Not applicable	MOU continued
02/05/2007	FDIC/CDFI	222322/2	MOU terminated
02/25/2008	FDIC/CDFI	344422/4	C&D (Effective June 17, 2008) Problem Bank Memorandum
03/09/2009	FDIC/CDFI	555555/5	C&D continued Problem Bank Memorandum

Source: ROEs for MetroPacific.
* In MetroPacific's response to the January 2006 examination, the bank included a Bank Board Resolution (BBR), dated March 16, 2006. The Board adopted the BBR in response to examiners' concerns as a result of the January 2006 safety and soundness and information technology examinations, and the bank's compliance visitation. Although MetroPacific adopted the BBR, the FDIC issued the MOU, effective June 9, 2006.

Examinations

January 2006. MetroPacific received a composite "3" rating at the bank's first full-scope examination in the January 2006 examination, which revealed that the overall condition of the bank was considered less than satisfactory and the overall infrastructure of the bank was less than sound due to the significant number of internal control deficiencies. The examiners noted that the Board and bank management needed to improve internal controls and bank oversight, and concluded that risk management policies and procedures for asset and liability management and segregation of duties and dual controls were inadequate. As a result of this examination, the FDIC issued an MOU effective June 9, 2006. The MOU addressed operational and information technology deficiencies and required that the bank:

- improve oversight by the Board and senior management and increase the Board's participation in the affairs of the bank;

[8] 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.

- retain management acceptable to the FDIC and the CDFI;
- adopt and implement a policy to provide adequate internal routine and control policies consistent with safe and sound banking practices;
- develop an internal audit program that establishes procedures to protect the integrity of the bank's operational and accounting systems;
- revise, adopt, and implement a written liquidity and funds management policy; and
- implement a policy establishing a formal information technology audit program that provided comprehensive and ongoing audit coverage.

In addition, examiners concluded that as of December 31, 2005, MetroPacific's earnings were less than satisfactory and the bank had sustained a net loss of $1.4 million, representing a loss that was $595,000 greater than projected in the bank's application for deposit insurance.

February 2007. Examiners determined that the bank's overall condition had improved, with adequate capital for the bank's risk profile and anticipated growth and satisfactory liquidity, and concluded that the bank's composite rating and all of the component ratings, except earnings, should be "2s". However, examiners concluded that (1) the bank's earnings were less than satisfactory, with expected profitability delayed until mid-year 2007, (approximately 1 year later than originally anticipated) and (2) MetroPacific had substantially complied with the MOU provisions, and recommended that the FDIC terminate the MOU.

February 2008. The bank's overall condition had begun to show significant deterioration, resulting in a further downgrade of the composite rating to a "4", indicating unsafe and unsound practices or conditions. In addition, several of the bank's component ratings were also downgraded to either a "3" or "4" at this examination. Examiners concluded that after 3 years of operations, MetroPacific's earnings were deficient, unable to support the risk profile of the institution, and continued to erode the bank's capital, with an uncertain prospect for near-term profitability.

MetroPacific's Board stipulated to a C&D on June 17, 2008 that included provisions to address issues related to (1) improving Board and management oversight, (2) providing effective loan policy over the bank's lending function, (3) maintaining Tier 1 Leverage Capital at 10 percent of total assets until sustained profitability was achieved, (4) providing for an adequate ALLL, and (5) improving credit administration and underwriting practices.

March 2009. Examiners concluded that the bank's condition was "extremely critically deficient," citing unsafe and unsound practices and inadequate risk management practices relative to the institution's size, complexity, and risk profile and warranted the greatest level of supervisory concern. Accordingly, the bank's composite and all of the component ratings were downgraded to a "5".

2008 and 2009 Problem Bank Designation. During the February 2008 and March 2009 examinations, the FDIC designated MetroPacific as a "problem bank." That designation was based on, but not limited to, the bank's:

- deteriorated financial condition,
- inadequate management and substantial turnover in critical management positions,
- noncompliance with the business plan and the FDIC's *Final Order for Deposit Insurance*,
- increased adversely classified assets,
- poor credit underwriting and administration,
- inadequate loan and loan concentration review functions,
- underfunded loan loss reserve,
- apparent violations of laws and regulations,
- inability to attain profitability, and
- inadequate capital levels.

Visitations and Offsite Reviews

The FDIC and CDFI also conducted four on-site and two offsite reviews that provided continued monitoring of MetroPacific from the bank's inception in 2005 through its failure.

August 2005 Visitation. Given the bank's de novo status, the FDIC and CDFI conducted a limited scope visitation to verify compliance with the orders issued by the CDFI and the FDIC related to the granting of the bank's charter and deposit insurance. Examiners concluded that (1) asset quality was satisfactory, (2) loan underwriting was adequate, (3) the ALLL was adequately funded, and (4) management's overall methodology and risk management was appropriate. However, DSC noted in the visitation report that the Board still had not addressed recommendations made during the application process to improve the bank's loan policy, such as establishing more specific portfolio mix targets, defining concentrations of credit, and aggregate reporting of loans exceeding loan-to-value limits.

September 2006 Visitation. This visitation was conducted to review the bank's progress in complying with the MOU issued in June 2006. The visitation report noted that, overall, the bank had made significant improvements in identifying weaknesses and complying with the provisions of the MOU, but bank management had not formalized its practices into Board-approved policies and programs. In addition, as follow-up to the MOU, the FDIC reviewed the quarterly progress reports that MetroPacific submitted to the FDIC and CDFI. Those reports outlined the actions that MetroPacific had taken or planned to take to address the provisions included in the MOU.

December 2007 and March 2008 Offsite Reviews. These reviews noted that asset quality had deteriorated, adverse classifications represented 68 percent of Tier 1 Capital, the ALLL was underfunded with classifications centered in large dollar construction and land loans, and significant underwriting and credit administration weaknesses existed. The examiners also noted that the bank remained unprofitable after more than 3 years of operation.

November 2008 Offsite Review. The FDIC initiated this offsite review that focused on the bank's asset quality. Examiners reported that asset quality continued to show signs of deterioration, as evidenced by an increase in adversely classified loans to $16.9 million from $8.8 million during the February 2008 examination, and a continued and significant decrease in the bank's earnings, with the return on assets decreasing from (.82) percent at the February 2008 examination to (3.05) percent.

Supervisory Identification of, and Response to, MetroPacific's Risks

Although MetroPacific had exceeded the parameters of its business plan in ADC concentrations within 6 months of operation and lacked an adequate loan policy to monitor these concentrations, examiners noted but did not take exception to the noncompliance and concentrations until the 2008 examination. Early identification of those risks, coupled with supervisory guidance and studies issued during MetroPacific's existence, should have prompted timelier supervisory action during the bank's de novo phase—particularly at the time of the February 2007 examination.

Growth and concentrations that exceeded and were inconsistent with the business plan. MetroPacific quickly and consistently exceeded the growth parameters for ADC loans included in the business plan and implemented a business strategy that resulted in an ADC concentration that was not consistent with projected growth rates and the bank's stated intention to avoid concentrations of credit. As discussed earlier in this report, MetroPacific's concentration in ADC loans existed 6 months after the bank opened in 2005 and was, at that time, over 20 percent higher than the bank's projected levels.

At the January 2006 examination, which was based on September 2005 financial data, DSC officials stated that examiners determined that MetroPacific's loan portfolio was limited and had not yet resulted in a specific concentration or significant deviation from the business plan. Further, CRE loans represented only 85 percent of Total Capital, far below the concentration levels warranting greater supervisory scrutiny according to the December 2006 guidance, entitled, *Concentrations in Commercial Real Estate, Sound Risk Management Practices*. However, it was evident at the February 2007 examination that a concentration in ADC loans was developing, with the bank's ADC portfolio (1) representing 97 percent of Total Capital (only 3 percentage points less than the 2006 supervisory criteria), and (2) exceeding the bank's projections included in its business plan. As such, the risks associated with the bank's concentrations were also increasing in 2007. As indicated below, the number of loans in the bank's portfolio had substantially increased by the February 2007 examination. More specifically:

- At the January 2006 examination, which was based on September 2005 financial data, loans totaled $12.4 million.

- At the following February 2007 examination, which was based on December 2006 financial data, loans totaled $34.7 million, representing an almost 200-percent increase in the number of loans.

Although the bank's loans had substantially increased by the February 2007 examination, examiners continued to conclude, as they had at the 2006 examination, that MetroPacific was in compliance with the bank's business plan and that there had not been a material or significant deviation from the plan. DSC officials stated that the examiners reached that conclusion because construction lending was an approved product line in the bank's original business plan approved by the FDIC.

The officials further explained that examiners:

- noted the difference between the planned and actual loan mix but did not consider it alarming, given that the percentage of ADC and CRE loans was nearly the same as the bank's peer group and not considered high in relation to Tier 1 Capital, and

- focused on internal control issues and operations, which were assessed as a more immediate risk to the safety and soundness of the institution.

Examiners' opinions regarding the bank's compliance with and material deviation from the business plan changed, however, at the February 2008 examination, when the bank's asset quality was deemed unsatisfactory due to an excessive volume of classified assets, and examiners noted numerous credit underwriting and administration issues and a flawed and underfunded ALLL. At that examination, examiners concluded that the bank was not in compliance with its business plan relative to (1) employing operating officers that were acceptable to the FDIC; (2) having CRE and ADC concentrations, including significant ADC-concentrated loans and out-of-territory lending; and (3) maintaining an adequate ALLL.

- **Operating officers.** Examiners concluded that the bank had been operating without a CCO, and the individuals serving as CFO and CEO did not have prior experience in those positions and/or had no prior lending experience. Examiners concluded that an experienced CCO was needed to address the bank's excessive level of problem loans and the significant underwriting and credit administration weaknesses identified at the examination.

- **CRE and ADC concentrations.** The February 2008 examination report stated that the business plan projected the ratio of construction loans to total loans at 8 percent at the end of the third year, versus the actual ratio of 41 percent, which examiners concluded was an excessive level. In contrast, SBA loans that had been projected to comprise 37 percent of total loans represented only 16 percent of total loans. In addition, examiners concluded that the bank management's (1) underwriting and credit administration expertise and risk management processes were not commensurate with the volume of construction and land development loans in the portfolio and (2) financial analysis skills needed to be strengthened to properly identify risk when underwriting construction and land development loans.

- **Maintaining an ALLL.** Examiners concluded that the bank's inability to maintain an adequate ALLL was directly related to the significant deterioration in the bank's asset quality, among other deficiencies.

It should be noted, however, that although examiners were required to address whether financial institutions were materially deviating from their business plans during an institution's de novo period, prior to the 2009 examination for MetroPacific, DSC had not issued guidance to examiners that specifically defined what would constitute a "material deviation" from a business plan. Such guidance has subsequently been issued. In addition, DSC has since issued guidance to clarify its supervision of de novo banks. Specifically, on August 28, 2009, the FDIC issued FIL-50-2009, entitled *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions*, which extended the de novo period to 7 years for examinations and capital and other requirements. In addition, material changes in business plans for newly insured institutions will require prior FDIC approval during the first 7 years of operation. Further, the guidance states that:

- Going forward, deposit insurance orders for state nonmember institutions will require institutions to obtain prior approval from the FDIC on any proposed major change or deviation in their business plan.

- The FDIC will evaluate proposed material changes to business plans to determine if the institution has sufficient capital, management expertise, and internal controls in place to adequately manage the risks.

- In those instances when an institution has implemented a material change in its business plan without providing prior notice or obtaining the FDIC's prior non-objection, the assessment of civil money penalties or other enforcement action against the institution or other appropriate parties should be considered.

Repeat deficiencies in the bank's loan policy related to monitoring and reporting high-risk concentrations. As early as 2004, examiners identified issues associated with the bank's inadequate loan policy related to the monitoring and reporting of concentrations. However, bank management failed to take timely and effective actions to address deficiencies in MetroPacific's loan policy identified during the September 2004 application process, the August 2005 visitation, and the January 2006 examination report. These issues, coupled with the rapid growth in high-risk ADC loans, should have resulted in earlier and stronger supervisory action. Although examiners stated in the February 2007 examination report that bank management had taken action to improve

MetroPacific's loan policy, examiners also identified additional deficiencies and other issues with the loan policy and continued to recommend that the bank take action to address these issues, as discussed earlier in this report. Examiners continued to report loan policy deficiencies during the February 2008 examination, noting that MetroPacific failed to take appropriate action to address its deficient loan policy. While supervisory action was taken to address the loan policy deficiencies in the June 2008 C&D, this action proved to be in vain, as concerns with the bank's loan policy were also noted at the subsequent January 2009 examination.

Supervisory Guidance and Studies Issued

2004 De novo Bank Study. In 2004, the DSC Atlanta Regional Office (ARO) led an interregional study of de novo financial institutions, and "young" banks (banks in the 4th through 9th years of operation), in fulfillment of a DSC 2004 business line objective. The purpose of the study was to review the timing of, and susceptibility to, problems of de novo and young banks and to determine important factors related to the application process for deposit insurance, compliance with business plans, and high-risk factors for those institutions, including CRE concentrations. MetroPacific exhibited risk factors reported in the 2004 study including, but not limited to (1) weak oversight by the Board, (2) inexperienced management and high turnover in key management positions, (3) departure from the business plan by exceeding projected asset growth, and (4) rapid asset growth in CRE and ADC loans.

2003 CRE Review. The DSC ARO also conducted a CRE Review Project in 2003 that confirmed the need for bank management to develop and implement lending programs that incorporate certain key components. The CRE review concluded that a sound CRE lending program begins with Board and senior management direction and oversight; and that developing and adhering to a comprehensive loan policy that establishes clear and measurable standards for production, underwriting, diversification, risk review, reporting, and monitoring were critical. As a result, CRE Review results were made available to all DSC regional offices through Regional Directors Memorandum entitled, *Commercial Real Estate Review Package* (CRRP), dated December 22, 2003, which stated that while the use of the CRRP was not mandatory, DSC Regional Directors might use the CRRP at their discretion to help assess CRE lending in markets where economic fundamentals or bank lending trends suggest significant increases in risk. The guidance also stated that, generally, banks with CRE loans to Tier 1 Capital ratios of 300 percent or more might be included in a CRRP visitation program.

DSC's Examination Manual. The Examination Manual states that the examiner's evaluation of a bank's credit administration and loan policy and the quality of the loan portfolio are among the most important aspects of the examination process.

MetroPacific's noncompliance with the business plan and developing CRE and ADC concentrations may not have been evident at the August 2005 visitation and the January 2006 examination. However, by the time the February 2007 examination was conducted, DSC should have identified the bank's noncompliance with the business plan and the risks associated with the high growth concentrations, and taken action to address those risks. We recognize that the C&D issued in June 2008 addressed deficiencies at the bank; however, due to the significant concentrations and lack of appropriate controls, MetroPacific's loan-related losses had already resulted in significant deterioration in the bank's asset quality, depleted earnings, and eroded capital.

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. Based on supervisory actions taken with respect to MetroPacific, the FDIC properly implemented applicable PCA provisions of the FDI Act, section 38. The effectiveness of PCA may have been impacted, however, by the fact that MetroPacific paid rates on certificates of deposit that exceeded the maximum permissible yield for *Adequately Capitalized* banks.

Table 6 illustrates the decline in MetroPacific's capital categories during the bank's history.

Table 6: MetroPacific's Capital Ratios Relative to PCA Thresholds for Well Capitalized Institutions

Period Ending	Tier 1 Leverage Capital	Tier 1 Risk-Based Capital	Total Risk-Based Capital	Capital Category
PCA Threshold	5% or more	6% or more	10% or more	
MetroPacific's Capital Ratios				
Dec-05	58.45	81.63	82.62	Well Capitalized
Dec-06	25.79	29.54	30.67	Well Capitalized
Dec-07	18.89	20.30	21.56	Well Capitalized
Jun-08	NA	NA	NA	Adequately Capitalized*
Dec-08	4.28	5.59	6.87	Under Capitalized
Mar-09	3.51	4.08	5.36	Under Capitalized

Source: UBPR and ROEs for MetroPacific.

* When MetroPacific entered into the June 2008 C&D, the bank's regulatory capital category was re-classified from Well Capitalized to Adequately Capitalized for PCA purposes as required by FDIC Rules and Regulation, Part 325, Subpart B.

As indicated above, MetroPacific's capital levels as of December 31, 2008 had dramatically declined from the bank's December 2007 capital levels, and continued falling through March 2009. In addition, during the March 2009 examination, examiners reported that although MetroPacific had not originated or renewed any brokered deposits since entering into the C&D, bank management had not adequately monitored deposit pricing restrictions to ensure compliance with regulatory restrictions.[9] As a result, MetroPacific continued to solicit and retain deposits utilizing rates that significantly exceeded local market averages in apparent violation of Part 337.6 of the FDIC Rules and Regulations. Specifically, examiners' review of rates on $20 million in time deposits that were originated or renewed after the C&D was issued indicated that the rates that MetroPacific paid for essentially all of those time deposits significantly exceeded the average prevailing rates offered within the bank's normal market area. Examiners concluded that, on average, the rates exceeded local market averages by 148 basis points, with variances as high as 241 basis points on some accounts.

On April 21, 2009, the CDFI issued a capital demand letter to MetroPacific's Board giving the bank until June 15, 2009 to raise approximately $5.7 million in capital. The FDIC issued a PCA Notification Letter to MetroPacific dated May 6, 2009, notifying the bank that it was deemed to be *Significantly Undercapitalized*. In compliance with section 38, the notification required the bank to submit a capital restoration plan to the FDIC by June 15, 2009. On June 19, 2009, the FDIC rejected MetroPacific's capital plan dated June 13, 2009, citing the bank's plan to increase capital and become *Adequately Capitalized* as unrealistic. MetroPacific did not obtain the required capital, and the CDFI closed the bank on June 26, 2009.

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 December 22, 2009, 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 MetroPacific's failure. In addition, DSC stated that, as a result of significant operational deficiencies noted at the first full-scope examination, MetroPacific agreed to a corrective program with an informal enforcement action in June 2006. Due to significant turnover in key management positions, MetroPacific lacked management stability and was unable to establish a sustainable core business model. DSC officials also stated that the February 2008 joint FDIC/CDFI examination identified a sharp increase in adversely classified assets, an inadequate ALLL, loan underwriting and administration weaknesses, and a significant deviation from MetroPacific's business plan, resulting in a formal enforcement action by the FDIC and CDFI.

[9] In addition to prohibiting the origination or renewal of any brokered deposit without a waiver, Part 337.6 of the FDIC Rules and Regulations restricts a bank that is not *Well Capitalized* from paying an effective yield on any deposit which exceeds by more than 75 basis points the effective yield paid on deposits of comparable size and maturity in the institution's normal market area.

With regard to our assessment of the FDIC's supervision, DSC stated that the supervisory program for de novo institutions was recently extended so that these institutions receive a full-scope examination every year for 7 years, as opposed to 3 years. Further, DSC stated that it is closely monitoring de novo business plans against actual performance throughout the 7-year period. DSC's *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions* describes the program changes for de novo institutions and warns that changes to business plans undertaken without required prior notice may subject institutions or their insiders to civil money penalties.

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 August 3, 2009 to November 30, 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope and Methodology

The scope of this audit included an analysis of MetroPacific's operations from February 7, 2005 until its failure on June 26, 2009. Our review also entailed an evaluation of the regulatory supervision of the institution over the same period.

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

- Analyzed ROEs and visitation reports prepared by the FDIC and the CDFI examiners from 2005 to 2009.

- Reviewed the following:

  - Documentation for offsite monitoring activities conducted by the FDIC.

  - Available work papers for FDIC examinations.

  - Correspondence maintained at DSC's San Francisco Regional Office and the Orange County Field Office.

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

Objectives, Scope, and Methodology

- Audit Reports prepared by the bank's external auditor, Vavrinek, Trine, Day & Co., LLP, CPAs, Laguna Hills, California.

- Pertinent DSC policies and procedures.

- Interviewed the following FDIC officials:

  - DSC management in Washington, D.C., and San Francisco.

  - FDIC examiners from the DSC Orange County Field Office who participated in MetroPacific examinations and visitations.

- Researched various banking laws and regulations.

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

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

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

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

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

Glossary of Terms

Term	Definition
Adversely Classified Assets	Assets subject to criticism and/or comment in an examination report. Adversely classified assets are allocated on the basis of risk (lowest to highest) into three categories: Substandard, Doubtful, and Loss.
Allowance for Loan and Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL that is adequate to absorb the estimated loan losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated loan losses associated with off-balance sheet loan instruments such as standby letters of credit.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
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 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 categories of undercapitalized institutions.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Consolidated Reports of Condition and Income data submitted by banks.

Acronyms

ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
ARO	Atlanta Regional Office
BBR	Bank Board Resolution
C&D	Cease and Desist Order
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CCO	Chief Credit Officer
CDFI	California Department of Financial Institutions
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CRE	Commercial Real Estate
CRRP	Commercial Real Estate Review Package
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FAS	Financial Accounting Standards
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FIL	Financial Institution Letter
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SBA	Small Business Administration
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

December 22, 2009

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

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of MetroPacific Bank, Irvine, California (Assignment No. 2009-052)

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 MetroPacific Bank (MPB) which failed on June 26, 2009. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on December 14, 2009.

The Report concludes that MPB's failure was due to the Board and management's inability to effectively manage regular operations due to excessive management turnover, and rapid growth in commercial real estate and acquisition, development and construction lending. MPB employed a total of two Chief Executive Officers, three Chief Financial Officers, and five Chief Credit Officers during its four year history, causing significant inconsistencies in loan underwriting, credit administration, and allowance for loan and lease loss (ALLL) practices. Due to expected initial losses and escalating loan losses in 2008 and 2009, the bank never reached profitability, resulting in declining capital reserves and eventually in MPB's failure.

From the time of MPB's opening in 2005 until it was closed, the FDIC and California Department of Financial Institutions (CDFI) performed annual examinations and two interim on-site visitations. As a result of significant operational deficiencies noted at the first full scope examination, MPB agreed to a corrective program with an informal enforcement action in June 2006. Due to significant turnover in key management positions, MPB lacked management stability and was unable to establish a sustainable core business model. The February 2008 Joint FDIC/CDFI examination identified a sharp increase in adversely classified assets, an inadequate ALLL, loan underwriting and administration weaknesses, and a significant deviation from MPB's business plan, resulting in a formal enforcement action by the FDIC and CDFI.

In recognition that elevated supervisory attention is necessary for de novo institutions, DSC recently extended its supervisory program so that these institutions receive a full scope examination every year for seven years, as opposed to three years. De novo business plans are being closely monitored against actual performance throughout the seven year period. The Financial Institution Letter issued in August 2009, describes the program changes for de novo institutions and warns that changes to business plans undertaken without required prior notice may subject institutions or their insiders to civil money penalties.

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