

# Office of Inspector General



Office of Material Loss Reviews  
Report No. MLR-10-047

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**Material Loss Review of First Regional Bank,  
Los Angeles, California**

September 2010



## **Why We Did The Audit**

The FDIC Office of Inspector General (OIG) contracted with KPMG LLP (KPMG) to conduct a material loss review of First Regional Bank (First Regional), Los Angeles, California.

On January 29, 2010, the California Department of Financial Institutions (CA DFI) closed First Regional and named the FDIC as receiver. On March 1, 2010, the FDIC notified the OIG that First Regional's total assets at closing were \$2.1 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was \$825.5 million. As of August 20, 2010, the estimated loss had declined to \$824.6 million. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, to conduct a material loss review of First Regional and retained KPMG for this purpose.

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

## **Background**

First Regional was a state nonmember bank that became insured on December 31, 1979, and primarily operated in Southern California. The bank was wholly-owned, along with six other subsidiaries, by First Regional Bancorp, a single-bank holding company. First Regional had eight offices; six were in Los Angeles County, one in Orange County, and one in Ventura County. More than three quarters of the bank's total deposits were held in its main office in Los Angeles County. Collectively, the bank's Board of Directors (Board) owned approximately 34 percent of the shares outstanding, and one of the senior officials of the bank owned approximately 30 percent of the shares outstanding.

First Regional's assets were concentrated in commercial real estate (CRE), with a significant portion of those loans in the acquisition, development, and construction (ADC) portfolio. The bank significantly increased its reliance on brokered deposits to fund loan portfolio growth.

## **Audit Results**

### **Causes of Failure and Material Loss**

First Regional's failure was due to (1) ineffective Board and management oversight, which included weak risk management practices, violations of laws and regulations, and lack of adherence to some examination recommendations; (2) high concentrations in CRE and ADC lending; (3) inadequate loan underwriting; (4) poor credit administration; and (5) increased dependence on brokered deposits as funding sources during a critical period in 2008. These practices and strategies exposed the bank to substantial risk in declining market conditions. Loan-related losses were responsible for the depletion of earnings and the

erosion of capital. First Regional's reliance on potentially volatile funding sources led to a liquidity crisis and the ultimate failure of the institution.

### **The FDIC's Supervision of First Regional**

Through its supervisory activities, the FDIC identified many of the key risks at First Regional. Concerns identified by examiners included: poor risk management practices, management's lack of adherence to examination recommendations, high concentrations in CRE and ADC lending and with specific borrowers, inadequate loan underwriting practices, and asset growth funded by brokered deposits. These concerns were noted by the FDIC and the CA DFI through examinations and supervisory actions from 2005 through 2009. From 2005 until the bank failed in January 2010, the FDIC and the CA DFI conducted five joint examinations and two limited-scope visitations, and the FDIC conducted off-site reviews, including daily liquidity monitoring beginning in 2008.

The FDIC relied principally on recommendations to address risk management deficiencies identified by examiners. Collectively, the FDIC and the CA DFI imposed a Memorandum of Understanding in 2005 and a Cease & Desist Order (C&D) in 2008. However, both actions primarily focused on Bank Secrecy Act-related issues with risk management deficiencies being addressed in a broad manner. A C&D with stronger language and more specific safety and soundness provisions requiring affirmative action on the part of the bank to correct deficiencies was issued in February 2009.

Examiners identified risks, downgraded component and composite ratings, made recommendations, and took several supervisory actions during the 4 years preceding the failure of First Regional. In retrospect, it appears that a more timely and stringent supervisory response based on the 2007 examination may have been called for given (1) the nature and extent of the risks that existed in the bank's loan portfolio at the time and (2) management's lack of acceptance of examiner findings and failure to implement prior examination recommendations related to those risks. In fairness to examiners, however, such steps may still not have been effective in prompting needed improvements given management's history of being nonresponsive to supervisory authorities.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38. First Regional was unable to solve its liquidity crisis or raise the required capital, and on January 29, 2010, the CA DFI closed the bank due to failing liquidity, declining capital, poor and declining asset quality, and insufficient earnings.

### **Management Response**

On August 27, 2010, the FDIC's Division of Supervision and Consumer Protection (DSC) provided a written response to a draft of this report. In its response, DSC reiterated the OIG's conclusions regarding the causes of First Regional's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. In addition, DSC stated that a financial institution letter was issued in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*, to enhance DSC's supervision of institutions, such as First Regional, with concentrated CRE/ADC lending and reliance on volatile non-core funding.



**DATE:** September 1, 2010

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

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

**SUBJECT:** *Material Loss Review of First Regional Bank,  
Los Angeles, California  
(Report No. MLR-10-047)*

The subject final report is provided for your information and use. Please refer to the Executive Summary, included in the report, for the overall audit results. The report did not contain recommendations, thus a response was not required. However, the Division of Supervision and Consumer Protection provided a written response on August 27, 2010. We incorporated the response into Part II of the final report.

If you have questions concerning the report, please contact me at (703) 562-6352 or Ann Lewis, Audit Manager, at (703) 562-6379. We appreciate the courtesies extended to the audit staff.

Attachment

cc: Stan R. Ivie, Regional Director, DSC  
Elaine D. Drapeau, Acting Chief, Office of Internal Control and Review, DSC  
James H. Angel, Jr., Director, OERM  
William S. Haraf, Commissioner, California Department of Financial Institutions

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*Part I*

*Report by KPMG LLP*

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**Material Loss Review  
First Regional Bank  
Los Angeles, California**

Prepared for the  
Federal Deposit Insurance Corporation  
Office of Inspector General

KPMG LLP  
2001 M Street, NW  
Washington, DC

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KPMG LLP  
2001 M Street, NW  
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September 1, 2010

## Executive Summary

Stephen M. Beard  
Assistant Inspector General for Material Loss Reviews  
Federal Deposit Insurance Corporation  
3501 North Fairfax Drive  
Arlington, VA 22226

### Material Loss Review Report for First Regional Bank, Los Angeles, California

Dear Mr. Beard:

This report represents the results of our work conducted to address the performance audit objectives relative to the Material Loss Review for First Regional Bank (First Regional or the Bank), Los Angeles, California. The objectives of this performance audit were to (1) determine the causes of First Regional's failure and the resulting material loss to the Deposit Insurance Fund (DIF) and (2) evaluate the FDIC's supervision of First Regional, including the FDIC's implementation of the Prompt Corrective Action (PCA) provisions of section 38.

#### *Causes of Failure*

First Regional's failure was due to (1) ineffective Board of Directors (Board) and management oversight, which included weak risk management practices, violations of laws and regulations, and lack of adherence to some examination recommendations; (2) high concentrations in Commercial Real Estate (CRE) and Acquisition, Development, and Construction (ADC) lending; (3) inadequate loan underwriting; (4) poor credit administration; and (5) increased dependence on brokered deposits as funding sources during a critical period in 2008. These practices and strategies exposed the Bank to substantial risk in declining market conditions. Further, loan-related losses were responsible for the depletion of earnings and the erosion of capital. First Regional's reliance on potentially volatile funding sources led to a liquidity crisis and the ultimate failure of the institution.

#### *Evaluation of Supervision*

Through its supervisory activities, the FDIC identified many of the key risks at First Regional. Concerns identified by examiners included: poor risk management practices, management's lack of adherence to examination recommendations, high concentrations in CRE and ADC lending and with specific borrowers, inadequate loan underwriting practices, and asset growth funded by brokered deposits. These concerns were noted by the FDIC and the California Department of Financial Institutions (CA DFI) through examinations and supervisory actions from 2005 through 2009. From 2005 until the Bank failed in January 2010, the FDIC and the CA DFI



conducted five joint examinations and two limited-scope visitations, and the FDIC conducted off-site reviews, including daily liquidity monitoring beginning in 2008.

The FDIC relied principally on recommendations to address risk management deficiencies identified by examiners. Collectively, the FDIC and the CA DFI imposed a Memorandum of Understanding (MOU) in 2005 and a Cease and Desist Order (C&D) in 2008. However, both actions primarily focused on Bank Secrecy Act (BSA)-related issues with risk management deficiencies being addressed in a broad manner. A C&D with stronger language and more specific safety and soundness provisions requiring affirmative action on the part of the Bank to correct deficiencies was issued in February 2009.

Examiners identified risks, downgraded component and composite ratings, made recommendations, and took several supervisory actions during the 4 years preceding the failure of First Regional. In retrospect, it appears that a more timely and stringent supervisory response based on the 2007 examination may have been called for given (1) the nature and extent of the risks that existed in the Bank's loan portfolio at the time and (2) management's lack of acceptance of examiner findings and failure to implement prior examination recommendations related to those risks. Still, such steps may not have been effective in prompting needed improvements, given management's history of inattentiveness to recommendations and noncompliance with supervisory action requirements.

#### *Prompt Corrective Action*

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e) of the FDI Act, and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved. Based on the supervisory actions taken with respect to First Regional, we determined that the FDIC properly implemented applicable PCA provisions of section 38 of the FDI Act.

We conducted our performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the performance 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.

The information included in this report was obtained during our fieldwork, which occurred from May 2010 to August 2010.

Very truly yours,

**KPMG LLP**

## Why We Did the Audit

On January 29, 2010, the CA DFI closed First Regional and named the FDIC as receiver. On March 1, 2010, the FDIC notified the Office of Inspector General (OIG) that First Regional's total assets at closing were \$2.1 billion and the estimated loss to the DIF was \$825.5 million. As of August 20, 2010, the estimated loss to the DIF had decreased to \$824.6 million. The estimated loss exceeds the \$200 million threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), signed into law July 21, 2010. The OIG was required by section 38(k) of the Federal Deposit Insurance (FDI) Act, as amended by the Financial Reform Act, to conduct a material loss review of the failure of First Regional, and retained KPMG LLP (KPMG) for this purpose.<sup>1</sup>

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

## Background

First Regional was established in Los Angeles, California as a state nonmember bank that became insured on December 31, 1979 and primarily operated in Southern California. The Bank was wholly-owned, along with six other subsidiaries, by First Regional Bancorp, a single-bank holding company. The Bank's wholly-owned subsidiary, Trust Administration Services Corporation, provided administrative services for self-directed retirement plans until the functions were shifted to the Bank's Trust Administration Department on August 31, 2006. Collectively the Board owned approximately 34 percent of the shares outstanding, and one of the senior officials owned approximately 30 percent of the shares outstanding.<sup>2</sup>

First Regional had eight offices; six were in Los Angeles County, one in Orange County, and one in Ventura County. More than three quarters of the Bank's total deposits were held in its main office in Los Angeles County. The Bank operated in competitive markets and its deposit market share was minimal (less than 1 percent) in each county where it operated.<sup>3</sup> Employment in the Bank's primary market areas of Los Angeles and Orange counties weakened, declining more than 4 percent in the third quarter 2009 from the previous year. Unemployment rates of 11.1 percent put these markets at an all-time high since data was first collected in the 1980s. Conditions also continued to be weak in the housing market across the state of California.

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<sup>1</sup> In conducting this performance audit and preparing this report, KPMG relied primarily on information provided by the FDIC OIG and the Division of Supervision and Consumer Protection (DSC). Appendix I, Objective, Scope and Methodology, describes in greater detail the procedures used by KPMG.

<sup>2</sup> DSC Supervisory History written in late 2009 prior to First Regional's failure.

<sup>3</sup> Deposit data is as of June 30, 2009 from the FDIC Summary of Deposits.

First Regional's assets were concentrated in CRE, with a significant portion of those loans in the ADC portfolio. Further, the Bank significantly increased its reliance on brokered deposits to fund loan portfolio growth.

Table 1 provides details on First Regional's financial condition as of December 2009, and for the 3 preceding calendar years.

**Table 1: Financial Condition of First Regional, 2006 to 2009**

Financial Measure	Dec-09	Dec-08	Dec-07	Dec-06
Total Assets (\$000s)	2,082,684	2,459,748	2,170,753	2,072,523
Total Loans (\$000s)	1,944,151	2,333,815	2,055,106	1,833,113
ADC as a Percentage of Total Loans	32.94	40.89	49.36	40.07
CRE as a Percentage of Total Loans	89.32	88.99	92.90	87.04
ALLL* (\$000s)	66,522	61,336	22,771	20,624
Total Deposits (\$000s)	1,664,450	2,150,888	1,740,337	1,628,965
Core Deposits** (\$000s)	1,271,192	1,764,234	1,577,236	1,506,141
Time Deposits over \$100,000 (\$000s)	393,259	386,653	163,101	122,823
Net Income (Loss) (\$000s)	(120,665)	(16,822)	42,410	46,656

Source: Uniform Bank Performance Reports (UBPR) for First Regional.

\* Allowance for Loan and Lease Losses.

\*\* Time Deposits under \$100,000 are included in Core Deposits.

## Causes of Failure and Material Loss

First Regional's failure was due to (1) ineffective Board and management oversight, which included weak risk management practices, violations of laws and regulations, and lack of adherence to some examination recommendations; (2) high concentrations in CRE and ADC lending; (3) inadequate loan underwriting; (4) poor credit administration; and (5) increased dependence on brokered deposits as funding sources during a critical period in 2008. These practices and strategies exposed the Bank to substantial risk in declining market conditions. Further, loan-related losses were responsible for the depletion of earnings and the erosion of capital. First Regional's reliance on potentially volatile funding sources led to a liquidity crisis and the ultimate failure of the institution.

## Management and Board Oversight

### Risk Management Practices and Strategies

From 2005 through 2009, First Regional's management exhibited risky practices that included policies allowing excessive concentrations in CRE and ADC lending and in specific borrowers and their entities, as well as out-of-area lending within the ADC portfolio. Other significant issues included lax underwriting standards when the risk of the loan portfolio should have prescribed more conservative standards, credit administration deficiencies that included an underfunded ALLL and a lack of timely recognition of problem credits, and a funding strategy for the Bank's asset growth that was largely dependent on non-core deposits that were unsustainable after the Bank's capital levels declined. Details regarding the impact of these practices and strategies are discussed in subsequent sections of this report.

At the 2008 examination, the examiners noted management’s decision to continue to concentrate on a CRE loan portfolio, especially real estate construction and development, in order to maintain higher yields and offset the Bank’s higher cost of funds. Moreover, the examiners noted that the downturn in the real estate market resulted in significant losses and risks to the Bank, depleted the current year’s earnings, and would have an impact on future earnings and capital.

Examiners at the July 2009 joint examination noted that Board management and oversight were critically deficient and that the Board’s desire for growth resulted in concentrations in speculative real estate lending and accounted for the Bank’s weakened condition. Further, there were loan losses and lost income suffered with the deterioration of the real estate market, a situation that was unprecedented in management’s experience.

Table 2 shows First Regional’s asset growth from 2005 through 2008. The most critical growth took place in 2008, which added to an already high concentration in CRE lending, and occurred during a period when the real estate market was deteriorating.

**Table 2: First Regional’s Asset Growth, 2005 to 2008**

Date	Total Assets (\$000s)	Percent change
12/31/2005	\$1,695,864	N/A
12/31/2006	\$1,943,835	14.62%
12/31/2007	\$2,064,491	6.21%
12/31/2008	\$2,341,554	13.42%

Source: UBPRs for First Regional.

Examiners at the July 2009 joint examination also noted that the Board and management implemented an aggressive lending policy, including high advance rates and out-of-area lending, which continued well beyond the time when other financial institutions had stopped that type of lending due to deteriorations in the market. Further, the Bank could not fund its growth through traditional core deposits, and the Board chose to continue to lend and fund construction projects with brokered deposits in 2008. The inability to solicit or renew the excessive level of brokered deposits led to First Regional’s liquidity crisis.<sup>4</sup>

#### Violations of Laws and Contraventions with Policy

In examinations conducted in the last several years prior to First Regional’s failure, the regulators noted several apparent violations of banking laws and contraventions with policy. Table 3 provides a summary of those violations and contraventions related to safety and soundness noted by examiners from 2005 until the last examination in July 2009.

<sup>4</sup> As of the June 2008 examination, First Regional’s capital level fell to *Adequately Capitalized*. This requires the FDIC to take certain mandatory actions, including imposing restrictions on obtaining new or rolling over existing brokered deposits.

**Table 3: Summary of First Regional’s Apparent Violations of Laws and Contraventions with Policy, 2005 to 2009**

Applicable Laws, Rules, and Regulations	Description	Examination Date				
		July-09	June-08	April-07	March-06	March-05
FDIC Rules and Regulations Section 365.2(a)	Each insured State nonmember bank shall adopt and maintain written policies that establish appropriate limits and standards for extensions of credit that are secured by liens on or interest in real estate, or that are made for the purpose of financing permanent improvements to real estate.					X
FDIC Rules and Regulations Section 365 Appendix A	The institution should monitor conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to its lending decisions.		X		X	X
FDIC Rules and Regulations Part 326.8 c(1)	All insured nonmember banks shall establish and maintain procedures reasonably designed to assure and monitor compliance with the requirements promulgated by 31 CFR Part 103 of the U.S. Treasury Financial Recordkeeping Regulations. In addition, the compliance program shall, at a minimum, provide a system of internal control to assure ongoing compliance.		X	X	X	
U.S. Treasury Financial Recordkeeping Regulations Section 31 C.F.R. 103.100(b)(2)(i)	Requires financial institutions to conduct record searches expeditiously when they receive a request from the Financial Crimes Enforcement Network.			X	X	
FDIC Rules and Regulations Part 323.3(a)(7)	States that appraisals are required for real estate related transactions, including transactions involving extensions of credit, unless there has been no obvious change in the material change in market conditions.		X			
FDIC Rules and Regulations Part 323.3(b)	In transactions that do not require the services of a state certified or licensed appraiser, the institution shall obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.	X	X			
FDIC Rules and Regulations Part 364.101, Appendix A	States that each institution should establish and maintain prudent underwriting practices that: are commensurate with the types of loans the institution will make and considers terms and conditions under which they will be made; take adequate account of concentration of credit risk; and are appropriate to the size of the institution and the nature and scope of its activities.	X	X			

Source: Reports of Examination (ROE) for First Regional.

Overall, the extent and repetition of some of these violations and contraventions provide further evidence of First Regional’s inadequate management and Board oversight that led to the failure of the Bank.

**Inadequate Response to Recommendations and Supervisory Actions**

In addition to the Bank’s regulatory violations, there were examination recommendations and supervisory action requirements that were not fully adhered to by First Regional management.

For example, there were repeated examination recommendations to reduce individual borrower concentrations. The March 2006 joint examination noted that two individual borrowers exceeded the Bank’s policy limit of 100 percent of Tier 1 Capital plus the ALLL at year-end 2005, yet the Bank continued to lend to these borrowers. It appeared that bank management had chosen to ignore not only the Bank’s policies, but also regulatory guidance. In addition, at the subsequent joint examination in 2007, examiners noted that the Board failed to ensure that the Bank substantially complied with the outstanding requirements of the MOU that was effective in

September 2005. Further, examiners noted that the Board had disregarded examiners' recommendations related to diversification of risk, which is one of the basic tenets of banking.

Examiners at the June 2008 examination noted that management continued to ignore examination findings related to the reduction of individual borrower concentrations and the practice of avoiding personal guarantees to remain within the Bank's legal lending limit. At the final joint examination in July 2009, examiners noted that the Board did not address regulatory concerns expressed during prior examinations regarding the Bank's concentrated risk in CRE.

### **Concentrations in CRE and ADC Lending**

Concentrations in CRE and ADC lending played a significant role in the quality and composition of First Regional's assets and the Bank's growth from 2005 to 2009. At the March 2005 joint examination, the Bank's concentration in CRE equaled 855 percent of Tier 1 Capital plus the ALLL. The examination also noted significant borrower concentrations. For example, there were two concentrations related to limited liability companies that were created and managed by two different borrowers. Each affiliated relationship exceeded 100 percent of Tier 1 Capital plus the ALLL. Despite recommendations in prior ROEs, the Bank had not established limits for its real estate concentrations of credit, as required by Part 365 – *Real Estate Lending Standards*, as previously illustrated in Table 3.

Examiners at the March 2006 examination noted that prior concerns regarding high concentration levels and inadequate monitoring of those concentrations were magnified as concentration levels increased even further without commensurate improvements in monitoring systems or the establishment of adequate controls or limits. Examiners also noted that the Bank's total assets had more than tripled in a 3-year period. The growth had been almost exclusively centered in CRE loans, and in particular, multi-family residential loans, and the inadequate diversification in the loan portfolio posed increased risk to the Bank.

The December 12, 2006, joint guidance<sup>5</sup> titled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Joint Guidance) does not establish specific CRE lending limits, but defines criteria to identify institutions potentially exposed to significant CRE concentration risk. According to the Joint Guidance, a bank that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria, may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- Total reported loans for construction, land development, and other land (referred to in this report as ADC) representing 100 percent or more of Total Capital; or
- Total CRE loans representing 300 percent or more of Total Capital where the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

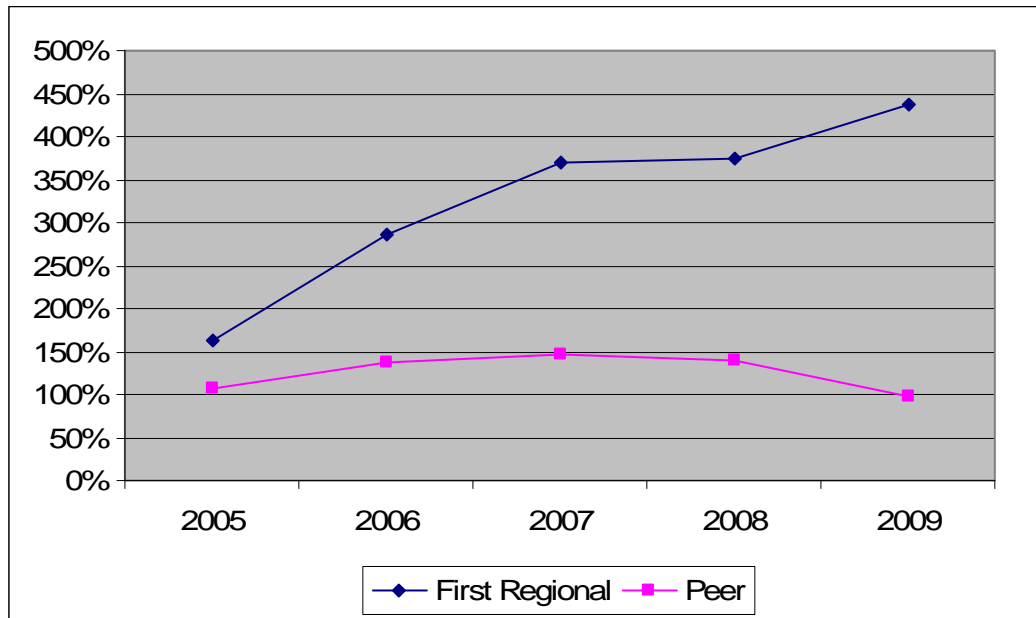
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<sup>5</sup> The guidance was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC (collectively referred to as "the agencies" in the guidance).



Figure 1 shows First Regional’s ADC concentration levels as a percentage of Total Capital compared to its peer group<sup>6</sup> from 2005 to 2009. As represented, the concentration level exceeded the supervisory criteria of 100 percent since 2005 and, more importantly, after the Joint Guidance was issued.

**Figure 1: First Regional’s ADC Concentration as a Percentage of Total Capital Compared to Peer Group, 2005 to 2009**



Source: UBPRs for First Regional.

Note: The concentration level at year-end 2009 was largely due to a substantial decrease in First Regional’s capital level.

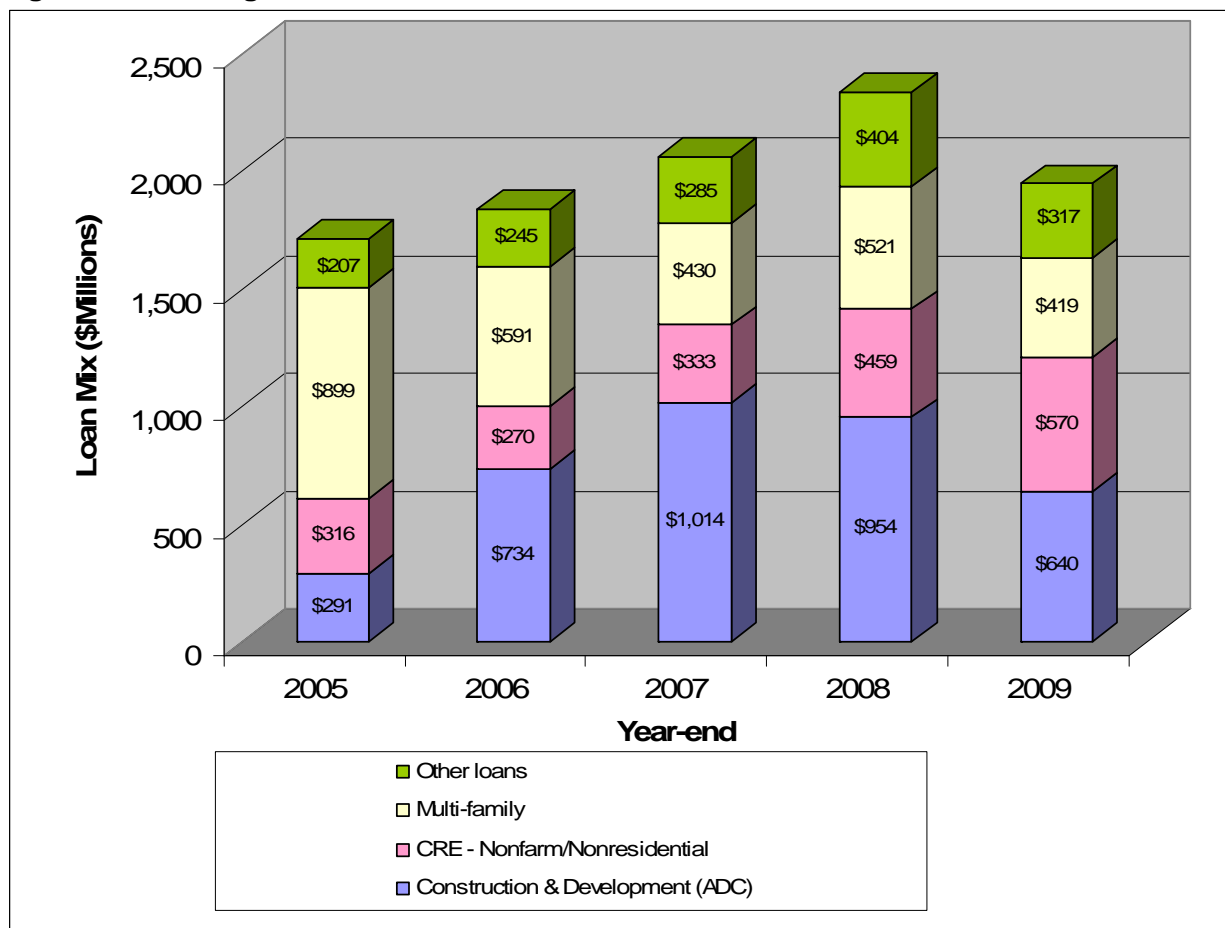
CRE concentration levels were also high in comparison to the Bank’s peer group. From 2005 through 2008, CRE concentration levels ranged from 623 percent to 840 percent, respectively, as a percentage of Total Capital, while the peer group concentration level ranged from 359 percent to 420 percent during the same timeframe.

Examiners at the April 2007 joint examination noted that the Bank extended various loans to the two aforementioned borrowers and limited liability entities controlled by them, which, when combined, totaled \$288.7 million and represented 122 percent of Tier 1 Capital plus the ALLL. Examiners noted the need for management to reduce the exposure from these large credit relationships and to diversify its loan portfolio. Examiners further noted that the risk of the concentration in apartment conversion projects managed by one of the borrowers was highly vulnerable to deterioration in the residential real estate market. The total CRE concentration grew 6 percent from the prior 2006 examination to more than \$1.5 billion, and property concentrations in multi-family and condominiums represented approximately \$569 million and \$428 million, respectively.

Figure 2 illustrates the changing composition of First Regional’s loan portfolio and the increase in higher-risk ADC and CRE loans, particularly in 2007 and 2008.

<sup>6</sup> First Regional’s peer group included all commercial banks having assets between \$1 billion and \$3 billion.

**Figure 2: First Regional's Loan Mix, 2005 to 2009**



Source: Call Reports for First Regional.

Examiners at the June 2008 joint examination noted that the volume of adversely classified assets had dramatically increased from \$1.3 million during the prior examination, or 0.5 percent of Tier 1 Capital plus the ALLL, to \$218.3 million, or 79.2 percent, respectively. CRE loan concentrations represented 1,119 percent of Tier 1 Capital plus the ALLL. This was a substantial increase from the 681 percent level identified at the prior examination. Condominium conversion and construction represented the largest CRE concentration at 285 percent of Tier 1 Capital plus the ALLL. Borrower concentrations represented 120 percent of Tier 1 Capital plus the ALLL, and included one of the previously-mentioned borrowers whose loans were now adversely classified and represented 36 percent of Tier 1 Capital plus the ALLL.

In the 2008 ROE, examiners noted that while monitoring of the CRE concentrations appeared to be adequate, the level of concentrations was a concern given the market conditions. Examiners further noted that asset quality had continued to deteriorate and was unsatisfactory. Adverse classifications were considered severe and were concentrated in the CRE portfolio, particularly in the financing of speculative real estate acquisition and development projects. In the section of

the ROE that addresses items subject to adverse classification, examiners noted problem loans in the Bank's out-of-area lending, including properties in Florida and Nevada.

Examiners at the July 2009 joint examination noted that asset quality was severely deficient, as the Bank's level of non-performing loans and the risks within the loan portfolio had dramatically increased. As of June 30, 2009, adversely classified items totaled \$534.9 million, or 195.24 percent of Tier 1 Capital plus the ALLL, as compared to \$218.3 million or 79.23 percent, respectively, at the prior examination. Further, one of the previously-mentioned borrowers showed financial weakness; \$97 million in classified assets related to this borrower were noted at the examination, representing about 63 percent of First Regional's relationship with this borrower. Examiners also noted that the Bank's high-risk lending strategy resulted in CRE concentrations that led to high levels of classified assets and losses in a deteriorating real estate market.

Table 4 summarizes First Regional's loan portfolio deterioration from 2005 through 2009.

**Table 4: First Regional's Total Nonaccrual Loans and Leases, Loans and Leases 30 to 89 Days Past Due, and Other Real Estate Owned, 2005 to 2009**

<b>Year Ended</b>	<b>Total Nonaccrual Loans and Leases (thousands)</b>	<b>Loans and Leases 30-89 Days Past Due (thousands)</b>	<b>Other Real Estate Owned (thousands)</b>
2009	\$350,584	\$55,599	\$70,245
2008	\$92,517	\$112,788	\$9,611
2007	\$2,000	\$21,440	\$0
2006	\$0	\$500	\$0
2005	\$2,195	\$1,786	\$0

Source: UBPRs for First Regional.

As illustrated above, of particular note are total nonaccrual<sup>7</sup> loans that climbed from \$2.0 million in 2007, to \$92.5 million in 2008, to more than \$350 million by year-end 2009.

As discussed in the Joint Guidance, rising CRE concentrations could expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market. Indeed, it appears that adverse changes in the economy coupled with First Regional's elevated risk exposure to CRE lending had a negative impact on the Bank's capital as a result of increased charge-offs and increased loan loss provisions.

<sup>7</sup> An asset is to be reported as being in nonaccrual status if: (1) it is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) payment in full of principal or interest is not expected, or (3) principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. (Source: FDIC Schedule RC-N – Past Due and Nonaccrual Loans, Leases, and other Assets)

## **Loan Underwriting**

Inadequate underwriting standards at First Regional increased the risk associated with the CRE concentration and contributed to deteriorating asset quality starting in 2008, but the underwriting issues were evident at earlier examinations. As early as 2005, examiners noted concerns regarding the Bank's underwriting and collateral review practices. Examiners at the March 2006 examination noted that due to underwriting weaknesses in several of the credits in the large borrower relationships, the principal could easily walk away from any of the projects without much loss should the real estate market suffer a downturn.

Examiners at the April 2007 examination continued to note inadequate underwriting and that, in some cases, the Bank did not obtain personal guarantees for both unsecured and secured debts. Examiners also noted that not taking personal guarantees from the principals on the credits from the two large borrower relationships was an unsafe and unsound practice. Further, examiners noted that credit approval memoranda lacked discussion of the project being financed and a detailed analysis of debt servicing given that the properties exhibited insufficient cash flow.

At the June 2008 examination, asset quality had significantly deteriorated with the declining economy and poorly performing loans, largely due to high CRE concentrations and the effect of poor underwriting practices. Examiners noted that many of the loans that had been adversely classified were underwritten with underlying properties that had insufficient cash flow to service the debt and marginal collateral support. A significant weakness cited at this examination was the practice of renewing or extending CRE credits in locations suffering considerable market deterioration without obtaining appropriate collateral evaluations or appraisals. Other weaknesses noted by examiners included inadequate credit analysis, outdated cash flows/rent rolls, and stale financial statements.

At the July 2009 final joint examination, examiners noted that collateral evaluation practices continued to be deficient, which resulted in a number of apparent violations, as shown earlier in Table 3.

## **Credit Administration**

Credit administration deficiencies also played a role in the asset quality problems at First Regional as well as impacted capital and earnings, particularly in the later stages of the institution. Examiners at the March 2005 joint examination noted that the Bank's appraisal reviewer did not have prior experience or formal training in evaluating appraisals. Examiners noted that during a discussion between the examiner and the appraisal reviewer in regard to a specific appraisal, the appraisal reviewer was unable to answer the examiner's questions.

At the March 2006 joint examination, examiners considered management's methodology for determining an adequate ALLL level to be satisfactory. However, the downgrade to Special Mention of a substantial portion of loans associated with the two large borrower relationships had resulted in an inadequate ALLL reserve. In addition, during the examination, the Bank charged off two loans totaling \$941,000, which increased the reserve shortfall to \$4.3 million.

Further, examiners noted that concerns regarding high concentration levels and inadequate underwriting guidelines were magnified as underwriting standards eased and concentration levels increased without commensurate improvement in a risk monitoring system. In reference to eased standards, examiners noted that bank policy required a minimum loan-to-value (LTV) limit of 80 percent, which was not excessive by itself, but when combined with the lack of requirement for a guarantee by the borrower/developer, this LTV limit increased the risk profile of the bank.

Examiners at the April 2007 joint examination noted that the ALLL was appropriately funded; however, the ALLL methodology was not in compliance with the December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (Policy Statement on ALLL). Examiners further noted that a key factor preventing compliance and impeding finalization of First Regional's new ALLL analysis program was the Bank's failure to evaluate a loss estimation model before it was employed in the ALLL analysis, as required by the new guidance.

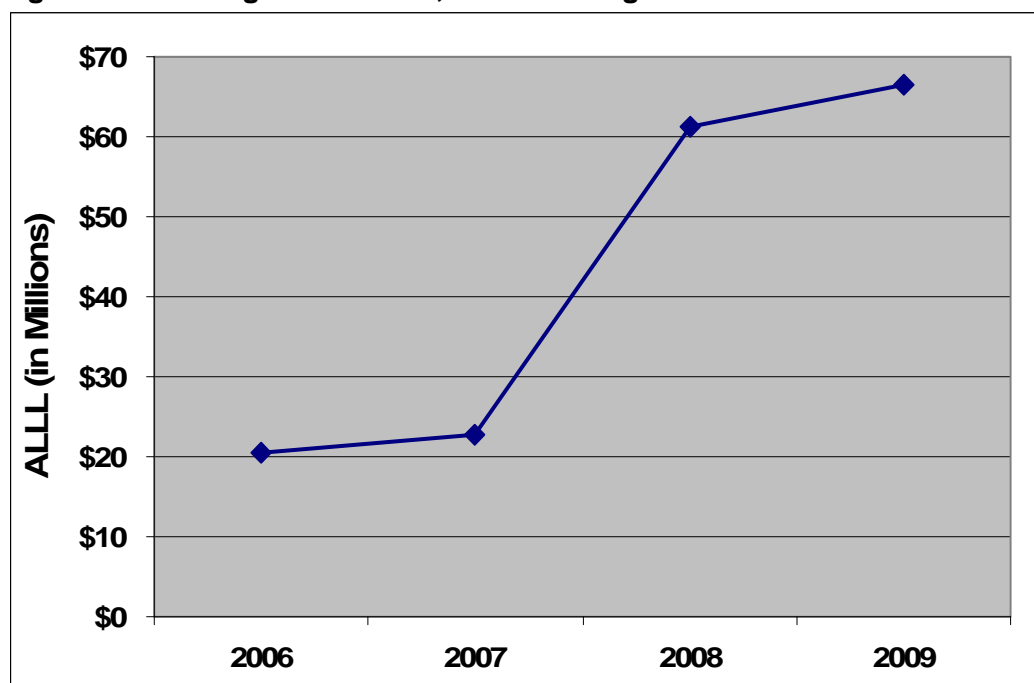
Examiners at the June 2008 joint examination noted that credit administration and risk identification practices were weak and warranted immediate strengthening. Further, 11 credits were downgraded by examiners at this examination, and several other credits that management downgraded just prior to the examination did not appear to have been properly risk-rated in a timely manner. Examiners noted that although the Bank's methodology for determining the ALLL was generally appropriate, the reserve was underfunded by \$10.8 million as of June 30, 2008. This was primarily due to the significant credit quality downgrades, as well as deficiencies in calculating reserve factors under Statement of Financial Accounting Standards (FAS) No. 114.<sup>8</sup>

Figure 3 illustrates that First Regional's ALLL increased almost \$38 million from year-end 2007 to year-end 2008 to a total of more than \$61 million. Additionally, First Regional's total ALLL compared to total loans and leases represented 1.1 percent in 2007, which was lower than the Bank's peer group, but grew to 2.63 percent in 2008, which outpaced the peer group level of 1.59 percent.

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<sup>8</sup> FAS No. 114 addresses the accounting by creditors for impairment of certain loans.

**Figure 3: First Regional's ALLL, Years Ending 2006 to 2009**



Source: UBPRs for First Regional.

Accelerated asset quality problems were detected by examiners at the July 2009 joint examination. Examiners noted that the Bank's ALLL was not maintained at an appropriate level in accordance with Generally Accepted Accounting Principles (GAAP) to cover estimated credit losses on individually evaluated loans that were impaired and estimated credit losses inherent in the remaining portfolio. Examiners determined that the ALLL was underfunded by a minimum of \$69 million as of June 30, 2009, based on the available and relevant information they were provided during the credit review.

Examiners further noted at the July 2009 examination that credit administration and risk identification practices continued to be weak and needed improvement. Fourteen internally-rated acceptable credits, totaling \$162.4 million, were downgraded by examiners at this examination. In three of those credits, management learned of significantly increased risk in the collection prior to the examination but failed to downgrade these credits in a timely manner. In addition, management had been slow in recognizing deterioration in previously identified problem credits. Other credit administration weaknesses included deficient credit memorandum information, troubled debt restructure reporting, and Regulation O<sup>9</sup> documentation.

Additionally, examiners noted that earnings had been depleted by the high level of provision expense required to fund the ALLL and that capital levels were eroded by the year-to-date losses and were insufficient to support the heightened level of risk. The prospects for improvement at the time did not look favorable as the ALLL level was also expected to remain high with a continued decline in credit quality and the further declines in the values of real estate collateral.

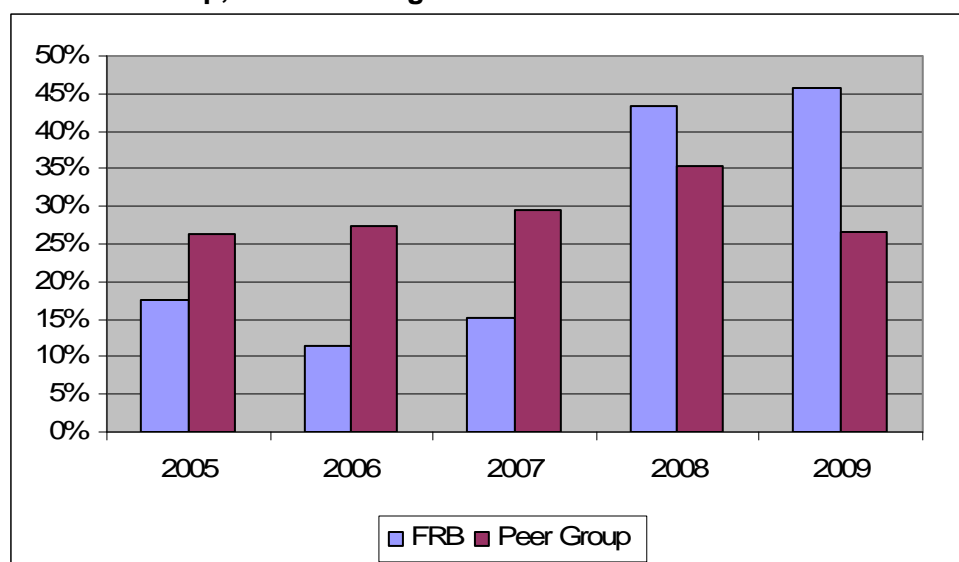
<sup>9</sup> Regulation O limits the amount of credit that member banks may extend to their own executive officers.

## Funding Strategy

First Regional primarily used core funding sources to support growth through 2007. Examiners at the June 2008 examination noted that brokered deposits represented \$8 million as of March 31, 2008. At year-end 2008, brokered deposits represented approximately \$650 million, which illustrated a dramatic shift in First Regional's funding strategy.

Figure 4 shows that First Regional had a less significant reliance on non-core deposits than its peers through 2007, but the reliance increased dramatically in 2008 as the net non-core funding dependency ratio increased from approximately 15 percent in 2007 to 43 percent at year-end 2008.

**Figure 4: First Regional's Net Non-core Funding Dependency Ratio Compared to Peer Group, Years Ending 2005 to 2009**



Source: UBPRs for First Regional, as of year-end.

First Regional's asset growth in 2008, funded by an increasing proportion of non-core deposits in the midst of a deteriorating economy and declining asset quality, put the Bank in a liquidity position that was difficult to maintain given restrictions in replacing those funding sources as a result of the Bank's capital category for purposes of PCA provisions.<sup>10</sup> Examiners at the June 2008 joint examination noted that deteriorated earnings performance and diminished capital ratios dictated the need for more stringent funds management practices. Additionally, liquidity was maintained at a high cost, and the Bank relied on non-core funding sources that could potentially become unavailable if the Bank continued to experience a weakened capital position.

First Regional also used an increasing level of time deposits or Certificates of Deposit (CDs) as funding sources as opposed to money market deposits. As of December 31, 2008, CDs of

<sup>10</sup> As noted earlier, as of the June 2008 examination, First Regional's capital level fell to *Adequately Capitalized*. This requires the FDIC to take certain mandatory actions including imposing restrictions on obtaining new or rolling over existing brokered deposits.

\$100,000 or more accounted for more than \$386 million of total deposits, representing an increase of 137 percent from the prior year. CDs under \$100,000 experienced a more dramatic increase of 449 percent over the prior year and accounted for more than \$714 million in deposits in 2008. More stable money market deposits decreased significantly over the same time period. The bank's increased reliance on CDs made funding operations more difficult as these deposits were less replaceable as they reached maturity, particularly in a declining interest rate environment.

Examiners further noted at the 2008 examination that while the Bank was below the Board-approved Leveraged Liquidity Ratio<sup>11</sup> policy minimum of 25 percent as of October 2007, the Bank had exceeded this level since July 2008. Examiners also noted that the funding needs of the loan portfolio resulted in management supplementing core deposits with wholesale funds, including the increased use of institutional time deposits, high-cost money market deposits, brokered deposits, and to a lesser degree, Federal Home Loan Bank (FHLB) advances. The majority of non-core deposits were solicited from institutional investors via money desk operations, or through money market deposits paying more than 75 basis points over the Bank's quoted money market rate.

Examiners at the July 2009 joint examination noted that the Bank continued to rely heavily on wholesale funding sources. Brokered deposits increased from \$3 million in December 2007 to \$700 million in March 2009. According to examiners, Bank management appeared to act in bad faith by acquiring brokered deposits just prior to signing a C&D in February 2009, after the Bank had been officially notified to restrict the use of brokered deposits. Examiners further noted that management considered the characterization of the brokered deposits being acquired in "bad faith" to be unfair as it had settled for lower amounts than originally ordered and had tried to cancel the outstanding orders after receiving the notice. In addition, examiners noted that the Bank had a scheduled runoff of approximately \$183 million in brokered deposits from September to December 2009. These brokered deposits could not be replaced given restrictions on such deposits due to the institution's diminished capital levels.

Asset growth in 2008 funded by brokered deposits made it difficult for the Bank to adjust to a declining economic landscape. First Regional did not have a contingent liquidity plan to replace brokered deposits and manage its funding strategy during a crisis until a plan was required by a supervisory action in 2009. At that point, the Bank was already in the midst of a liquidity crisis, which contributed to First Regional's ultimate failure.

## **The FDIC's Supervision of First Regional**

Through its supervisory activities, the FDIC identified many of the key risks at First Regional. Concerns identified by examiners included: poor risk management practices, management's lack of adherence to examination recommendations, high concentrations in CRE and ADC lending and with specific borrowers, inadequate loan underwriting practices, and asset growth funded by brokered deposits. These concerns were noted by the FDIC and the CA DFI through

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<sup>11</sup> A leverage ratio relates to the institution's level of debt and its ability to service that debt with short-term assets.



examinations and supervisory actions from 2005 through 2009. From 2005 until the Bank failed in January 2010, the FDIC and the CA DFI conducted five joint examinations and two limited-scope visitations, and the FDIC conducted off-site reviews, including daily liquidity monitoring beginning in 2008.

The FDIC relied principally on recommendations to address risk management deficiencies identified by examiners. Collectively, the FDIC and the CA DFI imposed an MOU in 2005 and a C&D in 2008. However, both actions primarily focused on BSA-related issues with risk management deficiencies being addressed in a broad manner. A C&D with stronger language and more specific safety and soundness provisions requiring affirmative action on the part of the Bank to correct deficiencies was issued in February 2009.

Examiners identified risks, downgraded component and composite ratings, made recommendations, and took several supervisory actions during the 4 years preceding the failure of First Regional. In retrospect, it appears that a more timely and stringent supervisory response based on the 2007 examination may have been called for given (1) the nature and extent of the risks that existed in the Bank’s loan portfolio at the time and (2) management’s lack of acceptance of examiner findings and failure to implement prior examination recommendations related to those risks.

## Supervisory History

The FDIC, in conjunction with the CA DFI, provided ongoing supervision of First Regional through regular on-site risk management examinations and the FDIC conducted on-site visitations and off-site reviews. Table 5 summarizes key information pertaining to the on-site risk management examinations and visitations that the FDIC and the CA DFI conducted from March 2005 until the institution failed.

**Table 5: First Regional’s Examination History, March 2005 to July 2009**

Date	On-Site Supervisory Effort	Supervisory Ratings (UFIRS)	Supervisory Action Taken
03/07/05	FDIC/CA DFI	223222/2	MOU 9/29/05
03/06/06	FDIC/CA DFI	333232/3	MOU*
04/23/07	FDIC/CA DFI	334222/3	C&D 3/10/08**
02/25/08	Visitation	No Ratings	Limited Scope: BSA
06/09/08	FDIC/CA DFI	444444/4	C&D 2/23/09***
03/09/09	Visitation	No Ratings	Limited Scope: Brokered Deposits
07/13/09	FDIC/CA DFI	555554/5	

Source: ROEs for First Regional and other DSC supervisory documents.

\* First Regional was still under the September 29, 2005 MOU at the March 6, 2006 examination.

\*\* 3/10/08 C&D replaced 9/29/05 MOU.

\*\*\* 2/23/09 C&D replaced 3/10/08 C&D.

Based on the March 2005 examination, the FDIC and the CA DFI issued an MOU that was signed on September 29, 2005 and primarily included requirements related to BSA issues. Among other things, the MOU required First Regional to:

- Enhance its customer due diligence documentation and implement effective customer risk rating program procedures in order to improve monitoring of suspicious activity;
- Modify its Suspicious Activity Report (SAR) filing procedures and improve the quality and completeness of all SAR filings;
- Develop and implement written lending and collections policies, including an independent appraisal review process; and
- Perform risk segmentation analysis of the concentration of credits.

Based on the findings at the April 2007 joint examination, a C&D issued by the FDIC was signed on March 10, 2008 that primarily addressed BSA concerns and to a lesser degree risk management issues and administration of the Bank's Trust Administration Department.

Requirements of the C&D included:

- Correction of all violations of law cited in the examination;
- Development, adoption, and implementation of (1) a written plan to provide guidance over its lending and collection functions and (2) policies to include guidance for limiting the concentration of credit; and
- Retention of management qualified to operate the institution in a safe and sound manner.

A second C&D was issued on February 23, 2009 by the FDIC and the CA DFI based on the findings of financial deterioration and the risk management deficiencies noted in the June 2008 joint examination. This C&D replaced the one issued in 2008, and among other things, required First Regional to:

- Raise Tier 1 Capital by \$12 million and maintain Tier 1 Capital equal to or exceeding 9.5 percent of the Bank's total assets until September 30, 2009, and thereafter equal to or exceeding 10 percent of Bank's total assets;
- Retain qualified management with certain experience and qualifications in key positions;
- Increase Board participation in Bank matters, including monthly meetings to cover operating policies, reports of income and expenses, and liquidity and interest rate sensitivity;
- Develop, adopt, and implement a written plan for the reduction and collection of delinquent loans;
- Revise, adopt, and implement written lending and collection policies to provide effective guidance and control over the Bank's lending function;
- Develop, adopt, and implement a diversification plan requiring prudent diversification of the Bank's loan portfolio; and
- Develop a liquidity policy with specific plans for increasing the Bank's on-balance sheet liquidity to an appropriate level and reducing the Bank's dependence on brokered deposits.

Lack of compliance with certain provisions of the C&D will be further discussed in subsequent sections of the report. On January 29, 2010, the CA DFI closed First Regional due to critical liquidity, poor asset quality, insufficient earnings, and inadequate capital.

### **Supervisory Response Related to Management and Board Oversight**

Examiners noted management's disregard or inability to comply with examination recommendations or the spirit of the supervisory action requirements throughout the period of our review as well as prior to 2005. At a CA DFI examination in 2004, examiners indicated that a First Regional senior official stated that management did not plan to implement limits on concentrations as the examination was recommending, and would only take steps to comply with the recommendation to monitor the geographic dispersion of real estate collateral. Examiners at the March 2005 joint examination noted that, despite recommendations in prior examinations, the Bank had not established limits for its real estate concentrations of credit, as required by Part 365 – Real Estate Lending Standards.

As previously mentioned, an MOU was issued based on the findings of the March 2005 joint examination. Most of the provisions were related to findings involving BSA; however, there were also risk management requirements. Examiners at the March 2006 joint examination noted that several provisions of the September 2005 MOU had not been implemented, and some provisions had only been partially implemented. Examiners at the April 2007 joint examination noted that it was the third consecutive examination where the BSA examination findings were unsatisfactory, and the Board failed to ensure that the Bank substantially complied with the outstanding MOU.

Further, examiners noted that First Regional's Board disregarded diversification of risk, which is one of the basic tenets of banking, particularly related to concentrations of credit with the two borrowers. Examiners at the April 2007 joint examination indicated that the Board must strengthen its supervision and direction to provide correction of deficiencies within an appropriate time period and prevent any further deterioration. Examiners recommended that the Board:

- Ensure that management develops procedures to correct deficiencies and implement recommendations provided in the examination in an appropriate timeframe;
- Ensure that management provides adequate staffing consisting of experienced personnel; and
- Review reports of management's progress in correcting deficiencies and implementing recommendations, including reviewing deficiencies not yet corrected and explanations for the lack of correction.

As previously noted, the March 2008 C&D required the Bank to have and retain qualified management, be assessed on its ability to comply with the requirements of the C&D, operate the Bank in a safe and sound manner, comply with applicable laws and regulations, and restore all aspects of the Bank to a safe and sound condition. Although management had complied with most of the provisions in the C&D dated March 10, 2008, several provisions still required

additional attention. Specific provisions not satisfactorily addressed included apparent violations of laws and regulations, previous examination recommendations, and management's ability to operate the Bank in a safe and sound manner.

In response to findings related to delayed recognition of problem credits at the June 2008 examination, examiners recommended that management ensure that risks in deteriorating markets were closely monitored and identified at the earliest opportunity in order to curtail losses. Examiners noted that management contended that they had taken a realistic approach to identify problem credits and did not believe that deterioration could have been detected earlier. Further, examiners noted that management continued to ignore examination findings related to the reduction of individual borrower concentrations and the practice of avoiding personal guarantees to remain within the Bank's legal lending limits.

The February 2009 C&D resulting from the June 2008 examination had more stringent and specific requirements to address management deficiencies beyond the less specific requirement in the previous C&D to retain qualified management and operate the Bank in a safe and sound manner. For example, the C&D required the Bank to hire a chief credit officer with significant appropriate lending, collection, and loan supervision experience and experience in improving a low quality loan portfolio. Further, the Bank had to notify the FDIC and the CA DFI before adding Board members and key senior officials and the officials were subject to the regulators' review and approval. Finally, the C&D required increased Board participation in Bank activities, including approving policies and holding meetings on key areas.

The FDIC was proactive and aggressive in assessing risk management practices and downgrading the Management component and other component ratings, when appropriate. In retrospect, more specific and stringent provisions and timeframes requiring affirmative action to correct deficiencies and fill specific management senior official roles, similar to those in the February 2009 C&D, may have been called for in earlier supervisory actions. Still, such steps may not have been effective in prompting needed improvements, given management's history of inattentiveness to recommendations and noncompliance with supervisory action requirements.

### **Supervisory Response Related to Loan Concentrations**

Examiners repeatedly identified and criticized segments of First Regional's loan concentrations at examinations during the review period. Table 6 summarizes the supervisory responses to the CRE and ADC concentrations from 2005 through 2008.

**Table 6: Supervisory Responses to First Regional's CRE and ADC Concentrations, 2005 to 2008**

<b>Examination as of Date</b>	<b>Asset Quality Component Rating</b>	<b>CRE Concentration as a Percentage of Total Capital</b>	<b>ADC Concentration as a Percentage of Total Capital</b>	<b>Examiner Comment</b>
12/31/2004	2	774 percent	136 percent	<p>Examiners noted that despite recommendations in prior regulatory ROEs, the Bank had not established limits for its real estate concentrations of credit.</p> <p>The September 2005 MOU required that the Bank perform risk segmentation with respect to concentrations of credit.</p>
12/31/2005	3	840 percent	162 percent	<p>Examiners noted that concentration limits set at 100 percent for borrower concentrations and 750 percent for industry concentrations did not appear meaningful and recommended that bank management establish policy limits for more narrowly-defined segments, such as multi-family loans.</p>
12/31/2006	3	623 percent	287 percent	<p>Examiners noted that the borrower relationships had been reduced, but were still significant.</p> <p>The March 2008 C&amp;D required the Bank to implement written lending and collection policies to provide effective guidance and control over the Bank's lending function, and the policies should include specific guidelines for limiting concentrations of credit.</p>
6/30/2008	4	850 percent	403 percent	<p>Examiners noted that the Bank updated its loan policy in March 2008 based on a C&amp;D requirement. The updated limits were a 942 percent overall CRE concentration of Tier 1 Capital plus the ALLL and a 100 percent borrower concentration limit, respectively. Examiners noted that the limits appeared arbitrary and there was no description of what factors were used to establish the guidelines.</p>

Source: ROEs and UBPRs for First Regional.

As illustrated in Table 6, CRE was maintained at a high level throughout this period, and within the CRE portfolio, ADC increased over each examination. The Asset Quality component was rated a “2” at the March 2005 joint examination and downgraded at the next examination in 2006 due largely to risk in borrower and specific industry concentrations as well as inadequate underwriting practices.

While the Bank had low levels of adversely classified assets and was in generally good financial condition during the 2006 and 2007 examinations, the Asset Quality ratings of “3” indicated recognition on the part of examiners of the risk inherent in the Bank’s practices. The April 2007 ROE noted the individual borrower and broader CRE concentrations and included recommendations to address risks in this area. In addition, as a result of the April 2007 examination, a C&D was issued effective March 10, 2008, which included a provision that broadly required that First Regional establish specific guidelines for limiting concentrations.

With respect to the timing of events regarding supervision of the Bank, the April 2007 examination was initiated on April 23, 2007 with an “as of” date of December 31, 2006. The exit meeting was held with the Bank’s Board and management on June 7, 2007. The C&D resulting from this examination was issued, effective March 10, 2008, about 9 months after the exit meeting. During this time, the condition of the Bank and the economy continued to erode. These circumstances, together with the previously-noted lax underwriting practices and continued high CRE concentrations, indicate that a timelier issuance of the C&D may have afforded regulators and the Bank additional opportunity to address concerns and issues noted and possibly limited the loss to the DIF.

At the June 2008 joint examination, the Asset Quality component was downgraded to a “4” as significant financial deterioration occurred at the Bank that had not been present at the previous examinations. As a result of that examination, the FDIC and the CA DFI issued the February 2009 C&D, which included a requirement that the Bank implement a written diversification plan for the Bank’s loan portfolio. The diversification plan was to include, but not be limited to: “specific goals and timeframes for a reduction in the Bank’s current concentration in construction and land development loans.” The C&D also required the plan to “include specific timeframes and goals for systematically reducing the amount of loans or other extensions of credit advanced, directly or indirectly, to or for the benefit of, any borrowers in the CRE concentrations, including construction and land development lending and large borrower concentrations.” As with the issues associated with management, similarly specific and more stringent language requiring affirmative action to correct deficiencies in the March 2008 C&D may have been warranted. In that regard, a DSC official told us that, in hindsight, given management’s risk tolerance and the Bank’s CRE and ADC loan concentrations, requiring the Bank to establish a plan earlier to reduce overall concentration levels and/or maintain higher capital levels to support the high concentrations may have been prudent.

## **Supervisory Response Related to Loan Underwriting**

Examiners noted examples of poor underwriting in the March 2006 examination report, including eased underwriting standards and inadequate cash flow analyses. Examiners at the April 2007 examination continued to note underwriting issues, including credit approval memoranda that lacked discussion of project status and detailed analysis as to how a borrower would service the debt on those properties exhibiting insufficient cash flow. Further, examiners noted that not taking personal guarantees from the principals in the two large borrower relationships was an unsafe and unsound practice given the degree of exposure in those relationships. Examiners recommended that management perform detailed cash flow analyses for guarantors whose financial strength was a primary reason for extending credit.

Examiners at the June 2008 examination noted that adverse classifications had resulted from relaxed lending practices, poor credit monitoring, and the deterioration in the real estate market. As previously discussed, the February 2009 C&D required that the Bank revise, adopt, and implement a written lending policy that would provide effective guidance over the Bank's lending function. Part of those requirements called for obtaining complete documentation, realistic repayment terms, and current credit information adequate to support the outstanding indebtedness of each borrower. Such documentation was to include current financial information, profit and loss statements or copies of tax returns, and cash flow projections.

Policy updates made by management in response to the C&D proved ineffective as the Bank's financial condition was critical at the July 2009 examination. To have been more effective, the February 2009 C&D requirements should have been imposed earlier.

## **Supervisory Response Related to Credit Administration**

Credit administration issues also played a role in the failure of the institution, and the FDIC included comments and recommendations in earlier examination reports related to this area, in addition to the severe ALLL underfunding and other credit administration issues noted at the final two examinations.

Examiners at the March 2005 examination indicated that the Senior Loan Committee approved performing stress analyses for real estate loans based on recommendations in a prior CA DFI examination, but the analyses only tested a 100-basis point increase in interest rates. Examiners noted that management should have included a stress test of 200 basis points.

At the March 2006 joint examination, examiners noted that concerns regarding concentrations were magnified as concentration levels had increased even further without commensurate improvements in risk monitoring systems, implementation of adequate controls, or the establishment of concentration limits. As discussed earlier, examiners had also noted at this examination that underwriting standards were eased.

Examiners further noted at the March 2006 examination that while they considered the ALLL methodology to be accurate, management should ensure the ALLL was restored to an adequate

level due to the downgrade at the examination to Special Mention of a substantial portion of the two borrower relationships. Examiners at the April 2007 examination noted that the ALLL methodology was not in compliance with new regulatory guidance. A senior bank official noted that management was enhancing the ALLL analysis program to provide a more appropriate level and that the final program would be in place within months after the completion of that examination.

Examiners at the June 2008 joint examination noted that the ALLL methodology would need to be revised to reflect current loan loss rates and applicable qualitative factors for various CRE loan categories, in accordance with the Policy Statement on ALLL. Examiners further noted that credits did not appear to have been properly risk-rated in a timely manner. Deterioration in the economy played a role in the decline in asset quality seen at this examination, and could have been viewed as another factor regarding why these credits were having problems. However, examiners further noted that management contended that they had taken a realistic approach to identifying problem credits and did not believe that deterioration could have been detected earlier.

Examiners also noted that management committed to appropriately fund the ALLL and contingency reserve, but they were unwilling to commit to the amount of deficiency noted during the examination until they had a better understanding of the rationale for all of the reserve factors applied in the calculation. Examiners noted that management was furnished with the reserve factors over 2 weeks prior to a Board meeting, and various opportunities for discussion were provided.

The February 2009 C&D required the Bank to maintain adequate capital as well as a fully-funded ALLL. In addition, the C&D required that the Bank recognize any necessary provision expense needed to increase the Bank's ALLL to an adequate level to compensate for the deterioration in the economic and real estate market, and to compensate for the various types of CRE loan concentrations noted in the June 2008 examination. The C&D also required that the Bank develop a written plan for the reduction and collection of classified assets and delinquent loans. The requirements of the February 2009 C&D were comprehensive and sufficient based on the 2008 examination, which was the first time when major problems with the Bank's ALLL methodology were detected.

Examiners at the July 2009 examination noted that the ALLL was underfunded by a minimum of \$69.9 million and management continued to defer recognition of developing problems in a timely manner, which represented a repeat examination issue. The resulting adjustment from the underfunding of the ALLL directly impacted the Bank's earnings and caused a decline in capital. As previously mentioned, on-site review of more current asset quality information may have been useful following the 2007 examination, through a visitation, given the Bank's high concentration levels and slow recognition of problems. Such a review may have enabled examiners to identify and address the extent of risk in First Regional's loan portfolio earlier. As discussed earlier, the FDIC did conduct an on-site visitation in February 2008, but BSA issues, not asset quality, were the focus of that review.



## Supervisory Response Related to First Regional’s Funding Strategy

The ability of the FDIC to criticize or have an impact on First Regional’s funding strategy was limited, as the increased reliance on brokered deposits largely happened between examinations in April 2007 and June 2008.

Examiners at the April 2007 examination noted that the net non-core funding dependence ratio was 11.31 percent. By year-end 2007, the ratio had increased to 15 percent, and then dramatically climbed at year-end 2008 to 43 percent. Examiners at the June 2008 examination rated Liquidity a “4” and noted that the liquidity position was inadequate and required close supervision by bank management. Liquidity was maintained at a high cost and relied significantly on non-core funding sources that had the potential to become unavailable if the Bank continued to have a weakened capital position. The February 2009 C&D, based on the findings of the June 2008 examination, stipulated that the Bank should implement a Liquidity Policy that would include specific plans to reduce the Bank’s reliance on volatile funding sources, including brokered deposits.

**Table 7: First Regional’s Deposits and FHLB Borrowings, Years Ending 2005 to 2009**

<b>Period Ending</b>	<b>Core Deposits</b>	<b>Brokered Deposits</b>	<b>Time Deposits of \$100,000 or More*</b>	<b>FHLB Borrowings</b>
	<b>(\$000s)</b>	<b>(\$000s)</b>	<b>(\$000s)</b>	<b>(\$000s)</b>
Dec-05	1,333,190	2,086	90,715	210,000
Dec-06	1,506,141	4,669	122,823	190,000
Dec-07	1,577,236	2,968	163,101	135,000
Dec-08	1,764,234	650,617	386,653	60,000
Dec-09	1,271,192	249,460	393,259	214,000

Source: UBPRs for First Regional.

\*Time Deposits of \$100,000 or more can sometimes be contained within brokered deposits

The economic downturn negatively affected asset quality and harmed capital ratios. The Bank’s liquidity crisis, which ultimately caused the failure of the Bank, was due to the shift in funding strategy to use more non-core deposits, specifically brokered deposits to fund asset growth and replace core deposits in 2008, as illustrated in Table 7. These non-core deposits were not replaceable as declining capital ratios prevented the Bank from accepting new brokered deposits or rolling over existing ones in 2009. The FDIC’s response to First Regional’s liquidity situation was adequate, as First Regional’s liquidity position appeared reasonable at the 2007 examination, including a non-core funding dependence ratio that was lower than peer. Subsequently, however, First Regional fueled asset growth using brokered deposits even when economic and bank conditions had deteriorated. The February 2009 C&D properly required the Bank to make plans to lower its reliance on brokered deposits.

## Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved. Based on the supervisory actions taken with respect to First Regional, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

Table 8 shows First Regional's PCA categories as of the examination dates covered by our review. Notwithstanding a brief period in 2006, the table illustrates that First Regional was considered *Well Capitalized* for PCA purposes until the 2008 joint examination, when the institution was already at serious risk of failure.

**Table 8: PCA Capital Categories for First Regional, 2005 to 2009**

Examination Date	Capital Category
3/07/2005	Well Capitalized
3/06/2006	Adequately Capitalized
4/23/2007	Well Capitalized
6/09/2008	Adequately Capitalized
7/13/2009	Undercapitalized

Source: ROEs and DSC Supervisory Documentation.

The June 2008 examination concluded that the Bank's capital levels were unsatisfactory, and examiners downgraded the Capital component rating to a "4". As of June 30, 2008, reported Tier 1 Leverage, Tier 1 Risk-Based, and Total Risk-Based Capital ratios were 9.58 percent, 8.85 percent, and 10.10 percent, respectively. Also, the Total Risk-Based Tier 1 Capital leverage ratio totaled 10.10 percent, a decrease from 12.04 percent from the prior examination. The examiners noted that the Total Risk-Based Capital ratio would drop to 8.98 percent as a result of the ALLL being underfunded and additional Loss classifications of \$44.1 million and the Bank would be considered *Adequately Capitalized*.

A C&D issued on February 23, 2009 required First Regional to, among other things:

- Raise Tier 1 Capital by \$12 million and maintain Tier 1 Capital equal to or exceeding 9.5 percent of the Bank's total assets until September 30, 2009, and thereafter maintain Tier 1 capital equal to or exceeding 10 percent of the Bank's total assets; and
- Develop a plan to meet and thereafter maintain the minimum risk-based capital requirement as described in Appendix A to Part 325 of the FDIC Rules and Regulations.

Based on the 2008 ROE, the FDIC issued a PCA notification letter on January 21, 2009, notifying First Regional that it was *Adequately Capitalized* and subject to certain mandatory actions, including a restriction on obtaining new or rolling over existing brokered deposits.

Examiners at the July 2009 examination noted capital to be deficient and, after adjusting for an underfunded ALLL, the Bank was considered *Undercapitalized* for PCA purposes. Examiners also noted the Board-approved capital plan of April 2009 that included a reduction in the Bank's asset size to improve the Bank's capital needed to be revised due to the financial condition of the institution. The Board was exploring many other possible options to augment capital, including selling the Bank.

The FDIC issued another PCA notification letter on September 17, 2009, notifying First Regional that, based on the July 2009 examination, the Bank was *Undercapitalized* for PCA purposes and that section 38 required the FDIC to take certain mandatory actions when an institution becomes *Undercapitalized*, including the requirement of a capital restoration plan that was due by November 9, 2009. In response, First Regional submitted a capital restoration plan, that was received by the FDIC on November 6, 2009.

An FDIC memorandum noted that this capital restoration plan was rejected because it was dependent on several key strategic initiatives that had not materialized, and it lacked a definitive timeline of when the Bank would return to *Adequately Capitalized*. The plan identified four potential transactions to address the Bank's capital needs. However, no definitive agreement was signed, and the plan did not indicate when any transaction was expected to materialize. The memorandum further noted that the plan needed to be concrete and specific regarding the steps and levels of capital to be raised and requested the Bank submit a new or revised capital restoration plan with the steps management would take to become *Adequately Capitalized*.

First Regional was unable to solve its liquidity crisis or raise the required capital, and on January 29, 2010, the CA DFI closed the Bank due to failing liquidity, declining capital, poor and declining asset quality, and insufficient earnings, and named the FDIC as receiver.

## Objectives, Scope, and Methodology

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### Objectives

We performed this performance audit to satisfy the requirements of section 38(k) of the FDI Act, and as amended by the Financial Reform 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 six 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 May 2010 to August 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, as described in the Scope and Methodology section, provides a reasonable basis for our findings and conclusions based on our audit objectives.

### Scope and Methodology

The scope of this audit included an analysis of First Regional from March 2006 until its failure on January 29, 2010, as well as review of previous supervisory documentation when relevant to the issues relating to the bank's failure. 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 utilized the following techniques:

- Analyzed examination and visitation reports prepared by FDIC and CA DFI examiners from 2006 to 2009.
- Reviewed the following documentation:
  - Financial institution data and correspondence maintained at the DSC's San Francisco Regional Office and Los Angeles Field Office, as provided to KPMG by DSC.
  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the Bank's closure.

- Pertinent DSC policies and procedures.
- Interviewed the relevant FDIC officials who had supervisory responsibilities pertaining to First Regional, which included DSC examination staff in the San Francisco Region.
- Interviewed appropriate officials from the CA DFI to discuss the historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the Bank.
- Researched various banking laws and regulations, including state laws.

KPMG relied primarily upon the materials provided by the FDIC OIG and DSC, including information and other data collected during interviews. KPMG did not perform specific audit procedures to ensure the information and data were complete and accurate. KPMG is, however, aware that Circular 12000.1, Cooperation with the Office of Inspector General, dated September 28, 2007, requires that all FDIC employees, contractors, and subcontractors cooperate with the OIG in order for the OIG to carry out its statutory mandate. To that end, all employees, contractors, and subcontractors must:

(1) Provide authorized representatives of the OIG immediate and unrestricted access to all Corporation, receivership, contractor, and subcontractor personnel, facilities, equipment, hard copy and electronic records, files, information systems, and other sources of information when requested during the course of their official duties.

(2) Provide authorized representatives of the OIG immediate and unrestricted access to any records or material available to any part of the FDIC.

We conducted interviews with DSC and CA DFI personnel to gain a better understanding of decisions made regarding the supervisory approach to the institution and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the FDIC and the Bank. KPMG relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

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

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, ROEs, and interviews of examiners to understand First Regional'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 the OIG's 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 are discussed, where appropriate, in this report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

### **Related Coverage of Financial Institution Failures**

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more comprehensive coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at [www.fdicig.gov](http://www.fdicig.gov). In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more comprehensive coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

## Glossary of Terms

Term	Definition
<b>Adversely Classified Assets</b>	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.
<b>Allowance for Loan and Lease Losses (ALLL)</b>	The ALLL is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institutions' stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
<b>Call Report</b>	Consolidated Reports of Condition and Income (also known as the Call Reports) are reports that are required to be filed by every national bank, state member bank, and insured nonmember bank pursuant to the Federal Deposit Insurance Act. These reports are used to calculate deposit insurance assessments and monitor the condition, performance, and risk profile of individual banks and the banking industry.
<b>Cease and Desist Order (C&amp;D)</b>	A formal enforcement action issued by financial institution regulators to a bank or affiliated party to stop an unsafe or unsound practice or violation. 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.
<b>Concentration</b>	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.
<b>FDIC's Supervision Program</b>	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 institutions. 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.
<b>Material Loss</b>	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Financial Reform Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of \$200 million.

## Glossary of Terms

Term	Definition
<b>Prompt Corrective Action (PCA)</b>	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, <i>Prompt Corrective Action</i> , of the FDI Act, 12 United States Code section 1831o, by establishing a framework for taking prompt corrective supervisory actions against insured nonmember banks that are less than adequately capitalized. The following terms are used to describe capital adequacy: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.
<b>Special Mention Assets</b>	A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
<b>Uniform Bank Performance Report (UBPR)</b>	The UBPR is an 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.
<b>Uniform Financial Institutions Rating System (UFIRS)</b>	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: <b>C</b> apital adequacy, <b>A</b> sset quality, <b>M</b> anagement practices, <b>E</b> arnings performance, <b>L</b> iquidity position, and <b>S</b> 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.



## Acronyms

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ADC	Acquisition, Development, and Construction
ALLL	Allowance for Loan and Lease Losses
BSA	Bank Secrecy Act
C&D	Cease and Desist Order
CAMELS	<u>C</u> apital, <u>A</u> sset Quality, <u>M</u> anagement, <u>E</u> arnings, <u>L</u> iquidity, and <u>S</u> ensitivity to Market Risk
CA DFI	California Department of Financial Institutions
CD	Certificate of Deposit
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
GAGAS	Generally Accepted Government Auditing Standards
LTV	Loan-to-Value
MOU	Memorandum of Understanding
OIG	Office of Inspector General
PCA	Prompt Corrective Action
ROE	Report of Examination
SAR	Suspicious Activity Report
UBPR	Uniform Bank Performance Report
UFIRS	Uniform Financial Institutions Rating System

*Part II*

*OIG Evaluation of Management Response*

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## OIG Evaluation of Management Response

We issued a draft of this report on August 10, 2010. The Division of Supervision and Consumer Protection (DSC) regional management provided us with additional information for our consideration, and we added the information to our report. On August 27, 2010, the Director, DSC, provided a written response to the draft report. That response is provided in its entirety on page II-2 of this report.

In its response, DSC reiterated the OIG's conclusions regarding the causes of First Regional's failure and cited several supervisory activities, discussed in the report, that were undertaken to address risks at the institution prior to its failure. In addition, DSC stated that a financial institution letter was issued in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition*, to enhance DSC's supervision of institutions, such as First Regional, with concentrated CRE/ADC lending and reliance on volatile non-core funding.

## CORPORATION COMMENTS



**Federal Deposit Insurance Corporation**

550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

August 27, 2010

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

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

**SUBJECT:** FDIC Response to the Draft Audit Report Entitled, Material Loss Review of First Regional Bank, Los Angeles, CA (Assignment No. 2010-040)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of First Regional Bank, Los Angeles, California (First Regional) which failed on January 29, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report (Report) received on August 10, 2010.

First Regional failed because the Board of Directors and management provided ineffective oversight, including weak risk management practices, inadequate loan underwriting, poor credit administration, violations of laws and regulations, and lack of response to examination recommendations. First Regional's significant concentration in commercial real estate (CRE), multi-family residential loans, and acquisition, development, and construction (ADC) loans with increased reliance on wholesale funding sources led to large losses and capital and liquidity deficiencies. The State of California Department of Financial Institutions (CA DFI) closed First Regional due to poor asset quality, insufficient earnings, critical liquidity problems, and inadequate capital to sustain operations.

From 2005 through 2009, the FDIC and CA DFI jointly conducted five full scope examinations and two visitations. The FDIC also conducted offsite reviews and monitoring activities. First Regional was under informal or formal enforcement actions on a continuing basis from January 2005 through its failure related to many aspects of its operations. At the joint examination in April 2007, examiners downgraded the management component to a "4" rating, based on the failure of the Board and officers to comply with provisions of the existing Memorandum of Understanding and their disregard for the risks associated with the extension of credit to two principal borrowers that resulted in excessive CRE concentrations. During 2008, the Board and management failed to comply with formal enforcement actions and continued to originate ADC loans with unacceptable large borrower concentrations in a rapidly declining real estate market. At the June 2008 joint examination, examiners downgraded First Regional to a composite "4" rating and to a composite "5" rating in July 2009. Formal orders to Cease and Desist were issued in March 2008 and February 2009.

DSC issued a Financial Institution Letter in 2009 on *The Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition* to enhance our supervision of institutions, such as First Regional, with concentrated CRE/ADC lending and reliance on volatile non-core funding.

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