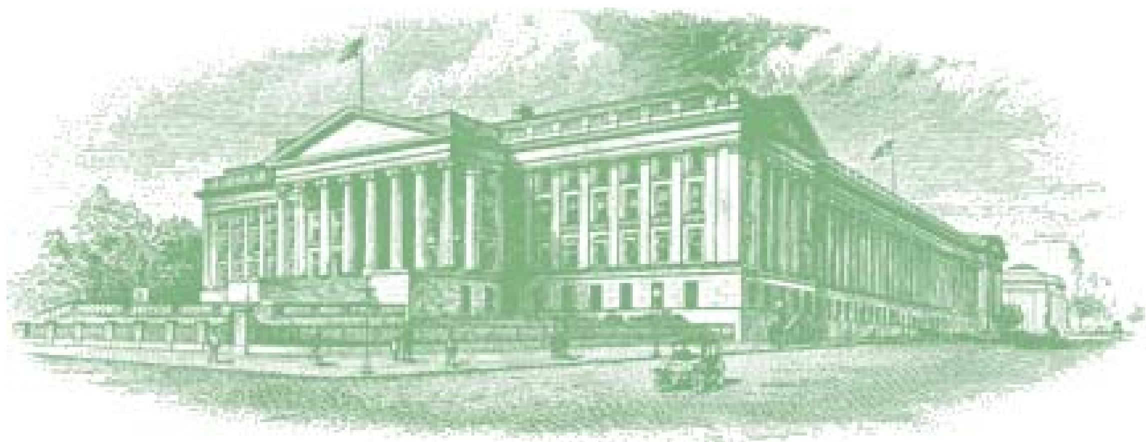
Audit Report



OIG-12-042

SAFETY AND SOUNDNESS: Material Loss Review of Pacific Coast National Bank, San Clemente, California

February 27, 2012

Office of Inspector General

Department of the Treasury

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Abbreviations

ALLL	allowance for loan and lease losses
CCO	chief credit officer
CEO	chief executive officer
COO	chief operating officer
CRE	commercial real estate
FDIC	Federal Deposit Insurance Corporation
MRA	matter requiring attention
OCC	Office of the Comptroller of the Currency
PCA	prompt corrective action
ROE	report of examination
TARP	Troubled Asset Relief Program

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February 27, 2012

John G. Walsh
Acting Comptroller of the Currency

This report presents the results of our material loss review of the failure of Pacific Coast National Bank, N.A. (Pacific Coast), of San Clemente, California, and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed Pacific Coast, a relatively new bank chartered in 2005, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on November 13, 2009. This review was mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of Pacific Coast's estimated loss to the Deposit Insurance Fund.[1,2] As of December 31, 2011, FDIC estimated that the loss would be $29.8 million.

Our objectives were to determine the causes of Pacific Coast's failure; assess OCC's supervision of Pacific Coast, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations to prevent a material loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed officials at OCC and FDIC. We conducted our fieldwork from February 2010 through May 2010. Appendix 1 contains a more detailed description of our review objectives, scope, and methodology. Appendix 2 contains

[1] At the time of Pacific Coast's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar years 2014 and thereafter.
[2] Certain terms that are underlined when first used in this report, are defined in *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (Apr. 11, 2011). That document is available on the Treasury Office of Inspector General's (OIG) website at http://www.treasury.gov/about/organizational-structure/ig/Documents/oig11065%20(508).pdf.

background information on Pacific Coast's history and OCC's assessment fees and examination hours.

In brief, our review found the primary causes of Pacific Coast's failure were high overhead expenses and operating losses, and management's pursuit of a highly concentrated growth strategy in construction and development and commercial real estate (CRE) lending. Pacific Coast's management and board of directors did not properly manage the bank's high-cost structure and aggressive growth, a situation that was aggravated by high turnover in the bank's lending department. Regarding supervision, OCC should have more forcefully addressed the bank's rapid growth, high concentrations, inadequate credit risk management practices, and inadequate management and board oversight using matters requiring attention (MRA) and appropriate CAMELS ratings. We concluded that once the supervision of Pacific Coast was transferred to OCC's Special Supervision Division in April 2009, its supervisory actions and use of PCA was appropriate.

We are reporting on another matter identified during our material loss review. We noted that Pacific Coast's holding company received $4.1 million under the Troubled Asset Relief Program (TARP) Capital Purchase Program which was downstreamed to the bank. The holding company was unable to repay the TARP funds when the bank failed. While we found OCC's review of the holding company's TARP application to be consistent with Capital Purchase Program guidance, we believe OCC should have reaffirmed the bank's condition before Treasury disbursed funds to Pacific Coast's holding company.

We are not making any recommendations to OCC as a result of our material loss review of Pacific Coast. We provided a draft of this report to OCC for its review. In a written response, which is included as appendix 3, OCC stated that it agreed with our conclusions as to the causes of Pacific Coast's failure.

Causes of Pacific Coast's Failure

The primary cause of Pacific Coast's failure was management's pursuit of a highly concentrated growth strategy in construction and development and CRE lending to offset the de novo bank's operating losses caused by high overhead expenses relative to earning assets. In addition, Pacific Coast's president/chief operating officer (COO) had limited experience in executive management positions; and most of its board directors had no prior experience as board members. The bank's board of directors also failed to adequately oversee the bank's operations. Also impacting the bank's operations was the high turnover in key credit and lending personnel, which led to poor credit risk management practices, including credit administration and risk identification issues.

High Overhead Expenses and Operating Losses

Pacific Coast opened on May 16, 2005, with a main office in San Clemente, California, and a branch in Encinitas, California. These offices were located in high-cost communities which contributed to the bank's high overhead expenses and became a burden when the performance of the branch office did not meet expectations.

In addition, Pacific Coast started its operations with four executive officers—a chief executive officer (CEO), president/COO, chief credit officer (CCO), and chief financial officer (CFO). According to OCC examiners, de novo banks typically start operations with three executive officers. As a result, Pacific Coast's personnel expenses were higher than those of other new banks. Furthermore, in 2007, Pacific Coast's higher personnel expenses continued as the bank employed 10 to 12 more support staff than had been originally projected. The support staff members were hired for the loan administration department to manage the increased lending volume and projected loan growth in 2008.

For 2006, Pacific Coast reported a $4.1 million operating loss, substantially more than the $1.8 million loss it projected. The loss was primarily due to high overhead expenses and lower-than-projected noninterest income. The bank's overhead costs continued to increase as the bank expanded its back-office infrastructure and added staff in anticipation of future construction and development and CRE loan growth. Also contributing to the losses was an unanticipated increase in the amortization of stock option expenses.

For 2007, Pacific Coast reported a $3.7 million loss, more than the $3 million it projected earlier that year. This operating loss was a result of high overhead expenses as well as a higher than projected allowance for loan and lease losses (ALLL) provision. According to OCC, as the risk exposure from management's pursuit of high-risk growth in construction and CRE loans grew, the bank's ALLL provisions increased. In the fourth quarter of 2007, Pacific Coast increased its ALLL provision by $810,000. At December 31, 2008, Pacific Coast reported $7.7 million in operating losses, and its ALLL provision increased by $5.8 million, or 416 percent, from the previous year.

Aggressive, Highly Concentrated Growth Strategy

Pacific Coast's original business plan called for one of the bank's primary products to be Small Business Administration (SBA) 7(a) and 504 loans.[3] However, slow growth in SBA lending, along with operating losses, led Pacific Coast's management to implement an aggressive growth strategy to generate profits.

Pacific Coast's assets grew by 100 percent in 2007 and 28 percent in 2008. The growth in 2007 was primarily from purchasing loan participations. In this regard, Pacific Coast purchased two sets of loan participations from Vineyard Bank (Vineyard)[4] totaling $25 million.[5] The growth was highly concentrated in the declining construction and development and CRE markets and led to high concentration risk. According to OCC, Pacific Coast's portfolios continued to grow at a time when other banks had ceased this type of lending.

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[3] SBA 7(a) loans provide small businesses with long-term, fixed rate financing to acquire major fixed assets for expansion or modernization. SBA 504 loans offers very small loans to start-up, newly established or growing business concerns.

[4] Vineyard was closed by OCC on July 17, 2009, and we performed a material loss review of the failure (OIG, *Safety and Soundness: Material Loss Review of Vineyard Bank, N.A.*, OIG-10-044 (July 13, 2010)).

[5] The $25 million was comprised of $12 million in CRE and $13 million in speculative construction loans. During the 2008 examination, OCC noted that Pacific Coast's purchase of $13 million of speculative construction loan participations from Vineyard did not conform to the requirements of OCC Banking Circular 181 and caused large, unplanned provisions to the bank's ALLL balance.

At December 31, 2006, Pacific Coast's construction and development and CRE loan portfolios represented 144 percent of capital; by December 31, 2007, the portfolios represented 582 percent. At September 30, 2009, real estate loans and commercial lending were 2,082 percent and 866 percent of capital, respectively. This dramatic increase in the bank's loans as a percentage of total risk based capital was due to depletion of the bank's capital from deterioration in its loan portfolios and losses.

OCC guidance to examiners specifies the following levels at which an institution's CRE loans represent a concentration risk requiring further analysis:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total risk-based capital; or
- total CRE loans represent 300 percent or more of the institution's total risk-based capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.[6]

The OCC guidance did not establish specific CRE lending limits; rather, it promoted sound risk management practices and appropriate levels of capital to enable institutions to continue to pursue CRE lending in a safe and sound manner. The sophistication of an institution's CRE risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution. In this regard, institutions should address the following key elements in establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

- board and management oversight,
- portfolio management,
- management information systems,
- market analysis,
- credit underwriting standards,

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[6] OCC Bulletin 2006-46, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Dec. 6, 2006).

- portfolio stress testing and sensitivity analysis, and
- credit risk review function.

Despite its high concentrations in CRE lending, Pacific Coast operated in a manner that was inconsistent with this guidance.

Inexperienced President/COO, Inadequate Board Oversight, and High Staff Turnover

Key Management Official Lacked Experience at the Executive Level

During a field examination conducted before Pacific Coast opened, OCC focused much of its attention on the president/COO's inexperience in executive positions. The president/COO had previously held lower-level officer positions and was unknown to the examiners. So, while OCC approved the bank's charter, it did so with the understanding that the CEO, who was a seasoned commercial banker and manager, would mentor the inexperienced president/COO for 3 years before the president/COO took over as CEO. When Pacific Coast's condition significantly deteriorated in 2008, OCC found the mentor CEO and the president/COO's performance to be critically deficient and specifically responsible for the decisions that led to the bank's poor condition.

Inadequate Board Oversight

Pacific Coast's board of directors consisted of many first-time board members. The board approved bank management's 2007 plan to adopt an aggressive, high-risk growth strategy and did not adequately monitor and control concentration risk. The board also allowed management to continue making construction and development and CRE loans when the real estate market showed visible signs of weakness. In addition, the board failed to select and appoint effective executive officers.

High Lending Department Turnover

Pacific Coast experienced high turnover in its lending department. Within a year and a half after its 2005 opening, all of the original loan officers in its main office had been terminated. During its 2009 full-scope examination, OCC examiners noted that the bank essentially operated without a qualified full-time CCO from

November 2008 to April 2009. According to OCC, Pacific Coast's high turnover in lending personnel and leadership, along with inadequate experience and training resulted in poor underwriting, credit administration, risk identification, and credit risk management, which ultimately led to deficiencies in the bank's loan portfolio.

In summary, Pacific Coast's management and board of directors did not properly manage the bank's high-cost structure and aggressive growth, a situation that was aggravated by high turnover in the bank's lending department. OCC closed Pacific Coast on November 13, 2009, and appointed FDIC as its receiver.

OCC's Supervision of Pacific Coast

OCC's supervision of Pacific Coast did not prevent a material loss to the Deposit Insurance Fund. OCC did not forcefully address the bank's rapid growth, high concentrations, inadequate credit risk management practices, the president/COO's inexperience in executive positions, and inadequate board of director oversight. Using its enforcement discretion, OCC delayed taking non-PCA enforcement action in response to a potential buyer of the bank.

Table 1 summarizes OCC's examinations of Pacific Coast and enforcement actions taken from 2006 to 2009.[7] Generally, MRAs represent the most significant items reported in reports of examination (ROE) requiring corrective action.

[7] OCC conducted its examinations and performed offsite monitoring of Pacific Coast in accordance with the timeframes prescribed in OCC's Comptroller's Handbook.

Table 1: Summary of OCC's Examinations and Enforcement Actions for Pacific Coast

		Examination Results			
Date started and type of examination	Assets (in millions)	CAMELS rating	Number of MRAs	Number of recommendations or suggestions	Enforcement actions
5/30/2006 Full-scope examination	$36	2/122312	1	6	None
4/2/2007 Full-scope examination	$56	2/122311	None	7	None
4/14/2008 Full-scope examination	$115	2/222422	4	2	None
9/30/2008[a] On-site monitoring	$138	2/222432	None	None	None
12/18/2008[b] Targeted examination	$138	3/333432	None	None	Notice of intent to establish minimum capital levels issued 3/31/2009
4/6/2009[c] Full-scope examination	$160	5/555553	4	2	Consent order (formal enforcement action) issued 8/18/2009

[a]This monitoring resulted in a downgrade in the bank's CAMELS component rating for liquidity.
[b]This targeted asset quality examination resulted in interim downgrades of the bank's CAMELS composite rating and its CAMELS component ratings for capital adequacy, asset quality, and management.
[c]FDIC accompanied OCC under the FDIC's back-up authority during this examination.
Sources: OCC ROEs, consent orders, and PCA directives; Pacific Coast call reports.

Pacific Coast's Growth and Loan Concentrations Not Promptly Addressed

Pacific Coast's assets grew considerably after the OCC examination in 2007 and into 2008; the growth in 2007 was primarily from purchasing loan participations. By late 2007, Pacific Coast exhibited several indicators of asset quality deterioration as defined in OCC guidance on CRE concentration risk management including (1) significant loan growth, (2) increasing nonperforming loans and significant ALLL changes, (3) large volumes of policy and underwriting exceptions, (4) inadequate loan reviews, and (5) increasing concentrations.

In 2006, a year after Pacific Coast opened, OCC recommended bank management improve its concentration management and reporting, and the reporting was improved. In 2008, OCC suggested that the bank's board of directors approve CRE risk exposure limits to conform to changes in the bank's strategies and respond to changes in market conditions[8]. OCC, however, did not report concentration management deficiencies as an MRA until it issued its 2009 ROE. At that time, CRE loans represented 937 percent of the bank's risk-based capital.

According to an OCC official, successful de novo banks normally have a more diversified portfolio. Pacific Coast's excessive concentrations made the bank extremely vulnerable to fluctuations in the real estate market. We believe that OCC should have taken stronger action to address the drastic increase in concentrations that occurred at Pacific Coast in 2007, well in advance of its 2009 MRA.

Pacific Coast's Inadequate Credit Risk Management Practices and Appraisal Reviews Not Promptly Addressed

According to the Comptroller's Handbook for OCC's Bank Supervision Process, the CAMELS component rating for asset quality reflects the quantity of existing and potential credit risk associated with the bank's loan and investment portfolios. The ability of management to identify, measure, monitor, and control credit risk; and an evaluation of the adequacy of the ALLL is also reflected in this rating. An asset quality rating of 3 is assigned when: (1) asset quality or credit administration practices are less than satisfactory; (2) trends are stable or indicate deterioration in asset quality; (3) there is an increase in risk exposure; or (4) there is in general a need to improve credit administration and risk management practices.

[8] OCC noted four matters requiring attention (MRAs) as a result of the 2008 examination. These MRAs involved credit risk management, problem loan reporting, appraisal reviews, and purchases of loans in whole or in part-participations.

As early as 2006, OCC noted issues with the manner in which Pacific Coast management monitored its loan portfolio and concentration risks. The 2006 ROE included an MRA for the bank's failure to consider and formally document the impact of economic conditions in its ALLL analysis. Pacific Coast's special mention loans increased from 0 percent to 12 percent of total loans from 2006 to 2007, prompting OCC to recommend that management closely monitor loans for early signs of deterioration.

During its April 2008 full-scope examination of Pacific Coast, OCC noted several credit administration issues involving risk identification, problem loan reporting, loan appraisal reviews, and purchased participations. Although OCC reported four MRAs in the bank's 2008 ROE to address these issues, it did not downgrade the bank's CAMELS component rating of 2 for asset quality at that time. In fact, OCC did not downgrade the asset quality rating to 3 until its December 2008 targeted examination.

We believe that OCC's concerns with the bank's credit risk management practices, which included credit administration and asset quality concerns in 2006 and 2008, along with the bank's highly concentrated growth and significant changes to the bank's ALLL provisions in 2007 should have resulted in a downgrade of asset quality at the end of the April 2008 examination. When we asked OCC examiners why they did not downgrade asset quality as a result of their April 2008 examination, they said they felt the MRAs would address the issue and did not think a downgrade was necessary.

In addition, we note that OCC gave bank management credit for addressing asset quality MRAs during its review of the holding company's TARP application in November 2008, but did not validate remediation of the MRAs until the 2009 full-scope examination.

Pacific Coast's Executive Management Issues and High Personnel Turnover Not Adequately Addressed

The CAMELS component rating for management involves the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

During the chartering process for Pacific Coast in 2004, OCC noted concerns about the president/COO's ability to lead the bank. OCC also had concerns about whether the president/COO would have sufficient support from the bank's board of directors and other management personnel to compensate for his lack of executive experience. OCC concluded there would be sufficient support from the bank's board. As mentioned above, OCC approved the bank's charter with the understanding that the CEO would mentor the president/COO. While OCC reviewed bank management during its safety and soundness examinations, OCC did not require the bank's board to address management deficiencies despite the (1) concerns raised during the chartering process, (2) high turnover of key lending personnel, (3) poor decisions of bank management, (4) frequent absences of the CEO, and (5) inadequate oversight by the bank's board.

The 2006, 2007, 2008, and 2009 ROEs did not contain any MRAs that addressed bank management or personnel turnover issues. In addition, with respect to the high turnover in the CCO position and lending personnel, OCC's 2007 ROE only recommended, but did not require, that bank management pay close attention to the significant changes in lending personnel and loan support staff. Pacific Coast received a CAMELS management component rating of 2 during the 2006, 2007, and 2008 full-scope examinations. It was not downgraded to 3 until the December 2008 targeted examination.

OCC's Use of Enforcement Action and PCA

When the bank's CAMELS composite rating was downgraded from 3 to 5 as a result of the 2009 full-scope examination, OCC transferred the supervision of Pacific Coast to its Special Supervision Division on April 23, 2009. At that time, OCC considered taking enforcement action but delayed action until

August 2009. We consider the supervisory discretion that was exercised by OCC to be reasonable. Also, we concluded that necessary PCA was taken. The following is a chronology of related events.

- On April 24, 2009, a private equity group expressed interest in acquiring Pacific Coast. In response, the Special Supervision Division began pursuing various receivership options for the bank.

- Pacific Coast's capital fell to the PCA undercapitalized category when it filed its call report for March 31, 2009. OCC issued a PCA directive on May 12, 2009, requiring the bank to submit an acceptable capital restoration plan by June 15, 2009. Pacific Coast did submit a plan. On July 21, 2009, OCC informed Pacific Coast's board that the plan was not acceptable because it did not contain the information required, lacked specificity, was based on future events outside the bank's control, and did not include specific steps to address unsafe and unsound practices.

- On July 31, 2009, the Washington Supervision Review Committee granted approval for issuance of a cease and desist (C&D) order and imposition of a PCA directive if the bank refused a consent order.

- On August 8, 2009, the private equity group withdrew its statement of intent to acquire Pacific Coast.

- On August 18, 2009, Pacific Coast's management and board agreed to the C&D order. The bank was closed approximately 3 months later.

Other Matter

TARP Funds Received by Pacific Coast

On October 31, 2008, Pacific Coast's holding company, Pacific Coast National Bancorp, applied for funds under the TARP Capital Purchase Program. To determine the bank's eligibility to receive TARP funds, OCC's local field office conducted a review of the bank's financial condition using data as of June 30, 2008, and preliminary data as of September 30, 2008.

The local field office recommended approval of the TARP application. The recommendation was based on an analysis of the bank's financial position at the time of the application, including a review of the bank's capital ratios, classified assets, and asset quality. In the documentation of its analysis, the field office noted that Pacific Coast experienced its first month of profitability in June 2008.[9] The field office also noted that management had ceased acquiring loan participations, sold some of its criticized assets, raised $1.5 million in capital in September 2008, and had been working with special mention SBA loan borrowers. In addition, the field office stated that management had addressed the four MRAs from the 2008 full-scope examination, which OCC intended to verify during a targeted review in early 2009.

The OCC field office's assessment of Pacific Coast also described the management team as competent, able to resolve supervisory issues successfully, and generally conservative. It recommended approval of the TARP application. When we asked an OCC examiner about the assessment of management, we were told that the primary focus was on the financial strength of the bank.

An OCC district official for the Western District said the TARP approval process was rigorous and cited the review of applications at the field and district levels. We also found that the Interagency TARP Capital Purchase Program Council approved Pacific Coast's application before it was sent to Treasury.[10] The same OCC district official emphasized that bank management had addressed questions from OCC headquarters about liquidity, concentrations, and earnings prior to the TARP Capital Purchase Program Council recommending approval.

[9] Although alternating months of profitability and losses are typical as a de novo bank becomes profitable, OCC later stated that Pacific Coast's profitability was achieved through superficial cost control measures that included staff reductions.
[10] The Interagency TARP Capital Purchase Program Council consisted of representatives from OCC, FDIC, the Board of Governors of the Federal Reserve System, and the former Office of Thrift Supervision.

On December 4, 2008, Treasury approved Pacific Coast National Bancorp's application for TARP funding. On January 16, 2009, the holding company received approximately $4.1 million in TARP funds, which it downstreamed to the bank in January, February, and April 2009.

According to a senior OCC official, shortly after Pacific Coast received the TARP funding, the "wheels fell off." An OCC problem bank analyst, who became involved with the bank after it issued its December 31, 2008, call report, added that significant asset quality problems hit the balance sheet that quarter. By February 19, 2009, the bank fell to barely above adequately capitalized and OCC district officials made inquiries to determine if the bank had already received the TARP funds. On March 6, 2009, OCC designated Pacific Coast to be in troubled condition due to significant weaknesses in board and management oversight, credit and concentration risk management, liquidity planning and monitoring, and deterioration in the bank's loan portfolio.

Pacific Coast National Bancorp's TARP application went through the appropriate review channels. However, the application was submitted and approved just before OCC started its December 2008 onsite asset quality review and Pacific Coast received updated loan appraisals which confirmed the significant deterioration of its portfolio in the fourth quarter of 2008.

While we found OCC's review of the holding company's TARP application to be consistent with Capital Purchase Program guidance, given the tenuous nature of Pacific Coast financial condition since its beginning and the problems noted by OCC with high concentrations and management of its operations, we do find its recommendation that the holding company receive TARP funds to be premature without additional verification. We believe that given these circumstances, it would have been prudent to have reaffirmed the bank's condition prior to Treasury disbursing the TARP funds to Pacific Coast National Bancorp. Had it done so, we believe that OCC may have reached a different conclusion about Pacific Coast's viability for TARP, and the $4.1 million in TARP funds would not have been lost when the bank failed. This underscores further the importance of ensuring that CAMELS component ratings reflect the actual conditions found during examinations and deficient conditions are reported as MRAs as appropriate.

Concluding Remarks

We are not making any new recommendations to OCC as a result of our material loss review of the Pacific Coast failure. As part of a previous material loss review we included a recommendation that OCC work with its regulatory partners to determine whether to propose changes to regulatory guidance and/or legislation to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations.[11] Our material loss review of Pacific Coast reaffirms the need for such limits or other controls on concentrations.

As discussed above, we are critical of OCC's recommendation of Pacific Coast National Bancorp for TARP funds. We did note that once deteriorating conditions at Pacific Coast became apparent, OCC did make inquiry on whether approved TARP funds had been paid. Since Treasury's authority to make new commitments under TARP expired on October 3, 2010, we are not making any specific recommendations in this area. However, as new programs may evolve from the economic crisis, OCC should consider what circumstances may warrant additional verification when asked to review national banks or thrifts under consideration for funding under such programs.

[11] OIG, *Safety and Soundness: Material Loss Review of Union Bank, National Association*, OIG-CA-10-009 (May 11, 2010).

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-0384. Major contributors to this report are listed in appendix 4.

Jeffrey Dye /s/
Audit Director

We conducted this material loss review of Pacific Coast National Bank, N.A. (Pacific Coast), of San Clemente, California, in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.[12] This section provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that:

- ascertains why the institution's problems resulted in a material loss to the insurance fund;
- reviews the agency's supervision of the institution, including its implementation of the Prompt Corrective Action (PCA) provisions of section 38; and
- makes recommendations for preventing any such loss in the future.

At the time of the bank's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

We initiated the material loss review of Pacific Coast based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of December 31, 2011, FDIC estimated that the loss to the Deposit Insurance Fund from Pacific Coast's failure would be $29.8 million.

Our objectives were to determine the causes of Pacific Coast's failure; assess the Office of the Comptroller of the Currency's (OCC) supervision of Pacific Coast, including implementation of the PCA provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish our objectives, we conducted fieldwork at OCC's headquarters in Washington, DC; OCC's field office in Carlsbad, California; and FDIC's Division of Resolutions and Receiverships in Irvine, California. We also interviewed personnel from OCC's district office in Denver, Colorado, and FDIC's Division of Supervision and Consumer Protection in both Orange County and San Francisco, California.

[12] 12 U.S.C. § 1831o(k).

We conducted our fieldwork from February 2010 through May 2010.

To assess the adequacy of OCC's supervision of Pacific Coast, we determined (1) when OCC first identified Pacific Coast's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OCC took to get the bank to correct the problems. We also assessed whether OCC (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following:

- We determined that the time period relating to OCC's supervision of Pacific Coast covered by our audit would be from January 2006 through Pacific Coast's failure on November 13, 2009. This period included quarterly monitoring as well as safety and soundness examinations.

- We reviewed OCC's supervisory files and records for Pacific Coast from 2006 through 2009. We analyzed examination reports, supporting workpapers, and related supervisory correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the regulatory action OCC used to compel bank management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.

- We interviewed and discussed various aspects of Pacific Coast's supervision with OCC officials and examiners to obtain their perspectives on the bank's condition and the scope of the examinations.

- We interviewed officials from FDIC's Division of Supervision and Consumer Protection and Division of Resolutions and Receiverships who were responsible for monitoring Pacific Coast for federal deposit insurance purposes and closing Pacific Coast.

- We reviewed Pacific Coast documents inventoried by FDIC upon closing the bank that were relevant to bank's failure and OCC's supervision of the institution.

- We assessed OCC's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[13]

While not a required part of a material loss review under section 38(k), we also reviewed OCC's supervisory file and inquired of OCC personnel concerning OCC's review and recommendation to the Department of the Treasury related to Pacific Coast National Bancorp's application for Troubled Asset Relief Program (TARP) funds under the Capital Purchase Program. Pacific Coast National Bancorp was the holding company for Pacific Coast. Based on the application and OCC's recommendation, Pacific Coast National Bancorp received $4.1 million in TARP funds.

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

[13] 12 U.S.C. § 1820(d).

History of Pacific Coast National Bank

Pacific Coast National Bank (Pacific Coast) of San Clemente, California, was a commercial community bank chartered in 2005. It operated two full-service retail banking offices, with its main office in San Clemente and an additional branch in Encinitas, California. As of December 31, 2008, Pacific Coast had approximately $143 million in assets. As of September 30, 2009, Pacific Coast had assets totaling approximately $131 million. Pacific Coast was wholly owned by a publicly traded one-bank holding company, Pacific Coast National Bancorp, Inc.

Pacific Coast's principal markets included the coastal regions of Southern Orange County and Northern San Diego County. Pacific Coast's original business plan focused on small business administration (SBA) loan products, such as SBA 7(a) and SBA 504 loans. In addition, the bank was certified as a preferred lender under SBA's preferred lenders program. When the bank's SBA loan portfolio did not develop as expected, the bank began originating primarily construction and land development and commercial real estate loans. It also embarked on a large number of construction and development and commercial real estate loan participations with other financial institutions.

OCC Assessments Paid by Pacific Coast and OCC Examination Hours

OCC funds its operations in part through semiannual assessments on national banks. OCC publishes annual fee schedules, which include general assessments to be paid by each institution based on the institution's total assets. If the institution is a problem bank (i.e., it has a CAMELS composite rating of 3, 4, or 5), OCC also applies a surcharge to the institution's assessment to cover additional supervisory costs. These surcharges are calculated by multiplying the sum of the general assessment by 50 percent for 3-rated institutions or by 100 percent for 4- and 5-rated institutions.

Table 3 shows the assessments that Pacific Coast paid to OCC from 2006 through 2009.

Table 3: Assessments Paid by Pacific Coast to OCC, 2006-2009

Billing Period	Examination Rating	Amount Paid	% of Total Collection
01/01/2006–06/30/2006	2	$11,083	0.004%
07/01/2006–12/31/2006	2	$13,306	0.004%
01/01/2007–06/30/2007	2	$16,160	0.005%
07/01/2007–12/31/2007	2	$19,084	0.006%
01/01/2008–06/30/2008	2	$24,602	0.007%
07/01/2008–12/31/2008	2	$27,677	0.008%
01/01/2009–06/30/2009	3	$29,094	0.008%
07/01/2009–12/31/2009	5	$44,631	0.012%

Table 4 shows the number of OCC staff hours spent examining Pacific Coast from 2006 through 2009.

Table 4: OCC Hours Spent Examining Pacific Coast, 2006-2009

Examination Start Date	Number of Examination Hours[a]
5/30/2006	386 hours
4/2/2007	364 hours
4/14/2008	605 hours
9/30/2008	27 hours
12/18/2008	270 hours
4/06/2009	118 hours

Source: OCC.
[a] Hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations. They do not include time spent performing off-site monitoring.

O **MEMORANDUM**

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Jeffrey Dye, Audit Director

From: John Walsh, Acting Comptroller of the Currency /s/

Date: February 13, 2012

Subject: Response to Material Loss Review of Pacific Coast National Bank

We have received and reviewed your draft report titled "Material Loss Review of Pacific Coast National Bank (Pacific Coast)." This review is mandated by section 38(k) of the Federal Deposit Insurance Act because of the magnitude of the bank's estimated loss to the Deposit Insurance Fund at the time of its failure. Your objectives were to determine the causes of Pacific Coast's failure; assess OCC's supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing such a loss in the future. To accomplish these objectives, you reviewed the supervisory files and interviewed officials at OCC and FDIC.

You concluded that the primary causes of Pacific Coast's failure were high overhead expenses and operating losses, and management's pursuit of a highly concentrated growth strategy in construction and development and commercial real estate lending. Pacific Coast's management and board of directors did not properly manage the bank's high-cost structure and aggressive growth, a situation that was aggravated by high turnover in the bank's lending department. We agree with these conclusions.

Your report did not contain any new recommendations.

Thank you for the opportunity to review and comment on your draft report. If you need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-874-5020.

Rashmi Bartlett, Audit Manager
Christen Stevenson, Auditor in Charge
Alicia Bruce, Referencer

Department of the Treasury

Deputy Secretary
Office of Strategic Planning and Performance Management
Office of the Deputy Chief Financial Officer, Risk and Control Group

Office of the Comptroller of the Currency

Acting Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

Federal Deposit Insurance Corporation

Acting Chairman
Inspector General

United States Senate

Chairman and Ranking Member
Committee on Banking, Housing, and Urban Affairs

Chairman and Ranking Member
Committee on Finance

United States House of Representatives

Chairman and Ranking Member
Committee on Financial Services

Government Accountability Office

Comptroller General of the United States