Audit Report

OIG-09-038

SAFETY AND SOUNDNESS: Material Loss Review of PFF Bank and Trust

June 12, 2009

Office of Inspector General

Department of the Treasury

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Abbreviations

ALLL	allowance for loan and lease losses
C&D	cease and desist

FDIC	Federal Deposit Insurance Corporation
MRBA	matters requiring board attention
ND	New Directions
OTS	Office of Thrift Supervision
PCA	prompt corrective action
PFF	PFF Bank and Trust
ROE	report of examination

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

June 12, 2009

Mr. John E. Bowman, Acting Director
Office of Thrift Supervision

This report presents the results of our review of the failure of PFF Bank and Trust (PFF), of Pomona, California, and the Office of Thrift Supervision's (OTS) supervision of the institution. Our review was mandated under section 38(k) of the Federal Deposit Insurance Act, as amended. OTS closed PFF and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on November 21, 2008. As of May 8, 2009, FDIC estimated that PFF's failure would cost the Deposit Insurance Fund $729.6 million.

Section 38(k) requires that we determine why PFF's problems resulted in a material loss to the insurance fund, review OTS's supervision of PFF, including implementation of the prompt corrective action (PCA) provisions of section 38, and make recommendations for preventing any such loss in the future. We reviewed the supervisory files and interviewed key officials involved in the regulatory enforcement matters. We conducted our fieldwork from November 2008 through April 2009 at OTS's headquarters in Washington, D.C.; OTS's regional office in Daly City, California; and PFF's corporate headquarters in Rancho Cucamonga, California. We also met with officials of FDIC's Division of Supervision and Consumer Protection in San Francisco, California, and interviewed FDIC's Division of Resolutions and Receiverships personnel.

Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains background information on PFF and OTS's thrift supervision processes. We also provide a glossary of terms as appendix 3. The terms are underlined and hyperlinked to the glossary where first used in the report. Appendix 4 is a chronology of significant events related to PFF and supervision of the thrift. Appendix 5 contains significant examination results and information on enforcement actions.

Results in Brief

The primary causes of PFF's failure were its (1) high concentration in construction and land loans and related credit losses and (2) inadequate capital relative to the levels of risk on its loans. These conditions were exacerbated by the drop in real estate values in PFF's markets. OTS also conducted an internal failed bank review as required by OTS policy. Consistent with our results, OTS's review found that credit losses on PFF's portfolio of construction and land loans caused PFF's failure.

OTS conducted timely and regular examinations of PFF and provided oversight through its off-site monitoring. OTS's internal failed bank review concluded that OTS did not effectively follow up on its October 2002 limited examination regarding PFF's high concentrations. OTS's review also found that its guidance should emphasize the need for a sound internal risk management system for higher-risk concentrations. We affirm OTS's internal findings and the need for corrective action.

We found that a stronger supervisory response to PFF's concentration in construction and land loans was warranted. We also found that OTS did not take timely action on PFF's inadequate capital levels when it may have made a difference. On the other hand, OTS took proper supervisory action to reduce the credit risk related to PFF's commercial business loans. By 2008, PFF's condition had worsened to the point that formal enforcement action was warranted under OTS guidance. However, OTS delayed taking formal enforcement action, pursuing instead various informal enforcement actions, as PFF was undergoing the process of being acquired by an investor. Although the planned acquisition ultimately did not occur, we concluded that OTS's exercise of regulatory discretion (taking informal rather than formal enforcement action) during this time was reasonable. We also concluded that OTS used its authority under PCA in an appropriate and timely manner.

We recommend that the Director of OTS ensure that the recommendations from OTS's internal assessment of the PFF failure are implemented and that the lessons learned from the assessment are taken into account going forward. In this regard, OTS should direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits for concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable. Additionally, OTS should formally communicate to the industry the guidance in New Directions (ND) Bulletin 06-14 as to OTS's expectation that concentration measurements and limits be set as a percentage of capital, not just as a percentage of total assets or loans, and the need for a sound internal risk management system (including stress testing, regular periodic monitoring, and other risk management tools) for higher-risk concentrations.

In a written response, OTS concurred with our recommendation. OTS plans to issue further guidance regarding concentrations to both the thrift industry and OTS staff that will address asset and liability concentration issues described in this report, as well as those that have been identified internally by OTS. OTS plans to implement our recommendation from this review by the end of the third quarter of 2009. We consider the planned actions as outlined in OTS's response to be responsive to our recommendation. The response is provided as appendix 7.

Causes of PFF's Failure

Beginning in 1997, PFF adopted a business strategy to concentrate on originating commercial business loans, construction and land loans (primarily residential tract construction), commercial real estate loans, and consumer loans (collectively referred to by PFF as the Four-Cs). Credit losses on its construction and land loans portfolio were the primary cause of PFF's failure. These loans were concentrated in some of California's hardest-hit real estate markets and represented a significant concentration of PFF's risk-based capital. PFF also did not maintain adequate capital relative to the risk levels of its loans.

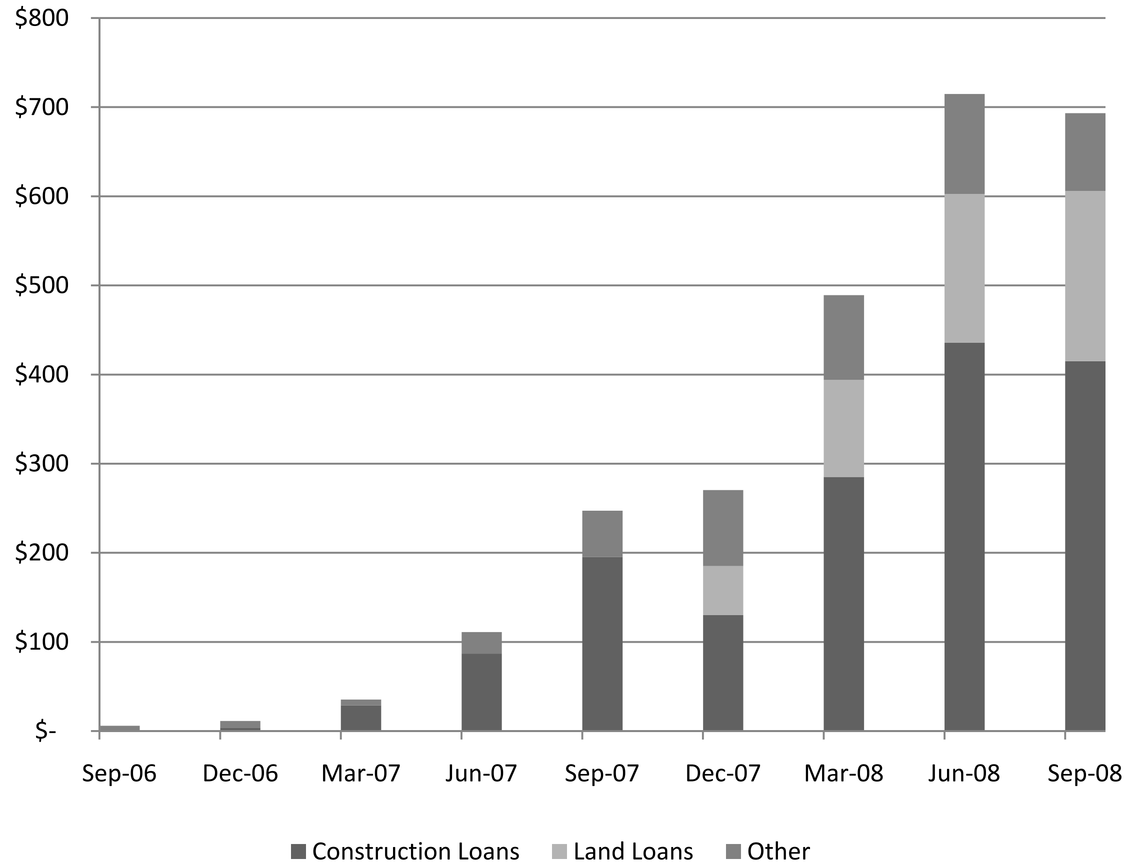
High Concentrations in Construction and Land Loans

OTS defines a concentration as a group of similar types of assets or liabilities that, when aggregated, exceeds 25 percent of a thrift's risk-based capital (core capital plus allowance for loan and lease losses (ALLL). Concentrations pose additional risk because the same economic, political, or environmental event can negatively affect the entire group of assets or liabilities.

PFF historically focused on single-family residential loans. Beginning in 1997, PFF embarked on a new business strategy to concentrate on originating the Four Cs, which were considered higher-yielding, but also higher-risk, than single-family residential loans. PFF still primarily carried single-family residential loans, which was the thrift's largest loan category throughout its existence, but as early as September 1998, construction and land loans totaled 122 percent of PFF's risk-based capital. By the end of 2006, the construction and land loan concentration rose to 258 percent of risk-based capital. While the aggregate dollar amount of construction loans declined from December 2006 to September 2008, declining capital levels resulted in PFF's concentrations in these loans increasing to 409 percent of risk-based capital as of September 30, 2008.

In addition, PFF reported positive annual net earnings ranging from $36 million to $53 million for the period 2001 through 2006. However, from July 2007 through September 2008, the thrift reported a net loss of $191 million. According to OTS documents, PFF's net loan charge-offs for the same period amounted to $284 million, which included $152 million of construction loans and $84 million of land loans. Figure 1 shows PFF's rising levels of past due and non-performing loans. PFF's construction and land loans constituted the largest portion of PFF's past due and non-performing loans.

Figure 1. PFF's Past Due and Non-Performing Loans, by Quarter and Type (in millions)



Source: OTS's 5-Quarter Uniform Thrift Performance Report for PFF

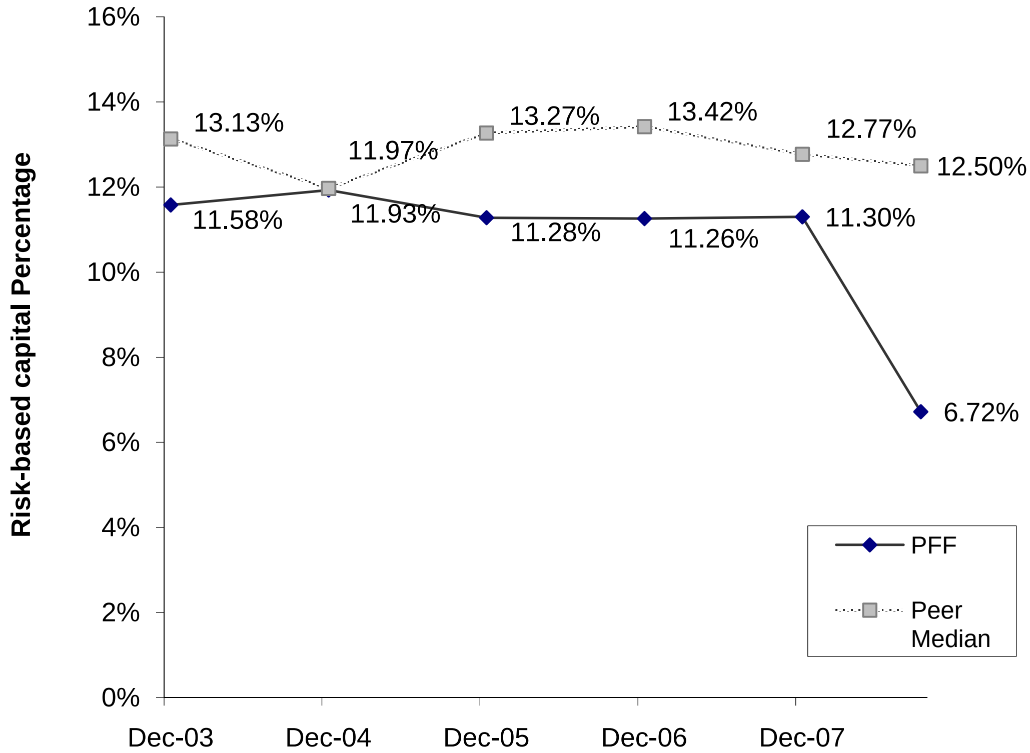
Inadequate Capital Levels

According to the OTS Examination Handbook, thrifts that engage in higher-risk activities require more capital, especially if the activities are conducted at significant concentration levels.[1] PFF historically maintained capital levels above the minimum 10 percent required to be categorized as well-capitalized. In the first quarter of 2005, PFF committed to OTS to keep its risk-based capital in excess of 11 percent. In 2007, PFF increased its internal risk-based capital level to 11.25 percent in response to concerns raised in OTS's October 2006

[1] OTS Examination Handbook, section 120, Capital Adequacy.

examination.[2] However, given PFF's significant exposure to loans considered to have higher levels of credit risk, such as construction and land loans, PFF's capital levels were nevertheless inadequate. PFF's risk-based capital levels were consistently below the levels of its peer group median despite its significantly higher-risk balance sheet relative to that group. PFF's assets in the 100 percent risk-weighted asset category were also always well above the peer group median. Figure 2 shows PFF's total risk-based capital compared to the levels of its peer median from December 2003 to September 2008.

Figure 2. Comparison of PFF's Risk-Based Capital to Peers' Risk-Based Capital



Source: Analysis of OTS's 5-Quarter Uniform Thrift Performance Report for PFF

Decline in Real Estate Values in PFF's Markets

PFF maintained a large concentration of construction and land loans in the Inland Empire region of California, which experienced severe declines in the real estate market. The region includes the counties of

[2] OTS's October 2006 report of examination (ROE) stated that PFF's capital margins were thin relative to its increasing risk profile and required the board to reassess the thrift's minimum capital targets.

Riverside and San Bernardino, and 45 percent of PFF's construction loans and over 55 percent of its land loans were located in these two counties. While growth in the Inland Empire region was initially driven by consumer demand for affordable housing, this demand combined with demand from developers, investors, and speculators to create significant price hikes. High prices along with rising interest rates, eventually led to declining home sales and prices.

By 2007, PFF noted a softening of the housing market, and demand for residential land in most of its lending areas fell sharply. According to the OTS 2007 ROE, as loan volume decreased, PFF management actively tried to identify, classify, and manage its problem assets. However, as demand for homes fell, developers were unable to sell off their land or homes, which impaired their ability to repay PFF. Home foreclosure rates in the Inland Empire region, PFF's primary market area, for the third quarter of 2008 were the third-highest among U.S. metropolitan areas. In the same quarter, the region's median single-family home price fell 39 percent from a year earlier. PFF was unable to withstand the speed and magnitude of this severe economic decline. As a result, PFF incurred significant losses, which, in combination with its inadequate capital level, ultimately caused the thrift's failure in November 2008.

OTS's Supervision of PFF

OTS conducted timely and regular examinations of PFF and provided oversight through its off-site monitoring. Table 1 summarizes the results of OTS's annual safety and soundness examinations and enforcement actions. Appendix 5 provides details of matters requiring board attention (MRBA), corrective actions, and other issues noted during the examinations.

Table 1. Summary of OTS's PFF Examinations and Enforcement Actions

		Examination Results			
Date started	Assets (in millions)[a]	CAMELS rating	Number of MRBAs[b]	Number of corrective actions	Enforcement actions
7/28/2003	$3,424	2/222122	2	9	None
8/30/2004	$3,825	2/222122	1	7	None
12/5/2005	$3,974	2/222122	0	4	None
10/30/2006	$4,505	2/222222	3	7	None
10/29/2007	$4,352	3/343422	6	20	None

Table 1. Summary of OTS's PFF Examinations and Enforcement Actions

Date started	Assets (in (millions)[a]	Examination Results: CAMELS rating	Number of MRBAs[b]	Number of corrective actions	Enforcement actions
1/10/2008	Limited exam	3/333322	-	-	Supervisory directives issued 1/18/08 and 2/7/08 Holding company board resolution issued 3/26/08
4/14/2008	Limited exam	4/443442	-	-	None
5/28/2008	Limited exam	4/443442	-	-	Supervisory directive issued
11/3/2008	Limited exam	None assigned			Memorandum of understanding with thrift and holding company issued 6/13/08
11/5/2008	Limited exam	5/543442	-	-	None
	NA	5/543442	-	-	PCA notice of undercapitalization issued 11/5/08 Supervisory directives issued 11/5/08 and 11/10/08 Cease and desist (C&D) order issued 11/10/08

Source: OTS ROEs and notices

[a] Amounts as of December 31 of each year, except for 2007, which is as of September 30, 2007

[b] MRBAs identified in OTS ROEs are not enforcement actions. However, failure by a thrift's board and management to address the matters could lead to an enforcement action.

OTS's Internal Failed Bank Review Identified Several Areas Needing Improvement

In accordance with OTS policy, OTS staff completed an internal review of the PFF failure.[3] As discussed in the March 2009 report resulting from that review, OTS determined that the primary cause of PFF's failure was credit losses on its portfolio of construction and land loans. The losses resulted from declining home and real estate values in the area where the underlying properties were located.

According to the internal review, OTS did not effectively follow up on OTS's October 2002 limited examination regarding concentrations. Specifically, OTS should have directed PFF's board to establish concentration limits during the July 2003 examination, in accordance with the guidance applicable at that time. In addition, the OTS internal review report stated that, at a minimum, action should have been directed at PFF during the October 2006 examination to reduce the thrift's exposure to construction and land loans.

OTS cited the following lessons learned in its report:

- When concentrations have been identified, it is necessary to require institutions to focus on limiting these concentrations as a percentage of capital plus ALLL. These limits as a percentage of capital should be much closer to 100 percent of capital or less, depending on the risk underlying the concentration.
- Concentration risk mitigation practices are essential regardless of current economic conditions.
- During extended periods of favorable economic conditions, high-risk activities and concentration risks can be masked by financial success.
- OTS West Region should have acted in late 2006 or early 2007 to reduce PFF's exposure to construction and land loans.
- Concentration levels in higher-risk activities should carry capital requirements in excess of "well-capitalized" levels.

[3] OTS policy requires that an internal assessment be conducted when a thrift fails. That assessment, referred to as an internal failed bank review, is performed by staff independent of the region responsible for supervisory oversight of the failed thrift. The report is reviewed and signed by the OTS Deputy Director of Examinations, Supervision, and Consumer Protection.

- Examination guidance issued by OTS, such as ND Bulletin 02-17, Concentrations of Risk, should be adhered to from the effective date of issuance until rescinded. ND Bulletin 02-17 was replaced by ND Bulletin 06-14, dated November 28, 2006.
- When a thrift and non-thrift subsidiary are engaged in similar activities, as was the case with PFF and the holding company's subsidiary, Diversified Builders Services, the concentrations of risk should be aggregated to minimize the total risk exposure to the thrift subsidiary.

The OTS report contained the following recommendations:

- OTS defines a concentration as a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of the association's core capital plus ALLL. When evaluating an institution's limits for concentrations that pose significant risk, such as construction and land loans, the limits should be set at lower levels as a percentage of core capital plus ALLL. OTS should closely review and monitor institutions that refuse to establish limits as a percentage of core capital plus ALLL or establish limits that are well in excess of 100 percent of core capital plus ALLL. The agency should pursue corrective action when the concentration limit is not reasonable. OTS's determination of the adequacy of concentration limits should consider management expertise, the effectiveness of systems for managing and monitoring concentration risk, and the risk exposure of the concentration.

- ND Bulletin 06-14 provides guidance for concentrations of risk. This guidance requires the examiner to identify concentrations that exceed 100 percent of core capital plus ALLL on the concentrations page in the ROE. OTS's expectation that concentration measurements and limits be set as a percentage of capital, not just as a percentage of total assets or loans, should be formally communicated to the industry. This guidance should emphasize the need for a sound internal risk management system for higher-risk concentrations. This should include such elements as stress testing, regular periodic monitoring of the portfolio concentration, and other robust risk management tools to address the concentration risk.

Based on our review of the examination records and reports and our interviews with OTS staff, we affirm OTS's internal findings and the need for corrective action.

A Stronger Supervisory Response to PFF's Concentration in Construction and Land Loans Was Warranted

By September 1998, PFF's construction and land loans represented a concentration of 122 percent of risk-based capital. By the end of 2006, the construction and land loan concentration had risen to 258 percent of risk-based capital. As stated previously, while the aggregate dollar amount of construction loans declined from December 2006 to September 2008, declining capital levels resulted in PFF's concentrations in these loans increasing to 409 percent of risk-based capital as of September 30, 2008. Although OTS examiners identified the increasing concentrations and the accompanying risks associated with PFF's higher-risk construction and land loans, appropriate supervisory action was not taken by OTS to limit the growth and concentrations in these loans.

According to OTS's October 2002 ND Bulletin 02-17, Concentrations of Risk, OTS examiners are to identify, report, evaluate, and develop an effective supervisory response concerning concentration of risk during examinations. Where supervisory concerns exist, examiners are to discuss them in the body of the ROE and promptly initiate appropriate corrective or supervisory action. ND Bulletin 02-17 required examiners to list specific concentrations of risk (defined as a higher-risk asset or liability whose aggregate total exceeds 25 percent of core capital) in an appendix to the ROE. ND Bulletin 06-14, issued in November 2006, superseded ND Bulletin 02-17 and defines a concentration as a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of core capital plus ALLL. ND Bulletin 06-14 also requires that examiners identify concentrations that exceed 100 percent of core capital plus ALLL on the concentrations page in the ROE. Additionally, both ND Bulletin 02-17 and ND Bulletin 06-14 require examiners to comment on the following factors inherent in the thrift's operations that could aggravate concentration risk:

- lack of board of director policies on concentrations and established limits on riskier types of business activities,

- lack of oversight by the board of directors,
- lack of management depth or expertise,
- poor internal controls or underwriting processes,
- rapid growth unchecked by management review and established limits on activity, and
- inadequate management information systems to identify and monitor concentrations of risk.

In October 2002, OTS recommended that PFF establish concentration limits based on geography, industry, and loans to related borrowers. However, OTS did not adequately follow up on this recommendation or address PFF's increasing concentration risks. PFF did not act on the recommendation to establish concentration limits until May 2006, almost 4 years after OTS had made the recommendation.[4]

According to OTS's internal failed bank review report, OTS should have directed PFF's board to establish concentration limits during the July 2003 examination in accordance with the guidance applicable at that time. The report further states that with the documented softening of the real estate market in late 2005 and moving into 2006, the concentration levels should have been reduced to limit PFF's exposure. In addition, OTS's review stated that, at a minimum, OTS should have acted during the October 2006 examination to reduce PFF's exposure to construction and land loans.

OTS's 2003 and 2004 ROEs did not contain separate discussions on concentrations in the appendix, as required by OTS guidance, despite the fact that concentrations in construction and land loans were at 181 percent and 166 percent of risk-based capital (core capital plus ALLL) in December 2002 and December 2003, respectively, and well above the 25 percent threshold established by OTS for identifying concentrations. PFF's concentrations in these loans continued to increase throughout 2007 and 2008.

[4] In May 2006, PFF did establish limits, stated as a percentage of its total loan portfolio (40 percent for construction and tract development loans), instead of as a percentage of core capital plus ALLL. However, OTS's October 2006 ROE did not make mention of this fact. OTS's October 2007 ROE stated that PFF set the limits for certain construction and land loans at 200 percent of core capital plus ALLL. OTS did not comment in this ROE on the appropriateness of the limit, just that the concentrations were large.

We believe that had OTS followed up on its October 2002 recommendation to establish concentration limits and taken more forceful action to address PFF's growing concentrations in construction and land loans, PFF would not have experienced the same levels of deterioration of its loans.

When we asked what actions OTS could have done differently from a supervisory standpoint with respect to PFF, OTS examiners stated that they should have addressed concentration risks at PFF earlier.

OTS Did Not Take Timely Action To Address PFF's Inadequate Capital Levels

Although OTS examiners noted in their ROEs that PFF's capital levels were low relative to the credit risk undertaken by the institution, OTS did not take timely supervisory action to address this condition. Under the framework established by section 38 of the Federal Deposit Insurance Act, as amended, the definition of a well-capitalized institution includes the institution's maintenance of a risk-based capital ratio of 10 percent or greater. Although PFF maintained capital levels above this threshold until December 2007, as shown in Figure 2, these levels were not sufficient relative to PFF's credit risk. Thus, as noted in OTS's internal failed bank review report, PFF's capital base was not sufficient to offset the write downs caused by the deterioration of the quality of its construction and land loans after the collapse of the real estate market in the Inland Empire region.

As noted earlier in this report, PFF's risk-based capital levels were consistently below those of its peers, while its risk-weighted asset ratios and assets in the 100 percent risk weighting category were well above those of its peers. When asked why OTS did not require PFF to raise its capital levels, OTS examiners told us that it would be difficult to mandate a particular capital level and that comparison to peer capital levels was only one of many factors in determining the adequacy of an institution's capital. Section 120 of OTS's Examination Handbook, Capital Adequacy, provides guidance to examiners on assessing capital adequacy. Although comparison to peers is indeed one among many factors to be considered, the guidance states that a thrift's level of capital is adequate when it meets regulatory requirements and is commensurate with the thrift's risk profile. In addition, the handbook notes that the various OTS capital requirements assume that a thrift primarily engages in traditional, relatively low-risk activities and that higher-risk activities require more capital, especially if the activities are conducted at significant concentration levels.

In the August 2004 ROE, OTS examiners noted that PFF's risk-based capital ratios were below the median of its peer institutions' ratios. The examiners also noted in the report that PFF had a significantly higher ratio of risk-weighted assets to total assets, compared to its peer group median. In the December 2005 ROE, OTS made similar observations regarding PFF's risk-based capital levels and also noted that PFF's ratio of risk-weighted assets actually increased, while the same ratio for PFF's peer group median declined. In the October 2006 ROE, OTS examiners noted that PFF's capital levels were thin relative to its increasing risk profile and required PFF's board to reassess the appropriateness of PFF's minimum capital targets. OTS's examiner-in-charge for the 2006 review told us that the reassessment provided by PFF was not adequate since it did not contain sufficient detail.

It is apparent that OTS did not take adequate and timely supervisory action to address PFF's inadequate capital levels, since (1) PFF was not required to raise its capital levels or reduce its high-risk concentrations; (2) PFF's CAMELS rating for the capital adequacy component was not downgraded until January 2008, when the thrift's asset quality deterioration was well underway; and (3) during 2007 OTS issued a letter to PFF stating that it did not object to PFF's issuing $24 million in dividends despite concerns expressed by OTS examiners regarding PFF's capital levels.

OTS Adequately Supervised PFF's Commercial Lending Operations

As part of PFF's new business strategy to focus on the Four-Cs beginning in 1997, the thrift began a commercial lending operation. During our review we determined that OTS appropriately focused its examination in this area and required deficiencies to be corrected. For example, in the 2003 ROE, OTS noted weaknesses in commercial loan underwriting and credit administration practices and issued corrective actions for improvement in these areas. The 2004 ROE noted that while OTS acknowledged PFF's efforts to address the previous concerns, the thrift needed further improvement in its commercial lending practices, policies, and procedures. In subsequent ROEs, OTS continued to cite deficiencies in PFF's commercial lending operations and required corrective actions, including requiring PFF to limit growth in this area until the deficiencies were corrected.

An OTS examiner in charge stated that because of the underwriting-related problems PFF had with its commercial loans, OTS devoted greater resources to this area. PFF was able to avoid the levels of deterioration in its commercial loan portfolio that it experienced on its construction and land loan portfolios.

OTS Delayed Formal Enforcement Action While Another Financial Institution Considered Acquiring PFF

On January 10, 2008, OTS made the decision to downgrade PFF's CAMELS composite rating to 3. The thrift's condition had significantly deteriorated and OTS noted that management and the board's performance in addressing PFF's problems was inadequate. According to OTS's enforcement guidance at the time, these conditions warranted a presumption that OTS would issue a formal enforcement action against PFF. And in fact, OTS did pursue the issuance of a Supervisory Agreement (a formal enforcement action) as a result of the rating downgrade. As part of the Supervisory Agreement drafted by OTS, PFF was to (1) maintain regulatory capital at no less than the then current levels, (2) reduce classified assets to no more than 30 percent of total capital by year-end 2008 or augment capital if those efforts failed, (3) restore the thrift to profitability, and (4) reduce the thrift's concentration of construction and land loans.

On March 21, 2008, OTS forwarded the proposed Supervisory Agreement to PFF. However, before the agreement was executed, OTS determined during a follow-up limited examination initiated in April that PFF's condition had continued to deteriorate and would result in a downgrade of the thrift's CAMELS composite rating to a 4. On April 23, 2008, OTS transmitted a letter to PFF's board notifying it of the downgrade and also that PFF was in troubled condition. The letter further advised PFF that OTS would seek to implement a C&D order (also a formal enforcement action) instead of the previously proposed Supervisory Agreement. OTS transmitted a draft C&D order to PFF's board in May 2008.

Around this time, PFF was engaged in discussions to be acquired by another financial institution. In June 2008, PFF's holding company reached an agreement with the institution, and the acquisition was to have been completed by September 30, 2008. With the signing of the agreement, OTS officials told us that they believed a formal enforcement action was no longer needed. OTS instead issued an informal enforcement action on June 13, 2008, in the form of a memorandum of understanding, which included the terms of the draft C&D order.[5]

OTS examiners told us OTS had a high level of confidence that the agreement to acquire PFF would improve PFF's condition in the short term and remedy its problems in the long term. The examiners cited various factors as the basis for this confidence including: (1) the proposed acquirer had made significant investments in PFF, including a $45 million investment in common stock, $7 million in preferred stock, and $9 million in trust preferred securities; (2) the proposed acquirer provided liquidity support for PFF in the form of a $200 million federal funds line; (3) a business plan that called for the proposed acquirer to maintain PFF's well-capitalized regulatory capital ratios while liquidating the PFF charter; and (4) the proposed acquirer received the necessary approvals from its regulators, including the Office of the Comptroller of the Currency, to consummate the deal.

While OTS delayed issuing formal enforcement actions during this period, it issued a series of informal enforcement actions to address PFF's deteriorating condition.[6] However, as economic conditions continued to deteriorate, the proposed acquirer could not consummate the transaction. It had incurred significant losses on its own investments in the Federal National Mortgage Association and Federal

[5] The memorandum of understanding required that PFF (1) ensure that capital is commensurate with its risk profile; (2) implement a plan to reduce problem assets; (3) cease all construction and land loans (including modifications); (4) diversify funding and ensure contingency plans; (5) provide 30 days' notice to OTS of any affiliate or subsidiary transaction; (6) abide by growth restrictions instituted by OTS; (7) not hire or replace senior executive officers or directors without notifying OTS; (8) not enter into contracts regarding compensation without ensuring that OTS does not object to them; (9) not provide any golden parachute payments; and (10) not pay dividends or other capital distributions.

[6] OTS issued supervisory directives in January 2008, February 2008, and May 2008, a board resolution in March 2008, and the memorandum of understanding with PFF in June 2008. A separate memorandum of understanding was also made at the same time with PFF's holding company that placed several restrictions on the holding company, including restrictions on dividend payments, incurring debt, and golden parachutes.

Home Loan Mortgage Corporation and was unable to secure sufficient funding to cover those losses and complete the transaction. The Office of the Comptroller of the Currency withdrew its approval to complete the transaction in November 2008, when it became apparent that the proposed acquirer could not complete the acquisition in a timely manner. OTS then resumed formal enforcement action on November 5, 2008, issuing a PCA Notice downgrading PFF's status to undercapitalized. On November 10, 2008, OTS transmitted the draft C&D order to the thrift and the holding company.[7] OTS closed PFF 11 days later.

Although it could be argued that OTS should have taken formal enforcement action sooner based on its enforcement guidance, we recognize that OTS policy allows for discretion. While the timing of the various enforcement actions was somewhat delayed, we concluded that OTS used its discretion in a reasonable manner in the case of PFF.

OTS Appropriately Used Prompt Corrective Action

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. PCA provides federal banking agencies with the authority to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility to discipline institutions based on criteria other than capital levels to help reduce deposit insurance losses caused by unsafe and unsound practices.

We concluded that OTS used its authority in an appropriate and timely manner under PCA. As of March 31, 2008, PFF's capital levels had fallen below the well-capitalized minimum requirements; therefore, on April 23, 2008, OTS issued a supervisory directive to, among other things, reclassify PFF's capital category to adequately capitalized. On November 5, 2008, based on PFF's filing of its September 30, 2008, quarterly thrift financial report, OTS notified PFF that it had fallen into the undercapitalized PCA capital category and that its CAMELS composite and Capital ratings were downgraded to 5. In accordance with PCA, the PCA notice required PFF to file a capital restoration plan no later than November 10, 2008. The PCA notice also required that

[7] The terms of the PCA Notice and draft C&D order comprehensively addressed the deficiencies at PFF identified by OTS. The details of the terms and required actions are included in appendix 4.

PFF abide by the mandatory PCA restrictions, which included restrictions on capital distributions, acquiring interest in any company or insured depository institution, and establishing any additional branch office. The PCA notice also required that PFF notify OTS of any changes in directors or senior executive officers, and of any transactions with affiliates. On November 18, 2008, OTS notified PFF that the capital restoration plan it had submitted was not acceptable[8] and downgraded the thrift's CAMELS component ratings for Asset Quality and Liquidity to 5 and its Management rating to 4. The thrift was closed 3 days later.

Recommendation

Our material loss review of PFF and a concurrent material loss review of Downey are the fourth and fifth such reviews we have performed of failed OTS-regulated financial institutions during the current financial crisis. Appendix 6 lists the prior completed material loss reviews and our associated recommendations. OTS management agreed with the prior recommendations and has taken or is taking corrective actions to address them.

As a result of our material loss review of PFF, we recommend that the Director of OTS ensure that the recommendations from OTS's internal assessment of the PFF failure are implemented and that the lessons learned from the assessment are taken into account going forward. In this regard, OTS should direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits for concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable. Additionally, OTS should formally communicate to the industry the guidance in ND Bulletin 06-14 as to OTS's expectation that concentration measurements and limits be set as a percentage of capital, not just as a percentage of total assets or loans, and the need for a sound internal risk management system (including stress testing, regular periodic monitoring, and other risk management tools) for higher-risk concentrations.

[8] OTS did not accept the capital restoration plan submitted by PFF because it did not project that PFF would become adequately capitalized by December 31, 2008, and remain adequately capitalized thereafter.

Management Response

OTS concurred with our recommendation. OTS plans to issue further guidance regarding concentrations to both the thrift industry and OTS staff that will address asset and liability concentration issues described in this report, as well as those that have been identified internally by OTS. OTS plans to implement our recommendation from this review by the end of the third quarter of 2009.

OIG Comment

OTS's planned actions meet the intent of our recommendations.

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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) 927-5776 or J. Mathai, Audit Manager, at (202) 927-0356. Major contributors to this report are listed in appendix 8.

Susan L. Barron
Audit Director

We conducted this material loss review of PFF Bank and Trust (PFF) in response to our mandate under section 38(k) of the Federal Deposit Insurance Act, as amended.[9] 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 provisions of section 38; and
- makes recommendations for preventing any such loss in the future.

Section 38(k) defines a loss as material if it exceeds 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 a material loss review of PFF based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of May 8, 2009, FDIC's Deposit Insurance Fund had recorded an estimated loss of $729.6 million.

To accomplish our review, we conducted fieldwork at the Office of Thrift Supervision's (OTS) headquarters in Washington, D.C.; its western region office in Daly City, California; and PFF's corporate headquarters in Rancho Cucamonga, California. We also met with officials of FDIC's Division of Supervision and Consumer Protection in San Francisco, California and interviewed FDIC's Division of Resolutions and Receiverships personnel. We conducted our fieldwork from November 2008 through April 2009.

To assess the adequacy of OTS's supervision of PFF, we determined (1) when OTS first identified PFF's safety and soundness problems, (2) the gravity of the problems, and (3) the

[9] 12 U.S.C. § 1831o(k).

supervisory response OTS took to get the thrift to correct the problems. We also assessed whether OTS (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 work:

- We determined that the time period covered by our audit would be from April 2002 through PFF's failure on November 21, 2008. This period included five full-scope safety and soundness examinations prior to OTS's April 2008 designation of PFF as a troubled institution and five limited-scope examinations during 2008.

- We reviewed OTS's supervisory files and records for PFF from 2002 through 2008. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OTS used to assess the thrift's condition, and the regulatory action used by OTS to compel thrift management to address deficient conditions. We also reviewed PFF's loan files to determine whether there were significant problems at origination not identified by OTS during its supervision of the institution. We judgmentally selected 25 of PFF's loan files to review, of which 16 were selected from the 100 loans with the highest outstanding loan balances. The remaining 9 files in our sample were files that had been reviewed by OTS. 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 the supervision of PFF with OTS officials and examiners to obtain their perspectives on the thrift's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring PFF for federal deposit insurance purposes.

- We interviewed FDIC's Division of Resolutions and Receiverships personnel who were involved in the receivership process, which was conducted before and after PFF's closure and the appointment of a receiver.

- We assessed OTS's actions based on its internal guidance and requirements provided by Federal Deposit Insurance Act, as amended by 12 U.S.C. § 1820(d).

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.

PFF History

PFF Bank and Trust (PFF) was established in 1892 as Pomona First Federal Savings and Loan Association and operated in the Inland Empire area (particularly Riverside and San Bernardino counties) of southern California. It maintained a federal mutual charter until 1996, when it was acquired by PFF Bancorp, Inc. (PFF Bancorp) and converted to a federally chartered stock savings association. PFF Bancorp, the holding company, maintained two wholly owned subsidiaries in addition to the thrift–Diversified Builders Services, Inc., which provided financing services to home builders and land developers, and Glencrest Investment Advisors, Inc., a registered investment adviser. The thrift's home office was in Pomona, California, while its corporate headquarters was in Rancho Cucamonga, California.

As of September 30, 2008, PFF operated 38 full-service retail branches in southern California. Its principal business strategy since 1997 consisted of attracting retail deposits and originating construction and land loans, consumer loans, commercial real estate loans, and commercial business loans, in addition to loans for one- to four-family residential mortgages. As early as 1998, the Office of Thrift Supervision (OTS) noted concentrations in PFF's loan portfolio for types of loans other than one- to four-family residential mortgages. However, PFF reported positive earnings every year from 1997 through 2006, and its loan portfolio did not indicate signs of deterioration until mid-2007. Past-due and nonperforming loans, which were nearly $6 million as of September 2006, rapidly climbed to nearly $111 million by June 2007 and exceeded $710 million by June 2008.

In June 2008, PFF Bancorp entered into an agreement with a potential acquirer that would have transferred PFF's performing assets and most of its liabilities to a national bank subsidiary of that entity that is regulated by the Office of the Comptroller of the Currency. In addition, the national bank subsidiary provided the thrift an unsecured $200 million federal funds line to support liquidity. However, the proposed acquirer was not able to close the transaction. On November 4, 2008, the Federal Reserve Board's approval of the application for acquisition of PFF expired. In addition, on November 5, 2008, the Office of the Comptroller of the Currency withdrew its approval. On November 21, 2008 OTS closed PFF and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. At the time of its closing, PFF had total assets of $3.7 billion and total deposits of $2.4 billion.

Appendix 4 contains a chronology of significant events regarding PFF.

Types of Examinations Conducted by OTS

OTS conducts various types of examinations including safety and soundness, compliance, and information technology.

OTS must conduct full-scope, onsite examinations of insured thrifts once during a 12-month cycle or an 18-month cycle.

OTS conducts a full-scope examination of an insured thrift every 12-months until the thrift's management has demonstrated its ability to operate the institution in a safe and sound manner and satisfied all conditions imposed at the time of approval.

The 18-month examination interval applies to insured thrifts that have total assets of $250 million or less that:

- received a CAMELS composite rating of 1 or 2 and a Compliance rating of 1 or 2 for their most recent examination;
- received a CAMELS Management component rating of 1 or 2 for their most recent examination;
- are well-capitalized;
- are not currently subject to a formal enforcement proceeding or order by OTS or FDIC; and
- have not undergone a change in control during the 12-month period since completion of the last full-scope examination.

During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns each thrift a composite rating based on its assessment of the overall condition and level of supervisory concern.

Enforcement Actions Available to OTS

OTS performs various examinations of thrifts that result in the issuance of reports of examinations (ROE) identifying areas of concern. OTS uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

Informal Enforcement Actions

When a thrift's overall condition is sound, but it is necessary to obtain written commitments from a thrift's board of directors or management to ensure that it will correct identified problems and weaknesses, OTS may use informal enforcement actions. OTS commonly uses informal actions for problems in

- well- or adequately-capitalized thrifts and
- thrifts with a composite rating of 1, 2, or 3.

Informal actions notify a thrift's board and management that OTS has identified problems that warrant attention. A record of informal action is beneficial in case formal action is necessary later.

If a thrift violates or refuses to comply with an informal action, OTS cannot enforce compliance in federal court or assess civil money penalties for noncompliance. However, OTS may initiate more severe enforcement action against a noncompliant thrift. The effectiveness of informal action depends in part on the willingness and ability of a thrift to correct deficiencies that OTS notes.

Informal enforcement actions include supervisory directives, memoranda of understanding, and board resolutions.

Formal Enforcement Actions

If informal tools do not resolve a problem that has been identified, OTS is to use formal enforcement tools.

Formal enforcement actions are enforceable under the Federal Deposit Insurance Act, as amended. They are appropriate when a thrift has significant problems, especially when there is a threat of harm to the thrift, depositors, or the public. OTS is to use formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems.

Because formal actions are enforceable, OTS can assess civil money penalties against thrifts and individuals for noncompliance with a formal agreement or final orders. OTS can also request a federal court to require the thrift to comply with an order. Unlike informal actions, formal enforcement actions are public.

Formal enforcement actions include cease and desist orders, civil money penalties, and prompt corrective action directives.

OTS Enforcement Guidelines

Considerations for determining whether to use informal action or formal action include the following:

- the extent of actual or potential damage, harm, or loss to the thrift because of the action or inaction;
- whether the thrift has repeated the illegal action or unsafe or unsound practice;
- the likelihood that the conduct may occur again;
- the thrift's record for taking corrective action in the past;
- the capability, cooperation, integrity, and commitment of the thrift's management, board of directors, and ownership to correct identified problems;
- the effect of the illegal, unsafe, or unsound conduct on other financial institutions, depositors, or the public;
- the examination rating of the thrift;
- whether the thrift's condition is improving or deteriorating; and
- the presence of unique circumstances.

Allowance for loan and lease losses (ALLL)	A valuation reserve established and maintained by charges against the financial institution's operating income. As a valuation reserve, it 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. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.
Board resolution	A document designed to address one or more specific concerns identified by the Office of Thrift Supervision (OTS) and adopted by a thrift's board of directors.
CAMELS	An acronym for performance rating components for financial institutions: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst. OTS uses the CAMELS rating system to evaluate a thrift's overall condition and performance by assessing each of the six rating components and assigning numerical values. OTS then assigns each thrift a composite rating based on its assessment of the overall condition and level of supervisory concern.
Capital restoration plan	Under the prompt corrective action (PCA) requirements of the Federal Deposit Insurance Act, as amended, a capital restoration plan is to be submitted to the appropriate federal banking agency by any undercapitalized insured depository institution. A capital restoration plan specifies the steps the insured depository institution is to take to become adequately capitalized, the levels of capital to be attained during each year in which the plan is in effect, how the institution is to comply with the restrictions or requirements then in effect, the types and levels of activities in which the institution is to engage, and any other information that the federal banking agency may require.

Cease and desist (C&D) order	A type of OTS formal enforcement action. A C&D order normally requires the thrift to correct a violation of a law or regulation, or an unsafe or unsound practice. OTS may issue a C&D order in response to violations of federal banking, securities, or other laws by thrifts or individuals, or if it believes that an unsafe and unsound practice or violation is about to occur.
Classified asset	A loan or other asset that in the opinion of examiners is at risk to some degree. Such assets fail to meet acceptable credit standards. The totals for classified loans are reported separately in thrift financial report. Examiners have adopted the following uniform guidelines for listing poorly performing loans: (1) loss, or complete write-off; (2) doubtful, where repayment in full is questionable; (3) substandard, where some loss is probable unless corrective actions are taken; and (4) special mention, indicating potential problems such as missing documentation or insufficient collateral. Supervisory agencies require that lenders write down loans classified as doubtful to 50 percent of the original book value and loans classified as loss by 100 percent in calculating the net capital available for making new loans.
Compliance	The part of a financial institution examination that includes an assessment of how well the institution manages compliance with consumer protection and public interest laws and regulations, including the Bank Secrecy Act.
Concentration	As defined by OTS, a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of a thrift's core capital plus ALLL. Concentrations may include direct, indirect, and contingent obligations or large purchases of loans from a single counterparty. Some higher-risk asset or liability types (e.g., residual assets) may warrant monitoring as concentrations even if they do not exceed 25 percent of core capital plus ALLL.

Concentration risk	Risk in a loan portfolio that arises when a disproportionate number of an institution's loans are concentrated in one or a small number of financial sectors, geographical areas, or borrowers. If loans are more broadly distributed, weaknesses confined to one or a small number of sectors, areas, or borrowers would pose a smaller risk to the institution's financial health.
CORE	An acronym for the rating components for thrift holding companies: Capital Adequacy, Organizational Structure, Risk Management, and Earnings. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst. OTS uses the CORE rating system to assess the financial condition of a savings and loan holding company.
Core capital	OTS defines core capital, or Tier 1 capital, as generally accepted accounting principles capital plus: (1) minority interests in equity accounts of fully consolidated includable subsidiaries, (2) mutual thrift non-withdrawable and pledged deposit accounts, (3) accumulated losses on certain available-for-sale debt securities, and (4) accumulated losses on qualifying cash-flow hedges. This amount is then reduced by: (1) investments in and advances to nonincludable subsidiaries, (2) goodwill and other intangible assets, (3) equity instruments not qualifying for Tier 1 capital (for example, cumulative preferred stock), (4) servicing assets and purchased credit card relationships in excess of limitations, (5) disallowed deferred tax assets, (6) credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital, and (7) accumulated gains on certain available-for-sale debt and equity securities and qualifying cash flow hedges.
Federal funds Line	Loans that banks make to each other to meet the reserve requirement set by the Federal Reserve.
Information Technology	An examination that includes review and evaluation

Examination	of the overall management of information systems used by a thrift, as well as the effectiveness of the internal audit and security functions for those systems.
Loan-to-value ratio	A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. In accordance with Interagency Guidelines for Real Estate Lending Policies (appendix to 12 C.F.R. § 560.101), institutions' internal loan-to-value limits should not exceed (1) 65 percent for raw land; (2) 75 percent for land development; and (3) 80 percent for commercial, multifamily, and other nonresidential loans. The guidelines do not specify a limit for owner-occupied one- to four-family properties and home equity loans. However, when the loan-to-value ratio on such a loan equals or exceeds 90 percent at the time of origination, the guidelines state that the thrift should require mortgage insurance or readily marketable collateral.
Matter requiring board attention	A practice noted during an OTS examination of a thrift that deviates from sound governance, internal control, and risk management principles. The matter, if not addressed, may adversely affect the thrift's earnings or capital, risk profile, or reputation or may result in substantive noncompliance with laws or regulations, internal policies or processes, OTS supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by the institution. Although matters requiring board attention are not formal enforcement actions, OTS requires that thrifts address them. A thrift's failure to do so may result in a formal enforcement action.
Non-performing Loans	Loans that are not earning income or payment of principal, interest is no longer anticipated, and payments are 90 days or more delinquent.

Past due Loans | Loans where payments are 30 to 90 days delinquent.

Prompt corrective action | A framework of supervisory actions, set forth in 12 U.S.C. § 1831o, for insured depository institutions that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as a thrift falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The prompt corrective action minimum requirements are as follows:

Capital Category	Total Risk-Based		Tier 1/ Risk-Based		Tier 1/ Leverage
Well capitalized[a]	10% or greater	and	6% or greater	and	5% or greater
Adequately Capitalized	8% or greater	And	4% or greater	and	4% or greater (3% for 1-rated)
Undercapitalized	Less than 8%	or	Less than 4%	or	Less than 4% (except for 1-rated)
Significantly Undercapitalized	Less than 6%	or	Less than 3%	or	Less than 3%
Critically Undercapitalized	Has a ratio of tangible equity to total assets that is equal to or less than 2 percent. Tangible equity is defined in 12 C.F.R. § 565.2(f).				

[a] To be well capitalized, a thrift also cannot be subject to a higher capital requirement imposed by OTS.

Risk-based capital | A thrift's risk-based capital is the sum of its Tier 1 capital plus Tier 2 capital (to the extent that Tier 2 capital does not exceed 100 percent of Tier 1 capital). This amount is then reduced by 1) reciprocal holdings of the capital instruments of another depository institution, 2) equity investments, and 3) low-level recourse exposures and residual interests that the thrift chooses to deduct using the simplified/direct deduction method, excluding the credit-enhancing

	interest-only strips already deducted from Tier 1 capital.
Risk-weighted asset	An asset rated by risk to establish the minimum amount of capital that is required within institutions. To weight assets by risk, an institution must assess the risk associated with the loans in its portfolio. Institutions whose portfolios hold more risk require more capital.
Safety and soundness	The part of an examination that includes a review and evaluation of each of the component CAMELS ratings (see explanation of CAMELS, above).
Supervisory directive	An informal enforcement action by OTS that is directed to a thrift to cease an activity or take an affirmative action to remedy or prevent an unsafe or unsound practice.
Thrift financial report	A financial report that thrifts are required to file quarterly with OTS. The report includes detailed information about the institution's operations and financial condition and must be prepared in accordance with generally accepted accounting principles. The thrift financial report is similar to the call report required of commercial banks.
Tier 1 (core) capital	An amount consisting of common shareholder's equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries. In accordance with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, OTS requires that Tier 1 capital represent 4 percent of total assets, or 3 percent for thrifts with a CAMELS composite rating of 1, adjusted for investment in subsidiaries, gains and losses on available-for-sale securities, and certain hedges.
Tier 2 (supplementary) capital	Includes (1) permanent capital instruments such as mutual capital certificates and non-withdrawable

	accounts not counted for Tier 1 capital, cumulative perpetual preferred stock, and qualifying subordinated debt, (2) maturing capital instruments (for example, non-perpetual preferred stock), (3) ALLL up to 1.25 percent of risk-weighted assets, and (4) up to 45 percent of unrealized gains, net of unrealized losses on available-for-sale equity securities with readily determinable fair values. In addition, Tier 2 capital may not exceed Tier 1 capital.
Troubled Condition	A condition in which a thrift meets any of the criteria below: • OTS notifies it in writing that it has been assigned a composite CAMELS rating of 4 or 5. • It is subject to a capital directive, a C&D order, a consent order, a formal written agreement, or a prompt corrective action directive relating to its safety and soundness or financial viability. • OTS informs it, in writing, of its troubled condition based on information available to OTS. Such information may include current financial statements and reports of examination.

The following chronology describes significant events in PFF Bank and Trust's (PFF) history, including examinations conducted and enforcement actions taken by the Office of Thrift Supervision (OTS).

1/1/1892 The thrift is established under the original name Pomona First Federal Savings and Loan Association.

10/1995 PFF Bancorp, Inc. (PFF Bancorp), the thrift's holding company, is incorporated for the purpose of acquiring and holding all the outstanding capital stock of the thrift.

3/28/1996 Pomona First Federal Savings and Loan Association reorganizes from a federally chartered mutual savings and loan association to a federally chartered stock savings thrift. The thrift also changes its name to Pomona Federal Bank and Trust.

12/24/1996 The thrift changes its name to PFF Bank and Trust.

7/14/1997 OTS issues a report of examination (ROE) indicating that the thrift's management and board have embarked on a business plan to focus on construction loans, commercial and industrial loans, commercial business loans, and consumer loans. The report results in a CAMELS rating of 2/222222.

10/13/1998 OTS begins a safety and soundness examination of PFF, which results in composite and CAMELS ratings of 2/222222.

1/10/2000 OTS begins a safety and soundness examination of PFF, after which OTS concludes that capital does not support the increasing level of higher risk loans. The examination results in composite and CAMELS ratings of 3/323224.

9/18/2000 OTS conducts a field visit and concludes that concerns from the January 10, 2000 examination have been addressed. OTS upgrades the thrift composite and CAMELS ratings to 2/222223.

2/20/2001 OTS begins a safety and soundness examination of PFF, which results in composite and CAMELS ratings of 2/222222.

5/20/2002 OTS begins a safety and soundness examination of PFF, which results in composite and CAMELS ratings of 2/222122.

7/28/2003	OTS begins a safety and soundness examination of PFF. The examination is completed on September 19, 2003, and results in composite and CAMELS ratings of 2/222122. PFF meets the regulatory capital standard for a well-capitalized designation.
8/30/2004	OTS begins a safety and soundness examination of PFF. The examination is completed on November 10, 2004, and results in composite and CAMELS ratings of 2/222122. PFF meets the regulatory capital standard for a well-capitalized designation.
12/5/2005	OTS begins a safety and soundness examination of PFF. The examination is completed on April 13, 2006, and results in composite and CAMELS ratings of 2/222122. PFF meets the regulatory capital standard for a well-capitalized designation.
10/30/2006	OTS begins a safety and soundness examination of PFF. The examination is completed on January 18, 2007, and results in composite and CAMELS ratings of 2/222222. PFF meets the regulatory capital standard for a well-capitalized designation.
8/10/2007	PFF Bancorp notifies the Securities and Exchange Commission that it will need to file its Form10-Q late as a result of an expanded internal asset review in process, specifically with respect to the status of certain loans that were less than 90 days past due at June 30, 2007.
8/13/2007	PFF Bancorp announces that it has concluded the internal asset review referenced in its Notice of Late Filing of Form 10-Q filed with the Securities and Exchange Commission on August 10, 2007.
10/29/2007	OTS begins a safety and soundness examination of PFF. The examination is completed on January 25, 2008, and results in composite and CAMELS ratings of 3/343422. PFF meets the regulatory capital standard for a well-capitalized designation.
1/10/2008	OTS begins a limited scope examination of PFF and issues a ROE stating that CAMELS component ratings for Capital, Management and Earnings will probably be downgraded from 2s to 3s and that the component rating for Asset Quality will be downgraded from a 2 to a 3 or 4.

1/18/2008	OTS issues a supervisory directive to PFF requiring 30-days written notice prior to entering into any transaction with affiliates.
2/7/2008	OTS issues a supervisory directive to PFF Bancorp prohibiting any further debt at the holding company or any non-thrift subsidiaries.
3/26/2008	PFF Bancorp issues a board resolution providing the following: (1) no dividends will be paid or capital distributions made without ensuring that OTS does not object to them; (2) no further debt will be assumed by the holding company; (3) the holding company will take all necessary steps to reduce the level of problem assets at subsidiary Diversified Builders Services, Inc.; (4) the holding company will provide OTS with written progress reports regarding criticized/classified assets held by the holding company or non-thrift subsidiaries; (5) the holding company and the thrift will comply with all matters requiring board attention (MRBA) set forth in the ROE.
4/14/2008	OTS begins a limited examination of PFF, focusing on Liquidity and Asset Quality. The examination results in downgrades of the CAMELS composite and Capital component ratings from 3s to 4s. The CAMELS component rating for Liquidity is downgraded from a 2 to a 4.
4/23/2008	OTS issues a supervisory directive to PFF that (1) downgrades the CAMELS composite and Capital component ratings from 3s to 4s; (2) designates PFF as being in troubled condition; (3) reclassifies the thrift's capital category to "adequately capitalized;" (4) advises the thrift of OTS's intent to issue a cease and desist (C&D) order; and (5) directs PFF to keep OTS apprised on a daily basis of material developments.
4/29/2008	OTS issues a letter to PFF to update the supervisory directive dated April 23, 2008. The letter assigns PFF a composite CAMELS rating of 4 based on the fieldwork performed to date. OTS further states that it will evaluate PFF's situation upon receipt of the March 2008 quarterly Thrift Financial Report filing.
4/30/2008	The New York Stock Exchange suspends trading of PFF Bancorp stock because of a potential liquidity crisis as PFF experiences increased deposit outflows due to negative press coverage.
5/28/2008	OTS concludes a limited scope examination of and recommends downgrading the Liquidity component rating from a 2 to a 4.

6/13/2008	OTS issues a memorandum of understanding to PFF requiring that the thrift (1) ensure that capital is commensurate with its risk profile; (2) implement a plan to reduce problem assets; (3) cease all construction and land loans (including modifications); (4) diversify funding and ensure contingency plans; (5) provide 30-days notice to OTS of any affiliate or subsidiary transaction; (6) abide by growth restrictions instituted by OTS; (7) not hire or replace senior executive officers/directors without notifying OTS; (8) not enter into contracts regarding compensation without ensuring that OTS does not object to them; (9) not provide any golden parachute payments; and (10) not pay dividends or other capital distributions.
6/13/2008	OTS issues a memorandum of understanding to PFF Bancorp requiring that: (1) no dividends or capital distributions be made without ensuring that OTS does not object to them; (2) no new debt is incurred without ensuring that OTS does not object to it; (3) no payments be made on existing debt; (4) all cash and liquid assets be made available for infusion as capital into thrift; (5) OTS be notified of any hiring or replacing of senior executive officers/directors; (6) no contracts regarding compensation be entered into without ensuring that OTS does not object; and (7) no golden parachute payments be made.
6/13/2008	PFF Bancorp signs an agreement with another entity that would transfer PFF's performing assets and most of PFF's liabilities to a national bank subsidiary of that entity. In addition, the national bank subsidiary provided the thrift an unsecured $200 million federal funds line to support liquidity.
7/24/2008	The Office of the Comptroller of the Currency approves the proposed acquisition of PFF's assets and assumption of PFF liabilities.
8/4/2008	The Federal Reserve Bank of Chicago approves the proposed acquisition of PFF.
9/30/2008	The proposed acquirer of PFF is not able to close the transaction.
10/30/2008	Due to continuing loan losses, the need for loan loss provisions, and the subsequent reduction of capital, PFF reports being undercapitalized in its thrift financial report as of September 30, 2008.

11/03/2008 OTS begins a limited scope examination of PFF to monitor and report on the thrift's liquidity position.

11/4/2008 The Federal Reserve Board's approval of the application for acquisition of PFF expires.

11/5/2008 OTS issues a prompt corrective action notice categorizing PFF as undercapitalized with a total risk-based capital ratio of 6.72 percent. The notice also requires that PFF file a capital restoration plan by November 10, 2008.

11/5/2008 The Office of the Comptroller of the Currency withdraws the approval to merge PFF into a subsidiary of the proposed acquirer.

11/5/2008 OTS issues a supervisory directive requiring PFF to (1) take all necessary measures to preserve/increase liquidity such as restricting any expenditures outside the normal scope of business, and provide daily liquidity reports to OTS; (2) pursue all options to obtain sufficient capital to achieve and maintain Tier 1 and total risk-based capital ratios of 8.0 percent and 12.0 percent, respectively; (3) take no actions to increase the risk profile of PFF; (4) comply with the memorandum of understanding of June 13, 2008; and (5) identify operational areas performed with the support of third parties and make contingency plans. OTS also downgrades the composite and Capital component ratings from 4s to 5s.

11/5/2008 OTS issues a separate supervisory directive to PFF Bancorp with requirements similar to those imposed on the thrift. The supervisory directive also downgrades PFF Bancorp's CORE composite rating to a 5.

11/7/2008 By letter, OTS extends the deadline to November 14, 2008 for PFF to file the capital restoration plan. On the same day and again on November 10, 2008, PFF requested federal funds lines from a national bank subsidiary of a proposed acquirer. The request is rejected as Office of the Comptroller of the Currency has instructed the bank not to honor any future requests from PFF and indicated that cancellation of the federal fund line is imminent.

11/10/2008 OTS issues a supervisory directive to PFF requiring it to take all necessary steps to immediately draw down all available outstanding credit facilities to enhance its liquidity position.

11/10/2008 OTS transmits draft C&D orders to PFF Bancorp and PFF. The orders include requirements that PFF (1) increase capital levels to well-capitalized status; (2) develop a plan to reduce classified assets; (3) develop a liquidity plan; (4) develop a long term strategic plan; prepare quarterly variance reports on PFF's compliance with its plan to reduce classified assets, liquidity plan, and long term strategic plan; and (5) notify OTS prior to entering into any transactions with affiliates.

11/14/2008 PFF submits a capital restoration plan to OTS that places primary reliance for recapitalization on an acquisition by December 31, 2008.

11/18/2008 OTS rejects the capital restoration plan because the alternatives it presents (absent the acquisition) fail to bring PFF to adequately capitalized status by December 31, 2008. OTS also denies the thrift's request for an extension to submit an amended plan. OTS downgrades PFF's CAMELS component ratings for Asset Quality and Liquidity from 4s to 5s and the Management rating from a 3 to a 4.

11/19/2008 The boards of PFF Bancorp and PFF execute Stipulation and Consent to Issuance of Orders to Cease-and-Desist.

11/21/2008 OTS closes PFF, and FDIC is appointed as receiver of the thrift. U.S. Bank, National Association, acquires all of the assets and most of the liabilities of the thrift.

This appendix lists the Office of Thrift Supervision's (OTS) full scope safety and soundness examinations of PFF Bank and Trust (PFF) beginning July 2003 until the thrift's failure in November 2008 and provides information on the significant results of those examinations. OTS also performed five limited scope examinations during 2008, which did not include matters requiring board attention or corrective actions. Generally, matters requiring board attention represent the most significant items requiring corrective action found by the examiners.

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
7/28/2003 9/19/2003	2/222122	$3,424	Matters requiring board attention • Provide OTS with results of the board's review of PFF's dividend policy. • Ensure improved management oversight of the land/mezzanine loan underwriting practices. Corrective actions • Re-evaluate dividend policy given the projected decline in PFF's total risk-based capital ratio and continuing increase in higher risk types of lending. • Improve management and regulatory reporting of mezzanine lending[10], loans to one borrower, troubled debt restructurings, high loan-to-value exceptions, modifications, and asset classifications. • Address the noted underwriting weaknesses related to the use of appraisals in land/mezzanine lending. • Improve underwriting and credit administration for commercial lending. • Continue close monitoring of the commercial business lending operation.	None

[10] PFF's mezzanine lending included short-term or interim financing that allowed borrowers to pull equity out of their project (usually land development) for the preparation or general improvement on lots prior to site development and construction.

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			• Institute appropriate reporting mechanisms to ensure loans made to executive officers are promptly reported to the board. • Adhere to required notification of the board for exceptions to internal policies. • Remove the OTS net portfolio value results from the holding company's public disclosures. • Implement periodic fair lending self-assessments consistent with the Interagency Fair Lending Examination Procedures. Other issues • While classified assets have declined during the review period, the level of classified assets continues to exceed the peer median level. • During the review period, most of PFF's asset growth was in construction loans, land loans, and commercial real estate loans. • PFF does not typically perform a thorough analysis of borrowers before originating loans. Instead, management emphasizes the viability of each project funded. • Loan underwriting was using inappropriate appraised values. OTS noted several examples of loan summaries using the value of completed properties ("as if completed" value) in determining a loan-to-value ratio, even though funds were not set aside to complete the work contemplated in the appraisal.	
8/30/2004 11/10/2004	2/222122	$3,825	Matters requiring board attention • Submit the result of management's assessment of PFF's lending to borrowers with subprime characteristics, and the	None

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			board's determination of how the analysis of these portfolios will impact PFF's ongoing analyses of the adequacy of risk-based capital and allowances for loan and lease losses (ALLL). <u>Corrective actions</u> • Complete a review of that portion of the single-family loan portfolio with subprime credit risk characteristics and determine whether additional ALLL or capital should be allocated to offset those risks. • Develop comprehensive policies and procedures for commercial lease financing that are consistent with current practice and procedure. • Develop and implement corrective measures to address the commercial lending related underwriting and credit monitoring deficiencies noted in OTS's October 25, 2004, findings memorandum to management. • Implement controls designed to ensure that loans made to executive officers are appropriately approved by the board. • Include all lending areas in the Internal Audit Plan. • Update and consolidate liquidity policies and procedures. • Update the interest rate risk/asset liability management policy to reflect the pre-purchase requirements of Thrift Bulletin 13a for significant transactions. <u>Other issues</u> • PFF's total risk-based capital fell below the internal 11.0 percent target in the third quarter of 2004 as a result of large capital distributions and balance sheet growth. • Risk-based capital ratios remain below	

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			the median for peer institutions. • As of June 30, 2004, the ratio of total risk-weighted assets to total assets was 77.2 percent for PFF compared to a peer median of 63.1 percent. • Weaknesses were noted relative to the lack of internal audit coverage of the lending area and the credit risk management function. • Management's capital adequacy assessment does not consider the Interagency Guidance on Subprime Lending. A review of the 2004 Internal Audit Plan revealed that audits of PFF's lending operation and credit review function were completely omitted from the scope of the internal audit process in fiscal 2004.	
12/5/2005 4/13/2006	2/222122	$3,974	Matters requiring board attention • None Corrective actions • Update the lending policy and procedures to include guidelines for underwriting "A- "and interest-only loans. • Limit commercial business lending growth until internal audits confirm the effectiveness of the October 2005 organizational changes. • Develop and approve a new management succession plan that considers recent executive management and directorate changes. • Amend policies and procedures related to significant purchase transactions to address requirements of TB-13a (and Chief Executive Officer Letter 195). Other issues	None

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			• Risk-based capital ratios continue to be lower than the peer group median as a result of the greater proportion of assets in higher risk-weighted categories. • PFF has greater concentrations of commercial real estate, construction, business, and consumer loans than the peer group. • The ratio of risk-weighted assets to total assets increased from 77.2 percent at June 30, 2004, to 81.3 percent at September 30, 2005, while the peer group median declined from 63.1 percent to 54.0 percent during the same period. • Although satisfactory overall, portfolio risk continues to increase and remains substantially higher than that of the peer group median.	
10/30/2006 1/18/2007	2/222222	$4,505	<u>Matters requiring board attention</u> • Provide the results of the board's reassessment of the appropriateness of PFF's minimum capital targets given the PFF's increasing risk profile. • Provide details of PFF's action plans for strengthening oversight of the commercial business lending function. • Provide reports benchmarking PFF's practices against the new Interagency Guidance on Commercial Real Estate concentrations and Nontraditional Mortgage Products. <u>Corrective actions</u> • Reassess the appropriateness of PFF's minimum capital targets relative to the thrift's increasing risk profile. • Strengthen oversight of the commercial	None

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			business loan portfolio. • Track the performance of loans approved by Desktop Underwriter[11] that deviate from internal policy guidelines. • Augment policy guidelines for single-family residential loans to detail specific mitigating factors that allow Desktop Underwriter's decision to deviate from internal policy guidelines. • Benchmark thrift practices against the new interagency guidance on commercial real estate concentrations and on nontraditional mortgage products. • Increase the use of transaction testing components in PFF's compliance self-assessment program where appropriate. • Expand fair-lending self-assessments to address potential marketing and prescreening issues in a manner consistent with the Federal Financial Institutions Examination Council's Fair Lending Examination Procedures. Other issues • Capital margins are thin relative to PFF's increasing risk profile. • The risk profile of the asset portfolio increased due to growth in the Four-Cs[12]. • PFF's level of construction, land, commercial real estate, business, and consumer loans exceed the median for its peer group; however, PFF's capital ratios are below the peer group median. • PFF's ratio of risk-weighted assets to total assets increased from 81.3 percent at September 30, 2005, to 84.8 percent	

[11] Desktop Underwriter was a loan underwriting and approval tool used by PFF for its single-family residential loan portfolio.
[12] The Four-Cs were commercial business loans, construction and land loans (primarily residential tract construction), commercial real estate loans, and consumer loans.

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			at September 30, 2006, while the peer group median ratio increased only from 63.9 percent to 65.7 percent during the same period. • Construction loan policy guidelines do not require a minimum "cash equity" for construction loan borrowers. Considering the weakening real estate market, we recommend that PFF's construction loan policy guidelines require a defined minimum cash equity investment from the borrowers.	
10/29/2007 1/25/2008	3/343422	$4,352	Matters requiring board attention • Provide a strategic plan that provides for preservation and enhancement of PFF's capital; improved core earnings and profitability; reduced concentrations of credit; and reduced classified assets. • Provide quarterly variance reports on PFF's progress in meeting strategic plan goals. • Report the results of the board's review of the appropriateness of reporting relationships of senior management for ensuring necessary independence and segregation of duties. • Advise OTS of any changes in the reporting relationships of senior management. • Provide results of an independent third-party review of PFF's construction and land loan portfolios to determine the appropriateness of classifications and loss recognition. • Provide details of corrective actions that will be taken to address commercial loan underwriting deficiencies. Corrective actions • Ensure the level of capital shown in PFF's strategic plan is adequate relative to the	None

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			risk profile of the Bank. • Support the newly implemented capital model with empirical data reflective of the current weak real estate market. • Develop a plan to reduce PFF's level of classified assets. • Develop a plan to reduce PFF's concentration of construction and land loans. • Obtain an independent third-party review of the construction and land loan portfolios to determine the appropriateness of classifications and loss recognition. • Evaluate the adequacy of loss factors incorporated in ALLL analysis to ensure they adequately address the current depressed real estate market. • Improve commercial loan underwriting practices. • Consider concentrations of risk and location in determining the scope of internal asset review. • Enhance special assets department and internal asset review to ensure that sufficient resources are retained to address problem assets. • Develop written policies and procedures for managing troubled assets, including guidance for transitioning construction loans to special assets department. • Develop a strategic plan that provides for the preservation and enhancement of capital, improved core earnings and profitability, reduced concentrations of credit, and reduced classified assets. • Evaluate reporting relationships of senior management to ensure appropriate independence and segregation of duties. • Document all transactions with affiliates in board minutes, and document	

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			executive sessions of the board as appropriate. • Update the audit policy to reflect current internal audit practices, and audit the thrift financial report by the second quarter of 2008. • Develop a plan to return PFF to profitability. • Ensure adequate tracking and close monitoring of uninsured deposits. • Provide the board's asset and liability committee more timely and more complete Sendero model[13] results to ensure a proactive interest rate risk measurement and monitoring. • Develop policies and procedures on model validation that govern all of PFF's internal models. • Develop a plan to bring PFF's net interest income exposure to interest rate risk within board-approved limits. • Implement enhanced nontraditional mortgage consumer protection procedures consistent with OTS guidance. <u>Other issues</u> • Generally, the rapid deterioration in asset quality is attributable to PFF's concentration in tract construction and land loans.	
1/10/2008 1/10/2008 (Limited Examination)	3/333322	N/A	This limited examination was part of the ongoing full scope safety and soundness examination that started on October 29, 2007. The examination report recommended the downgrade of PFF's composite rating from a 2 to a "3" and recommended the downgrades of Capital,	None

[13] Sendero was the software system used by PFF to measure and monitor the thrift's exposure to interest rate risk.

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
			Asset Quality, Management, and Earnings CAMELS ratings from 2s to 3s.	
4/14/2008 (Limited Examination)	4/443442	N/A	The scope of this examination focused on the review of asset quality and liquidity • As a result of the findings of this review, the thrift's composite CAMELS rating was reduced to a 4, and the component CAMELS ratings for Capital and Liquidity were also downgraded to 4s. • Liquidity was negatively impacted by negative publicity surrounding the suspension of trading of PFF's stock for one day on April 30, 2008 (relating to a delay in the press release of the thrift's earnings), the financial condition of the thrift and its perception in the market and by depositors, the thrift's precipitous stock price drop (over 90 percent in one year), and newspaper speculation regarding potential regulatory action. • PFF's net deposit outflow from April 30, 2008 to June 12, 2008, was $403 million. The majority of this outflow occurred between April 30, 2008 and May 14, 2008, with a total net deposit decline of $249.1 million, or 8.1 percent of total deposits at April 30, 2008. • The merger agreement entered into by PFF Bancorp positively impacted liquidity. • PFF's asset quality continued to deteriorate rapidly during the quarter ending March 31, 2008, and loan loss provisions and charge-offs resulted in significant losses.	None
5/28/2008 5/28/2008 (Limited Examination)	4/443442	N/A	Downgraded PFF's Liquidity component CAMELS rating to a 4	

Date examination started/ended	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention, corrective actions, recommendations and other issues cited in reports of examinations and limited examination reports	Formal Enforcement Action
11/3/2008 11/24/2008 (Limited Examination)	None assigned	N/A	Examination was conducted to monitor PFF's liquidity.	None
11/5/2008 11/5/2008 (Limited Examination)	5/543442	N/A	Offsite downgrade of Composite and Component ratings	
11/18/2008 11/18/2008	5/554452	N/A	Offsite downgrade of Asset Quality, Management, and Liquidity ratings	
Source: OIG Analysis of OTS Reports of Examinations for PFF Bank & Trust.				

We have completed three mandated material loss reviews of failed thrifts since April 2008, starting with the material loss review of NetBank, FSB. This appendix provides our recommendations to the Office of Thrift Supervision (OTS) resulting from these reviews. OTS management concurred with the recommendations and has taken or planned corrective actions that are responsive to the recommendations. In certain instances, the recommendations address matters that require ongoing OTS management and examiner attention.

Report Title	**Recommendations to OTS Director**
Safety and Soundness: Material Loss Review of NetBank, FSB, OIG-08-032 (Apr. 23, 2008) OTS closed NetBank and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on September 28, 2007. At that time, FDIC estimated that NetBank's failure would cost the Deposit Insurance Fund $108 million.	Ensure that the recommendations/lessons learned from OTS's internal assessments of the NetBank failure, as described on pages 21 and 28 of that report, are implemented. Re-emphasize to examiners that for 3-rated thrifts, formal enforcement action is presumed warranted when certain circumstances identified in the OTS Examination Handbook are met. Examiners are also directed to document in the examination files the reason for not taking formal enforcement action in those circumstances. Establish in policy a process to assess the causes of thrift failures and the supervision exercised over the institution and to take appropriate action to address any significant supervisory weaknesses or concerns identified.
Safety and Soundness: Material Loss Review of IndyMac Bank, FSB, OIG-09-032 (Feb. 26, 2009) OTS closed IndyMac on July 11, 2008, and named FDIC as conservator. As of My 8, 2009, FDIC estimated that IndyMac's failure would cost the Deposit Insurance Fund $10.7 billion.	Ensure that action is taken on the lessons learned and recommendations from the OTS internal review of the IndyMac failure. Caution examiners that assigning composite CAMELS ratings of 1 or 2 to thrifts with high-risk, aggressive growth business strategies need to be supported with compelling, verified mitigating factors. Such mitigating factors should consider things such as the institution's corporate governance, risk management controls, allowance for loan and lease losses methodologies, concentration limits, funding sources, underwriting standards, and capital levels and whether the mitigating factors are likely to be sustainable in the long-term. Another important factor that should be considered is the extent to which the thrift offers nontraditional loan products (regardless of whether loans are

	sold or retained) that have not been stress tested in difficult financial environments, and whether the thrift can adequately manage the risks associated with such products. OTS should re-examine and refine as appropriate its guidance in this area.
Safety and Soundness: Material Loss Review of Ameribank, Inc., OIG-09-036 (April 7, 2009) OTS closed Ameribank and appointed the FDIC as receiver on September 19, 2008. As of December 31, 2008, FDIC estimated that Ameribank's failure would cost the Deposit Insurance Fund $33.4 million.	Remind examiners of the risks associated with rapid growth in high-risk concentrations. Remind examiners to conduct more thorough loan sampling from the portfolio if they identify a rapid increase in concentration. Remind examiners of the examination guidance for thrift third-party relationships, with particular attention to the assessment of the risk the relationship may pose to the thrift's safety and soundness. Assess the need for guidance requiring risk assessment of construction rehabilitation account loans as an integral part of assessing a thrift's overall risk. Ensure that the recommendations and the lessons learned from OTS's internal assessment of the Ameribank failure are implemented.

Office of Thrift Supervision
Department of the Treasury

John E. Bowman
Acting Director

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June 11, 2009

MEMORANDUM FOR: Susan L. Barron, Audit Director
Office of Inspector General
U.S. Department of the Treasury

FROM: John E. Bowman /s/
Acting Director

SUBJECT: Draft Audit Report on the Material Loss Review of PFF Bank and Trust

Thank you for the opportunity to comment on your draft audit report entitled "Material Loss Review of PFF Bank." The report focuses on the causes of the failure of PFF Bank and Trust (PFF), and the oversight responsibility of the Office of Thrift Supervision for PFF.

The OIG report on PFF contains three recommendations:

- Ensure that the recommendations and lessons learned from the internal assessment of the PFF failure are implemented and that the lessons learned from the assessment are taken into account going forward;
- OTS should direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits for concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable; and,
- OTS should formally communicate to the industry the guidance in ND Bulletin 06-14 as to OTS's expectation that concentration measurements and limits be set as a percentage of capital, not just as a percentage of total assets or total loans, and the need for a sound internal risk management system (including stress testing, regular periodic monitoring, and other risk management tools) for higher-risk concentrations.

OTS concurs with the recommendations and will implement the Office of Inspector General (OIG) recommendations from this Material Loss Review by the end of the third quarter of 2009. We plan to issue further guidance regarding concentrations to both the thrift industry and OTS staff that will address asset and liability concentration issues described in the OIG's report, as well as those that have been identified internally by OTS.

Once again, thank you for the opportunity to review and respond to your draft report. We appreciate the professionalism and courtesies provided by the staff of the OIG.

Jaideep Mathai, Audit Manager
Amnoiphorn Samson, Analyst in Charge
Chereeka Straker, Auditor
Shaneasha Edwards, Program Analyst
Asha Mede, Referencer

Department of the Treasury

Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control

Office of Thrift Supervision

Acting Director
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

United States Senate

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

Chairman and Ranking Member
Committee on Finance

U.S. House of Representatives

Chairman and Ranking Member
Committee on Financial Services

Federal Deposit Insurance Corporation

Chairman
Inspector General

U.S. Government Accountability Office

Acting Comptroller General of the United States