Audit Report

OIG-11-090

SAFETY AND SOUNDNESS: Material Loss Review of First Federal Bank of California

August 3, 2011

Office of Inspector General

DEPARTMENT OF THE TREASURY

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

August 3, 2011

MEMORANDUM FOR **JOHN WALSH**
ACTING COMPTROLLER OF THE CURRENCY

FROM: Kieu T. Rubb /s/
Audit Director

SUBJECT: Material Loss Review of First Federal Bank of California

INTRODUCTION

This memorandum presents the results of the material loss review of First Federal Bank of California (First Federal), Santa Monica, California. First Federal was regulated by the Office of Thrift Supervision (OTS). We are providing the results of this review for your information since the Office of the Comptroller of the Currency (OCC) assumed regulatory responsibilities for federal savings associations pursuant to P.L. 111-203.

OTS closed First Federal and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on December 18, 2009. At that time, FDIC estimated that First Federal's loss to the Deposit Insurance Fund was $144.4 million. However, in December 2010, FDIC revised the estimated loss to the Deposit Insurance Fund to $10 million.

Under section 38(k) of the Federal Deposit Insurance Act, we are responsible for conducting a material loss review of the failure of First Federal.[1] To help fulfill this responsibility, we contracted with Crowe Horwath LLP (Crowe Horwath), an independent public accounting firm. Crowe Horwath's report dated July 13, 2011, is provided as Section I.

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[1] At the time of First Federal's failure, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k) defines a material loss as a loss to the Deposit Insurance Fund in excess of $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar year 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met).

RESULTS OF MATERIAL LOSS REVIEW

We concur with Crowe Horwath's reported conclusions regarding First Federal's causes of failure and OTS's supervision of First Federal.

- First Federal failed primarily because of its high-risk growth strategy executed in 2004 and 2005 with excessive concentration in option adjustable-rate mortgages (option ARMs) without implementing adequate controls to manage the associated risks. First Federal funded this growth strategy with brokered deposits. Additional underwriting risk stemming from originating reduced documentation loans combined with the rapid decline in the economic environment, resulted in the deterioration of the thrift's asset quality, including a substantial volume of problem loans and material loan losses.

- OTS used informal actions to restrict the thrift's growth and required First Federal to increase its capital levels. In addition, First Federal's CAMELS ratings were downgraded. OTS issued a cease and desist (C&D) order and required the development of a capital restoration plan while First Federal was still well-capitalized. While these actions were appropriate, OTS could have also responded with more timely formal enforcement actions. As a result, OTS's supervision of First Federal did not prevent a material loss to the Deposit Insurance Fund.

Details of Crowe Horwath's conclusions are contained in their report.

We also concur with Crowe Horwath's reported recommendations that:

- OTS ensure that action is taken on the recommendations in the internal failed bank review for First Federal that was issued October 28, 2010.

- OTS remind examiners to adhere to OTS guidance on the timing of formal enforcement actions, especially with thrifts whose CAMELS ratings[2] are a composite 3 or worse over examinations cycles.

OBJECTIVES, SCOPE, AND METHODOLOGY

Under section 38 (k), we are responsible for preparing a report to OTS that (1) ascertains why First Federal's problems resulted in a material loss to the Deposit Insurance Fund; (2) reviews OTS's supervision of the institution, including

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[2] CAMELS is an acronym for performance rating components for financial institutions: Capital adequacy, Asset quality, Management, 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.

its implementation of the prompt corrective action provisions of section 38(k); and (3) makes recommendations for preventing any such loss in the future.

To help fulfill this responsibility, we contracted with Crowe Horwath to perform a material loss review in accordance with generally accepted government auditing standards. We evaluated the nature, extent, and timing of the work; monitored progress throughout the audit; reviewed Crowe Horwath-prepared documentation; met with its principals and staff; evaluated key judgments; met with OTS officials; performed independent tests of OTS supervisory records; and performed other procedures we deemed appropriate in the circumstances. We conducted our work in accordance with generally accepted government auditing standards.

Section II identifies the recipients of this report. Should you wish to discuss the report, you may contact me at (202) 927-5904.

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Section I

Crowe Horwath LLP's Audit Report on the Material Loss Review of First Federal Bank of California

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Appendices

Abbreviations

ARM	adjustable-rate mortgage
C&D order	cease and desist order
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
MRBA	matter requiring board attention
OIG	Treasury Office of Inspector General
OTS	Office of Thrift Supervision
PCA	prompt corrective action
ROE	report of examination
SFR	single-family residential
TFR	Thrift Financial Report

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Inspector General
Department of the Treasury

RE: Transmittal of Results for the Material Loss Review Report for First Federal Bank of California, a Federal Savings Bank, Santa Monica, California.

This letter is to acknowledge delivery of our performance audit report of the Material Loss Review for First Federal Bank of California, a Federal Savings Bank (First Federal). The objectives of this performance audit were to: (1) determine the causes of First Federal's failure and resulting material loss to the Deposit Insurance Fund and (2) evaluate the Office of Thrift Supervision's (OTS) supervision of First Federal, including implementation of the prompt corrective action (PCA) provisions of section 38. First Federal was closed by OTS on December 18, 2009. The estimated loss to the Deposit Insurance Fund as of June 10, 2011, was $10 million.

The performance audit results are in the accompanying performance audit report. The information included in this report was obtained during our fieldwork, which occurred during the period from April 2010 through June 2010.

We conducted our 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.

We also included several appendices to this report. Appendix 1 contains a more detailed description of our material loss review objectives, scope and methodology. Appendix 2 contains background information on First Federal and OTS's supervision processes. Appendix 3 is a glossary of terms used in this report. The terms defined in the glossary are underlined the first time they are used in the report. Appendix 4 provides OTS's comments regarding the report's recommendations.

Crowe Horwath LLP

Fort Lauderdale, Florida
July 13, 2011

Results in Brief

The primary cause of First Federal's failure was a high-risk growth strategy executed in 2004 and 2005 with excessive concentration in option adjustable-rate mortgages (option ARMs) without implementing adequate controls to manage the associated risks. First Federal funded this growth strategy with brokered deposits. Additional underwriting risk stemming from originating reduced documentation loans combined with the rapid decline in the economic environment, resulted in the deterioration of the thrift's asset quality, including a substantial volume of problem loans and material loan losses. Loan losses, with significantly diminished earnings and capital ratios, ultimately resulted in the failure of First Federal.

As a result of First Federal's significant growth and increase of option ARMs as percentages of its assets and risk-based capital, OTS used informal actions to restrict the thrift's growth and required First Federal to increase its capital levels. In addition, First Federal's CAMELS ratings were downgraded. OTS issued a cease and desist (C&D) order and required the development of a capital restoration plan while First Federal was still well-capitalized. While these actions were appropriate, we conclude that OTS could have also responded with more timely formal enforcement actions.

During our material loss review, OTS completed an internal failed bank review of First Federal which concluded that, similar to our material loss review, First Federal's high growth in single-family residential (SFR) mortgages, funded by brokered deposits and borrowings, and less than full documentation underwriting contributed to its failure. The review recommended that OTS should regard significant unplanned and/or uncontrolled growth as higher-risk activity; take prompt action to establish and enforce concentration limits, particularly with higher risk assets; consider reduced documentation underwriting loans as unsafe and unsound unless risk mitigating controls are in place; and assign CAMELS ratings of 1 or 2 to thrifts with higher risk, aggressive growth strategies only if supported by mitigating risk management factors.

Our material loss review affirms the findings and recommendations of OTS's internal review.

Recommendations

We are recommending that OTS (1) ensure that recommendations from the internal failed bank review of First Federal are implemented and (2) remind examiners to adhere to OTS guidance on when formal enforcement actions should be taken, especially with thrifts whose CAMELS ratings continue to deteriorate over examinations cycles.

Management Response

Although OTS management concurs with the recommendations, there is no practical way to implement them, given OTS' imminent sunset and the practical fact that half of the OTS regulatory staff are attending previously scheduled Office of the Comptroller of the Currency staff conferences this week and next.

We included management's response in its entirety as Appendix 4.

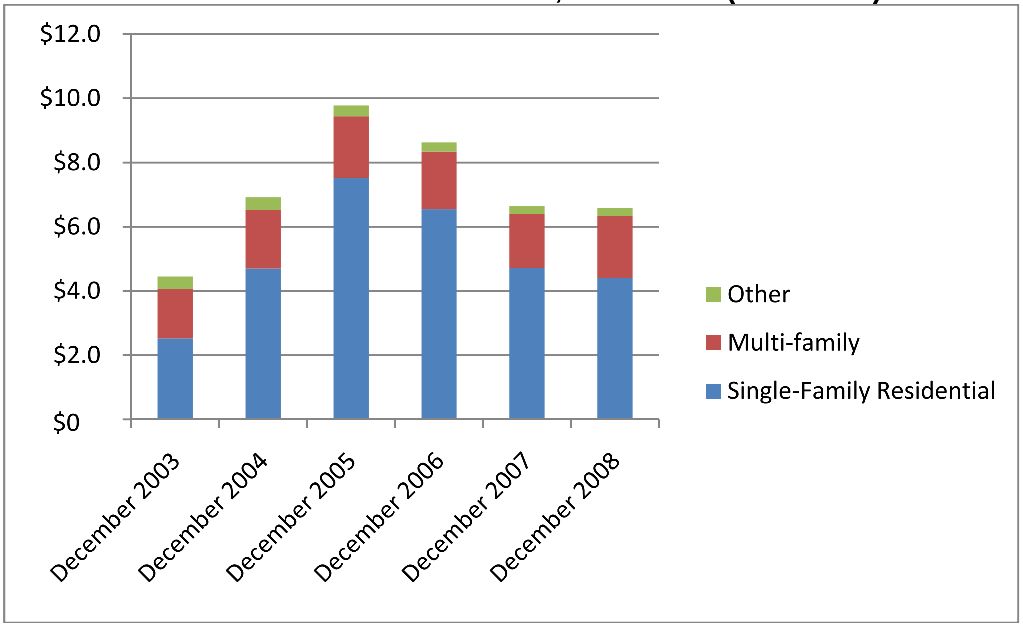
Causes of First Federal's Failure

In 2004 and 2005, First Federal's board and management embarked on a high growth strategy in option ARMs without implementing adequate controls to manage the associated risks. The growth strategy was funded with brokered deposits. First Federal originated most of these loans using reduced documentation standards. The increased concentration in option ARMs and reduced underwriting requirements significantly increased overall risk. Due to these conditions, combined with the rapid decline in the economic environment and specifically property values in California, the thrift experienced deterioration in asset quality, including a substantial volume of problem loans and material loan losses. Despite extensive option ARM portfolio modifications which did not result in a stronger performing portfolio, loan losses resulted in significantly diminished earnings, reduced capital, and ultimately, the failure of First Federal.

High Concentration in Option ARMs

First Federal historically focused on SFR loans and multi-family loans. In 2004 and 2005, First Federal substantially grew its loan portfolio by primarily originating and holding SFR option ARMs. As figure 1 indicates, SFR loans totaled $2.5 billion in 2003 and by 2005 had increased to $7.5 billion. In 2006, the thrift started to reduce option ARM originations in an effort to reduce its option ARMs concentration. However, First Federal had already created a significant concentration of loans originated in 2004 and 2005 which negatively impacted its concentration of risk.

Figure 1: First Federal's Loan Portfolio Growth, 2003–2008 (in billions)



Source: OTS Thrift Financial Reports (TFR), December 31, 2003 – December 31, 2008.

Excess concentrations in higher-risk assets pose additional risk to a thrift because negative events, such as declining property values, economic deterioration and natural disasters, have a greater detrimental impact on overly concentrated groups.[1] First Federal's SFR portfolio, (option ARMs constituted the majority of this portfolio) as a percentage of risk-based capital, was significant during 2005 to 2009. The level was as high as 57% in December 2005 and was 41% in September 2009.

Further, high concentrations are subject to additional risk when they consist of nontraditional mortgage products, such as option ARMs. These loans are riskier because they give borrowers the option of making a minimum monthly payment that may not cover the accrued interest charges, let alone the principal amount. For borrowers who pay the minimum payment, the result is negative amortization.

First Federal's negative amortization loans generated large amounts of capitalized interest, which was recorded on the thrift's books as accrued (uncollected) interest income in accordance with generally accepted accounting principles. According to the 2009 report of examination (ROE), First Federal's negative amortization peaked at $308 million in the second quarter of 2008. In June 2009, the negative

[1] OTS New Directions Bulletin 06-14, Concentrations of Risk.

amortization remained significant at $234 million, which was 77 percent of First Federal's tier 1 capital.

First Federal significantly increased its option ARMs concentration in 2004 and 2005. By 2007, when the real estate market began to deteriorate at unprecedented levels, the SFR portfolio experienced significant credit deterioration. The SFR portfolio past due rate in December 2007 was 3.84% and it continued to elevate through 2009. SFR portfolio past dues were 10.56% in September 2009.

Reliance on Brokered and Higher Cost Deposits for Liquidity

First Federal relied on wholesale funding sources, including Federal Home Loan Bank (FHLB) advances, brokered deposits, Fed Funds Purchased and Repurchase Agreements to support its significant option ARM growth. As table 3 shows, wholesale funding sources totaled $4.4 billion in 2004 and increased to $7.0 billion in 2005 before declining in 2007 to $3.0 billion.

Table 3: First Federal Wholesale Funding Sources

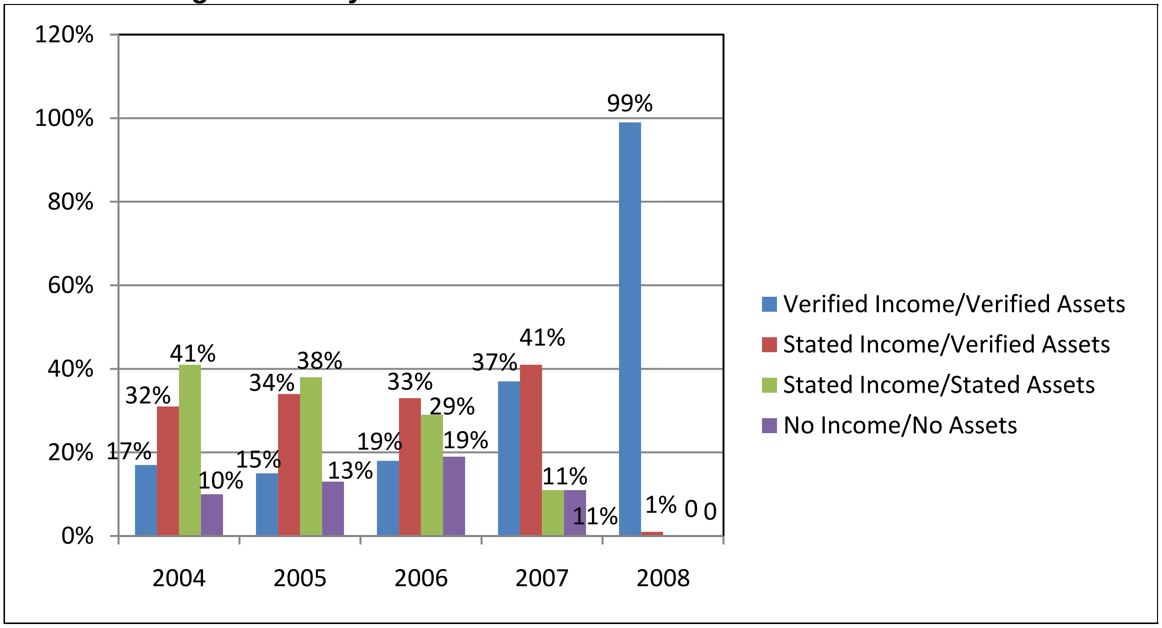
(in billions)	December 2004	December 2005	December 2006	December 2007	December 2008
FHLB Borrowings	$3.01	$4.16	$1.49	$2.08	$2.06
Brokered Deposits	$1.20	$1.71	$2.80	$0.82	$1.70
Fed Funds Agreements	$0.19	$1.16	$0.98	$0.12	$0.00
Total	$4.40	$7.03	$5.27	$3.02	$3.76

Source: Federal Deposit Insurance Corporation (FDIC) website and FirstFed Financial Corporation 10K reports.

Ineffective Controls Over High Option ARMs Concentration

First Federal did not apply the same underwriting criteria normally associated with conventional mortgages for its option ARMs. Borrowers were able to obtain an option ARM based on stated income with reduced or no documentation. This type of underwriting is riskier by nature, and when First Federal began offering these types of loans they had never been tested in stressful economic conditions. As shown in figure 2, reduced documentation loans accounted for more than 80 percent of the SFR loans originated in 2004, 2005, and 2006.

Figure 2: SFR Loan Originations by Documentation Level



Source: FirstFed Financial Corporation 10-K reports.

Approving loans to borrowers without verifying income and asset representations increased the option ARM portfolio credit risk. When the economic downturn started in late 2007, First Federal began tightening its underwriting criteria. However, it was too late for the thrift to reduce or mitigate the risk in its option ARM portfolio. First Federal's option ARMs concentration, generated primarily by reduced documentation underwriting, had a negative impact on the thrift's asset quality and financial condition.

Decline in First Federal's Real Estate Markets

By 2007, there were clear indications that the economy as a whole and the real estate market, in particular, were in decline. Before 2007, the banking industry had experienced strong financial performance and success. Many bank portfolios became heavily concentrated in real estate because it was profitable and in high demand.

First Federal's concentration in SFR option ARMs was primarily in California. In 2007, in conjunction with the deterioration of housing markets throughout the United States, the thrift's lending markets began to experience a real estate downturn. Consequently, First Federal's nonperforming real estate loans and allowance for loan and lease losses (ALLL) increased significantly. For example, SFR charge-offs increased from $14 million in 2007 to over $353 million in 2008.

In summary, First Federal failed to implement adequate controls and manage the risks associated with its high-risk growth in 2004 and 2005 and concentration in option ARMs. When economic conditions declined and the thrift incurred substantial losses, First Federal was unable to sustain its earnings and capital at acceptable levels. The thrift was not successful in its attempts to raise additional capital. Deeming the thrift in an unsafe and unsound condition, OTS closed First Federal on December 18, 2009, and appointed the FDIC as receiver.

OTS's Supervision of First Federal

OTS recognized the risk of First Federal's significant growth in option ARMs beginning in 2004 and responded by increasing its monitoring of the thrift. While OTS did not issue a formal regulatory action until 2009, they used informal actions to restrict the thrift's growth in option ARMs beginning in 2006. OTS identified the change in First Federal's risk profile starting in 2005 and downgraded the asset quality and management CAMELS component ratings accordingly.

The following actions were taken by OTS to limit the loss of First Federal's failure (estimated to be $10 million as of June 10, 2011):

(1) restrict growth,
(2) decrease dependence on wholesale deposits,
(3) require a capital restoration plan when the thrift was still well-capitalized, and
(4) allowing/approving First Federal's contingent capital plan which provided for voluntary receivership if their capital raising efforts were not successful.

However, OTS should have responded to the concentration in option ARMs and the deterioration of the CAMELS ratings with formal enforcement actions sooner.

OTS's Supervisory History and Actions

Table 5 summarizes the results of OTS's safety and soundness and limited-scope examinations of First Federal from 2004 until its closure in December 2009.[2] Generally, matters requiring board attention (MRBAs) represent the most significant items reported in ROEs requiring corrective action.

[2] OTS conducted its examinations and performed offsite monitoring of First Federal in accordance with the timeframes prescribed in the OTS Examination Handbook.

Table 5. Summary of OTS's Examinations of and Enforcement Actions Against First Federal					
		Examination Results (Source: OTS ROEs and enforcement actions)			
Date started/date completed	**Total assets (in $ billions) at time of examination**	**CAMELS rating**	**No. of MRBAs**	**No. of recommendations/ corrective actions**	**Informal/formal enforcement actions**
7/19/2004 9/7/2004 Full-scope examination	$5.5	1/121121	None	None	None
4/14/2005 4/14/2005 Limited examination	$7.5	2/221121	N/A	N/A	N/A
8/8/2005 1/11/2006 Full-scope examination	$9.8	3/333231	4	13	None
9/11/2006 5/3/2007 Full-scope examination	$10.3	3/232332	5	8	None
9/10/2007 11/27/2007 Full-scope examination	$7.4	3/233222	5	6	Board resolution (informal enforcement action) dated January 24, 2008
9/29/2008 3/13/2009 Full-scope examination	$7.4	4/444443	6	9	C&D order (formal enforcement action) issued 1/26/2009
5/18/2009 5/18/2009 Notice of rating downgrades	N/A	5/554543	Reclassified from well-capitalized to adequately-capitalized. Amended C&D order issued May 28, 2009.		

Action Taken by OTS Leading to Receivership

As stated in the OTS Examination Handbook, OTS has long maintained that "no documentation" residential real estate lending is an unsafe and unsound practice.[3] In addition, the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks stated that loans to individuals who do not demonstrate the capacity to repay from sources other than the collateral pledged, are generally considered unsafe and unsound. In the case of First Federal, up to 72 percent of the thrift's option ARMs

[3] OTS Examination Handbook, Appendix F One- to Four-Family Residential Real Estate Lending, Section 212F.

approved during 2004 through 2006 were based on stated income or stated income and stated assets. An additional 10 percent to 19 percent were underwritten without employment, income, or asset information. During this period, as much as 85 percent of First Federal's option ARMs originated between 2004 and 2006 were not prudently underwritten in a safe and sound manner based on OTS guidance.

OTS first identified concerns with the SFR portfolio concentration risk and asset quality in the August 2005 examination. In the September 2008 examination, OTS continued to report concerns related to concentration risk and significant deteriorations in asset quality. Due to the elevated risk position identified during the examination, OTS took additional actions. Specifically, OTS issued a supervisory directive in November 2008 which required FirstFed Financial Corporation (FFC), the thrift's holding company, to engage a qualified independent investment banking firm to analyze strategies for raising additional capital to support the thrift's activities. Continued asset and earnings deterioration and declining capital ratios caused OTS to issue a notice of troubled condition designation in December 2008 which included restrictions on growth, compensation and benefits, third party contracts, dividends, and transactions with affiliates.

Capital raising efforts were not successful, and in January 2009 OTS issued C&D orders to First Federal and FFC which included:

- A requirement to submit a capital plan within 15 days that indicated how the thrift would maintain a well-capitalized status at each quarter-end through 2011.
- Restrictions on any dividend payments to the holding company.
- Restrictions on the holding company's debt.
- Restrictions on the holding company's payment of debt.
- Restrictions on entering into or changing employment contracts.

In the ROE issued March 2009, OTS lowered First Federal's composite CAMELS rating to 4 and identified 6 MRBAs and 9 corrective actions.

OTS conducted a comprehensive limited examination in May 2009 and reviewed the thrift financial report (TFR) of March 31, 2009, noting further declines in performance and financial strength. Based on this limited examination OTS downgraded the composite and three CAMELS component ratings to 5. On May 28, 2009, OTS issued amended C&D orders requiring FFC to submit a detailed capital restoration plan that would increase the thrift's core capital to 7 percent and risk-based capital to 14 percent by September 30, 2009.

When FFC did not comply with the capital requirements at September 30, 2009, OTS required the holding company to submit a contingent capital plan. The contingent capital plan submitted by FFC indicated they would raise $515 million in capital and inject $450 million of capital into the thrift by December 2, 2009. The contingent capital plan also indicated that if FFC was not successful raising needed capital by December 2, 2009, the thrift would voluntarily consent to receivership within 2 days. OTS did not object to this contingent capital plan.

Stronger Response to Growth and Concentration in Option ARMs Was Warranted by OTS

OTS issued ROE comments and MRBAs to restrict First Federal’s option ARM growth, enhance lending practices and increase capital levels prior to 2008. However, these actions did not specifically address First Federal’s credit concentration risk; and therefore formal enforcement action specifically for this risk should have been issued more timely.

Also, according to section 80 of the OTS Examination Handbook, if an institution receives a CAMELS composite 3-rating for two consecutive examinations following the association or holding company entering into an informal enforcement action, the informal action is deemed insufficient to address the issues. In addition, formal enforcement actions are to be used when informal actions are or would be unsuccessful in prompting corrective action.

OTS did not comply with this guidance. The initial C&D order and the first formal enforcement action were issued in January 2009, 14 months after the third consecutive ROE with a composite CAMELS rating of 3. These actions were taken during the examination that started in September 2008, where OTS ultimately downgraded the composite CAMELS rating to 4.

We discussed with OTS why a formal enforcement action was not taken earlier in accordance with OTS guidance. OTS personnel reiterated that in January 2008, OTS did take an informal enforcement action through issuance of the Board Resolution. OTS personnel did not have specific recollection as to why they choose the Board Resolution as the appropriate supervisory response.

Prompt Corrective Action Used Appropriately

The purpose of PCA is to resolve the problems of insured depository institutions that result in 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 supervise institutions based on criteria other than capital to help reduce deposit insurance losses caused by unsafe and unsound practices. For example, OTS's Enforcement Action Policy allows the regulator to impose more severe limitations than a thrift's PCA capital category would otherwise permit or require if it is determined that the thrift is operating in an unsafe or unsound condition or engaging in unsafe or unsound practices.

First Federal's capital levels remained above the PCA minimum for well-capitalized institutions until the June 2009 TFR, when the thrift fell to adequately-capitalized. OTS performed a limited-scope examination in July 2009 which focused on First Federal's compliance with the May 2009 C&D's capital ratios. OTS had already instituted corrective actions prior to June 2009 due to safety and soundness concerns. While not directly related to PCA, the issuance of the C&D and related restrictions were corrective measures taken earlier in the year by OTS that included the capital restoration plan typically required under PCA.

We concluded that OTS appropriately used its authority under PCA, and in a timely manner, as the thrift's capital levels fell. However, these actions did not prevent First Federal's failure.

OTS Internal Failed Bank Review

In accordance with OTS policy, an internal review of First Federal's failure was performed to determine the causes of failure, evaluate the supervision exercised by OTS, and provide recommendations based upon the findings of the review.[4] The OTS review determined that First Federal's failure was caused by high growth, funded by brokered deposits and borrowings, of SFR mortgages with negative amortization and less than full documentation underwriting features. First Federal's

[4] 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 OTS's deputy director of examinations, supervision, and consumer protection. OTS's Southeast Region initiated an internal review of First Federal following its failure in December 2009. The scope of the review focused primarily on OTS's supervision from April 2002 to December 2009.

concentration in these assets, during a period of economic downturn in California, resulted in losses that were unsustainable.

The OTS report made the following recommendations:

- OTS should continue to take steps to ensure that growth of all savings associations is prudent, adequately-capitalized, and directed and managed in a safe and sound manner. Significant unplanned and/or uncontrolled growth should be regarded as higher-risk activity. Growth that involves anything new, such as new products and practices, should be closely monitored.
- OTS should take prompt action to establish and enforce concentration limits, particularly with higher risk types of assets.
- OTS should consider as an unsafe and unsound practice the use of reduced documentation underwriting, including stated income and stated asset underwriting, unless appropriate mitigating risk controls are in place.
- Assigning composite CAMELS ratings of 1 or 2 to thrifts with higher risk, aggressive growth business strategies should be supported with factors that mitigate the risk, such as risk management controls and capital planning.

Our material loss review affirms the findings and recommendations of OTS's internal review.

Recommendations

As a result of our material loss review of First Federal, we recommend that OTS do the following:

1. Ensure that recommendations from OTS's internal failed bank review of First Federal's are implemented.

   Management Response
   Although OTS management concurs with the recommendations, there is no practical way to implement them, given OTS' imminent sunset and the practical fact that half of the OTS regulatory staff are attending previously scheduled Office of the Comptroller of the Currency staff conferences this week and next.

   Crowe Horwath Comment
   Agreed.

2. Remind examiners to adhere to OTS guidance on the timing of formal enforcement actions, especially with thrifts whose CAMELS ratings are a composite 3 or worse over several examinations cycles.

   Management Response
   Although OTS management concurs with the recommendations, there is no practical way to implement them, given OTS' imminent sunset and the practical fact that half of the OTS regulatory staff are attending previously scheduled Office of the Comptroller of the Currency staff conferences this week and next.

   Crowe Horwath Comment
   Agreed.

Our objectives were to determine the causes of the First Federal Bank of California (First Federal) failure and assess its supervision by the Office of Thrift Supervision (OTS). We conducted this material loss review of First Federal under contract with the Department of the Treasury Office of Inspector General (OIG) in response to its mandate under section 38(k) of the Federal Deposit Insurance Act.[5] 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.[6]

The OIG contracted with our firm to conduct this material loss review of First Federal based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of June 10, 2011, FDIC estimated that the loss to the Deposit Insurance Fund from First Federal's failure would be $10 million.

To accomplish our review, we conducted fieldwork at OTS's region office in Daly City, California. We also met with officials of FDIC's Division of Resolutions and Receiverships in Irvine, California. We conducted our fieldwork from April 2010 through June 2010.

To assess the adequacy of OTS's supervision of First Federal, we determined (1) when OTS first identified First Federal's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the thrift to correct the problems. We also assessed whether OTS (1) might have discovered problems

[5] 12 U.S.C. § 1831o(k).
[6] At the time of First Federal's failure on December 18, 2009, section 38(k) defined a loss as material if it exceeded the greater of $25 million or 2 percent of the institution's total assets. Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds $200 million for calendar years 2010 and 2011, $150 million for calendar years 2012 and 2013, and $50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to $75 million if certain conditions are met). Section 38 (k) also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

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 period covered by our audit would be from July 2004 through the thrift's failure on December 18, 2009. This period included five full-scope and one limited-scope safety and soundness examinations prior to the appointment of FDIC as receiver of the thrift on December 18, 2009.
- We reviewed OTS's supervisory files and records for First Federal from 2004 through December 2009. 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 OTS used to compel thrift management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.
- We interviewed OTS officials and examiners, discussed various aspects of the supervision of First Federal, and obtained their perspectives on the thrift's condition and the scope of the examinations.
- We interviewed FDIC officials who were responsible for monitoring First Federal for federal deposit insurance purposes.
- We reviewed First Federal documents obtained by FDIC and inventoried by FDIC Division of Resolutions and Receiverships personnel.
- We assessed OTS's actions based on its internal guidance and requirements of the Federal Deposit Insurance Act.[7]

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.

[7] 12 U.S.C. § 1811 et seq.

History of First Federal

First Federal Bank of California, a Federal Savings Bank (First Federal), was founded in 1929 as First Federal, FSB, and its original thrift charter was issued in 1933. In 1935, First Federal became a federally chartered mutual association. In 1983 First Federal converted to a federally chartered stock company. First Federal became a wholly owned subsidiary of FirstFed Financial Corporation (FFC) in 1997. FFC was a holding company that operated primarily as a financing vehicle for the thrift.

First Federal was historically a residential mortgage lender and was consistently profitable. It had low loan delinquencies, good asset quality, and strong capital levels until 2004 when the thrift embarked on a strategy to generate significant growth and increase its option adjustable rate mortgage (option ARM) portfolio. In December 2003 total assets were $4.8 billion and by the end of 2005 total assets had increased to $10.5 billion.

The decline in housing prices in First Federal's California market area in 2007 contributed to rising delinquencies in its large portfolio of option ARMs. Furthermore, a significant portion of these loans were originated during the peak of the real estate market and were underwritten mostly using alternative documentation standards. Ultimately, the combination of an excessive concentration in risky option ARMs and a downturn in economic conditions overwhelmed First Federal's capacity to absorb the losses on its option ARM portfolio. OTS closed the thrift on December 18, 2009.

Types of Examinations Conducted by OTS

OTS conducts various types of examinations, including safety and soundness, compliance, trust and information technology. Table 6 shows the number of OTS staff hours spent examining First Federal from 2004 to 2009.

Table 6: Number of OTS Hours Spent Examining First Federal, 2004-2009

Examination Start Date	Number of Examination Hour
7/19/2004	1,021
8/8/2005	1,782
1/3/2006	230
9/11/2006	2,029
5/29/2007	176
9/10/2007	2,872
9/29/2008	3,377
7/29/2009	784
11/30/2009	295

Source: OTS.
*Hours are totaled for safety and soundness, information technology, and compliance examinations only.

OTS must conduct full-scope examinations of insured thrifts either once every 12 months or once every 18 months, depending on the size of the thrift and other factors. First Federal was on a 12-month cycle. During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns the thrift a CAMELS composite rating based on its assessment of the thrift's overall condition and OTS's level of supervisory concern.

Enforcement Actions Available to OTS

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

Informal Enforcement Actions

When a thrift's overall condition is sound but it is necessary to obtain written commitments from its 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 for 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.

The effectiveness of informal action depends in part on the willingness and ability of a thrift to correct deficiencies that OTS notes. 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.

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

Formal Enforcement Actions

Formal enforcement actions are enforceable under the Federal Deposit Insurance Act. 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 uses formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems.

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 a 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.

OTS Assessments Paid by First Federal

OTS funds its operations in part through semiannual assessments on thrifts. OTS determines each thrift's assessment by adding together three components reflecting the thrift's size, condition, and complexity. OTS computes the size component by multiplying a thrift's total assets, as reported on its thrift financial report, by the applicable assessment rate. The condition component is a percentage of the size component and is imposed on thrifts that have a 3, 4, or 5 CAMELS composite rating. OTS imposes a complexity component if (1) the thrift administers more than $1 billion in trust assets; (2) the outstanding balance of assets fully or partially covered by recourse obligations or direct credit substitutes exceeds $1 billion; or (3) the thrift services over $1 billion of loans for others. OTS calculates the complexity component by multiplying set rates by the amounts by which an association exceeds each threshold. Table 7 shows the assessments that First Federal paid to OTS from 2004 through 2009.

Table 7: Assessments Paid by First Federal to OTS between 2004 and 2009

Billing Period	Exam Rating	Amount Paid
7/1/2004–12/31/2004	1	$ 398,052
1/1/2005–6/30/2005	1	$ 494,720
7/1/2005-12/31/2005	2	$ 618,823
1/1/2006–6/30/2006	3	$ 1,087,983
7/1/2006–12/31/2006	3	$ 1,156,928
1/1/2007–6/30/2007	3	$ 1,144,988
7/1/2007–12/31/2007	3	$ 992,013
1/1/2008–6/30/2008	3	$ 900,089
7/1/2008–12/31/2008	3	$ 871,157
1/1/2009–6/30/2009	4	$ 1,222,190
7/1/2009–12/31/2009	5	$ 1,149,770
Total		**$10,036,713**

Source: OTS.

Allowance for loan and lease losses	An estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid.
Board resolution	A document designed to address one or more specific concerns identified by the Office of Thrift Supervision and adopted by a thrift's board of directors.
Brokered deposit	Any deposit that is obtained, directly or indirectly, from a deposit broker. The bank or thrift solicits deposits by offering rates of interest that are significantly higher than the rates offered by other insured depository institutions in its normal market area. Use of brokered deposits is limited to well-capitalized insured depository institutions and, with a waiver from the Federal Deposit Insurance Corporation, to adequately-capitalized institutions. Undercapitalized institutions are not permitted to accept brokered deposits. (See 12 U.S.C. § 1831(f) and 12 C.F.R. 337.6.)
CAMELS	An acronym for performance rating components for financial institutions: capital adequacy, asset quality, management, 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.
Capital restoration plan	A plan submitted to the appropriate federal banking agency by an 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 order	A type of formal enforcement action. A cease and desist order issued by the Office of Thrift Supervision normally requires the thrift to correct a violation of a law or regulation, or an unsafe or unsound practice. The Office of Thrift Supervision may issue a cease and desist 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.
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 the Office of Thrift Supervision, a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of a thrift's core capital plus allowance for loan and lease losses. Concentrations may include direct, indirect, and contingent obligations or large purchases of loans from a single counterparty.
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.
Conventional mortgages	A conventional mortgage is a type of mortgage in which the underlying terms and conditions meet the funding criteria of Fannie Mae and Freddie Mac. This mortgage usually has a 30-year fixed interest rate and requires at least a 20 percent down payment.
Division of Resolutions and Receiverships	A division within the Federal Deposit Insurance Corporation that is charged with resolving failing and failed financial institutions, including ensuring that depositors have prompt access to their insured funds.
Federal Home Loan Bank System	A system of 12 regional cooperative banks created by Congress from which member institutions borrow funds to finance housing, economic development, infrastructure, and jobs. The system provides liquidity to member institutions that hold mortgages in their portfolios and facilitates the financing of mortgages by making low-cost loans, called advances, to members. Advances with a wide variety of terms to maturity, from overnight to long-term, are available to members and are collateralized. Advances are designed to prevent any

possible loss to Federal Home Loan Banks, which also have a super lien (a lien senior or superior to all current and future liens on a property or asset) when institutions fail. To protect their position, Federal Home Loan Banks have a claim on any of the additional eligible collateral in a failed institution. In addition, the Federal Deposit Insurance Corporation has a regulation that reaffirms the priority of Federal Home Loan Banks, which can demand prepayment of advances when institutions fail.

Fed Funds Purchased and Repurchase Agreements	Fed funds purchased are reserve account balances purchased for periods longer than a single day, but generally less than 90 days. Thrifts purchase Fed funds for an extended period when they see their borrowing needs lasting several days, or they believe short-term rates may rise and they want to lock in the current rate. A repurchase agreement is a sale of securities coupled with an agreement to repurchase the securities at a higher price on a later date. A repurchase agreement is similar to a secured loan. Most repurchase agreements (or repos, as they are called) are overnight transactions, with the sale taking place one day and repurchase the next. Long-term repos, or term repos, can extend for a month or more, usually for a fixed time period.
FICO score	A credit score provided to lenders by credit reporting agencies to reflect information that each credit bureau keeps on file about the borrower. The scores are produced from software developed by the Fair Isaac Corporation. The scores take into consideration borrower information such as (1) timeliness of payments; (2) the length of time credit has been established; (3) the amount of credit used versus the amount of credit available; (4) the length of time at present residence; and (5) negative credit information such as bankruptcies, charge-offs, and collections. The higher the credit score is, the lower the risk to the lender.
Formal agreement	A type of formal enforcement action authorized by statute. Formal agreements are generally more severe than informal actions and are disclosed to the public. Formal actions are also enforceable through the assessment of civil money penalties.

Full-scope examination	Examination activities performed during the supervisory cycle that (1) are sufficient in scope to assign or confirm an institution's CAMELS composite and component ratings, (2) satisfy core assessment requirements, (3) result in conclusions about an institution's risk profile, (4) include onsite supervisory activities, and (5) generally conclude with the issuance of a report of examination.
Generally accepted accounting principles	A widely accepted set of rules, standards, and procedures for reporting financial information established by the Financial Accounting Standards Board.
Information technology examination	An examination that includes review and evaluation of the overall management of information systems used by a thrift and of the effectiveness of the internal audit and security functions for those systems.
Matter requiring board attention	A practice noted during an Office of Thrift Supervision 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, 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, the Office of Thrift Supervision requires that thrifts address them. A thrift's failure to do so may result in a formal enforcement action.
Negative amortization	Occurs when the monthly payments on a loan do not cover all of the interest owed. The unpaid interest is added to the principal and is referred to as capitalized interest. With negative amortization, a borrower may owe more than the original loan amount even after making several payments. Additionally, the borrower's equity in the property will decrease over time unless the property value increases at a higher rate than negative amortization.

Option ARMs	Option ARMs are adjustable rate, high-risk loans that feature, among other things, possible negative amortization and significant payment increases as rates recast.
Prompt corrective action	A framework of supervisory actions for insured 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 an institution falls into lower capital categories. The capital categories are well-capitalized, adequately-capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. (See 12 U.S.C. § 1831o.) 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, an institution also cannot be subject to a higher capital requirement imposed by the Office of Thrift Supervision.

Recourse	With respect to financial assets such as loans, the legal ability of the purchaser of an asset to make a claim against the seller of the asset if the debtor fails to pay. For example, a loan sold with a recourse provision would allow the loan's purchaser to make a claim against the loan's seller in the event of debtor default.
Risk-based capital	The sum of Tier1 plus Tier 2 capital.

Safety and soundness	The part of an examination that includes a review and evaluation of each CAMELS component (see explanation of CAMELS, above).
Stated income loan	A specialized mortgage loan for which the lender verifies employment and assets, but not income. Instead, income is simply stated on the loan application.
Subordinated debt	Debt that is either unsecured or has a lower priority than that of another debt claim on the same asset or property. Subordinated debt is also called junior debt.
Supervisory directive	An informal enforcement action by the Office of Thrift Supervision that directs a thrift to cease an activity or take an affirmative action to remedy or prevent an unsafe or unsound practice.
Tangible equity	Total assets minus intangible assets minus total liabilities.
Tier 1 capital	Common shareholder's equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.
Tier 2 capital	Subordinated debt, intermediate-term preferred stock, cumulative and long-term preferred stock, and a portion of the allowance for loan and lease losses.
Thrift financial report	A financial report that thrifts are required to file quarterly with the Office of Thrift Supervision. 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.
Troubled condition	A condition in which a thrift meets any of the following criteria: (1) the Office of Thrift Supervision notifies it in writing that it has been assigned a CAMELS composite rating of 4 or 5; (2) it is subject to a capital directive, a cease and desist order, a consent order, a formal written agreement, or a prompt corrective action directive relating to its safety and soundness or financial viability;

	or (3) the Office of Thrift Supervision informs it in writing of its troubled condition based on information available to the Office of Thrift Supervision. Such information may include current financial statements and reports of examination.
Wholesale funding	Funding obtained by financial institutions through such sources as federal funds, public funds, FHLB advances, the Federal Reserve's primary credit program, foreign deposits, and brokered deposits.

Office of Thrift Supervision
Department of the Treasury

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July 12, 2011

MEMORANDUM FOR: Crowe Horwath
Contractor to
Office of Inspector General
U.S. Department of the Treasury

FROM: Thomas A. Barnes
Deputy Director

SUBJECT: Draft Material Loss Review of
First Federal Bank of California, FSB
Santa Monica, CA

Thank you for the opportunity to comment on the draft memorandum prepared by Crowe Horwath entitled "Material Loss Review of First Federal Bank of California, FSB, Santa Monica, California," (the Bank).

The memorandum summarizes the primary causes of the Bank's failure, which are consistent with the information contained in the OTS Reports of Examination and documents in support of the grounds for receivership. Specifically, the memorandum cites the primary cause of the failure was a high risk growth strategy, funded with brokered deposits, with excessive concentration in option adjustable rate mortgages without the implementation of adequate controls to manage the risk. In addition, underwriting risk stemming from the origination of reduced documentation loans, combined with the rapid decline in the economic environment, resulted in the deterioration of the bank's asset quality, including a substantial volume of problem loans and material loan losses.

The memorandum discusses the internal failed bank review completed by OTS and reaffirms the recommendations from that review addressing risks from uncontrolled growth, concentrations and reduced documentation lending. The memorandum also recommends that OTS staff be reminded of OTS enforcement guidance applicable to thrifts with deteriorating CAMELS ratings. Although OTS management concurs with the recommendations, there is no practical way to implement them, given OTS's imminent sunset date and the practical fact that half of the OTS

Crowe Horwath
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regulatory staff are attending previously scheduled Office of the Comptroller of the Currency staff conferences this week and next.

Thank you again for the opportunity to review and respond to the draft memorandum on First Federal Bank of California, FSB. OTS appreciates the professionalism and courtesies provided by the staff from Crowe Horwath and the Office of Inspector General.

Section II

Report Distribution

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