



Audit Report



OIG-10-011

SAFETY AND SOUNDNESS: Material Loss Review of American Sterling Bank

November 25, 2009

Office of
Inspector General

Department of the Treasury

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Abbreviations

ASB	American Sterling Bank
ASC	American Sterling Corporation
ALLL	allowance for loan and lease losses
CEO	chief executive officer
C&D order	cease and desist order
Countrywide	Countrywide Home Loans
CRP	capital restoration plan
FDIC	Federal Deposit Insurance Corporation
GAAP	generally accepted accounting principles
HFS	held-for-sale

MRBA	matter requiring board attention
OTS	Office of Thrift Supervision
PCA	prompt corrective action
REO	real estate owned
ROE	report of examination
USB	Universal Savings Bank

*The Department of the Treasury
Office of Inspector General*

November 25, 2009

John E. Bowman, Acting Director
Office of Thrift Supervision

This report presents the results of our review of the failure of American Sterling Bank (ASB), of Sugar Creek, Missouri, and of the Office of Thrift Supervision's (OTS) supervision of the institution. OTS closed ASB and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on April 17, 2009. Section 38(k) of the Federal Deposit Insurance Act mandated this review because of the magnitude of ASB's estimated loss to the deposit insurance fund.¹ As of October 31, 2009, FDIC estimated that loss would be \$41.9 million. FDIC also estimated that ASB's failure resulted in a loss of \$0.2 million to its Transaction Account Guarantee Program.

The objectives of our review were to determine the causes of ASB's failure; assess OTS's supervision of the thrift, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing any such loss in the future. To accomplish these objectives, we reviewed the supervisory files and interviewed key officials involved in the regulatory enforcement matters. We conducted fieldwork at OTS's headquarters in Washington, DC; its Western Region Office in Irving, Texas; and at ASB's former headquarters in Sugar Creek, Missouri. We also interviewed officials and examiners at FDIC's Division of Supervision and Consumer Protection in Kansas City, Missouri, and interviewed personnel from FDIC's Division of Resolutions and Receivership. Appendix 1 contains a more detailed description of our objectives, scope, and methodology.

This report contains several other appendices. Appendix 2 provides background information on ASB and OTS's thrift supervision processes. Appendix 3 is a glossary of terms used in this report (when

¹ 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.

first used in the text, the terms are underlined and hyperlinked to the glossary). Appendix 4 is a chronology of significant events related to ASB and OTS's supervision of the thrift. Appendix 5 contains significant examination results and information on enforcement actions.

Results in Brief

The causes of ASB's failure were (1) losses sustained by its mortgage banking operation and (2) ineffective management and inadequate board oversight. Among other things, ASB senior management engaged in a litany of improper accounting transactions starting in 2007 that masked the thrift's deteriorating financial condition. We referred these transactions to the Treasury Inspector General's Office of Investigations. The thrift's inaccurate financial reporting delayed OTS from taking required PCA as the thrift's capital was depleted.

OTS's supervision did not adequately address ASB's problems early enough to prevent a material loss to the deposit insurance fund. OTS did not require ASB to scale back its mortgage banking operation even though the bank was experiencing continuous losses and high staff turnover. In addition, OTS did not enforce federal banking regulations or follow its own guidance requiring ASB to hold additional capital to mitigate its [recourse](#) exposure to sold loans. OTS also did not adequately review a noncash capital contribution of a [participation loan](#) to ASB by ASB's holding company.

It should be noted that OTS conducted an internal failed bank review of ASB's failure. OTS's internal review found that ASB's failure primarily resulted from (1) losses related to the thrift's significant mortgage banking operation and an excessive concentration in held-for-sale (HFS) loans and (2) inadequate management and insufficient independence from the operations of American Sterling Corporation (ASC), the thrift's holding company. OTS's review concluded that it should have (1) taken increasingly aggressive steps with ASB's management and board to scale back or at least minimize the scope of the institution's mortgage operation and (2) placed more emphasis on ensuring that supervision and administration of the thrift by its board and management were not subject to the dominating adverse influence of the chief executive officer (CEO) and the management of

ASC. Our material loss review affirmed OTS's internal findings and the need for earlier corrective action.

We also concluded that as ASB adjusted and refiled its financial reports as required by OTS, OTS used its authority under PCA in an appropriate and timely manner.

We are recommending that OTS (1) ensures that action is taken on its internal failed bank review of ASB; (2) reminds supervisory and examination staff of the importance of requiring thrifts to hold capital to mitigate their recourse exposure on sold loans; (3) reminds supervisory and examination staff to scrutinize capital contributions made to thrifts, especially noncash capital contributions; and (4) ensures examiners take forceful action to mitigate losses whenever a thrift's line of business incurs losses that threaten the viability of the institution.

In a written response, OTS concurred with our recommendations and agreed to implement the recommended actions in a timely manner. OTS stated that it has taken action pursuant to its internal failed bank review of ASB. These actions included issuing new internal guidelines in May 2009 to ensure appropriate enforcement action and issuing a memorandum to thrift chief executive officers in July 2009 to address asset and liability concentrations and related risk management practices. Although we consider OTS's planned actions to be responsive to our recommendations, OTS did not identify estimated dates for completing its planned actions. OTS will need to develop and record in the Joint Audit Management Enterprise System (JAMES), the Department of the Treasury's audit recommendation tracking system. OTS's response is provided as appendix 7.

Causes of ASB's Failure

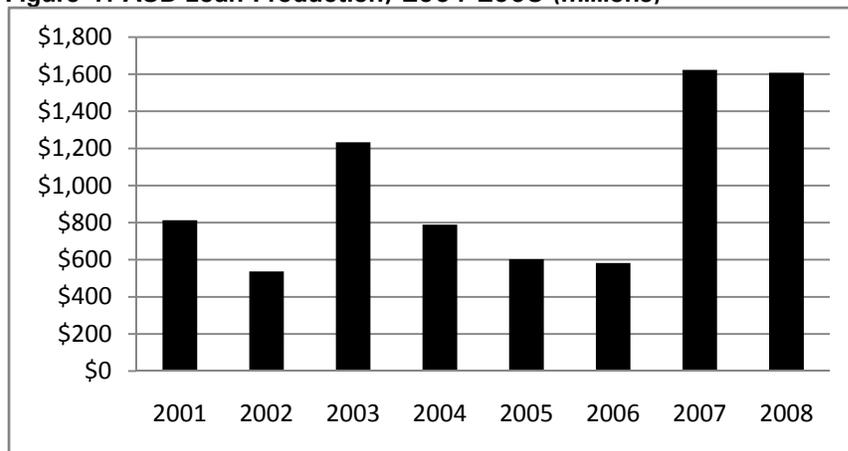
ASB failed because of losses sustained by its mortgage banking operation and because of ineffective management and inadequate board oversight.

Losses Sustained by ASB's Mortgage Banking Operation

ASB was unable to recover from the severe losses incurred primarily from its mortgage banking operation. The expansion of ASB's mortgage banking operation just prior to the crisis in the mortgage market significantly contributed to its large losses. Additionally, the thrift did not maintain adequate capital to cover its recourse exposure on sold loans.

ASB organized its mortgage banking operations in Irvine, California, in 1997. In 2001, OTS examiners noted in their report of examination (ROE) that ASB had a very active mortgage banking division and depended on the sale of loans to be profitable. ASB significantly expanded its mortgage banking operation in August 2006, when it acquired the mortgage banking division of Universal Savings Bank (USB) located in Milwaukee, Wisconsin. With this acquisition, ASB increased its staff size by 123 and acquired nine loan production offices located in several states. Figure 1 shows the volume of ASB's loan production from 2001 through 2008.

Figure 1: ASB Loan Production, 2001-2008 (millions)



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

ASB was profitable from 2001 through 2005, reporting more than \$11 million in net income over the 4 year period, despite high overhead expenses associated with its mortgage banking operation. However, OTS examiners noted that ASB's mortgage banking operation led to volatility in its earnings. For example, in the 2002 ROE, OTS examiners stated that poor results from the thrift's

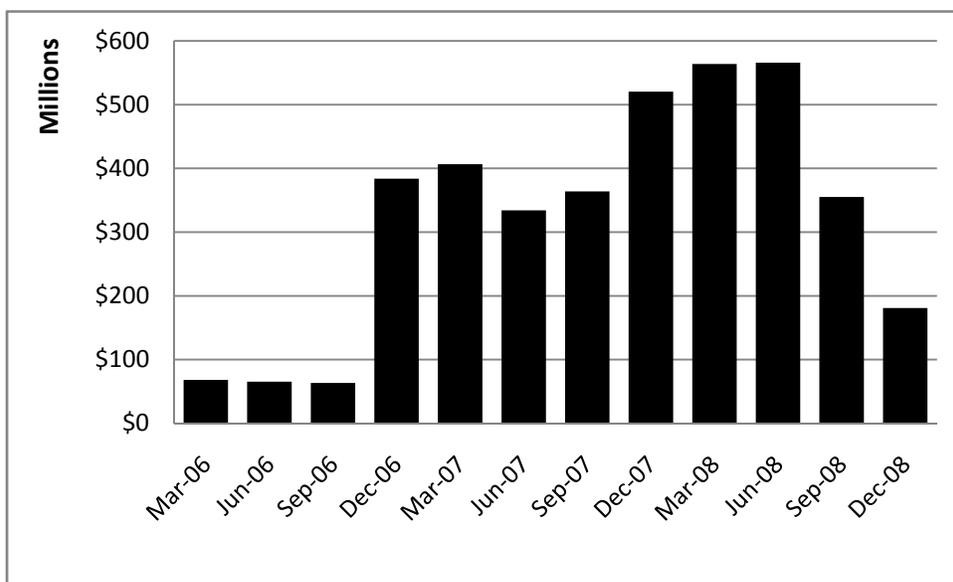
mortgage banking operation were the primary reason for its below-average earnings. In the 2004 ROE, OTS examiners stated that although ASB's earnings remained volatile, they improved substantially during the review period because of the volume of ASB's mortgage banking operation. Then ASB's net income declined from \$3.5 million in 2004 to \$1.1 million in 2005, and its mortgage banking division had a net loss of \$769,000 in 2005. ASB's earnings deteriorated further after its acquisition of USB's mortgage banking division in August 2006 because of increased overhead expenses and difficulty in selling loans to the secondary market.

ASB reported consecutive quarterly net losses beginning in the fourth quarter of 2005 through the fourth quarter of 2007. After being profitable in the first quarter of 2008, ASB's quarterly losses resumed in the second quarter of 2008. ASB reported annual net losses of \$1.7 million in 2006, \$3.7 million in 2007, and \$40.9 million in 2008. These losses resulted from (1) a decline in gains from loan sales, (2) losses incurred by ASB's mortgage banking division, and (3) ASB's difficulty in selling [Alt-A loans](#) due to market concerns about the risk posed by subprime mortgage loans. In addition, despite increased loan production in 2007 and 2008, as shown in figure 1, ASB's mortgage operation was not profitable because ASB had expended substantial time and incurred substantial expense processing applications for loans that ultimately did not close.

Inadequate Capital to Support Recourse Provisions

As a significant part of its business, ASB originated and then sold mortgage loans to investors. For most sales, the sale agreements contained recourse provisions that required ASB to repurchase loans or refund fees if certain events occurred within a specified period of time. These events included early payment default, early payoff, borrower fraud and misrepresentation, and noncompliance with investor underwriting standards. Figure 2 shows the amount of loans that ASB sold with recourse exposure from the first quarter of 2006 through the fourth quarter of 2008.

Figure 2: ASB's Loans Sold With Recourse, by Quarter (millions)



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

Federal banking regulations define recourse and require that recourse obligations be weighted for risk in determinations of an institution's risk-based capital.² In addition, OTS's examination handbook requires that institutions hold capital on a recourse exposure for the full amount of the transferred assets, as if the assets were still on the balance sheet.³ One exception in the OTS examination handbook is that a thrift does not have to hold recourse capital for qualifying one-to-four-family residential loans that the thrift has sold if the sale contract allows only 120-days or less for return of those loans.

Many of ASB's sale agreements contained recourse provisions that allowed the return period for the sold loans beyond 120 days. Therefore, ASB should have risk-weighted these loans and included them in its calculations for determining risk-based capital. However, ASB included only the assets reported on its balance sheet in its risk-based capital calculations, and did not hold any additional capital to account for its recourse exposure. In the 2007 ROE, OTS examiners stated that ASB's risk-based capital ratios did not reflect the risk weighting of sold loans that ASB might have to repurchase. In

² 12 CFR 567

³ OTS Examination Handbook, section 221, app. B.

addition, the examiners' workpapers showed that, as of March 31, 2007, ASB's capital should have been much higher than the amount on its books if OTS guidance had been followed. With the exception of the 2007 ROE and related workpapers, we did not find sufficient information in OTS's other ROEs and examination workpapers to make a determination on how much of ASB's sold loans should have been risk weighted and included in determining ASB's risk weighted capital requirements, for the periods covered by those ROEs.

By 2008, due in part to the downturn of the mortgage market, investors began to examine the performance of their loan purchases; as a result, many of ASB's loan purchasers demanded that the thrift repurchase the loans. Countrywide Home Loans (Countrywide), one of ASB's largest loan purchasers, demanded that ASB repurchase approximately \$32.5 million in loans due to [early payment default](#). While ASB and Countrywide settled this claim for \$4.3 million, ASB received an additional \$18 million in claims for repurchase from six other loan purchasers in January 2009, although ASB's management and legal counsel estimated the repurchase or settlement loss to be approximately \$690,000. By March 2009, ASB informed OTS of that it had received an additional \$23.1 million in repurchase claims from investors.

Another contributing factor to ASB's mortgage banking related losses in 2008 was an OTS-required \$10.3 million write down to record ASB's held for sale (HFS) loans at fair value. ASB had reported its HFS portfolio at par, which was improper in light of market conditions and not in accordance with generally accepted accounting principles (GAAP).

Ineffective Management and Inadequate Board Oversight

ASB management did not adequately identify, measure, monitor, or control significant risks that threatened the viability of the institution, as evidenced by (1) improper accounting transactions that distorted capital and income, (2) ASB's ill-timed acquisition of USB's mortgage banking division, and (3) significant staff turnover. In addition, ASB's CEO had a dominant influence over the board of directors, who did not question the actions of senior thrift management.

Improper Accounting Transactions

ASB's senior management engaged in a litany of improper accounting transactions that concealed and distorted ASB's true financial condition. Some of these transactions also allowed ASB to inaccurately report its PCA status as well-capitalized as of March 31, 2008, when in fact it was not well capitalized. As a result, ASB improperly accepted \$19 million of brokered deposits.⁴ ASB was required to reverse the following improper transactions when OTS examiners identified them during the June 2008 examination:

Loan to a not-for-profit foundation Made in 2001, ASB charged off the balance of this loan, \$390,000, in 2005. ASC, the holding company, assumed the loan from ASB in an attempt to collect the amount owed. In 2007, ASC contributed the loan back to ASB as a \$400,000 capital contribution. As recorded by ASB, this transaction resulted in a \$265,000 after-tax gain and increased ASB's capital by \$265,000. OTS examiners determined that this loan was a worthless asset that was improperly included in ASB's capital. In this regard, section 110 of OTS's examination handbook allows savings associations to only accept, without limit, cash, cash equivalents, or other high-quality marketable assets as capital contributions. A savings association may not accept other forms of contributed capital without receiving prior approval from OTS. ASB did not obtain such approval.

Loan to a state political party In April 2007, ASC contributed to ASB a \$2 million loan participation of a \$3 million loan to a state political party. ASB credited the loan participation to capital with the understanding that the borrower would repay the loan by June 30, 2007. However, no payments were made on the principal and the loan participation was never paid off. Moreover, it was not a loan that ASB could have made under its lending authority because the thrift did not obtain any financial information on the

⁴ If ASB had not recorded the improper transactions, it would have had to report its status as undercapitalized rather than well-capitalized (a drop of 2 regulatory capital levels). 12 CFR § 337.6 provides that an undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposit.

borrower, analyze the borrower's repayment capability, or seek approval for the loan participation from ASB's board of director's loan committee. Further, like with to the loan to the not-for-profit organization, ASB did not obtain the required prior approval from OTS.

Capital surplus entries In early 2008, ASB recorded two journal entries for accounts receivable from ASC. The entries were posted as receivables in the thrift's general ledger for \$280,000 and \$470,000, with a credit to ASB as capital surplus of \$750,000. ASB's senior management reported that this capital contribution was based on the proceeds of the anticipated sale of property owned by ASC. These journal entries were not supported by any documentation or actual capital contribution to ASB. ASB's senior management backdated these journal entries to December 31, 2007, to allow ASB to meet minimum capital levels and to report its status as well-capitalized as of December 31, 2007.

The recording of the above three transactions ultimately resulted in ASB's filing inaccurate quarterly thrift financial reports for June 2007 through March 2008. Upon discovery of these transactions, OTS directed ASB to reverse them, rendering ASB undercapitalized as of July 29, 2008, and in troubled condition. Other examples of improper accounting transactions that concealed and distorted ASB's true financial condition are discussed below.

Lender's representation and warranty insurance master policy In December 2007, ASB purchased a lender's representation and warranty master policy from American Sterling Insurance Corporation, an affiliated entity, to defer the impact of losses at the bank over a 24-month period. The mortgage insurance was applied to loans held for sale, loans in the portfolio, and real estate owned (REO). In accordance with GAAP, ASB was required to record REO at the lower of cost or market value less cost to sell. However, ASB netted the projected losses against expected insurance recoveries, effectively reflecting REO at an amount higher than net realizable value and understating expenses in its income statement. ASB management used the mortgage insurance program to continue to report inflated capital and minimize loan losses on its thrift financial reports, allowing ASB to avoid regulatory intervention and controls that would have limited the

growth of its wholesale mortgage business. ASB also did not classify assets in accordance with regulatory guidance or its policy, or maintain an adequate allowance for loan and lease losses (ALLL). In addition to being a violation of GAAP and inconsistent with regulatory guidance,⁵ the insurance did not comply with regulations related to transactions with affiliates⁶ and OTS's conflicts of interest regulation.⁷ At OTS's direction, ASB rescinded the warranty policy.

HFS loans and REO valuations ASB elected to adopt Statements of Financial Accounting Standards 157 and 159 as of January 1, 2007, which required that ASB report its HFS mortgage loans at the lower of cost or fair value and to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Therefore, ASB should have obtained fair value valuations for its HFS and REO assets beginning in the first quarter of 2007. ASB management, however, decided to carry the HFS assets at par, and did not carry the REO assets at fair value. On August 28, 2008, OTS directed ASB's management to obtain a third-party valuation for its HFS portfolio. That valuation identified a loss of \$3 million for the portfolio. ASB's independent auditor questioned the independence of the third party chosen by ASB's management.⁸ Therefore, again at OTS's direction, ASB obtained a second third-party valuation that determined that an \$11.5 million write-down was required to state REO and HFS loans at fair value. At OTS's direction, ASB recorded the HFS portfolio at fair value based on the second valuation.

Deferred tax asset As of December 31, 2007, ASB had \$11.8 million of cumulative net operating losses, which resulted in a deferred tax asset of \$4.6 million.⁹ ASB's management was unable to provide adequate support that this asset would be realized. After being directed by OTS to establish a valuation allowance in

⁵ Interagency Guidance on Certain Loans Held for Sale (Mar. 26, 2001).

⁶ 12 CFR 223.51, 12 CFR 223.52, and 12 CFR 563.41.

⁷ 12 CFR 563.200.

⁸ At the time of receivership in 2009, ASB's independent auditor had not completed its audit of the thrift's financial statements for the year ended December 31, 2007, and had not started the audit for 2008. Prior to 2007, ASB had received unqualified opinions on its financial statements.

⁹ A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

accordance with GAAP for the assets, ASB wrote-off the asset value in August 2008 thereby reducing capital by \$4.6 million.

Accrued loan fee income In December 2008, ASB's chief operating officer reported to OTS that ASB had recorded nearly \$707,000 of loan fee income on April 30, 2008, related to refinancing a group of mortgage loans that ASB did not own and that ASB had never refinanced or purchased. As a result of this transaction, ASB's net losses for the quarters ending June 30, 2008, and September 30, 2008, were understated, and ASB's capital position and reported capital ratios were overstated. According to OTS examiners, ASB's management deliberately made these entries to inflate earnings and increase capital. OTS examiners said that when asked about the rationale for these transactions, senior ASB management stated that they had been undertaken to keep the thrift in the well-capitalized category.

We referred the improper accounting transactions discussed above to the Treasury Inspector General's Office of Investigations.

III-Timed Acquisition of USB Mortgage Banking Division

ASB's primary business activity was mortgage banking, which it greatly expanded in August 2006 through its acquisition of USB's mortgage banking division. ASB hired all 123 former employees of the division, approximately doubling the number of thrift employees. ASB also acquired nine loan production offices and opened an additional three in 2007. According to OTS's examination staff, ASB's acquisition of the USB mortgage banking division was not supported by proper due diligence or proper board approval. In addition, ASB made the purchase when the mortgage market was beginning its downturn and other loan producers were attempting to reduce their mortgage banking exposure. Both the increase in personnel and loan production offices immediately increased ASB's operating costs. The thrift's losses, which had begun in the fourth quarter of 2005, accelerated after the acquisition. ASB continued to experience losses in 2007 and 2008 that were driven by high operating costs associated with the institution's ill-timed expansion of its mortgage banking operations.

Staff Turnover

Staff turnover was a chronic problem at ASB. In its 2002 ROE, OTS examiners noted that ASB's mortgage banking department performed unsatisfactorily during the review period because excessive staff turnover had disrupted operations. OTS also expressed concern about whether ASB management could conduct business effectively in light of frequent turnover of critical staff. In its 2007 ROE, OTS examiners again noted significant staff turnover. Out of ASB's 140 employees at the beginning of 2006, 69 had left by year-end; departing employees included top loan producers and other loan production personnel. According to OTS's examination staff, this turnover resulted partly from the confrontational management style of ASB's president, who was terminated by ASB's board in November 2006. Other key departures between late 2005 and early 2007 included the compliance officer and the controller.

Inadequate Board Oversight

A thrift's board of directors is ultimately responsible for overseeing the affairs of the thrift. Specifically, the board's responsibilities include (1) establishing business goals, standards, policies, procedures, and operating strategies; (2) hiring and retaining executive officers with the skills, integrity, knowledge, and experience appropriate for the nature and scope of their responsibilities; (3) periodically evaluating management's performance; and (4) reviewing operating results. At ASB, the board of directors failed to exercise sufficient oversight of the thrift's management.

As early as 2001 and 2002, OTS examiners noted that the thrift's CEO was a dominant influence over the board. In the 2008 ROE, OTS examiners stated that board oversight during the review period was poor to nonexistent and that despite the thrift's poor financial results, only isolated instances of tough questioning of the thrift's CEO by the board occurred. Among the deficiencies noted by OTS examiners were the board's lack of knowledge about ASB's numerous accounting deficiencies and the significant issues threatening the thrift's viability. Our review of minutes from ASB board of directors meetings from 2004 through early 2008 confirmed these observations. For example, we found no evidence that senior ASB management had properly informed the board about major decisions and issues, such as the

acquisition of USB's mortgage banking division, the capital contributions made by the holding company, or the financial condition of the bank prior to 2008.

After being notified of the thrift's various problems by OTS examiners in August 2008, the thrift's board took action, consenting to OTS's cease and desist (C&D) order, conducting more meetings, questioning senior ASB management, and communicating with OTS.

Agreement for Sale of ASB Not Completed

On January 9, 2009, ASC entered into an agreement for the sale of ASB stock to a potential acquirer. On January 15, 2009, OTS approved the potential acquirer's holding company application related to the acquisition of ASB. The potential acquirer, however, was unable to complete the acquisition of ASB and on April 17, 2009, OTS closed ASB and appointed FDIC as receiver.

OTS's Supervision of ASB

OTS's supervision of ASB did not prevent a material loss to the deposit insurance fund. OTS did not require ASB to scale back its mortgage banking operation, follow guidance on recourse exposure, or adequately review ASC's noncash capital contribution of a participation loan to ASB. We attribute these conditions to lack of examiner adherence to existing OTS guidance, and not to a problem with the guidance itself.

Table 1 summarizes the results of OTS's safety and soundness and limited examinations of ASB from 2004 until its closure.¹⁰ Appendix 5 provides details of completion dates, matters requiring board attention (MRBA), corrective actions, enforcement actions, and other findings associated with the examinations.

¹⁰ OTS conducted its examinations and performed off-site monitoring of ASB in accordance with the timeframes prescribed in the OTS Examination Handbook.

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

Date started/date mailed	Total assets (in millions) at time of examination ^a	Examination Results			
		CAMELS rating	Number of MRBA	No. of corrective actions	Formal enforcement actions
3/29/2004 5/11/2004	\$239	2/222222	0	0	None
1/3/2006 3/9/2006	\$194	2/222222	0	0	None
4/09/2007 7/23/2007	\$249	3/223322	3	3	None
6/27/2007 6/27/2007	NA	Limited exam: CAMELS composite rating downgraded from 2 to 3			
4/9/2008 4/9/2008	NA	Limited exam: CAMELS Asset quality rating downgraded from 2 to 3			
6/30/2008 12/5/2008	\$258	5/545544	13	15	C&D order, effective 8/20/2008 PCA directive, effective 1/15/09 Civil money penalty, effective 3/30/09
7/29/2008 ^a 7/30/2008	NA	Limited exam: CAMELS composite rating downgraded from 3 to 4 and recommended downgrades of CAMELS Capital adequacy, Management administration, Earnings, and Sensitivity to market risk ratings from 2 to 4			Issuance of PCA directives associated with undercapitalized status
8/1/2008 ^a 8/1/2008	NA	Limited exam: CAMELS composite rating downgraded from 4 to 5, and CAMELS Capital adequacy and Management administration ratings downgraded from 4 to 5			Issuance of PCA directives associated with critically undercapitalized status
8/8/2008 ^a 8/8/2008	NA	Limited exam: Downgraded CAMELS Liquidity rating from 2 to 5			
9/23/2008 ^a 9/23/2008	NA	Limited exam: Downgraded CAMELS Asset quality rating from 3 to 4			

Source: OTS ROEs and notices.

^aThese limited examinations were part of the ongoing full-scope examination that was begun on June 30, 2008, and completed on December 5, 2008.

OTS's full-scope examination started on June 30, 2008, found a multitude of problems related to ASB's performance and OTS examiners concluded that ASB was in an unsafe and unsound condition. OTS examiners attempted to address these problems with the use of a C&D order, MRBAs, and corrective actions. While appropriate, these actions proved to be unsuccessful. Before this examination, OTS's supervision did not adequately address ASB's problems early enough to prevent ASB's failure.

Significant Areas of Supervisory Weaknesses Prior to 2008

ASB Was Not Required to Scale Back Its Mortgage Banking Operation

OTS did not require ASB to scale back its mortgage banking operation despite high losses and high staff turnover at the thrift. As mentioned above, ASB sustained losses related to mortgage banking as early as 2005 and continued to sustain losses in subsequent years. ASB also experienced significant staff turnover that disrupted operations. However, instead of decreasing its dependence on mortgage banking, ASB increased its loan production by expanding into new retail and wholesale mortgage markets, as demonstrated by the thrift's 2006 acquisition of USB's mortgage banking division. During 2007 through 2008, ASB's annual mortgage production was approximately \$1.6 billion compared to \$582 million in 2006. However, ASB's mortgage business was consistently unprofitable in its later years largely because of the high expenses associated with this line of ASB's business.

In its ROEs for 2006 and 2007, OTS did not raise any specific concerns with the scale of ASB's mortgage operations despite losses, high expenses related to mortgage production, high staff turnover, and the departure of senior thrift management. In addition, our review of OTS's examination workpapers found no indication that OTS challenged ASB's monthly loan production goals. For example, an examination workpaper from OTS's 2007 examination of ASB states that ASB estimated it needed \$150 million in loan sales per month to break even. However, we did not find indications that OTS sufficiently scrutinized this estimate or discussed alternative strategies to mitigate ASB's losses should the break-even production goal not be met. When asked whether OTS should have required ASB to decrease its mortgage production due to the thrift's numerous problems, OTS's examination staff said that it should have if drastic problems had existed.

It wasn't until June 13, 2008, that OTS took forceful action regarding ASB's mortgage banking operations when it issued a supervisory directive that required ASB to maintain a minimum core capital ratio of 7.5 percent. On August 20, 2008, OTS issued a C&D order that required ASB to limit its asset growth and not to expand its product lines or business activities without a written nonobjection notice from

OTS. ASB's financial condition had by then severely deteriorated and its capital levels had fallen to the PCA category of critically undercapitalized. As discussed earlier, ASB senior management engaged in a litany of improper accounting transactions that masked the thrift's deteriorating financial condition. The thrift's inaccurate financial reporting delayed OTS from taking required PCA as the thrift's capital was depleted.

ASB's Recourse Exposure Was Not Addressed

OTS did not enforce regulatory requirements or follow internal guidance related to the capital treatment of loans with recourse provisions sold by ASB. Federal banking regulations¹¹ and OTS guidance¹² require institutions to hold capital on a recourse exposure for the full amount of the transferred assets, as if the assets were still on the balance sheet. OTS guidance provides an exception to this requirement for qualifying one-to-four-family residential loans for which the sale contract allows only a 120-day or less return period.

As indicated by Figure 2, ASB sold over \$3.8 billion in loans with recourse exposure from the first quarter of 2006 through the fourth quarter of 2008. However, ASB did not hold any additional capital to account for this recourse exposure, as required, and included only the assets reported on its balance sheet in its risk-based capital calculations.

The 2007 ROE stated that ASB's risk-based capital ratios did not reflect the risk weighting of sold loans with recourse provisions. In addition, the examiners' workpapers for the examination indicated that as of March 31, 2007, ASB's risk-weighted assets needed to be increased by over \$266 million. This would have meant that ASB's capital amounts should have also been increased as of March 31, 2007. However, OTS did not require ASB to increase its capital and instead allowed the thrift to continue holding capital for only the assets reported on its balance sheet. When we asked why ASB was not required to raise its capital levels, OTS's examination staff said that guidance on this matter was unclear. In addition, because of ASB's previous history of low levels of losses on loans sold with recourse, OTS's examination staff did not believe that they would

¹¹ 12 CFR 567.

¹² OTS Examination Handbook, section 221, app. B.

have been justified in requiring ASB to raise its capital levels. They also said that they had sought guidance on the issue from OTS headquarters but did not receive a response that was sufficient to resolve the matter. Specifically, the guidance sought related to unique terms in some of ASB's loan sale agreements that may have reduced ASB's recourse exposure. We believe that federal regulation and OTS guidance clearly state that thrifts are to hold additional capital to mitigate recourse exposure on sold loans and the OTS examination staff should have more aggressively pursued this issue.

As noted earlier, ASB experienced severe losses from its mortgage banking operation and by 2008 began receiving demands by investors to repurchase a significant number of loans that it had sold. Because of its inadequate capital levels, ASB could not absorb the losses it incurred on its mortgage banking operation or the repurchase claims on loans it had sold. According to a senior OTS headquarters official, if OTS had required ASB to hold more capital to cover the recourse exposure, the thrift would have absorbed more of the losses, and losses to the deposit insurance fund would have likely been less.

ASC's Contribution of a Participation Loan to ASB Was Not Adequately Reviewed

As discussed above, in March 2007 ASC provided a noncash capital contribution to ASB in the form of a \$2 million loan participation on a \$3 million loan to a state political party. On April 10, 2007, ASB forwarded to an OTS Western Region field manager a letter detailing its 2007 revenue projections, asset growth, and capital plan supporting the asset growth. The letter specified that ASC had contributed a \$2 million participation in a loan due to be paid in June 2007. OTS's 2007 ROE stated that ASC had provided ASB a \$2 million capital injection to help the thrift qualify as well-capitalized. The 2007 ROE and the examination workpapers, however, did not include any evidence that the loan participation asset supporting the capital contribution was scrutinized. OTS's Western Region staff acknowledged that the loan participation was not adequately reviewed at the time.

In the June 2008 examination, OTS examiners determined that the loan did not meet the requirements set forth in federal banking

regulations to be considered a permissible loan to a political party.¹³ Because of the improper classification of the capital contribution as a loan, ASB's capital was overstated by \$2 million from the time the capital contribution was recorded in March 2007 until OTS required that the transaction be reversed in 2008. Therefore, ASB improperly reported itself as well-capitalized instead of adequately capitalized, allowing it to continue obtaining brokered deposits contrary to federal banking regulations.¹⁴

OTS's Internal Failed Bank Review Identified Areas Needing Improvement

In accordance with its policy, OTS performed an internal failed bank review to determine the causes of ASB's failure, evaluate the supervision exercised by OTS, and provide recommendations based on the findings of the review.¹⁵ The OTS review, completed in August 2009, determined that ASB's failure resulted from (1) losses related to the thrift's significant mortgage banking operation and an excessive concentration in HFS loans and (2) inadequate management and insufficient independence from ASC operations.

The review identified the following two areas where supervision should have been more effective:

1. OTS should have taken increasingly aggressive steps with ASB's management and board to scale back or at least minimize the scope of the mortgage operation.

¹³ According to 11 CFR § 100.82, a loan of money to a political committee or a candidate by a federally chartered depository institution is not a contribution by the lending institution if the loan is made in accordance with applicable banking laws and regulations and in the ordinary course of business. A loan is deemed made in the ordinary course of business if it (1) bears the usual and customary interest rate of the lending institution for the category of loan involved, (2) is made on a basis that assures repayment, (3) is evidenced by a written instrument, and (4) is subject to a due date or amortization schedule.

¹⁴ 12 CFR § 337.6 states that an adequately capitalized insured depository institution may not accept, renew, or roll over any brokered deposit unless it has applied for and been granted a waiver of this prohibition by FDIC.

¹⁵ 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 Northeast Region initiated an internal review of ASB. The scope of the review focused primarily on OTS's supervision from January 1, 2006, to receivership of ASB on April 17, 2009.

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2. OTS should have placed more emphasis on ensuring that supervision and administration of the thrift by its board and management were not subject to the dominating adverse influence of the CEO and ASC management.

The internal review also made two recommendations to OTS:

1. OTS should conduct periodic meetings or telephone presentations with thrift boards of directors following examinations, even when the CAMELS composite rating assigned is 1 or 2.
2. OTS examiners should generally perform on-site examinations at the principal locations of a thrift's higher-risk lines of business. For institutions with multiple higher-risk locations, on-site examinations should be conducted at these locations on a rotational basis, based on current risk factors.

The internal review did not provide a recommendation to address the concentration issues noted. According to the report, OTS's CEO letter 311, Risk Management: Asset and Liability Concentrations, adequately addressed the concentration issues.¹⁶

Based on our review of the examination records and reports and interviews with OTS staff, we affirm OTS's internal findings and the need for corrective action. In addition, we determined that OTS should have enforced the federal regulatory requirement and followed its own guidance related to ASB's recourse exposure and conducted a more thorough review during its 2007 examination of ASC's capital contributions.

OTS's Use of Prompt Corrective Action

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to FDIC's deposit insurance fund. PCA requires federal banking agencies to take certain actions when an institution's capital drops to certain levels. It 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.

¹⁶ Issued on July 9, 2009

Once the true financial condition of ASB was known in 2008, OTS implemented PCA as described below. We concluded that the actions taken were timely and in accordance with PCA requirements.

- During the June 2008 examination, OTS examiners required ASB to reverse certain improper accounting transactions. The reversal of these transactions resulted in ASB becoming undercapitalized. On July 29, 2008, OTS issued a supervisory directive that served as a PCA notice to (1) notify ASB of its undercapitalized status, (2) deem ASB as being in troubled condition, and (3) downgrade ASB's CAMELS composite rating to 4. In accordance with PCA, the notice required ASB to file a [capital restoration plan](#) (CRP) no later than September 12, 2008. The notice also required that ASB 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 further required that ASB notify OTS of any changes in directors or senior executive officers and of any transaction with affiliates exceeding \$20,000.
- As the result of the continuing examination started by OTS in June 2008, OTS notified ASB on August 1, 2008, that it had fallen into the critically undercapitalized PCA capital category and that its CAMELS composite, capital adequacy, and management ratings had been downgraded to 5. The August 1 notice required ASB to file a [CRP](#) by August 11, 2008, a month sooner than the July 29 supervisory directive, and to abide by the mandatory PCA restrictions set forth in the supervisory directive.
- On October 10, 2008, OTS issued a supervisory directive upgrading ASB to significantly undercapitalized after the thrift received a \$7.5 million capital contribution from ASC. The PCA notice required that ASB abide by the sanctions applicable to critically undercapitalized institutions.
- On December 31, 2008, OTS notified ASB that the CRP it had submitted was not acceptable and issued a notice of intent to issue a PCA directive.

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- On January 14, 2009, OTS notified ASB that it had fallen into the critically undercapitalized PCA capital category. The PCA notice required ASB to file another CRP by January 19, 2009. It also required that ASB 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 ASB notify OTS of any changes in directors or senior executive officers and of any transaction with affiliates exceeding \$5,000.
 - OTS verbally waived ASB's requirement to submit a CRP by January 19, 2009, due to a January 9, 2009, agreement between ASC and a potential acquirer to sell all ASB stock to the potential acquirer. On February 17, 2009 ASB submitted a CRP, which included that fact that ASC had entered into a stock purchase agreement with a potential acquirer.

On April 17, 2009, OTS rejected ASB's CRP submitted to OTS on February 17, 2009 because the plan did not provide a suitable means of recapitalizing the thrift. According to OTS, it could not determine whether the CRP was likely to succeed in restoring ASB's capital level to adequately capitalized since the CRP was based on a contingency that was outside the control of ASB and the potential acquirer. Other deficiencies that OTS noted included unrealistic projections of earnings and capital ratios, and unacceptably high levels of loan production volume. The thrift was closed the same day and placed into FDIC receivership.

Recommendations

Our material loss review of ASB is the seventh such review we have performed of failed OTS-regulated financial institutions during the current financial crisis. Appendix 6 lists the prior completed material loss reviews of OTS-regulated financial institutions 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 ASB, we recommend that the Director of OTS do the following:

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1. Ensure that the recommendations from OTS's internal review of the ASB failure are implemented and that the lessons learned from the review are taken into account going forward.
 2. Remind supervisory and examination staff of the importance of requiring thrifts to hold capital, as required by federal banking regulations, to mitigate their recourse exposure on sold loans.
 3. Remind supervisory and examination staff to properly scrutinize capital contributions made to thrifts, especially noncash capital contributions.
 4. Ensure supervisory and examination staff take forceful action to mitigate losses whenever a thrift's line of business incurs losses that threaten the viability of the institution.

Management Response

OTS concurred with our recommendations and agreed to implement the recommended actions in a timely manner. OTS stated that it has taken action pursuant to its internal failed bank review of ASB, including issuing new internal guidelines in May 2009 for Enforcement Review Committee meetings to ensure appropriate enforcement action, and issuing a CEO memorandum in July 2009 to address asset and liability concentrations and related risk management practices.

OIG Comment

We consider OTS's planned actions to be responsive to our recommendations. OTS will need to establish an estimated completion date for completing its planned actions, and record that date in JAMES.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-0384 or J. Mathai, Audit Manager, at (202) 927-0356. Major contributors to this report are listed in appendix 8.

Jeffrey Dye
Audit Director

Our objectives were to determine the causes of American Sterling Bank's (ASB) failure and assess the bank's supervision by the Office of Thrift Supervision (OTS). We conducted this material loss review of ASB in response to our mandate under section 38(k) of the Federal Deposit Insurance Act.¹⁷ 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 ASB based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of October 31, 2009, FDIC estimated that ASB's failure would cost the deposit insurance fund \$41.9 million. FDIC also estimated that ASB's failure resulted in a loss of \$0.2 million to its Transaction Account Guarantee Program.

To accomplish our review, we conducted fieldwork at OTS's headquarters in Washington, DC; its Western Region Office in Irving, Texas; and ASB's former headquarters in Sugar Creek, Missouri. We also interviewed officials and examiners at FDIC's Division of Supervision and Consumer Protection in Kansas City, Missouri, and personnel at FDIC's Division of Resolutions and Receivership in Dallas, Texas. We conducted our fieldwork from April 2009 through September 2009.

¹⁷12 U.S.C. § 1831o (k).

To assess the adequacy of OTS's supervision of ASB, we determined (1) when OTS first identified ASB'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 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 September 2002 through American Sterling's receivership on April 17, 2009. This period included three safety and soundness examinations before OTS identified ASB as a troubled institution and assigned it a composite CAMELS rating of 4.
- We reviewed OTS supervisory files and records for ASB from 2002 through 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 and discussed various aspects of the supervision of ASB with OTS officials, examiners, and attorneys to obtain their perspective on the thrift's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring ASB for federal deposit insurance purposes.
- We interviewed FDIC Division of Resolutions and Receiverships personnel who were involved in the resolution

and receivership process, which was conducted before and after ASB's closure and the appointment of a receiver.

- We selectively reviewed ASB documents that had been taken by FDIC and inventoried by FDIC Division of Resolutions and Receivership personnel. We identified from FDIC's inventory list those documents for our review that were most likely to shed light on the reasons for the thrift's failure and OTS's supervision of the institution.
- We assessed OTS's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act.

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.

American Sterling History

American Sterling Bank (ASB) was established in 1907 as the Bank of Levasy, a state-regulated commercial bank, in Levasy, Missouri. The bank moved to Sugar Creek, Missouri, and changed its charter to become a national bank in 1963 and was renamed Sugar Creek National Bank. The bank's name was changed in 1983 to Sterling National Bank and again, in 1998, to American Sterling Bank. In February 2001, ASB converted to a national thrift and became a wholly owned subsidiary of American Sterling Corporation (ASC), a California holding company formed in 1984. In addition to banking, ASC's primary operations were insurance underwriting and insurance services.

ASB had its home office and two additional full-service offices in the Kansas City, Missouri, metropolitan area. Two other branches were located in Carefree, Arizona, and Foothill Ranch, California. ASB's business focused on retail banking, commercial banking, and mortgage banking. Its mortgage banking operations, which had been established in 1997, expanded in August 2006, when the thrift acquired the mortgage banking division of Universal Savings Bank (USB) of Milwaukee, Wisconsin. The acquisition included nine loan-production offices, in Arizona, California, Colorado, Missouri, Texas, and Wisconsin.

ASB generated profits from 2001, when the Office of Thrift Supervision (OTS) started its supervision of ASB, through the third quarter of 2005. From the fourth quarter of 2005 through the fourth quarter of 2007, however, ASB reported consecutive quarterly losses. These losses resulted primarily from high costs related to its mortgage banking operations. The losses accelerated with ASB's August 2006 acquisition of USB's mortgage banking division. ASB incurred annual net losses of \$1.7 million in 2006, \$3.7 million in 2007, and \$40.9 million in 2008.

Beginning in 2007 and into 2008, ASB also recorded improper accounting entries that distorted its capital and earnings. OTS examiners questioned these entries during their June 2008 examination of ASB. The thrift was required to reverse the invalid capital entries, which eventually rendered ASB critically undercapitalized.

On January 9, 2009, ASC entered into an agreement for the sale of ASB stock to a potential acquirer. The agreement was contingent upon the potential acquirer's obtaining approval to receive funds from the Troubled Asset Relief Program. On January 15, 2009, OTS approved the potential acquirer's holding company application related to the acquisition of ASB. However the potential acquirer was unable to complete the acquisition of ASB and on April 17, 2009, OTS closed ASB and appointed FDIC as receiver. At the time of closing, ASB had total assets of \$174.4 million.

Appendix 4 contains a chronology of significant events regarding ASB.

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 examinations of insured thrifts either once every 12 months or once every 18 months. During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns each thrift a CAMELS composite rating based on its assessment of the overall condition and level of supervisory concern.

OTS uses the 12-month cycle until a thrift's management has demonstrated its ability to operate the institution in a safe and sound manner and has satisfied all conditions imposed at the time of approval of its charter. The 18-month examination cycle applies to insured thrifts that have total assets of \$500 million or less that

- received a [CAMELS](#) composite rating of 1 or 2 and a Compliance component 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 their last full-scope examination.

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 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.

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. 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.

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;

Appendix 2
Background

- 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.

Alt-A loan

A mortgage loan that typically does not involve income verification or documentation of income, assets, or employment. Instead, loan approval is based primarily on the applicant's credit score.

[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](#)

A plan required under the prompt corrective action (PCA) requirements of the Federal Deposit Insurance Act to be submitted to the appropriate federal banking agency by any undercapitalized insured depository institution. A capital restoration plan specifies the steps the 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 formal enforcement action. A C&D order issued by OTS 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 reports. 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.

Core capital

Tier 1 capital consisting of primarily of stockholder's equity.

Early payment default

Status of mortgages that become 90 or more days delinquent or go into default during their first year.

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 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.

Net debit cap

The maximum dollar amount of uncollateralized daylight overdrafts that an institution may incur in its Federal Reserve account. A daylight overdraft occurs when an institution transfers funds in excess of its reserve account balance at a Federal Reserve bank. Daylight overdrafts must be covered by the end of each business day. An institution with a net debit cap of zero may not incur daylight overdrafts.

Nonperforming loan

A loan that is not earning income or payment of principal, for which interest is no longer anticipated, and for which payments are 90 days or more delinquent.

Participation loan

A loan made by more than one lender and serviced by one of the participants. Participation loans make it possible for large borrowers to obtain bank financing when the amount borrowed exceeds the legal lending limit of an individual bank.

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.

Recourse	With respect to financial assets such as loans, the legal ability of the purchaser an asset to make a claim against the seller of the asset if the asset 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	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

An amount that 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 (e.g., nonperpetual 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.

Transaction Account
Guarantee Program

Component of FDIC's Temporary Liquidity Guarantee Program. FDIC established the Temporary Liquidity Guarantee Program in October 2008 as part of a coordinated effort by the FDIC, the Department of the Treasury, and the Federal Reserve to address unprecedented disruptions in credit markets and the resultant inability of financial institutions to fund themselves and make loans to creditworthy borrowers. The Temporary Liquidity Guarantee Program is composed of two distinct components: (1) the Debt Guarantee Program and (2) the Transaction Account Guarantee Program. Pursuant to the Debt Guarantee Program, FDIC guarantees certain senior unsecured debt issued by participating entities.

Pursuant to the Transaction Account Guarantee Program, FDIC guarantees all funds held in qualifying noninterest-bearing transaction accounts at participating insured depository institutions. Originally scheduled to expire on December 31, 2009, FDIC extended the Transaction Account Guarantee Program in August 2009 until June 30, 2010. Participating insured depository institutions pay an assessment fee for the additional FDIC guarantee.

Troubled condition

A condition in which a thrift meets any of the following criteria:

- 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 American Sterling Bank's (ASB) history, including examinations conducted and enforcement actions taken by the Office of Thrift Supervision (OTS).

- | | |
|------------|--|
| 2/1/1907 | The Bank of Levasy, located in Levasy, Missouri, is chartered as a state bank. |
| 12/31/1959 | The Bank of Levasy is established as a nonmember bank with FDIC. |
| 10/7/1963 | The Bank of Levasy moves to Sugar Creek Missouri, is renamed Sugar Creek National Bank, and becomes a national bank. |
| 10/19/1983 | Sugar Creek National Bank is renamed Sterling National Bank. |
| 12/1/1998 | Sterling National Bank is renamed American Sterling Bank. |
| 1/8/1999 | American Sterling Corporation (ASC) files an application to become a savings and loan holding company. American Sterling Bank (ASB) files an application to convert from a national bank to an OTS-regulated savings bank. |
| 12/6/1999 | OTS approves permission for ASB to convert from a national bank to a federal savings bank. In addition, ASB becomes a wholly owned subsidiary of ASC. |
| 2/28/2001 | OTS regulation of ASB and ASC begins. |
| 7/30/2001 | OTS begins a safety and soundness examination of ASB, which is completed on September 9, 2001. OTS determines the thrift to be financially sound but finds numerous weaknesses in records, systems, and controls. The board of directors is deemed less than fully effective. The CAMELS composite and component ratings are 2/223222. |
| 11/14/2001 | OTS begins a field visit of ASB to address concerns from the 2001 safety and soundness exam. OTS concludes that there are improvements in ASB's internal audit and investment policies, and that management is making satisfactory progress in addressing information technology concerns. |

- 11/20/2002 OTS begins a safety and soundness examination of ASB, which is completed on January 1, 2003. OTS determines the thrift to be fundamentally sound. The CAMELS composite and component ratings are 2/223222.
- 12/31/2002 ASB reports net income of \$1.4 million and paid \$1.0 million in dividends to ASC.
- 12/31/2003 ASB reports net income of \$4.2 million and paid \$2.0 million in dividends to ASC.
- 3/29/2004 OTS begins a safety and soundness examination of ASB, which is completed on May 11, 2004. OTS deems the thrift fundamentally sound, but asks that management classify the Millennium Gate Foundation loans as a loss. The CAMELS composite and component ratings are 2/222222.
- 12/31/2004 ASB reports net earnings of \$3.5 million and paid dividends of \$6.3 million to ASC.
- 12/31/2005 ASB reports net earnings of \$1.1 million and paid dividends of \$2.0 million to ASC.
- 1/3/2006 OTS begins a safety and soundness examination of ASB, which is completed on March 9, 2006. OTS deems the thrift fundamentally sound but notes that ASB's loan sales to the secondary market have slowed. The CAMELS composite and component ratings are 2/222222.
- 8/1/2006 ASB acquires the mortgage banking division of Universal Savings Bank, Milwaukee, Wisconsin. The acquisition includes nine loan production offices.
- 11/15/2006 The board of directors votes to terminate the president of ASB. An executive team comprising the chief executive officer (CEO), vice chairman, and executive vice president assumes the president's duties. The vice chairman is later appointed acting president.
- 1/1/2007 ASB's board formally adopts Statement of Financial Accounting Standard No. 159 to carry the thrift's mortgage pipeline at fair

	value.
3/12/2007	ASB receives notification from Federal Deposit Insurance Corporation (FDIC) that as of December 31, 2007, the thrift's capital category had fallen from well-capitalized to adequately capitalized.
3/31/2007	ASC provides ASB a \$2 million noncash capital injection to help the thrift qualify as well-capitalized. ASC also purchases a problem loan from ASB, paying the entire \$400,000 balance, which the thrift had previously charged off. ASB's capital category returns to well-capitalized.
4/9/2007	OTS begins a safety and soundness examination of ASB, which is completed on July 23, 2007. Since the previous OTS examination, the thrift has had six consecutive quarters of net losses and experienced major changes in senior management and turnover of key personnel. The CAMELS composite and component ratings are 3/223322.
April 2007	ASB's vice president/compliance officer resigns.
4/10/2007	ASB provides OTS an earnings and capital plan. It indicates the intent of ASB's management and ASC's owners to take appropriate actions to ensure that the thrift remains well-capitalized at all times.
4/25/2007	ASC's board of directors passes a resolution confirming ASC's commitment to ensure that ASB remains well-capitalized.
5/25/2007	ASB's controller resigns, and ASB's treasurer is designated to perform the controller's accounting duties.
6/27/2007	OTS conducts a limited examination to downgrade ASB's CAMELS composite rating from 2 to 3.
9/25/2007	The board of directors approves a motion to create a new position of co-CEO and to appoint two people to that position. The positions are to become effective on September 30, 2007.
12/31/2007	ASB incurs a loss of \$3.7 million for 2007.

- 12/31/2007 ASB enters into a lender's representation and warranty master policy with American Sterling Insurance Corporation (ASIC) to defer the impact of losses at the thrift over a 24-month period resulting from mortgage loan representations and warranties.
- 4/9/2008 OTS downgrades ASB's CAMELS asset quality component rating from 2 to 3 due to substantial increases in nonperforming and classified assets.
- 6/4/2008 Countrywide Home Loans submits to ASB a written demand letter for ASB's repurchase of approximately 124 loans due to early payment default. The aggregate amount of the 124 loans is \$27.5 million.
- 6/13/2008 OTS issues a supervisory directive to the ASB board requiring ASB to maintain a minimum core capital ratio of 7.5 percent, effective immediately.
- 6/30/2008 OTS begins a safety and soundness examination of ASB, which is completed on December 5, 2008. OTS determines that the thrift is in an unsafe and unsound condition, the performance of the institution is critically deficient, and there are inadequate risk management practices relative to the complexity and risk of operations. The thrift receives final CAMELS composite and component ratings of 5/545544. Throughout the examination, OTS conducts limited of examinations to downgrade ASB's composite and component ratings.
- 7/14/2008 ASB violates OTS's Supervisory Notice 08-01 by not submitting its 2007 audit report within 90 days of its fiscal year end.
- 7/15/2008 In response to an ASB co-CEO's inquiry about submitting real estate as a capital injection, OTS informs the co-CEO that it will allow only cash or cash equivalents contributed from the holding company to be included in ASB's capital.
- 7/21/2008 ASB notifies OTS of its various capital-raising initiatives such as the holding company contributing capital and sale of property held by the holding company.

7/29/2008	OTS conducts a limited examination to downgrade ASB's CAMELS composite rating from 3 to 4 and to downgrade capital, management, earnings, and sensitivity component ratings to 4. The examination was part of the safety and soundness examination initiated in June 2008.
7/29/2008	OTS rejects ASB's capital-raising initiatives detailed in the July 21, 2008, notification. OTS also directs ASB to record the appropriate adjusting or reversing journal entries for improper transactions made regarding capital and earnings.
7/29/2008	OTS issues a supervisory directive to ASB prohibiting the thrift from initializing transactions with affiliates exceeding \$20,000 without prior written notification and receipt of written non-objection from OTS.
7/29/2008	OTS issues a letter notifying ASB of its undercapitalized status, being deemed in troubled condition, and the downgrade of its CAMELS composite rating to 4.
8/1/2008	OTS conducts a limited examination to downgrade ASB's CAMELS composite rating from 4 to 5 and its capital and management component ratings from 4 to 5. This examination was part of the safety and soundness examination initiated in June 2008.
8/1/2008	OTS issues a letter notifying ASB of its critically undercapitalized status, the downgrade of its CAMELS composite rating to 5, and the requirement to file a capital restoration plan by August 11, 2008.
8/4/2008	The Federal Reserve Bank of Kansas City issues a letter placing ASB's Federal Reserve account on real-time monitoring. The net debit cap is reduced to a zero cap.
8/5/2008	FDIC issues a letter to ASB allowing the thrift to borrow \$25 million from the Federal Home Loan Bank.
8/7/2008	The Federal Home Loan Bank and the Federal Reserve Bank terminate lines of credits to ASB.

8/8/2008	OTS downgrades ASB's CAMELS liquidity component rating from 2 to 5.
8/11/2008	OTS issues a letter to the ASB board of directors disapproving of an ASB media statement disclosing the bank's prompt corrective action (PCA) status.
8/12/2008	ASB's board of directors approves a proposed OTS cease and desist (C&D) order.
8/13/2008	OTS issues a letter notifying ASB of deficiencies in its capital restoration plan.
8/13/2008	OTS issues a supervisory directive to the ASB board restricting communication of inaccurate or confidential supervisory information to the news media.
8/20/2008	OTS issues a C&D order to ASB. The order includes requirements that ASB (1) meet and maintain a leverage ratio of 7.5 percent and total risk-based capital of 10 percent by September 12, 2008; (2) submit to OTS a weekly status report regarding its capital-raising activities; (3) file a capital restoration plan; (4) submit a written demand to the holding company for a cash payment of \$2 million; (5) not accept any noncash contributions of any type; (6) ensure the accuracy of its thrift financial reports; (7) not prepare any dividend or other capital distribution; (8) not engage in any transaction with any affiliate in an amount exceeding \$20,000.
8/22/2008	FDIC approves ASB's request to rescind a lender's representation and warranty master policy that ASIC sold to ASB.
8/23/2008	ASB and ASIC agree to a total rescission of the lender's representation and warranty master policy.
8/26/2008	OTS approves the extension of the due date of the 2007 external audit.
8/28/2008	OTS issues a supervisory directive to ASB regarding valuation of the held for sale portfolio and the adjustment for those projections on

the balance sheet as of September 12, 2008.

- 9/19/2008 OTS regional enforcement counsel submits a recommendation to conduct a formal examination of the board of directors and senior management of the thrift and the holding company regarding certain bookkeeping entries that had the effect of materially misrepresenting the financial condition of the bank.
- 9/23/2008 OTS conducts a limited examination to downgrade ASB's CAMELS asset quality component rating from 3 to 4.
- 9/24/2008 OTS issues a supervisory directive to ASB to reflect fair value adjustments on ASB's books and provide notification of the downgrade of ASB's CAMELS asset quality component rating to 4.
- 10/10/2008 OTS designates ASB as significantly undercapitalized after a \$7.5 million capital infusion from the holding company.
- 10/14/2008 The OTS Western Region director approves the recommendation submitted on September 19, 2008, for the formal examination of ASB.
- 11/7/2008 OTS receives notification that ASB reached a settlement with Countrywide Home Loans (Countrywide) that required ASB to sell at least 70 percent of all qualifying loans originated each month from December 1, 2008, through April 30, 2010, to Countrywide. In exchange, Countrywide agreed to accept the \$4.3 million it had withheld from ASB as settlement of all the recourse claims that Countrywide had made against ASB until the time of the agreement.
- 11/12/2008 OTS approves ASB's November 7, 2008 resolution with Countrywide.
- 11/26/2008 OTS extends deadlines for compliance with the August 20, 2008, C&D order.
- 12/31/2008 OTS rejects ASB's capital restoration plan and issues a notice of intent to issue a PCA directive.
- 12/31/2008 A potential acquirer files a holding company application with OTS

related to the proposed acquisition of ASB.

- January 2009 ASB's co-CEOs and an executive vice president resign.
- 1/9/2009 ASC and a potential acquirer enter into a stock purchase agreement for the sale of ASB stock, which they amend on January 16, 2009. The agreement is contingent upon approval of the potential acquirer's application for funding under the Troubled Asset Relief Program.
- 1/12/2009 OTS issues a liquidity directive to ASB that directs ASB to maintain \$50 million in cash and cash equivalents.
- 1/14/2009 OTS designates ASB as critically undercapitalized.
- 1/15/2009 OTS issues a PCA directive that requires ASB to improve its capital and includes restrictions on capital distributions, management fees, and asset growth.
- 1/15/2009 OTS approves a holding company application for the potential acquirer to purchase the stock of ASB. OTS extends the February 14, 2009, deadline for consummation of the acquisition to March 31, 2009, and later extends the deadline to April 30, 2009.
- 1/21/2009 ASB's chief operating officer becomes interim CEO.
- 1/22/2009 OTS issues a supervisory directive stating that ASB must submit an updated list of loan repurchase requests and all other legal claims by January 30, 2009.
- 2/2/2009 OTS sends a letter to ASB notifying the thrift of a proposed civil money penalty regarding the violation of flood insurance regulations. OTS found that ASB engaged in a pattern or practice of violations of 12 CFR § 572.9(C), which requires that a savings association that makes, increases, extends, or renews a loan secured by a building or mobile home located or to be located in a special flood hazard area must provide a written notice of this fact to the borrower "within a reasonable time before completion of the transaction." OTS's review of a sample of 25 loans revealed 19 instances in which ASB had failed to provide the required notice

within a reasonable time before completion of the transaction.

- 2/4/2009 OTS issues a supervisory directive to ASC directing ASC to immediately reimburse ASB \$192,304 for all unpaid intercompany payables of ASC and its nonbank subsidiaries that were made in violation of OTS's August 26, 2008, C & D order concerning transactions with affiliates.
- 3/4/2009 OTS issues a civil money penalty, effective March 30, 2009, requiring that ASB pay \$1,600 for failing to make a delivery of a written notice of the availability of flood insurance within a reasonable time before the completion of transactions in cases in which loans were secured by buildings or mobile homes located or to be located in special flood hazard areas.
- 3/5/2009 OTS approves a 30-day extension for the filing of ASB's December 31, 2008, audit reports.
- 4/17/2009 OTS rejects ASB's capital restoration plan.
- 4/17/2009 ASB is closed by OTS and placed into FDIC receivership.

Appendix 5
 OTS Examinations and Enforcement Actions

This appendix lists the Office of Thrift Supervision’s (OTS) full-scope safety and soundness examinations of American Sterling Bank (ASB) beginning March 2004 until the thrift’s failure in April 2009 and provides information on the significant results of those examinations. OTS also performed six limited-scope examinations during 2008, which did not include matters requiring board attention (MRBA) or corrective actions. Generally, MRBAs represent the most significant items requiring corrective action found by the examiners.

Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
3/29/2004 5/11/2004	2/222222	\$239	<p data-bbox="621 863 948 884"><u>Matters requiring board attention</u></p> <ul data-bbox="670 890 769 911" style="list-style-type: none"> <li data-bbox="670 890 769 911">• None <p data-bbox="621 953 802 974"><u>Corrective actions</u></p> <ul data-bbox="670 980 769 1001" style="list-style-type: none"> <li data-bbox="670 980 769 1001">• None <p data-bbox="621 1016 927 1037"><u>Other issues/recommendations</u></p> <ul data-bbox="670 1043 1170 1900" style="list-style-type: none"> <li data-bbox="670 1043 1170 1115">• Asset Quality: Management should classify the \$390,000 unsecured credit to Millennium Gate Foundation as a loss. <li data-bbox="670 1121 1170 1213">• Management: Management should reassess monthly provisions once it establishes an adequate loss history for the mortgage banking operation. <li data-bbox="670 1220 1170 1291">• Management: Management should develop a management continuity and succession plan for key officers. <li data-bbox="670 1297 1170 1369">• Management: Directors should avoid conflicts of interest of any sort, or even the appearance of a conflict of interest. <li data-bbox="670 1375 1170 1476">• Management: ASB should improve documentation of outstanding exceptions, management responses, and timelines for improvements. <li data-bbox="670 1482 1170 1608">• Management: Management should update the institution’s Gramm Leach Bliley Act risk assessment to reflect current risk priorities and to evaluate the adequacy of controls to protect confidential information. <li data-bbox="670 1614 1170 1766">• Earnings: Core income improved due to an increase in mortgage loan interest income, fee income, and a decrease in the interest expense on deposits. However, core earnings remained negative due to the impact of the general and administrative expenses. <li data-bbox="670 1772 1170 1900">• Liquidity: Management should develop and the board should approve written guidance for the management of liquidity and cash flows. Also, the board or an appropriate committee should receive and monitor periodic reports projecting 	None

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Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
1/03/2006 3/09/2006	2/222222	\$194	<p style="text-align: center;">cash flows.</p> <p><u>Matters requiring board attention</u></p> <ul style="list-style-type: none"> • None <p><u>Corrective actions</u></p> <ul style="list-style-type: none"> • None <p><u>Other issues/recommendations</u></p> <ul style="list-style-type: none"> • Asset quality: Asset quality remains satisfactory. However, despite a decline in loans, classified assets and nonperforming loans increased during the review period. • Asset quality: Classified assets increased \$657,000 to \$6.5 million since the prior examination. This was due to a \$3.2 million increase in classified loans and a \$2.6 million decrease in real estate owned. • Earnings: The mortgage banking division failed to break even in 2005. The president attributed the lower production to a slowdown in refinance activity and the departure of two high-volume loan producers. • Liquidity: ASB operates a very active mortgage banking function. It originates loans through a network of brokers, underwrites the loans to investor specifications, and sells them to investors on a servicing released basis. 	None

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Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
4/09/2007 7/23/2007	3/223322	\$249	<p data-bbox="623 474 954 495"><u>Matters requiring board attention</u></p> <ul data-bbox="667 499 1192 758" style="list-style-type: none"> <li data-bbox="667 499 1192 575">• Management: Revise and approve the management succession plan. Submit a copy of the management succession plan to OTS. <li data-bbox="667 579 1192 655">• Management: Appoint a local, full-time chief executive officer (CEO); submit a copy of the resolution to OTS. <li data-bbox="667 659 1192 758">• Earnings: Beginning August 31, 2007, submit monthly production reports, operating results, and budget variance reports to OTS within 30 days of each calendar month-end. <p data-bbox="623 768 808 789"><u>Corrective actions</u></p> <ul data-bbox="667 793 1192 1052" style="list-style-type: none"> <li data-bbox="667 793 1192 890">• Management: Revise and approve the management succession plan by September 30, 2007. Submit a copy of the revise plan to OTS. <li data-bbox="667 894 1192 970">• Management: Appoint a full-time, local CEO by September 30, 2007, and submit a copy of the resolution to OTS. <li data-bbox="667 974 1192 1052">• Earnings: Submit production reports, operating results, and budget variance reports to OTS within 30 days of each calendar month-end. <p data-bbox="623 1062 932 1083"><u>Other issues/recommendations</u></p> <ul data-bbox="667 1087 1192 1860" style="list-style-type: none"> <li data-bbox="667 1087 1192 1268">• Capital: By the end of the December 2006 quarter, ASB reported core and risk-based capital ratios of 5.19 percent and 8.36 percent, respectively. Since the risk-based capital ratio fell below 10 percent, ASB's capital status declined from well-capitalized to adequately capitalized. <li data-bbox="667 1272 1192 1453">• Capital: Effective March 2007, American Sterling Corporation (ASC) provided ASB a \$2 million capital injection to help the thrift qualify as well-capitalized. ASC also purchased a problem loan from ASB, paying the entire \$400,000 balance, which the thrift had previously charged off. <li data-bbox="667 1457 1192 1554">• Capital: As of March 31, 2007, ASB reported a core capital ratio of 6.72 percent and total risk-based ratio of 11.71 percent, which exceeded the thresholds for well-capitalized. <li data-bbox="667 1558 1192 1654">• Asset quality: Management must closely monitor large loan concentrations against the loan to one borrower (LTOB) limit to prevent future violations. <li data-bbox="667 1659 1192 1755">• Management: ASB must monitor all critical vendors and document the reviews in the Early Default Payment Steering Committee or board minutes. <li data-bbox="667 1759 1192 1860">• Earnings: Management must file Schedule CMR (Consolidated Maturity and Rate) for the June 2007 quarter and subsequent quarters in a timely manner. 	None

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Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
6/27/2007 6/27/2007 (Limited examination)		N/A	OTS conducts a limited examination to downgrade ASB's CAMELS composite rating from 2 to 3.	None
4/09/2008 4/09/2008 (Limited examination)	3/233322	N/A	OTS downgrades ASB's Asset Quality rating from 2 to 3.	<ul style="list-style-type: none"> Supervisory Directive issued 6/13/2008
6/30/2008 12/05/2008	5/545544	\$258	<p><u>Matters requiring board attention</u></p> <ul style="list-style-type: none"> Capital: Recapitalize the bank to be adequately capitalized or execute an agreement to sell or merge ASB that is acceptable to OTS Asset quality: Obtain independent fair value assessments of the held for sale (HFS) portfolio on a quarterly basis and record appropriate entries reflecting this valuation on the institution's financial statements. Asset quality: Bring loans exceeding LTOB limitations into compliance. Management: Engage an independent, qualified individual to review all books and records, financial reports, and all accounting-related policies and procedures to ensure that they accurately reflect the institution's financial position, provide adequate controls, and are consistent with generally accepted accounting principles (GAAP) and prudent accounting practices. Management: Hire an individual responsible for maintaining accurate books and records, complying with GAAP and prudent accounting practices, and keeping the board fully aware of financial matters. Liquidity: Make all efforts to renegotiate investor contracts as soon as possible to limit or eliminate the institution's early payment default risk. Liquidity: Submit to OTS a status report on all claims to early payment default risk or other similar demands. Liquidity: Monitor early payment default (EPD) risk and other liability for sold loans and establish and maintain an appropriate contingent liability to account for this risk. Sensitivity to market risk: The board and management must improve internal rate of return (IRR) management practices to fully comply with Thrift Bulletin 13a, including documenting and validating the methodologies and assumptions utilized in the internal model. Sensitivity to market risk: Obtain an independent review of internal controls governing the IRR management process. The review should include an assessment of the assumptions, parameter values, and methodologies used in the internal model. 	<ul style="list-style-type: none"> Supervisory Directive issued 7/29/2008, 8/13/2008, 8/28/2008, 9/24/2008, 1/22/2009, and 2/4/2009, Cease and desist (C&D) order: 8/20/2008 PCA: 1/15/2009 Civil money penalty: 3/30/2009

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Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
			<ul style="list-style-type: none"> • Sensitivity to market risk: Reconcile OTS and internal model results and quarterly thereafter. <p><u>Corrective actions</u></p> <ul style="list-style-type: none"> • Capital adequacy: Management and the board shall increase capital to the required level mandated in the C&D order and the Capital Directive. OTS apprised the board of its obligation, formalized in the C&D order, to sell or merge the institution or obtain a capital infusion to bring ASB to at least adequately capitalized by December 31, 2008. • Asset quality: Management and the board should obtain independent fair value assessments of the HFS portfolio on a quarterly basis and record appropriate entries reflecting this valuation on the institution's financial statements. • Asset quality: Management and the board must bring loans exceeding LTOB limitations into compliance. • Management: By January 31, 2009, the board should engage an independent, qualified individual to review all books and records, financial reports, and all accounting-related policies and procedures to ensure that they accurately reflect the institution's financial position, provide adequate controls, and are consistent with GAAP and prudent accounting practices. • Management: The board should hire a competent accounting professional responsible for maintaining accurate books and records, complying with GAAP and prudent accounting practices, and keeping the board fully aware of financial matters. • Liquidity: ASB must renegotiate investor contracts to limit or eliminate the institution's EPD risk. • Liquidity: ASB must monitor its EPD risk and other liability for sold loans and establish and maintain an appropriate contingent liability to account for this risk. • Liquidity: By December 31, 2008, ASB must submit a status report of all demands from investors to repurchase loans or otherwise pay damages. • Sensitivity to market risk: Management must implement procedures to ensure the preparation and filing of an accurate Schedule CMR. • Sensitivity to market risk: By January 31, 2009, the board and management must improve IRR management practices to fully comply with Thrift Bulletin 13a. • Sensitivity to market risk: Management must document and validate the methodologies and assumptions utilized in the internal model. • Sensitivity to market risk: The board must ensure that ASB obtains an independent review of internal controls governing the IRR management process. The review should include an assessment of the assumptions, parameter values, and methodologies 	

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Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
			<p>used in the internal model.</p> <ul style="list-style-type: none"> • Sensitivity to market risk: Management must reconcile OTS and internal model results, provide written explanation for variances, and report to the board at least quarterly. 	
			<p><u>Other issues/recommendations</u></p> <ul style="list-style-type: none"> • Capital: ASB's current capital levels are noncompliant with the C&D order. ASB also fails to comply with PCA regulations as management did not provide an acceptable capital restoration plan. • Capital: Management recorded inappropriate noncash capital contributions and did not deduct all required amounts from regulatory capital. • Capital: OTS identified several items resulting in overstatement of the level of capital and respective capital ratios. The items were improperly recorded capital transactions related to loans and intercompany receivables from the holding company totaling \$3 million, failure to deduct disallowed deferred tax assets from capital, and consolidated capital requirement reporting errors. As a result of this false and misleading reporting of capital, ASB obtained brokered deposits in violation of 12 C.F.R. 337.6 and continued mortgage banking operations without sufficient support to its operations. • Asset quality: Problem loans were high and ASB had a large unrecognized mark-to-market loss on the loans in its HFS portfolio. • Asset quality: Accounting practices were noncompliant with GAAP, resulting in untimely recognition of loan and market losses. • Asset quality: Classification of assets was inconsistent with internal policy and recommended industry practice. • Asset quality: The allowance for loan and lease losses was not adequate and the institution's methodology for establishing it needs revision. • Management: Concerns and significant risks were not adequately identified, measured, monitored, or controlled and now threaten the viability of the institution. • Management: Issues of material concern include failure to maintain adequate capital commensurate with risk. Also of concern is the institution's inappropriate accounting entries, inaccurate books and records, failure to comply with regulations and prudent operating practice, and inappropriate transactions with affiliates. • Management: Management did not correct all information technology deficiencies identified at the previous examination, and a third-party review of ASB's information technology operations disclosed additional deficiencies that ASB was in the process of correcting. 	

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Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
			<ul style="list-style-type: none"> • Management: ASB lacked a program to audit/verify its compliance with Fair Lending regulations. • Management: OTS found recurring violations of the notice requirements of the Flood Disaster Protection Act. This is a repeat violation from the prior examination. • Earnings: Earnings were critically deficient and insufficient to support operations and maintain appropriate capital and allowance levels. • Earnings: Losses were driven by high operating costs associated with the institution’s ill-timed expansion of its mortgage banking operations and insufficient loan production. Escalating levels of problem assets caused by weakened real estate and credit markets also contributed to the losses. • Earnings: Financial statements were not accurate. Deficiencies included the failure to comply with GAAP, false and misleading accounting entries, failure to recognize loan losses in a timely manner, and stale-dated and unsupported accounting items. • Liquidity: Liquidity diminished during the review period as loan application volume exceeded ASB’s capability to effectively process loans and quickly consummate loan sales with investors. • Liquidity: The liquidity strategy was not adequate and culminated in a liquidity shortage in March/April 2008. ASB resolved the liquidity shortage by obtaining \$19 million in short-term brokered deposits. In August 2008, another liquidity crisis developed that continues to threaten the viability of the institution. • Liquidity: Additional significant concerns with the mortgage operation were the inaccurate valuation of the mortgage loan warehouse, the failure to revise investor contracts to limit the impact of EPDs, and the large amount of investor-rejected loans held in the HFS portfolio. OTS found on average that the institution was valuing the loans in the warehouse at par, which was not consistent with GAAP and not commensurate with the risk of the loans in the HFS portfolio. • Liquidity: In June 2008, Countywide demanded that ASB repurchase approximately \$32.5 million in loans due to EPD concerns. During the examination, Countrywide deducted \$4.1 million in previously withheld loan sale proceeds. Management reported this amount as a receivable and wrote off this amount during the examination. Management must review this exposure and establish and maintain an appropriate contingent liability to account for this risk at least quarterly. • Liquidity: Certain risk limit guidelines were either out of date, were exceeded on several occasions, or were not being formally monitored for compliance. Management attributed these weaknesses to poor 	

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Start/end date of examination	CAMELS Ratings	Assets (\$ millions)	Significant safety and soundness MRBAs, corrective actions, recommendations, and other issues cited in reports of examinations and limited examination reports	Enforcement action
7/29/2008 7/30/2008 (Limited examination)	4/434424	N/A	<p>documentation and will improve documentation and revise applicable policies to address these concerns.</p> <ul style="list-style-type: none"> Sensitivity to market risk: Due to material CMR reporting errors, weaknesses in model assumptions relied on by ASB, and inadequate books and records, OTS could not fully assess the institution's IRR profile. <p>This limited examination was part of the ongoing full-scope safety and soundness examination that started on June 30, 2008. The examination report recommended the downgrade of ASB's composite rating from 3 to 4 and recommended the downgrades of Capital, Management, Earnings, and Sensitivity component ratings to 4.</p>	Issuance of PCA directives associated with undercapitalized status
8/01/2008 8/01/2008 (Limited examination)	5/535424	N/A	<p>This limited examination was part of the ongoing full-scope safety and soundness examination that started on June 30, 2008. The examination report recommended the downgrade of ASB's composite rating from 4 to 5 and the Capital and Management component ratings from 4 to 5.</p>	Issuance of PCA directives associated with critically undercapitalized status
8/08/2008 8/08/2008 (Limited examination)	5/535454	N/A	OTS downgraded ASB's Liquidity rating from 2 to 5.	None
9/23/2008 9/23/2008 (Limited examination)	5/545454	N/A	OTS downgraded ASB's Asset Quality rating from 3 to 4.	None

We have completed, prior to this review, six mandated material loss reviews of failed thrifts since September 2007, 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
<p><i>Safety and Soundness: Material Loss Review of NetBank, FSB, OIG-08-032 (Apr. 23, 2008)</i></p> <p>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.</p>	<p>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.</p> <p>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.</p> <p>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.</p>
<p><i>Safety and Soundness: Material Loss Review of IndyMac Bank, FSB, OIG-09-032 (Feb. 26, 2009)</i></p> <p>OTS closed IndyMac on July 11, 2008, and named FDIC as conservator. As of May 8, 2009, FDIC estimated that IndyMac's failure would cost the Deposit Insurance Fund \$10.7 billion.</p>	<p>Ensure that action is taken on the lessons learned and recommendations from the OTS internal review of the IndyMac failure.</p> <p>Caution examiners that assigning composite CAMELS ratings of 1 or 2 to thrifts with high-risk, aggressive-growth business strategies needs 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</p>

Appendix 6
Prior OIG Material Loss Review Recommendations

	<p>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.</p>
<p><i>Safety and Soundness: Material Loss Review of Ameribank, Inc., OIG-09-036 (Apr. 7, 2009)</i></p>	<p>Remind examiners of the risks associated with rapid growth in high-risk concentrations.</p>
<p>OTS closed Ameribank and appointed 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.</p>	<p>Remind examiners to conduct more thorough loan sampling from the portfolio if they identify a rapid increase in concentration.</p> <p>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.</p> <p>Assess the need for guidance requiring risk assessment of construction rehabilitation account loans as an integral part of assessing the thrift's overall risk.</p> <p>Ensure that the recommendations and the lessons learned from OTS's internal assessment of the Ameribank failure are implemented.</p>
<p><i>Safety and Soundness: Material Loss Review of PFF Bank and Trust, OIG-09-038 (June 12, 2009)</i></p>	<p>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 do the following:</p>
<p>OTS closed PFF and appointed 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.</p>	<p>Direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits of concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable.</p> <p>Formally communicate 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.</p> <p>Formally communicate the need for a sound</p>

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	internal risk management system that includes stress testing, regular periodic monitoring, and other risk management tools for higher-risk concentrations.
<p><i>Safety and Soundness: Material Loss Review of Downey Savings and Loan, FA, OIG-09-039 (June 15, 2009)</i></p> <p>OTS closed Downey and appointed FDIC as receiver on November 21, 2008. As of May 8, 2009, FDIC estimated that Downey's failure would cost the Deposit Insurance Fund \$1.4 billion.</p>	<p>Ensure that the recommendations from OTS's internal assessment of the Downey failure are implemented and that the lessons learned from the assessment are taken into account going forward. In this regard, OTS should do the following:</p> <p>Direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits of concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable.</p> <p>Assess the need for more guidance for examiners on determining materiality of concentrations and determining appropriate examiner response to high-risk concentrations, including when to impose absolute limits to prevent excessive concentration</p> <p>Formally communicate the need for a sound internal risk management system that includes stress testing, regular periodic monitoring, and other risk management tools for higher-risk concentrations.</p> <p>Formally communicate the guidance in ND 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 assets or loans.</p>
<p><i>Safety and Soundness: Material Loss Review of Suburban Federal Savings Bank, OIG-09-047 (Sept. 11, 2009)</i></p> <p>OTS closed Suburban and appointed FDIC as receiver on January 30, 2009. As of August 14, 2009, FDIC estimated that Suburban's failure would cost the Deposit Insurance Fund \$126 million.</p>	<p>The director of OTS should do the following:</p> <p>Ensure that the recommendations from OTS's internal assessment of the Suburban failure are implemented and that the lessons learned from the assessments are taken into account going forward.</p> <p>Ensure that regional offices more closely monitor and scrutinize the amendments to thrift financial reports made by institutions for accuracy and consider appropriate action where chronic errors are found, including enforcement action and assessment of civil money penalties.</p>

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Have regional offices ensure that examiners conduct timely and adequately scoped field visits to determine whether thrifts with repeat problems have taken appropriate corrective action. In the event that the field visits find that corrective action has not been taken, examiners should be instructed to elevate the supervisory response, including the taking of enforcement action when necessary.

Appendix 7
Management Comments



Office of Thrift Supervision
Department of the Treasury

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John E. Bowman
Acting Director

November 23, 2009

MEMORANDUM FOR: Jeffrey Dye
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
American Sterling Bank

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

The Inspector General report on ASB includes several recommendations for OTS. The recommendations state that the Director of OTS do the following:

1. Ensure that the recommendations from OTS's internal review of the ASB failure are implemented and that the lessons learned from the review are taken into account going forward.
2. Remind supervisory and examination staff of the importance of requiring thrifts to hold capital, as required by federal banking regulations, to mitigate their recourse exposure on sold loans.
3. Remind supervisory and examination staff to properly scrutinize capital contributions made to thrifts, especially noncash capital contributions.
4. Ensure supervisory and examination staff take forceful action to mitigate losses whenever a thrift's line of business incurs losses that threaten the viability of the institution.

OTS concurs with the findings and recommendations of the Material Loss Review and will ensure the recommended actions will be implemented in a timely manner.

The agency has already taken action pursuant to its internal failed bank review. These actions include issuing new internal guidelines in May 2009 for Enforcement Review Committee meetings to ensure appropriate enforcement action. The agency also issued a CEO memorandum in July 2009 to address asset and liability concentrations and related risk management practices.

Appendix 8
Major Contributors to This Report

Jeffrey Dye, Audit Director
Jaideep Mathai, Audit Manager
Regina Morrison, Auditor-in-Charge
Alicia Bruce, Auditor
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Department of the Treasury

Deputy Secretary 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