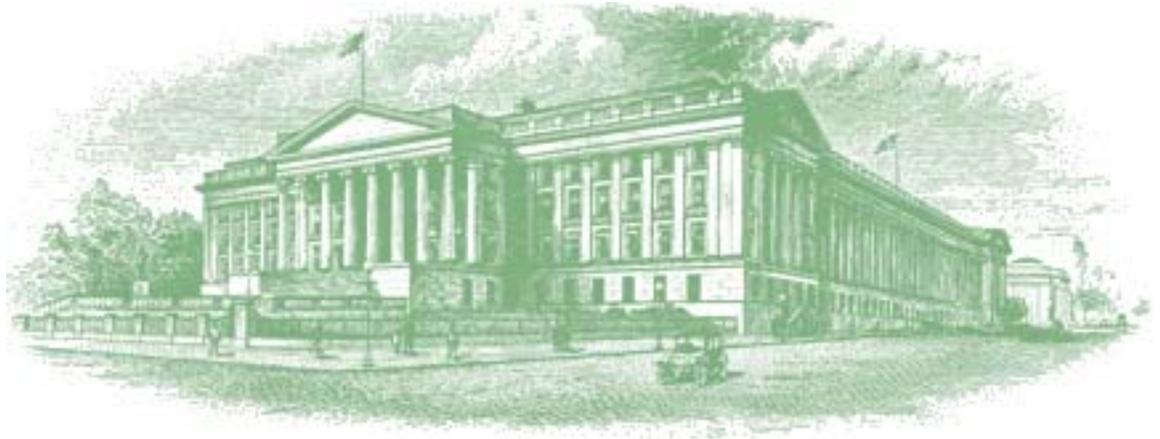




Audit Report



OIG-09-044

SAFETY AND SOUNDNESS: City National Corporation Capital Purchase Program Case Study

August 27, 2009

Office of
Inspector General

Department of the Treasury

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Abbreviations

ALLL	Allowance for Loan and Lease Losses
City National	City National Corporation
CPP	Capital Purchase Program
CRA	Community Reinvestment Act
EESA	Emergency Economic Stabilization Act of 2008
OCC	Office of the Comptroller of the Currency
OFS	Office of Financial Stability
Recovery Act	American Recovery and Reinvestment Act of 2009
SIG	Special Inspector General
TARP	Troubled Asset Relief Program
UFIRS	Uniform Financial Institutions Rating System

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*The Department of the Treasury
Office of Inspector General*

August 27, 2009

Herbert M. Allison, Jr.
Assistant Secretary for Financial Stability

John C. Dugan
Comptroller of the Currency

As part of our interim oversight of the Troubled Asset Relief Program (TARP),¹ we initiated an audit of the selection of the City National Corporation (City National), the one-bank holding company for City National Bank located in Los Angeles, California,² for participation in the Capital Purchase Program (CPP). The purpose of our work was to (1) provide a case study of the approval process used by Treasury for allowing City National's participation in CPP and (2) determine the controls in place to ensure the approval of this financial institution was consistent with TARP objectives. Appendix 1 contains a detailed description of our objectives, scope, and methodology.

In brief, based on our review, City National met the required criteria to receive CPP funding. At the time of the corporation's approval, limited policies and procedures were in place relating to the review and approval of TARP applications. We determined that the Office

¹ The Emergency Economic Stabilization Act of 2008 established a Special Inspector General for TARP (SIGTARP) to provide program oversight. Until that office became operational, the Secretary of the Treasury asked the Treasury Office of Inspector General (OIG) to provide interim oversight.

²In a July 16, 2009 press release, City National Corporation designated City National Plaza in downtown Los Angeles as its headquarters. Previous to this designation, it had been headquartered in Beverly Hills, California since 1955.

of the Comptroller of the Currency (OCC) and Treasury followed those limited policies and procedures for approving City National for CPP.

We provided a draft of this report to the Office of Financial Stability (OFS) and OCC for review and comment. In a written response, OFS concurred with the findings in this case study. OFS's response also discusses additional controls around the processing of CPP applications that have been put in place subsequent to the approval of City National to access TARP funds through the CPP. OFS further states that it continues to promote financial stability through the CPP and directs CPP participants to report monthly on lending data that can be used as an indication of the impact the TARP funds are having on the availability of credit and taxpayers. OFS's response is provided as appendix 3. OCC provided us technical comments and suggested edits which we addressed as appropriate in this report. We also provided a draft of this report to City National for informational purposes.

Appendix 1 contains a detailed description of our objectives, scope, and methodology.

Emergency Economic Stabilization Act of 2008

In October 2008, Congress passed and the President signed the Emergency Economic Stabilization Act of 2008 (EESA). Among other things, EESA provided Treasury with broad, flexible authorities to create programs to encourage U.S. financial institutions to build capital and increase the flow of financing to businesses and consumers to support the economy.

Treasury OIG's Interim Oversight of TARP

The main focus of our interim oversight was to gather information required for mandatory reporting by the SIGTARP. Specifically, we requested and were provided a listing of financial institutions approved by Treasury for CPP, and the type and amounts of the transactions. We were also provided access to the individual financial institution files containing application and approval information for CPP. The information we collected was turned over

to the SIGTARP on January 16, 2009, about a month after the appointment of the SIGTARP. In addition, as part of our interim oversight, we performed a case study of City National to provide an understanding of how Treasury approved financial institutions and holding companies for participation in CPP and to determine the controls in place to select recipients for participation in CPP. Details of the approval process for participation in CPP are included in appendix 2.

Case Study Results

City National Corporation

Corporation and Bank Background

City National, a one-bank holding company for City National Bank, had total assets of \$16.5 billion as of December 31, 2008, which included \$12.4 billion in loans.

City National Bank is located in Los Angeles, California and delivers banking, trust, and investment services through 63 offices in Southern California, the San Francisco Bay area, Nevada, and New York City. City National also delivers investment and wealth advisory services through its wealth advisory affiliates.

City National's lending activities are predominantly in California, and, to a lesser extent, in New York and Nevada. Although the corporation has a diversified loan portfolio, a substantial portion of credit performance depends on the economic stability of Southern California. Credit performance also depends, to a lesser extent, on economic conditions in the San Francisco Bay area, Nevada, and New York. According to a public statement made by bank management in March 2008, City National only made home mortgage loans to its private banking clients and the bank had never foreclosed on any of the loans.

In its September 30, 2008, 10-Q report,³ City National stated that it received preliminary approval of its application for Treasury to invest approximately \$395 million in City National's preferred stock and warrants, which would bring City National's Tier 1 capital ratio to approximately 12 percent. City National also stated that it would use the funds to pursue its longstanding growth strategy, including expanding existing client relationships, adding new clients, increasing loans, and making selected acquisitions.

Treasury's Approval of City National Corporation for CPP Participation

City National received \$400 million of CPP funds on November 21, 2008, through a Treasury purchase of its preferred stock with warrants. OCC, City National Bank's federal regulator, received the holding company's application for \$400 million in CPP funding on October 22, 2008. OCC reviewed the application and prepared the case decision memorandum.

On October 23, 2008, OCC forwarded a recommendation for approval of City National and 10 other applicants to receive CPP funding. The maximum federal investment in a participating CPP institution is the lesser of \$25 billion or 3 percent of the institution's risk-weighted assets. OCC stated in the recommendation that the amount requested by City National exceeded 3 percent of its risk-weighted assets based on second quarter 2008 financial information. In this regard, City National's risk-weighted assets were \$13,193,308,000 as of the end of the second quarter. Three percent of that amount equaled \$395,799,000, which was \$4,201,000 less than City National's requested amount of \$400,000,000.

In its recommendation for approval, OCC stated that consistent with application guidelines, the second-quarter information had been updated by City National to include events that occurred after quarter-end. According to OCC, the updated information indicated that 3 percent of City National's risk-weighted assets as of the end

³ Form 10-Q is a quarterly report required by the Securities and Exchange Commission that includes unaudited financial statements and provides a view of the company's financial position during the year. The report must be filed for each of the first three quarters of the company's fiscal year.

of the third quarter exceeded its requested amount of \$400 million, and therefore, within the maximum amount allowed.

City National received preliminary approval from the TARP Investment Committee that same day, pending verification that the requested amount of \$400 million was within program requirements. In an e-mail dated November 12, 2008, the Federal Reserve Board informed OFS that the requested amount of \$400 million was within 3 percent of City National's total risk-weighted assets as reported to the Federal Reserve Board on the holding company's third-quarter FR Y9-C form.⁴ On November 21, 2008, City National received \$400 million of CPP funds through a Treasury purchase of preferred stock with warrants.

We assessed the process and controls associated with OCC's review and recommendation to OFS and the TARP Investment Committee's preliminary recommendation of approval and the Interim Assistant Secretary for Financial Stability's subsequent final approval for City National to receive CPP funding. At the time the corporation received preliminary approval, only limited policies and procedures relating to the review, approval, and timing of the receipt of the funds were in place. We determined that in the case of City National, OCC and CPP management followed the policies and procedures at the time of review and approval.

Subsequent Events and Changes to CPP

The American Recovery and Reinvestment Act of 2009

CPP has remained largely the same since its inception, with the most significant exception being the changes made as a result of the American Recovery and Reinvestment Act of 2009 (Recovery Act) enacted February 17, 2009. In this regard, the Recovery Act,

⁴ Bank holding companies with total consolidated assets of \$500 million or more are required to file FR Y-9C reports with the Federal Reserve Board quarterly. In addition, other bank holding companies meeting certain criteria may be required to file this report, regardless of size. FR Y-9C reports collect basic financial data from domestic bank holding companies on a consolidated basis in the form of a balance sheet, an income statement, and detailed supporting schedules, including a schedule of off-balance-sheet items. The information is used to assess and monitor the financial condition of bank holding company organizations, which may include parent, bank, and nonbank entities.

Section 7001, amended Section 111 of EESA to impose more stringent rules on executive compensation. Additionally, under the original terms of CPP established by Treasury, banks were prohibited from repaying funds received for the first 3 years unless they completed a qualified equity offering. With the provisions introduced by the Recovery Act, once an institution notifies Treasury that it wants to repay the CPP investment, Treasury must permit the institution to repay subject to consultation with its federal banking supervisor.

Monthly Reporting on Lending Activity by City National

CPP recipients are now directed by Treasury to report monthly on lending data that can be used as an indication of the impact the TARP funds are having on the institution and consumers. Treasury also intends to provide quarterly reports that will illustrate balance sheet changes for all CPP recipients to help taxpayers easily assess lending and other activities of banks receiving Government investments. According to OFS, these reports do not specifically provide data on the use of TARP funds; however, they do increase transparency and accountability for the financial institutions.

Through the CPP Monthly Lending Reports published on OFS's website, FinancialStability.gov, Treasury reports the monthly lending data collected from CPP recipients. This data includes the average consumer loans outstanding, average commercial loans outstanding and total loans outstanding at month end.⁵ The monthly lending report data for City National Bank through April 2009 appear in Table 1 below.

⁵ The category Consumer Loans generally includes loans used for personal, family, or household uses including residential mortgages, home equity, credit card, and other consumer loans such as auto, student loans, and other consumer loans. The category Commercial Loans generally includes loans for commercial and industrial purposes to sole proprietorships, partnerships, corporations, and other business enterprises, whether secured or unsecured, single payment, or installment. They also include loans to individuals for commercial, industrial, and professional purposes, but not for investment or personal expenditure purposes. These loans generally include commercial and industrial, small business and commercial real estate.

Table 1: City National Bank's Monthly Lending Activity (in millions)

	Average Consumer Loans	Average Commercial Loans	Total Loans
February-2009	\$4,198	\$8,232	\$12,430
March-2009	\$4,207	\$8,158	\$12,366
April-2009	\$4,268	\$8,067	\$12,335

Source: CPP Monthly Lending Reports February, March and April 2009

City National Bank's monthly lending reports indicated that it continued to originate, refinance and renew loans in the consumer lending area, while commercial lending decreased. It is important to note, however, the data reported so far is for a very limited period (3 months as of the end of our fieldwork). Treasury's Monthly Lending and Intermediation Snapshot Report, which collects similar data from the top 21 financial institutions who received TARP funds, also reported a similar decline in commercial lending by those institutions. According to Treasury's analysis, the decrease is mainly because the banks focused on preserving liquidity, strengthening their balance sheets, and paying down existing debt rather than taking on new debt.

City National's Announced Intention to Repay Treasury

On May 4, 2009, City National announced a public offering to sell approximately 2.7 million shares priced the following day at \$39 a share. According to the press release, City National intended to use proceeds from the offering toward the redemption of preferred stock and the repurchase of warrants sold to Treasury as part of CPP. The offering raised about \$100 million. As of the date of this report, City National has not applied to Treasury to return the money, and has not publicly announced a timetable for the submission of its application.

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The major contributors to this report were Susan Barron, Audit Director, and Lisa DeAngelis, Senior Auditor. We appreciate the courtesies and cooperation provided to our staff. If you wish to discuss this report, you may contact me at (202) 927-5400.

Marla A. Freedman
Assistant Inspector General for Audit

The purpose of our work was to (1) provide a case study of the approval process used by Treasury for allowing City National's participation in CPP and (2) determine the controls in place to ensure the approval of this financial institution was consistent with TARP objectives.

To meet our objectives, we

- reviewed the Emergency Economic Stabilization Act (EESA), and amendments to EESA by the American Recovery and Reinvestment Act of 2009, and applicable guidance on CPP;
- documented the process for reviewing and approving applications requesting CPP funding;
- discussed with Office of Comptroller of the Currency (OCC) and CPP officials the methodology for review, recommendation, and approval of City National to receive CPP funding;
- reviewed the application, case file decision memorandum, and correspondence relating to the review and approval of City National;
- reviewed a sample of other case files for comparison and analysis of the City National case decision;
- reviewed public financial and performance reports filed by City National and other financial institutions, and public releases by City National.

We performed our work from December 2008 to June 2009.

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.

Section 101 of the Emergency Economic Stabilization Act (EESA) authorized the Secretary of the Treasury to establish the Troubled Asset Relief Program (TARP) to purchase, and to make and fund commitments to purchase troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with EESA and the policies and procedures developed and published by the Secretary. Using this authority, on October 14, 2008, Treasury announced a voluntary Capital Purchase Program (CPP) under which Treasury could purchase senior preferred shares, on standardized terms, of financial institutions. The application deadline for publicly-held institutions was November 14, 2008, the deadline for applications from eligible privately-held financial institutions was December 8, 2008, the deadline for S-corporations was February 13, 2009, and the deadline for small institutions with assets less than \$500 million is November 21, 2009.⁶ The deadline for mutual holding companies was May 7, 2009; for mutual banks, the deadline was May 14, 2009.

For publicly-held institutions, such as City National, the minimum amount of senior preferred stock available for purchase from a participating institution was 1 percent of its risk-weighted assets.⁷ The maximum amount was the lesser of \$25 billion or 3 percent of risk-weighted assets. The senior preferred shares pay to the federal government a cumulative dividend rate of 5 percent per annum for the first 5 years and reset to a rate of 9 percent per annum after year 5.

The financial institution must meet certain criteria to qualify for participation in CPP. These criteria include meeting certain regulatory ratio requirements and obtaining a recommendation from the institution's regulatory agency. Upon review of the application by Treasury, each institution is assigned to one of the following categories:

⁶ Small institutions may apply for CPP assistance up to 5 percent of their risk-weighted assets.

⁷ Risk-weighted assets are rated by risk to establish the minimum amount of capital that is required within institutions. Institutions whose portfolios hold more risk require more capital.

Category 1 – Presumptive approval

For presumptive approval, an institution must meet one of the following criteria:

- Have a composite CAMELS⁸ rating of 1
- Have a composite CAMELS rating of 2 for the most recent examination which is no more than 6 months old
- Have a composite CAMELS rating of 2 or 3 for the most recent examination which is more than 6 months old and have acceptable performance ratings as follows: Classified Assets/Net Tier 1 Capital plus Allowance for Loan and Lease Losses (ALLL)⁹ ratio less than 100 percent; Non-Performing Loans plus Other Real Estate Owned/Net Tier 1 Capital plus ALLL ratio less than 40 percent; Construction Development Loans/Total Risk-Based Capital¹⁰ ratio less 300 percent; and a Community Reinvestment Act (CRA)¹¹ rating of at least satisfactory.

⁸ CAMELS refers to the Uniform Financial Institutions Rating System (UFIRS) adopted by the Federal Financial Institutions Examination Council in November 1979. UFIRS takes into consideration certain financial, managerial, and compliance factors that are common to all institutions. Under UFIRS, each financial institution is assigned, by a regulator, a composite CAMELS rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern.

⁹ ALLL is an estimate of uncollectible amounts that is used to reduce the book value of a bank's loan and lease portfolio to the amount that is expected to be collected.

¹⁰ Total Risk-Based Capital represents the amount of capital based on an assessment of credit risks that a company should hold to protect it against adverse developments. The formula is Total Capital (Tier 1 and Tier 2 capital)/Risk-Adjusted Assets. For an institution to be deemed well-capitalized under the provisions of Prompt Corrective Action (12 CFR 6.4), its total risk-based capital ratio must be 10 percent or greater.

¹¹ CRA is a law designed to encourage commercial banks and savings associations to meet the needs of borrowers in all segments of their communities, including low- and moderate-income neighborhoods. It requires regulated financial institutions to meet the credit needs of the local communities in which they are chartered, consistent with safe and sound operation. Accordingly, regulators, among other things, periodically examine financial institutions under their supervision for CRA compliance and consider this information when approving applications for new bank branches or for mergers and acquisitions.

Category 2—Presumptive CPP Council review

An institution's application for participation must be forwarded to the CPP Council for further review if the institution meets the following criteria:

- Has a composite CAMELS rating of 2 for the most recent examination which is more than 6 months old and has overall unacceptable performance ratios, as described above
- Has a composite CAMELS rating of 3 and has overall unacceptable performance ratios, as described above

The CPP Council consists of representatives from the four primary federal banking agencies (Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision, Federal Deposit Insurance Corporation, and Board of Governors of the Federal Reserve System), with Treasury officials as observers.

Category 3—Presumptive denial

An institution is presumptively denied if it received a composite CAMELS rating of 4 or 5 for the most recent examination.

Review and Approval for CPP Participation

At the time that City National Corporation was being considered for participation in CPP, interested financial institutions were required to submit their application requesting CPP funding to their federal

banking agency.¹² The agency, in this case OCC, analyzed the application using standard review procedures and made recommendations to Treasury's Office of Financial Stability (OFS) as to whether the request should be approved. If the agency recommends the institution for receipt of funds, it would forward the application and recommendation to OFS. If the agency were to determine that the institution is not eligible for CPP funding, it would suggest that the institution withdraw its application. If an institution is a category 2 or 3 and the agency wants to recommend approval or is unclear whether an institution should be approved, the agency would forward the application and standard forms to the CPP Council¹³ for further review. For Category 2 institutions, the CPP Council evaluates the viability of institutions applying for CPP funding. After the CPP Council reviews an application for CPP participation, it forwards its recommendation with a supporting decision memorandum and forms to OFS.

Upon receipt of a recommendation and supporting documentation from the federal banking agency or CPP Council, OFS reviews the documents for completeness and forwards them to the Chief Investment Officer and Chief Compliance Officer for Treasury's OFS. All applications are forwarded for review by Treasury's TARP Investment Committee for preliminary approval and allocation.

The TARP Investment Committee serves as an advisory body to the Assistant Secretary for Financial Stability. Investment Committee recommendations are by majority vote. Committee membership consists of the Assistant Secretary for Financial Stability; Assistant Secretary for Financial Institutions, Assistant Secretary for Financial Markets, Assistant Secretary for Economic Policy, and Chief Investment Officer for OFS, or their designees.

¹² The Federal Reserve Board is the primary regulator for City National Corporation, the holding company for City National Bank. City National Bank's primary regulator is OCC. The application for participation in CPP was forwarded to OCC for review because the majority of the holding company's assets are held by City National Bank.

¹³ The CPP Council serves as an advisory body to Treasury to ensure that the guidelines governing acceptance of institutions into CPP are applied effectively and consistently. Specifically, the CPP Council provides recommendations to Treasury on institutions whose condition or supervisory records pose exceptions or unique issues with respect to the participation guidelines set forth by Treasury and regulatory agencies. To help ensure objectivity, the CPP Council consists of one representative from each of the primary federal banking agencies.

The TARP Investment Committee assesses the overall strength and viability of institutions without considering potential funds received under CPP. The committee gives considerable weight to the federal banking agency and CPP Council recommendations as set forth in the case memoranda. In addition, the following factors are considered: (1) the existence of a bona fide merger agreement involving the financial institution, (2) a confirmed equity investment in the institution, and (3) whether the institution has been particularly adversely affected by write-downs of preferred stock in a government-sponsored enterprise (e.g., Fannie Mae, Freddie Mac). An applicant qualifying as a Category 2 or 3 institution will still be considered for participation in CPP if they are affected by any, or all, of these factors. If the committee decides to recommend preliminary approval for an institution to receive CPP funding, the OFS staff communicates Treasury's preliminary decision to the applicant and the regulatory agency. Investment Committee recommendations are recorded in meeting minutes and are also filed by CPP staff.

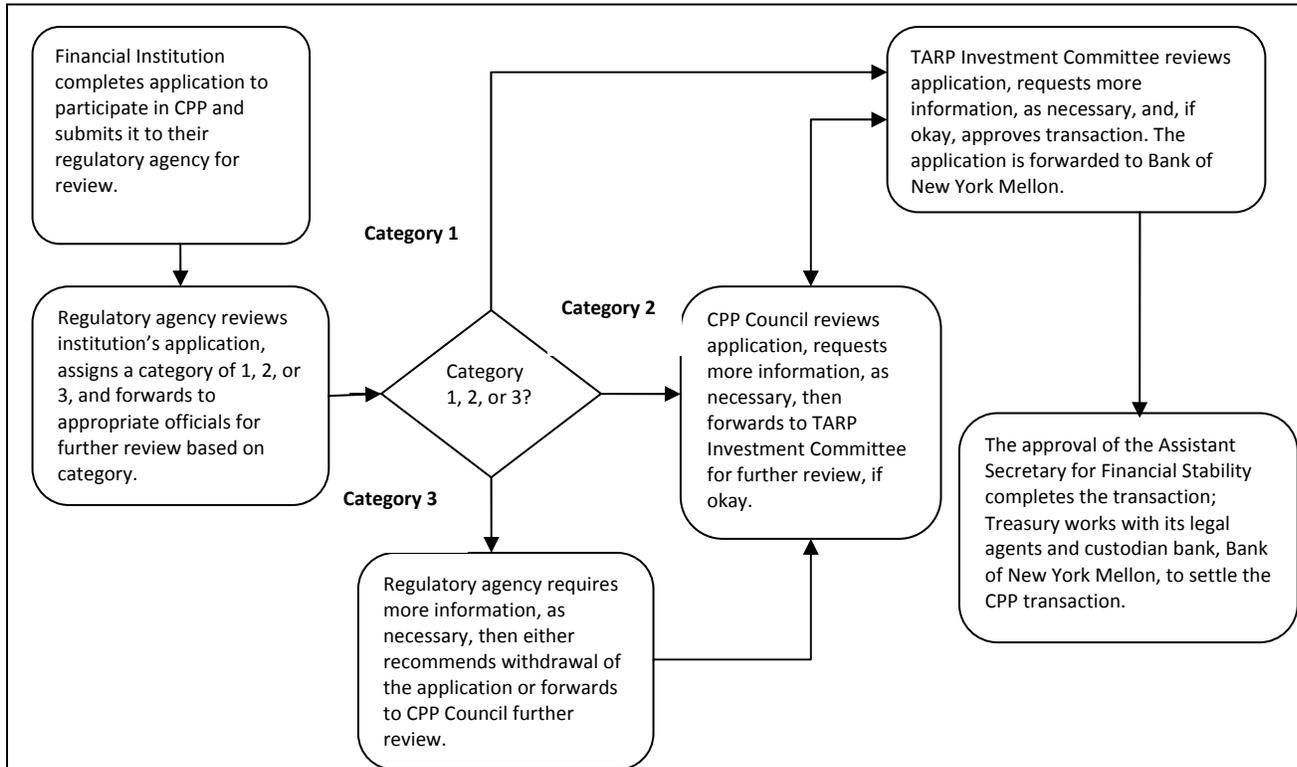
Final acceptance occurs when the institution submits the required documentation to Treasury, the applicable transaction closes, and the Assistant Secretary for Financial Stability signs the documents. In a December 2008 interview, a TARP official told us that no procedures were in place to determine the order in which institutions receive CPP funding. In practice, the order has been determined by when an institution provides all its required documentation after its application has been preliminarily approved. If the financial institution receives final approval, OFS coordinates with its custodian, the Bank of New York Mellon, to disburse funds and receive securities. In addition, the Bank of New York Mellon serves as the collection agents for dividend payments.¹⁴

The steps for processing and acceptance of applications under CPP are depicted in Figure 1 on the following page.

¹⁴ On October 14, 2008, Treasury announced the selection of Bank of New York Mellon as its custodian for TARP as authorized by EESA. The bank is to provide the accounting of records, hold all cash and assets, provide pricing and asset valuation services, and assist with other related services.

Appendix 2
Program Requirements

Figure 1: CPP Process



Note: We reviewed the CPP application procedures very early in the development of the policies and procedures for the CPP. Subsequent to the completion of our fieldwork more procedures have been added to enhance the process. One of those procedures is a CPP staff review of applications before presentation to the TARP Investment Committee. This step is not shown in the Figure above as it was not in place during our fieldwork.

Appendix 3
Management Response



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 19, 2009

Ms. Marla Freedman
Assistant Inspector General for Audits
Department of the Treasury, Office of Inspector General
740 15th Street, N.W. Suite 600
Washington, D.C. 20220

Dear Ms. Freedman:

This letter provides the Office of Financial Stability's (OFS) official comment on the case study your office recently completed on City National Corporation's approval to access Troubled Asset Relief Program (TARP) funds through OFS's Capital Purchase Program (CPP).

OFS agrees with the findings in this case study which, after careful consideration of the facts, concluded that the Office of the Comptroller of the Currency (OCC) and Treasury management followed the policies and procedures in place at the time City National Bank was approved for CPP investment.

The case study review documents the flow of information between City National Bank and its federal regulator, the OCC, which reviewed the City National Bank application and prepared the case decision memorandum recommending approval to receive CPP investment. In addition, the case study examines the TARP Investment Committee's role in verifying that lenders' requested investment amounts adhere to program requirements.

Further, the case study examines the subsequent events and changes to the CPP following the City National Bank investment including passage of The American Recovery and Reinvestment Act of 2009 which amended Section 111 of the Emergency Economic Stabilization Act of 2008 (EESA), which imposed more stringent rules on executive compensation.

While the process in place during the first days of the CPP was certainly adequate, OFS swiftly worked to build additional controls around the processing of CPP applications, and is pleased to note that the process is now enhanced by additional layers of review, which have been in place since November 2008. OFS continues to promote financial stability through the CPP and directs CPP participants to report monthly on lending data that can be used as an indication of the impact the TARP funds are having on the availability of credit and taxpayers.

The enhanced transparency this case study brings to the CPP's approval process is appreciated. OFS looks forward to working with Treasury's Office of Inspector General to further improve TARP programs.

Sincerely,

Herbert M. Allison, Jr.
Assistant Secretary for Financial Stability

Department of the Treasury

Deputy Secretary
Assistant Secretary for Financial Stability
Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control
Special Inspector General for the Troubled Asset Relief Program

Office of the Comptroller of the Currency

Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner