TO: Charles Taylor

FROM: Richard Rumley

DATE: July 16, 2003

RE: Metropolitan Mortgage

This report summarizes my findings and recommendations resulting from my visit with Metropolitan Mortgage and Securities Co., Inc. ("Metro") on July 13 – 15, 2003.

At the request of Mr. Charles Taylor and the management of Metro, I was retained to conduct a limited analysis of the underwriting, production and administrative processes associated with the origination and retention of Metro's commercial real estate investment portfolio. During the assignment I met briefly with each of the following individuals:

Nobu Hara, V.P. Human Resources
Andy Belew, Mgr. REO
Greg Liegy, Mgr. Workout
Paul Sandifur, CEO and President
Erik Skaggs, V.P. Market Development
Gregg Weed, Mgr. Commercial Lending
Dan Geittman, Underwriting
Elaine Hoskin, C.O.O and Risk Management
Tom Sackman
Mike Agostinelli, General Counsel
Jim Lehr, Mgr. underwriting

Every one with whom I met was most courteous and seemingly candid. All appeared sufficiently knowledgeable within their sphere of responsibility and were willing to express their frustrations and satisfactions with issues that materially impacted or influenced their effectiveness and contributions. Notwithstanding this, not having time to become intimately acquainted with the performance history of each person, I am not able to conclude if I was being fed rhetoric or if each were truly contributing to the best of their abilities. One senior individual volunteered that it was his assessment that within the company there is generally a lot of talk but little results. In any event, I was able to get a sense of the perceivable problems that each of the participants felt were lurking within the corporate body.

Metro has been experiencing a steady increase in problem loans associated with it's commercial real estate loan portfolio and is determined to identify and rectify the problems. On a go-forward basis, they want to enhance product quality and underwriting standards. In identifying the key problem areas associated with the existing portfolio, the problem loan portfolio manager essentially narrowed it down to poor underwriting execution. This included poor project feasibility and economic analysis, poor borrower financial and expertise scrutiny, lack of market studies, and lack of product knowledge by the originator and underwriter. The portfolio mix currently administered by the workout group consists, in essentially equal portions, of land, multifamily, mixed commercial, and hospitality properties.

The company originates commercial real estate loans as a part of the investment portfolio for its insurance company operations. Metro prides itself as a niche lender specializing in difficult, higher risk, (less than "A" rated) credits in turn for greater yields. They do not consider themselves as being in the same competitive arena with conventional financial institutions and traditional insurance companies – nor do they want to be. Higher risk credits include all type land loans, and bridge type loans on under performing income type properties such as multifamily and hospitality properties. They also advertise and attempt to provide rapid closing services as an inducement to capture a greater client population. This practice, too, can prove to be a gateway to underwriting sloppiness if unwarranted pressures are applied. Added to this, I have been told that from time to time, closing contingencies have been waived, modified, or even ignored in order to facilitate a closing deadline. No mention was made of the materiality aspects of such actions.

During the interview process another common "industry normal" complaint was aired. Aggressive production goals are periodically imposed on originating staff which they indicate preclude their ability to provide careful analysis. On the other side, handling such volume can often be beyond the available resources of the underwriting and support staffs. Again, this compounds the loan quality problem since Metro's assets are inherently more risky than Class "A" credits, thus greater attention to underwriting and loan structure issues should be given. Both production and underwriting personnel have mentioned that they are often under pressure from the company's leaders to meet the company's financial targets.

Loan production staff are compensated 100% on a commission basis with remuneration tied to the fee and the interest rate spread they are able to negotiate. The minimum acceptable pricing is 2 points and a 12% annual rate. The concept of pricing vs. risk is not understood. Pricing is whatever the loan originator can negotiate. This practice is not conducive to building long term customer relationships. I would like to see the company build a flexible pricing model that reflects loan quality issues.

I made no assessment of the skills, experiences, and qualifications of origination personnel nor did I evaluate their abilities to understand and structure acceptable loan opportunities. Typically, purely commissioned staff fail to represent their employer/client with utmost dedication. They are driven to produce volume and income rather than insure quality. They have no account responsibility after the loan is booked. Likewise, often this type individual does not have the necessary underwriting background and loan structure knowledge to be an effective and responsible originator. *I would consider revising the compensation package to encourage loan quality and performance and employer loyalty while still providing favorable compensation incentives. More back-end incentives could be introduced which would be tied to loan performance and job stability.*

There is a communication divide between the loan production staff and the underwriters which appear to be caused by the absence of well formulated and published underwriting guidelines. Loan officers are pressured to produce product which can provide yield objectives, meaning higher risk credits, while the underwriters are often at a loss or unsure of how to structure these credits. It is my understanding that standing teams have been recently formed composed of a loan originator and two underwriters who jointly work on credits. This was introduced to improve trust and efficiency between the two staffs. The potential problem here is that the particular credit being evaluated by a team may be so complex that it is beyond their individual abilities to comprehend, analyze, and structure properly. It could be that an underwriter assigned to a different team may be more qualified to participate in the evaluation.

I discussed the present underwriting process with Mr. Lehr. In my opinion, their procedures are fully acceptable. If the procedures are adhered to faithfully, and assuming qualified staff are assigned to the credit, and assuming the underwriter's possess the ability to arrive at a supportable conclusion, acceptable credits should be able to be produced.

There is also an obvious and recognized communication breakdown between loan servicing and problem loan administration. Problem loans have not been identified or addressed until they have reached 90 days past due. Because of this, ideal work out solutions are often unattainable. I have been informed that this deficiency is being addressed, initially by an outside servicing and asset management source.

Since the lending business model focuses on collateral value rather than cash flow, having confidence in the appraiser to assign a supportable value is paramount. I have been informed that Metro's in-house appraisal staff is quite competent and employ a panel of qualified appraisers outside the Spokane area. I was also informed that Metro has a competent inspection team who evaluate construction progress and funds disbursement. I have been further informed that Metro employs qualified in-house entitlement and environmental professionals.

I did not get the opportunity to review, in depth, loan presentation packages that have been submitted to the loan committee for decision. The one I did review, however, I considered inadequate. Although the package was presented in the new format, the final presentation was more form than substance. For example, no analysis or conclusions were made of critical elements that a decision maker should know such as borrower capacity or exit strategies. It <u>appeared</u> to me that the loan officer and underwriter had little understanding of the transaction or did not have the capability to assess and distill financial and property data.

RECOMMENDATIONS

Issues to be addressed immediately:

- Conduct an independent portfolio review of selected booked credits to evaluate the affects of current underwriting policies as they pertain to property and borrower profiles. Process should include a complete file review of financials, sponsor competency, appraisal, approval conditions, and project feasibility. The review process should also include verbal interviews with origination, underwriting, legal, and appraisal staff when deemed necessary and if the participating individuals are still available.

- Develop written underwriting policies and procedures that pertain to the company's business model. These will be structured as flexible guidelines rather than absolute declarations. Areas covered will include (but not be limited to):
  Loan types
  Borrower profile –financial
  Borrower profile – expertise
  Borrower profile -- legal
  Yield and pricing expectations
  Advance rates
  Property guidelines
  Loan terms
  Valuation requirements
  Documentation requirements
  Disbursement procedure and requirements
  Geographic location
  Borrower concentrations
  Product concentration
  Location concentrations
  Contractor profiles
  Environmental issues
  Title requirements
  Payment schedule

  Management, production and underwriting staff will all be given the opportunity to provide input to the process.
- Metro needs to implement a process to focus on the following issues:
  - Identify potential problem loans prior to their reaching 90 day delinquency.
  - Assign ownership of the loan to a qualified individual for follow-up. Provide guidelines of authority for permitted unilateral actions and process for committee decision. Identify committee level authorities.
  - Process for transferring credits to workout group if loan reaches 90 past due, bankruptcy or judgment filings, or other "permanent" impairment possibilities have been identified
  - Review reserve and loss analysis
  - Initiate a tracking and reporting system for management information
  - Prepare necessary forms to accomplish the above.

- Form a loan review department who's responsibility would be to
  - Validate underwriting consistency to policy standards
  - Validate documentation sufficiency and accuracy
  - Validate adherence to approval conditions
  - Assign an in-house loan grade which would assess credit risk AND establish the frequency of the follow-up review cycle. e.g. A marginal credit may be selected to be re-examined every 6 to 12 months where an "exceptional" credit may be re-examined every 2 to 3 years.