

and the sales-projections. Land loans especially are susceptible to default events because of their nature and position within the over-all development cycle. If development and entitlement objectives or markets are uncooperative, or if the developer lacks essential expertise or is overly optimistic, the viability of the project can be placed in serious jeopardy. These are the predominant loan products being originated at Metro, but the Company is not doing a good job at this.

As an off-set to weak financial strength, the loans should provide for interest and carrying reserves plus have assurances that any development and entitlement expenses are covered by loan proceeds or first-in equity contributions. Cash out transactions should be discouraged unless the project is adequately funded to cover all hard and soft costs.

UNDERWRITING COMMENTS

I want to address some specific underwriting issues found consistently throughout my review. It is possible that many of these issues were considered and discussed but not captured in writing for file documentation.

Lack of validity of the stated exit strategy

No validation of the ability to be able to achieve the exit strategy at all much less within the allotted loan term. Stated exit strategies were "sale", "refinance", "construction loan", etc. No support for how or when the exit process would or could occur.

Lack of financial analysis discussion based on loan purpose

Consistent throughout my review was the absence of analysis of how debt service was to be handled. Although financial statements were in the file, no critical financial analyses were ever found. In my opinion, after reviewing the financial statements and tax returns that were included in the files, the financial strength of the many of the borrower's was obviously inadequate to meet anticipated debt service or potential development shortfall demands based on the loan's purpose and structure. In other instances I was uncertain about the borrower's financial capacity and would have needed to have direct contact with the borrower to clarify my questions. During my review I discovered that it is not uncommon for loan officers never to have direct contact with their borrowers, and thus not be privy to essential character and financial information.

Interest reserves not sufficient to cover the entire loan term.

Unless the borrower can demonstrate unqualified financial strength, an interest reserve account should be established in any development type loan and should be in a sufficient amount to carry project debt service requirements until reasonable expectation that the project will commence generating sufficient cash flow, or be refinanced, or be sold. A borrower's alternative or independent cash flow sources must be identified, validated, and discussed. I found in many instances, no reserve accounts were established or insufficient reserves were established. An example of the latter case was a loan with a 24 month term and a 12 month reserve account. The reserve account was established with no identifiable support that the project (1) could be in a marketable or refinanceable state within 12 months, (2) that the project could be sold or cash

The **first** is the monitoring function typically assigned to a Loan Service Department or to a Construction Disbursement / Administration Department.

Loan Service is normally charged with monitoring loans for payment collection, tax liens, insurance continuity, notification issues, and when applicable, compliance with loan covenants and condition such as collection of interim financial statements, collection of rent rolls, sales and leasing reports, etc. These are usually fully disbursed loans where no development activity is being funded by the loan proceeds.

When the loan is for the development and construction of land or structure improvements and where funds have been withheld for completion of the improvements, the lender must establish a formalized disbursement and inspection program. This form of servicing and project monitoring is generally handled by specialized personnel outside the "normal" loan servicing functions.

I did not form any definitive opinion as to the sufficiency of these operations since this was not within the scope of my assignment.

The **second** type of monitoring obligation is that typically administered by an account officer as an extension of the original loan approval. Where loans for projects undergoing transition or where certain future achievement expectations were identified during the original underwriting phase, the account officer should be in regular contact with the borrower to see if the project is on track, the anticipated achievement milestones were reached, and if the original exit expectations remain valid. Metro fails to have this level of follow up monitoring in place.

In several instances I contacted the originating loan officers who were still with the company about the current condition of certain loans where defined expectations were originally delineated and on which certain underwriting assumptions were based. In one instance there was to be a sale of the property in August 2003. The loan officer could not give me the current status of this transactions and further informed me that such follow up is traditionally not his responsibility. This attitude is not unique within this group and is supported by their manager.

No interim follow up is conducted if loan payments are current. All loans that I reviewed are, by their nature, in need of some level of periodic follow-up by qualified loan staff, not by typical loan servicing personnel. Short term land loans and development loans, especially those undergoing an entitlement process or some level of property enhancement need to be discussed with the borrower on a regular schedule. Questions regarding the entitlement status, marketing and sales efforts, local market events or any other matters that would have an effect on the loan's performance should be evaluated. This is especially critical if origination assumptions were based on some milestone performance expectation. An impediment to this is the fact that loan officers are not compelled to initiate or maintain communication with the party responsible for the success or

failure of the project and for the repayment of the loan. In summary, loan officers are not charged with the responsibility for the credits that they originate

In a typical financial institution where loans are offered, loan officers are traditionally the primary contact with the borrower. A professional loan officer would be involved with the loan from its inception to its payoff. This is especially evident with short term, volatile loans. It would not be expected that a loan officer maintain permanent contact with a borrower connected with a long term, 10 to 30 year amortizing type loan. Within your industry, however, major insurance companies with real estate loan portfolios do make periodic project inspections and require periodic operating reports, financial statements, rent rolls, etc. throughout the life of loan.

EARLY WARNING PROCESS

As a part of the over-all Monitoring process, I highly recommend that Metro establish an "Early Warning Committee" to monitor performing loans currently on the books that may have inherent characteristics for potential default such as impending maturity dates or depleting interest reserves. Please refer to ATTACHMENT 2 for further information.

OTHER IMPEDIMENTS TO QUALITY PORTFOLIO DEVELOPMENT AND LOAN ADMINISTRATION

Major issue is the Corporate Culture.

Most individuals with whom I talked indicated frustration with the lack of direction from superior authorities.

Of great concern were comments made to me and practices in place that reflect attitudes and obstacles preventing the establishment of a quality loan portfolio.

For example, listed below are a sample of comments about the organizational structure, corporate culture and other matters that impact the origination and administration of the commercial real estate portfolio.

Loan Officers - comments

Must do higher risk transactions or we can't do business

We are niche lenders, we offer opportunities normally not available through conventional sources

"Lend to own philosophy" – expect REO to bail us out

Our principal relationships are with our broker contacts not the borrower

We have never met our borrowers

It has not been emphasized about maintaining contact with the borrower or following up on the projects

We have no clear direction of what we can originate

We would welcome guidelines in which to operate

Too restrictive policies and guidelines might impact our market niche

Loan officers indicated that they recognize the weakness of the borrower to develop and perform but their philosophy is that since our "recovery" rate is high and since we are perceived as collateral lenders, liquidation of collateral should bail us out.

The fallacy of this comment has not been relayed to origination staff. REO reports that the loss rate is about 12-13% on REO/foreclosed properties although development projects generally show profits.

Comments about loan officers:

Hesitant to disclose all known facts to underwriters and management especially negative ones? Fear of losing commission if loan is rejected

Underwriter's - comments

Afraid that speaking up in a public environment will be an act of insubordination

May lose job, not many alternative employment opportunities in Spokane

Told to keep our head down and keep a low profile

Pressure to support credits and over-look flaws

No definitive underwriting direction

Need greater authority (some suggested absolute authority to reject - I do not support this approach)

REO - Comments about current foreclosure portfolio.

Problems generally caused by inexperienced developers who do not understand the entitlement process.

More speculators than professional developers. Expect to quick flip property rather than develop

Developers do not have the financial capacity to ride the development process through to sale

Most projects are premature by two to three years

Major problems with the foreclosure portfolio - 12-13% loss factor. Loss attributed to high basis because of added accruals. May recover all or majority of original principal but not yet analyzed.

Over-all recovery is because of success of development portfolio.

Flexible pricing needed

Some level of flexible pricing should be provided to attract lower risk credits. Pricing would be based on risk assessment. Nothing would prevent loan officers from negotiating higher yields.

Default interest and exit fees

Default interest rates, late charges and other reasonable penalty assessments are standard in the lending industry. However, the levels charged by Metro plus the magnitude of exit fees often assessed are deterrents to obtaining reasonable loan opportunities from acceptable borrowers. At the back-end, these fees and rates certainly discourage the ability to develop reasonable work out solutions where the borrower may have the ability to contribute additional equity for a forbearance or other temporary relief provided he has expectations of participating in the value added created by his sweat and financial support.

Exit fees may be appropriate where favorable pricing is offered to a good borrower with a quality project and Metro wants to participate in the potential upside. This may be perceived as an equity kicker with a reasonable expectation of collection.

Origination sourcing

Because of production goals and the necessity to explore geographic locations outside of Spokane and other local communities to achieve production goals, loan officers rely on the national mortgage broker community for their leads. In fact, they rely so heavily on the broker for product to where the loan officers admittedly pledge their principal allegiance to the outside broker rather than the welfare of borrower. As stated earlier, our loan officers seldom meet the borrower. They rely on the broker to maintain the liaison between Metro and the borrower. This places in question the quality of the loans the Company examines and represents a potential impediment to originating a quality loan. There is no reason the broker can not be protected while allowing unfettered access to the borrower. I understand too that some brokers are not located in the same community as the borrower or project. This further exacerbates the problem.

FINAL THOUGHTS

Quality loan products are not being generated because there is insufficient corporate directive to produce such loans. The perceived mission is to generate volume.

It was brought to my attention that in the past management directive was to increase production goals. In order to meet the higher volume expectations, managers were directed to employ sufficient staff to meet the anticipated increase in work load. The outcome was apparently not successful. Was this a question of the inability to identify suitable credits or were there internal

organizational and infrastructure issues which prevented credits from proceeding through the internal pipeline?

Line management is not emphasizing quality nor setting standards for its staff. There is lack of direction from senior management and the inability of line management to focus on a common goal. Loan production and underwriting are independent functions, under separate management, and operating under separate missions. There is a continuing struggle between the two staffs because each consider the other as impediments to accomplishing their respective goals. Communication is often lacking and when it does occur, is generally contentious.

Loan officers are not accountable for quality of the product they originate. They are agents taking orders from other brokers whose loyalties are with each other rather than the lender or borrower. Once the loan opportunities arrive in-house, they are then delivered to underwriters who are expected to underwrite and structure the credit, rather than the loan officer.

Underwriters are under pressure to support credits. If serious objections to loan quality are raised, the underwriters feel they must capitulate or be considered insubordinate, or not be considered as a team player.

There are often ways to underwrite around the challenging type credits so frequently presented to Metro for its consideration and which comprise a significant portion of the Company's current portfolio. However, these creative and risk mitigating elements were not evident in the credits I examined.

There is no question that some loan "opportunities" are totally unacceptable and no amount of underwriting creativeness could correct the deficiencies. I found such instances in the 2002 portfolio. Loan officers should identify and eliminate these situations immediately and not wait for the underwriters to become involved.

Of a more sensitive nature, I would question the capability of some of the production and underwriting staff to be able to achieve desired portfolio results. This opinion is ONLY based on my cursory observations and reinforced by comments freely expressed to me by other staff members, whose agenda I am unaware. Some production and underwriting staff are undoubtedly fully capable of originating and underwriting solid credits within Metro's environment. Some are not and should be identified.

Underwriting staff is very eclectic offering a wide range of backgrounds and experiences. Their skills are very essential and should be sought when specialized expertise is called upon (i.e. valuation, entitlement, credit, development, etc.) to analyze unique situations inherent in the specific credit. What I question are their individual abilities and understanding of real estate credits in a corporate lending environment, and the level of comprehensive and innate real estate underwriting

skills required to be an indispensable resource to the production staff in recognizing, underwriting and structuring sound credits.

A product mix evaluation should be conducted. Heavy concentration in land loans is evident. Management must make it clear that other commercial loan types are acceptable. The completion and adoption of formal written loan policies and underwriting guidelines will go far in communicating this fact.

Provided Metro is not concerned about its non-performing portfolio and has other resources to provide operating cash flow, the current philosophy of lending against collateral value and viewing liquidation of collateral as the PRIMARY source of repayment is supportable. To make this work the advance margins must be low, valuation assumptions must be well supported, the project must exhibit a good feasibility rating, the intended development process must be completed, and the property must be readily marketable upon conclusion of the foreclosure process. To be marketable, the property must have some level of demand for its entitled use and be in a state of readiness for further development or be in a condition of becoming self supporting. If all the above are positive, Metro should be able to recover all or a significant portion of the original principal, accrued coupon interest, and reasonable costs after a reasonable foreclosure / sale process.

In many instances the properties being funded have been premature for their intended purpose. Feasibility suggests that several years will be required before sufficient demand for the property is shown.

My opinion is that Metropolitan needs to reevaluate its corporate culture, organizational structure, staffing profile, and operating procedures if it is truly committed to operating an effective Commercial Real Estate Lending business.

The Company must:

- Clearly set and communicate objectives for the portfolio quality it expects to place on its books.
- Identify the type products it considers acceptable for the portfolio.
- Develop supportable written loan and underwriting policies for the products it wants to originate
- Set standards and expectations for the production, underwriting, closing, administration, and other support staffs. Staff accountability issues must be addressed.
- Support training of key individuals who have been placed in positions in which they lack experience.
- Thoughtfully consider implementation of an organizational restructure.
- Strengthen line management
- Develop loan administrative practices and guidelines
- Develop workable loan performance reporting, and accounting systems
- Establish an internal loan review / quality analysis system

- Develop an effective early warning program
- Review loan servicing responsibilities and practices

I would expect that the new head of the real estate lending operation will address the vital operational concerns and provide solutions to enhance the quality of the portfolio, to develop effective operational and administrative process, ensure loan performance, and to resolve interpersonal issues.