

August 28, 2003

TO: C. Paul Sandifur, Jr
Chairman of the Board

FROM: Richard C. Rumley

I was retained by Metropolitan Mortgage & Securities Co. to provide consulting and advisory services to the Chairman of the Board of Directors. My specific services were to conduct an underwriting sufficiency / quality review on a selected portion of the commercial real estate loan portfolio which was originated during 2002 and to assist in the development of commercial lending loan policies and underwriting guidelines.

Review of selected 2002 originated loans

It was suggested that during 2002 several procedures or enhancements were incorporated within the underwriting process to ensure better loan quality. Metro wanted an independent validation of these effects of the process. My analysis included a complete file review, a review of the loan's purpose, a loan structure analysis based on the purpose, a review of the appraisal including value appropriateness and value assumptions, and a review of the borrower's financial capacity. I also engaged in verbal interviews with production and underwriting managers, loan officers, loan underwriters, workout specialists and REO representatives regarding their recollection of the specific loan in the review and their general thoughts about origination, credit quality, corporate culture, and organizational issues.

Twenty two loans were pulled for my review.

ASC Machine Tool	Mt. Olympus
Bevard Crossing	Multiplex
CWB Limited	Ranchero Cahill
D.W. Sivers	Resources Planning
Gordon Hakes	Rockland Group
Greenville 148	RPM III
Imperial Mixed Use	Watt/Solus Group
John Davin	Sun Costal Financial
Mathew Malouf	Trillium
Metro Phoenix	W.E. Callaghan
MRF Carbon Canyon	Young America Homes

Twelve of the loans reviewed can be classified as land transactions. The purpose of most of these loans was to facilitate the acquisition of individual parcels, or the acquisition and assemblage

of multiple land parcels, and to allow "sufficient" time to enhance the value of the property to its highest and best use. Exit strategies were never clearly defined or validated but appeared to focus on selling the master parcel to potential sub-dividers or to developers. The success of the projects were dependent on the borrower's competency to complete the entitlement process, and other permitting and mapping processes in a timely manner. As such, I tried to assess the borrower's related experience level, their financial capacity to support debt service payments during the development process should project achievement progress became derailed, and the feasibility that the product was marketable in the current environment.

Several refinance transactions were also included. Most of these were to accommodate the repayment of existing debt held by other lenders and to provide cash out to the borrower for other non project and undefined applications.

One loan was not real estate related but consisted of financing option rights to purchase and develop excess sites located adjacent to several Wyndam Hotels. Locations are high-end resort communities throughout the United States. The option rights were assigned to Metro and UCC Filings were recorded. I did not evaluate in depth the acceptability of this credit. Repayment is based solely on the financial capacity of the borrower. One partner, Watt Industries, I know well and consider a respected, experienced, and financial capable company.

In order to remain unbiased in my review, I initially did not inquire into the specific "enhancements" that were represented as being incorporated into the "underwriting" process during 2002. Subsequent to completion of my review, I did ask about the enhancements and was informed that the improvements consisted of (1) appraisal ordering procedures, (2) strengthening entitlement review process, and (3) expanding borrower background credit checking. I concur that each represents appropriate and essential strategies to aid in the safety and soundness of the lending process but none, in my estimation, reflect or solve critical underwriting issues.

In conjunction with my review I also met with work out and an REO representative to provide me with their assessments of the causes that inflated their portfolios.

Findings

Let me first preface my comments on the underwriting quality with my observation regarding the quality of the essential loan approval submission package. I found it challenging to comprehend the level of underwriting sufficiency and transaction justification due to the absence of critical supporting loan analysis documentation. Credit approval packages submitted to members of a loan committee for their decision and approval should represent the culmination of the loan analysis and loan structuring processes undertaken by the loan officer, underwriters and other team members to ensure a safe and sound loan with an acceptable level of risk. Narratives should clearly explain the purpose of the transaction, address all crucial underwriting considerations including the borrower's development plan, collateral acceptability, borrower analysis, exit strategy, and any unique and vital

details required to close and monitor this specific loan. With this in mind, the writes-ups prepared by Metro's staff are seriously deficient. From a personal perspective, after reading the work products, I questioned whether the loan officers and underwriters exhibited the essential skills and level of understanding required of lending staff to meet the goals and expectations of their company to originate and underwrite acceptable commercial real estate loans. This is only my perception but my intuition has been somewhat reinforced by verbal discussions with numerous in-house staff. I strongly recommend that the content and quality of the loan officer's written credit submissions be brought up to a minimum professional level. I have drafted a recommended format for this document which is identified as ATTACHMENT 1 to this memorandum.

I acknowledge that a more complete written format does not in itself mean that the quality of a loan will be improved, but it will remind the loan officer of the critical underwriting issues that must be discussed, clearly display the knowledge and understanding of the transaction by the loan officer, and will unquestionably permit more informed decisions during the approval phase. Management, auditors, and regulators will be able to feel more confident that the major underwriting elements were considered and evaluated and loan decisions were made with full knowledge of the essential factors. A well-constructed and complete write-up also provides a historical record to aid in subsequent loan reviews, ensuing asset management concerns (workout programs, REO), and potential future litigation matters.

Now to my conclusion regarding the underwriting sufficiency of the 2002 loans.

Based on what I found from my review of the twenty two files, Metro can expect a continuation of the upward trend in the default rate of its commercial real estate loan portfolio. Unacceptable elements present in the existing problem loan and REO portfolios are still prevalent.

The principal negative elements remain (1) the borrower's questionable ability and level of expertise to adequately perform the development or entitlement processes needed to successfully accomplish the loan's stated purpose, (2) unsupportable or unrealistic exit strategies, and (3) the borrower's lack of financial strength to support debt service after reserves are exhausted (if any were established). I also found that in connection with the majority of refinance transactions, the borrower's displayed little or no current or perceived ability to provide supplemental cash flow support to meet future debt service obligations. It was apparent that the principal source of repayment would have to be the eventual liquidation of the collateral. In some cases, the viability of the borrower remaining in business was unmistakably in question but not addressed by the loan officer in their presentation.

On a positive note, the enhancements placed into effect during 2002 with regard to appraisal and entitlement control appeared satisfactory.

I found no material problems in the valuation process and felt that the underwriting values could be supported. Because of the low lending margins, if foreclosure became necessary, Metro could probably recover the original loan amount together with reasonable holding expenses. There should be no expectation, however, of full recovery of a loan's revised carrying basis if default interest and exit fees continue to accrue.

It also appeared that proper attention is given to entitlement issues because of the contributions of your qualified in-house staff. Again, despite this attention, I could find no comments in the files regarding the ability of the borrower to successfully accomplish the entitlement process. As I will mention later, Metro generally does not follow up on the entitlement process unless funds have been withheld for entitlement expenses.

The inclusion of more thorough background credit checks as a 2002 enhancement feature is more of a procedural matter than underwriting. Greater attention was supposedly given to conducting more informed background credit, legal and criminal checks on the borrower and the related principals. This information is a matter of public record. No attention has been given to conducting a reasonable financial analysis of the borrower including contacting credit references, analyzing financial statements, evaluating alternative sources of cash flow, and tax returns. I could find no evidence that any underwriting attention was given to off-setting the obvious weak financial condition of many of the sponsors or guarantors. Although the files usually contained copies of financial statements and tax returns, I have been told that their presence is more for documentation sufficiency rather than for analysis. Most financial statements were self prepared and appeared questionable as to their veracity. *Recommend that financial statements be signed, dated and contain language to the effect that to the best of the signors knowledge, they are true and accurate, that false representation is perjurious and an acknowledgement that these are being submitted in conjunction with a loan request to Metropolitan Mortgage.*

I continue to emphasize the importance of relying on, or at least recognizing, the financial strength of the borrower considering the nature and type of loans that Metro originates. Such emphasis relates to the assumption that the Company seeks to establish and maintain a portfolio of performing loans and is not relying predominately on the liquidation valuation of the collateral.

Real estate loans on income producing properties and construction loans for the development of an income producing property (multi family, office buildings, etc.) are referred to as *project type* loans and are analyzed on the basis of the pro forma cash flow to be generated by the project. These analyses can be complex and involve an understanding of current market rates, vacancy rates, absorption trends, market conditions, rent abatements, operational expenses, marketing and leasing costs, and tenant improvement allowanices. Metro currently originates few of these type loans.

Land loans, loans to owner-users, and other *credit type* loans, must be evaluated based on cash flow sources detached from the project. Land and development loans for the acquisition and manufacture of individual lots must also be carefully scrutinized in the light of the marketing plan

flowing within 12 months, or (3) the borrower had the capacity to carry debt service from alternative financial source if the reserve account was depleted..

GENERAL UNDERWRITING AND PROCEDURAL ISSUES

Metro's continued ingrained philosophy is to rely on the liquidation value of collateral as the primary source of repayment rather than the ability of the borrower's or project's cash flow to repay the loan. In my discussions with loan staff, this philosophy is still manifest in the minds and attitude of the participants. The positive side of this philosophy is that considering the supportable value of the collateral combined with the low advance rate against value, loan recovery, even after a reasonable foreclosure process, may be adequate to prevent significant losses.

The collateral backing the loans appeared appropriately valued provided the appraisal assumptions were accurate and provided the borrower possessed the expertise to pursue the development process through to satisfactory completion. In addition, for the most part I would concur that the appropriate value was selected for underwriting purposes.

Processes in place to substantiate collateral value and ensure proper collateral perfection appeared to be sufficient. Appraisal analysis, entitlement and environmental reviews, emphasis on site inspections, and closing and legal processes all confirm the attention and reliance that Metro, as a collateral based lender, gives to the real estate asset backing the loan.

In my review of the refinance loans there were numerous instances where considerable amount of loan proceeds were disbursed to the borrower even when their ability to repay was doubtful. When I questioned the decisions to permit cash out disbursements to these weak borrowers rather than fortifying interest reserves, the comment was that the assumption is that the borrower will use the funds to meet debt service payments and that the Metro can now charge interest on the fully disbursed loan amount. Even more problematic is that in some cases the refinance was to provide funds to payoff an existing lender who demanded repayment because of the failing financial condition of the borrower.

LOAN MONITORING AND FOLLOW-UP

The processes of effectively monitoring loans is in need of improvement. Early detection of potential problems can have a major impact on the performance of the loan portfolio and possibly reverse the default trend. At this time, unless the loan is a construction loan with undisbursed funds, monitoring principally consists of payment processing and first evidence of a potential problem occurs only upon a payment default.

There are two monitoring concepts that need to be addressed: