Office of Inspector General

Office of Material Loss Reviews
Report No. MLR-11-002

Material Loss Review of Advanta Bank Corp., Draper, Utah

October 2010

Office of
Inspector General

Executive Summary

Material Loss Review of Advanta Bank Corp., Draper, Utah

Report No. MLR-11-002
October 2010

Why We Did The Audit

On March 19, 2010, the State of Utah Department of Financial Institutions (UDFI) closed Advanta Bank Corp. (Advanta), Draper, Utah and named the FDIC as receiver. On April 1, 2010, the FDIC notified the Office of Inspector General (OIG) that Advanta's total assets at closing were $1.1 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $635.6 million. As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OIG conducted a material loss review of the failure of Advanta. As of September 3, 2010, the estimated loss to the DIF had decreased to $459.1 million.

The audit objectives were to (1) determine the causes of Advanta's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) provisions of section 38.

Background

Advanta's Organizational Structure and Business Strategy

Advanta was a state-chartered non-member industrial bank that was insured in 1991 and headquartered in Draper, Utah. Advanta had no branches but conducted its operations on a national level. The bank marketed depository services though a corporate Web site, provided online banking services, and communicated with customers via the telephone, wire, and mail systems. Advanta was considered a monoline credit card bank. Its primary focus was on prime small business credit card customers, and it did not have any other significant banking operations. Advanta was wholly-owned by Advanta Corp., Spring House, Pennsylvania. The parent holding company also wholly-owned Advanta Bank, Wilmington, Delaware. Advanta had one subsidiary, Advanta Business Receivables Corporation (ABRC). ABRC was involved in Advanta's credit card securitization activities, which, as described below, were a contributing factor in the bank's failure.

Concepts Associated with Securitizations

Generally defined, the securitization of credit card receivables is the process by which these financial assets are transformed into securities. Simply stated, a securitization involves an institution selling its credit card receivables to a special purpose trust, which pays for the receivables by selling securities to investors. The securities sold are backed by the cash flows generated from the credit cards.

Securitizations, when used properly, provide financial institutions with a useful funding, capital, and risk management tool. Securitization activities are susceptible, however, to economic influences and present other risks that need to be managed and controlled. Weak underwriting standards, poor servicing, or inadequate liquidity and capital planning are examples of risks, which, if poorly managed, can damage a credit card issuer's reputation and cause serious financial problems.

Performance and termination triggers are embedded in the structure of most credit card securitizations. These triggers are intended to protect investors against deteriorating credit quality of the underlying pool of credit card receivables by returning principal to the investors as quickly as possible. Decisions

regarding early amortization, or a wind-down event, are made by the trustee or, under certain circumstances, upon a vote by the investor certificate holders. If a securitization goes into early amortization, there are immediate implications for the credit-card-issuing bank's capital and liquidity. Longer term, the bank's reputation as a credit card originator or servicer is damaged and its revenue stream is impaired.

Audit Results

Causes of Failure and Material Loss

Advanta failed due to insolvency brought on by the Board of Directors' (Board) and management's failure to implement risk management practices commensurate with the risks associated with the bank (1) being a monoline small business credit card bank and (2) engaging in significant securitization activity. In particular, Advanta's Board and management failed to develop adequate contingency plans for responding to an early amortization of the bank's securitizations and failed to incorporate those plans into the bank's capital planning model. The bank's plan did not include an early amortization event because management believed it could avert an early amortization by supporting the securitization trust through various means. However, when faced with such an event, those means did not materialize, and the Board and management's handling of the situation resulted in increased loan losses, which ultimately led to the bank's insolvency.

Overall, Advanta's Board and management created a high-risk business strategy that focused on credit card loans to small business customers. These loans were unsecured, revolving lines-of-credit, with average credit lines greater than an average consumer credit card. In the years preceding the bank's failure, the FDIC and the UDFI each expressed concern about Advanta's risk management practices and made recommendations for improvement. However, the actions taken by Advanta's Board and management to address these concerns and recommendations were neither timely nor adequate.

The FDIC's Supervision of Advanta

The FDIC, in conjunction with the UDFI, provided supervisory oversight of Advanta in the form of risk management and compliance examinations, a visitation, and off-site monitoring and, overall, supervision was quite extensive. The FDIC's supervisory functions (risk management and consumer protection) coordinated effectively when inter-disciplinary concerns emerged. In particular, the FDIC's consumer protection function identified, reported on, and coordinated a unified supervisory response with the FDIC's risk management function. Notably, as a result of this coordination, substantive violations associated with Advanta's credit card re-pricing campaign were identified and corrective actions and penalties were pursued.

The FDIC also prepared semi-annual capital market reviews of the bank intended to identify key risks and assist with supervision. Further, from the start of the November 2008 examination to the bank's closing on March 19, 2010, examiners were frequently onsite conducting examinations or monitoring the institution's liquidity position.

Material Loss Review of Advanta Bank Corp., Draper, Utah

Report No. MLR-11-002
October 2010

The FDIC's off-site review program did not detect any significant emerging risks early enough to impact the FDIC's supervisory strategy. Advanta was flagged for off-site review one time between January 2005 and July 2009. Specifically, the FDIC's off-site review system identified Advanta for review in May 2009 based on the FDIC's automated review criteria. The review was completed in July 2009 and identified a high and increasing risk profile. However, by this time, the bank's credit card securitization had already entered into early amortization, and the FDIC had downgraded the bank on an interim basis to a composite "4" rating.

During its examinations, the FDIC routinely recognized that Advanta maintained a monoline operational structure with assets being primarily funded through securitization activities, and that its operational strategies resulted in a unique and potentially increased risk profile for the bank. In addition, the FDIC identified and reported on the bank's significant loan growth as early as the September 2006 examination. However, the FDIC considered the bank's structure and growth to be largely mitigated by the bank's maintenance of Tier 1 Leverage and Total Risk-Based capital ratios in excess of 20 percent and growing levels of on-balance sheet liquidity in the form of cash and Federal funds sold. In hindsight, earlier and greater supervisory emphasis or concern could have been expressed regarding the failure of the bank's capital allocation model and contingency funding plans to incorporate more extreme stress scenarios. Such action would have helped ensure adequate capitalization and liquidity to support an unwinding of the securitizations through early amortization, a significant risk associated with Advanta's monoline business strategy.

With respect to PCA, based on the supervisory actions taken, the FDIC properly implemented applicable PCA provisions of section 38 in a timely manner.

Management Response

On October 1, 2010, the Director, Division of Supervision and Consumer Protection (DSC), provided a written response to a draft of this report. That response is provided in its entirety as Appendix 4 of this report. In its response, DSC reiterated the OIG's conclusions regarding the causes of Advanta's failure, pointing out that Advanta failed due to insolvency brought on by the Board and management's failure to implement risk management practices commensurate with the unique nature of Advanta's business model. With regard to our assessment of the FDIC's supervision of Advanta, DSC summarized the supervisory history described in our report and recognized that it could have required Advanta to incorporate an early amortization scenario in its capital allocation model and contingency funding plans. DSC also pointed out that beginning in January 2010, institutions engaged in securitization activity, in the manner followed by Advanta, have been required to consolidate securitized assets for financial reporting purposes as a result of the implementation of Statement of Financial Accounting Standards (FAS) 166 and FAS 167. This accounting change will minimize the capital and liquidity risks associated with early amortization events for institutions following a business model similar to Advanta.

Contents

	Page
Background	2
Basic Concepts Associated with Securitization and Early Amortization	3
Advanta's Financial Condition in the Years Preceding Its Failure	4
Causes of Failure and Material Loss	4
Advanta's Monoline Business Strategy	5
Advanta's Securitization Activity	10
The FDIC's Supervision of Advanta	11
Supervisory History	12
Supervisory Response to Advanta's Monoline Business Strategy	16
Supervisory Response to Advanta's Securitization Activity	18
Implementation of PCA	19
Corporation Comments	21
Appendices	
1. Objectives, Scope, and Methodology	22
2. Glossary of Terms	25
3. Acronyms	29
4. Corporation Comments	31
Tables	
1. Financial Condition of Advanta, 2005 to 2009	4
2. Advanta's Examination History from 2006 to 2010	12
3. Advanta's Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions	20
Figures	
1. Advanta's Growth of Loans, Securitizations, and Commitments	6
2. Net Charge-Offs and Delinquencies Related to Advanta's Credit Card Portfolio and Securitizations	7
3. Advanta Business Card Master Trust's Quarterly Excess Spread	8

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226

Office of Material Loss Reviews
Office of Inspector General

DATE: October 1, 2010

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/Signed/

FROM: Stephen M. Beard
Assistant Inspector General for Material Loss Reviews

SUBJECT: *Material Loss Review of Advanta Bank Corp., Draper, Utah* (Report No. MLR-11-002)

As required by section 38(k) of the Federal Deposit Insurance Act (FDI Act), and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act), the Office of Inspector General (OIG) conducted a material loss review (MLR) of the failure of Advanta Bank Corp. (Advanta), Draper, Utah. The State of Utah Department of Financial Institutions (UDFI) closed the institution on March 19, 2010, and named the FDIC as receiver. On April 1, 2010, the FDIC notified the OIG that Advanta's total assets at closing were $1.1 billion and that the estimated loss to the Deposit Insurance Fund (DIF) was $635.6 million. The estimated loss of $635.6 million exceeds the $200 million MLR threshold for losses occurring between January 1, 2010 and December 31, 2011, as established by the Financial Reform Act. As of September 3, 2010, the estimated loss to the DIF had decreased to $459.1 million.

When the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed receiver, the FDI Act states that the Inspector General of the appropriate federal banking agency shall make a written report to that agency. The report is to consist of a review of the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action* (PCA); a determination as to why the institution's problems resulted in a material loss to the DIF; and recommendations to prevent future losses.

The objectives of this material loss review were to (1) determine the causes of Advanta's failure and the resulting material loss to the DIF and (2) evaluate the FDIC's supervision of Advanta, including the FDIC's implementation of the PCA provisions of section 38 of the FDI Act. This report presents our analysis of Advanta's failure and the FDIC's efforts to ensure that Advanta's Board of Directors (Board) and management operated the institution in a safe and sound manner. The report does not contain formal recommendations. Instead, as major causes, trends, and common characteristics of institution failures are identified in our MLRs, we will communicate those to FDIC management for its consideration. As resources allow, we may also conduct more

comprehensive reviews of specific aspects of the FDIC's supervision program and make recommendations as warranted.[1]

Appendix 1 contains details on our objectives, scope, and methodology. We also include several other appendices to this report. Appendix 2 contains a glossary of key terms, including material loss, the FDIC's supervision program, and the Uniform Financial Institutions Rating System, otherwise known as the CAMELS ratings. Appendix 3 contains a list of acronyms and Appendix 4 contains the Corporation's comments on this report.

Background

Advanta was a state-chartered non-member industrial bank that was insured in 1991 and was headquartered in Draper, Utah. Advanta had no branches, but conducted its operations on a national level. The bank marketed depository services though a corporate Web site; provided online banking services; and communicated with customers via the telephone, wire, and mail systems. Advanta was considered a monoline credit card bank. In that regard, its primary focus was on prime small business credit card customers,[2] and it did not have any other significant banking operations. Advanta was recognized as one of the largest issuers of credit cards to businesses and business professionals in the United States. Due to Advanta's relatively unique strategic focus, the FDIC stated that Advanta did not have a functional peer group for comparative analysis. As a result, the FDIC placed limited reliance on comparative analysis of the bank to its assigned peer group averages, and this report will also only provide limited comparative analysis.

Advanta was wholly-owned by Advanta Corp., located in Spring House, Pennsylvania. As of December 2007, Advanta Corp.'s Chairman of the Board and Chief Executive Officer controlled 32 percent of the holding company Class A voting stock and was the largest individual shareholder. The parent holding company also wholly-owned Advanta Bank, Wilmington, Delaware. Advanta had one subsidiary, Advanta Business Receivables Corporation (ABRC). ABRC was involved in Advanta's credit card securitization activities, which, as discussed later in this report, were a contributing factor in the bank's failure. In order for readers to better understand how credit card securitizations played such an important role in Advanta's operations, and the complexity of such transactions, a discussion follows on how securitizations work, the benefits and risks, and what happens when the performance of the credit cards and associated securities begins to deteriorate.

[1]A further discussion of OIG-related coverage of financial institution failures can be found in the *Objectives, Scope, and Methodology* section of our report.

[2] The FDIC indicated that Advanta originated only a small percentage of accounts to customers with Fair Isaac Corporation (FICO) scores under 661 (the regulatory cut-off for a prime versus subprime designation).

Basic Concepts Associated with Securitization and Early Amortization

Generally defined, the securitization of credit card receivables is the process by which these financial assets are transformed into securities. Simply stated, a securitization involves an institution selling its credit card receivables to a special purpose trust, which pays for the receivables by selling securities to investors. The securities sold are backed by the cash flows generated from the credit cards. The seller usually retains a subordinate interest or share in the trust as further protection to the owners of the securities.

The securities typically issued by the originators of the credit card securitizations offer investors alternative levels of protection against default risk by pooling the cash flows and paying them out to investors through a tiered, or tranched, priority structure. Each tranche has an associated par value and yield and all, except perhaps the most junior tranches, will be rated by a credit rating agency. The cash flows through a "waterfall" created by the terms of the different tranches. The most senior investments (typically receiving the highest rating awarded by the various bond agencies) have the highest priority claim on the cash flows and are paid first. The remaining cash flows are then allocated to fill the terms of the next highest priority tranche and so on through the priority structure. When all the credit card loans in the pool are performing, each tranche will receive the promised cash flows. As credit card loans default, the lowest priority tranche suffers losses first. If the credit card losses are large enough, the claims of the lowest tranche could be wiped out completely, and the second-lowest priority tranche would begin to bear losses. As losses grow, they are spread to sequentially higher priority tranches.

Securitizations, when used properly, provide financial institutions with a useful funding, capital, and risk management tool. By using securitizations, a credit card issuer may be able to obtain lower cost funding, diversify its funding sources, improve financial indices, potentially lower regulatory costs, and increase its ability to manage interest rate risk. Securitizations are the largest funding source for credit cards, representing over 50 percent of the industry's funding.

Securitization activities are susceptible, however, to economic influences and present other risks that need to be managed and controlled. Weak underwriting standards, poor servicing, or inadequate liquidity and capital planning are examples of risks, which, if poorly managed, can damage a credit card issuer's reputation and cause serious financial problems. The key to a bank's success with using securitizations lies in the quality of the underlying receivables, which is directly related to the underwriting and credit risk management techniques employed. Banks that have an excessive dependence on securitizations for funding could experience significant liquidity issues if this funding source becomes unavailable. Further, a significant reliance on securitizations may result in a bank outgrowing other alternatives, such as traditional borrowing facilities.

Performance and termination triggers are embedded in the structure of most credit card securitizations. These triggers are intended to protect investors against deteriorating credit quality of the underlying pool of credit card receivables by returning principal to

the investors as quickly as possible. The most prominent credit card securitization protective trigger for investors is tied to the excess spread.[3] The triggering amount and calculation can vary, but most commonly it is based on the consecutive 3-month average excess spread falling to or below zero. Decisions regarding early amortization, or a wind-down event, are made by the trustee or, under certain circumstances, upon a vote by the investor certificate holders.

If a securitization goes into early amortization, there are immediate implications for the credit-card-issuing bank's capital and liquidity. The securitization vehicle's trustee stops buying replacement credit card receivables since it is now required to use the principal payments collected to begin paying off the investors. The credit-card-issuing bank now has to fund the new receivables without being able to subsequently sell them to the securitization vehicle. The bank has to either find a new funding source (internal and/or external) or start reducing the cardholders' line availability. The latter is not typically a viable option if the bank wants to stay in the credit card business. Longer term, the bank's reputation as a credit card originator or servicer is damaged and its revenue stream is impaired. Furthermore, longer-term liquidity and capital implications exist even if the bank can ride out the early amortization event.

Advanta's Financial Condition in the Years Preceding Its Failure

Table 1 summarizes selected financial information for Advanta for the year ending December 31, 2009 and for the 4 preceding calendar years.

Table 1: Financial Condition of Advanta, 2005 to 2009

Financial Measure	Dec 2009	Dec 2008	Dec 2007	Dec 2006	Dec 2005
Total Assets ($000s)	$1,525,931	$3,106,694	$2,217,247	$1,958,239	$1,662,359
Total Loans ($000s)	$751,919	$426,569	$943,606	$1,131,352	$896,472
Total Deposits ($000s)	$1,519,471	$2,554,707	$1,668,159	$1,374,270	$1,179,368
Net Income (Loss) ($000s)	($451,294)	$6,320	$100,623	$107,146	$81,304
Total Securitizations ($000s)	$1,599,319	$4,511,651	$5,315,421	$4,073,128	$2,880,401

Source: Uniform Bank Performance Reports (UBPR) and Reports of Condition and Income (Call Reports) for Advanta.

Causes of Failure and Material Loss

Advanta failed due to insolvency brought on by the Board and management's failure to implement risk management practices commensurate with the risks associated with the bank (1) being a monoline small business credit card bank and (2) engaging in significant securitization activity. In particular, Advanta's Board and management failed to develop adequate contingency plans for responding to an early amortization of the bank's securitizations and failed to incorporate those plans into the bank's capital planning

[3] Excess spread is the difference between the gross yield on the pool of securitized receivables less the cost of financing those receivables (weighted average coupon paid on the investor certificates), charge-offs, servicing costs, and any other trust expenses. Excess spread is typically a source of credit enhancement for the certificates since it is commonly available to absorb losses on the assets.

model. The bank's plan did not include an early amortization event because management believed it could avert an early amortization by supporting the securitization trust through various means. However, when faced with such an event, those means did not materialize, and the Board and management's handling of the situation resulted in increased loan losses, which ultimately led to the bank's insolvency.

Overall, Advanta's Board and management created a high-risk business strategy that focused on credit card loans to small business customers. These loans were unsecured, revolving lines-of-credit, with average credit lines greater than an average consumer credit card. In the years preceding the bank's failure, the FDIC and the UDFI each expressed concern about Advanta's risk management practices and made recommendations for improvement. However, the actions taken by Advanta's Board and management to address these concerns and recommendations were neither timely nor adequate.

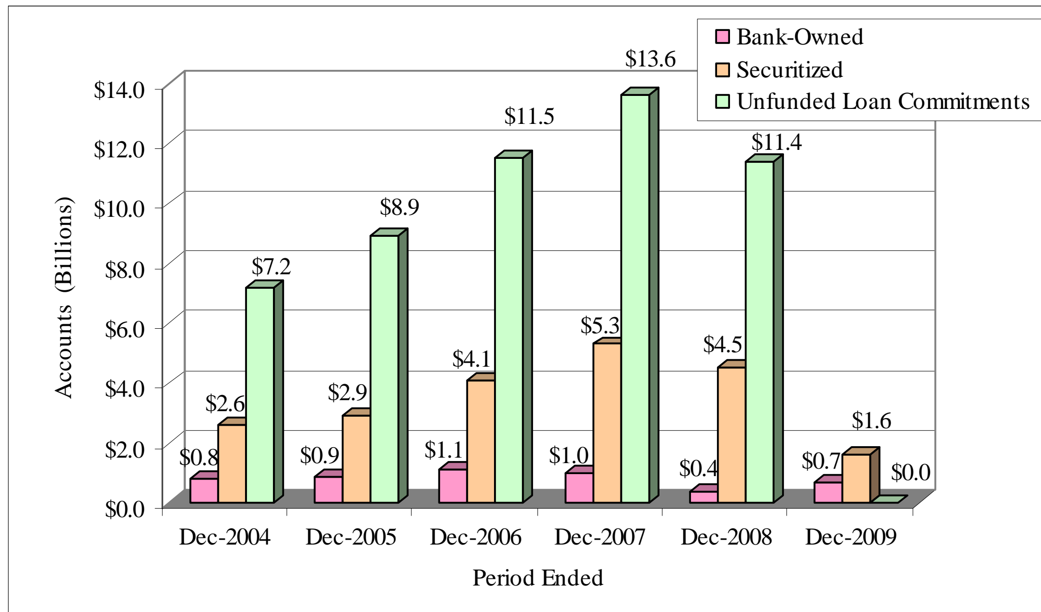
Advanta's Monoline Business Strategy

Advanta's monoline business strategy created a concentration of assets within a portfolio of small business credit card loans,[4] without sufficient mitigating controls in the form of robust contingency plans for responding to an early amortization of the bank's securitizations and incorporation of those plans into the bank's capital and liquidity planning models. Such loans were both owned by the bank and, to a significant extent, sold to investors through securitizations. Management's actions to counteract increasing delinquencies as the economy deteriorated resulted in further deterioration of the bank's condition. As of December 2007, the bank's credit card loans equaled 211 percent of total capital, and unfunded loan commitments equaled 3,047 percent of total capital. Advanta's management permitted these loan concentrations to exist without adequately planning for the possibility that the securitizations would go into early amortization.

Figure 1 illustrates the growth of Advanta's credit card loan portfolio (funded and unfunded) and credit card securitizations in the years preceding the bank's failure. Although the bank's overall credit card loan portfolio growth appears moderate, the bank began to significantly grow its credit card accounts from 2004 to 2007, and began to significantly increase its credit card securitization activities from 2005 to 2007. As a result, the bank's credit card operations and the associated risk increased significantly over this 3-year period.

[4] For regulatory reporting purposes, small business credit card loans are included in the Commercial and Industrial (C&I) loan portfolio.

Figure 1: Advanta's Growth of Loans, Securitizations, and Commitments



Source: OIG analysis of Call Reports for Advanta.

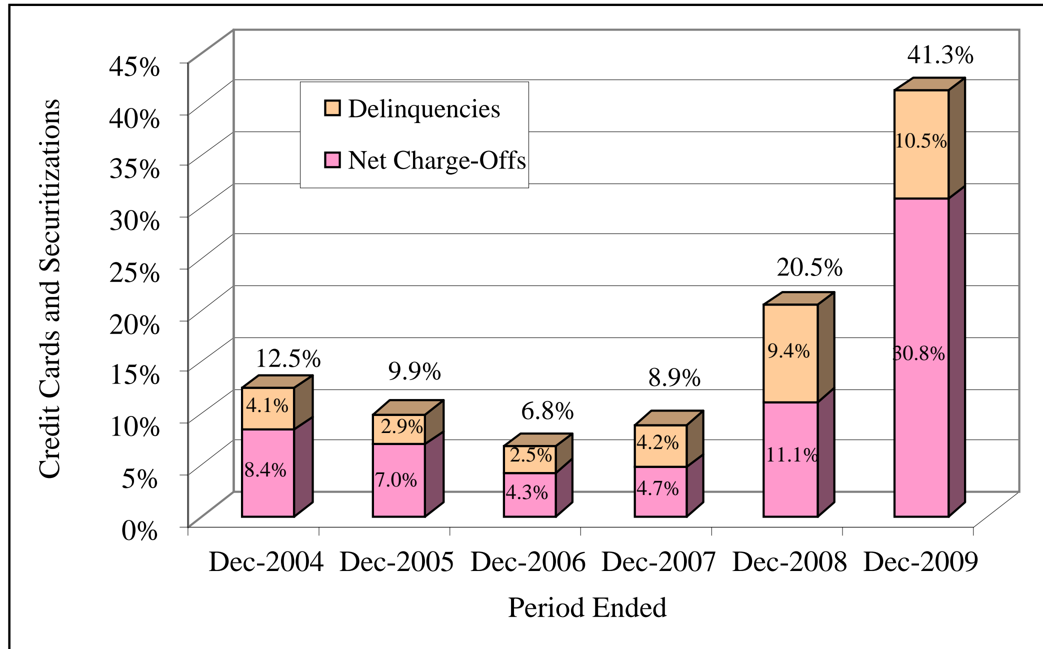
Figure 1 also reflects the impact of management's actions to cancel charging privileges on all accounts, the early amortization of the securitization trust, and the placement of the bank in a self-liquidation mode in 2009.

<u>Net Losses Through Charge-Offs</u>

Advanta began to experience a rapid and significant increase in credit card delinquencies and charge-offs in 2008 and 2009, as borrowers were impacted by rapidly deteriorating economic conditions, brought on, in part, by economic disruptions in the mortgage, securitization, and job markets. Specifically, from January 2006 to December 2009, the bank recognized net charge-offs of $384 million in its credit card loan portfolio. Such delinquencies and charge-offs also negatively impacted Advanta's securitizations, which, during the same time period, incurred net charge-offs of $1.9 billion. Although Advanta did not incur the securitizations' net charge-offs directly, the bank's profitability was significantly impacted by the deterioration of the securitizations' excess spread provided to the bank.

Figure 2 illustrates the growing rate of net charge-offs and delinquencies within Advanta's credit card loan portfolio and securitizations. The charge-off and delinquency rates began to significantly increase in March 2008 and continued to increase each quarter thereafter, showing a second significant increase in December 2008. According to FDIC management, the continued increases in charge-offs and delinquencies were attributable, in part, to Advanta's aggressive re-pricing increases on the credit cards, particularly in September and October 2008. These re-pricing increases are discussed in more detail later in our report.

Figure 2: Net Charge-Offs and Delinquencies Related to Advanta's Credit Card Portfolio and Securitizations



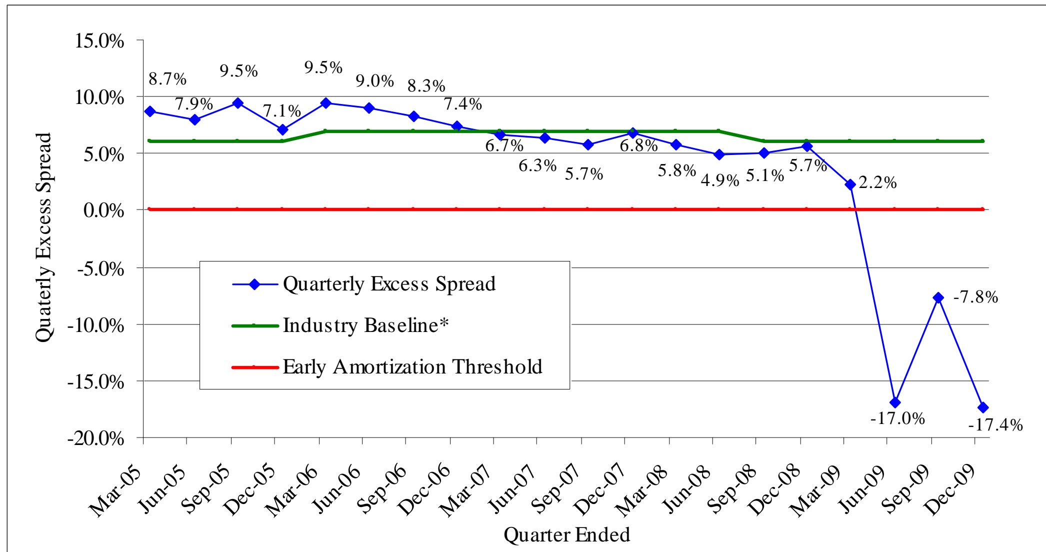
Source: OIG analysis of UBPRs for Advanta.

The rising level of charge-offs not only resulted in losses in the bank-owned portion of the credit card portfolio but also caused a decrease in the excess spread of the securitized portion of the portfolio. Such a decrease in the excess spread is significant because the drop in the 3-month average excess spread to below zero resulted in an early amortization of the securitization trust in June 2009. In response to rising loan losses and early amortization of the securitization trust, the bank also cancelled credit card charging privileges for all cardholders in order to prevent a rapid increase in on-book receivables.

The early amortization event and cancellation of charging privileges led to increased losses on the bank's assets related to the securitization. According to industry experts, an institution's excess spread is the most important and comparable analytical factor in analyzing credit card securitizations. Additionally, as discussed previously, the excess spread percentage acts as one of the triggers for initiating an early amortization event.

As indicated in Figure 3, the excess spread steadily decreased from 9.5 percent in March 2006 to 4.9 percent in June 2008. During roughly the same time period, the industry's average excess spread ranged from 7 percent to 9 percent.

Figure 3: Advanta Business Card Master Trust's Quarterly Excess Spread



Source: OIG analysis of monthly statements filed by ABRC with the Securities and Exchange Commission.
* According to Citigroup Global Markets Ltd.'s *Credit Card ABS Primer*, dated October 31, 2008, the industry's average excess spread from December 2001 to December 2005 ranged roughly from 6 percent to 7 percent, from March 2006 to July 2008 ranged from 7 percent to 9 percent, and was projected to remain in the range of 6 percent to 7 percent in the future (short-term), with a worst case projected average of 3 percent.

Figure 3 also shows an increase in the excess spread in the latter half of 2008. This increase is related to bank management's decision to significantly increase interest rates on outstanding credit card balances. However, such increases turned out to be temporary. Ultimately, a rapidly rising level of charge-offs led to a sharp decline in the excess spread percentages and the early amortization of the trust in June 2009.

Credit Administration and Risk Analysis and Recognition Practices

As the economy began to negatively impact the bank's small business credit card customers, Advanta's credit administration practices exacerbated the problem and its risk analysis and recognition practices failed to keep pace with the resulting changes in portfolio behavior. Additionally, Advanta's Board and management failed to adequately plan for a scenario involving early amortization of the securitizations. In the November 2008 report of examination, the FDIC identified weaknesses in the following areas.

Credit Administration. FDIC examiners found that Advanta:

- Engaged in aggressive re-pricing of customer finance charges, involving both the re-priced interest rates and the frequency of successive re-pricing events. Of particular note, approximately 68 percent of the credit card loan portfolio was re-priced in 2008 to encourage potentially higher-risk borrowers to pay off their accounts. However, these price increases resulted in much higher minimum payments for customers and made it very difficult for customers already struggling to make their minimum payments to cure any outstanding delinquency. The FDIC reported in its December 2008 compliance examination report that a

large number of accountholders received substantial rate increases that raised their annual percentage rates, in some cases, to as high as 37 percent. Within the November 2008 examination report (issued in September 2009), the FDIC reported that the effect of rapidly increasing finance charge rates on minimum payments contributed to the acceleration of charge-offs in the latter half of 2008 and early 2009.

- Had substantive violations of Section 5 of the Federal Trade Commission (FTC) Act regarding Unfair[5] or Deceptive Acts or Practices (UDAP), which are considered to be illegal credit practices, and of Regulation B, which implements the Equal Credit Opportunity Act.[6] The FDIC attributed the violations to management's inadequate oversight, unfamiliarity with the requirements (of the statutes and regulations), and lack of monitoring and audit procedures relative to these statutes and regulations. In particular, Advanta engaged in over 1 million re-pricing actions on existing credit card accounts. Based on these practices, from June 2007 through November 2008, the FDIC cited the following substantive violations:

    - Section 5 of the FTC Act – Advanta engaged in unfair practices related to its aggressive re-pricing of customer finance charges, involving both the re-priced interest rates and the frequency of successive re-pricing events. In particular, the bank engaged in unfair acts or practices when it imposed credit card rate increases based on criteria that were neither known nor communicated to customers. In addition, the bank did not adequately notify the customers that their applicable interest rate had been increased, did not disclose the amount of the increased rate, did not effectively disclose the customers' right to opt-out of the rate increase, and did not provide customers with sufficient time to exercise their right to opt-out.

    - Regulation B – Advanta did not provide complete and/or sufficient notification letters to its accountholders. In particular, the notification letters did not provide customers with specific reasons for the adverse actions, disclose the customer's right to receive a statement of specific reasons, and/or provide the name and address of the FDIC's Consumer Response Center.

- Cancelled all card utilization privileges without fully considering the possible outcomes. According to the FDIC, Advanta management relied upon optimistic assumptions in a stress scenario where little historical data existed to determine whether the bank could remain viable.

---

[5] Section 5 of the Federal Trade Commission Act prohibits unfair acts or practices. An act or practice is unfair where it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers, and (3) is not outweighed by countervailing benefits to consumers or to competition. Public policy may also be considered in the analysis of whether a particular act or practice is unfair.

[6] The Equal Credit Opportunity Act and Regulation B require disclosure by creditors of the specific reasons for adverse action taken against the customer, including the small business borrower. This disclosure allows customers to identify and remedy credit issues, as well as correct inaccurate credit information.

Risk Analysis and Recognition Practices. According to examination reports, Advanta:

- Failed to incorporate into its allowance for loan and lease loss methodology (1) the impact of the early amortization of the bank's securitization trust; (2) anticipated and actual changes in portfolio behavior associated with the continued economic downturn, the aggressive re-pricing strategy, and the cut-off in credit card account utility; and (3) the impact of management's change to a 120-day charge-off period.

- Failed to maintain an adequate allowance for loan and lease losses.

- Failed to consider the impact of early amortization in the bank's capital allocation model and liquidity contingency funding plan.

Advanta's Securitization Activity

Advanta's significant involvement in securitization activities contributed to the failure of the bank when the securitizations went into early amortization due to rising loan losses, increasing delinquencies, and a deteriorating economy. According to the Division of Supervision and Consumer Protection's (DSC) *Risk Management Manual of Examination Policies* (Examination Manual), securitizations can be an effective funding method for banks. However, there are risks associated with using securitization as a funding source, including early amortization clauses to protect investors if the performance of the underlying assets does not meet pre-specified criteria. If an early amortization clause is triggered, the issuing institution must begin paying principal to bondholders earlier than originally anticipated and will have to fund new receivables that would have otherwise been transferred to the trust. The issuing institution must monitor the performance of the securitization to anticipate cash flow and funding ramifications due to early amortization clauses.

Advanta first noted signs of "economic disruptions" in August of 2007. According to a 2009 Federal Reserve Bank of Dallas economic study, due to the financial crisis that began in August 2007, securitization market activity virtually halted and interest rate spreads on securitizations reached unprecedented low levels, as investors demanded higher risk premiums. According to the FDIC, the securitization market for small issuers collapsed in August 2007 and for all other issuers in November 2007.

In November 2007, Advanta began to provide more favorable terms (for example, return on investment and time to final principal payment) to third-party investors. Such terms reflected the level of perceived market risk. Advanta also began to experience significant declining sales/issuance volume as of September 2007, and increasing delinquencies and loan losses in its own credit card portfolio and securitizations in March 2008. Advanta's last securitization sold to an outside investor was in May 2008. A year later, in May 2009, bank management publicly announced that it intended to let the securitizations go into early amortization in June 2009.

Ultimately, according to the November 2008 examination report (issued in September 2009 as noted earlier), the bank's poor cardholder performance caused cash flows from the securitized notes to fall below the bank's excess spread requirements in May 2009, leading management to announce that the securitized notes (Advanta Business Card Master Trust) would go into early amortization. This action would require the bank to fund all newly generated credit card receivables (i.e., credit card charges by customers), which would cause an increase in on-book receivables, a decline in capital ratios, and a dissipation of liquidity. However, the bank did not have sufficient financial resources, support, or contingency funding to fund its credit card customers on an ongoing basis.

The bank's contingency funding plans did not adequately take into consideration the potential impact to operations that could be caused by the bank's securitizations going into early amortization, or the bank's access to the securitization markets being limited. According to Financial Institution Letter (FIL) 84-2008, entitled, *Liquidity Risk Management*, dated August 26, 2008, liquidity risk measurement and management systems should reflect an institution's complexity, risk profile, and scope of operations. The August 2008 FIL states, in part, that banks that use securitizations should ensure that their contingency funding plans address relevant stress events. In particular, contingency funding plans should incorporate events that could rapidly affect an institution's liquidity, including a sudden inability to securitize assets. In addition, the guidance states that securitizing institutions should also have plans in place to address early amortization events.

Advanta Corp. management recognized, within their 2006 and 2007 Annual Reports, that any substantial reduction in its ability to complete securitizations could negatively impact its results of operations and financial condition. However, according to the FDIC, prior to, and early on in the economic crisis, the possibility of the bank's securitizations going into early amortization never occurred to the bank. Despite the heightened risk structure of the bank's loan activities, bank management failed to ensure that the risk associated with this activity was adequately identified, measured, monitored, and controlled. According to the November 2008 examination report, bank management first added/considered the potential lack of access to the securitization markets into the bank's stress test scenarios and models to provide for its contingency funding plans in December 2008 – 6 months after the bank's last securitization issuance. As a result, bank management did not effectively plan for and react to the securitization's early amortization and market disruptions that rendered further securitizations economically unfeasible.

The FDIC's Supervision of Advanta

The FDIC provided supervisory oversight of Advanta in the form of risk management and compliance examinations, a visitation, and off-site monitoring. The FDIC's supervision addressed both consumer protection and risk management issues and, overall, was quite extensive. However, in hindsight, earlier and greater supervisory emphasis and/or concern could have been expressed regarding the failure of the bank's capital allocation model and contingency funding plans to incorporate more extreme stress

scenarios to ensure adequate capitalization and liquidity to support an unwinding of the securitization through early amortization.

Supervisory History

The FDIC, in conjunction with the UDFI, provided ongoing supervision of Advanta through regular on-site risk management examinations and a visitation. The FDIC also prepared semiannual capital market reviews of the bank intended to identify key risks and assist with supervision. Further, from the start of the November 2008 examination to the bank's closing on March 19, 2010, examiners were frequently onsite conducting examinations or monitoring the institution's liquidity position. During this time period, the FDIC was involved in discussions with the bank, the bank's parent holding company, and UDFI, regarding bank proposals to improve its financial condition. Most notably, in a May 2009 New York Regional Office letter, the FDIC informed Advanta's Board that a proposal by the Board to close accounts to new activity and to simultaneously purchase a large portion of Class A securitization notes was unusual and could pose a considerable risk. Ultimately, the FDIC stated that

> In view of the winding down of deposit taking activities and credit card operations, we [the FDIC] request that management either submit a new business strategy for our [the FDIC's] review and comment or, if applicable, a plan for the voluntary termination of deposit insurance.

Advanta was also identified for off-site review due to the increased probability of a rating downgrade; however, the institution had already been downgraded through the onsite activities.

Table 2 summarizes key information pertaining to the on-site risk management examinations and visitation that the FDIC and UDFI conducted of Advanta from September 2006 until the institution failed in March 2010.

Table 2: Advanta's Examination History from 2006 to 2010

Examination/Visitation Start Date (Issuance Date)	On-Site Supervisory Effort	Supervisory Ratings	Supervisory Action
January 11, 2010 (March 1, 2010)	Joint Examination	555555/5	The bank was closed on March 19, 2010.
October 26, 2009	Visitation	No Rating	None
November 17, 2008 (September 9, 2009)	Joint Examination	555544/5	None
May 20, 2009		344422/4	Interim Rating Change. Cease and Desist Order (C&D) issued on June 30, 2009.
October 15, 2007 (February 5, 2008)	Joint Examination	122111/2	None
September 25, 2006 (January 5, 2007)	Joint Examination	121112/2	None

Source: Examination reports, problem bank memoranda, and formal enforcement actions for Advanta.

As indicated in Table 2, during the initial period covered by our review, Advanta was considered a well-performing institution that consistently received composite "2" supervisory ratings. At the 2006 and 2007 examinations, examiners identified and reported the unique business plan of the bank and conducted comprehensive reviews of the bank's securitization activities. According to FDIC management, examiners also reflected the risk associated with the plan in the bank's ratings by assigning a composite "2" rating despite performance metrics that otherwise were generally indicative of a composite "1" rating, including capital ratios in excess of 20 percent, returns on average assets in excess of 5.50 percent, and maintenance of cash and Federal funds sold ranging from 22 to 32 percent of total assets. From September 2006 to the bank's closing in March 2010, the FDIC and the UDFI performed four joint risk management examinations and a visitation. The FDIC first expressed a heightened level of supervisory concern during the November 2008 examination, and that concern was initially reflected in interim rating downgrades in May 2009.

Enforcement Actions

The FDIC and UDFI separately issued two sets of formal enforcement actions between 2006 and the bank's failure. A brief description of these enforcement actions follows.

- **June 2009 C&D (FDIC).** Advanta stipulated to the FDIC's risk management C&D based on the May 2009 Interim Rating Change Memorandum that downgraded the bank's ratings. The interim rating change was based, in part, on the pending results of the November 2008 risk management examination, and the January 2007 and December 2008 compliance examinations. In addition, bank management notified the FDIC that the charge-off rate in the credit card portfolio was continuing to escalate and had reached a point that could cause early amortization of the securitizations and bank management intended to allow that to occur. Further, charging privileges for all active accounts would be terminated, and financial support to the securitization trust funding the credit card receivables would no longer be provided.

  The June 2009 C&D contained 21 provisions addressing such areas as maintaining qualified management; ensuring adequate staffing and accounts receivable servicing; increasing Board supervision; developing strategic plans that provided for the orderly discontinuance of deposit-taking operations; developing an executive compensation plan; developing a written capital plan; restricting dividends; maintaining a "*Well Capitalized*" capital position; developing plans to address possible liquidity events; restricting transactions with and on the behalf of the parent holding company and affiliates; restricting cash transactions, contract authority, material balance sheet transactions, and brokered deposits; correcting violations; and providing progress reports.

- **October 2009 C&D Order (UDFI).** Advanta also stipulated to the UDFI's risk management C&D, which contained 21 provisions similar to the FDIC's June 2009 C&D. Based on our discussions with the UDFI, UDFI senior management

officials stated that the issuance of their enforcement action was delayed due to the timing of the November 2008 examination report issuance.

- **November 2009 Consent Order (FDIC).** Advanta stipulated to the FDIC's risk management Consent Order based on the parent holding company's filing for protection under Chapter 11 of the U.S. Bankruptcy Code on November 8, 2009. The consent order contained four provisions that superseded certain provisions of the June 2009 C&D, and replaced them with tighter restrictions on affiliate transactions and contractual agreements.

- **November 2009 Consent Order (UDFI).** Advanta stipulated to the UDFI's risk management Consent Order, which contained identical requirements to the FDIC's November 2009 Consent Order.

The FDIC's Coordination of Supervisory Functions

The FDIC's supervisory functions (risk management and consumer protection) coordinated effectively when inter-disciplinary concerns emerged. In particular, the FDIC's consumer protection function identified, reported on, and coordinated a unified supervisory response with the FDIC's risk management function. As discussed elsewhere in this report, substantive violations associated with Advanta's credit card re-pricing campaign were identified and corrective actions and penalties were pursued, based on the coordinated efforts of the following FDIC offices:

- The Consumer Response Center (CRC) identified an increasing volume of consumer complaints and notified the New York Regional Office's senior compliance personnel of CRC concerns in the summer of 2008.

- The New York Regional Office's senior compliance personnel scheduled a targeted visitation to review the identified concerns for the 4th quarter of 2008 and coordinated with DSC risk management personnel.

- The Salt Lake City Field Office's compliance examination team initiated the visitation and, based on their findings, subsequently expanded the review into a full-scope examination in December 2008. The December 2008 Compliance Examination resulted in a rating downgrade and the citation of substantive UDAP and Regulation B violations. During the compliance and risk management examinations, the respective Field Office Supervisors held periodic meetings and the respective examiners-in-charge communicated daily.

- The New York Regional Office's senior compliance personnel pursued an enforcement order (coordinated with risk management), civil money penalties, and restitution for consumers harmed by Advanta's practices.

- The New York Regional and Salt Lake City Field Office's risk management team also effectively incorporated the compliance examination team's findings and

concerns into the risk management assessment of the bank and in the pursuit of corrective actions.

FDIC senior compliance management stated that the identification and citation of Advanta's UDAP and Regulation B violations were among the first consumer compliance matters that had a substantial and direct impact on the assessment of the bank's safety and soundness. As a result, the FDIC included Advanta in a case study in DSC's forward-looking supervision training program.

Off-site Reviews

The FDIC's off-site review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies, such as examination schedules, can be adjusted appropriately. The FDIC electronically generates an Off-site Review List (ORL) each quarter and performs off-site reviews for each 1- and 2- rated bank that appears on the list. The system-generated ORL includes institutions that are identified by:

- The Statistical CAMELS Off-site Rating (SCOR) system as having a 35 percent or higher probability of downgrade to 3 or worse,[7] or
- The Growth Monitoring System (GMS) as having a growth percentile of 98 or 99.[8]

The FDIC's off-site review program did not detect any significant emerging risks early enough to impact the FDIC's supervisory strategy. The FDIC ORL flagged Advanta for off-site review one time between January 2005 and July 2009. Specifically, the FDIC's off-site review system identified Advanta for review in May 2009 based on the FDIC's automated review criteria established for the SCOR system. Based on Advanta's March 2009 financial data, the SCOR system reported that the bank had a 45 percent chance of being downgraded to a 3 or worse – which was driven by the bank's earnings performance, asset quality, and management. The review was completed in July 2009 and identified a high and increasing risk profile. However, by this time, the bank's credit card securitization had already entered into early amortization, and the FDIC had downgraded the bank on an interim basis to a composite "4" rating and obtained the Board's stipulation to a June 24, 2009 C&D to guide corrective action. Also of note, the FDIC's GMS did not identify Advanta for an off-site review, despite the bank's significant level of growth (through securitization) and reliance on securitization markets for funding. Based on the GMS's established criteria, unique risk factors such as a bank's rapid and significant securitization growth and reliance on certain non-traditional funding sources are not considered in the system's computations.

[7] SCOR is a financial model that uses statistical techniques, off-site data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
[8] GMS is an off-site rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.

In addition to the off-site review conducted by the New York Regional Office, the FDIC's Salt Lake City Field Office prepared semiannual capital market reviews on certain banks, including Advanta. According to FDIC management, these semiannual capital market reviews were conducted under a national program, and Advanta had been covered by the program since 1999. These reviews included, in part, an overview of Advanta's business strategy, growth, profitability, delinquency and loss rates, securitization activities, and recent examination findings. In particular, the December 2007 review identified certain key risks facing the bank and recommended that a capital markets specialist participate on subsequent examinations to enhance the FDIC's supervision of Advanta.

Supervisory Response to Advanta's Monoline Business Strategy

The FDIC routinely recognized the existence of Advanta's monoline operational structure and the bank's unique and potentially increased risk profile due to its operational strategies. In addition, the FDIC identified and reported on the bank's significant loan growth as early as the September 2006 examination. The FDIC considered the bank's structure and growth to be largely mitigated by the bank's maintenance of Tier 1 Leverage and Total Risk-Based capital ratios in excess of 20 percent and growing levels of on-balance sheet liquidity in the form of cash and Federal funds sold. However, in hindsight, earlier and greater supervisory emphasis or concern could have been expressed regarding the failure of the bank's capital allocation model and contingency funding plans to incorporate more extreme stress scenarios. Such action would have helped ensure adequate capitalization and liquidity to support an unwinding of the securitizations through early amortization, a significant risk associated with Advanta's monoline business strategy.

Supervisory Analysis of Asset Quality

The FDIC regularly assessed Advanta's asset quality in its examination reports, and examination work papers for the September 2006 and October 2007 examinations indicated that the FDIC had performed a comprehensive review of the bank's securitizations. However, consistent with the FDIC's examination policy, the respective examination reports presented limited, if any, commentary on the quality of the bank's outstanding securitizations until quality became a concern. For example, although documented in the examination work papers, the September 2006 and October 2007 examination reports did not discuss the structure and performance of the securitization trust in terms of its overall size, the balances invested in each tranche, and the quality and investment rating of the each tranche structure. Further, the FDIC did not fully discuss the quality and continuing reliance on the performance of the outstanding securitizations until the November 2008 examination report. In addition, key asset quality performance ratios presented in these examination reports were limited to the bank-owned credit cards, and did not address the securitizations.

Supervisory Analysis of the Economy and Securitization Markets

The October 2007 examination report provided a detailed discussion of the deteriorating national economy. In particular, the FDIC reported on the downturn in the subprime mortgage markets and on Advanta's concerns over the "credit crunch's" potential impact to the bank's unsecured lending operations. In the report's confidential section, the examiners reported the following observations:

> Over the past several months, and especially during the examination, the subprime mortgage crisis has begun to impact other areas of the market, including Alt-A lending, portions of the prime lending market, general mortgage lending, the mortgage backed securities market, and to a certain extent corporate bonds. The overall real estate market both nationally and in the specific . . . regions of the bank appear to be showing signs of weakness. Housing prices are dropping, foreclosures are rising, and as more hybrid mortgages start to re-price, consumers will likely be impacted.
>
> After the examination ended, examiners noted that the parent company's stock price dropped dramatically . . . due to the market's concerns over the effects of the subprime market and the fact that management held an unscheduled conference call with investors to essentially withdraw their earnings projections for 2008.

The examination report also noted that Advanta increased industry exposure monitoring (tracking the bank's exposure to real estate-related businesses), and examiners encouraged Advanta to emphasize conservative practices as the economy continued to show signs of weakening. In particular, the October 2007 examination report primarily focused on how the downturn in the housing market could impact the bank's small business cardholder performance as opposed to how a disruption in the mortgage-backed securitization market might expand into the credit card securitization market. In addition, the October 2007 examination report identified securitizations as the bank's primary funding source but did not discuss the outlook for the credit card securitization market or the future viability of that market as a funding source for the bank. Supervisory concern was not expressed, and recommendations were not formulated, to address the various economic and market risk factors faced by the bank due to its securitization activities. According to the FDIC, examiners believed that they had addressed the risk that was apparent at the time, by encouraging Advanta to emphasize conservative underwriting and account management practices as the economy continued to show signs of weakening.

Supervisory Analysis of Parent Holding Company Support

The FDIC routinely analyzed issues related to the ownership and control of Advanta by Advanta Corp. The FDIC first reported that the parent holding company was not a source of financial strength within the November 2008 examination report. In particular, the FDIC concluded that Advanta Corp. had limited ability to provide support in the form of liquidity and capital injections into the bank. Subsequently, the FDIC sought to obtain

additional holding company support for Advanta. However, in the January 2010 examination report, examiners reported that:

- Advanta Corp. filed for Chapter 11 Bankruptcy protection in November 2009.
- Advanta Corp.'s executive management stated that they refused to comply with the UDFI and FDIC C&Ds and Consent Agreements.
- Advanta Corp.'s executive management stated that their intention was not to provide any capital support to the bank and that their priority was to protect the parent company's assets and resources for the creditors of Advanta Corp.

The FDIC also reported that Advanta Corp. had sufficient cash and cash equivalents, of almost $100 million, to fund operations for the short-term; however, the parent holding company did not have sufficient resources to fund operations and debt obligations over an extended time period. Overall, the FDIC concluded that the bank's parent company did not have the willingness or capacity to support the bank.

UDFI's senior management stated that Advanta was a unique industrial bank, in that its parent holding company did not engage in any commercial (mercantile) operations, did not generate a diverse revenue stream, and relied heavily on the success of the bank to support its own profitability. In particular, as of December 2007, Advanta represented roughly 80 percent of the consolidated holding company's total assets and 140 percent of net income. Of particular note, UDFI senior management stated that a significant weakness existed due to the lack of Capital and Liquidity Maintenance Agreements between the bank, the holding company, and the regulatory agencies. The UDFI officials stated that had these agreements been in place, Advanta Corp. could not have refused to provide additional support to Advanta, which could have mitigated the loss to the DIF. The UDFI stated that these agreements are currently formulated and placed on all new charters; however, this practice was not in place when Advanta was established.

Supervisory Response to Advanta's Securitization Activity

The FDIC routinely assessed the bank's available liquidity and noted that the bank's assets were primarily funded through securitization activities. In addition, the FDIC reported in the September 2006 examination report that the bank's securitization activities were well managed and that favorable pricing of recent issues indicated adequate market acceptance. Examination reports and off-site reviews documented that bank management was maintaining increasing levels of cash and Federal funds sold, with the amount as a percentage of total assets growing from 22 percent at June 30, 2006 to 32 percent at June 30, 2007, and to 44 percent by year-end 2007. However, the FDIC did not require the bank's contingency funding plans to incorporate scenarios that contemplated early amortization until after the securitization markets collapsed, and just before the bank's securitizations went into early amortization, during the November 2008 examination.

According to the *Credit Card Securitization Manual*, dated March 2007, examiners should review the liquidity implications of the bank's securitization activities in relation to the bank's normal liquidity management process, including contingency planning. Contingency plans should also provide for funding alternatives in the event of a complete withdrawal from the securitization market or in the event of a reduction in credit availability. The manual also states that early warning mechanisms related to early amortization triggers should be in place.

Both the September 2006 and October 2007 examination reports discussed the bank's sources of contingency funding and assessed the adequacy of such funding based on the funding sources' abilities to meet the bank's short-term (available liquidity) needs. The FDIC did not assess the bank's contingency funding plans in case of a significant downturn in the economy or restricted access to the securitization markets. However, the Salt Lake City Field Office's December 2007 off-site review (performed by a Capital Markets Subject Matter Expert just after the October 2007 examination) included the following observation:

> While liquidity is considered satisfactory, with cash and Federal funds sold accounting for nearly 45 percent of year-end assets, the bank is highly dependent on securitizations for funding. Furthermore, all deposits are potentially volatile liabilities. Whether brokered or originated from other sources, the institution pays high interest rates that are well above the average rates paid by banks. Consequently, the need for sound asset quality, backup liquidity, and an effective contingency funding plan is magnified.

Even though the bank maintained increasing levels of liquidity and high levels of capital, earlier and greater supervisory analysis and/or concern could have been expressed regarding the failure of the bank's contingency liquidity funding plan to incorporate the possibility of early amortization.

Implementation of PCA

The purpose of PCA is to resolve problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325 of the FDIC Rules and Regulations implements PCA requirements by establishing a framework for taking prompt corrective action against insured state-chartered nonmember banks that are not adequately capitalized. The FDIC is required to closely monitor the institution's compliance with its capital restoration plan, mandatory restrictions defined under section 38(e), and discretionary safeguards imposed by the FDIC (if any) to determine if the purposes of PCA are being achieved. Based on the supervisory actions taken with respect to Advanta, we determined that the FDIC properly implemented applicable PCA provisions of section 38.

The FDIC issued timely notices related to the institution's capital category, reviewed and monitored the institution's Call Reports and UBPRs, obtained and reviewed progress reports on enforcement actions, conducted onsite reviews and monitoring of PCA

restrictions, and conducted periodic discussions with the institution's management regarding compliance with the restrictions imposed under each PCA capital category.

Advanta was considered *Well Capitalized* for PCA purposes until June 30, 2009, when the FDIC issued a C&D on Advanta that contained a capital provision. The C&D directed the bank to maintain a level of capital that corresponded to the PCA capital standards for *Well Capitalized* institutions. As a result, when Advanta was subject to this enforcement action, the bank was considered *Adequately Capitalized* for PCA purposes. Subsequent to the issuance of the June 2009 C&D, Advanta's capital ratios quickly fell below the levels required for *Well Capitalized* institutions. As a result, in September 2009 the bank became *Undercapitalized*, and in December 2009 the bank became *Critically Undercapitalized*. Table 3 illustrates Advanta's capital levels relative to the PCA thresholds for *Well Capitalized* institutions, and the significant decline in Advanta's capital levels from June 2007 to December 2009.

Table 3: Advanta's Capital Levels Relative to PCA Thresholds for Well Capitalized Institutions

Capital Ratio	*Well Capitalized* Threshold	Oct-2007 Examination (As of Jun-2007)	Nov-2008 Examination (As of Mar-2009)	As of Sep-2009	As of Dec-2009
Tier 1 Leverage Capital	5% or more	20.86%	5.77%	3.73%	(2.00%)
Tier 1 Risk-Based Capital	6% or more	21.18%	11.24%	8.93%	(4.07%)
Total Risk Based Capital	10% or more	22.44%	12.55%	10.28%	(4.07%)

Source: OIG analysis of UBPRs, and the October 2007, November 2008, and January 2010 examination reports for Advanta, as well as section 38 of the FDI Act and 57 Federal Register 44866-1.

The FDIC's key actions in implementing PCA and monitoring Advanta's adherence to PCA included the following:

- **June 30, 2009.** Although a PCA Notification Letter was not issued that informed Advanta that it was considered to be *Adequately Capitalized*, the June 2009 C&D contained provisions that were similar to and/or more stringent than the restrictions imposed on *Adequately Capitalized* banks. In particular, Advanta was restricted from further use of brokered deposits and was required to submit a Capital Restoration Plan.

- **October 27, 2009.** Based on Advanta's September 2009 Call Reports, the FDIC issued a PCA Notification Letter informing the bank that it was *Undercapitalized* based on PCA capital standards. As a result of this capital designation, the bank was subject to various restrictions, including limitations on asset growth, payments to insiders, and the issuance and renewal of any brokered deposits. In addition, the bank was again required to submit a Capital Restoration Plan by November 26, 2009.

- **March 2, 2010.** Based on the January 2010 examination, completed February 2010, the FDIC provided the bank with a second PCA notification letter that informed

Advanta that it was *Critically Undercapitalized*[9] for PCA purposes, the lowest PCA capital designation. As a result, the bank was subject to further restrictions, including, but not limited to, the following: entering into material transactions, extending highly leveraged credit, engaging in covered transaction, and paying excessive compensation.

In response to the June 2009 C&D and PCA Notification Letters, Advanta submitted three Capital Restoration Plans in July 2009, December 2009, and March 2010. The FDIC rejected all three plans due, in part, to the plans' high-risk nature, failure to provide for new contributions of permanent capital, and/or lack of a performance guarantee from the parent holding company. Ultimately, on March 19, 2010, the UDFI closed the institution and named the FDIC as receiver, due the bank's insolvency resulting, in part, from eroding/deteriorating capital.

Corporation Comments

On October 1, 2010, the Director, DSC, provided a written response to a draft of this report. That response is provided in its entirety as Appendix 4 of this report. In its response, DSC reiterated the OIG's conclusions regarding the causes of Advanta's failure, pointing out that Advanta failed due to insolvency brought on by the Board and management's failure to implement risk management practices commensurate with the unique nature of Advanta's business model. With regard to our assessment of the FDIC's supervision of Advanta, DSC summarized the supervisory history described in our report and recognized that it could have required Advanta to incorporate an early amortization scenario in its capital allocation model and contingency funding plans. DSC also pointed out that beginning in January 2010, institutions engaged in securitization activity, in the manner followed by Advanta, have been required to consolidate securitized assets for financial reporting purposes as a result of the implementation of Statement of Financial Accounting Standards (FAS) 166 and FAS 167. This accounting change will minimize the capital and liquidity risks associated with early amortization events for institutions following a business model similar to Advanta.

[9] According to Part 325 *Subpart B – Prompt Corrective Action,* an insured depository institution is deemed to be *Critically Undercapitalized* if it has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

Objectives, Scope, and Methodology

Objectives

We performed this audit in accordance with section 38(k) of the FDI Act, which provides, in general, that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the Inspector General of the appropriate federal banking agency shall prepare a report to that agency reviewing the agency's supervision of the institution. The FDI Act requires that the report be completed within 6 months after it becomes apparent that a material loss has been incurred.

Our audit objectives were to (1) determine the causes of Advanta's failure and resulting material loss to the DIF and (2) evaluate the FDIC's supervision of the institution, including implementation of the PCA provisions of section 38.

We conducted this performance audit from May 2010 to September 2010 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.

Scope and Methodology

The scope of this audit included an analysis of Advanta's operations from December 2004 until its failure on March 19, 2010. Our review also entailed an evaluation of the regulatory supervision of the institution from September 2006 to the bank's closing.

To achieve the objectives, we performed the following procedures and techniques:

- Analyzed examination reports prepared by the FDIC and the UDFI examiners from September 2006 to January 2010. These included risk management, compliance, and industrial bank holding company inspection reports.

- Reviewed the following:

  - UBPR and Call Report data from December 2004 to December 2009.

  - Examination work papers for the November 2008 and January 2010 examinations, as provided by DSC. In addition, subsequent to our examiner interviews, the FDIC provided work papers for the September 2006 and October 2007 examinations documenting the examiners' analysis of the bank's securitizations.

  - Correspondence maintained at DSC's New York Regional Office and Salt Lake City Field Office, as provided by DSC, from 2006 to 2010.

Objectives, Scope, and Methodology

  - Reports prepared by the Division of Resolutions and Receiverships (DRR) and DSC relating to the bank's closure.

  - External audit reports and other public records of the parent holding company from 2006 to 2008.

  - Pertinent DSC policies and procedures, and various banking laws and regulations.

  - Various economic data and market studies related to the contraction of the securitization markets.

- Interviewed the following FDIC officials:

  - DSC management (for both risk management and compliance disciplines) in Washington, D.C., the New York Regional Office, and Salt Lake City Field Office.

  - FDIC examiners (for both risk management and compliance disciplines) from the Salt Lake City Field Office, who participated in the examinations or reviews of examinations of Advanta.

  - A DSC subject matter expert on credit card securitizations (not involved in the FDIC's supervisory history of Advanta).

- Met with officials from the UDFI to discuss their historical perspective of the institution, its examinations, and other activities regarding the state's supervision of the bank.

We performed the audit work at the OIG's offices in Arlington, Virginia and Dallas, Texas.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations

Consistent with the audit objectives, we did not assess DSC's overall internal control or management control structure. We relied on information in DSC systems, reports, examination reports, and interviews of examiners to understand Advanta's management controls pertaining to causes of failure and material loss as discussed in the body of this report.

Objectives, Scope, and Methodology

We obtained data from various FDIC systems but determined that information system controls were not significant to the audit objectives and, therefore, did not evaluate the effectiveness of information system controls. We relied on our analysis of information from various sources, including examination reports, correspondence files, public information and testimonial evidence to corroborate data obtained from systems that was used to support our audit conclusions.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this material loss review, we did not assess the strengths and weaknesses of DSC's annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objectives. DSC's compliance with the Results Act is reviewed in program audits of DSC operations.

Regarding compliance with laws and regulations, we performed tests to determine whether the FDIC had complied with provisions of PCA and limited tests to determine compliance with certain aspects of the FDI Act. The results of our tests were discussed, where appropriate, in the report. Additionally, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

Related Coverage of Financial Institution Failures

On May 1, 2009, the OIG issued an internal memorandum that outlined major causes, trends, and common characteristics of FDIC-supervised financial institution failures that had resulted in a material loss to the DIF. The memorandum also indicated that the OIG planned to provide more in-depth coverage of those issues and make related recommendations, when appropriate. Since May 1, 2009, the OIG has issued additional MLR reports related to failures of FDIC-supervised institutions and these reports can be found at www.fdicig.gov. In June 2010, the OIG initiated an audit, the objectives of which are to (1) determine the actions that the FDIC has taken to enhance its supervision program since May 2009, including those specifically in response to the May 2009 memorandum, and (2) identify trends and issues that have emerged from subsequent MLRs.

In addition, with respect to more in-depth coverage of specific issues, in May 2010, the OIG initiated an evaluation of the role and federal regulators' use of the Prompt Regulatory Action provisions of the FDI Act (section 38, *PCA* and section 39, *Standards for Safety and Soundness*) in the banking crisis.

Glossary of Terms

Term	Definition
Affiliate	Under section 23A of the Federal Reserve Act (12 U.S.C. section 371c), an affiliate generally includes, among other things, a bank subsidiary, or a company that (1) controls the bank and any other company that is controlled by the company that controls the bank, (2) is sponsored and advised on a contractual basis by the bank, or (3) is controlled by or for the benefit of shareholders who control the bank or in which a majority of directors hold similar positions in the bank.
Allowance for Loan and Lease Losses (ALLL)	The ALLL 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. It is established in recognition that some loans in the institution's overall loan and lease portfolio will not be repaid. Boards of directors are responsible for ensuring that their institutions have controls in place to consistently determine the allowance in accordance with the institution's stated policies and procedures, generally accepted accounting principles, and supervisory guidance.
Call Report	Reports of Condition and Income, often referred to as Call Reports, include basic financial data for insured commercial banks in the form of a balance sheet, an income statement, and supporting schedules. According to the Federal Financial Institutions Examination Council's (FFIEC) instructions for preparing Call Reports, national banks, state member banks, and insured nonmember banks are required to submit a Call Report to the FFIEC's Central Data Repository (an Internet-based system used for data collection) as of the close of business on the last day of each calendar quarter.
Cease and Desist Order (C&D)	A C&D is a formal enforcement action issued by a financial institution regulator pursuant to 12 U.S.C. section 1818 to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Concentration	A concentration is a significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Contingency Funding (or Liquidity) Plan	A written plan that defines strategies for addressing liquidity shortfalls in emergency situations. Such plans delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Contingency funding plans should be regularly tested and updated to ensure that they are operationally sound. DSC uses the term contingency funding plan and contingency liquidity plan interchangeably.

Glossary of Terms

FDIC's Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) (1) performs examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations and (2) issues related guidance to institutions and examiners.
Financial Holding Company	A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The Federal Reserve Board is responsible for supervising the financial condition and activities of financial holding companies.
Growth Monitoring System (GMS)	GMS is an off-site rating tool that identifies institutions experiencing rapid growth or having a funding structure highly dependent on non-core funding sources.
Material Loss	As defined by section 38(k)(2)(B) of the FDI Act, and as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the period beginning January 1, 2010 and ending December 31, 2011, a material loss is defined as any estimated loss in excess of $200 million.
Off-site Review Program	The FDIC's Off-site Review Program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. Off-site reviews are performed quarterly for each bank that appears on the Off-site Review List. Regional management is responsible for implementing procedures to ensure that Off-site Review findings are factored into examination schedules and other supervisory activities.
Peer Group	Institutions are assigned to 1 of 15 peer groups based on asset size, number of branches, and whether the institution is located in a metropolitan or non-metropolitan area.

Glossary of Terms

Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the Deposit Insurance Fund. Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Risk-Based Capital	A "supplemental" capital standard under Part 325 of the FDIC Rules and Regulations. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2).
Statistical CAMELS Off-site Rating (SCOR) System	SCOR is a financial model that uses statistical techniques, off-site data, and historical examination results to measure the likelihood that an institution will receive a CAMELS downgrade at the next examination.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. section 325.2(v), as **The sum of**: • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock; and • Minority interest in consolidated subsidiaries; **Minus:** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).

Glossary of Terms

Tier 2 (Supplemental) Capital	Tier 2 capital is defined in Appendix A to Part 325 of the FDIC Rules and Regulations, and is generally the sum of: • Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; • Cumulative perpetual preferred stock, long-term preferred stock and related surplus; • Perpetual preferred stock (dividend is reset periodically); • Hybrid capital instruments; and • Term subordinated debt and intermediate-term preferred stock.
Tranches	Multiple classes of equity and debt that are set in a senior or subordinate position to one another based upon seniority in bankruptcy and timing of repayment. The tranches are divided into three general categories: (1) Senior tranche; (2) Mezzanine tranche; and (3) Equity tranche.
Uniform Bank Performance Report (UBPR)	The UBPR is an individual analysis of financial institution financial data and ratios that includes extensive comparisons to peer group performance. The report is produced by the Federal Financial Institutions Examination Council for the use of banking supervisors, bankers, and the general public and is produced quarterly from Call Report data submitted by banks.
Uniform Financial Institutions Rating System (UFIRS)	Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Each component, and an overall composite score, is assigned a rating of 1 through 5, with 1 having the least regulatory concern and 5 having the greatest concern.

Acronyms

ABCMT	Advanta Business Card Master Trust
ABRC	Advanta Business Receivables Corporation
ALLL	Allowance for Loan and Lease Losses
C&D	Cease and Desist Order
C&I	Commercial and Industrial
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CLP	Contingency Liquidity Plan
CRC	Consumer Response Center
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
DSC	Division of Supervision and Consumer Protection
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FICO	Fair Isaac Corporation
FIL	Financial Institution Letter
FTC	Federal Trade Commission
GMS	Growth Monitoring System
OIG	Office of Inspector General
ORL	Off-site Review List
PCA	Prompt Corrective Action

Acronyms

UBPR	Uniform Bank Performance Report
UDAP	Unfair or Deceptive Acts or Practices
UDFI	Utah Department of Financial Institutions
UFIRS	Uniform Financial Institutions Rating System

Corporation Comments

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

October 1, 2010

TO: Stephen Beard
Assistant Inspector General for Material Loss Reviews

/Signed/

FROM: Sandra L. Thompson
Director

SUBJECT: Draft Audit Report Entitled, Material Loss Review of Advanta Bank Corp., Draper, Utah (Assignment No. 2010-037)

Pursuant to Section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Deposit Insurance Corporation's Office of Inspector General (OIG) conducted a material loss review of Advanta Bank Corp., Draper, Utah (Advanta), which failed on March 19, 2010. This memorandum is the response of the Division of Supervision and Consumer Protection (DSC) to the OIG's Draft Report received on September 10, 2010.

Advanta failed due to insolvency brought on by the Board of Directors' (Board) and management's failure to implement risk management practices commensurate with the unique nature of Advanta's business model. As the economy began to negatively impact Advanta's small business credit card customers, management enacted a series of decisions that ultimately affected viability. Most significantly, management increased the interest rates on the majority of the card holder accounts and later cancelled charging privileges for all cardholders. Advanta's Board and management failed to consider the potential impact of these decisions on portfolio performance and violated consumer protection laws by failing to give clear and timely notice to consumers before raising their interest rates. Further, despite FDIC warnings about the legal, credit and reputational risks associated with the cancellation of charging privileges, management relied upon optimistic assumptions to determine whether Advanta could remain viable. Management's decisions led to mounting loan losses, early amortization of the securitized receivables, and erosion of capital.

DSC and the Utah Department of Financial Institutions conducted comprehensive supervision of Advanta, and DSC maintained strong coordination between its two supervisory functions, risk management and consumer protection. While Advanta maintained high levels of liquidity and capital in recognition of the risks associated with its business model and contemplated actions to prevent an early amortization scenario, DSC could have also required Advanta to incorporate such a scenario in its capital allocation model and contingency funding plans. Beginning in January 2010, institutions engaged in securitization activity, in the manner followed by Advanta, have been required to consolidate securitized assets for financial reporting purposes as a result of the implementation of Statement of Financial Accounting Standards (FAS) 166 and FAS 167. This accounting change will minimize the capital and liquidity risks associated with early amortization events for institutions following a business model similar to Advanta.

Thank you for the opportunity to review and comment on the Report.