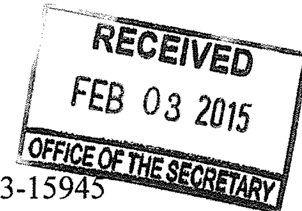
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

THOMAS A. NEELY, JR.,

Respondent.

Admin. File No 3-15945



EXPERT REPORT OF DALE KITCHENS
February 2, 2015

I. NATURE OF ASSIGNMENT

My name is Dale Kitchens and I am a resident of Southlake, Texas, a suburb of Dallas. The Division of Enforcement of the United States Securities and Exchange Commission ("SEC") has retained me as an expert in in the application of U.S. Generally Accepted Accounting Principles ("GAAP") and as an accounting and regulatory expert regarding accounting for and reporting of nonaccrual loans and allowances for loan and lease losses ("ALLL") in connection with this matter. This matter is an SEC enforcement administrative proceeding against Thomas A. Neely, Jr., former Commercial Credit Executive of Regions Bank. Within this report, Thomas A. Neely, Jr. is also referred to as "Neely" or the "Respondent."

Regions Financial Corporation (together with its subsidiaries on a consolidated basis, "Regions" or "Company") is a financial holding company headquartered in Birmingham, Alabama, which operates throughout the South, Midwest and Texas. Regions is an SEC registrant that is required to file various regulatory reports with the SEC, including periodic financial reports required by the 1934 Securities Act such as annual reports in Form 10-K and quarterly reports in Form 10-Q.

Regions conducts its banking operations through Regions Bank, an Alabama chartered commercial bank that is a member of the Federal Reserve System (the "Federal Reserve"). Regions Bank provides traditional commercial, retail and mortgage banking services, as well as other financial services in the fields of investment banking, asset management, trust, mutual funds, securities brokerage, insurance and other specialty financing. At December 31, 2008, Regions had total consolidated assets of approximately $146.2 billion, total consolidated deposits

of approximately $90.9 billion and total consolidated stockholders' equity of approximately $16.8 billion.[1]

I express certain expert opinions herein I have formed related to matters concerning certain Regions' accounting policies and practices as reported in its March 31, 2009 SEC Form 10-Q ("March 2009 10-Q") that were directly or indirectly affected by actions of Neely including the determination of, and accounting for certain nonaccrual commercial real estate ("CRE") loans and related ALLL.

The opinions that I express in this report are my professional opinions based on my: (i) education and training; (ii) prior professional experience, as discussed further herein; (iii) analyses of numerous investigative transcripts and depositions, documents produced in this case; (iv) independent research; (v) professional judgment; and (vi); analyses of various Regions' regulatory reports filed with the SEC. Refer to Appendix 1 for a copy of my curriculum vitae and Appendix 2 for a listing of information I have analyzed and considered in arriving at my opinions.

II. PROFESSIONAL QUALIFICATIONS

I am a certified public accountant ("CPA"), licensed in the State of Texas, with over 33 years of professional experience as a financial accountant, financial statements auditor and financial consultant serving companies in a broad range of industries, including financial services and mortgage lending. I am also a long-time member of the American Institute of Certified Public Accountants ("AICPA").

I am currently a Managing Director with Berkeley Research Group, LLC ("BRG"), a consulting firm headquartered in Emeryville, California. Prior to joining BRG in January 2012, I

1 Source: Regions' 2008 SEC Form 10-K, Item 1.

served as a Senior Assurance Services Partner at Ernst & Young LLP ("EY"), one of the four largest global public accounting, auditing and business advisory firms, commonly referred to as the "Big Four." My retirement from EY in December 2011 culminated a 31-year career in public accounting.

The scope of services in EY's Assurance Services practice includes performing audits of companies' financial statements and providing fraud investigation and dispute services ("FIDS"). I was the EY partner in EY's Southwest Sub-Area responsible for leading FIDS related services for EY's audit clients. In that capacity, I directly participated in certain financial statement audits performed by EY, especially those that involved allegations of fraud or financial reporting manipulation.

My professional experience includes: performing financial statement audits and internal control reviews; leading numerous fraud and forensic accounting investigations related to a variety of matters for SEC registrants, privately-held companies and federal agencies; serving as an expert witness and as an arbitrator in purchase price disputes related to the application of GAAP; serving as a consulting and testifying expert in accounting, auditing and forensic accounting related engagements, including auditor liability cases focused on the application of GAAP and generally accepted auditing standards ("GAAS") and standards issued by the Public Accounting Company Oversight Board ("PCAOB"), ("PCAOB Auditing Standards"); serving as an accounting and financial expert witness in various civil disputes; developing accounting and auditing standards for EY and the accounting profession; and developing and leading training courses on accounting and auditing topics for EY professionals and external groups.

A significant portion of my 34 year accounting, auditing and consulting career has been devoted to the professional application, evaluation and critique of the application of GAAP, and

to the application of SEC and other regulatory reporting requirements in connection with audits and the preparation of financial statements. A significant portion of my financial accounting and auditing career has been devoted to serving clients in the real estate and financial services industries.

From 1995 through 2000, I served as a partner in EY's National Audit Office where I co-authored the *Ernst & Young Global Audit Methodology* released globally in 1997; led the team that developed the EY supplemental audit guidance for audits of companies in the real estate industry; led EY's research and development activities (*i.e.*, the "Real Time Auditing Project") to automate the firm's audit processes with new information technologies; and served as the primary author that incorporated the provisions of the auditor's risk assessment process into EY's *Global Audit Methodology*. EY's National Audit Office is the group within the firm delegated the responsibility for assisting in the development of GAAS for the auditing profession and developing EY's methodologies and guidance to implement GAAS for the firm's audit practice.

From 2005 through 2008, I served as EY's Americas Practice Leader for all fraud and investigation services provided by EY in the U.S., including financial reporting fraud and restatement cases. During my tenure as the fraud and investigation services practice leader, our FIDS investigative teams participated in a wide variety of investigations, including allegations related to financial reporting fraud and manipulation, bribery and corruption, investment schemes (*e.g.*, Ponzi schemes and sham transactions), regulatory violations (*e.g.*, compliance with various federal and state laws and regulations), misappropriation of assets, collusive fraud involving third parties (*e.g.*, vendors or customers), the improper recognition of revenue in financial statements and other types of corporate fraud.

A. Financial Accounting and Financial Statement Audit Related Experience

Over my 33 year career performing professional accounting, auditing and consulting services, I have gained significant experience in applying financial accounting, auditing and regulatory pronouncements and practices.

Following are summaries of certain of my experiences related to financial accounting and financial statement related matters:

- During my career, I have led or participated in hundreds of audits of the financial statements of SEC registrants and privately-held entities, including real estate investment trusts and financial institutions such as banks, thrifts and mortgage companies. I also supervised or participated as quality reviewer in numerous audits of financial statements and advisory engagements over a broad range of industries.
- From 2002 through 2011, I led numerous engagements assisting in accounting related investigations on behalf of audit committees and management of companies ranging from Fortune 20 companies to small privately-held businesses. Those engagements included independent investigations for audit committees and advisory assessments for management regarding allegations of financial reporting misconduct. These engagements included the review of financial statement accounting and auditing matters.
- I have extensive experience in analyzing the audits performed by independent public accounting firms, especially those involving real estate and mortgage related assets and investment securities, in order to determine whether or not the auditors complied with GAAS or PCAOB Auditing Standards and whether the audited financial statements were presented in accordance with GAAP.

Examples include:

- Serving as a member of audit quality review teams that analyzed selected audits performed by various EY audit teams in a variety of industries to determine whether or not the audit teams had complied with GAAP and GAAS;
- Conducting evaluations of auditor compliance with GAAP and GAAS on behalf of various federal agencies;
- Serving as a neutral arbitrator involving merger and acquisition disputes over the proper application of GAAP related to working capital adjustments, closing balance sheets and earn-out calculations; and
- Serving as a retained expert witness or consultant regarding the proper application of GAAP and GAAS or PCAOB Auditing Standards for counsel on behalf of various accounting firms in litigation related to prior audits they had performed.

B. Experience Accounting For and Auditing Commercial Real Estate Loans

I have significant experience, throughout my career, applying the provisions of GAAP, bank regulatory and SEC financial reporting requirements to the recognition of interest income and losses on non-performing CRE loans such as those owned and reported by Regions in its March 2009 10-Q.

In 1989 and 1990, I served by appointment as a *Professional Accounting Fellow* in Washington D.C. with the Office of Thrift Supervision ("OTS"), the Bureau of the U.S. Treasury Department that regulates the thrift industry. While serving with the OTS, my experiences included, but were not limited to, the following where I:

- Advised the OTS Director and other agency executives on accounting, auditing and regulatory matters including those related to lending activities, loan loss reserves and capital adequacy;
- Served as the OTS Chief Accountant's liaison with the OTS Capital Markets Group, which provided agency expertise regarding thrift investment and capital market activities;
- Participated as an advisor in the examinations of financial institutions across the U.S. active in residential and commercial mortgage lending and mortgage servicing;
- Participated in the analysis, evaluation and critique of audit work papers of audits of regulated thrifts conducted by independent public accounting firms;
- Represented the OTS as a liaison with accounting and auditing professional standard setting bodies, and in this capacity, I attended meetings with: the Financial Accounting Standards Board ("FASB") and its Emerging Issues Task Force; the SEC; the AICPA and other federal regulatory agencies regarding the development and interpretation of GAAP and GAAS;
- Consulted with and advised the FASB staff in the development of Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("FAS 115") and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* ("FAS 114"); and
- Served as one of the OTS Chief Accountant's designated subject matter experts to respond to questions from regulated financial institutions, field examiners, and other regulatory agencies regarding regulatory accounting and GAAP and GAAS issues

related to real estate lending and investment matters, including accounting for nonaccrual CRE loans and related ALLL.

C. Expert Witness and Consulting Services Related Experience

Over the past 28 years, I have been retained as a testifying financial expert or consulting expert in connection with numerous litigation matters for a broad range of companies and U.S. government agencies, especially those involving financial services, mortgage lending and real estate.

Following are summaries of certain of my expert witness and related consulting experiences:

- I have served as an expert witness or retained consultant for several U.S. Government agencies related to the audits of financial statements, investigations and litigation matters including the following examples:
  - I served as the SEC's testifying GAAP accounting expert in an enforcement case in federal district court in New Mexico filed against the former CEO, CFO and CAO of a large residential mortgage origination and securitization company. The case involved the restatement of financial statements and going concern considerations resulting from *other-than-temporary* impairment of debt securities under Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*
  - I served as the FDIC's testifying GAAP and regulatory reporting expert in an arbitration conducted in Washington, D.C. that involved the accounting for charge-offs and losses incurred by a Puerto Rican commercial bank on a large portfolio of impaired commercial real estate loans.
  - I was retained by the U.S. Department of Justice to testify on behalf of the U.S. in a case pending in the U.S. Court of Claims in Washington, D.C. The case related to a $5 billion thrift that had failed in the early 1990s as a result of losses stemming from commercial real estate loans and investments; and
  - I testified as an expert witness in Federal District Court in Houston on behalf of the Federal Deposit Insurance Corporation. The case stemmed from the failure of several commercial banks that failed from losses suffered on commercial loans, including real estate loans. My testimony resulted from the analysis of commercial and real estate loans and the timing of related allowances for loan losses recorded by the banks, as well as various federal banking laws and regulations governing the payment of dividends.

- In 2004, I was retained by counsel for a Fortune 20 financial institution to analyze numerous GAAP accounting issues being investigated by the institution's primary regulator and the SEC, including those related to derivatives and hedging activities, allowances for loan losses, asset impairment, loan premium/discount amortization and other accounting issues. The regulatory actions led to a multi-billion dollar restatement of previously-issued financial statements and an SEC enforcement settlement.

- In 2011, I served as a testifying expert for a Fortune 600 diversified manufacturing company in a case filed against the company in Federal District Court in New Jersey. My testimony related to the application of SEC financial reporting requirements related to the calculation of revenue from the sale of a large business unit.

- I have served as a testifying expert and consulting expert to various Big Four and second tier accounting and auditing firms in connection with professional malpractice lawsuits brought against them resulting from their audits of financial statements. My testimony and consultations in those cases related to the proper application of GAAP, SEC financial reporting requirements and GAAS. A significant number of those engagements related to financial services, mortgage lending and real estate.

- I served as a testifying expert for a Fortune Global 30 investment bank (plaintiff) in a suit brought against a large U.S. commercial bank. The case related to a $600 million portfolio of subprime loans purchased by the investment bank from a subprime mortgage originator that were included in several mortgage-backed securitizations.

- I was retained as a testifying expert for a small Texas bank to calculate actual damages related to the bank's liability under the provisions of a securities safekeeping agreement. I testified during multiple depositions and during a jury trial in probate court in Galveston, Texas in that case.

- I was retained as a testifying expert by counsel on behalf of an SEC registrant and its insurance carrier to investigate and analyze the financial condition of the company in order to evaluate its ability to post a $28 million supersedes bond ordered by a Texas state court.

III. SUMMARY OF MY OPINIONS

After performing extensive analyses on the documents, facts and testimony I have considered in this case and after considering relevant professional standards and SEC rules and regulations, I have formed the following professional opinions and observations:

- The financial statements included in Regions' March 2009 10-Q, as originally filed by Regions with the SEC on May 11, 2009, contained material misstatements (*i.e.*,

material intentional errors) directly related to the actions of Neely, causing Regions to not comply with GAAP and SEC rules and regulations. Specifically, the loans discussed in this report that were pulled from nonaccrual in March 2009 should have been classified as nonaccrual as of March 31, 2009 because full collection of contractual principal and interest on these loans was sufficiently in doubt by that time. Neely's actions in keeping these loans on accrual status at quarter end materially overstated both the non-performing loans and earnings before taxes that Regions reported in its first quarter of 2009 financial statements. Moreover, the evidence that I have reviewed suggests that Neely's actions were intended to enable his division to meet a specified non-performing loan target that had been communicated to senior bank management. Such misstatements are qualitatively material under applicable accounting literature, regardless of the actual amount.

- Evidence of the indicia of financial reporting fraud resulting from the actions of Neely in March 2009 related to the reporting of certain non-performing loans in Regions' March 2009 10-Q exists in this case as discussed in detail in the remaining sections of my report. Some notable examples of the indicia of financial reporting fraud are:
    - The evidence I have reviewed suggests that Neely's actions were intended to enable his division to meet a specified non-performing loan target that had been communicated to senior bank management.
    - While there was substantial documentation of the reasons why these loans were recommended to be reclassified as nonaccrual loans as of March 31, 2009, there is almost a complete absence of contemporaneous documentation explaining why those recommendations were rejected or the rational supporting the decision to keep those loans on accrual at quarter end.
    - Neely and other Regions personnel provided misleading information to the Federal Reserve in connection with that agency's target review of Regions in May 2009. That review was focused on uncovering the reasons why many of the loans discussed in this report were pulled from nonaccrual status in march 2009

The remainder of this report provides explanations and supporting references for my opinions and includes additional opinions I have formed.

IV. BACKGROUND INFORMATION

A. Definitions

This section defines additional acronyms and key terms used throughout this report.

(1) **AQF-** Asset Quality Forecast- a weekly report prepared by each of the various regions of the Regions' Special Assets Department showing or forecasting, inter alia, future non-performing loans. That report had sections that are relevant to my analysis. The first section, "Forecast for NPL", listed loans that had been

recommended for nonaccrual. The second, referred to as "PUE" (Potential Upcoming Event), was a watch list of other loans that might become non-accrual at some future point. In the first quarter of 2009, this weekly report was sent to senior management in Birmingham, including Neely, Michael Willoughby and Jeffrey Kuehr (referenced below), and many of the loans in the Forecast for NPL section of the report were discussed at the weekly AQF meetings.

(2) **Charge-off** – Refers to the portion of a loan that is deemed a total loss that is not recoverable (the recorded book balance of the loan) and is written off.

(3) **CRE** – Refers to commercial real estate.

(4) **Division Exhibit(s)** – Used in source cites throughout this report; refers to the exhibits listed on the Division of Enforcement's First Amended Exhibit List in this matter, many of which were also used in sworn witness testimony taken by the staff of the Federal Reserve in its investigation of the same conduct that resulted in this case being filed.

(5) **FAS 5** – Statement of Financial Accounting Standards No. 5 – *Accounting for Contingencies* ("FAS 5"). FAS 5 was issued by the FASB in 1975 and it was the primary accounting standard related to impairment recognition of smaller balance homogeneous loans held by banks (*e.g.* residential mortgages or credit card receivables) in the first quarter of 2009.

(6) **FAS 114** – Statement of Financial Accounting Standards No. 114 – *Accounting by Creditors for Impairment of a Loan* ("FAS 114"). FAS 114, issued by the FASB, was the authoritative source of GAAP for determining and reporting impairment losses on larger balance, non-homogeneous loans, such as CRE loans held by a commercial bank, in the first quarter of 2009. FAS 114 was developed and issued by the FASB in 1994 using the core principles set forth in FAS 5 for asset impairment recognition.

(7) **GSCO** – Refers to Regions' Group Senior Credit Officer.

(8) **HFS - Held for Sale** – Refers to loans that have been identified for sale and for which a company has made the decision to sell.

(9) **LTV** – Refers to "loan-to-value" ratio. Mortgage lenders and regulatory agencies use this ratio to understand how the outstanding amount of a loan (the unpaid principal and interest balances) compares to (or is supported by) the appraised value (or market value) of the loans collateral. For example, a loan of $80,000 made for a borrower to purchase real estate with a current appraised market value of $100,000 would yield an 80% LTV ratio. While the LTV ratio is an indicator of collateral adequacy, it is not an accurate indicator of how much a lender would recover of a loan's value upon foreclosure because the ultimate sales price received or foreclosed assets generally falls short of the appraised market value and the LTV ratio does not account for the costs of maintaining the asset until the collateral can be foreclosed and sold. And, it does not take into account the costs

of disposal such as brokerage fees. Accordingly, a loan generally requires a LTV ratio well below 100% (*e.g.*, 80% or less) to ensure adequate collateral value to avoid credit loss on the loan in the event of borrower default requiring bank foreclosure.

(10) **NPA** – Refers to non-performing asset, *i.e.*, bank assets that are not producing income as intended.

(11) **NPL** – Refers to non-performing loan. They are also referred to as "nonaccrual loans" because NPLs are loans that are no longer accruing contractual interest income. The terms NPL and "nonaccrual loans" are generally used interchangeably, including in this report. They are a subset of non-performing assets ("NPAs"), which, in addition to NPLs, include assets like other real estate owned ("OREO"), *i.e.*, real estate assets that the bank acquires and owns though foreclosure.

(12) **OREO** – Refers to Other Real Estate Owned. It represents foreclosed real estate taken from a borrower by a lender in satisfaction of a defaulted mortgage loan.

(13) **PLR** – Refers to "Problem Loan Report," which was a Regions detailed report prepared by SAD or other officers involved in loan workouts that described the status of a problem loan.

(14) **PSOR** – Refers to Primary Source of Repayment.

(15) **PUE** – Used herein to mean Potential Upcoming Event.

(16) **Pulled Loans** – The loans evaluated in this report that the SEC alleges were improperly pulled from nonaccrual status by Neely as of March 31, 2009. These loans include CRE loans made by Regions to the following borrowers with the following outstanding loan balances at March 31, 2009:

- Glove Factory Holdings LLC - $24.7 million;
- Resorts Construction LLC - $21.2 million;
- Water's Edge One LLC - $15.5 million;
- McCar Development Corp - $9.4 million;
- First West Cutler - $10.9 million;
- Seahaven Finance LLC - $6.8 million;
- Designers Choice Cabinetry - $2.6 million;
- Richland Investments LLC - $41.9 million;
- Wilval LLC - $5.2 million;
- River Glenn LLC - $3.8 million; and
- Kicklighter Custom Homes, Inc. - $2.6 million.

(17) **REVS** – Refers to Regions Real Estate Valuation Services department.

(18) **Rules 6 Report (a/k/a "Processing List")** – Rules 6 Report was designed as an electronic record documenting the specific actions for individual loans to be formally taken by Regions Bank and reflected in its accounting systems. The Report 6 was prepared by staff within Region Bank's Credit Risk Reporting group.

(19) **SAD** – Refers to the Special Assets Department, a specialized group within Regions Bank that had the responsibility of "working out" or resolving problem loans for maximum loan collection and recovery.

B. References to Various Witnesses or Regions Employees

This section of my report lists the names of various witnesses in this matter or Regions employees referred to in this report and their position or title during the first quarter of 2009.

(1) Tom Aderhold, Regions Special Assets Division Region Manager who reported to Jeff Kuehr except while Steve Wood served as a SAD Group Manager;

(2) John Baldwin, Regions Executive Vice President, Special Assets Division;

(3) Carey Barrentine, Regions Bank Risk Management who reported to Michael Willoughby;

(4) Susan Bell, Regions Special Assets Division, Relationship Manager reported to Kent Harrell;

(5) Donald Bius, Regions Special Assets Division, Relationship Manager who reported to Bill Teegarden;

(6) Jeffrey Cash, Regions Executive Vice President, Florida Real Estate who reported to Brett Couch;

(7) Scott Corrigan, Regions Special Assets Division Region Manager who reported to Kuehr (until Steve Wood was hired as a SAD Group Manager);

(8) Adam Dixon, Regions Credit Review personnel;

(9) Andrea Florio, VP, Regions Credit Risk Reporting, who reported to Shannon Welch;

(10) Roger Fox, Regions Group Senior Credit Officer who reported to Tom Neely;

(11) Kent Harrell, SVP and team leader within Regions Special Assets Division who reported to Aderhold;

(12) Jordy Henson, representing prospective purchasers for one of the "Pulled Loans";

(13) Edward Hutchison, hired as a Group Manager in SAD in March 2009, reported to Jeffrey Kuehr;

(14) Robert Korte, Regions Special Assets Division Regional Manager who reported to Kuehr;

(15) Jeffrey Kuehr, Head of SAD, reported to Michael Willoughby;

(16) Scott McLay, Vice President- Regions Atlanta Real Estate Division who reported to Wendell Burns, but who also had loan workout responsibilities;

(17) Tom Neely, Regions Business Service Credit Executive, reported to Michael Willoughby;

(18) David Papke, Regions Group Senior Credit Officer who reported to Neely;

(19) Roderick Reimer, Regions Special Assets Division Relationship Manager, reported to Kent Harrell;

(20) Michael Smith, Regions Group Senior Credit Officer reported to Neely;

(21) William Teegarden, Regions Special Assets Division Region Manager who reported to Kuehr until Ed Hutchison was hired as a SAD Group Manager in early March 2009; and

(22) Michael Willoughby, Regions Chief Credit Officer ("Willoughby") who reported to Bill Wells (see below).

(23) William C. "Bill" Wells, Regions Chief Risk Officer.

C. Regions' Internal Loan Risk Rating System

During the first quarter of 2009, Regions Bank assigned risk ratings to certain loans to reflect the level of risk associated with that loan. The higher the rating, the greater the risk, to Regions Bank. The following risk ratings used by Regions are relevant to my analysis:

- **Risk Rating of "60" or "RR 60"-** Loan was rated "Special Mention." Credits [extensions of credit such as a loan] with this risk rating supposedly had "potential weakness[es] which may, if not corrected, weaken the credit or inadequately protect the bank's position at some future date." According to Regions' Commercial Loan Policies Manual, examples of credits in this category were borrowers with "declining operating trends which have not yet jeopardized debt repayment," or "a weakening balance sheet which has not yet jeopardized liquidation of the debt."

- **Risk Rating of "70" or "RR 70"–** Loan was rated as "Substandard-Accruing." Credits with this risk rating supposedly had "clearly defined weaknesses which presently jeopardize debt repayment." According to Regions' Commercial Loan Policies Manual, examples of substandard credits included "primary source of repayment was inadequate", "failure to adhere to original repayment schedule or repayment source which does not materialize credit has become clearly collateral or guarantor reliant", or "collateral coverage may potentially be inadequate due to a weakening balance sheet and/or the quality of the collateral pledged." [2]

- **Risk Rating of "75" or "RR 75"** – Loan was rated as "Substandard-Nonaccrual." According to Regions' Commercial Loan Policies Manual, loans with this rating exhibited some or all of the characteristics of loans with a 70 rating, but the debtor was also placed on nonaccrual status, which meant that no interest income could be recognized on the loan due to concerns over the collectability of outstanding principal and interest recognized in prior periods. When a loan is placed on nonaccrual, interest income previously recognized in the current period had to be reversed. For example, if a loan was placed on nonaccrual status on March 31, 2009, Regions was required to reverse interest income previously recorded in January and February 2009 in addition to any interest income recorded in March 2009.[3]

- **Risk Rating of "80" or "RR 80"** – Loan was rated "Doubtful." Credits with this rating "exhibit all the characteristics of substandard loans, with the added characteristic that "the evident weaknesses make collection or liquidation of the debt, in full, highly questionable or improbable based upon current facts, conditions or values." An email sent by a SAD Regional Manager explained that, "if you know, or strongly suspect, you have some loss but you can't determine what that loss is, you have a Doubtful (RR80)." Division Exhibit ("Div. Ex.") 98.

V. ACCOUNTING FOR NPLS (NONACCRUAL LOANS) AND RELATED LOAN LOSSES

A. NPLs

NPLs are loans that are not generating the stated (or contractual) interest rate because of non-payment from the borrower or the bank's perception that full payment of the contractually

[2] It is my understanding that, under Regions' accounting practices, Regions provided a loan loss allowance for each CRE loan that was risk rated 70, Substandard-Accruing, calculated at 12.5% of the outstanding loan balance.

[3] It is also my understanding that, under Regions' accounting practices, each CRE loan risk rated 75, Substandard-Nonaccrual, or higher with an outstanding loan balance of $2.5 million or more required a FAS 114 calculation to determine the required loan loss allowance.

due principal and/or interest on the loan is in doubt, even if the loan was then current. Nonaccrual loans are a subset of non-performing assets ("NPAs"), which, in addition to nonaccrual loans, include assets like other real estate owned ("OREO"), *i.e.* real estate that the bank owns though foreclosure.

A commercial bank's basic operating business model is to use customer deposits (checking accounts, savings accounts, certificates of deposit, etc.), which are generally insured by the FDIC, to make loans to businesses and individuals that generate interest income. A banks management of credit risk and timely and accurate reporting of non-performing loans and credit losses to investors, regulatory agencies and other users of its financial reports is extremely important to allow a sufficient understanding of the bank's financial condition.

As stated in the SEC's charging document in this case, GAAP does not provide specific guidance regarding the recognition of interest income on impaired loans. In that regard, the following quote from FAS 114 states the following:

> "17. This Statement does not address how a creditor should recognize, measure, or display interest income on an impaired loan. Some accounting methods for recognizing income may result in a recorded investment in an impaired loan that is less than the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral). In that case, while the loan would meet the definition of an impaired loan in paragraph 8, no additional impairment would be recognized. Those accounting methods include recognition of interest income using a cost-recovery method, a cash-basis method, or some combination of those methods."[4]

The FASB decided not to provide specific interest income recognition guidance for impaired loans because of the differing environments in which lenders operate (*i.e.*, some have required accounting guidance from regulatory agencies that must be followed, such as commercial banks, and other lenders do not). Accordingly, each lender has the flexibility to

[4] FAS 114, paragraph 17.

adopt its own interest income recognition accounting policies used to prepare its GAAP based financial statements.

The following quote from Regions' 2008 10-K sets forth the GAAP accounting policy for interest income recognition and placing loans on nonaccrual status adopted by Regions:

> "**Loans are placed on non-accrual status when management has determined that full payment of all contractual principal and interest is in doubt,** **or** the loan is past due 90 days or more as to principal and/or interest unless the loan is well-secured and in the process of collection. **When a loan is placed on non-accrual status, uncollected interest accrued in the current year is reversed and charged to interest income**. Uncollected interest accrued from prior years on loans placed on non-accrual status in the current year is charged against the allowance for loan losses. Charge-offs on commercial loans occur when available information confirms the loan is not fully collectible and the loss is reasonably quantifiable... Interest collections on non-accrual loans for which the ultimate collectability of principal is uncertain are applied as principal reductions [*i.e.*, cost recovery method]. Regions determines past due or delinquency status of a loan based on contractual payment terms."[5] [Emphasis added]

In addition, the following describes Region's nonaccrual loan policy in further detail:

"The loan is placed on non-accrual if **any** of the following occurs:

1. A loan should be placed on non-accrual (even if current) if collection in full of contractual principal and interest becomes doubtful or if the loan is classified "Doubtful" or "Loss" by the Relationship Manager, Area Credit Officer, Senior Credit Officer, or Credit Review,
2. A partial charge-off has occurred, unless the loan has been brought current under its contractual terms (original or restructured terms) and the remaining principal and interest is considered to be fully collectible. Reference Section 800-10, Troubled Debt Restructuring,
3. Delinquent on any principal or interest for 90 days or more unless the obligation is both well secured and in the process of collection."[6] [Emphasis Added]

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[5] Regions' Form 10-K for the year ended December 31, 2008, page 100.

[6] Div. Ex. 357, p. 1.

Further, as a federally regulated commercial bank, Regions is required to file a quarterly FFIEC[7] Consolidated Report of Condition and Income (referred to as a "Call Report") with its federal regulators that must be prepared in accordance with GAAP. One of the key components of the Call Report is Schedule RC-N-Past Due and Nonaccrual Loans, Leases, and Other Assets ("RC-N-Past Due")

The Call Report Instructions for RC-N-PAST DUE defines a past due loan as follows:

> "Past Due – The past due status of a loan or other asset should be determined in accordance with its contractual repayment terms. For purposes of this schedule, grace periods allowed by the bank after a loan or other asset technically has become past due but before the imposition of late charges are not to be taken into account in determining past due status."[8]

The Call Report Instructions further define a nonaccrual loan as follows, which is consistent with Regions stated nonaccrual policies stated described previously:

> "Nonaccrual – For purposes of this schedule, an asset is to be reported as being in nonaccrual status if:
>
> (1) It is maintained on a cash basis because of deterioration in the financial condition of the borrower,
>
> (2) **Payment in full of [loan] principal or interest is not expected,** or
>
> (3) Principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection."[9] [Emphasis Added]

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[7] The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Consumer Financial Protection Bureau, and to make recommendations to promote uniformity in the supervision of financial institutions.

[8] Reports of Condition and Income Instructions, General Instructions, FFIEC 031 and 041 RC-N-1 (3-08), RC-N- PAST DUE.

[9] Ibid.

With respect to the third condition above (3) that requires nonaccrual status classification, the terms "well secured" and "in the process of collection" are further defined in the Call Report Instructions as follows:

> "An asset is 'well secured' if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is 'in the process of collection' if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.
>
> For purposes of applying the third test for nonaccrual status listed above, the date on which an asset reaches nonaccrual status is determined by its contractual terms. If the principal or interest on an asset becomes due and unpaid for 90 days or more on a date that falls between report dates, the asset should be placed in nonaccrual status as of the date it becomes 90 days past due and it should remain in nonaccrual status until it meets the criteria for restoration to accrual status..."[10]

The Call Report includes a line item (Item No. 7) to one of its schedules for "Additions to Nonaccrual Assets During the Quarter" and instructs that banks should "[r]eport the aggregate amount of all loans, leases, debt securities, and other assets (net of unearned income) that have been placed in nonaccrual status during the calendar quarter ending on the report date. Include those assets placed in nonaccrual status during the quarter that are included as of the quarter-end report date in Schedule RC-N, column C, items 1 through 9. Also include those assets placed in nonaccrual status during the quarter that, before the current quarter-end, have been sold, paid off, charged-off, settled through foreclosure or concession of collateral (or any other disposition of the nonaccrual asset) or have been returned to accrual status. In other words, the aggregate amount of assets placed in nonaccrual status since the prior quarter-end that should be reported in

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[10] Ibid.

this item should not be reduced, for example, by any charge-offs or sales of such nonaccrual assets. If a given asset is placed in nonaccrual status more than once during the quarter, report the amount of the asset only once."

B. Accounting for Loan Losses – FAS 114

Another key consideration for troubled loans is whether or not the lender is required to recognize credit losses on the loans. While it is possible that a CRE loan might meet the conditions for nonaccrual loan status but not require the recognition of credit losses, many troubled CRE loans do. FAS 114 was issued by the FASB to give accounting guidance for impairment loss recognition on larger balance, non-homogeneous loans, such as Regions' CRE loans discussed in this report.

The following quote from FAS 114 sets forth the GAAP standards for the recognition of credit losses on impaired loans:

> "8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in this Statement and in Statement 5, [FAS 5] as amended, *all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement."[11]
>
> "10. The term *probable* is used in this Statement consistent with its use in Statement 5, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows:
>
> *Probable.* The future event or events are likely to occur.
>
> *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
>
> *Remote.* The chance of the future event or events occurring is slight.

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[11] FAS 114, paragraph 8.

The term probable is further described in paragraph 84 of Statement 5, which states:

> The conditions for accrual in paragraph 8 [of Statement 5] are not inconsistent with the accounting concept of conservatism. **Those conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued.** [Emphasis added.] They require only that it be *probable* that an asset has been impaired or a liability has been incurred and that the amount of loss be *reasonably* estimable. [Emphasis in original]"[12]
>
> "13. When a loan is impaired as defined in paragraph 8 of this Statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable...A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense."[13]

As previously mentioned, Regions' accounting practice was to provide a loan loss allowance for loans risk rated 70 (Substandard-Accruing) calculated at 12.5% of the outstanding loan balance. But, for CRE loans over $2.5 million, Regions calculated the loan loss allowance for each individual loan risk rated 75 under FAS 114 via a detailed FAS 114 calculation based on the loans collateral value, less costs to dispose of the collateral. Therefore, moving a loan from "Substandard-Accruing" (RR 70) to "non-accrual" (RR 75) in situations where the collateral value is significantly less than the outstanding loan balance causes the recognition of substantial

[12] Ibid., paragraph 10.

[13] Ibid., paragraph 13.

additional loan losses above the 12.5% allowance provided for RR 70 loans. In the latter sections of this report, I calculate the material additional loan loss impact on Regions' March 2009 10-Q caused by Neely keeping the Pulled Loans on accrual status as of March 31, 2009.

VI. CERTAIN REGIONS' CRE LOANS EVALUATED REQUIRED NONACCRUAL STATUS AND RECOGNITION OF IMPAIRMENT LOSSES

This section of my report sets forth my opinions related to certain individual Regions CRE loans that I have evaluated, specifically the assessment of such loans for proper "nonaccrual" status classification and whether such loans required recognition of loan losses under GAAP and federal banking agencies guidelines as of March 31, 2009. The loans I evaluated are the loans that I understand the SEC alleges were improperly pulled from nonaccrual status and continued to be classified as accrual status in Regions' March 31, 2009 10-Q ("the Pulled Loans"). While these loans were classified as accrual as of March 31, 2009 by Regions as a result of the actions of Neely and others pulling them from the nonaccrual loan list, my analysis as described below makes it abundantly clear that all the following loans should have been classified as "nonaccrual" effective March 31, 2009 and that additional loan losses should have been recognized on these loans.

A. Regions Faced a Distressed Economic Environment in the First Quarter of 2009

The severely distressed economic and financial environment Regions and its borrowers were operating in during the first quarter of 2009 is an important backdrop for Neely's actions upon his discovery of the significant underreporting error in forecasted NPLs in mid-March 2009. (Div. Ex. 136). These pressures would have provided a heightened motivation for Neely to underreport actual NPLs for the quarter. Many of the loans covered in the latter sections of this

report were CRE development loans related to real estate developments in Florida, which was one of the hardest hit real estate markets during the 2008-2009 financial crisis.

It is clear from the documents and testimony that I have reviewed in this case, that containing and minimizing the adverse financial effects of NPLs was a key goal of Regions' management, especially Neely, in early 2009 as problem loans continued to escalate. In just the two-year period between March 31, 2007 and March 31, 2009, Regions' reported NPLs had ballooned from $349.8 million[14] to $1.641 billion[15]. In addition to NPLs, the following disclosure in Regions' March 2009 10-Q shows that NPAs almost doubled from the prior year:

> "Total non-performing assets were $2.3 billion at March 31, 2009 compared to $1.7 billion at December 31, 2008 and $1.2 billion at March 31, 2008."[16]

As a result of the severe effects of the financial crisis, Regions' common stock price dropped from a pre-crisis high of $38.87[17] per share at October 13, 2006 to just $4.26[18] per share on March 31, 2009, a drop of almost 90%. The level of NPAs, including NPLs, resulting from the 2008-2009 financial crisis had such a devastating impact on the stock price of Regions because of the reduction in income generating assets, the recognition of losses that were under-reserved and the substantial uncertainty that investors perceived about potential additional losses embedded in the loan portfolio.

As a result of capital adequacy concerns surrounding commercial banks in the first quarter of 2009, the Federal Reserve performed "stress tests" of the capital adequacy of Regions

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14 Regions' Form 10-Q for the quarter ended March 31, 2008, page 33.

15 Regions' Form 10-Q for the quarter ended March 31, 2009 ("March 2009 10-Q"), page 36.

16 Ibid., page 36.

17 http://finance.yahoo.com/q/hp?s=RF&a=09&b=31&c=2006&d=02&e=31&f=2009&g=d

18 Ibid.

Bank and other commercial banks. These were tests which focused on key risks such as credit risk, market risk, and liquidity risk designed to determine whether the banks had enough capital to withstand the impact of adverse developments. The Federal Reserve was actively performing the stress tests on Regions Bank during March 2009 when the actions of Neely to pull impaired loans off the NPL list occurred.

The financial statements footnote, quoted below, included in Regions' March 2009 10-Q disclosed the fact that Regions was not given the results of the stress test by the Federal Reserve until May 7, 2009, which was just 4 days before the March 2009 10-Q was filed with the SEC, but after Neely had already pulled the loans described later in this report from NPL status. Also, the following disclosure indicates that Regions was required to raise $2.5 billion in additional capital as a result of the Federal Reserve stress tests.

> "NOTE 13—Subsequent Event
>
> On May 7, 2009, the final results of the Federal Reserve's Supervisory Capital Assessment Program were released to the Company. **Regions is required to submit a capital plan to its regulators by June 8, 2009 detailing the steps to be utilized to increase total Tier 1 Common** [capital] **by $2.5 billion**, of which at least $0.4 billion must be new Tier 1 equity. Regions is seeking to raise the full amount of additional capital through a range of actions which could include liability management strategies, equity issuances and asset dispositions. If Regions is able to raise the full amount through these actions, the Company would not need to rely on the U.S. government for any additional capital. However, if necessary, the government's programs do allow the conversion of up to $2.1 billion of the $3.5 billion of preferred stock that was issued under the Capital Purchase Program during 2008 into convertible preferred stock available under the Capital Assistance Program. Capital raising actions must be completed by November 9, 2009."[19] [Emphasis Added]

A substantial further repercussion of the requirement for Regions to raise additional capital was the substantial dilution of the interests held by current common stockholders because

[19] Regions' March 2009 10-Q, page 28.

the additional capital had to be raised when its stock price was near a historic low. The following Form 8-K disclosure indicates that on May 27, 2009 Regions raised $2.09 billion of additional capital, including issuing common stock at a price of $4 per share, which had the effect of diluting existing shareholders:

> "On May 27, 2009, Regions issued and sold 460 million shares (which includes 60 million optional shares purchased by the underwriters) of its common stock at a price to the public of $4 per share and 250,000 shares of its 10% Mandatory Convertible Preferred Stock, Series B ('Mandatory Convertible Preferred Stock'), at a price to the public of 100% of the initial liquidation preference of $1,000 per share...The offerings will generate gross proceeds of approximately $2.09 billion, without giving effect to the exercise of the underwriters' options to purchase additional shares of Mandatory Convertible Preferred Stock."[20]

The extreme adverse financial and economic conditions Regions and its borrowers faced in the first quarter 2009 were important context for Neely's actions resulting in the understatement of the level of NPLs reported in Regions' corporate records and regulatory and public filings, including its March 2009 10-Q. The credit quality ratios of banks, including the ratio of performing to non-performing loans, were important metrics considered by financial analysts in the banking industry.[21] When a bank's credit quality is in decline because of non-performing loans and increases in charge-offs, this may be viewed as an indication that the bank's earnings and capital may be at risk, and may affect the bank's share price. The economic environment, the ballooning levels of NPLs at Regions, and the stress testing by the Federal Reserve would have created significant pressures to avoid ending the first quarter of 2009 with NPL levels that substantially exceeded internal forecasts, particularly when the overage was a

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20 Regions' SEC Form 8-K dated May 27, 2009.

21 *See, e.g.*, Barclays Capital January 21, 2009 research report for Regions Financial (Regions_041212SECSubpoena_006499 – 501), which discusses the "NPA ratio" as a performance metric. The NPA ratio is the ratio of non-performing assets to total assets.

result of a mathematical error discovered near the end of the quarter. Indeed, a January 2009 report from Bernstein Research, an analyst covering Regions, stated "We believe the most critical credit statistic this cycle will be NPA inflows."[22]

B. Background Regarding the Removal of the Loans at Issue From the Processing Report and Other Pertinent Events

1. Introduction

The documents and testimony that I have reviewed shows that the Business Services unit of Regions, with the input of Neely, identified early in the quarter a target level for quarter end NPLs. (*See, e.g.*, Div. Ex. 7 at REG00382752 (Neely asking Regional Managers and Credit Officers to identify quarterly goals); and REG00292358 (Neely notes that NPLs were "over our quarter end forecast"); Div. Ex. 239 (Neely announcing 2d quarter goal "for your area to hit the NPL forecast as reported in the 4/17 AQF")); *see also,* Teegarden Depo, p. 44-46; Fox Depo, p. 43).

There is nothing unusual with banks attempting to forecast quarter end NPLs. But those forecasts constantly change as the quarter progresses because the conditions of the loans and the borrowers are fluid. The manner in which the Business Services unit of Regions used NPL goals was a questionable practice at best, as the target number was identified early in the quarter, and communicated to Regions' executive council, which consisted of Regions Bank's senior management. The documents and testimony that I reviewed shows that Neely and others then encouraged and/or pressured SAD and credit personnel to meet that goal by making aggressive accrual decisions throughout the quarter.

As a result of the discovery of a significant forecasting error in mid-March, Neely realized that the NPLs for Regions' Business Services unit would likely exceed the first quarter

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22 Regions_041212SECSubpoena_006268.

target by a significant amount. (Div Ex. 136). A few days later, a significant number of loans that had been recommended for nonaccrual status at quarter end were pulled from the nonaccrual list (the Pulled Loans), and remained on accrual as of March 31, 2009. To the extent that any of the Pulled Loans were deliberately or recklessly misclassified as a result of a deliberate effort to meet predetermined NPL targets or to arbitrarily limit reported NPLs, this would render any such misclassification qualitatively material (in addition to being quantitatively material). (See discussion below at Section VII, pp. 94-108). The documents and testimony that I have reviewed give rise to concerns that the Pulled Loans were unreasonably maintained on accrual status at March 31, 2009 in order to meet a target for NPLs established early in the quarter, or in order to limit reported NPLs for the quarter for other improper reasons. Heightening my concerns is the complete lack of documentation supporting the decision to pull these loans from nonaccrual. Below, I offer the foundation for these concerns and cite the pertinent source documents.

The concerns over deliberate misstatement of NPLs arise from at least four related areas:

- The discovery of a large forecasting error in mid-March 2009 that caused the first quarter NPL forecast to exceed the target by a significant margin;
- The process by which the loans were recommended for nonaccrual and were ultimately removed from the processing report;
- The movement of most of the Pulled Loans to nonaccrual status in the second quarter of 2009 despite no significant change in circumstances from March 31; and
- The role of Neely and others in responding to the targeted examination by the Federal Reserve, including their roles in providing misleading information about the deliberative process resulting in the removal of the Pulled Loans from the Processing List.

2. Relevant Structure of Regions Bank

In the first quarter of 2009, Regions' lending was divided into two main business lines: Business Services and Consumer. Business Services loans consisted largely of commercial real estate loans and "commercial and industrial" loans. Consumer loans included such credits as residential home equity lines. Regions' Credit Department, which was responsible for approving loans, was similarly divided into a Business Services unit, headed by Neely, and a consumer unit, headed by Barbara Godin.

Typically, when Business Services loans were rated "substandard," responsibility for those loans was transferred from the production side of Regions (a/k/a "the line") to SAD. SAD was dived into various geographical regions, and each region consisted primarily of Relationship Managers, who reported to Regional Managers. In one Florida region, some Relationship Managers reported to a team leader, who reported to the Regional Manager. SAD and the Credit Department tracked the levels of NPLs and non-performing assets for both Business Services and Consumer loans.

3. The Asset Quality Forecast (AQF)

The principal tool employed by SAD to forecast NPLs was the Asset Quality Forecast, or AQF report. In late 2008 and in the first quarter of 2009, the AQF report was updated approximately weekly in conjunction with SAD's AQF meetings. The report would list so-called "above-the-line" nonaccrual forecasts, as well as Potential Upcoming Events ("PUEs") for various loans. Loans that appeared on the PUE portion of the AQF ("below the line") were considered not yet ripe for a nonaccrual, but worthy of being on a watch list because of identifiable concerns. Before a loan became a nonaccrual forecast on the AQF, it would typically be nominated for such treatment by the responsible SAD Relationship Manager and

then reviewed by SAD Regional Manager. By late 2008, the Group Senior Credit Officer ("GSCO") in each region, all of whom reported to Neely, was also expected to participate in the preparation of their regional AQF. (*See, e.g.*, Div. Ex. 7 at REG00402821, REG00382752). The AQF report would specify the month during the quarter in which SAD and the Credit Officers believed the loan should be processed as a nonaccrual loan in Regions Bank's accounting system. Once a loan was entered as a nonaccrual loan on the Processing List, it would make its way to Regions Bank's books and records as a matter of course, absent purposeful action to remove it.

In the first quarter of 2009, each region within SAD submitted its AQF weekly, and those reports were consolidated by staff within Regions' Credit Risk Reporting. A summary report was added by Credit Risk Reporting that showed, among other things, the total amount of NPLs that were forecasted as of that week and the variance in those forecasts from week to week. The consolidated AQF was circulated to Neely, Willoughby, Kuehr, the SAD Regional Managers and the GSCOs (or at least made available to them). The forecasts would typically be vetted at an AQF meeting by Willoughby, Neely, Kuehr and others.

4. <u>March 12-14, 2009: The NPL Forecasting Error</u>

By February 12, 2009, Neely and other senior management within Regions had established a first-quarter target of $1.551 billion for Business Services NPLs. (Div. Ex. 59). On March 11, 2009, Business Services was on track to meet this target, as the AQF forecast was $1.552 billion. (Div. Ex. 481).[23] On March 12, however, Andrea Florio of Credit Risk Reporting discovered a large error in the NPL forecast. (Div. Ex. 136). The error arose in connection with two categories of NPLs—Rules Based and BB Flexlines. "Rules Based" NPLs

[23] The initial AQF for March 11 forecasted NPLs at $1.572 billion (Div. Ex. 120 at REG00367014), but a few days later this number was adjusted downward to $1.5517 billion. (Div. Ex. 142).

were those loans under a certain dollar amount that were taken to nonaccrual because they met certain objective criteria, *e.g.*, 90 days past due. BB Flexlines were generally smaller credits with a typical term of 12 months. As discussed, *infra*, the error occurred because Florio had been provided with the newly forecasted Rules Based and BB Flexlines NPLs for the month of March only, rather than the whole quarter, and she had incorporated those numbers into the March 11 AQF. (Florio Depo, p. 148-49).

Contemporaneous emails and other evidence show this to have been a matter of concern for Neely, Willoughby and Florio. (Div. Exs. 138, 167; Neely Depo, p. 273-74; Florio Depo I, p. 149-150). Shortly before the discovery of the error, on or around March 6, certain members of the Executive Council, which consisted of Regions Bank's most senior management, including its Chief Executive Officer, Chief Financial Officer and Chief Risk Officer, had been briefed on SAD's expected NPL performance for the first-quarter target. (Florio Depo, p. 151-52, 159). When the error was discovered, the Chief Risk Officer of Regions Bank, Bill Wells, was briefed about it and its effect on the first quarter forecast. (Div. Exs. 138, 135; Florio Depo I at 176-77).

Florio, Carey Barrentine, who was the head of Regions' Credit Risk Reporting, and others, came into the office on Saturday, March 14, 2009 and confirmed that the error was as Florio had feared. (Florio Depo, p. 153, Div. Exs. 142, 145). Florio determined that the error had caused the most recent NPL forecast (March 11) of $1.552 billion to be understated by $159 million. (Div. Exs. 142, 143, 145). Correction of the error put the NPL forecast well above the $1.552 billion target. (Div. Ex. 481). In addition, correction of another error relating to "held-for-sale" loans caused the NPL forecast to go up by an additional $48 million. Taking into account all of the adjustments (including several offsetting downward adjustments), the NPL

forecast as of March 14 had increased to $1.71 billion. (Div. Exs. 142, 143, 145, 481).[24] This meant that in order for SAD to meet its declared NPL target of $1.552 billion, it would need to eliminate $158 million in forecasted NPLs in the limited few days remaining in the quarter. Over the next week or so, modifications were made to the NPL forecast that reduced actual reported first-quarter NPLs to below the target. The SEC's charges arise from the manner in which these reductions were achieved.

5. Process Relating to the Pulling of the Loans

a. March 17, 2009: Neely Solicits Rationales for Keeping Loans on Accrual

On March 16, 2009, a meeting ("the March 17 Meeting") was called for the following day in order to discuss NPLs $2.5 million and greater (as well as non-value charges $1 million and greater). (Div. Ex. 151). Early in the morning before the March 17 Meeting, Neely sent a series of emails to several GSCOs who reported to him, requesting that they provide him with rationales for keeping specified loans on accrual in the event that he needed to defend such decisions. (Div. Exs. 160, 161, 163). The loans named by Neely included many of the loans that, in two to three days' time, would be removed from the nonaccrual processing report—namely, Seahaven Finance, Richland, First West Cutler, Opus Waters Edge, Resorts Construction and Glove Factory.

The premise of Neely's inquiries—namely, his "needing" and "wanting" to leave loans on accrual—suggest a desire to limit NPLs for reasons unrelated to the proper application of the governing standards. Neely's request for support for continued accrual status—rather than the credit officers' views on the proper classification of the credits—raises concerns. That Neely

[24] Other internal projections show Business Services NPLs rising as high as $1.744 billion on March 14, 2009 after the error was discovered. (Div. Ex. 414).

made "NPL Help" the subject line of one of his emails suggests that he had an agenda beyond simply ensuring that the loans were properly classified. Finally, Neely's remark to Papke and Cash that he was "looking for anything" indicates that Neely was not merely engaged in a pedantic exercise with his senior credit officers or playing the role of devil's advocate. Neely received responses to his emails providing him with the points that he requested. The credit officers' views on whether the loans met the criteria for accrual at the time were neither invited nor volunteered.

Neely has defended reaching out to his senior credit officers, to the exclusion of the responsible SAD officers, on the ground that the former reported to him, whereas the latter did not. (Neely Depo, p. 278). Neely, however, had already established a course of conduct of regular contact and correspondence with SAD managers on problem assets. (Div. Ex. 7). Several of the SAD Regional Managers and GSCOs stated that Neely functioned as the *de facto* head of SAD. (Aderhold Depo, p. 26; Korte Depo, p. 15-16; Teegarden Depo, p. 16; Fox Depo, p. 23; Papke Depo, p, 46). In addition, Neely himself referred to Regions being a "matrix" organization in rationalizing his repeated directives that the SAD Regional Managers and the GSCOs work together as partners on issues relating to SAD's portfolio of loans. (Neely Depo, p. 37, 104). Another factor that is critical to my analysis is that any post-hoc rationalization given by Neely to defend his actions in authorizing the removal of these large credits from nonaccrual processing is at odds with the explanations provided to Federal Reserve examiners in connection with a targeted review of Regions' nonaccrual process that commenced in May 2009 and the particular loans that are the subject of my report.

b. March 17, 2009: Meeting to Review NPLs $2.5 Million and Greater; Neely Identifies Loans to be Kept from Going Nonaccrual

The March 17 Meeting began at 9 a.m. CT (10 a.m. ET) and was scheduled for 90-minutes. (Div. Exs. 151; 158). The testimony from several of the SAD Regional Managers who participated, makes it apparent that no decisions to remove any of the Pulled Loans from the nonaccrual processing report were made at the meeting. (Aderhold Depo, p.45-46, 48, 141, Corrigan Depo, p. 153-54; Korte Depo, p. 62-63; Teegarden Depo, p. 72). Shortly after the meeting, at 10:43 a.m., Neely sent David Papke an email with "Seahaven" in the subject line asking, "Is this past due?" (Div. Ex.162). After getting a response from Papke, however, Neely forwarded the email string to Willoughby and Kuehr at 10:58 am with the comment: "I would add Seahaven to our fix group." In my opinion, this is further evidence that no decision on the accrual status of Seahaven was reached at the March 17 Meeting.

At least during the first quarter of 2009, it appears to have been the practice within SAD and Credit Risk Reporting to prepare in-play lists, the purpose of which was to indicate which large commercial real estate and other loans that had been forecast as nonaccruals for the quarter that might yet come off of the NPL (or AQF) forecast. The last "in play" list circulated by Jeff Kuehr, the head of SAD, prior to the events of March 17, did not include the following Pulled Loans: Designers Choice, First West Cutler, Glove Factory, Resorts Construction, River Glenn, Seahaven, and Waters Edge. (Div. Ex. 151).[25]

Neely directed Florio to prepare a new "in play" list, and she did so, creating several successive iterations of it. (Florio Depo I, p. 197-198, 201-202; Div. Exs. 175, 411-13). She sent what appears to be an early iteration of the "in play" list to Carey Barrentine at 1:53 p.m. Florio's new "in play" list identified a number of loans $2.5 Million and Greater, including all of

[25] Wilval was not on the March 11 AQF as a NPL.

the Pulled Loans, as being "in play," with the exceptions of Seahaven (listed as a "fixed adjustment as of March 17") (Div. Ex. 411) and Wilval. All of the Pulled Loans on the list had previously been slated for nonaccrual status. (Florio I Depo, p. 201). Florio provided versions of the new "in play" list to Neely and Kuehr. (Florio I Depo, p. 204). Neely subsequently met with Florio and her direct supervisor, Shannon Welch (Florio I Depo, p. 23); Neely communicated to Florio and Welch which loans (including the Pulled Loans) were "fixed" and therefore no longer needed to go on nonaccrual. (Florio I at 206-07; Div. Ex. 413).

c. March 19-20, 2009: Pulled Loans Removed from Processing List

The Pulled Loans had each been identified on the February 28, 2009 Rule 6 Report (a/k/a Processing List) as appropriate for nonaccrual. (Div. Ex. 82). Seahaven and Wilval were pulled from the Rule 6 Report on March 19, and McCar, Glove Factory, Richland, Kicklighter, Waters Edge One, River Glen, Designers Choice Cabinetry, First West Cutler Gardens, and Resorts Construction were removed from the Rule 6 Report on March 20. (Div. Ex. 198).

d. No Change in Quality of Credits at Issue From March 11 to March 19-20 that Would Warrant Removal of Loans from Processing List

As discussed in more detail elsewhere in this Report, there were no meaningful changes in the quality of the credits at issue that could justify the resuscitation of the nonaccrual candidates in a very short time span. (See below, pp. 46 - 94). As of March 11, 2009 every one of the Pulled Loans except Wilval was forecasted as a March nonaccrual on the AQF. (Div. Ex. 479). In most cases, the Pulled Loans had appeared on the AQF as nonaccrual forecasts for many weeks. (Ibid.) As of March 11, only three of the Pulled Loans were regarded as "in play"; by March 17 or 18, nine of them were being regarded as "in play" and one—Seahaven—was considered "fixed." (Div. Exs. 175; 424). On March 19-20, the loans were removed from the

Processing List. (Div. Ex. 198). The change in treatment of the loans was unmatched by commensurate improvements in the actual quality of the credits.

e. The Forecasting Error in "Rules Based" and "BB Flexlines" Causing the NPL Target to be Exceeded was Offset Through "Saves" from Forecasted NPLs $2.5 Million and Greater

The forecasting errors that Florio discovered on March 12, and that she verified on March 14, had been made in two categories of NPLs known as Rules Based and BB Flexlines. (Div. Exs. 142, 145; Florio Depo, p. 173-74). The amount of the understatement of NPLs from the forecasting error relating to these two types of loans was $142,140,000. (Div. Ex. 142). The total amount of the Pulled Loans was $144.6 million. (Div. Ex. 479). The net amount of commercial credits pulled from the Processing List after March 14 was actually $164.2 million (Div. Ex. 198). Loans comprising only $144.6 million of this amount, however, have been challenged by the Division of Enforcement. What is noteworthy, however, is that the Business Services unit managed to bring its reported NPLs in under its declared target, in large part, by reducing Non-Rules Based NPLs $2.5 Million and Greater—even though the forecasting error that caused the problem related to the smaller Rules Based and BB Flexline loans.

Non-Rules Based NPLs $2.5 Million and Greater shrank appreciably in the reported March 31, 2009 NPL figures, below the relatively tight range in which that component had been forecasted through the time of Florio's discovery of the large forecasting error. This can be seen in table below:

	NPLs $2.5 Million and Greater ($MM)	NPLs Under $2.5 Million ($MM)	Total NPLs ($MM) [v. $1.551B target]
Feb. 27, 2009 Forecast	**$1,146.9**	**$387**	**$1,533.9**
March 6, 2009 Forecast	**$1,212.5**	**$389.5**	**$1,602.0**
March 11, 2009 Forecast	**$1,182.9**	**$368.8**	**$1,551.7**
March 14, 2009 Forecast	**$1,144.8**	**$564.9**	**$1,709.7**
March 31, 2009 Actual	**$853.7**	**$642.6**	**$1,496.2**

(Div. Exs. 78, 120, 142, 206 at REG00994325, 242 at REG00423542)

As demonstrated above, from February 27 through March 11, immediately before Florio calculated the impact of the recently discovered NPL forecasting error, NPLs $2.5 Million and Greater were expected to finish the quarter in the relatively narrow range of $1,146.9 million to $1,212.5 million. Similarly, NPLs Under $2.5 Million were expected to fall somewhere in the band from $368.8 million to $389.5 million. The discovery of the large error in the forecast for Rules Based and BB Flexlines, however, caused NPLs Under $2.5 Million to jump to $564.9 million in the March 14 forecast. The reported March 31, 2009 NPL figures show that "saves" were made from loans $2.5 Million and Greater to make up for the unexpected jump in NPLs in smaller loans. The table further illustrates how the reported actual NPLs $2.5 Million and Greater of $853.7 million trailed recent forecasts by a wide margin (approximately $300 million), mainly as a consequence of "saves" for which there were no reasonable justification.

f. SAD Repeatedly Affirmed That Most of The Pulled Loans Should Go On Nonaccrual By Quarter-End

(i) Every Pulled Loan But One Was Recommended for Nonaccrual on the March 11, 2009 AQF

Every one of the Pulled Loans except Wilval appeared as a nonaccrual forecast on the March 11 AQF report just before Florio's discovery of the NPL forecasting error. (Div. Ex. 479). Wilval was forecast for nonaccrual on the March 6 AQF report, and it remained on the nonaccrual Processing List until it was removed on March 19. (Ibid.)

(ii) The Loans Were Abruptly Pulled Despite Consensus Within SAD Week Over Week That They Should Be Moved to Nonaccrual

One red flag of concern relating to the process is the contrast between the abruptness of the removal of the eleven Pulled Loans from the processing report, and the amount of time that most of these loans were viewed by SAD as non-performing. (Div. Ex. 479). For example, First West Cutler, Kicklighter, River Glen, and Seahaven had appeared as nonaccrual forecasts in eight straight AQF reports dating back to January, 2009. (Ibid.) Designer's Choice and Richland were both tagged for nonaccrual in the five consecutive AQFs preceding the discovery of the NPL forecasting error, and they were on the PUE watch list for three weeks before that. (Ibid.) The abrupt removal of the Pulled Loans from the Processing List following the March 14 revisions to the NPL forecast warrants a high level of scrutiny in light of the consensus among the attendees at the SAD meetings, over many weeks in most cases, that the loans should go non-performing in the first quarter.

(iii) Only 3 of the 11 Pulled Loans Were Considered "In Play" for Possible Avoidance of NPL Status Immediately Prior to the Discovery of the NPL Forecasting Error

A further red flag of concern is the removal from the Processing List of many loans that were not on the most recent "in-play" list, indicating a higher level of certainty that these loans should go nonaccrual. As of March 11—the day before the discovery of the NPL forecasting error—only three of the eleven Pulled Loans (Kicklighter, McCar, and Richland) were considered "in play." (Div. Exs. 151, 480). For the March 11 AQF, seven of the Pulled Loans—Designer's Choice, First West Cutler, Glove Factory, Resorts Construction, River Glen, Seahaven, and Water's Edge—were straight nonaccrual recommendations with no identified path for remaining on accrual status. (Ibid).

Moreover, three of the Pulled Loans had been considered "in-play" in February, but were dropped from the "in-play" list in March, suggesting that there was consensus among Neely, SAD and the GSCOs that there was no longer any known realistic chance for the loans to escape nonaccrual status. Specifically, Glove Factory, Designer's Choice and River Glen appeared on the "in-play" list as of the February 27, 2009 AQF, but were no longer regarded as being "in-play" as of either the March 6 or the March 11 AQFs, even though they continued to be forecasted as NPLs after being dropped from the "in-play" list. (Div. Exs. 95, 480). That these three loans were pulled from the Processing List after the outlook for them had become bleaker, according to SAD's records, is another process-related concern.

g. Seven of the Pulled Loans Were Removed From the Processing List Against the Pending Recommendations of the SAD Regional Managers

The SAD Regional Managers typically were familiar with the facts and circumstances relating to the quality of the credits assigned to their respective regions. The SAD Relationship

Managers, who frequently interfaced directly with the borrowers for loans in SAD, reported to the Regional Managers. According to those familiar with SAD's processes, recommendations from the SAD Regional Managers were the typical way that accrual status loans would move to nonaccrual status. (Aderhold Depo, p. 24-25; Korte Depo, p. 64). The recommendations of the SAD Regional Managers historically were accorded a high level of deference, both because of their knowledge and their roles. (*See, e.g.*, Aderhold Depo, p. 24-25, Carrigan Depo, p. 40). In my experience, this is consistent with industry practice, where significant deference is given the recommendations of the front line officers who typically are the most knowledgeable about the particular credit.

As already noted, all of the Pulled Loans except for Wilval were above-the-line nonaccrual recommendations on the March 11, 2009 AQF. Some of the SAD Regional Managers did offer or consent to certain "saves" after the discovery of the NPL forecasting error and Kuehr's notice of the March 17 Meeting (*see, e.g.*, Div. Ex. 150). For seven of the eleven Pulled Loans, however, the SAD Regional Managers did not deviate from their nonaccrual recommendations. In addition, several of the Regional Managers refused to provide retroactive support for the pulls after the Federal Reserve sought explanations as part of its targeted examination. (Aderhold Depo, p. 53;Korte Depo, p. 87-89). The seven loans for which the SAD Regional Managers' NPL recommendations remained in effect at the time of the pulls were: Seahaven, McCar, Glove Factory, Waters Edge One, Designers Choice Cabinetry, First West Cutler Gardens, and Resorts Construction. (Aderhold Depo, p. 53-55, 93, 133, 136, 140; Teegarden Depo, p. 74, 145; Korte Depo, p. 61-62; Div. Exs. 192, 198).

h. The SAD Regional Managers Were Given No Advance Notice of the Pulls and Were Surprised To Learn of Them

The SAD Regional Managers were not consulted or given advance warning about the removal of most of the loans at issue (particularly, Seahaven, McCar, Glove Factory, Waters Edge One, Designers Choice Cabinetry, First West Cutler Gardens, and Resorts Construction). Nor did they receive timely or orderly notification after the loans had been pulled. The SAD weekly update meeting scheduled for March 25 was cancelled. (Div. Ex. 186). On March 30, Trudy Mayoros, a lower-level SAD administrative employee, took it upon herself to email the SAD Regional Managers a document showing "NPL Changes" for six days, including March 19 and 20. (Div. Ex. 198). Her email stated: "Below is a list of NPAs pulled/added in March. Some may need to go back on the AQF in April." (Ibid.)

Some of the SAD Regional Managers and Group Senior Credit Officers had learned about the pulls in late March 2009 through unofficial channels. For example, SAD Regional Manager Scott Corrigan emailed David Papke on March 26 to inform him that John Baldwin, the SAD officer responsible for the FAS 114's (relating to allowances for impaired loans) was missing the FAS 114 for First West Cutler Gardens, among others. (Div. Ex. 194). Baldwin replied to Corrigan that Papke had just informed him that First West Cutler and two other loans would not be going NPA, so he would not need the FAS 114s for those loans. (Ibid.) Corrigan forwarded the email string to three other SAD Regional Managers (Tim McCarthy, Tom Aderhold, and Bill Teegarden) to share what Baldwin had told him. Corrigan said he just learned that several FAS 114's [impairment calculations] would not be needed because the loans were not going NPA in March; he remarked:

> "I never heard anything about it!!! Did any of you have deals that were supposed to go NPA this month pulled without your knowledge? I have never seen anything like this before. I'm hoping it's a mistake." (Ibid).

A short time later on March 26, Aderhold replied to Corrigan, copying Teegarden and McCarthy:

> "No it is not. Without my knowledge until Papke told me I had several big credits *pulled by Neely to avoid NPA* and several went to HFS which do not require a FAS [114 impairment calculation]." [Emphasis Added]. (Ibid.)

Teegarden responded to Corrigan with the comment: "Sounds like we are managing to a number." (Div. Ex. 192). Similarly, on March 26, SAD Regional Manager Robert Korte emailed the Orlando SAD team about Resorts Construction, a loan whose supervision was being transferred from the St. Louis SAD team. Korte described the credit as "96 townhomes under construction in Orlando, being built around a water park that doesn't exist. This is a time-eating beast, with a LOT of issues." (Div. Ex. 196). In the same email string, Oscar Bruni, a SAD Relationship Manager in Orlando, wrote on March 27:

> "I noticed today that the relationship is RR70/Accruing. Is it forcasted [sic] in the AQF for NPA status in the first quarter 2009? The interest is paid to 12/31/2008 with next due 1/31/2009. Is this a 90-day past due at March 31, 2009? Is there a Change Request Form in process?" (Ibid.)

Korte responded as follows:

> "We processed it for nonaccrual in March, as it was forecasted. I think we also ran through a downgrade to 80, but can't specifically recall. All of the foregoing doesn't matter anyway, as Birmingham pulled it from NPA, and it will remain on accrual at 3/31/09. It's not going to be 90+ at the end of March, but as we all know, that doesn't define a nonaccrual loan. I'll let you guys handle the AQF forecast on this one going forward." (Ibid.)

The exclusion of the SAD managers from the decision to pull many of the credits at issue from the processing report, the lack of notice to them, and their reactions upon finding out about the Pulled Loans all add to the concerns that the loans were pulled from the nonaccrual report for an improper purpose.

6. The Pulled Loans Were Classified As Non-Performing In the Second Quarter of 2009 Without Any Appreciable Decline in the Quality of the Credits Relative to the First Quarter

Further concerns about deliberate misclassification arise from the movement of all but one of the Pulled Loans to nonaccrual status early in the second quarter of 2009 without any material change in the quality of the credits. In this regard, it is noteworthy that all risk rating changes for large commercial credits required sign-off by Neely and Willoughby. Given that there were no material changes in the condition of the credits from March 31 through their placement on nonaccrual, this raises a question of whether Neely and Willoughby declined to let the nonaccruals be processed in the first quarter in order to artificially shrink the reported level of NPLs.

Eight of the Pulled Loans were placed on nonaccrual on April 24, 2009, just over three weeks after the first-quarter end, and prior to the May 11, 2009 filing date of the March 2009 10-Q, including: Designers Choice, First West Cutler, Glove Factory, Kicklighter, Resorts Construction, River Glen, Seahaven, and Waters Edge, without any apparent material change in their condition. (See Div. Exs. 318, 479). Two of the Pulled Loans, McCar Development and Richland, were placed on nonaccrual later in the second quarter on May 22 and June 30, respectively. (Ibid.) Wilval went on nonaccrual on September 30, 2009. (Ibid.)

The lack of any material change in credit quality to explain the acceptance of their NPL status in the second (and, in one case, the third) quarter—in contrast to the rejection of recommended NPL status in the first quarter—is addressed in another section of my report on a loan-by-loan basis. (See pp. 46 - 94). In that section, I specifically address why Regions Bank's written responses to the Federal Reserve's inquiry about what changed after March 31 to justify placing the Pulled Loans on nonaccrual do not pass muster.

7. The Federal Reserve's Targeted Examination of Regions' Nonaccrual Procedures for First Quarter 2009

On May 13, 2009, examiners of the Federal Reserve commenced a surprise targeted examination designed to understand Regions Bank's nonaccrual process and the circumstances surrounding Regions' removal of 16 large commercial credits from the nonaccrual Processing List, including the Pulled Loans, in the first quarter of 2009. (Div. Exs. 257, 260, 270). The targeted examination involved examiner requests for access to all documents and all communications pertaining to Regions Bank's nonaccrual process and to the pulling of the Pulled Loans from nonaccrual, meetings and interviews of Regions Bank employees, the review of Regions Bank records, and written responses by Regions Bank to requests for information. (Ibid.) The documents and testimony show that Neely played a significant role in dealing with the targeted examination. For example, he attended the kickoff meeting with the Federal Reserve staff, (Div. Ex. 257) and attended the meeting of Regions' personnel to prepare for that kickoff meeting with the Federal Reserve. (Florio Depo, p. 246-48). He is also copied on virtually all of the subsequent internal Regions' email traffic regarding the review (*See, e.g.*, Div. Exs. 260, 261, 268, 271, 279, 298), and he appears to have pressured certain credit officers to give misleading information to the Federal Reserve. (Papke Depo, 46- 48).

Some actions taken by Neely and others appear to have been calculated to limit the Federal Reserve's access to relevant information. Neely also appears to have been involved in providing misleading information to the Federal Reserve bank examiners about the removal of the subject loans from the Processing List. Actions by Neely or others to obstruct and/or mislead the Federal Reserve bank examiners could be considered indicative of an attempt to avoid the discovery of their role in misclassifying loans.

a. Indications of Intent to Withhold AQF Reports from Federal Reserve Bank Examination Staff

Several documents that I reviewed show that the Federal Reserve asked for documents relating to the forecasting of NPLs. (Div. Exs. 257, 300). Andrea Florio, the Credit Risk Reporting employee who discovered the large error in the NPL forecast in mid-March 2009, testified that Neely instructed her not to volunteer to the Federal Reserve bank examiners the existence of the AQF reports, and, if asked about such reports, *to deny their existence*. (Florio Depo, p. 270-71). Because the AQF reports were the principal documentation that the SAD Regional Managers had been long recommending most of the Pulled Loans for nonaccrual, Florio's claim, if credited, raises questions about Neely's motivations.

b. Neely Directed that the Term "Modifications by SAD Regional Managers" be Added to a List of NPL Changes Before Being Sent to the Federal Reserve Bank Examiners

Of greater concern still, perhaps, is Florio's testimony that Neely instructed her to alter a document during the course of the Federal Reserve's targeted examination in a manner that rendered the document false and misleading. Florio testified that, shortly after the kick-off meeting between the examiners from the Federal Reserve and Regions' personnel, including Neely and Florio, Neely instructed her to alter a record intended to be provided to the examiners. Specifically, Neely directed Florio to retitle Credit Risk Reporting's "NPL Changes" document—the one that Trudy Mayoros had circulated to the SAD Regional Managers on March 30—to "Modifications from SAD Regional Managers." (Florio Depo., p. 264-66; Div. Exs. 198 and 260). This change falsely indicated that the SAD Regional Managers, rather than Neely, had originated pulling of loans from the Rule 6 Report. According to Florio, Neely told her that the revised document would be sent to the Federal Reserve bank examination staff. (Ibid.) In fact,

the altered document was provided to the Federal Reserve with Neely's knowledge. (Div. Exs. 260, 318).

The documents and testimony that I have reviewed demonstrate that the SAD Regional Managers appear to have had no involvement with the removal of at least seven of the Pulled Loans. For these seven loans, the Regional Managers appear to have recommended that the loans be classified as nonaccrual and not to have deviated from their recommendations. There is no indication that they were ever consulted about the removal of the loans from the Processing List, and they appear to have learned about the pulls after the fact. The Regional Managers' real-time frustration upon learning that their loans were being kept on accrual status is evident in the emails quoted above. (Div. Exs. 192, 194, 196 and 237).

Neely appears to have been fully involved in the process leading to the removal of the loans, and therefore must be presumed to have known that most of the Pulled Loans did not represent "Modifications from SAD Regional Managers." Moreover, as an email from Neely dated March 17 shows, Neely, himself—not a SAD Regional Manager—nominated Seahaven for the "fixed" list. (Div. Ex. 162). If Florio's assertions are credited, Neely's role in altering the NPL Changes document could be regarded as consistent with an attempt to conceal his role in artificially depressing the level of reported NPLs.

c. Regions' May 29 and July 2, 2009 Written Response to the Federal Reserve Bank Examiners Contained Misleading Statements

On May 29, 2009, Regions provided its written response to a May 26 request by the Federal Reserve for information about the first-quarter removal of loans from the Processing List and their treatment as NPLs not long thereafter. (Div. Exs. 294, 308, 318). The response included both the "Modifications from SAD Regional Managers" report that had been retitled at Neely's direction and previously submitted to the examiners and written narratives purporting to

explain the basis for the decisions to pull the loans from nonaccrual. (Div. Ex. 318). Although Kuehr signed the cover letter, he obtained assistance from other Regions Bank employees in drafting many of the narratives. (See, *e.g.* Div. Ex. 308-09, 313-15). Email traffic shows that both that Neely and Willoughby were provided with drafts of Kuehr's cover letter to the regulators (Div. Exs. 310, 319), that they had an opportunity to make revisions (Div. Ex. 311), and that they received drafts of at least some of loan narratives for their review. (Div. Ex. 295).

The May 29 letter explicitly stated that the calls to remove the Pulled Loans from nonaccrual were made by "our very seasoned and professionally experienced Regional Managers and Credit Officers . . . ." (Div. Ex. 318). As already noted, however, it appears from the documents and testimony reviewed that the SAD Regional Managers never "made the calls" to remove at least seven of the Pulled Loans from the Processing List, and that the loans were kept on accrual against their wishes. (See, *e.g.*, Div. Exs. 192, 194, 196, 237). (Two of the seven, McCar and Glove Factory, appear to have had the support of the credit officer but not the SAD Regional Manager. Smith Depo., p. 76; Teegarden Depo, p. 142, 145). The insertion of this misleading statement in the letter to the regulators is consistent with Florio's testimony about the insertion of the term "Modifications from SAD Regional Managers" on the NPL changes document before it was sent to the regulators.

The written narratives for the loans at issue also appear to contain evasive or misleading responses to the regulators' inquiry into who "initiated/requested" the removal of the various loans from the Processing List. Specifically, for those loans for which there appears to not have been support from either the SAD Regional Managers or the credit officers for continued accrual status, the response to the regulators' inquiry into who "initiated/requested removal" was as follows: "Decision made on 3/17 as part of monthly meeting; Potential NPL's $2.5MM and

Greater." This response was given for First West Cutler Gardens, Resorts Construction, Waters Edge One, Designers Choice Cabinetry, and Glove Factory. (Div. Ex. 318). A number of participants in the March 17 Meeting, however, deny that any such decisions were made at the meeting, and the surprise they expressed in emails that they sent around upon learning that their loans had been pulled supports their recollections. (Div. Exs. 192, 194, 196). In addition, the narrative for Seahaven states that credit officer David Papke "initiated/requested" removal of the loan. (Div. Ex. 318, p.5), when it was actually Neely who recommended adding that loan to the "fix group." (Div. Ex. 162).

Neely and Willoughby were both copied on the signed version of Kuehr's May 29 letter that went to the Federal Reserve. (Div. Ex. 318). There is no indication that they corrected any of the inaccurate information that was provided to the regulators. Despite the fact that the Federal Reserve examiners' May 26 request directed that "each level of the chain should sign and indicate their concurrence/non-concurrence with the decision (*e.g.*, Relationship Manager, Regional Manager, SAD Director, Head of Business Services, and Chief Credit Officer)" (Div. Ex. 294), the narratives were not signed.

The Federal Reserve reiterated its request for signatures on each of the narratives, however, this request was never complied with. Instead, Kuehr attached the identical loan narratives with the same responses about who initiated/requested removal, to his July 2, 2009 letter to the Federal Reserve. (Div. Ex. 346). Neely and Willoughby were also copied on that letter. In that letter, Kuehr tried to explain why Regions Bank chose not to comply with the Federal Reserve's request that the narratives be signed by each person in the chain of the approval process. Kuehr stated that "the requested documentation was never maintained by Regions Bank and we believe it would not be proper to create it now. Asking bank associates to

concur/not concur with a decision made in March or April using today's knowledge is not representative of the events that occurred at the time of the actual decision." (Div. Ex. 346). It appears, however, that responsible Regional Managers and Credit Officers for some of the Pulled Loans would not have been willing to sign the narratives.

In my review of the documentary record in this case, I also note that there is no indication that Neely ever communicated to the bank examiners either the $1.551 billion NPL target for the quarter or the circumstances of the March 13, 2009 discovery by Neely and others of the large error in the NPL forecast, which resulted in the NPL target being exceeded by approximately $158 million, or the flurry of activity over the next several days that resulted in the Pulled Loans being removed from the Rules 6 Report on or about March 18-19, 2009. In my opinion, these facts would likely have been critical to the Federal Reserve examiners gaining a full understanding of Regions Bank's nonaccrual process and the circumstances the led to the pulling of the subject loans from nonaccrual processing.

C. Specific Loans Pulled from Nonaccrual (NPL) Status

In this section of the report, I express my opinions on whether the Pulled Loans should have been kept on accrual as of March 31, 2009 given the facts known to Regions at the time.

1. Glove Factory Holdings LLC

a. Nonaccrual status was appropriate as of March 31, 2009

Regions' loan to Glove Factory Holdings LLC was originated to finance development and construction of a 7.44 acre, 122 unit - five story condo and a 96 slip marina on the Tennessee River in Knoxville, Tennessee, near Neyland Stadium where the University of Tennessee plays football. (Div. Ex. 37 at REG00094111 and Div. Ex. 460 at Regions_041212SECSubpoena_0003967).

The loan was transferred to SAD during the third quarter in 2008 (Div. Ex. 37 at REG00094110; Div. Ex. 460 at Regions_041212SECSubpoena_0003723 and 3882). The outstanding loan balance at March 31, 2009 was $24.7 million (Div. Ex. 460 at Regions_041212SECSubpoena_0003882).

By March 2009, there were several key problems identified with the Glove Factory loan. The project was beyond the scheduled completion date due largely to unforeseen remediation requirements and had significant cost overruns. (Div. Exs. 37, 237; Teegarden Depo, p.82). Regions had retained third parties to (a) determine the estimated cost to complete and (b) to oversee payment to vendors and completion of the project. (Div. Ex. 237). The consultant hired by Regions anticipated that approximately $6 million of additional funding would be needed to complete the project. (Ibid.) In addition, the number of presale contracts had dropped from 86 to 21 as of March 2009, which was well below the original closing threshold of 55 units, and the 21 presale contracts that remained had all expired. (Div. Ex. 460 at Regions_041212SECSubpoena_0003884).[26] Based on most recent appraisals, there was a collateral shortfall approximately $580,000 (Div. 37), and that shortfall would only increase if Regions were to fund the $6 million needed to complete the project. The Regions GSCO (Group Senior Credit Officer) assigned to this loan, Smith, acknowledged essentially all these issues in a February 26, 2009 email to Neely. (Div. Ex. 77). He also noted possible environmental contamination issues related to the project, which was confirmed by Teegarden in his deposition (Div. Ex. 77; Teegarden Depo, p.139).

As part of its workout plan, Regions intended to restructure the credit to lend the $6 million of additional funds that were needed to complete the project. (Div. Exs. 77, 237).

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[26] Other documents suggest 23 presale contracts as of March 2009. (Div. Ex. 37).

Because lending the additional funds would only exacerbate the collateral shortfall, Regions was demanding that the guarantors, Michal Blonder and Brad Johnson, contribute approximately $3 million of additional funds to the project as a condition precedent to the restructuring. (Div. Exs. 125, 178, 188, 217). Regions anticipated that at least some of these funds would have to come from a trust fund for which Blonder was a beneficiary. (Div. Exs. 125, 163, 217). Throughout February and March, Blonder had repeatedly rejected Regions' requests to commit any funds from his trust to the project, and Regions' personnel were not optimistic that he would change his mind. (Div. Exs. 77, 126, 163, 188).

Also, on March 16 and 17, 2009, at the very same time Neely was pulling the Glove Factory loan from nonaccrual, he was actively negotiating with Jordy Henson, a former SouthTrust banker who was representing a group with an interest in buying the project, to sell the loan. (Smith Depo, p. 128, Div. Ex. 152). Neely testified that he was trying to de-risk the loan and find an "indicative pricing." (Neely Depo., p. 326-328, 333). But in a March 16 email, Neely told Henson "Interest is to move fast at a best price." (Div. Ex. 152 at REG00293200). On March 17, 2009, Neely informed Jordy Henson that Regions would accept a price point of 65 to 70 cents on the dollar. (Div. Ex. 152 at REG00291660). If Regions went ahead with the note sale at that time, it would not collect full principal and interest. This email from Neely makes clear that he anticipated that Regions would incur a loss on the loan of at least 30%.

The loan appeared on the February 27, 2009 AQF as a projected NPL for March 2009, and it remained on the subsequent AQFs through March 11, the last AQF circulated prior to March 17. (Div. Ex. 479). On March 17, at 7:40 AM, Neely sent an email to Smith asking, "If I wanted to leave [Glove Factory] on accrual over quarter end what should be some of my

arguments." (Div. Ex. 163). Smith responded with various arguments. (Ibid.) The loan was subsequently pulled from the nonaccrual list and remained on accrual as of March 31.

After reviewing all the known facts and issues described above, the Glove Factory loan should have been placed on nonaccrual status as of March 31, 2009 because full collection of principal and interest was sufficiently in doubt. Adam Dixon, a member of Regions' Credit Review department, acknowledged all the stated issues above by his email March 31 to Teegarden, with copies to Smith, Don Bius (a SAD Relationship Manager) and others. Dixon concluded that a full repayment of principal and interest was not reasonably assured; explaining that pre-sale contracts for condos had declined to 19 by that time and there was a collateral shortfall of approximately $2.2 million based on the estimated cost to complete of $6.155 million. (Div. Ex. 201 at REG00724806). After reviewing Dixon's analysis, Teegarden responded to Smith, "Hard to argue with his logic." (Ibid.)

On April 20, 2009, in response to questions from Regions' Credit Review department about the appropriate accrual status for Glove Factory as of December 31, 2008 and March 31, 2009, Kuehr sent an email to Teegarden asking him to construct an accrual defense for Glove Factory. (Div. Ex. 230). Teegarden responded "It is a bit more difficult to argue for 3/31 since we all believed it would go [nonaccrual] in March." (Div. Ex. 237).

I have reviewed the arguments that Regions gave to the Federal Reserve, in connection with that agency's May 2009 targeted review of Regions, for supposedly keeping the loan on accrual as of March 31, 2009. (Div. Ex. 318 at p. 9). Those reasons were (1) on-going negotiations with the borrower about supplying additional collateral to cover the collateral deficiency (that would result if Regions loaned the additional $6 million needed to complete the project); and (2) the possibility of recovering full principal and interest if the project were

completed, all remaining presales closed and additional condo sales occurred, and a number of boat slips also sold. (Ibid.) Those reasons do not justify an accrual status as of March 31, 2009. As mentioned, Regions was relying on the guarantor (Blonder) to offer a portion of his trust fund to address the collateral deficiency. Yet, internal Regions documents show that they suspected Blonder would not agree to this request. Absent a reasonable assurance that Blonder would change his stance, Regions should not have continued accrual status.

Although Smith's March 17 response to Neely's request for arguments to keep Glove Factory on accrual noted that Blonder had previously used his trust "to secure a letter of credit for the TIF money on this project," that did not give sufficient assurance that Blonder would do so in this instance. (Div. Ex. 163). As mentioned, Blonder had refused such requests from Regions to date. Moreover, Smith's email did not indicate how long ago Blonder had used his trust to support the project. More importantly, Smith's email does not indicate whether the amount Blonder previously committed from his trust to secure the letter of credit came close to the amount of the trust that Regions was expecting Blonder to contribute in March 2009.

In addition, the number of presale contracts had dropped from 86 to 21 as of March 2009, which was well below the original closing threshold of 55 units, and the 21 presale contracts that remained as of March had all expired. (Div. Ex. 460 at Regions_041212SECSubpoena_0003884). Thus, there was insufficient assurance that the 21 presale contracts on which Regions was relying to collect full principal and interest would ultimately close. Most importantly, in March 2009 Neely was negotiating the sale of the Glove Factory note and was willing to take a discount of 35 cents on the dollar. (Div. Ex. 152 at REG00291660). This confirms that Regions did not anticipate collecting full principal and interest as of March 31, 2009. In fact, a letter of intent to sell the Glove Factory loan was

presented to the potential buyer on April 9, 2009 for a purchase price of approximately 55% of the loan balance. (Div. Ex. 475). Because this occurred before Regions filed its Form 10-Q for the quarter ended March 31, 2009, Regions should have written this loan down to the prospective purchase price prior to filing of that 10-Q, which was filed with the SEC on May 11, 2009.

I note that the Federal Reserve examiner who reviewed the accrual status of Glove Factory as part of that agency's targeted review agrees with my conclusion that this loan should have been classified as nonaccrual as of March 31, 2009. (Div. Ex. 444). Consistent with my opinion, the examiner concluded that the pending negotiations with the debtor did not provide sufficient justification to delay the nonaccrual classification, noting:

> "[N]egotiations had been underway for several months with no funds received from borrower. It is the view of the examiner that [the decision to keep the loan on accrual] was not sound as it is unclear what financial incentive the borrower would have had to increase his equity in a project that would be under water as the collateral value was below debt on the property, and significant funds were needed to complete [the] project." (Ibid.)

I also note that, in his deposition, Smith conceded that he was too optimistic when he responded to Neely's March 17 request for argument to keep Glove Factory on accrual. (Smith Depo, p. 96-97, 123-124).

Glove Factory was eventually placed on nonaccrual status on by Regions on April 24, 2009. (Div. Ex. 318, p. 9). When asked by the Federal Reserve to identify the new developments between March 31 and April 24 that led to the nonaccrual classification, Regions' letter that was previewed by Neely claimed that "in mid-April, the borrower indicated that he was unable to put any additional money into the project and that he was unsuccessful in gaining family support from family members relative to further encumbrance of the trust." (Ibid.) These facts were sufficiently apparent to Regions as of March 31. As mentioned, Regions' renewal of the loan in March 2009 hinged on Blonder's agreement to commit part of his trust, (*see, e.g.* Div.

Ex. 217 at REG00055274), and multiple internal Regions' documents generated prior to March 31 show that this was unlikely. In any event, because the loan was placed on nonaccrual on April 24th, which was before Regions filed its Form 10-Q for the first quarter of 2009 (May 11, 2009), applicable accounting principles required Regions to classify Glove Factory as nonaccrual for purposes of the financial statements filed with that report.

b. *Glove Factory should have been moved to Held for Sale as of March 31, 2009*

(i) Accounting for Loans Held-for-Sale

CRE and other loans are carried on the statement of financial condition (balance sheet) of a commercial bank in accordance with GAAP, as described below, as long as management has the intent and ability to hold them for the foreseeable future or until maturity or payoff:

> "*a. Loans and Trade Receivables Not Held For Sale.* Loans and trade receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any charge offs, the allowance for loan losses (or the allowance for doubtful accounts), any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans."[27]

However, once management has decided to sell a loan (or a group of loans), the accounting treatment stated above is no longer acceptable under GAAP. Instead, the loan(s) should be reclassified from "loans held-for-investment" to "loans held-for-sale" in the bank's balance sheet and carried at the lower of cost or fair value, as indicated below, in accordance with GAAP:

> "*c. Sales of Loans Not Held For Sale.* **Once a decision has been made to sell loans not previously classified as held for sale, such loans should be transferred into the held-for-sale classification and carried at the lower of cost or fair value**. At the time of the transfer into the held-for-sale classification,

[27] Source - AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others,* December 26, 2001, paragraph 8a.

> any amount by which cost exceeds fair value should be accounted for as a valuation allowance."[28] [Emphasis Added]

Following is a quote from Regions' 2008 Form 10-K that confirms Regions' policy for accounting for loans held-for-sale as required by GAAP:

> "Commercial real estate mortgage loans held for sale are carried at the lower of cost or fair value..."[29]

Fair value is defined in the GAAP literature as follow:

> "5. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[30]

Accordingly, once bank management has decided to sell a loan, the loan should be immediately reclassified to "held-for-sale" in the bank's balance sheet and valued at the lower of cost or estimated fair value (*i.e.*, a reasonable estimate of what price the loan would sell for in an orderly transaction between market participants).

(ii) There is Sufficient Evidence of the Decision to Sell Glove <u>Factory by March 31, 2009</u>

Neely admitted that, during the first quarter of 2009, he had primary responsibility within Regions for deciding which CRE loans within SAD would be sold and for determining the acceptable sales price. (Neely Depo, p. 108, 117, 141-42, 165-66, 168-169, 178). As discussed previously, Neely was actively negotiating with Jordy Henson in March 2009 to sell Glove Factory. In a March 16 email, Neely told Henson "Interest is to move fast at a best price." (Div. Ex. 152 at REG00293200). On March 17, 2009, Neely informed Henson that Regions would

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28 Ibid., paragraph 8c.

29 Regions' 2008 SEC Form 10-K, page 100.

30 Statement of Financial Accounting Standards No. 157, *Fair Value Measurements,* paragraph 5, issued by the FASB in September 2006.

accept a price point of 65 to 70 cents on the dollar. (Div. Ex. 152 at REG00291660; Smith Depo, p. 128). Although Neely claimed that he was only trying to find "indicative pricing," (Neely Depo, p. 326-328), his statement that he was interested in moving fast with a sale, coupled with his specifying an acceptable price, is sufficient evidence of the intent to sell the loan to warrant reclassification of this loan into the Held for Sale category as of March 31, 2009, and to mark the value of the loan down by at least 35%.

2. Resorts Construction LLC

Regions issued Resorts Construction, LLC a construction loan on December 22, 2006 in the amount of $12.1 million to construct 56 townhomes in Orlando, FL. (Div. Ex. 466 at Regions_041212SECSubpoena_0000587, 602). At the time of loan origination, 100% of the units were pre-sold (Ibid. at Regions 041212SECSubpoena_0000587). In November 2007, Regions Bank issued Resorts Construction, LLC a $28 million revolving line of credit, which included the $12.1 million from December 2006, to construct the remaining pre-sold townhomes units in Tierra del Sol over the next 24 months (452 remaining, 56 under construction - total 508 units). (Ibid. at Regions_041212SECSubpoena_0000580, 1010). The loan to Resorts Construction, LLC had an unpaid loan balance of $21.2 million at March 31, 2009 (Ibid. at Regions_041212SECSubpoena_0000959).[31]

The development Tierra del Sol was also approved as a Community Development District (CDD) with the first phase of bonds ($25 million) funded on December 29, 2005. (Div. Ex. 466 at Regions_041212SECSubpoena_0000589). Construction of the project had not been proceeding at the expected pace, and the maturity of the loan was extended from September 30,

[31] Ultimately, Regions filed a foreclosure suit (Div. Ex. 466 at Regions_041212SEC Subpoena0000467) and recorded charged-offs totaling $16.5 million in August 2009, February 2010 and May 2010. (Ibid. at Regions_041212SECSubpoena_00001080).

2008 to December 31, 2008 in order to accommodate the delay. (Div. Ex. 11). Contrary to expectations, there had been no unit closings by January 2009, and payment on the loans were 60 days past due as of March 31, 2009. (Div. Ex. 466 at Regions_041212SECSubpoena_0000464, 667-668).

A January 2009 risk rating change form notes the deteriorating quality of the credit, such as serious cash flow problems of the borrower, insufficient fund availability to complete the project, unpaid liens filed against the project, and unpaid CDD assessments, leading to a risk rating downgrade from 60 to 70. (Div. Ex. 35). The loan was transferred to SAD in February 2009 (Div. Ex. 466 at Regions_ 041212SECSubpoena_0000965).

The credit problems were exacerbated by a negative February 26, 2009 article from the Wall Street Journal on the pull-out of institutional investors from the Resorts Construction development due to the project's ties to Allen Stanford [Ponzi scheme convicted felon] with possible fraud issues. (Div. Exs. 102, 129). On March 4, Korte, the SAD Regional Manager for this loan, forwarded the article to Fox, the Group Senior Credit Officer, with the admonition:

> "This is quite a mess that we've been trying to keep together. We had crisis managers that we had retained to go into the operation to take a hard look at the validity of contracts and other things. We did not get the cooperation that we expected...We had a lengthy discussion with counsel yesterday, and we'll be making a demand and putting a receiver in asap. I was trying to hold off until 2nd quarter NPA on this one, but knowing what we now know . . . this should be a March NPA...Huge loss potential and very wide potential outcome." (Div. Ex. 102).

On March 4, Fox responded, with a copy to Neely, "I agree. Based on this latest development, there's no question but this is now an NPA." (Ibid.) On March 12, a Commercial Workout Strategy ("CWS") was prepared for this loan, noting that a risk rating of doubtful (80) had been submitted because of the significant, although unquantifiable, shortfall in collateral. (Div. Ex. 129). The form also noted that the borrower was "out of funds." (Ibid.) By the end of

March 2009, payment was 59 days past due. (Div. Ex. 466 at Regions_041212SECSubpoena_0000467, 978)

The CDD bonds also posed a significant threat to the Resorts Construction loan. As noted in the CWS, by March 2009, payments to the CDD were in default and Regions needed to keep that debt current "as their rights could be superior to" Regions. (Div. Ex. 129). Because the CDD bondholders were threatening foreclosure, Regions paid $299,000 to the bondholders on March 12, increasing the amount of the debt that it was owed from the borrowers. (Div. Ex. 128).

By March 2009, there were also a number of serious issues with respect to the project itself. While the developer claimed that 56 units had been sold to foreign buyers, the developer did not produce the contracts to back up the claim, raising questions about the legitimacy of those contracts. (Div. Ex. 466 at Regions_041212SECSubpoena_0000980; Div. Ex. 129). Furthermore, the borrower was uncooperative with a crisis manager hired by Regions and tasked with determining the validity and status of the sales contracts. (Div. Ex. 129). Regions observed that its loss exposure would be "huge" if the buyers walked or didn't really exist. (Ibid.) Also, by March 31, only 36 out of 96 units were complete and Regions estimated that another $5 million would be needed to complete the project. Moreover, the construction of amenities, a separate construction project not financed through Regions, was expected to be the key selling point of the project. But construction of those amenities had not even started by March 2009 due to lack of funding (Div. Ex. 129). Regions did not expect the sales of units to close because construction of the amenity project had not yet started. (Div. Ex. 466 at Regions_041212SECSubpoena_0000978)

The loan was forecasted as a nonaccrual on March 9, 2009 (Div. Ex. 118) and it appeared as an NPL on the March 11 AQF. Korte's testimony confirms that there was agreement that Resorts Construction should go to nonaccrual at the end of March 2009. (Korte Depo, p. 60-61). On March 17, however, Neely sent an email to Roger Fox, asking "if I needed to leave Resorts Construction on accrual over quarter end what would be some of my arguments." (Div. Ex. 160). Fox was surprised by this email given that, just two weeks earlier, he had told Neely "there's no question but this is now an NPA." (Fox Depo, p. 94; Div. Ex. 102). Fox responded with several arguments that referenced the condition of the loan at origination, *i.e.*, several years prior, but not the current condition. (Fox Depo, p. 94-95; Div. Ex. 160). Fox did not think that the loan should be kept on accrual and thought that once Neely saw how weak the best accrual arguments were, Neely would have to conclude that the loan should be placed on nonaccrual. (Fox Depo, p. 95). At the March 17 Meeting later that day, when the status of all loans above $2.5 million forecasted for March NPL were discussed, however, there was no discussion of the accrual status of this loan. (Korte Depo, p. 76-79).

The loan was nevertheless pulled from nonaccrual and remained on accrual status as of March 31, 2009. Korte believed that the decision to pull the loan from nonaccrual was made by Regions' personnel in Birmingham, Alabama. (Div. Ex. 196). Given the above circumstances as of March 31, the Resorts Construction relationship should have been placed on nonaccrual based on the following Regions' policies:

(1) Payment in full of interest and principal was not expected, as evidenced by the facts that borrower's payments to bondholders were in default, additional unit sales were not expected, and borrower was uncooperative in ascertaining the status of existing sales contracts; and

(2) Repayment depended on obtaining additional financing or liberal repayment terms, as evidenced by Regions' move to make protective advance payments to avoid CDD bond trustee action.

Regions offered the Federal Reserve no valid reasons for why the Resorts Construction loan was kept on accrual as of March 31, 2009. (Div. Ex. 318, p. 20). The main factor cited by Regions was its decision in March to transfer responsibility for following the loan from St. Louis special asset staff to Orlando staff. (Ibid.) Regions contended that the Orlando staff was working to determine the status of the pre-sold contracts, the cost to complete the project, and the impact of the CDD financing on the project, among other things. (Ibid.) None of the factors listed by Regions, however, was sufficient to overcome the substantial doubts regarding full collection of principal and interest raised by the known circumstances relating to the credit. In fact, the SAD Regional Manager in St. Louis testified that if, in fact, Regions maintained the loan in accrual because of the transfer to Orlando, this would be an unreasonable decision, and that he knew of no justification for keeping the loan on accrual. (Korte Depo., p. 123).

Notably, the loan was placed on nonaccrual on April 24, 2009. (Div. Ex. 318 p. 20-21). Regions claimed that the only new developments between March 31 (when the loan was on accrual) and April 24 was that the Orlando SAD Relationship Manager met with the developer and that additional due diligence was conducted. (Ibid.) These are not valid reasons for delaying the nonaccrual classification until April 2009 given the significant weaknesses that were known as of March 31.

I note that the Federal Reserve examiner who reviewed the accrual status of Resorts Construction agreed with my conclusion that the loan should have been classified as nonaccrual as of March 31, 2009. (Div. Ex. 449). The examiner opined that "the project was clearly in distress and the [risk rating form] from the relationship manager spelled out that the borrower

had run out of cash, the CDD was in default and required additional funds to keep the debt current, additional funds for construction were required of at least $1.2 MM, collateral value was likely below debt outstanding and validity of sales contracts was in doubt." (Ibid.)

3. Water's Edge One, LLC

Regions had a $20 million participation in a $90 million construction loan agented by Wachovia (lead lender) for the development of Water's Edge One, a residential and mixed use condominium development in Clearwater, Florida. Water's Edge One, LLC was the borrower and Opus South Corp. was the guarantor for this loan. (Div. Ex. 471 at Regions_041212SECSubpoena_0006132, 5779-5780). Opus Corp was the parent company for Opus South. (Ibid. at Regions_041212SECSubpoena_0006101). Opus South, Opus Corp and Water's Edge were controlled by the same principals. The Water's Edge unpaid loan balance was $15.5 million on March 31, 2009. (Div. Ex. 471 at Regions_041212SECSubpoena_0006129).

Phase I of the Water's Edge project consisted of 133 condo units in a 25 story tower and 19 townhomes. Included in the loan was excess land for Phase II of the project as well as approximately 10,130 square feet of retail space and a structured parking garage providing for 309 spaces. The participation loan was approved in October 2005. At the time, Water's Edge CRE was valued at $117 million for condos and $6.7 million for excess land. (Div. Ex. 471 at Regions_041212SECSubpoena_0005779-5780). Completion of Phase I was anticipated in July 2008. (Ibid. at Regions_041212SECSubpoena_0005988).

While the project was under construction, nearly complete and 80% pre-sold, it was discovered that there was an issue with the purchase contracts that put all the contracts into rescission because Opus did not complete a HUD filing. It was determined by Regions that the problem with the contracts could not be remedied after the fact or ignored and that all contracts

would have a three year rescission period starting from date of contract, including after a unit had closed. The loan was then downgraded to 70. Opus had to register the property with HUD and fix and amend the contracts to comply with HUD requirements. It had to notify buyers and provide incentives to enter into new contracts. Opus expected to begin approaching buyers in February or March 2009, but anticipated knowing how many contracts would fallout until June. (Div. Ex. 471 at Regions_041212SECSubpoena_0006100 -6101). Given the market conditions and the fact that all the units under contract were at "above market" rates, considerable contract fall-out was expected. (Ibid. at Regions_041212SECSubpoena_0005818).

The June 2008 PLR shows that all payments continued current and cash flow sources were available to support debt. (Div. Ex. 471 at Regions_041212SECSubpoena_0006110 - 6111). The loan had been upgraded to a 60 with a modification which reduced the total exposure to $82 million and Regions' share to $18.2 million with the LTV improving to 90% with additional collateral. (Ibid.) The loan covenants included the borrower reducing the loan to 80% LTV by December 31, 2008 and to 70% LTV by September 30, 2009. (Ibid.)

Although in September 2008, the loan was downgraded back to 70 due to SNC review, by December 31, 2008, it was in compliance with the modification covenant requiring a $8 million loan balance pay down and 80% LTV by December 31, 2008. (Div. Ex. 471 at Regions_041212SECSubpoena_0006119, 6121).

In February 2009, Opus Corp informed Regions that it would no longer make payments on loans that do not cash flow. (Div. Ex. 471 at Regions_041212SEC Subpoena_0006124). Regions did not expect that further payments would be made on the Water's Edge credit because sales were minimal. (Ibid). In fact, consistent with the borrower's announcement, Opus did not make the February 2009 interest payment on the Water's Edge loan. (Ibid). Consequently, the

loan appeared on the February 19 AQF report as a forecasted NPL for March, and it remained on the ensuing weekly AQF reports as an NPL forecast thought March 11, the last AQF circulated prior to the March 17 Meeting. (Div. Ex. 479). On March 6, Cash recommended that the loan be downgraded to 75 and placed on nonaccrual. (Div. Ex. 107; Cash, Depo, p. 110-13). Papke, the Group Senior Credit Officer for this loan, agreed that the Water's Edge loan should be classified as nonaccrual by March 31, 2009 given that Opus had warned of its impending bankruptcy and the project had trouble making payments. (Papke, Depo, p. 184-87). Aderhold, the SAD Regional Manager for Water's Edge, also thought the loan should have gone to nonaccrual in March because "[t]hey're giving the properties back, they're getting ready to file bankruptcy, they've already told you they can't pay or not going to pay...[t]hat's a non-accrual." (Aderhold Depo, p. 139-144; Div. Ex. 179).

On March 16, 2009, Cash emailed Neely advising that Wachovia, the agent bank for this credit, was in the process of placing the loan on nonaccrual and noting that the loan was 79 days past due. (Div. Ex. 148). On March 19, Florio advised by email that it appeared that Waters Edge would only pay $264,000 of the scheduled $2 million loan payment. (Div. Ex. 179).

In summary, as of March 31, 2009, the borrower was delinquent and had stated that they were considering filing bankruptcy and would no longer have the funds to support the Water's Edge project, and the agent bank had advised Regions that it was in the process of placing the loan on nonaccrual. These facts created sufficient doubt as to the full collection of principal and interest so as to warrant nonaccrual status for the loan as of March 31, 2009.

Despite these facts, the Water's Edge loan ultimately was not placed on nonaccrual in March 2009. Neely sent an email at 6:39 am on March 17 asking Papke and Cash for any reasons that might support keeping the loan on accrual. (Div. Ex. 161). The May 29 letter to the

Federal Reserve, which Neely reviewed, stated that the decision to keep the loan on accrual was made as part of the March 17 Meeting and that the loan was kept on accrual because (1) Opus had made several recent payments on the loan and appeared to have a line of credit available to fund additional payments, and (2) Opus South (the guarantor of the loan) had cash and, notwithstanding the statement that it would no longer make payments for projects that were not cash flowing, had recently made payments on certain non-cash flowing projects. (Div. Ex. 318 at p. 13).

These are not sufficient reasons to keep the loan on accrual. The fact that Opus had made several recent payments should have been given little if any weight because those payments predated the debtor's announcement that it would no longer make payments for projects that did not cash flow. In fact, Aderhold opined that this was not a sufficient reason to keep the loan on accrual because Opus had specifically said it wouldn't pay Water's Edge in February/March 2009. (Aderhold Depo, p. 149-157). Also, the fact that Opus South had made several payments for non-cash-flowing projects was of minimal significance. On March 13, Neely was told that "All Opus South loan interest payments for March have been made with the exception of Water's Edge." (Div. Ex. 140). This should have made clear that Water's Edge was within the group of loans that the debtor no longer intended to support. Moreover, the few non-cash flowing projects for which Opus South continued to make payments were "very small" loans, *i.e.*, much smaller than Water's Edge. (Cash Depo. at 128-29). Given this fact, Cash advised Neely in March that all Opus South loans, including Water's Edge, should remain on nonaccrual despite the March payments on certain loans. (Div. Ex. 140). Most importantly, the letter to the Federal Reserve does not mention that, prior to March 31, 2009, Regions knew the agent bank for this credit was in the process of placing the loan on nonaccrual. Regions' own documents

show this was a crucial fact that must be considered in the accrual decision. Kuehr's March 16 email to the SAD Regional Managers, which was cc'd to Neely and Willoughby specifically advised "Want to ensure that our risk rating and accrual status is consistent with the agent." (Div. Ex. 151).

Regions waited until April 24, 2009 to place the loan on nonaccrual and told the Federal Reserve that the post March 31 development was learning in a meeting with Opus that Opus would file bankruptcy in a week. (Div. Ex. 318, p. 14). As discussed previously, because this was before Regions filed its Form 10-Q for the quarter ended March 31, 2009, the loan should have been classified as nonaccrual for purposes of the financial statements contained in that report. Moreover, the facts previously discussed show that there was sufficient information available to Regions prior to March 31 to justify nonaccrual status at that time.

I note that the Federal Reserve examiner who reviewed the accrual status of this loan agreed with my conclusion that this loan should have been classified as nonaccrual as of March 31, 2009. (Div. Ex. 452). The examiner opined that the loan "should have been placed on NA in March because:

- on 2/26/2009 borrower stated that it, and parent, would no longer support projects (this one) that were not cash flowing;
- lead bank notified Regions that Feb and March interest payments were [past due] and a Notice of Default would be sent to borrower;
- on 3/30/2009 lead bank notified Regions that borrower would miss March principal payment." (Ibid.)

4. <u>McCar Development Corp</u>

McCar Homes ("McCar") was a privately-held homebuilder located in Atlanta, Georgia and had been ranked among the top ten builders for over a decade. McCar built single-family homes that ranged in sales price from the mid-$100,000 to $300,000, targeting the entry-level to

first move-up buyers. (Div. Ex. 463 at Regions_041212SECSubpoena_0004339). Regions held a $50 million participation in a $300 million Homebuilder Borrowing Base Revolver, including an accordion feature to a maximum of $400 million. This was a syndication loan with Wachovia serving as the agent. (Div. Ex. 463 at Regions_041212SECSubpoena_0004337, 4348). Regions' share of the total unpaid loan balances with McCar was $9.4 million on March 31, 2009, and the loans were 21 and 36 days past due. (Div. Ex. 463 at Regions_041212SECSubpoena_0004548).

The initial term of the revolver was three years. At the borrower's option, and subject to lender approval, the borrower could request a one-year extension of maturity on an annual basis. It was secured with all real estate inventory of McCar until leverage conditions were met, after which it was unsecured. (Div. Ex. 463 at Regions_041212SECSubpoena_0004337-4338).

The facility came to maturity in November 2008. As of September 2008, the borrower was actively looking for opportunities to liquidate current lot positions, as well as fee based opportunities, to provide them with immediate cash-flow for overhead, as well as additional revenue, without adding liabilities. Based on cash-flow projects provided by the borrower, in order for the McCar to survive the economic and housing downturn, additional equity had to be raised and injected into the company. This concern had been raised by Regions with Regions Bank prompting the borrower to pursue investors for additional capital, which would be coupled with equity provided by the principal of McCar. (Div. Ex. 463 at Regions_041212SECSubpoena_0004522-4523).

On February 26, 2009, Smith informed Neely that McCar had announced that it did not have sufficient cash flow to pay interest on the loan, but would help liquidate the company and maintain the properties. Smith said the loan was scheduled for March 2009 nonaccrual status.

(Div. Ex. 77). The PLR dated February 28, 2009 notes that a forbearance under which McCar would commence an orderly liquidation was being negotiated between members of the Bank Group and the final scenario would result in a loss to the lending group. (Div. Ex. 491 at REG00367578-7579).

The credit was placed on the February 27, 2009 AQF as a forecasted NPL for March, and it remained on the ensuing weekly AQFs through March 11. (Div. Ex. 479). On March 6, Scott McLay, a loan officer handling the workout of this credit, prepared a Commercial Workout Strategy, which included a recommendation to downgrade the loan to nonaccrual. (Div. Ex. 52). The primary reason for the nonaccrual designation was that the sale associated with the planned restructure of the credit would result in a loss of part of the collateral. (Smith testimony, 184-5). Indeed, a relationship summary dated March 23 states that the restructuring (referred to as the "sixth modification to the forbearance agreement"), was under negotiation that would attempt to recover as much principal as possible for the Bank Group by allowing the borrower to liquidate operations based on a forecasted budget. (Div. Ex. 182). Most significantly, that summary noted that the "[p]rojected loss to the Bank Group," from the restructuring totaled $35 million (excluding the sale of some undeveloped lots that were valued at $13.3 million). (Ibid.)

Given McCar's cash flow problems and expected inability to repay the principal in full, McCar should have been placed on nonaccrual status effective March 31, 2009 as payment in full of principal and interest was not expected. Moreover, McCar was in default of the modified loan agreement that provided for the liquidation of the company by December 31, 2009. Indeed, given that the Bank Group had, prior to March 31, 2009, estimated the potential loss to be incurred if the restructuring completed, a strong argument could be made that McCar should

have been downgraded to 80 (doubtful) as of March 31, 2009. On May 22, 2009, Regions placed the relationship on nonaccrual status. (Div. Ex. 318, p. 8).

I have reviewed the reasons that Regions provided the Federal Reserve for keeping the McCar loan on accrual as of March 31. (Div. Ex. 318, p. 8). Specifically, Regions claimed that the loan was kept on accrual because there were strong indications that the proposed restructuring under negotiation at the time would close and that the "[p]rojections provided by the borrower indicated a positive LTV through the first five months of the extension," which "would carry the builder into the selling season." (Ibid.) These are not sufficient reasons for maintaining the accrual status of this credit. Multiple internal Regions' documents make clear, that the borrower had advised the Bank Group that it no longer had sufficient cash to continue operations and the restructuring under negotiation in March 2009 was intended to allow the debtor to conduct an orderly liquidation of its assets. (Div. Exs. 52, 182; Div. Ex. 463 at Regions_041212SECSubpoena_0004549). While Regions and the other lenders in the Bank Group hoped that the restructuring would maximize their recovery of principle, they anticipated that the maximum recovery would still result in a loss. (Ibid.)

Regions' letter to the Federal Reserve represented that, after March 31, it learned that the agent bank for the credit had placed the loan on nonaccrual. (Div. Ex. 318 at p. 8). This supposedly was the only change in the loan after March 31, 2009 that led Regions to place the loan on nonaccrual. This was not an adequate reason to delay the nonaccrual decision past March 31. As mentioned, Regions knew as of March 31 that it was likely to incur a loss on this loan.

Regions' internal discussions regarding the accrual narrative to be given the Federal Reserve for this loan support my conclusion. Specifically, the SAD Group Manager, Ed

Hutchison, emailed Scott McLay on May 19, 2009, with a copy to Smith and Wendell Burks (McLay's supervisor) stating:

> Our instructions are to clarify how we arrived at our accrual status as of 3/31/09, not what happened subsequently. In the McCar case my understanding of the facts are essentially these:
>
> * * *
>
> Our assessment of the 6th modification then in process was that the loan would be brought and maintained current on interest and the full collection of P&I was both expected and could be substantiated (details in file).

(Div. Ex. 283). McLay responded that this was an incorrect assumption, stating "With the 6th Modification, the Bank Group was aware that we would not collect all principal, but interest would remain current." (Ibid.) Hutchison then responded to McLay, Smith and Burks "Given Scott's first . . . comment regarding the collection of principal, how did we avoid a charge or doubtful classification." (Ibid.)

I note that the Federal Reserve examiner who reviewed the accrual status of this loan agreed with my conclusion that this loan should have been classified as nonaccrual as of March 31, 2009. (Div. Ex. 446). The examiner opined "This loan should have been placed on NA in March because on 3/10/2009 borrower stated that it would cease business at year end resulting in a best case 20+% loss to banks." (Ibid.)

5. First West Cutler

This loan was made to finance First West Cutler's acquisition and renovation of an apartment complex of 198 units in Miami, Florida. At the end of 2008, it was discovered that 49 of the units held as collateral were fraudulently sold as condominiums to pay-off the debts of a loan to a different institution. (Div. Ex. 106). The loan was subsequently downgraded to a risk rating of 70 and transferred to SAD in October of 2008. (Div. Exs. 12, 14; Papke Depo., p. 139 -

141). A foreclosure complaint was filed by Regions in November 2008 and demand for full payment was made to the borrower. (Div. Exs. 17, 459 at Regions_041212SECSubpoena_0001130). As of March 31, 2009, the unpaid loan balance was $10.9 million and the loan was 54 days past due. (Div. Ex. 459 at Regions_041212SECSubpoena_0001289-1292).

A new appraisal was obtained as of February 23, 2009 that valued the property at $8.3 million. (Div. Ex. 459 at Regions_041212SECSubpoena_0001156). This appraisal revealed a collateral deficiency of at least $2.6 million. Regions pursued foreclosure litigation during the first quarter of 2009 to obtain a summary judgment and title to the collateral for subsequent sale. (Ibid. at Regions_041212SECSubpoena_0001130, Div. Ex. 106). Fidelity was the title company, which Regions filed the suit against, who provided the title insurance to these mortgage holders. Fidelity had offered a settlement for $7.0 million dollars on the note to settle Region's fraud claims against them, but Regions was willing to accept no less than $9 million. The litigation was not resolved as of March 31, 2009. (Div. Exs. 17, 47, 104; Papke Depo, p. 143 – 145; Carrigan Depo, p. 87 - 88, 98 - 100).

First West Cutler was on the AQF as early as January 21, 2009 as a projected NPL for March, and it remained on every ensuing weekly AQF as a projected NPL through March 11. (Div. Ex. 479). Regions' personnel prepared a risk rating change form on March 6 to change First West Cutler's risk rating from 70 to 75 (nonaccrual). (Div. Ex. 106). Papke, his credit officers and his staff, and Corrigan agreed that the loan should be taken to nonaccrual as of March 2009. (Papke Depo, p 87, Corrigan Depo, p.132; Div. Ex. 291). The reasons for their conclusions included: (1) the fraudulent sale of the certain apartments, (2) the borrower had defaulted on the loan agreement; (3) the borrower had ceased to make interest payments; and (4)

Regions expected that foreclosure litigation would continue without receipt of interest (much less principal) payments from the borrower. (Div. Ex. 106). According to Papke, nothing occurred between March 6 and the end of March that suggested First West Cutler was not going nonaccrual. (Papke Depo. p. 147 - 148, 154).

Despite the longstanding forecast for nonaccrual, Neely sent an email to Papke and Cash at 6:39 AM on March 17, 2009 asking, "If I needed to defend leaving the following on accrual status over quarter end what should be some of my arguments" and included First West Cutler on the list. (Div. Ex. 161). There does not appear to have been any response to this email. Regions' letter to the Federal Reserve states that the decision to pull the loan from nonaccrual was made during the March 17 Meeting. Papke did not agree with pulling the loan from the nonaccrual list because there was a potential for a loss on the loan, and thought the loan should have been nonaccrual according to the policies and procedures of Regions. (Papke Depo, p. 149-50). Corrigan also did not support pulling this loan from the nonaccrual list, and he only learned the loan was pulled in a subsequent conversation with Papke. (Div. Ex. 291).

The loan should have been placed on nonaccrual effective March 31, 2009 due to uncertain collateral, which eliminated the expectation of full loan principal collection. Collection became doubtful and loan repayment depended on recourse from a client of deteriorating financial condition. The offer from Fidelity that Regions received in late February or early March would have yielded a loss of $2 million and Regions had impaired collateral, as 49 units had been sold outside of the trust. (Div. Ex. 104). Regions recognized these implications, as there were email communications indicating hesitancy to enter into a contract on the Fidelity offer due to having to accept a write-down (loss) in the first quarter of 2009. (Papke Depo, p. 181, Carrigan Depo, p. 98 - 100; Div. Exs. 47, 72, 293, 253, and 254). The institution

of foreclosure proceedings against the debtor also heightened the probability that Regions would not recover full principal and interest, as borrowers frequently cease payments once foreclosure proceedings have begun.

First West Cutler was eventually put on nonaccrual on April 24, 2009. (Div. Exs. 318, p.17; Papke Depo. p. 153-54). The loan was subsequently moved to held-for-sale in the second quarter of 2009. The loan had charge-offs of $3,178,000 by the end of 2009. (Div. Ex. 459 at Regions_041212SECSubpoena_0001312, 1317, 1360).

I have reviewed the reasons that Regions gave the Federal Reserve for keeping the First West Cutler loan on accrual as of March 31, 2009. These reasons included the potential lawsuit against Fidelity (the title insurance company), which Regions supposedly thought would allow it to recover full principal and interest. (Div. Ex. 318 p. 17-18). The reasons given to the Federal Reserve did not justify keeping the loan on accrual. As noted, Regions had indicated that it was willing to sell the loan to Fidelity for $9 million which would have resulted in almost a $2 million loss. Moreover, Fidelity had only offered $7milllion as of March, which represented an even larger potential loss for Regions. Indeed, even Regions conceded that it did not have sufficient justification to keep the loan on accrual. In its May 29 letter to the Federal Reserve, Regions conceded "Clearly we came to this [nonaccrual] conclusion in April but agree that we should have gotten there a month earlier." (Div. Ex. 318, p.1). Regions did not adequately explain, however, why it rejected the sound and long-standing recommendations of the SAD Relationship Manager (Corrigan) and the Group Senior Credit Officer (Papke) who were most knowledgeable about the circumstances pertaining to the credit.

I note that the Federal Reserve examiner who reviewed the accrual status of this loan in connection with the targeted review in May 2009 agreed with my conclusion that this loan

should have been classified as nonaccrual as of March 31. (Div. Ex. 443). The examiner opined, "This entire $10.9MM exposure should have been placed on Nonaccrual in March 2009, with $3.1MM on Substandard and $7.8MM on Doubtful because:

- Loan Fraud & Title Fraud: Sponsor fraudulently sold and closed on the sale of 49 condo units without any proceeds from those sales going to Regions; sponsor has admitted selling those units and using proceeds to retire debt with another financial institution; SARs have been filed for the loan and title frauds as well as for check kiting by sponsor between his operating accounts with Regions in name of FWCG and accounts he maintained with Wachovia;

- Lawsuits & Foreclosure: Regions has had to sue borrower and guarantor for recovery of $7.8MM in estimated net sales proceeds (discounted) for the 49 units for which title was fraudulently conveyed;

- Collateral value $8.3MM (1/23/09) yields 131% LTV; [and]

  * * *

- Default letter was issued by Regions on 3/27/09, when loan matured." (Ibid.)

6. Seahaven Finance LLC

In April 2006, Regions participated in condominium construction financing in the amount of $73 million to Seahaven Finance LLC ("Seahaven") (Div. Ex. 470 at Regions_041212SECSubpoena_0005454, 0005451), of which Regions held $30 million of the loan funded for a proposed 280-unit condominium complex to be located on Front Beach Road in Panama City Beach, Bay County, Florida. Regions' unpaid loan balance was $6.8 million at March 31, 2009. (Div. Ex. 470 at Regions_041212SECSubpoena_0005451,5484).

The loan was downgraded to a Risk Rating of 60 and subsequently downgraded to a Risk Rating of 70 in late December 2007 due to mounting concerns over potential buyer fallout and a legal complaint that had been filed in November 2007 by unit purchasers, which accounted for 42 units by the end of November. (Div. Ex. 470 at Regions_041212SECSubpoena_0005491). The lenders agreed to extend the maturity date of the loan in May 2008. (Div. Ex. 470 at

Regions_041212SECSubpoena_0005717). The loan was transferred to SAD in February 2008. (Ibid. at Regions_041212SECSubpoena_0005678).

An auction held in December 2008 resulted in the sale of 21 units (after rescissions), seven of which closed, that generated $885,000 of net sales. In addition, there were five post auction unit sales that generated an additional $570,000 in net sales. At that time, the anticipated net proceeds, assuming all 26 units closed, were $85,000 short of the debt associated with the units sold requiring borrower equity or lender approval of the shortage. Papke confirmed these issues had not been resolved by the end of March 2009 and that this loan should have been on nonaccrual status at March 31, 2009. (Div. Exs. 20, 470 at Regions_041212SECSubpoena_0005661, Papke Depo, p. 199 - 202). The loan became collateral dependent in the fourth quarter of 2008 due to having to use auctions to sell the units. (Div. Ex. 470 at Regions_041212SECSubpoena_0005641 - 5648).

In December 2008, Susan Bell, who appears to have been the SAD Relationship Manager handling this credit, emailed Aderhold, "I am concerned that the wheels are fixing to come off on this one," noting that the debtors wanted to use forfeited earnest money deposits to pay expenses and the recent auction "was a bust and they are running out of money." (Div. Ex. 20). She expressed concern that "the principals are not going to be able to hold on." (Ibid.)

By January 28, 2009, approximately 136 units remained unsold. The borrower attempted to expand the sales strategy to auctions, bulk buyers and pursuit of an equity partner; however, those potential strategies were not successful. (Div. Ex. 470 at Regions_041212SECSubpoena_0005486). The property was appraised at $18.1 million at January 28, 2009 (Div. Ex. 470 at Regions_041212SECSubpoena_0005498). On January 31, Bell began preliminary discussions with the debtors regarding a longer term renewal that would

allow the borrower time to: a) sell additional units; b) bring in an equity partner; or c) find a buyer for the note. (Div. Ex. 470 at Regions_041212SECSubpoena_0005649)

On February 11, 2009, Bell advised Aderhold that she had an agreement to extend the Seahaven loan to January 31, 2010, and questioned whether that permitted removal of the loan from nonaccrual, even though a related credit with the same debtor (St. Andrews land) had already been downgraded. (Div. Ex. 58). When Aderhold asked if Seahaven had a separate source of repayment, Bell answered, "Seahaven has money left in loan to fund interest." Aderhold then advised "if they can't pay on other loans then we cannot rely on a loan funded [interest reserve] to keep off NPA." (Ibid.) On February 18, Bell submitted the proposed renewal to senior management for approval. (Div. Ex. 90). Consistent with Aderhold's earlier instruction, however, she advised her SAD team leader, Kent Harrell, on the same day that, notwithstanding the proposed renewal, she was "going to have to move [Seahaven] to NPA due to a related credit." (Div. Ex. 485).

In early March, Regions noted that few properties were being sold and the ones that were came at extremely discounted prices. (Div. Ex. 115 at REG 00816365). Bell also expressed concern that the appraisals "will come back lower than those in the file, given the continued weakness in the [Panama City Beach] market." (Ibid.; Papke Depo, p. 203).

Seahaven was forecasted to go nonaccrual as early as the January 21, 2009 AQF, and the loan remained on every subsequent AQF report though March 11. (Div. Ex. 479). On March 2, 2009, Bell prepared a Commercial Workout Strategy noting that the loan "is being moved to 75 in March, 2009 due to (1) related indebtedness rated a 75 and (2) Lack of repayment source other than interest reserve." (Div. Ex. 90). The form also noted "Seahaven continues to close units

sporadically, but while the sales prices are sufficient to repay our debt, there are no excess proceeds to cover interest carry." (Ibid.)

The loan was pulled from nonaccrual in March 2009, after Neely sent an email to Papke and Cash asking for any argument that would defend leaving that loan on accrual status over quarter end. (Div. Ex. 161). After Papke responded with several arguments, Neely forwarded that email Willoughby, Kuehr and others (but did not include Papke), stating "I would add Seahaven to our fix group." (Div. Ex. 162).

Given the condition of the loan as of March 31, 2009, collection of full principal and interest was sufficiently in doubt so as to warrant nonaccrual status for this loan. Indeed, Seahaven was eventually moved to a Risk Rating 75 and nonaccrual status on April 24, 2009. Because this was prior to May 11, 2009, when Regions filed its Form 10-Q for the quarter ended March 31, 2009, the loan should have been classified as nonaccrual for purposes of the financial statements within that Form 10-Q.

I have reviewed the purported reasons that Regions gave the Federal Reserve for keeping Seahaven on accrual as of March 31, 2009. Those were:

1. Loan was current;
2. RM had recently negotiated a one year renewal that was in the approval process;
3. Interest reserve sufficient to cover loan for remaining term without selling another unit;
4. Borrower continuing efforts to find an equity partner to infuse capital and pay down the loans;
5. 1/09 appraisal showed 1:1 collateral coverage; and
6. Guarantor group had recently entered into an agreement to resolve the existing mechanics liens. (Div. Ex. 318 at p. 5).

These facts do not justify keeping the loan on accrual status. By March 31, 2009, Seahaven had become collateral dependent as the borrower was having trouble selling off units even at extremely discounted prices. (Div. Exs. 20, 115). Moreover, the debtors had been relying on forfeited earnest money deposits to pay operating expenses and the loan-funded interest reserve to remain current on its loan payments. (Div. Exs. 20, 90). Aderhold correctly noted that reliance on an interest reserve to remain current did not justify keeping the loan on accrual. (Div. Ex. 58). In fact, just a few months earlier, Kuehr, the head of SAD, had acknowledged that "living off interest reserves" was not a sufficient justification for maintaining a loan on accrual status. (Div. Ex. 39A). Moreover, the mere fact that the borrowers were looking for an equity partner was of no import as there did not appear to be any realistic prospect in sight. In fact, Regions' letter to the Federal Reserve does not mention that Seahaven had been unsuccessful in soliciting joint venture partners up to that point. (Div. Ex. 115). Most importantly, Regions' letter does not mention that a related loan with the same borrowers (St. Andrews) had been placed on nonaccrual as of March 31 for non-payment, and that Seahaven had no viable independent source of repayment given the poor condition of the project (*i.e.*, slow sales and greatly reduced prices).[32]

I note that Papke agreed with my conclusion that the reasons given to the Federal Reserve did not justify keeping Seahaven on accrual. Papke explained that those reasons, which came largely from his March 17 email to Neely, did not give the complete picture of the loan's status, as it didn't mention that units weren't being sold, that the borrower was having trouble making their payments, or that Regions was only doing a one-year renewal to "kick it down the road."

[32] I determined that the St Andrews credit was classified as non-accruing as of March 31 because it had been recommended for nonaccrual in February and March (Div. Exs. 58, 215, 470 at Regions_041212 SECSubpoena_0005644), and is not listed as one of the loans that was pulled from nonaccrual in March (Div. Ex. 198, p. 2-3).

(Papke Depo at p. 199 - 202, 206, 207). He noted that had Neely asked him whether the loan should be non-accruing, rather than just the arguments that would defend keeping the loan on accrual over quarter end, he would have given a different answer. (Papke Depo at p. 207). I also find it notable that Neely's ensuing email on March 17, directing that Seahaven be added to the fix group, *i.e.*, to pull from nonaccrual, did not include Papke. Nor was Bell consulted in connection with this decision, even though she was the SAD Relationship Manager who recommended the loan be placed on nonaccrual. (Div. Ex. 451).

Finally, I note that staff from the Federal Reserve who reviewed the accrual status of this loan as part of that agency's May 2009 targeted review of Regions concluded that Seahaven deserved nonaccrual status as of March 31. The reasons cited by the Federal Reserve were:

- Sponsors defaulted on St. Andrews (related debt);
- Guarantors failed to honor their legal commitments;
- Guarantors can no longer carry Seahaven's interest;
- Contract fallout effectively negates presales, and absorption slowed considerably in 2008 – 2009 vis-à-vis 2007;

(Div. Ex. 451).

7. Designers Choice Cabinetry

Designer's Choice Cabinetry, Inc.'s ("Designers Choice"), headquartered in Florida, manufactured, sold and installed European-style cabinets through kitchen dealers and independent sales representatives. Sales were driven primarily by new residential construction and remodeling projects. (Div. Ex. 457 at Regions_041212SECSubpoena_0002282, 2441 and 2586). The loan at issue was originated in early 2006 by AmSouth, which later merged with Regions in the same year, to finance Designer's Choice expansion cost and to refinance the current outstanding mortgages on the properties due to the low interest rates. (Div. Ex. 457 at

Regions_041212SECSubpoena_0002282 and 2308 - 2340). The collateral for the loan was the property, improvements and equipment being financed. (Ibid.) The unpaid loan balance was $2.6 million at March 31, 2009. (Div. Ex. 457 at Regions_041212SECSubpoena_0002424) and the borrower was 45 days past due. (Ibid. at Regions_041212SECSubpoena_0002547).

Following four consecutive quarterly losses combined with a health issue of the Designer's Choice CEO (the guarantor), the loan was transferred to SAD in February 2007 (Div. Ex. 457 at Regions_041212SECSubpoena_0002542). A December 2008 entry in the Problem Loan Report noted that, although the borrower continued to reduce expenses and had turned a profit in August 2008, refinancing attempts to date had been unsuccessful. (Div. Ex. 457 at Regions_041212SECSubpoena_0002549).

On February 10, 2009, Aderhold advised that Designer's Choice had been added to the weekly AQF as a projected NPL because "the borrower can no longer pay." (Div. Ex. 54). The loan remained on every subsequently weekly AQF through March 11, the last AQF before the March 17 Meeting. (Div. Ex. 479). On February 18, Rod Reimer, the SAD Relationship Manager for the credit, emailed Aderhold and Harrell noting that, according to the debtor's January borrowing base certificate, the debtor was "over margined" by about $100,000, meaning that there was inadequate collateral under the loan agreement to support the outstanding debt. (Div. Ex. 64). Reimer also noted that the guarantor lacked sufficient liquid assets to bring the loan back into margin and was talking with bankruptcy counsel (suggesting bankruptcy was possible). (Ibid.) Reimer advised that the bank had not received the debtor's workout proposal, which was apparently additional collateral to be provided from a friend, and concluded "I believe that it is evident that they are not going to be able to make their March 1 principal pay down on

the Bonds without a cash infusion or additional funds advanced from the bank." (Ibid.) Reimer thus recommended placing the loan on nonaccrual. (Ibid.)

On February 27, 2009, a risk rating change form was prepared for the loan so that it could be downgraded from a 70 to 75 (nonaccrual) risk rating. (Div. Ex. 80). The form noted that the borrower/guarantor had run out of cash and had not reimbursed the bank for the scheduled annual $145,000 bond principal payments that were funded by the bank. (Div. Exs. 80, 97). The borrower also told Regions in the first quarter of 2009 that there was a potential investor who indicated an interest in possibly investing in Designer's Choice. (Div. Ex. 97). But I have seen no documents suggesting that the bank ever received anything in the first quarter, such as a letter of intent from the potential investor, indicating that this was a realistic option. Indeed, the March 3 workout strategy notes that Regions would review the plan when received from the debtor and determine whether a restructure was feasible. (Div. Ex. 97).

With all the known facts and problems with the loan as of March 31, 2009, the loan should have been placed on nonaccrual status. By the end of the first quarter in 2009, the borrower had suffered from the immense overall economic downturn and real estate slowdown, especially in the new residential construction market that impacted its primary target market. These facts, coupled with the borrower's known historical financial losses in 2007 and the CEO's health issue, indicate that Regions could not reasonably have expected to recover full repayment of outstanding principal and interest balances on the loan. Indeed, Aderhold testified that he was inclined to keep the loan in nonaccrual status by the end of March 2009. (Aderhold Depo, p.118-121, 127-128).

In its letter to the Federal Reserve, Regions claimed that it rejected the recommendation of Reimer and Aderhold and kept this credit on accrual as of March 31, 2009 given the

borrower's representation that he was "working with an investor" who "was going to inject cash into the company." (Div. Ex. 318 at p. 16). Regions also noted that the 3/09 SWAP interest payment was made by the borrower. (Ibid.) Regions also represented that it placed the loan on nonaccrual on April 24, 2009 after "the proposed investor never made the cash injection and formal LOI was never presented," no other prospects materialized, and borrower advised that he could not make schedule payments. (Ibid.) These were not valid justifications to delay the nonaccrual until April. As noted, Regions knew of the borrower's precarious financial condition in March, when he advised that he was out of money and would not be able to repay the bank for the bond payments that Regions had funded. (Div. Ex. 97). The debtor's representations that there were on-going negotiations with a potential investor were also an insufficient basis to delay nonaccrual. Absent a letter of intent and some indication as to the investor's financial capacity, the mere possibility of a future investor does not provide reasonable assurance that full principal and interest will be collected. I also note that, because this loan was placed on nonaccrual before Regions filed its Form 10-Q for the quarter ended March 31, 2009, which was filed on May 11, 2009, this loan should have been classified as nonaccrual for purposes of the financial statements and related disclosures filed with that public report.

8. Kicklighter Custom Homes, Inc.

In 2003, AmSouth Bank, that later merged with Regions Bank, issued a loan to Kicklighter Custom Homes, Inc. ("Kicklighter") for the purpose of acquisition, development and construction of lots and single-family homes near Jacksonville, Florida in the amount of $5 million. (Div. Ex. 462 at Regions_041212SECSubpoena_0003983). The unpaid loan balance at March 31, 2009 was $2.6 million. (Ibid. at Regions_041212SECSubpoena_0004266).

In November 2008, Regions downgraded Kicklighter's risk rating from 60 to 70 because the borrower had begun to slowly pay monthly interest payments due to limited cash flow and slow sales. (FRB ATL002216, Div. Ex. 462 at Regions_041212SECSubpoena_0004046-4050).

In addition, Kicklighter had not reduced the retail price of homes enough to exit the stale inventory, did not have a plan to liquidate assets and had refused to right size inventory under the line of credit. (Div. Ex. 462 at Regions_041212SECSubpoena_0004056). The loan was subsequently transferred to SAD in December 2008. (Ibid. at Regions_041212SECSubpoena_0004053). By December 2008, the loan had become 31 days past due. (Ibid. at Regions_041212SECSubpoena_0004043). By mid-March 2009, the debtor had stopped building new homes and had begun discounting the existing inventory of homes. But he had let go all of his sales staff and was thus dependent on local real estate listing agents and phone calls from advertisement to generate sales. (Div. Ex. 476).

Kicklighter had been forecast as nonaccrual by SAD as early as the January 21, 2009 AQF, and the loan remained as a projected nonaccrual loan in every subsequent AQF through March 11, 2009. (Div. Ex. 479). In January 2009, Kicklighter was also on a list of loans with a "high" probability of going nonaccrual during the first quarter and potentially being listed in the first quarter 2009 Note Sale Efforts (*i.e.*, a list of loans that Regions was considering selling). (Div. Ex. 30).

The March 31, 2009 PLR stated that the borrower made the full December 2008 payment in January 2009 and was willing to keep account current. (Div. Ex. 462 at Regions_041212SECSubpoena_0004053-4057). In March 2009, the property had an updated appraisal that indicated a market value of $1,260,000 (Div. Ex. 462 at Regions_041212SECSubpoena_0004099). The loan became collateral dependent in the first

quarter of 2009 based on current collateral appraised values, stale inventory, and the borrower's inability to curtail or right-size the loans based on LTV's; therefore, the original PSOR changed. The accrual status and risk rating of 70 was based on the payment delinquency being less than 81 days and the borrower's history of reducing principal upon the sale of collateral. (Div. Ex. 462 at Regions_041212SECSubpoena_0004259 - 62).

After Kicklighter brought the loans current in March 2009, Papke asked Aderhold on March 13, "Now what are we going to do? Non-accrual?" (Div. Ex. 141). In response, Aderhold stated he could not tell from the information provided what the borrower's debt service capabilities were and suggested that the loan should remain on nonaccrual until they could ascertain whether the debtor had sufficient debt servicing capacity from the rental income. (Ibid.) On March 17, despite having forecasted the loan as a March NPL for eight consecutive weeks, and in contrast to his March 13 recommendation to keep the loan on nonaccrual until more information could be obtained, Aderhold switched course and recommended delay of the nonaccrual until Regions knew for sure the borrower could not support the credit. (Div. Exs. 159, 284).

This loan should have been placed on nonaccrual effective March 31, 2009 because the loan became collateral dependent with an updated appraisal of $1,260,000, when current the outstanding balance was $2,567,000. (FRB ATL002207; Div. Ex. 462 at Regions_041212SECSubpoena_0004099, and 4259 - 62). This shortfall and stale inventory made collection of full principal highly unlikely.

In April 2009, the incomplete information Aderhold previously noted should be gathered before pulling from nonaccrual was gathered in full and indicated that, even with the new rental income, there was still insufficient income to service all the debt. The credit was thus placed on

nonaccrual status by Regions on April 24. (Div. Ex. 318 at p. 12). Because the loan was classified as nonaccrual in April, before Regions filed its Form 10-Q for the quarter ended March 31, 2009, this loan should have been classified as nonaccrual for purposes of the financial statements filed in the Form 10-Q.

The loan subsequently experienced charge-offs in 2009. (Div. Ex. 462 at Regions_041212SECSubpoena_0004317 - 4332). In September 2009, the loan balance was 262 days past due and it had a prior charge-off of approximately $575,000. (Ibid. at Regions_041212SECSubpoena_0004283-4287). By December 2009, the loan was 354 days past due. (Ibid. at Regions_041212SECSubpoena_0004290-4294) and in April 2010 additional balances had been charged off and the loan was sold. (Ibid. at Regions_041212SECSubpoena_0004042, 4315).

I have reviewed the reasons that Regions gave the Federal Reserve for deciding to keep the loan on accrual status as of March 31, 2009. Specifically, Regions noted the payments received in March, coupled with the information it had received suggesting excess cash flow from the debtor's rental properties, led Regions to pull the loan from nonaccrual "to determine whether this new cash flow would support the debt service." (Div. Ex. 318 at p. 12). Regions also claimed that, after March 31, "the due diligence progressed [and] it was determined that some of the rental properties presented by the borrower were not our collateral and could not be relied upon for debt service." (Ibid.) These are not sufficient justifications to have delayed the nonaccrual until April. Given the collateral deficiency, the problems facing the debtor relating to the project (*e.g.*, slow sales and stale inventory) and the fact that the PSOR had changed from the project that was being financed to the debtor's rental properties, Regions should have followed

Aderhold's initial recommendation to keep the loan on nonaccrual until it ascertained whether the rental income would be sufficient to service the debt.

I note that the Federal Reserve examiner who reviewed the accrual status of this loan agreed with my conclusion that this loan should have been classified as nonaccrual as of March 31, 2009. (Div. Ex. 445). The examiner opined, "This loan should have been placed on NA in March 2009 because

- The borrower was past due on the principal for a majority of notes, confirming his poor financial condition and lack of liquidity;
- The new appraisals (reviewed 3/17/2009) showed that the loan was poorly secured with an aggregate LTV of 142%."

(Ibid.) The examiner also found Aderhold's March 16 recommendation to keep the loan off nonaccrual to be inadequate, noting that his recommendation failed to reflect past due status of principal for several of the notes; new appraisals showing underwater LTV; and new F/S showing lack of liquidity. (Ibid.)

9. River Glen LLC

On December 20, 2004, AmSouth Bank approved an $8.6 million first mortgage loan to River Glen to acquire 210 gross and 168 usable acres for development into 278 single-family residential lots in Nassau County, Yulee, Florida. The unpaid loan balance was $3.8 million at March 31, 2009 and the loan was approximately 70 days past due. (Div. Ex. 469 at Regions_041212SECSubpoena_0002142). An interest reserve of $563,798 was included in the construction loan budget. 258 lots of the 278 lots to be developed were to be sold to Maronda Homes, Providence Homes and Morrison Homes. (Div. Ex. 469 at Regions_041212SECSubpoena_0001999-2001).

The loan was downgraded in October 2008 to Risk Rating 60 due to slow builder lot take-downs and greater reliance on the guarantor for principal repayment. Of the three original builders, only Maronda Homes remained as a potential buyer as of the end of 2008 because Providence homes defaulted and Taylor Morrison was asked to exit the project in November 2008 due to non-performance. (Div. Ex. 469 at Regions_041212SECSubpoena_0002138 - 2139).

The loan matured on December 21, 2008. By the end of December, loan payment was 11 days past due and was in the process of renewal with a full fee and interest escrow reserve. (Div. Ex. 469 at Regions_041212SECSubpoena_0002028). The renewal was to be for only for six months in order to review CDD payment performance by the developer with an option to extend. Regions was reducing its letter of credit exposure at that time. (Div. Ex. 469 at Regions_041212SECSubpoena_0002138 - 2139).

By the end of January 2009, the loan had been downgraded to Risk Rating 70 and transferred to SAD (under the supervision of Kent Harrell), as the borrower and guarantors admitted inability to service or support the loan, or meet impending CDD bond obligations. (Div. Ex. 469 at Regions_041212SECSubpoena_0002142). The February 13, 2009 Commercial Workout Strategy prepared by Harrell noted that limited sales activity resulted in insufficient cash flow for interest and curtailments. (Div. Ex. 60). That document also noted that a downgrade to 75 (nonaccrual) was "in process." In March, Regions knew of several critical issues related to the loan that needed to be resolved on or before April, mainly (1) the pending payment of approximately $540,000, consisting of CDD debt service, real estate taxes, and HOA (home owners association) fees, and (2) finalizing the builder contract (Maronda) in the project. (Div. Exs. 60, 73, 469 at Regions_041212SECSubpoena_0002142).

In March 2009, as part of its workout plan, Regions was seeking to finalize a forbearance agreement with River Glen that would give the debtor additional time to finalize its agreement with Maronda Homes for continued takedowns of 3 lots per month over the following 12 months. (Div. Ex. 73). The expectation was that if executed, the contract with Maronda would provide sufficient funds to repay Region's loan. But the borrower was also facing an April payment to the CDD bondholders, plus delinquent property taxes, in the amount of $540,000. (Div. Ex. 73). Because the debtor did not have sufficient cash flow to make this payment, Regions anticipated that approximately $416,000 of that amount would have to be advanced by Regions. (Div. Ex. 469 at Regions_041212SECSubpoena_0002142- 2144). The CDD bonds had a senior priority interest to Regions, and Regions understood that the failure to make the CDD payment would result in a foreclosure action by the bondholders. (Div. Ex. 469 at Regions_041212SECSubpoena_0002138- 2139). This conundrum led Kent Harrell to recommend in an email to Neely in February that the loan be placed on nonaccrual. (Div. Ex. 73).

River Glen had been forecasted as a March nonaccrual as early as January 21, 2009, and the loan remained as a forecasted March NPL on every AQF between January 21 and March 11. (Div. Ex. 479). The appraisal review addendum signed on March 19 notes a significant decline (52% on an annualized basis over 7 months) in the value of the project. The decline was due mainly to builders declining to buy lots and renegotiating their lot take-down agreements. This, in turn, was a consequence of the sharp decline in the housing market. House prices had fallen 10% over the previous year and were expected to further decline at the rate of 10% per year. (Div. Ex. 469 at Regions_041212SECSubpoena_0002171).

It is clear that River Glen should have been placed on nonaccrual effective March 31, 2009 because the evidence above matches the following Regions' criteria for placing the loan on nonaccrual:

(1) Payment in full of principal and interest was not expected;
(2) Payment depended on special financing due to the borrower's deteriorating financial condition; and
(3) Regions would have to advance an additional $416,000 to prevent CDD foreclosure action in order to protect its collateral.

In fact, Regions admits that the loan was placed on nonaccrual status on April 24, 2009 for the precise concern that Regions noted in February and March: the debtor failed to make the April payment on the CDD bonds, causing the bondholder to consider foreclosure proceedings. (Div. Exs. 318, 450, 483). Because Regions' downgrade occurred prior to the May 11, 2009 filing date of its March 2009 10-Q, the River Glen loan should have been classified as nonaccrual for purposes of the financial statements that were filed with that report.

Regions told the Federal Reserve examiners that it decided to keep the River Glen loan on accrual as of March 31, 2009 because "the borrower had negotiated a contract with M[a]ronda Homes that appeared to be able to cover all P&I, taxes and CDD payments over an approximate four year period." (Div. Ex. 318 p. 15). This does not appear to be completely accurate, as internal Regions documents suggest that the Maronda homes contract, even if finalized, would not generate sufficient cash to cover the initial bond payment and tax outlays due in April. (Div. Ex. 73).

I note that the Federal Reserve bank examiner who reviewed the accrual status of this loan agreed with my conclusion that River Glen should have been taken to nonaccrual as of March 31, 2009. (Div. Ex. 450). Specifically, the examiner noted the following factors

supported nonaccrual status prior to March 31, 2009, "1) troubled project in a problem market; 2) the primary credit matured on 12/21/2008 (forbearance followed) and went into interest default on 1/20/2009 (70 days past-due at quarter-end); 3) there was no guarantor/principal support; 4) sales limited; 5) reduced collateral value (estimated at 8% in a 1Q2009 FAS 114 analysis, and later determined to be much higher through reappraisal; and 6) prospect of significant, extended carrying costs." (Div. Ex. 450). With respect to Regions' purported reliance on the potential contract with Maronda as an excuse for delaying the accrual decision until April, the examiner concluded, "While further deterioration in [the] situation regarding the CDB servicing might have occurred in April 2009, the likelihood of default on this debt was recognized in internal documents produced in 1Q2009." (Div. Ex. 450).

10. Wilval LLC

The loan agreement was signed between Wilval and Regions on October 4, 2005 to finance a residential development in Henrico County, Virginia, called Riverview Green. (Div. Ex. 472 at Regions_041212SECSubpoena_0001380). The original loan amount of $4.5 million was increased to $5 million in February 2006. (Ibid. at Regions_041212SECSubpoena_0001382-1383). The loan was transferred to SAD in January 2009. (Div. Ex. 484). The unpaid loan balance was $5.2 million at March 31, 2009. (Regions_041212SECSubpoena_0001595).

Phases I and II of Riverview Green were to include 216 residential condominium units. An additional 184 multi-family sites were planned for phase III. According to a lot purchase contract dated August 31, 2005, with Eagle Construction of Virginia, Inc., the subject sites were under contract for prices of $50,000 to $85,000. (Div. Ex. 472 at Regions_041212SECSubpoena_0001386).

This acquisition and development loan was to be repaid from scheduled lot sales; however, the company that committed to the lot purchase walked away from the purchase

contract in 2006. From 2007 to 2009 the borrower unsuccessfully tried to identify another purchaser of the lots while the economy continued to deteriorate. Therefore, the development of the project was never started, resulting in a land loan. (Div. Ex. 472 at Regions_041212SECSubpoena_0001466). By January 2009, Regions noted that the loan's guarantor, Hank Wilton, was "stressed for cash," as of January 2009. (Div. Ex. 484).

In February 2009, Hank Wilton told Regions that a developer, Ryan Homes, was interested in putting the lots under contract, but would not do so until the Spring of 2010. (Div. Ex. 472 at Regions_041212SECSubpoena_0001604). Therefore, Regions was working with the borrower to establish an interest reserve for an additional year until Ryan Homes would purchase the land. (Div. Ex. 472 at Regions_041212SECSubpoena_0001612; Div. Ex. 484). Regions noted that it would ask for additional collateral in connection with establishing the interest reserve. (Div. Ex. 484). The guarantor on the loan told Regions that Regions "would receive information the beginning of April about additional collateral property and have scheduled a meeting to discuss what was needed to proceed for the middle of April." (Div. Ex. 472 at Regions_041212SECSubpoena_0001596)

A Charge Off/Non-Accrual/Risk Rating Change Form dated March 9, 2009 indicated a change in Risk Rating from 70 to 75 and placement of the loan on nonaccrual status. (Div. Ex. 490). The borrower had been past due for January 2009 interest and was going to be 90 days past due as of March 31, 2009. (Ibid.) Sales were slow and the borrower had to find payment sources elsewhere. (Ibid.) The March 9 form indicated that the loan's collateral value of $9.6 million was greater than the outstanding balance of $5.2 million, so no charge off was recommended at the time. (Ibid.)

The loan was kept on accrual as of March 31, 2009 after the borrower paid one month of the past due interest in March. (Div. Ex. 318 at p. 7). Although the Regions' officer who collected the payment expressed some disappointment that he only got one month's past due interest from the debtor in March, the SAD Regional Manager noted "you didn't buy a month, you bought a quarter end." (Div. Ex. 492).

As of March 31, 2009, Regions was still working with the borrower to establish an interest reserve. (Div. Ex. 472 at Regions_041212SECSubpoena_0001615). Given that the borrower was looking for payment sources elsewhere and Regions had not established an interest reserve by the end of the quarter, the loan should have been placed on nonaccrual as full repayment of interest and principal could not be reasonably expected. The documents discussed above also raise concerns that, in making the accrual decision in March 2009, Regions' personnel were unduly focused on collecting an interest payment to keep the loan from going 90 days past due. (Div. Exs. 487, 488, 492). Instead, they should have focused on the likelihood that there would be full collection of principal and interest.

The credit was put on nonaccrual status in September 2009 as interest fell 90 days past due and the financial strength of the guarantors became doubtful. Regions received a new appraisal of the loan collateral in the first quarter of 2010. The appraised market value was revised downward by the REVS to $7 million. (Div. Ex. 472 at Regions_041212SECSubpoena_0001471). On September 29, 2010, Regions recognized a $2.7 million charge-off (impairment loss) on the loan and moved the loan to held-for-sale on October 1, 2010, and then sold the loan. (Div. Ex. 472 at Regions_041212SECSubpoena_0001702 - 1705).

I note that the Federal Reserve examiner also concluded as part of its May 2009 targeted review that Wilval should have been placed on nonaccrual as of March 31, 2009. (Div. Ex. 453). The Federal Reserve reasoned in part that Regions Bank recognized the precarious nature of the loan by seeking a new interest reserve to be funded by Regions. (Ibid.)

11. Richland Investments LLC

This was a participation loan (*i.e.*, multiple lenders funded the loan) in the original amount of $80 million in which Regions was the lead bank and funded $45 million of the loan amount. The other two lenders in the group were Raymond James and National City. The basic nature of the loan was to allow the borrower to acquire un-entitled land parcels in the path of expected future development, creating perceived future value through the entitlement process, and reaping profits when exiting those acquisitions. (Div. Ex. 467 at Regions_041212SECSubpoena_0002840-2842). On January 1, 2009, Regions' loan balance was $41.9 million out of $74.4 million total outstanding debt. (Div. Ex. 467 at Regions_041212SECSubpoena_0002818). The loan was transferred to SAD in December of 2008. (Div. Ex. 111). In March 2009, the loan was assigned to Holland & Knight, a law firm, that initiated the default process on this loan and related debt. (Ibid.) Regions' unpaid loan balance was $41.9 million at March 31, 2009. (Div. Ex. 467 at Regions_041212SECSubpoena_0002904).

By early March 2009, the borrower had provided Regions with debt and cash flow statements indicating insufficient cash flow to service the debt and operate the real estate for 12 months and the borrower had expressed an unwillingness to continue servicing the debt. (Div. Ex. 111). By that time, the borrower had ceased making interest payments on the loan, and Regions' internal documents concluded that the borrower only had the capacity to provide a one-year interest carry, which was insufficient to cover the debt until such time as the properties that

served as collateral for the loan could be sold. (Div. Ex. 116). While the debtor's financial statements showed $13 million in liquidity, he and his related entities also carried debt balances in excess of $500 million with required annual interest payments exceeding $12 million. (Ibid.) On March 7, Cash emailed Neely that "the chances are strong" that Richland would go nonaccrual in March. (Div. Ex. 114).

On March 9, 2009, a risk rating change form was prepared by the SAD Relationship Manager to downgrade the loan to a 75 risk rating (nonaccrual). (Div. Ex. 116; see also Papke Depo, p 105, 118, 119, Cash Depo, p. 163 - 169). In late March 2009, Regions received new appraisals indicating a LTV of 104%, with a collateral deficiency of $2.8 million. (Div. Ex. 181). By late March, the loan was approaching 90 days past due until March 27, when the debtor paid one month's past due interest. (Div. Ex. 1). Richland appeared as a projected NPL on the February 11 AQF report, and was identified as a projected March NPL on every subsequent AQF report through March 11. (Div. Ex. 479). When Richland was forecasted to go NPL, Neely told Aderhold that Regions couldn't afford to have a credit this big going nonaccrual that quarter [first quarter ended March 31, 2009]. (John Baldwin Depo, p. 64).

In March 2009, Regions was negotiating with the debtor a restructuring of the loan with the hope that it would avoid placing the loan on nonaccrual. The restructuring that Regions was negotiating included (1) the borrower funding, in advance, a one year interest reserve of approximately $3 million; (2) the borrower continuing to pay operating costs, including taxes of $536,000 per year to maintain entitlements and preserve the value of the collateral; (3) the bank group extending the term of the loan for 18 months; and (4) the borrower agreeing to pay down the debt by $5 million over the next 18 months. (Div. Exs. 121, 159). In return, the borrower was asking for a release from its guaranty. (Div. Ex. 121). Regions' hope was that, by giving

the debtor additional time, he could sell some of the properties and reduce the loan balance. (Ibid.)

Although a March 16, 2009 email from Aderhold suggests that there was sufficient agreement on the proposed restructuring to warrant taking this loan off of nonaccrual, other documents I have reviewed suggest that there were at least two areas of uncertainty with respect to the proposed restructuring as of March 31. First, Aderhold claimed that the other banks "had given us positive initial responses" to the proposed restructuring. (Div. Ex. 159). But a February 24 email from one of the banks (National City) advised that it "is not in agreement with the proposal (draft dated 2/19/09) issued by Regions Bank to extend the Richland . . . indebtedness." (Div. Ex. 74).[33] Several subsequent documents reflect Regions' concern in March and April that National City might not agree to the proposed restructuring. A March 10, 2009 email to Neely and others states that, while Raymond James was supportive of proposal, National City/PNC "seem to supportive but have not given us the same level of confidence that we have gotten from Raymond James." (Div. Ex. 121). An April 3, 2009 email from National City advised Regions "the proposed Forbearance and Modification Agreement provided by 3/29/09 has not been approved by National City in its present form." (Div. Ex. 214). Later in April, after National City demanded that an independent forensic accountant review Richland's financial statements before any restructuring be finalized, Aderhold fretted to Papke "[i]f we cannot get Nat City/PNC to go along with our plan then Richland Investments will have to go NPA this quarter." (Div. Exs. 246, 247). It was not until May 20, after Regions filed its Form

[33] Notably, the proposal in February to which National City objected included a demand that the debtor contribute additional collateral, but the proposal to which Aderhold claimed all banks had given positive responses did not include this protection for the banks. (Div. Exs. 69, 121, 159).

10-Q for the first quarter, that National City agreed to the restructuring proposed by Regions. (Div. Ex. 287).

Second, there was sufficient uncertainty about whether the borrower would actually fund the $3million reserve. Cash acknowledged that the year of interest and tax payments, if received before the quarter end, could possibly be enough to sway managers into pulling it from nonaccrual, but without that there would not be enough support for the pull. (Cash Depo, p. 170 - 172). Regions' June 30, 2009 PLR states that "a $2,800,000, one year interest reserve/curtailment in conjunction with a restructure is being negotiated," showing that the payment had not been made as of March 31, 2009. (Div. Ex. 467 at 041212SECSubpoena_0002909-2910).

Given the uncertainty as to whether National City would agree to the modification and the debtor's failure to fund the reserve by March 31, there was sufficient doubt as to the collection of full principal and interest on this loan as of March 31, 2009 such that the loan should have been placed on nonaccrual status by that time. In its letter to the Federal Reserve, Regions stated that the pending negotiations for the restructuring provided a sufficient basis for keeping the loan on accrual as of March 31. But, in March the borrower had provided debt and cash flow statements indicating insufficient cash flow to service debt and operate the real estate for 12 months. (Div. Ex. 111). The borrower had also narrowly avoided becoming 90 days past due at the end of March by making on month's interest payment on March 27. (Div. Ex. 1). Although the borrower had sizeable liquid net worth, the annual interest payments on all debt obligations approximated his total liquid assets. Thus, while the borrower may have orally agreed fund a $3 million reserve, given his precarious financial situation, Cash correctly noted that Regions should have kept the loan on nonaccrual until the debtor actually funded that

reserve. Indeed, the borrower had not funded this reserve by June 30, by which time Regions had placed the loan on nonaccrual. (Div. Ex. 467 at 041212SECSubpoena_0002909-2910).[34]

VII. MY MATERIALITY ASSESSMENTS AND CONSIDERATIONS

I have analyzed the financial impact of the misstatements described in the previous sections of this report, and I have concluded that those misstatements were, in fact, both quantitatively and qualitatively material to Regions' March 2009 Form 10-Q and its related April 21, 2009 Form 8-K earnings release and Exhibits 99.1 and 99.2 accompanying that 8-K. This section of my report further discusses the bases for my opinions regarding materiality.

A. Materiality Authoritative Guidance

SEC Staff Accounting Bulletin: No. 99 – *Materiality* ("SAB 99") issued August 12, 1999 provides the primary source of materiality guidance used by the SEC, registrants and independent auditors in the evaluation of the materiality of misstatements of financial statement items and related disclosures.

SAB 99 describes materiality as follows:

> "Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important. In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:
>
> > The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a

[34] It appears that the Federal Reserve did not prepare a narrative for Richland in connection with its May 2009 targeted review.

fact is material if there is – a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available. SAB 99 also refers to the percentage of reported amounts that registrants and auditors have used for assessing materiality (*e.g.*, amounts below 5% of reported amounts). As indicated in the following quote from SAB 99, the SEC has cautioned auditors and registrants about using percentages solely in materiality assessments:

> "The [SEC] staff is aware that certain registrants, over time, have developed quantitative thresholds as 'rules of thumb' to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. **One rule of thumb in particular suggests that the misstatement or omission of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management.** The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law." [35]

Furthermore, the SEC has clarified in SAB 99 that a percentage threshold such as 5% may be helpful in a preliminary assessment, but rule-of-thumb percentages cannot be used as a substitute for a full analysis of all relevant considerations as indicated below:

> "The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that – without considering all relevant circumstances – a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a 'rule of thumb' as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant's financial statements. **A matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important.** In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:

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[35] SEC Staff Accounting Bulletin: No. 99 – *Materiality*, Staff Accounting Bulletins, Topic 1: Financial Statements, M. Materiality, 1. *Assessing Materiality.*

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."

Indeed, SAB 99 makes clear that amounts below 5% can be material requiring that the materiality assessment include both quantitative and qualitative factors and analysis as indicated below:

"Evaluation of materiality requires a registrant and its auditor to consider *all* the relevant circumstances, and **the [SEC] staff believes that there are numerous circumstances in which misstatements below 5% could well be material.** Qualitative factors may cause misstatements of quantitatively small amounts to be material."

"Under the governing principles, an assessment of materiality requires that one views the facts in the context of the 'surrounding circumstances,' as the accounting literature puts it, or the 'total mix' of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the 'total mix' includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that **financial management and the auditor must consider both 'quantitative' and 'qualitative' factors in assessing an item's materiality**. Court decisions, Commission rules and enforcement actions, and accounting and auditing literature have all considered 'qualitative' factors in various contexts."

"...the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to 'manage' earnings, are immaterial. While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to 'manage' reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements. The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to 'manage' earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement."

"It is unlikely that it is ever 'reasonable' for registrants to record misstatements or not to correct known misstatements – even immaterial ones – as part of an ongoing effort directed by or known to senior management for the purposes of 'managing' earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate 'in reasonable detail.'"

Therefore, the SEC and independent auditors consider that any misstatements or unsupported entries used by management of a registrant designed to manage or manipulate reported amounts or to meet financial targets are *per se* material regardless of the magnitude of the amounts. The reasonable presumption is that if the amounts are important enough for management to manipulate, they are considered by management to be material to financial statement users. Stated differently, there are no quantitative thresholds for intentional misstatements in financial reports.

B. Quantitative Materiality of Reported Non-performing Loans

The amount and level of NPLs are extremely important reported financial metrics for commercial banks like Regions Bank, especially during times of economic distress and financial crisis as experienced by Regions Bank in the first quarter of 2009. Stockholders, potential investors, financial analysts, rating agencies and other market participants place a high degree of significance on the amount and level of NPLs for assessing the financial strength and future income producing ability of a commercial bank. In fact, I reviewed several research reports issued in late 2008 and early 2009 by analysts covering Regions. These reports expressed concerns about the growing levels of non-performing assets on Regions' balance sheet. [36]

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[36] *See, e.g.*, Regions_041212SECSubpoena_006268 (January 2009 report from Bernstein Research states "We believe the most critical credit statistic this cycle will be NPA inflows."); Regions_041212SEC Subpoena_006308 (December 2008 Credit Suisse report states "we remain concerned with the rapid pace of credit quality deterioration . . . .);

continued . . .

In my opinion, the importance of accurate reporting of NPLs by commercial banks is a key factor to consider in assessing the materiality of reported amounts. Regions' reported $1.641 billion in NPLs in its Form 10-Q for the quarter ended March 31, 2009. As a result of the financial and economic crisis facing Regions' borrowers, especially those operating in Florida, the level of NPLs had grown significantly to record levels by March 31, 2009. Table 1 below illustrates the substantial growth in Regions' reported NPLs over just a two-year period:

Table 1

Date	**Reported NPLs**
March 31, 2007	$349.8 million[37]
March 31, 2008	$1.024 billion[38]
March 31, 2009	$1.641 billion[39]

Even more stark is the significant increase in non-accrual loans (NPLs) in the first quarter of 2009. The reported balance of non-accrual loans at March 31, 2009 was $1.641 billion as indicated above, but the balance of non-accrual loans at December 31, 2008 was $589 million less at $1.052.[40] While the total amount of non-accrual loans outstanding remained relatively flat over the nine-month period between March 31, 2008 and December 31, 2008, (*i.e.*, $1.024

Regions_041212SECSubpoena_006328 (December 2008 research report by Morgan Stanley states, "[E]xpected credit deterioration is one of the key drivers of our Underweight rating.").

37 Regions' March 31, 2008 SEC Form 10-Q.

38 Regions' March 2009 10-Q.

39 Ibid.

40 Ibid.

billion compared to $1.052 billion), in just the first quarter of 2009 the reported non-accrual loans outstanding increased a staggering 56% (*i.e.*, $589 million divided by $1.052 billion), excluding the Pulled Loans.

Table 2 below lists certain of the Pulled Loans and their related outstanding loan balances at March 31, 2009 that were incorrectly classified as "accrual" in Regions' March 2009 10-Q as a result of Neely's improper actions to override the nonaccrual recommendations of SAD and other Regions' personnel as described in detail in the previous sections of this report:

Table 2

Borrower	**March 31, 2009 Outstanding Loan Balance**[41]
Glove Factory Holdings LLC	$24.7 million
Resorts Construction LLC	$21.2 million
Water's Edge One LLC	$15.5 million
McCar Development Corp	$9.4 million
First West Cutler	$10.9 million
Seahaven Finance LLC	$6.8 million
Designers Choice Cabinetry	$2.6 million
Total	**$91.1 million**

The misclassified loans listed above totaling $91.1 million represented 5.6% of the $1.641 billion of NPLs reported in Regions' March 2009 Form 10-Q, related April 21, 2009 Form 8-K earnings release and other public filings. In my professional opinion, the $91.1

41 As referenced in previous sections of this report.

million in misstated NPLs was material to Regions' March 2009 10-Q and April 21, 2009 Form 8-K disclosures from both a quantitative and qualitative perspective.

In addition to the loans listed above, Table 3 below lists additional Pulled Loans that were also improperly classified as "accrual" in Regions' March 2009 10-Q, as described in previous sections of this report:

Table 3

Borrower	**March 31, 2009 Outstanding Loan Balance**[42]
Richland Investments LLC	$41.9 million
Wilval LLC	$5.2 million
River Glenn LLC	$3.8 million
Kicklighter Custom Homes, Inc.	$2.6 million
Total	**$53.5 million**

Combined, the misclassified loans in Table 2 and Table 3 above, which totaled $144.6 million, represented 8.8% of the $1.641 billion of NPLs reported in Regions' March 2009 10-Q and were grossly material from a quantitative standpoint.

C. Quantitative Materiality of Understated FAS 114 Loan Losses

As discussed in previous sections of my report, a significant impact of classifying loans as "nonaccrual" under GAAP and Regions' accounting policies was the need to assess and recognize losses on the impaired loans. Regions' December 2008 loan loss policy states the following:

[42] Ibid.

> "Specific Allocations[43] are developed for loans and leases that have been individually deemed to be impaired. Commercial, Commercial Real Estate and Business Banking loans with a general ledger balance greater than or equal to $2,500,000 that have been placed on non-accrual are subject to individual review for potential impairment on a quarterly basis."

In assessing impairment for CRE loans exceeding $2.5 million, Regions prepared FAS 114 loan loss calculations. Those calculations provided the foundation and support for the amount of impairment losses to recognize on impaired loans, including loans on nonaccrual status. The documents produced by Regions in this case that I have considered contain the following FAS 114 loan losses calculated by Regions' management for some of the Pulled Loans discussed in the previous sections of my report. Table 4 below lists those loan impairment losses included in Regions' FAS 114 calculations that correspond to loans listed in Table 2 (*i.e.*, loans pulled from the nonaccrual status list that had been recommended for nonaccrual classification as of March 31, 2009 by SAD Regional Managers):

[43] The 2008 policy defines "Specific Allocations" as: "...an estimate of the inherent loss relating to a particular loan or lease. If the Bank can estimate a probable loss under either FAS 114 or FAS 5, then a portion of the Allowance is allocated to that loan or lease."

Table 4

Borrower	Regions' Calculated Loan Loss	As of Date
Glove Factory Holdings LLC	$8.7 million[44]	June 30, 2009
Resorts Construction LLC	$12.4 million[45]	March 31, 2009
Water's Edge One LLC	$7.3 million[46]	June 30, 2009
McCar Development Corp	$3.8 million[47]	June 30, 2009
First West Cutler	$2.7 million[48]	March 31, 2009
Seahaven Finance LLC	$2.0 million[49]	June 30, 2009
Designers Choice Cabinetry	$.5 million[50]	June 30, 2009
Total	**$37.4 million**	

In addition, Table 5 below lists Regions' FAS 114 loan losses calculated on loans listed in Table 3 shown previously:

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44 Regions did not perform a FAS 114 calculation for this loan because it was classified as "accrual" at March 31, 2009 and the loan was transferred to "held-for-sale" and sold in the quarter ended June 30, 2009. The amount above is the documented impairment charge-off (recognized credit loss) on the loan in the quarter ended June 30, 2009 prior to its transfer to held-for-sale status. The source of the $8.7 million loan loss is Div. Ex. 460 at Regions_041212 SECSubpoena_003959.

45 Regions' FAS 114 calculation, Div. Ex. 200 at REG00736091.

46 Regions' FAS 114 calculation, Regions_041212SECSubpoena_0006227.

47 Regions' FAS 114 calculation, Div. Ex. 344 at Regions_041212 SECSubpoena_0004669.

48 Regions' FAS 114 calculation, Div. Ex. 493 at REG01380720.

49 Regions' FAS 114 calculation, Div. Ex. 343 at Regions_041212 SECSubpoena_0005734.

50 Regions' FAS 114 calculation, Div. Ex. 345 at Regions_041212 SECSubpoena_0002740.

Table 5

Borrower	Calculated Loan Loss	As of Date
Richland Investments LLC	$7.3 million[51]	June 30, 2009
Wilval LLC	No loss reported[52]	N/A
River Glenn LLC	$0.6 million[53]	March 31, 2009
Kicklighter Custom Homes, Inc.	$0.8 million[54]	June 30, 2009
Total	**$8.7 million**	

As previously discussed, it is my understanding that the Pulled Loans listed in Table 2 and 3 were risk rated 70 (Substandard-Accruing) and reported as such by Regions as of March 31, 2009. As such, Regions calculated an allowance for loan losses for each loan based on 12.5% of the outstanding loan balance. Accordingly, at March 31, 2009, Regions had recognized an allowance (impairment loss) for the loans in Table 2 and 3 of $11.4[55] million and $6.7[56] million, respectively, for a total recognized allowance of $18.1 million. The net increase in the provision

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51 Regions' FAS 114 calculation, Div. Ex. 342 at Regions_041212 SECSubpoena_0002963.

52 Regions' FAS 114 calculation, Div. Ex. 472 at Regions_041212 SECSubpoena_0001683.

53 Regions' FAS 114 calculation, Div. Ex. 209.

54 Regions did not record an FAS 114 impairment for Kicklighter, as the note was on accrual as of March 31, 2009, and, although the loan was classified as nonaccrual in April, by the end of the second quarter the outstanding loan balance was below the minimum balance for which FAS 114s were required because certain amounts of the loan had been charged off during the second quarter. (Div. Ex. 462 at Regions_041212SECSubpoena_0004313, 4315). The amount above is the documented impairment charge-off (recognized credit loss) on the loan in the quarter ended June 30, 2009. (Ibid.)

55 Calculated as the $91.1 million total shown in Table 2 multiplied by 12.5%.

56 Calculated as the $53.5 million total shown in Table 3 multiplied by 12.5%.

for loan losses in Regions' March 31, 2009 consolidated statement of income that would result from the additional loan losses listed in Tables 4 and 5 would be as follows:

- Losses as shown in Table 4 of $37.4 million minus the $11.4 million allowance previously recognized (as indicated above) for net additional losses (increase in "Provision for loan losses") of $26.0 million that should have been reflected in Regions' March 31, 2009 consolidated statement of income.
- Losses as shown in Table 5 of $8.7 million minus the $6.7 million allowance previously recognized (as indicated above) for net additional losses (increase in "Provision for loan losses") of $2.0 million that should have been reflected in Regions' March 31, 2009 consolidated statement of income.

Accordingly, had Regions not removed the Pulled Loans from nonaccrual status, it would have been required to report an additional "provision for loan losses" under GAAP of approximately $28.0 million, or more, in its March 2009 10-Q.

Regions reported "income before income taxes" and a "provision for loan losses" of $392 million[57] and $425 million, respectively, for the first quarter 2009 in its March 2009 10-Q as filed on May 11, 2009. Had the seven loans listed in Table 2 been classified as nonaccrual as of March 31, 2009 (*i.e.*, those loans where Neely improperly overrode the SAD personnel's conclusions that the loans should have been classified nonaccrual as of March 31, 2009), Regions would have reported an increase in the provision for loan losses of at least $26 million and a corresponding reduction in reported income before income taxes. The $26 million represents 6.1% of Regions' reported provision for loan losses of $425 million and 6.6% of the reported income before income taxes of $392 million. And, the total additional provision for

[57] Regions' March 2009 10-Q.

loans losses required for the 11 loans listed in Tables 2 and 3 of $28.0 million represents 6.6% and 7.1% of Regions' March 31, 2009 reported provision for loan losses and income before income taxes, respectively.

It is my professional opinion that either $26.0 million or $28.0 million in overstated income before income taxes and understatement in the provision for loan losses was material to the financial statements and other disclosures included in Regions' March 31, 2009 10-Q based on a quantitative materiality assessment. Further, because the errors in Regions' March 31, 2009 10-Q resulted from the manipulation of reported amounts to meet financial targets, as discussed in detail in previous sections of this report, it is my opinion that the misstatements were qualitatively material regardless of magnitude.

I have analyzed a recent calculation prepared by Regions that purports to calculate the increase in the provision for loan losses ("Provision Estimate") related to the Pulled Loans. (Regions_012115SECRequest_0000001). That analysis shows that the additional increase in the provision for loan losses required for the seven loans listed in Table 2 was $31.6 million (versus $26.0 million per my analysis) and the increase for the11 loans listed in Tables 2 and 3 was $35.3 million (versus my analysis of $28.0 million). In my view, the Regions' analysis referred to above supports my conclusions regarding quantitative materiality.

D. Use of Regions' Allowance for "Stressed Industries and Imprecision"

During the first quarter of 2009, Regions had three components to its ALLL (loan loss allowance). Those components were a portion of the ALLL to cover: 1) FAS 5 losses; 2)FAS 114 losses; and 3) potential losses caused by industries under stress and imprecision in loss calculations ("S&I Allowance"). The documents I have reviewed suggest that Regions has taken

the position that the S&I Allowance could have been used to absorb the additional loan losses discussed in the preceding Section C (Materiality) of this report.

In my opinion, the portion of the ALLL designated for stressed industries and imprecision cannot be used under GAAP and SEC reporting requirements to mitigate (or offset) the losses required to be recognized on the Pulled Loans as of March 31, 2009 as described in Section ***C*** above for the following reasons.

At March 31, 2009, the S&I Allowance maintained by Regions was approximately $155.2 million with $53.5 million of that amount designated to loans in14 industries under stress and $101.7 million designated to imprecision in risk ratings, etc. (Div. Ex. 225, page 2 and 7).

In my opinion, none of the $53.5 million stressed industries amount can be used to offset losses on the Pulled Loans because it was provided to cover losses on loans that were "Pass" risk rated in 14 broad industries (*e.g.*, Trucking & Transportation, Restaurants, Boat and RV Manufactures, etc.) not CRE loans risk rated at 70 as were the Pulled Loans. Regarding the $101.7 million ALLL balance at March 31, 2009 that was designated for "imprecision," a Regions' policy document describes how it was determined and allocated as follows:

> "Inherent in any estimation process is a margin of imprecision. Management has set a range of 1.32% to 18.84% of the total FAS 5 allocations within ALLL to insure adequate coverage. The imprecision adjustment is allocated to each of the [loan] product groups on a pro-rata basis determined by the proportion of FAS 5 allowance assigned to each group."

The $101.7 million S&I Allowance designated to imprecision at March 31, 2009 was allocated across a $95.7 billion portfolio (product groups) of loans of which CRE loans only represented $25.9 billion (*i.e.*, only 27%). Since the vast majority of the $101.7 million was allocated to non-CRE loans and because Regions still held $25.6 billion in CRE loans, it would not be appropriate, in my opinion, to use the S&I Allowance to absorb the additional FAS 114

losses required on the Pulled Loans as of March 31, 2009. Any use of the S&I Allowance to absorb FAS 114 losses on the Pulled Loans as of March 31, 2009 would result in the need to replenish the S&I Allowance by an increase in the provision for loan losses of an equal amount to adequately cover the potential losses in the remaining loan portfolio perceived by Regions in my view.

Furthermore, it is not appropriate to use any portion of the S&I Allowance to cover intentional errors under any circumstances. As previously mentioned, there are no materiality thresholds for intentional errors. I also note that Regions' S&I Allowance dropped from $295.1 million at December 31, 2008 to $155.2 million as of March 31, 2009 (a decline of 47.4%), while NPLs increased a staggering 56% in the first quarter of 2009. (Div. Ex. 225, Regions' March 2009 10-Q). This reinforces my conclusion that the S&I Allowance could not have been sufficient to absorb the additional impairment charges had the Pulled Loans been taken to nonaccrual as of March 31, 2009.

E. Use of a $9.0 Million First Quarter Passed Adjustment

As a result of a review of Regions first quarter 2009 financial statements, it was determined by Regions that a $9.0 million adjustment to reduce "Non-Interest Expense" related to debt in a fair value hedge was not material and the adjustment was not recognized in the 2009 10-Q. (Regions_061114SECRequest_000004).

I have read testimony that asserts the $9.0 million passed adjustment could be used to offset the income statement effect of increasing the provision for loan losses related to the Pulled Loans. As stated in the following quote from the auditing standards issued by the Public Company Accounting Oversight Board, the quantitative materially assessment of adjustments to

financial statements requires the consideration of the adjustments "individually" as well as in the aggregate:

> **".04** Financial statements are materially misstated when they contain misstatements whose effect, **individually** or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. Misstatements can result from errors or fraud."[58] [Emphasis Added].

Because the $9.0 million passed non-interest expense adjustment and the $28.0 million adjustment to increase the provision for loan losses related to the Pulled Loans (as previously described) effect two separate line items in Regions March 31, 2009 consolidated statement of income, the individual effect of the $28.0 million required adjustment must be considered and evaluated separately. That assessment, as I have previously described, results in my conclusion the $28.0 million necessary adjustment related to the Pulled Loans was, in fact, material to Regions' March 2009 10-Q. Furthermore, the $9.0 million adjustment would have no impact on the determination of qualitative materiality as there are no materiality thresholds for intentional errors as previously mentioned.

VIII. COMPENSATION

BRG is being compensated at a rate of $625 per hour for time incurred by me in connection with my analyses and testimony, plus reimbursement of expenses incurred. BRG is also being compensated for time incurred by my professional staff at hourly rates that range from $140 to $495 per hour, depending on each person's position within the firm.

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58 PCAOB AU 312, paragraph .04.

IX. PRIOR TESTIMONY

1. In 2014, I testified on behalf of the United States Securities and Exchange Commission as an expert in the application of GAAP and SEC reporting requirements in deposition in *In re SEC v. Goldstone, et al*, Case No. CIV 12-0257 JB/LFG (D. N.M.).

2. In 2014, I testified on behalf of the FDIC in the matter of Banco Popular De Puerto Rico v. Federal Deposit Insurance Corporation, as Receiver of Westernbank Puerto Rico, AAA Case No.: 32 148 Y 00369

3. In 2014, I testified on behalf of BDO USA, LLP in the matter of Litex Industries, Limited v. BDO USA, LLP, Cause No. DC-13-00344 in District Court, 14th Judicial District, Dallas County, Texas.

4. In 2014, I testified on behalf of Dow Chemical Company in the matter of Dallas Stars, LP et. al. v. Zurich American Insurance Company and Dow Chemical Company, Case No. 296-05049-2011, in District Court, 296th Judicial District, Collin County, Texas.

5. In 2011, I testified on behalf of Ingersoll-Rand Company as a financial expert witness in deposition in the following consolidated cases: *In re Nye, et al. v. Ingersoll-Rand Company*, Civil Action No. 08-3481 (DRD) (D. N.J.), *Brown, et al. v. Ingersoll-Rand Company*, Civil Action No. 08-4260 (DRD) (D. N.J.), and *Bond et al. v. Ingersoll-Rand Company*, Civil Action No. 08-5371 (DRD) (D. N.J.).

6. I have not testified as an expert witness in any other matters in the past 4 years.

X. PUBLICATIONS

1. I had the following chapters of a professional book published within the past ten years:

> I am a contributing author to the AICPA's *The Guide to Investigating Business Fraud* published by the AICPA in 2009. The chapters I co-authored include

"Basics of Investigations" and "Working with Regulators and Parallel Investigations."

2. I have not had any other materials published externally during the past ten years. I had the following article published relevant to the issues involved in this case (*i.e.*, loan impairment) in 1994:

FAS 114 and 118: Implementation of New Loan Impairment Standards, *The Journal of Corporate Accounting & Finance*, Volume 6, Number 2, 1994, published by John Wiley & Sons, Inc., New York.

XI. RIGHT TO SUPPLEMENT AND ADDITIONAL WORK TO BE PERFORMED

Because discovery in this case has not yet been completed, I anticipate performing additional analyses that may impact my opinions and testimony. For example, I have not yet had access to the opinions, reports and supporting documentation from the Respondent's expert(s) as they have not been filed in this case. At a minimum, I may provide supplemental testimony to address various findings and opinions of Respondent's experts, or new testimony elicited at trial in this matter. Since the opinions expressed herein are based upon analyses performed to date, I reserve the right to supplement or otherwise revise this report at a later time if new or additional information becomes available and that information revises or supplements my opinions. In addition to submitting this report, I reserve the right to comment upon, or otherwise rebut, the testimony of the Respondent's expert(s) in this case.

Dated: February 2, 2015

Respectfully submitted,

Dale Kitchens

EXHIBIT 1 – CURRICULUM VITAE OF DALE KITCHENS

EXHIBIT 2 – LISTING OF INFORMATION CONSIDERED

Curriculum Vitae

Exhibit 1

BRG
Berkeley Research Group

DALE KITCHENS
BERKELEY RESEARCH GROUP, LLC

EDUCATION

Bachelor of Science in Accountancy (cum laude honors) – University of Arkansas at Little Rock

Kellogg Executive Program – Kellogg School of Management, Northwestern University

Attended thousands of hours of continuing professional education courses and instructed numerous internal and external seminars over a 33 year professional career

PRESENT EMPLOYMENT

Managing Director, Berkeley Research Group, LLC

PREVIOUS POSITIONS

Senior Partner, Ernst & Young LLP (EY), Assurance and Fraud Investigations & Dispute Services, 1995-2011:

Partner, Kenneth Leventhal & Company LLP, Audit and Consulting Services, 1987-1989; 1991-1995:

Professional Accounting Fellow, Office of Thrift Supervision (OTS), Washington D.C., U.S. Department of the Treasury, 1989-1991:

Auditor, Arthur Andersen & Co., 1981-1986

CERTIFICATIONS AND DESIGNATIONS

Certified Public Accountant (CPA) licensed in the State of Texas

Certified in Financial Forensics (CFF) by the AICPA

PROFESSIONAL AFFILIATIONS

Current member of the AICPA, the Texas Society of CPAs (TSCPAs) and the Fort Worth Chapter of the TSCPAs

Served as a member of the Institute of Internal Auditors

Served as a member of the Mortgage Bankers Association

Served on the TSCPAs Financial Institutions Committee by appointment

Served as Chairman of the Dallas Chapter of the TSCPAs Financial Institutions Committee by appointment

Served as Treasurer of the Financial Managers Society, Southwest Region

Served as a member of the Dallas Chapter of the TSCPAs Real Estate Committee

Served as a member of the Real Estate Financial Executives Association

Served as a member of the Real Estate Council, North Texas

SELECTED SPEAKING ENGAGEMENTS AND PROFESSIONAL PUBLICATIONS

- Delivered numerous speeches and presentations on accounting, auditing, investigative and financial related topics at industry and professional meetings across the U.S.
- Guest lecturer to accounting and auditing students at various universities including: the University of Texas at Austin; Southern Methodist University; Texas A&M University; Baylor University; Texas Tech University; and the University of Texas at Arlington.
- Featured as a key panelist in various webcasts on global fraud related topics viewed by thousands of corporate accounting, legal, compliance and financial executives across the U.S.
- Contributing author of *The Guide to Investigating Business Fraud* published by the AICPA in 2009 - chapters co-authored by Mr. Kitchens include "Basics of Investigations" and "Working with Regulators and Parallel Investigations."
- Mr. Kitchens has been quoted in various articles and publications in the U.S and abroad on topics relating to fraud, accounting and auditing and other business related matters over his career.

Exhibit 2 – Listing of Information Considered

In addition to the information cited in the text and footnotes to my accompanying report, the following is a listing of information I considered in forming my opinions:

Bates Range:
FRB ATL001434 - FRB ATL001537
FRB ATL000394 - FRB ATL000704
FRB ATL000239 - FRB ATL000272
FRB ATL002177 - FRB ATL002231
FRB ATL002619 - FRB ATL002654
FRB ATL000425 - FRB ATL000454
FRB ATL001538 - FRB ATL001743
FRB ATL000273 - FRB ATL000295
FRB ATL000030 - FRB ATL000031
FRB ATL000706 - FRB ATL000749
FRB ATL003441 - FRB ATL003490
FRB ATL003491 - FRB ATL003514
Regions_061312SECSubpoena_0021074
Regions_031114SECSubpoena_0001033
Regions_041212SECSubpoena_006499 - Regions_041212SECSubpoena_006501
Regions_041212SECSubpoena_006267 - Regions_041212SECSubpoena_006266
Regions_061312SECSubpoena_0018707 – Regions_061312SECSubpoena_0018716
Regions_061312SECSubpoena_0018885.xls
Regions_012115SECRequest_0000001

Case Exhibits Received:
Division Exhibits: 1-501
Respondent Exhibits: R. Exh. 1 - 228
SEC Investigative Exhibits: RFC-1 - RFC-15, RFC-20 - RFC-48

Investigative Testimony Transcripts:
Aderhold (2012.02.27)
Baldwin (2012.02.28)
Barrentine (2012.10.11)
Barrentine (2012.02.01)
Barrentine (2013.04.17)
Bruni (2012.02.27)
Carrigan (2013.1.15)
Cash (2013.1.17)
Cooley (2012.09.12)
Corrigan (2012.04.03)
Esteves (2012.02.23)
Ferino (2011.12.07)
Florio (2011.12.07)
Florio (2012.08.21)
Fox (2012.05.21)
Godin (2012.08.23)
Haley (2012.01.30)
Hodges (2015.01.21)
Jackson (2012.09.12)
Jackson (2013.04.17)
Jarema (2011.12.06)

Exhibit 2 – Listing of Information Considered (Continued)

Johnson (2012.05.23)
Korte (2012.01.31)
Kuehr (2013.07.01)
Laney (2012.05.22)
Lewis (2012.08.09)
Logsdon (2012.11.13)
McCrite (2012.09.11)
Mead (2011.12.08)
Mead (2012.04.02)
Neely (2014.06.16)
Neely (2012.08.29)
Papke (2012.02.29)
Payne (2012.09.11)
Roberts (2013.01.16)
Rogers (2012.04.04)
Rogers (2012.07.03)
Sheehy (2013.04.17)
Smith (2012.04.02)
Teegarden (2012.03.28)
Turner (2012.08.21)
Turner (2012.08.22)
Wells (2013.2.27)
Willoughby (2012.11.13)
Willoughby (2012.11.14)

Case Filings:

Order of Prohibition Issued Upon Consent dated June 25, 2014
Notice of Assessment of a Civil Money Penalty and Notice of Intent to Prohibit Pursuant to Section 8 of the Federal Deposit Insurance Act, as Amended dated June 25, 2014
Consent Order and Assessment of Civil Money Penalty Issued Upon Consent Pursuant to the Federal Deposit Insurance Act, as Amended dated June 25, 2014
Order of Prohibition Issued Upon Consent dated June 25, 2014
Order Instituting Cease and Desist Proceedings

SEC Filings:

Regions Financial Corporation 10Ks, 10Qs, and 8Ks (2008 - 2009)

Other:

Neely - Regions Impact Analysis Narrative.pdf
Neely - Regions Impact Analysis.pdf