

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 69442 / April 24, 2013**

**ACCOUNTING AND AUDITING ENFORCEMENT**  
**Release No. 3456 / April 24, 2013**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-15299**

**In the Matter of**

**CAPITAL ONE FINANCIAL  
CORPORATION, PETER A.  
SCHNALL, AND DAVID A.  
LAGASSA,**

**Respondents.**

**ORDER INSTITUTING  
CEASE-AND-DESIST PROCEEDINGS PURSUANT TO  
SECTION 21C OF THE SECURITIES  
EXCHANGE ACT OF 1934, MAKING  
FINDINGS AND IMPOSING CEASE-AND-DESIST  
ORDER AND CIVIL PENALTIES**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Capital One Financial Corporation, Peter A. Schnall, and David A. LaGassa ( collectively “Respondents”).

**II.**

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over themselves and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings and Imposing a Cease-and-Desist Orders and Civil Penalties (“Order”), as set forth below.

**III.**

On the basis of this Order and Respondents’ Offers, the Commission finds that:

## SUMMARY

1. Capital One Financial Corporation (“Capital One”), a provider of consumer and commercial lending and diversified banking services, materially understated its provision for loan and lease losses (the “provision for loan losses” or “loan loss expense”) for the second and third quarters of 2007. The understatement was of the provision for loan losses for Capital One’s auto finance business, known as Capital One Auto Finance (“COAF”). As a result of the understatement, Capital One materially understated its provision for loan losses by as much as \$72 million for its second quarterly filing and as much as \$51 million in its third quarterly filing. Capital One also failed to maintain effective internal controls to ensure the appropriate and accurate recording and reporting of its loan loss expenses. Accordingly, Capital One violated the reporting, books and records and internal controls provisions of the Exchange Act, and Capital One’s Chief Risk Officer at the time, Peter A. Schnall (“Schnall”), and COAF’s Divisional Credit Officer at the time, David A. LaGassa (“LaGassa”) were each a cause of Capital One’s violations.

2. Starting no later than October 2006 and continuing through the third quarter of 2007, COAF, as well as nearly every other Capital One consumer lending business, experienced significantly higher charge-offs and delinquencies for its loans than it had forecasted. COAF, whose profitability was primarily derived from extending credit to subprime consumers, experienced these higher loss variances across all types of loans. By the second quarter of 2007, credit markets began to deteriorate, and COAF assessed from its internal loss forecasting tool that its escalating loss variances were attributable to an increase in a forecasting factor it called the “exogenous.” This factor measured the impact on credit losses from conditions external to the business, including macroeconomic conditions. A change in the exogenous factor generally had a significant impact on COAF’s loan loss expense, and it was closely monitored by the company through its loss forecasting tool.

3. Instead of incorporating the full exogenous levels generated by its loss forecasting tool into COAF’s loss forecast, Capital One failed to include any of COAF’s exogenous-driven losses for the second quarter provision for loan losses and only included one-third of such incurred losses in its third quarter provision for loan losses. The exogenous losses were an integral component of Capital One’s methodology for calculating its provision for loan losses. The decisions made concerning the treatment of elevated exogenous levels gave insufficient weight to the evidence available at the time. As a result, Capital One’s second and third quarter loan loss expense for COAF did not appropriately estimate probable incurred losses in accordance with accounting requirements. Accordingly, Capital One violated the periodic reporting provisions of the Exchange Act.

4. As a result of Capital One’s understatement, Capital One’s consolidated provision for loan and lease losses was understated by approximately 18% in the second quarter and 9% in the third quarter of 2007. COAF’s loan loss expense was understated by approximately 40% and 21%, respectively, for the second and third quarters of 2007.

5. Because Capital One failed to include certain incurred losses as of its balance sheet date and adequately document the rationale for its accounting treatment for such losses, it violated the books and records and internal control provisions of the federal securities laws. These failures also violated Capital One's own policies and procedures, which, among other things, required Capital One's accounting group to ensure that COAF's loan loss expense was properly supported and documented and required Capital One's credit risk management function to fully disclose the significant assumptions underlying its loan loss allowance determination to the management committee responsible for ensuring that Capital One's allowance comported with accounting guidelines.

## **RESPONDENTS**

6. **Capital One Financial Corp.** is a Delaware company, headquartered in McLean, Virginia, that provides commercial and consumer lending and diversified banking services. Capital One's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange (Ticker: COF). Capital One files periodic reports, including Forms 10-K and 10-Q, with the Commission pursuant to Section 13(a) of the Exchange Act and related rules thereunder.

7. **Peter A. Schnall**, age 49, was the Chief Risk Officer of Capital One, a position he held from June 2006 until January 31, 2013. Beginning in 2002, Schnall oversaw Capital One's Credit Risk Management group. As part of his responsibilities, Schnall supervised the Chief Consumer and Commercial Credit Officers. As their supervisor, Schnall was ultimately responsible for, among other things, Credit Risk Management's loan loss allowance recommendations that are provided to Capital One's Corporate Accounting Group, resulting from the quarterly loss forecasting process conducted by the Chief Consumer and Commercial Credit Officers' organizations for each of Capital One's consumer and commercial lending divisions. Schnall reported directly to the Chief Executive Officer of Capital One.

8. **David A. LaGassa**, age 44, is currently a Managing Vice President within Capital One's Financial Services division. From March 2007 through March 2010, including the time of the events described in this Order, LaGassa was the Divisional Credit Officer for COAF. As the Divisional Credit Officer, LaGassa was responsible for managing the COAF loss-forecasting function. LaGassa reported to the Chief Consumer Credit Officer, who, in turn, reported to Schnall.

## **FACTS**

### Relevant Accounting Principles for Allowance for Loan and Lease Losses

9. The allowance for loan and lease losses ("allowance") represents a company's best estimate of incurred losses<sup>1</sup> inherent in its loan portfolio at any given financial reporting date.

---

<sup>1</sup> The term "incurred losses" refers to an estimated loss that meets the following two conditions for accrual as set forth in paragraph 8 of Statement of Financial Accounting Standards ("FAS") No. 5 ("FAS 5"), Accounting for Contingencies: "(a) information available prior to the issuance of the financial statements indicates that it is probable

The provision for loan losses, in turn, is the periodic cost (*i.e.*, quarterly, annually, etc.) of maintaining an adequate allowance. An increase to the allowance, or an “allowance build,” is recorded as an expense on the institution’s income statement and decreases net income for that period. The Commission has issued extensive guidance to financial institutions to ensure that their accounting for loan losses is consistent with Generally Accepted Accounting Principles (“GAAP”) and well documented.<sup>2</sup>

10. In accounting for COAF’s loan loss expense, Capital One was required to satisfy the requirements of FAS 5, which, generally, provides that losses should be recorded if they are both probable and reasonably estimable.<sup>3</sup> Pursuant to FAS 5, an entity must capture the reasonable estimate of losses “in light of the current economic environment” that exists as of the balance sheet date.<sup>4</sup> Given that the allowance is subjective and represents one of the key elements in a bank’s financial statements, it is critical to maintain rigorous internal controls over the allowance-setting process.<sup>5</sup>

---

that an asset had been impaired or a liability had been incurred at the date of the financial statements [...]; and (b) the amount of the loss can be reasonably estimated.” Further, FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss an Interpretation of FASB Statement No. 5, states in paragraph 3 (in part) “[w]hen condition (a) in paragraph 8 is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, condition (b) in paragraph 8 is met and an amount shall be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued.”

<sup>2</sup> Accounting for loan losses is governed by FAS 5, Accounting for Contingencies, and FAS No. 114, Accounting by Creditors for Impairment of a Loan. In December 1986, the SEC issued Financial Reporting Release No. 28, which added subsection (b) Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported, of Section 401.09, Accounting for Loan Losses by Registrants Engaged in Lending Activities, to the Codification of Financial Reporting Policies. In July 2001, the SEC staff issued Staff Accounting Bulletin No. 102 (“SAB 102”), Selected Loan Loss Allowance Methodology and Documentation Issues. In addition to Commission guidance, in July 2001, the banking regulators, after issuance of a proposed policy statement and consideration of comments, issued a “Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.”

<sup>3</sup> Because Capital One has deemed the loans within the COAF portfolio to be a homogeneous population with similar risk characteristics, the company accounts for the COAF provision for loan losses in accordance with FAS 5, rather than FAS 114.

<sup>4</sup> Paragraph 23 of FAS 5 states “[w]hether the amount of loss can be reasonably estimated (the condition in paragraph 8(b)) will normally depend on, among other things, the experience of the enterprise, information about the ability of individual debtors to pay, and appraisal of the receivables *in light of the current economic environment.*” (Emphasis added). Interagency Policy Statement on the Allowance for Loan and Lease Losses (“Interagency Policy”), which operates as regulatory interpretive guidance on FAS 5, similarly states that management should consider the impact of “current qualitative or environmental factors” that exists as of the balance sheet date.

<sup>5</sup> Accounting for Loan Losses by Registrants Engaged in Lending Activities, 51 Fed. Reg. 237 (Dec. 10, 1986) (codified at 17 C.F.R. part 211) (“FR-28”) expresses the Commission’s views regarding certain matters affecting reported amounts of loan losses, including, among other things, the need for procedural discipline in determining amounts of loan losses to be reported. Specifically, expected in the books and records of a registrant such as Capital One include “documentation of a systematic methodology to be employed each period in determining the amount of loan losses to be reported, and rationale supporting each period’s determination that the amounts reported were adequate.” Further, “specific rationale upon which the amount actually reported in each individual period is based – *i.e.*, the bridge between the findings of the detailed review and the amount actually reported in each period – would be documented to help ensure the adequacy of the reported amount...” Several years after the publication of FR-28, the SEC Staff issued SAB 102 to provide a more detailed explanation of its expectations concerning the allowance-

## The Credit Risk Management Function

11. Capital One's consumer credit divisions, during the relevant period, primarily included U.S. Credit Card, COAF, Installment Loans and the so-called United Kingdom division. These businesses were divided in two distinct branches: Credit Risk Management ("CRM"), supervised by Schnall; and the branch that is responsible for, among other things, originating new loans, underwriting loans and marketing credit products ("the business side"), headed by the President of each of these businesses. CRM is responsible for preparing the quarterly loss forecast that is used to develop the allowance. Although the business side had no reporting duties to CRM or official loss forecasting responsibilities, CRM considered the business side an important stakeholder in the loss forecasting process and relied on it for providing views on credit risk during the relevant period.

12. Schnall had ultimate supervisory authority over the loss forecasting function for all consumer and commercial businesses at Capital One as well as CRM's allowance recommendations for these businesses. Schnall directly supervised the Chief Consumer Credit Officer for Capital One, who assumed the role in September of 2006. The Chief Consumer Credit Officer, in turn, directly supervises each Divisional Credit Officer ("DCO") assigned to a particular business division. The DCOs manage the teams that conduct the quarterly loss forecasting process for their respective business divisions, which is used to generate a recommendation to the Chief Consumer Credit Officer, who then reviewed that recommendation with Schnall. The recommendation is then sent to Capital One's senior finance and accounting officials for setting a provision for loan losses. During the relevant period, LaGassa was the DCO for COAF.

## Allowance Methodology for COAF and the "Exogenous Factor"

13. Capital One's policies and procedures require a systematic methodology to determine management's best estimate of its allowance. The methodology in place included the use of a loss forecasting tool known as "Look Ahead." The purpose of Look Ahead is to assist management in developing an accurate and reasonable quarterly loss forecast, which is used to make CRM's allowance recommendation.

14. In preparing its quarterly loss forecast for COAF during the relevant period, CRM considered, among other things, outputs from Look Ahead. CRM's loss forecast is, in turn, converted to an allowance recommendation for COAF. Capital One's internal controls over the loan loss expense component of its financial reporting, therefore, is directly impacted by Look Ahead. Pursuant to Capital One's policies and procedures, CRM was required to document its

---

setting process, including the development, maintenance and documentation of a comprehensive, systematic and consistently applied process for determining the allowance. SAB 102 further details that a registrant should "maintain documentation to support its method of estimating loan losses" and "maintain copies of the economic and other reports that provided source data." SABs reflect the views of Commission staff regarding certain accounting-related practices and represent interpretations and policies used by Commission staff to administer the federal securities laws.

allowance recommendations and the key judgments underlying the recommendations. By the time CRM adopted Look Ahead for use in COAF in the first quarter of 2007, the tool had been used for several years by Capital One's credit card division, its largest business. CRM tested Look Ahead for use in COAF and concluded that the tool was superior to the then-current loss forecasting tool, and adopted Look Ahead as part of its loss forecasting methodology in arriving at a reasonable forecast.

15. The Look Ahead model utilizes at least five years of COAF historical loss data, which is needed to run the model. The tool analyzes actual loan losses and breaks them down into four constituent loss drivers: (a) maturation (losses due to the age of an account); (b) vintage (losses due to credit quality based on when a loan was booked); (c) seasonality (loss variance patterns due to the time of year); and (d) exogenous, a residual factor that identifies losses that Look Ahead is not able to attribute to any of the other three factors. The exogenous output of Look Ahead can include both internally driven and externally driven factors, including losses relating to macroeconomic and credit deterioration. An increase in the exogenous factor reflects an increase in losses across all loan vintages, regardless of the age of the accounts, including the broad spectrum of loans that do not share the same underwriting, pricing or collection strategy. In its loss forecasting policies and procedures, Capital One generally used the term "exogenous" to represent losses driven by factors outside the company, including macroeconomic trends.

16. CRM's loss forecasting policies during the relevant period stated that the exogenous factor, a "key element" in loss forecasting, was estimated based on "recent industry [exogenous] factor performance and the application of judgment." The policies further stated that the "general bias" was to estimate the exogenous factor at current observed levels, unless there was compelling data" justifying a deviation. Given that the external credit environment had a material impact on incurred losses during the second and third quarters of 2007, FAS 5 required that Capital One properly assess that environment in estimating its' incurred exogenous-driven losses.

17. The exogenous factor generated by Look Ahead was viewed by loss forecasters at COAF, during the relevant period, as the most important factor in making an allowance recommendation and was closely monitored by Capital One. Unlike the other factors in the tool, the exogenous is a direct multiplier on the entire loss forecast.

18. CRM, in fact, adopted the Look Ahead tool in COAF because of its ability to develop a more reliable exogenous output than the previous model generated. CRM noted in its Look Ahead validation documents that accurate and timely understanding of the exogenous factor was "critical in an uncertain economic environment." CRM concluded, after a period of extensive testing, that the "Look Ahead generated exogenous curve is more aligned with several pieces of external data," including competitor data, the credit card business' exogenous factor, and other economic factors, such as trends in the Gross Domestic Product growth rate, unemployment rate and used car price index.

#### Deteriorating Credit Environment Prior to the Second Quarter of 2007

19. COAF's auto financing business includes several lines of business focused on dealer-driven and direct financing platforms, both of which provide financing to subprime and prime consumers. Within subprime financing, the Dealer Subprime business constituted the largest area of profitability for COAF. COAF's dealer and direct subprime businesses were deemed high risk by Capital One because the customers were at the lower end of the credit quality spectrum.

20. Beginning no later than October 2006, Capital One started to face higher, unexplained loan charge-offs and delinquencies than it had forecast in virtually all of its consumer lines of business, including the credit card business, COAF, Global Financial Services and U.K. division. COAF continued to experience significant higher actual losses than forecast, referred to internally as adverse or negative variances, for the next four consecutive months. Moreover, COAF experienced negative variances across both dealer and direct lines of businesses and across both prime and subprime credit segments. Given the magnitude and broad scale of the losses, COAF was concerned that it was experiencing a credit turn, which was understood within the company to mean a phenomenon where there is a general worsening in the credit environment in a way that drives credit losses for consumer lending businesses.

21. For the month of January 2007, COAF's actual losses, or charge-offs, were 20% higher than forecast, creating a significant loss problem for the business. In a February 5, 2007 email, a top level COAF business official advised Schnall and other senior finance officials that "COAF credit results for January are quite concerning, continuing a trend that we've seen since October [2006]" and that the "underlying trends suggest that gap [the adverse variance] is widening over time." In a report entitled "COAF Credit Risk Performance Assessment" dated February 12, 2007, COAF identified that, for the period of October 2006 through January 2007, "losses exceeded forecasts by a sizable margin [averaging 10.4%] for the past 4 months, creating substantial risk to our earnings." Given the sustained negative variances, CRM and COAF business officials explored the possibility that COAF was experiencing a credit turn and discussed that such a scenario could cause future losses of up to \$100 million over the course of the year.

22. As early as the first quarter 2007, Schnall and other CRM officials learned that an adverse exogenous turn was causing higher delinquencies and significant credit deterioration in Capital One's credit card business. For example, CRM officials learned in March 2007 that an official from the credit card business had warned against assuming that the credit card business' unexplained adverse variances were temporary, describing such an assumption as "aggressive" and "underpredict[ing] losses." The credit card business official further stated that, given the subprime mortgage problems in the industry and increase in subprime credit card delinquencies, there was a 70% chance that an "exogenous shift" was occurring.

23. Given the negative loss variances in COAF, CRM increased COAF's allowance by \$70 million at the end of the first quarter. This allowance build was intended to account, primarily, for internally driven, non-exogenous causes for higher charge-offs, such as risk expansion measures that the business had taken in extending credit to riskier applicants and worsening performance of certain loan portfolios from acquisitions. There was a continued concern by a senior official in COAF, however, that a credit turn brought on by exogenous worsening had

likely caused the adverse variances, and this concern continued to play an important role in CRM's credit risk assessments for COAF. In the second and third quarters of 2007, CRM identified exogenous worsening as a significant risk to its COAF loss forecasts but, as set forth below, did not adequately incorporate such worsening into COAF's allowance reserves.

#### The Look Ahead Exogenous Uptick in the Second Quarter of 2007

24. In April, the first month in the second quarter, COAF again suffered an adverse forecast variance where its actual losses came in 11% higher than forecast. At the same time, the Look Ahead tool reflected a 5% uptick in the exogenous factor.

25. LaGassa discussed in a May 7, 2007 email with his loss forecast team that, given the large allowance build in the first quarter that was intended to cover losses associated with COAF's credit risk expansion, COAF should expect the gap between actual and forecasted losses to narrow, not worsen. CRM and COAF business officials also became concerned that the company was facing a credit turn, which would indicate a longer term loss problem for the business. LaGassa, for example, expressed concerns to his forecast team in the May 7, 2007 email that the April forecast miss was broad-based, impacting all loan vintages and all COAF business units. LaGassa further discussed that the pattern of losses were what he would expect to see in a credit turn.

26. By May, COAF's actual losses had increased to 23% above forecast, while the Look Ahead exogenous was now 14% higher and considered to be a significant uptick. The loss levels for certain COAF businesses were even worse, including, for example, the Direct Subprime business, which suffered 30% higher actual losses than forecast.

27. In response to the loss situation, LaGassa organized a "swat team" to diagnose the drivers of the losses. From June 2-11, 2007, LaGassa provided almost daily email updates to Capital One senior executives, including Schnall and senior COAF business officials, regarding the swat team's loss assessment. By June 11, LaGassa highlighted for these officials the following significant facts: (a) the Look Ahead tool had shown a 14% exogenous uptick; (b) the largest driver of the losses stemmed from "environmental worsening" from the exogenous increase; and (c) the worsening was broad-based, occurring across all vintages and lines of businesses, including subprime and the better credit quality loans in the prime business, signaling an "exogenous shift."

#### Capital One's Failure to Recognize Projected Exogenous Losses in COAF's Second Quarter Loan Loss Expense

28. By the close of the second quarter loss forecast in mid-June of 2007, CRM had assessed that COAF's allowance build would increase by approximately \$72 million by year-end if the current Look Ahead exogenous level was assumed to continue at that level for the 12-month period covered by the loss forecast. In assessing how to incorporate the exogenous impact into the forecast and allowance recommendation, LaGassa proposed the following three options to Schnall and others: (a) none of the exogenous worsening would be factored into the forecast, resulting in no exogenous impact to the allowance recommendation; (b) factoring in only one-

third of the exogenous level, resulting in a \$24 million allowance impact by year-end; or (c) factoring in the entire, current exogenous level, resulting in a \$72 million allowance impact by year-end.

29. LaGassa informed his loss forecasting team, in an early June email, that the Installment Loan division, which (unlike COAF) had a forward looking exogenous tool, expected a 10% increase in losses over the course of 2007 “due to macro-economic softening” which he believed was “another indicator that we [COAF] should be expecting some worsening [. . .].” CRM was also aware that the credit card business, Capital One’s largest business, had already declared a credit turn based on the several months of unexplained worsening across all vintages and account ages.

30. As reflected in a June 15, 2007 email, a top-level COAF business executive informed Schnall and other senior Capital One business and finance executives that mid-month June loss numbers were unfavorable to forecast. Moreover, LaGassa informed a senior CRM official that based on the early June numbers, “our indications are that elevated unit loss levels are continuing to occur.”

31. In a June 19, 2007 email to Schnall, a senior CRM official and COAF business and finance executive, LaGassa expressed that the exogenous worsening was not included in COAF’s loan loss forecast, and that, based on mid-month results, he was “not optimistic that we are going to suddenly see a slowing in losses” and assessed that COAF would continue to face adverse variances.

32. CRM ultimately chose to assume that no part of the elevated exogenous level generated by Look Ahead would continue, resulting in the under-accrual of Capital One’s loan loss reserve. This recommendation was made by LaGassa to the Chief Consumer Credit Officer and approved by Schnall. CRM’s decision, which departed from the observed exogenous from Look Ahead, gave insufficient weight to the evidence of exogenous-driven incurred losses as of the second quarter balance sheet date. As a result, Capital One’s second quarter loan loss expense for COAF did not appropriately incorporate information necessary to determine incurred losses under GAAP.

33. Had the full amount of the exogenous been incorporated by CRM, Capital One’s consolidated second quarter loan loss expense would have been \$473 million, an increase of 18% over the \$401 million that was reported. Further, Capital One’s consolidated net income would have been reduced from \$750 million to \$699 million, a 7% decrease. COAF’s loan loss expense would have increased from \$182 million to \$254 million, nearly a 40% increase, and COAF would have reported a net loss of \$13 million rather than net income of \$38 million for the second quarter.

#### Capital One’s Recognition of Only One-Third of Exogenous Losses in the Third Quarter

34. For the third quarter, COAF suffered approximately 15-20% in higher actual losses than forecast, while the Look Ahead exogenous factor remained at elevated levels for five straight months, including by 12.5% for most of the third quarter. By the third quarter, CRM had

assessed that COAF faced a potential allowance build by year-end of \$100 million, \$85 million of which resulted from incorporating the full exogenous levels generated from Look Ahead.

35. In August, Schnall and others were informed that Capital One's net asset charge-off from its company-wide loan portfolio was higher than forecast due, in large part, to loan charge-offs from exogenous worsening in COAF. Also by August 2007, Capital One took steps internally to protect its business interests against the exogenous impact. The Dealer Subprime business, COAF's largest area of profits, for example, took a series of steps to mitigate its risks from the exogenous worsening, including tightening credit standards and underwriting policies "to match the recently observed exogenous level," as reflected in emails from LaGassa to several Capital One senior executives, including Schnall. Further, as reflected in an August 30, 2007 email, Schnall wanted to build COAF's capital plan around "something somewhat worse than our expectations" given how close COAF was running to its capital targets.

36. In a September 10, 2007 email to a COAF finance official, LaGassa advised that "despite the huge [allowance] impact of just assuming exogenous stays flat, I don't assess such an assumption to be 'conservative' – in fact, I think it is a bit optimistic." CRM, nonetheless, recommended that only one-third of the current exogenous impact be incorporated for the allowance.

37. In both the September 10, 2007 email, as well as another email on September 11 to a senior CRM official and a senior COAF business executive that was forwarded to Schnall, LaGassa recommended incorporating only one-third of the current exogenous impact into the loan loss expense while recognizing and noting that the recommendation would create a high risk to the loss forecast.

38. As reflected in a September 28, 2007 document entitled "September Credit Outlook and Corporate Implications" that was sent to CRM officials as well as other top level finance and accounting executives, there was a "preponderance of evidence" across Capital One's consumer businesses of credit worsening arising from delinquency and overall exogenous worsening.

39. By the end of the third quarter loss forecast, COAF's business leaders identified as its "#1 Top Risk" the deterioration in credit quality in subprime markets "due to negative movement in the economy (mortgage market) and a general credit turn," as reflected in an August 29, 2007 presentation.

40. A senior CRM official who reported to Schnall, recommended to Schnall that COAF, consistent with the credit card business, recognize the current level of exogenous worsening— an \$85 million loan loss expense impact by year-end. Schnall, after discussions with that official, noted that he and the other official were in agreement to recognize "some, but not all, of the worsening in order to avoid oversteer," but that they should highlight the remainder to management and the finance and accounting teams as a "high" internal financial risk. Schnall should have taken steps to ensure that differing views and approaches to CRM's exogenous treatment were communicated to Capital One's allowance committee, which was responsible for ensuring that COAF's allowance complied with FAS 5.

41. CRM decided to incorporate one-third of the exogenous level, which translated into a \$28 million exogenous impact on the loss forecast and allowance. Because the decision gave insufficient weight to evidence of COAF's exogenous-driven losses, the third quarter COAF provision for loan losses did not appropriately incorporate information necessary to determine incurred losses under GAAP. The decision was also not adequately documented or communicated to the committee responsible for vetting allowance decisions.

42. CRM's exogenous treatment was questioned by COAF loss forecasters. These loss forecasters raised concerns within CRM regarding the decision to incorporate only one-third of the exogenous impact. The loss forecasters believed that incorporating anything less than the full exogenous level would result in an insufficient allowance. The loss forecasters, however, were not provided documentation or rationale supporting the exogenous decisions.

43. Had Capital One incorporated the full exogenous worsening in COAF, its consolidated third quarter provision for loan losses would have been \$647 million, an increase of 9% over the \$596 million that was actually reported. Further, consolidated net loss for the quarter would have been \$115 million, a 41% increase over the reported net loss of \$82 million. For COAF, the provision for loan losses would have been \$296 million, which is 21% higher than COAF's \$245 million reported loan loss expense for the quarter. COAF's \$4 million reported net loss would have been more than nine times greater than reported, or approximately a net loss of \$37 million.<sup>6</sup>

#### Capital One's Deficient Controls Over Loss-Forecasting in COAF's Prime Business

44. In the third quarter of 2007, CRM conducted a loss forecasting analysis to determine the loss impact attributable to COAF's Dealer Prime business, including losses arising from a failed "front-end pricing strategy" and a troubled portfolio known as "ONYX BAU" that COAF had acquired from another lender. This process involved, among other things, running the Look Ahead tool and engaging in discussions with COAF's Dealer Prime business team. CRM determined through this process that the loss impact arising from worsening portfolios in the Dealer Prime business represented the second largest contributor of COAF's total incurred losses (following exogenous-driven losses).

45. CRM's loan loss expense recommendation for the loss impact attributable to its worsening Dealer Prime portfolio, however, was at least \$10 million less than what its initial loss forecasting analysis yielded. Similar to the exogenous treatment, CRM did not adequately document why it did not fully incorporate its initial loss forecasting analysis for COAF's Dealer Prime business, which included the results of Look Ahead. CRM failed to maintain adequate documentation supporting its loan loss expense recommendation relating to COAF's worsening Dealer Prime loan portfolio. Further, the basis for CRM's allowance recommendation relating to COAF's Dealer Prime business, which was at least \$10 million less than its initial loss

---

<sup>6</sup> Had Capital One appropriately incorporated exogenous-driven losses in the second quarter, the magnitude of the understatement of the Company's third quarter financial results would have been proportionally less.

forecasting analysis, was not communicated to Capital One's Allowance Advisory Committee, which is responsible for reviewing CRM's allowance recommendations.

#### Capital One's Internal Control Failures Over COAF's Allowance-setting Process

46. Capital One failed to incorporate sufficient amounts of COAF's exogenous-driven losses into the second and third quarter loss forecasts for COAF and, in turn, its loan loss expense, as a result of its deficient internal controls over the COAF allowance-setting process. Schnall and LaGassa failed to ensure that CRM followed Capital One's policies and procedures governing the exogenous treatment, documented the reasons and rationale for excluding the exogenous impact on COAF's loan loss expense, and addressed prior audit concerns. Schnall failed to ensure that CRM's allowance decisions and their rationale related to the COAF exogenous treatment were adequately communicated to Capital One's accounting group or the Allowance Advisory Committee, Capital One's committee responsible for vetting allowance decisions. Further, Capital One's accounting group failed to ensure that the COAF provision for loan losses for the second and third quarters of 2007 was properly supported, documented and determined in accordance with accounting requirements.

#### Capital One's Failure to Follow Policies and Procedures Regarding Exogenous Forecasting

47. Capital One's treatment of the exogenous factor in the second and third quarters of 2007 was inconsistent with its policies and procedures. CRM's COAF exogenous policy was to incorporate the current Look Ahead exogenous levels into COAF's loss forecast and, in turn, the provision for loan losses, unless there was "compelling data" justifying a departure from its policies.

48. CRM's COAF loss forecasting policies from October 2005 through August 2007 stated that the exogenous factor, a "key element" in loss forecasting, "is estimated based on recent industry [exogenous] factor performance and the application of judgment" but "[o]ur general bias is to project future industry factor at current observed levels unless there is compelling data to do otherwise."

#### Capital One's Failure to Adequately Address Prior Internal Audit Concerns Regarding COAF's Loss Forecasting

49. By the second quarter of 2007, Capital One was aware of several risks to COAF's allowance process from its exogenous forecasting that were identified by Internal Audit.

50. In 2005, an Internal Audit report that was sent to Schnall found that, despite the ability of the exogenous factor to drive significant swings in loss assessments, CRM did not have a reliable method to forecast it in COAF. In responding to the finding, CRM acknowledged that its current exogenous methodology was not "very scientific and also not reliable."

51. In 2006, another Internal Audit review found that CRM had "no guard rail process" in place governing when the COAF exogenous factor should be changed. CRM agreed with the audit finding and tasked COAF's then Director of Loss Forecasting with the responsibility of

developing a guard rail process for governing how the exogenous factor would be incorporated into the forecast.

52. In the first quarter of 2007, the COAF Director of Loss Forecasting proposed a policy, stating that “future exogenous will be straight-lined based on the last data point or average of the last 3 data points, if the data is [sic] too volatile.” The concept of “straight-lining” was a common term of art in the company, which meant that the last data point, or current exogenous level, in a model would be carried forward for purposes of loss forecasting and, in turn, setting the allowance. The “guard rails” policy further noted that if an exception to this rule was applied, the exogenous treatment would be documented.

53. The guard rails policy was sent to officials of COAF and to LaGassa, who were informed that the new policy “closed out” the audit concern over exogenous forecasting.

54. CRM, in setting the COAF loan loss expense, failed to follow the “guard rails” policy by not “straight-lining” the current exogenous—which would have incorporated the full worsening—or documenting the rationale for why it deviated from the policy.

55. By the third quarter of 2007, Capital One’s Internal Audit group identified in its audit planning materials that there was a “significant risk” that COAF gave “insufficient consideration of external factors (credit environment, economy, legislation, etc.)” in determining its allowance. This risk was identified by Internal Audit as “high” in terms of impacting allowance decisions.

56. In addition, during the course of performing its procedures, Internal Audit expressed concerns internally regarding CRM’s exogenous treatment for COAF in both the second and third quarters of 2007. Internal Audit sought support for COAF’s exogenous treatment from COAF’s loss forecasters. While the loss forecasters did not provide a complete explanation of why the full exogenous was not included in the allowance, based on the information that was provided, Internal Audit nonetheless signed off on the COAF allowance without raising any issues or findings for both the second and third quarters.

#### Capital One’s Failure to Adequately Document Support for COAF’s Allowance

57. The exogenous treatment was an important assumption made for purposes of the loss forecasts upon which the calculation of COAF’s loan loss expense was based. CRM was responsible for ensuring that such important assumptions were adequately documented in Capital One’s books and records. During the second and third quarters of 2007, despite requirements in policies and procedures, several internal directives, Commission expectations detailed in FR-28, and subsequently under SAB 102, regarding the need to document the rationale supporting assumptions used, CRM failed to ensure that the exogenous assumptions made for purposes of the COAF loss forecast and allowance recommendation were adequately documented.

58. In 2006, there were several memos that were sent to CRM forecasters and CRM officials, including Schnall, highlighting the need for CRM to formalize the exogenous documentation process. One such memo stated that the exogenous sign-off “is becoming increasingly important” because “changes in exogenous outlook drive a significant portion of the loss forecast

. . . . therefore documenting our exogenous assumptions becomes critical.” Another memo dated August 8, 2006, acknowledged that the need to have documentation and governance surrounding exogenous assumptions was critical because “[a]s we get closer to a potential credit turn, there is increasing scrutiny inside and outside of CRM on our economic assumptions.” The August memo further recognized that “the use of [exogenous] assumptions in our ALLL [allowance] calculation requires explicit documentation and sign-off to satisfy Sarbanes-Oxley certification requirements.”

59. In the third quarter of 2007, Schnall, a senior finance executive and other credit officials were sent a report from a CRM director level employee, highlighting the importance of documenting exogenous assumptions in light of the credit worsening experienced throughout the company. The report explicitly stated that “[w]e should be explicit about all assumptions in the outlook, particularly when they differ from current trends, consensus view or historical pattern.”

#### Failure to Adequately Communicate Key Assumptions and Judgments Regarding COAF’s Exogenous Treatment to the Allowance Advisory Committee

60. One of CRM’s key functions was to provide a recommendation concerning the provision for loan losses for each consumer lending business and the assumptions supporting them, on a quarterly basis, to the Allowance Advisory Committee (“allowance committee”), which functioned as an advisory committee to Capital One’s Chief Financial Officer for purposes of critically assessing CRM’s allowance recommendations. The allowance committee was comprised of top-level executives with accounting expertise, such as the Controller, Assistant Controller and Chief Accounting Officer of Capital One, who were responsible for ensuring that Capital One’s allowance was compliant with GAAP.

61. Schnall, as Capital One’s Chief Risk Officer, was a key member of the committee, along with another newly-appointed senior CRM official, and was ultimately responsible for ensuring that CRM’s key allowance-related judgments and assumptions were adequately communicated to the allowance committee.

62. During the second and third quarters of 2007, the allowance committee process was one of Capital One’s primary internal controls over the allowance-setting function and for ensuring GAAP compliance of CRM’s allowance-related decisions. As described by an Internal Audit report, the company’s allowance policies “assign approval authority for the [allowance] methodologies . . . to the Allowance Advisory Committee.” The committee’s oversight over the COAF allowance determination was particularly critical, given that Capital One’s accounting group did not otherwise analyze support for CRM’s allowance recommendations for COAF or have insight into COAF’s loss forecasting function.

63. Capital One’s accounting group relied on CRM and Schnall to provide information concerning the judgments underlying the allowance recommendations during allowance committee meetings. Schnall, however, did not take adequate steps to ensure that CRM’s exogenous treatment for COAF and supporting rationale in the second and third quarters of 2007 were adequately communicated to the allowance committee or documented in materials provided to the committee.

64. Schnall also failed to ensure that sufficient information was included in the written materials provided to the allowance committee. For example, in connection with an allowance committee meeting that took place on September 28, 2007, the presentation materials reflected that COAF's allowance impact from recognizing a "steady state" (current exogenous levels) was \$23 million, instead of the full \$85 million impact the Look Ahead exogenous factor reflected. The presentation materials also inaccurately reflected a \$23 million allowance impact from a "base risk increase" scenario, which analyzes exogenous worsening beyond current levels, even though the allowance impact from the Look Ahead exogenous factor should have reflected an amount higher than \$85 million.

#### Failure of Capital One's Accounting Group to Obtain Support for CRM's Exogenous Treatment

65. Capital One's allowance policy required that the Director of Loan Accounting "review the monthly [allowance] calculations and supporting documentation" for each of the business divisions, including COAF. With regard to the COAF allowance, however, this policy was not followed in the second and third quarters of 2007, and the role of Capital One's accounting group was limited to recording the journal entry to post the allowance and performing balance sheet reconciliations, as opposed to performing a detailed validation or verification of the allowance calculations.

66. Because Capital One failed to implement a system for Capital One's accounting group to monitor the COAF loss forecast, CRM loss forecasters were not required to—and did not—provide Accounting with support for judgments that were made in the forecast, including the exogenous assumptions.

#### Capital One's On-Top Adjustments to the COAF Loss Forecast

67. During the second and third quarters of 2007, Capital One did not employ its standard "grounds-up" loss forecasting practice for COAF and, instead, carried out the loss forecast through a series of on-top adjustments.

68. When CRM ran its loss forecasting tool in its entirety, it generated a "grounds-up" forecast that used the loss analysis results as the basis for a quarterly loss forecast. In the second and third quarters, however, LaGassa, with the knowledge of Schnall, the corporate accounting group and internal audit, did not run Look Ahead to generate a grounds-up forecast.

69. During these quarters, LaGassa was implementing a redesign of the loss forecasting process. Because his team was working on the redesign, LaGassa instructed the team to start with the previous quarter's forecast and then apply "on-top" adjustments to arrive at a new forecast. The on-top adjustments were made on the basis of CRM's subjective views on changes in trends from the prior quarter's forecast. During this period, CRM ran Look Ahead only for purposes of monitoring COAF's exogenous, while choosing not to produce a full loss forecast using Look Ahead loss data, such as maturation, vintage and seasonality. While the practice of making on-top adjustments is not *per se* improper, Capital One was required to ensure that proper controls surrounding the on-top adjustments were in place, given the adverse credit

deterioration experienced by COAF and the inherent risks stemming from making on-top adjustments. The company, however, failed to ensure that the on-top adjustments were properly supported and documented.

70. By the third quarter, CRM was aware of certain deficiencies and risks surrounding a forecast based on on-top adjustments, including at least one loss forecaster's concerns that a manually adjusted forecast would lead to a less accurate forecast and another concern by a senior CRM official who expressed frustration over "making an exogenous credit assumption for loss forecasting and provision build in Q3, in the absence of a full bottoms-up forecast." CRM, nonetheless, chose to carry out yet another on-top adjusted forecast in the third quarter using the understated second quarter's forecast as the foundation.

### **VIOLATIONS**

71. Section 13(a) of the Exchange Act and Rule 13a-13 thereunder require that every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission information, documents and annual and quarterly reports as the Commission may require, and, pursuant to Rule 12b-20 of the Exchange Act, mandate that periodic reports contain such further material information as may be necessary to make the required statements not misleading.

72. Section 13(b)(2)(A) of the Exchange Act and Rule 13b2-1 thereunder require reporting companies to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets, and prohibit any person from, directly or indirectly, falsifying or causing to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act.

73. Section 13(b)(2)(B) of the Exchange Act requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.

74. As a result of the conduct described above, Capital One violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder because the provision for loan and lease losses, which excluded exogenous-driven losses for COAF, was materially understated, and income before taxes was materially overstated, and, thus, the Company filed inaccurate periodic reports with the Commission for the quarters ended June 30, 2007 and September 30, 2007.

75. As a result of the conduct described above, Capital One violated Section 13(b)(2)(A) of the Exchange Act because it did not keep books, records or accounts that accurately reflected its loan loss expense for COAF.

76. As a result of the conduct described above, Capital One violated Section 13(b)(2)(B) of the Exchange Act because it failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that its loan loss expense is recorded as necessary to permit preparation of financial statements in accordance with GAAP.

77. As a result of the conduct described above, Schnall and LaGassa caused Capital One's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rule 13a-13 thereunder. As a result of that same conduct, Schnall and LaGassa violated Rule 13b2-1 under the Exchange Act in that they indirectly caused Capital One's violation of Section 13(b)(2)(A) of the Exchange Act.

#### IV.

78. In determining to accept Capital One's Offer, the Commission considered remedial acts undertaken by Capital One. Among other things, Capital One redesigned COAF CRM's loss forecasting process starting in the fourth quarter of 2007, established an allowance subcommittee, which meets quarterly to review the preliminary quarterly allowance calculations for the company's consumer businesses, appointed key personnel in the accounting group to review key assumptions underlying the allowance and implemented additional controls designed to prevent similar deficiencies going forward, including a formal process for documenting the exogenous treatment in allowance determinations.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Capital One cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder.

B. Pursuant to Section 21C of the Exchange Act, Schnall and LaGassa cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 13a-13 and 13b2-1 thereunder.

C. Respondent Capital One shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$3,500,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;<sup>7</sup>
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or

---

<sup>7</sup> The minimum threshold for transmission of payment electronically is \$50,000.00 as of April 1, 2012. This threshold will be increased to \$1,000,000 by December 31, 2012. For amounts below the threshold, respondents must make payments pursuant to option (2) or (3) above.

(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center  
Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Capital One Financial Corp. as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Gerald W. Hodgkins, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

D. Respondent Schnall shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$85,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;<sup>8</sup>
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center  
Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Peter A. Schnall as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Gerald W. Hodgkins, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

---

<sup>8</sup> The minimum threshold for transmission of payment electronically is \$50,000.00 as of April 1, 2012. This threshold will be increased to \$1,000,000 by December 31, 2012. For amounts below the threshold, respondents must make payments pursuant to option (2) or (3) above.

E. Respondent LaGassa shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$50,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;<sup>9</sup>
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center  
Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying David A. LaGassa as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Gerald W. Hodgkins, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

By the Commission.

Elizabeth M. Murphy  
Secretary

---

<sup>9</sup> The minimum threshold for transmission of payment electronically is \$50,000.00 as of April 1, 2012. This threshold will be increased to \$1,000,000 by December 31, 2012. For amounts below the threshold, respondents must make payments pursuant to option (2) or (3) above.